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Macroeconomic and fiscal challenges faced by the Southern and Eastern Mediterranean region

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Abstract

The current fiscal imbalances and fragilities in the Southern and Eastern Mediterranean countries (SEMC) are the result of decades of instability, but have become more visible since 2008, when a combination of adverse economic and political shocks (the global and European financial crises, Arab Spring) hit the region. In an environment of slower growth and higher public expenditure pressures, fiscal deficits and public debts have increased rapidly. This has led to the deterioration of current accounts, a depletion of official reserves, the depreciation of some currencies and higher inflationary pressure.

To avoid the danger of public debt and a balance-of-payment crisis, comprehensive economic reforms, including fiscal adjustment, are urgently needed. These reforms should involve eliminating energy and food subsidies and replacing them with targeted social assistance, reducing the oversized public administration and privatizing public sector enterprises, improving the business climate, increasing trade and investment openness, and sector diversification. The SEMC may also benefit from a peace dividend if the numerous internal and regional conflicts are resolved.

However, the success of economic reforms will depend on the results of the political transition, i.e., the ability to build stable democratic regimes which can resist populist temptations and rally political support for more rational economic policies.

1. Introduction

Over the last decade, most of the Southern and Eastern Mediterranean countries (SEMC) experienced a deterioration of their fiscal accounts. This unfavorable trend primarily concerns countries which are net oil importers but can also be observed in oil-producing Algeria. Some countries (Lebanon and Egypt) have suffered serious fiscal imbalances for a long time. In others (such as Jordan, Morocco and Tunisia), the fiscal balances deteriorated more recently as a result of various adverse shocks (the global financial crisis and the direct or indirect impact of the Arab Spring) and the policy responses to them.

As a result, some countries have accumulated relatively high, by emerging-market standards, gross public debt, exceeding 140% of GDP in Lebanon, close to 90% of GDP in Egypt, over 80% of GDP in Jordan, over 70% in Israel and over 60% in Morocco (all data for 2013). Such a high level of indebtedness can lead to various adverse macroeconomic consequences depending on the source of deficit and debt financing, such as problems with continuous debt financing/ rollover (risk of sovereign insolvency), a narrowing of the room for maneuver in expenditure policy (as a result of growing interest payments), higher taxation, increasing debt monetization which, in turn, can lead to higher inflation and depleting official reserves, etc. Actually, countries such as Egypt or Tunisia are already facing these challenges in a dramatic way.

The purpose of this paper is to provide an in-depth analysis and a diagnosis of the fiscal challenges faced by selected SEMC in the long-term as well as policy recommendations on strategies of fiscal adjustment. A special emphasis will be given to energy and food subsidies and the inefficient public sector, which are among the main causes of fiscal imbalances.

Geographically, the analysis covers 9 countries which are considered by the European Union as their Southern neighbors under the European Neighborhood Policy (ENP) initiative (see http://eeas.europa.eu/enp/), i.e. Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, Syria and Tunisia, subject to data availability. Unfortunately, we are not able to cover the 10th Southern neighbor of the EU, Palestine, due to data constraints and its political situation as an occupied territory.

Although there have been a number of analyses related to fiscal policy issues in individual SEMC and a few on the entire region (see e.g. De Wulf, Coutinho & Sassanpour, 2009), this paper offers substantial value added to the existing knowledge in three different ways:

- It provides a long-term ex-post and ex-ante analysis of the SEMC's fiscal problems instead of short-term analyses, which prevail in various bulletins and studies

by international financial organizations (IFI) such as the International Monetary Fund (IMF) and World Bank (WB);

- It updates existing studies (for example, De Wulf, Coutinho & Sassanpour, 2009) through an in-depth analysis of the consequences of both the global financial crisis and the Arab Spring (both direct and indirect);
- It provides a comparative cross-country analysis, which also refers to the selected experience of other emerging-market regions.

The paper is structured as follows. In Section 2 we provide an overview of long-term macroeconomic and fiscal trends in the SEMC as compared to other regions, which is supplemented in Section 3 by a more contemporary analysis. In particular, we try to enumerate factors and trends which have contributed to the recent fiscal deterioration in a number of SEMC. Section 4 concentrates on the deep causes of fiscal imbalances such as energy and food subsidies and an inefficient public sector. Section 5 deals with the negative consequences of fiscal deterioration on the fiscal policy itself, monetary policy and external balances. Section 6 contains a discussion of major directions of fiscal adjustment and fiscal reforms in the SEMC. Section 7 summarizes the major findings and conclusions of this paper.

The dominant analytical framework and methodology consist of an analytic narrative supported by a cross-country statistical comparison based on the available statistical databases (in the first instance, those of the IMF and WB). The paper will partly draw from the research output produced under the EU FP7 project on "Prospective Analysis for the Mediterranean Region (MEDPRO)" – see http://www.medpro-foresight.eu.

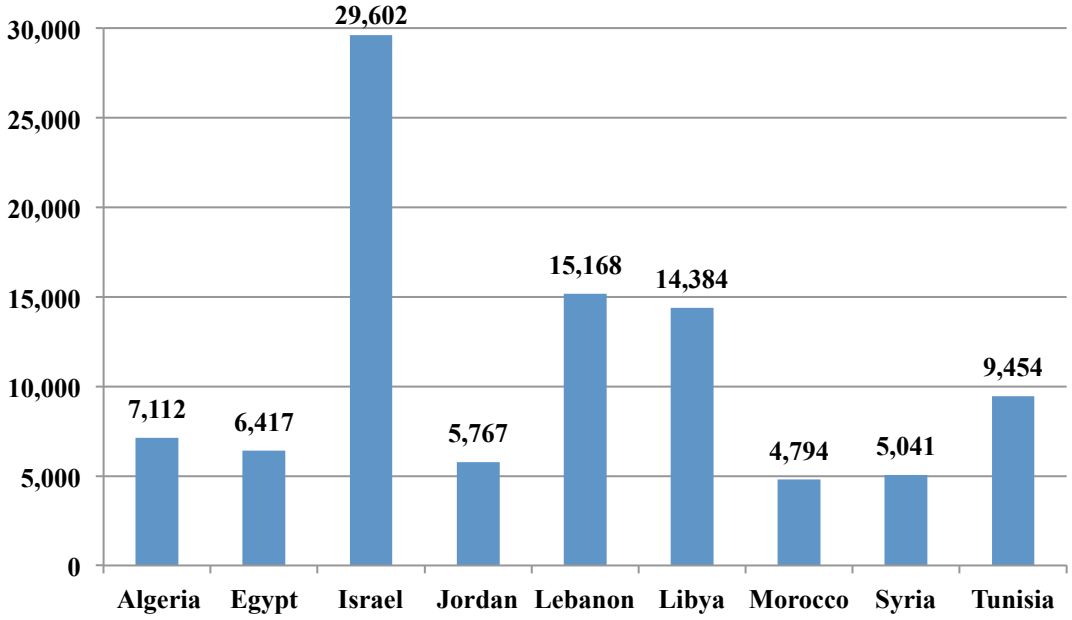
2. Macroeconomic and fiscal trends in SEMC 1980-2010

2.1 Level of economic development and pace of economic growth

Most of the SEMC represent middle-income levels with the exception of Israel, which, with its GDP per capita level (in PPP terms) close to 30,000 USD, belongs to the high-income group according to the World Bank classification[1]. Five SEMC (Algeria, Jordan, Lebanon, Libya, and Tunisia) are part of the upper-middle income category, and the three remaining countries (Egypt, Morocco and Syria) are lower-middle income economies (see Figure 1).

[1] See http://data.worldbank.org/about/country-classifications/country-and-lending-groups#High_income.

Figure 1. MED11: GDP per capita, current international dollars, in PPP terms, 2010



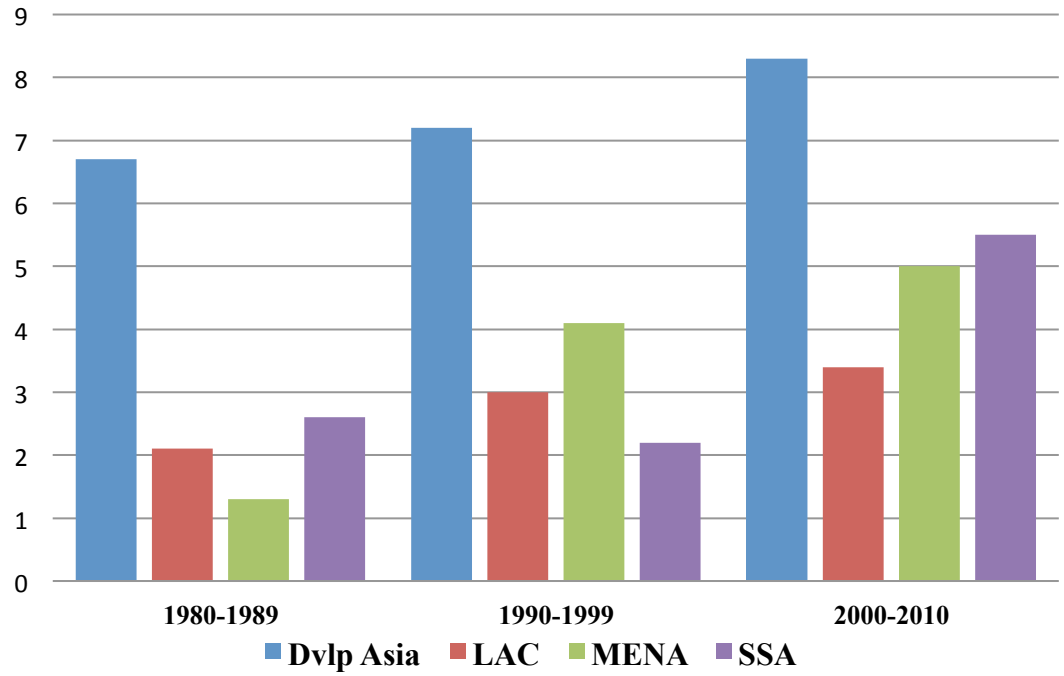
Source: IMF World Economic Outlook database, April 2012.

As shown in Figure 2, the pace of economic growth in the analyzed region was not particularly impressive for quite a long time (especially in the 1980s) as compared to other emerging markets and developing economies (EMDE) (see Couthino, 2012). It was also extremely volatile as a consequence of its strong commodity export dependence (and changes in commodity prices) and various political shocks (see below)[2].

In the 1970s, the SEMC greatly benefited from the oil price boom, through a sharp increase in exports and investments in oil-producing countries such as Algeria, Libya and, to a lesser extent, Egypt, Syria, and Tunisia. These gains spilled over to neighboring countries through significant increases in worker remittances, trade, and capital flows. However, a substantial part of these windfall gains were misused for pursuing expensive and inefficient import-substitution strategies, prestige infrastructure investment projects, and populist social policies involving, among others, huge price subsidies.

[2] Please note that Figure 2 contains data for the Middle East and North Africa (MENA) region, which covers eight SEMC (all but Israel and Palestine) plus six Gulf states, Yemen, Iraq, Iran, Djibouti, Sudan and Mauritania. Thus it can provide only a very rough estimate of the historical growth record of the SEMC.

Figure 2. Growth of real GDP in EMDE regions, 1980-2010, annual average, in %



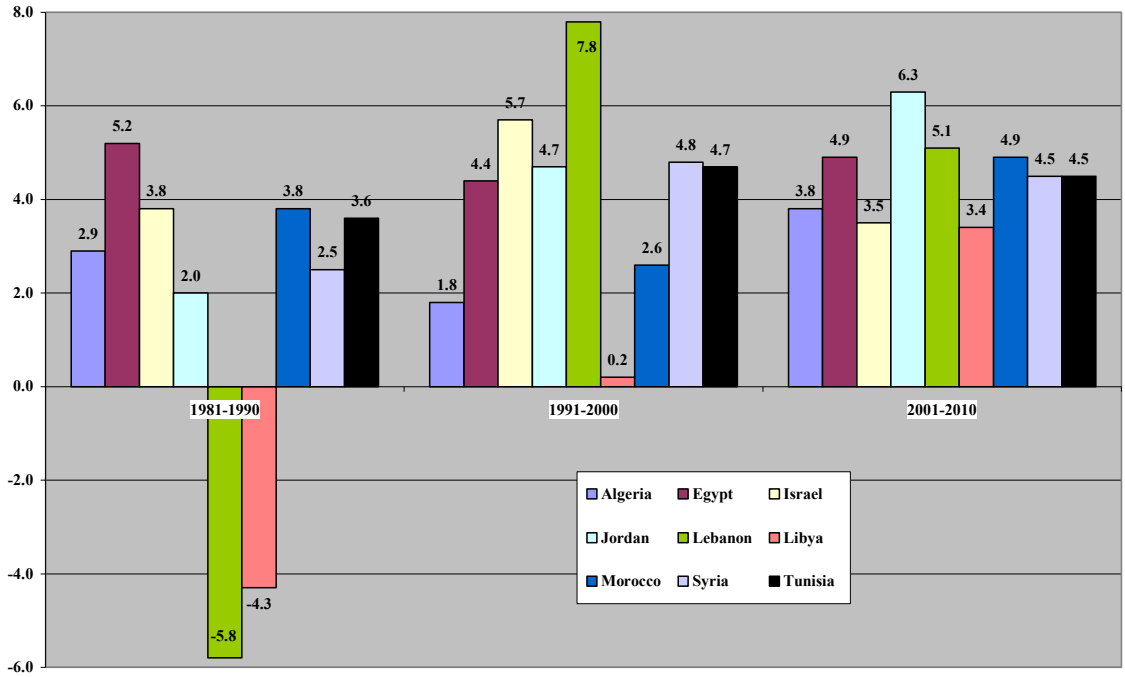
Note: LAC – Latin America and Caribbean, MENA – Middle East and North Africa, SSA – Sub-Saharan Africa.

Source: IMF WEO database, April 2012; author's own calculation.

The economic model which dominated in several Arab countries in the 1960s and 1970s, especially in Algeria, Egypt, Libya, Syria and Iraq and, to a lesser extent in Tunisia, was sometimes referred to as Arab socialism. It relied heavily on public ownership, administrative interference in market forces, central planning, the militarization of the economy and trade protectionism (Dabrowski, 2012; MENA, 2004). Israel also followed a kind of 'socialist' economic model at that time, with a large share of public and collective ownership and heavy government regulation.

Political conflicts also had a negative impact on growth performance in the region. The most striking case is Lebanon, once the richest country of the region which suffered one and half decades of sectarian civil war (1975-1990). Other examples include the protracted Israeli-Palestinian conflict, the civil war in Algeria in the early 1990s, international sanctions against Libya in the 1990s or the conflict between Morocco and Algeria over Western Sahara.

Figure 3. Growth of real GDP in SEMC, 1980-2010, annual average, in %



Source: IMF WEO database, October 2013; author's own calculation.

Since the early 1980s (Egypt) and 1990s (Algeria and Tunisia), individual countries started, at least partially, to depart from administrative dirigisme in the economic sphere, usually with the active engagement of the IMF and World Bank. This process was driven both by external factors (a fall in oil prices in the mid-1980s, the collapse of the Soviet bloc, economic reforms in China, India and other developing countries) and domestic policy needs (combatting macroeconomic instability and the desire to avoid political unrest). In the decade of the 2000s, even the most closed and statist countries, such as Libya and Syria, started to conduct more flexible economic policies and limited market reforms (Dabrowski & De Wulf, 2013).

Countries such as Egypt, Israel, Jordan, Morocco, and Tunisia that pursued reforms subsequently improved their growth performance (see Figure 3). However, if one takes into account the continuous high rate of population growth (over 2% annually), the growth rates recorded in the 2000s (Table 1) allowed for only a moderate improvement in GDP per capita. Furthermore, they were volatile and suffered from the global financial crisis in 2008-2009 (see Section 3.1).

It is also worth remembering that the prospects for the economic growth of major hydrocarbon producers (Libya, Algeria and, to a lesser extent, Syria) remain highly dependent on oil and natural gas prices. Indirectly, through intra-MENA[3] trade, migrant remittances, tourism and capital flows, other countries (especially Egypt and Lebanon) have benefited from the oil boom of the 2000s. If hydrocarbon prices

[3] i.e., including the Gulf countries and Iraq, which are even larger hydrocarbon producers than SEMC.

decline seriously (as they did in the second half of 2008 but only for a few months), their major producers in the MED region could face the danger of fiscal and balance of payments crises and economic downturn, especially in the context of imprudent management of the oil windfall.

Table 1. MED11 countries: annual growth rates, 2001-2010

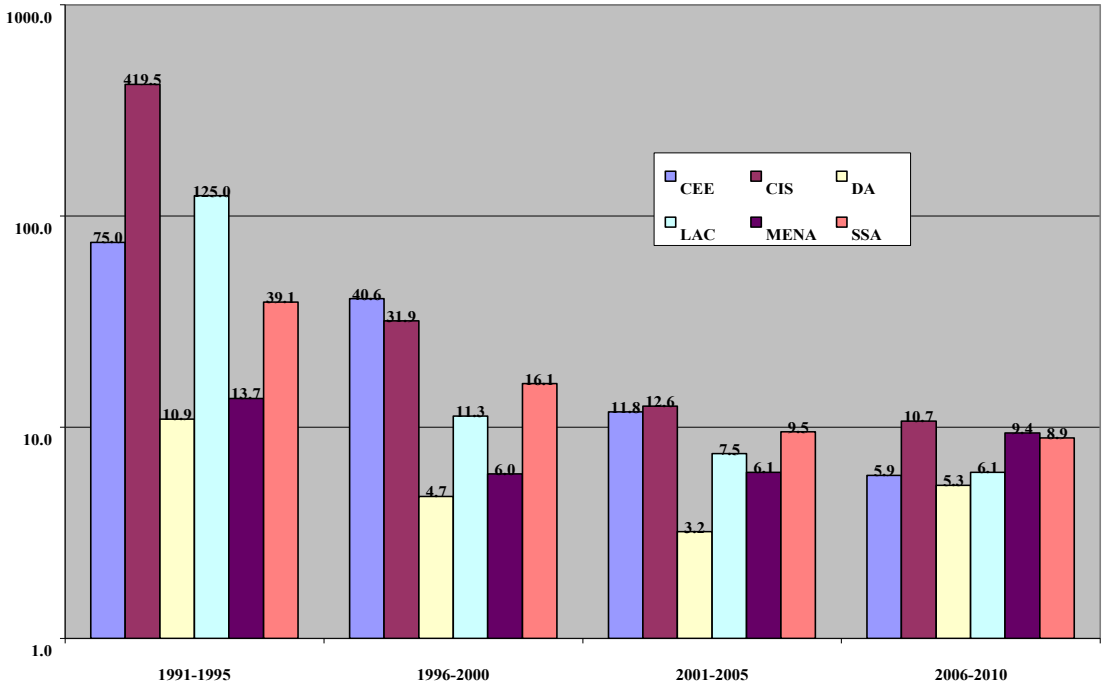
Country	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Algeria	3.0	5.6	7.2	4.3	5.9	1.7	3.4	2.0	1.7	3.6
Egypt	3.5	3.2	3.2	4.1	4.5	6.8	7.1	7.2	4.7	5.1
Israel	-0.2	-0.1	1.5	4.9	4.9	5.8	6.9	4.5	1.2	5.7
Jordan	5.3	5.8	4.2	8.6	8.1	8.1	8.2	7.2	5.5	2.3
Lebanon	3.9	3.4	1.7	7.5	0.7	1.4	8.4	8.6	9.0	7.0
Libya	-1.8	-1.0	13.0	4.5	11.9	6.5	6.4	2.7	-0.8	5.0
Morocco	7.6	3.3	6.3	4.8	3.0	7.8	2.7	5.6	4.8	3.6
Syria	3.7	5.9	-2.0	6.9	6.2	5.0	5.7	4.5	5.9	3.4
Tunisia	4.9	1.7	5.5	6.0	4.0	5.7	6.3	4.5	3.1	2.9

Notes: Yellow fields – IMF estimates; no data for Palestinian Autonomy.
Source: IMF World Economic Outlook database, October 2013.

2.2 Inflation

As seen in Figure 4, the MENA region was not the worst (as compared to other EMDE) in terms of inflation levels in 1990s and 2000s. Its relative performance deteriorated only slightly in the second half of the 2000s, especially in the years preceding the global financial crisis.

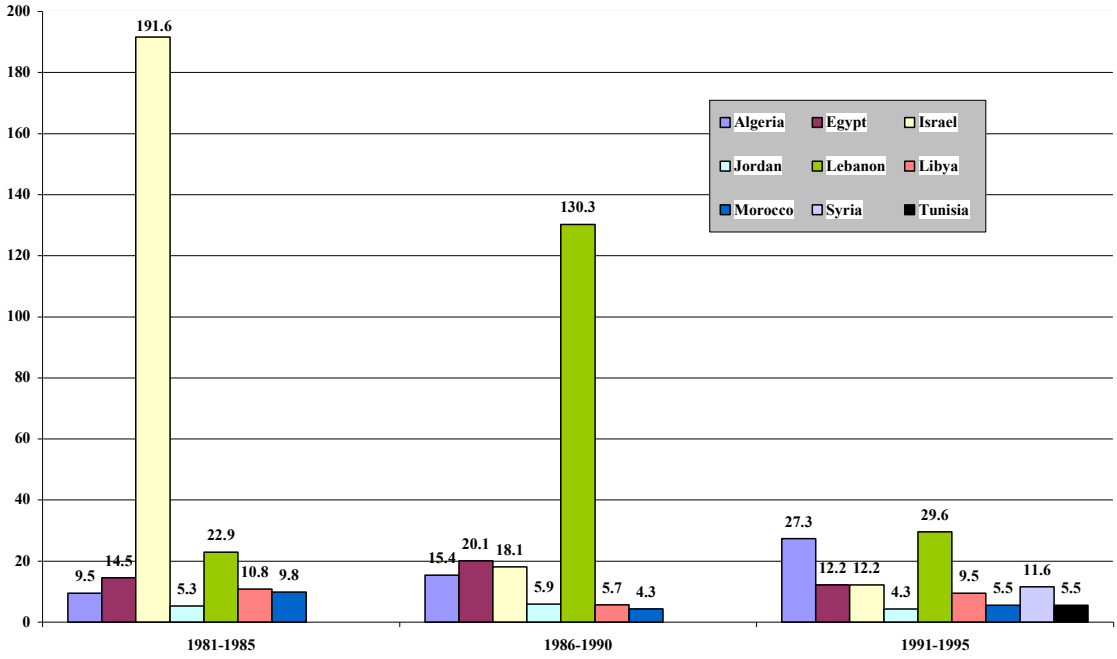
Figure 4. End-of-year inflation in EMDE regions, in %, period average, 1991-2010



Note: CEE – Central and Eastern Europe, CIS – Commonwealth of Independent States, DA – Developing Asia, LAC – Latin America and Caribbean, MENA – Middle East and North Africa, SSA – Sub-Saharan Africa.
Source: IMF WEO database, October 2013; author's own calculation.

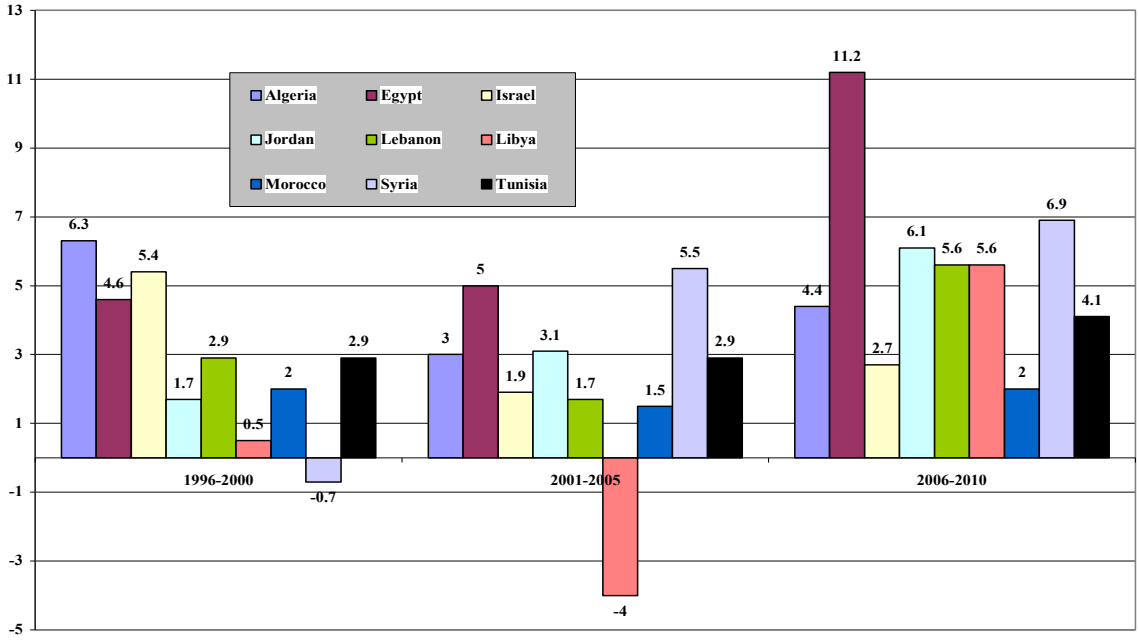
However, if one analyzes the earlier period (for which there are no cross-regional comparative inflation statistics), the situation looks less rosy. 'Socialist' policies in the 1960s-1980s resulted not only in a poor growth record (Section 2.1) but also in high, sometimes very high, inflation. In addition, the extensive price and foreign exchange controls led to a physical shortage and black market for some goods, similarly to former communist countries.

Figure 5. End-of-year inflation in SEMC, in %, period average, 1981-1995



Source: IMF WEO database, October 2013; author's own calculation.

Figure 6. End-of-year inflation in SEMC, in %, period average, 1996-2010



Source: IMF WEO database, October 2013; author's own calculation.

For individual SEMC, cross-country comparable inflation statistics are available as of 1980[4] so we do not have data for the earlier period. As a result, Figure 5 presents average end-of-year inflation for the period of 1981-1995 when some countries had already launched market-oriented reforms and stabilization policies.

Nevertheless, progress in reducing inflation, especially in the 1980s, was rather modest if not disappointing. Only two countries – Jordan and Morocco – managed to keep average inflation at one-digit levels in that period. The other end of spectrum was represented by Israel and Lebanon, which suffered high inflation or even hyperinflation. In the case of Israel, this was caused by high fiscal deficits and wage indexation (Bruno et al., 1988). In the case of Lebanon, it was caused by the civil war. Other countries can be considered examples of chronic moderate inflation, remaining at two-digit levels through most of the analyzed period. In the case of Algeria, the internal political conflict of the early 1990s was one of the factors responsible for inflation approaching an average annual level of 30%.

Better macroeconomic management in the 1990s and 2000s led to relative macroeconomic stability. In particular, sounder monetary and fiscal policies resulted in lower inflation in the second half of the 1990s and the first half of the 2000s (Figure 6). All SEMC managed to keep them at one-digit, sometimes very low levels (Syria and Libya even recorded periods of price decline).

However, in the second half of the 2000s, inflation started to pick up again in all of the SEMC (Figures 4 and 6), particularly in Egypt. This was caused by a combination of global and domestic inflationary pressures. The former originated from the overheating of the world economy and the abundant global liquidity built up by the lax monetary policy of the US Federal Reserve and other major central banks. Countries which pegged their currencies to the US dollar (all except Israel, Morocco and Tunisia) imported inflation via high commodity prices and a depreciating US currency. Domestic factors included high fiscal deficits (see Section 2.3).

2.3 Fiscal balances

A long-term analysis of fiscal balances is difficult due to the incomplete cross-country datasets of the IMF. For all nine SEMC comparative statistics of general government (GG), net lending/borrowing covers the period since the early 2000s; earlier data are available only for selected countries. In the case of Jordan, they start in 1985, for Algeria, Libya, Morocco and Syria – in 1990, in Tunisia – in 1991, in Israel and Lebanon – in 2000, in Egypt – in 2002.

[4] Inflation data series for Syria and Tunisia start from 1991 only.

Table 2. GG net lending/borrowing in SEMC, % of GDP, 1991-2010

Country	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Algeria	3.8	0.8	-5.9	-1.9	0.6	3.9	2.9	-3.6	-1.9	9.7	3.7	1.2	4.9	5.3	13.6	13.9	6.1	9.0	-5.4	-0.4
Egypt	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	-11.3	-9.0	-8.3	-8.4	-9.2	-7.5	-8.0	-6.9	-8.3
Israel	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	-3.8	-6.2	-7.6	-7.8	-6.0	-4.9	-2.6	-1.5	-3.7	-6.3	-4.6
Jordan	-14.3	0.3	-0.5	-1.4	-3.9	-2.8	-2.5	-6.0	-3.5	-4.7	-3.6	-2.4	0.2	-1.7	-5.0	-3.5	-5.7	-5.5	-8.9	-5.6
Lebanon	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	-23.6	-20.7	-16.0	-13.8	-9.7	-8.6	-10.5	-10.9	-9.7	-8.3	-7.7
Libya	8.7	0.1	-6.0	-2.8	3.9	11.7	-2.2	-2.4	5.9	14.1	0.1	7.2	6.4	11.7	31.4	31.8	28.6	28.3	6.2	17.2
Morocco	-1.1	-2.4	-2.6	-3.2	-3.3	1.1	1.9	1.7	3.6	-2.2	-4.3	-4.9	-4.2	-3.8	-6.2	-2.0	-0.1	0.7	-1.8	-4.4
Syria	-6.6	-7.3	-5.0	-6.0	-3.8	-2.8	-1.8	-2.8	-1.5	-1.4	2.3	-2.0	-2.7	-4.2	-4.4	-1.1	-3.0	-2.9	-2.9	-7.8
Tunisia	-4.4	-2.8	-2.6	-1.1	-3.2	-4.0	-2.6	-1.8	-2.2	-2.3	-2.1	-2.2	-2.2	-2.2	-2.8	-2.6	-2.0	-0.6	-1.2	-0.9

Notes: Yellow field – IMF estimate.

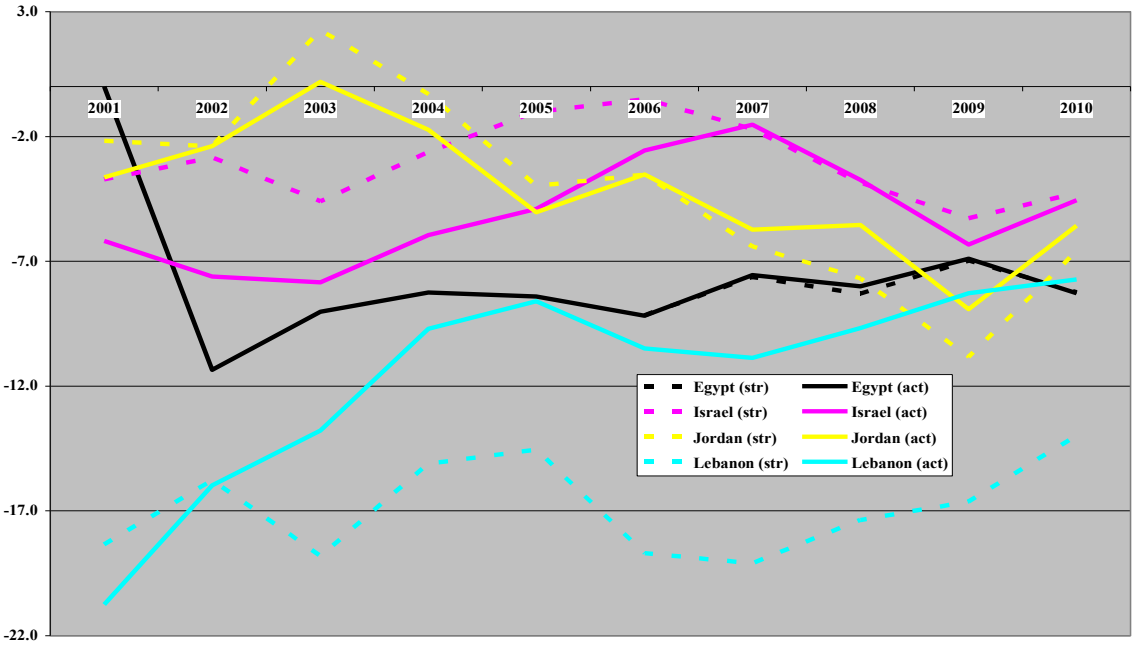
Source: IMF WEO database, October 2013.

As seen in Table 2, Lebanon represents the worst fiscal performance in the region. In the early 2000s, i.e. a decade after the civil war ended, its fiscal deficit still exceeded 20% of GDP. In subsequent years, it decreased to between 8 and 11% of GDP and remained at that level through the entire decade of the 2000s. Egypt is the next worst performer. Since 2002, when GG balance data according to GFS standards first became available, its deficit oscillated between 7 and 11% of GDP. Fiscal deficits in Israel exceeded 5% of GDP in the early 2000s, slightly improving in the second half of the decade (apart from 2009, the year of the global financial crisis).

The smallest fiscal imbalances were recorded in Tunisia (less than 3% of GDP in most of the analyzed period) and Morocco. Jordan and Syria can be ranked as intermediate performers: their fiscal imbalances were larger, on average, than in Tunisia and Morocco but smaller as compared to Lebanon, Egypt and Israel.

Finally, the two large hydrocarbon exporters, Algeria and Libya, demonstrated high volatility in their fiscal accounts, following changes in oil and natural gas prices and outputs, and various political developments (like the civil war in Algeria in the early 1990s).

Figure 7. Structural vs. actual GG balances in selected SEMC, % of GDP, 2001-2010



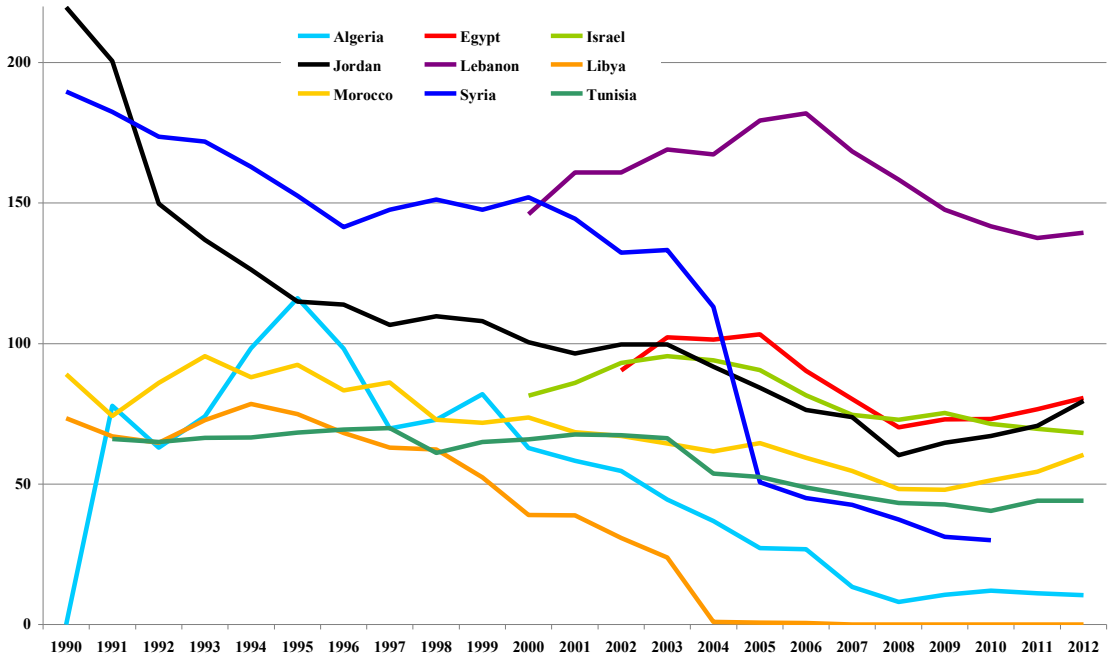
Source: IMF WEO database, October 2013.

It is important to note that in spite of relatively high growth rates (see Section 2.1), several SEMC increased their fiscal deficits in the second half of the 2000s. This concerns Egypt, Jordan, Lebanon and, to a lesser extent, Israel. The unsustainable path of fiscal policy is confirmed by Figure 7 according to which structural deficits, at least in Lebanon and Jordan, exceeded actual ones (data on structural deficits are available for only four SEMC).

2.4 Public debt

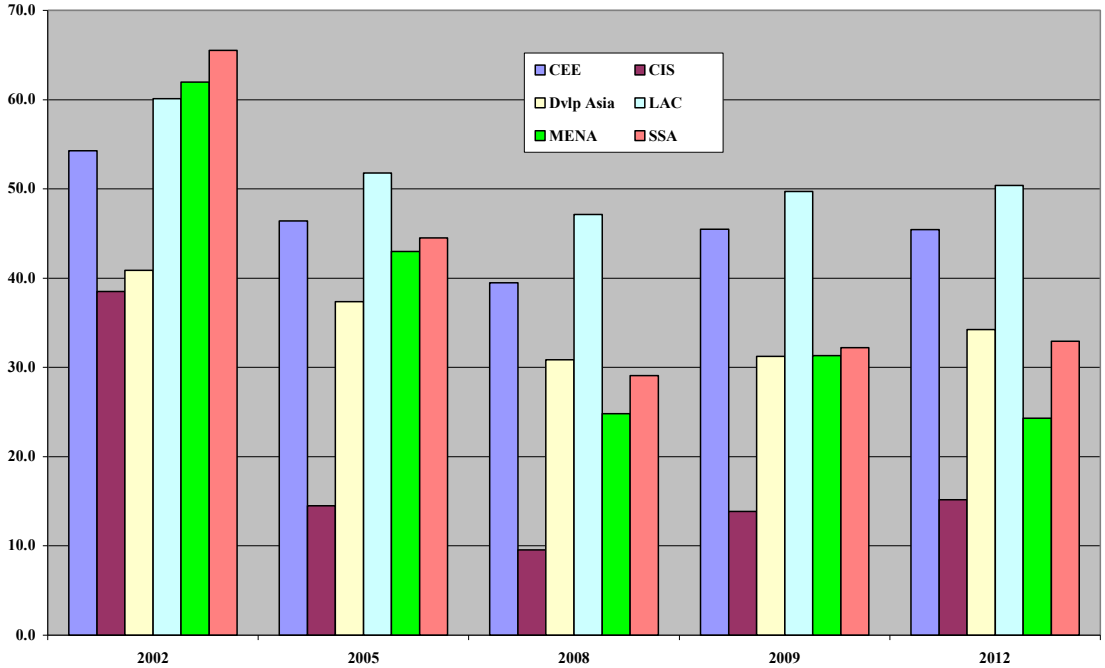
Volatile and often imprudent fiscal performance had to have an impact on the level of public indebtedness. As seen in Figure 8, in the 1990s, all SEMC represented a high level of GG gross debt to GDP by emerging market standards.

Figure 8. GG gross debt in SEMC, % of GDP, 1990-2012



Source: IMF World Economic Outlook database, October 2013.

Figure 9. GG gross debt in EMDE regions, in % of GDP, 2002-2012



Note: CEE – Central and Eastern Europe, CIS – Commonwealth of Independent States, DA – Developing Asia, LAC – Latin America and Caribbean, MENA – Middle East and North Africa, SSA – Sub-Saharan Africa.
Source: IMF WEO database, October 2013.

In the second half of the 1990s and the first half of the 2000s, the situation improved substantially due to an increase in oil prices in oil producing countries (Libya, Algeria and Syria) and large-scale privatization in Jordan (Figure 8 and Table 3). Other SEMC (except Lebanon) also recorded

improvements, albeit less impressive. As a result, the level of public indebtedness of the entire region went down in relation to GDP and in comparison with other EMDE regions (Figure 9).

Table 3. GG gross debt in SEMC, % of GDP, 2000-2010

Country	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Algeria	62.8	58.3	54.7	44.5	36.8	27.2	26.8	13.4	8.1	10.5	12.1
Egypt	n/a	n/a	90.4	102.3	101.5	103.3	90.3	80.2	70.2	73.0	73.2
Israel	81.4	86.0	93.1	95.6	94.1	90.6	81.6	74.6	72.9	75.3	71.5
Jordan	100.5	96.5	99.7	99.6	91.8	84.3	76.3	73.8	60.2	64.8	67.1
Lebanon	146.1	160.9	160.9	169.0	167.3	179.4	181.9	168.4	158.4	147.6	141.7
Libya	39.0	38.8	30.8	23.8	0.9	0.6	0.6	0.0	0.0	0.0	0.0
Morocco	73.7	68.4	67.1	64.4	61.7	64.6	59.4	54.6	48.2	48.0	51.3
Syria	152.1	144.5	132.4	133.4	113.0	50.7	45.0	42.7	37.3	31.2	30.0
Tunisia	65.9	67.6	67.4	66.4	53.7	52.5	48.8	45.9	43.3	42.8	40.4

Source: IMF World Economic Outlook database, October 2013.

However, there are two important caveats. First, the reduction in the public debt-to-GDP ratio in the 2000s resulted, to a large extent, from the relatively rapid growth of nominal GDP (denominator). Second, towards the end of that decade, it started to deteriorate in some countries (Algeria, Egypt, Jordan and Morocco) which could be partly but not exclusively attributed to the impact of the global financial crisis of 2008-2009. Domestic policy factors, in particular, the continuation of energy and food subsidies in an environment of growing global commodity prices played an equally important role. We will come back to these issues in Sections 3 and 4.

3. Recent fiscal deterioration in the region

3.1 Economic and political background

Since 2008, the SEMC have experienced three adverse shocks: (i) the global financial crisis of 2008-2009; (ii) the European sovereign debt and financial crisis of 2010-2013 and (iii) the Arab Spring.

The first stage of the global financial crisis (2008-2009) had a negative impact on EMDE through several channels such as (i) the collapse of global trade; (ii) the decline in prices of oil and other commodities; (iii) the drying up of liquidity on international markets; (iv) the sudden stop in capital flows; (v) decreasing remittances of labor migrants; and, (vi) decreasing tourist revenues (see Dabrowski, 2010).

For the SEMC, channels (i), (ii), (v) and (vi) were key factors. The SEMC were less affected by financial market contagion as the financial sector in most SEMC remained relatively closed to the external world. Also, the role of foreign direct investment (FDI) and other (largely short-term) private capital flows was not as important as in the case of other EMDE (see Sekkat, 2012, Woodward and Safawi, 2012). In addition, a substantial part of private capital flows has an intra-regional character, originating from the Gulf countries.

The overall impact of the first stage of the global financial crisis on the SEMC was rather moderate and short-lived. As seen in Table 4, only Libya experienced a modest recession in 2009 (-0.8%) due to a sharp decline in oil prices in the second half of 2008. Algeria, Egypt, Israel, Jordan and Tunisia recorded a growth slowdown while Lebanon, Morocco and Syria continued to grow at the previous pace or even faster (Lebanon's growth rate was record-high in 2009 at 9.0%).

Table 4. Basic macroeconomic indicators in SEMC, 2007-2013

Country	Indicator	2007	2008	2009	2010	2011	2012	2013
Algeria	Annual growth of real GDP, %	3.4	2.0	1.7	3.6	2.6	3.3	3.1
	End-of-year inflation, %	4.8	4.9	5.8	2.7	5.2	9.0	8.2
	GG net lending/borrowing, % of GDP	6.1	9.0	-5.4	-0.4	-0.4	-5.1	-1.7
	GG gross debt, % of GDP	13.4	8.1	10.5	12.1	11.1	10.5	10.8
	Current account balance, % of GDP	22.6	20.1	0.3	7.5	8.9	5.9	1.8
Egypt	Annual growth of real GDP, %	7.1	7.2	4.7	5.1	1.8	2.2	1.8
	End-of-year inflation, %	8.6	20.2	10.0	10.7	11.8	7.3	9.8
	GG net lending/borrowing, % of GDP	-7.5	-8.0	-6.9	-8.3	-9.8	-10.7	-14.7
	GG gross debt, % of GDP	80.2	70.2	73.0	73.2	76.6	80.6	89.5
	Current account balance, % of GDP	2.1	0.5	-2.3	-2.0	-2.6	-3.1	-2.6
Israel	Annual growth of real GDP, %	6.9	4.5	1.2	5.7	4.6	3.4	3.8
	End-of-year inflation, %	3.4	3.8	3.9	2.7	2.2	1.6	2.1
	GG net lending/borrowing, % of GDP	-1.5	-3.7	-6.3	-4.6	-4.2	-4.9	-5.1
	GG gross debt, % of GDP	74.6	72.9	75.3	71.5	69.7	68.2	70.4
	Current account balance, % of GDP	3.2	1.4	3.8	3.1	1.3	0.3	2.3
Jordan	Annual growth of real GDP, %	8.2	7.2	5.5	2.3	2.6	2.8	3.3
	End-of-year inflation, %	5.1	9.1	2.7	6.1	3.3	7.2	3.2
	GG net lending/borrowing, % of GDP	-5.7	-5.5	-8.9	-5.6	-6.8	-8.8	-9.1
	GG gross debt, % of GDP	73.8	60.2	64.8	67.1	70.7	79.6	83.9
	Current account balance, % of GDP	-16.8	-9.3	-3.3	-5.3	-12.0	-18.1	-9.9
Lebanon	Annual growth of real GDP, %	8.4	8.6	9.0	7.0	1.5	1.5	1.5
	End-of-year inflation, %	6.0	6.4	3.4	5.1	3.1	10.1	3.5
	GG net lending/borrowing, % of GDP	-10.9	-9.7	-8.3	-7.7	-6.1	-9.0	-10.4
	GG gross debt, % of GDP	168.4	158.4	147.6	141.7	137.5	139.5	143.1
	Current account balance, % of GDP	-4.1	-7.7	-9.3	-9.9	-12.4	-16.2	-16.7
Libya	Annual growth of real GDP, %	6.4	2.7	-0.8	5.0	-62.1	104.5	-5.1
	End-of-year inflation, %	7.6	9.7	0.3	3.3	26.6	-3.7	10.0
	GG net lending/borrowing, % of GDP	28.6	28.3	6.2	17.2	-6.6	19.4	-5.4
	GG gross debt, % of GDP	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	Current account balance, % of GDP	44.1	42.5	14.9	19.5	9.1	29.2	-4.7
Morocco	Annual growth of real GDP, %	2.7	5.6	4.8	3.6	5.0	2.7	5.1
	End-of-year inflation, %	2.0	4.2	-1.6	2.2	0.9	2.6	2.3
	GG net lending/borrowing, % of GDP	-0.1	0.7	-1.8	-4.4	-6.7	-7.6	-5.5
	GG gross debt, % of GDP	54.6	48.2	48.0	51.3	54.4	60.5	61.8
	Current account balance, % of GDP	-0.1	-5.2	-5.4	-4.1	-8.1	-10.0	-7.2
Syria	Annual growth of real GDP, %	5.7	4.5	5.9	3.4	n/a	n/a	n/a
	End-of-year inflation, %	4.8	15.4	1.7	6.3	n/a	n/a	n/a
	GG net lending/borrowing, % of GDP	-3.0	-2.9	-2.9	-7.8	n/a	n/a	n/a
	GG gross debt, % of GDP	42.7	37.3	31.2	30.0	n/a	n/a	n/a
	Current account balance, % of GDP	-0.2	-1.3	-2.9	-2.8	n/a	n/a	n/a
Tunisia	Annual growth of real GDP, %	6.3	4.5	3.1	2.9	-1.9	3.6	3.0
	End-of-year inflation, %	5.1	4.0	4.0	4.1	4.2	5.9	5.3
	GG net lending/borrowing, % of GDP	-2.0	-0.6	-1.2	-0.9	-3.4	-4.9	-6.8
	GG gross debt, % of GDP	45.9	43.3	42.8	40.4	44.0	44.0	45.5
	Current account balance, % of GDP	-2.4	-3.8	-2.8	-4.8	-7.3	-8.1	-8.0

Notes: Yellow field – IMF estimate.

Source: IMF WEO database, October 2013.

The impact of the European debt and financial crisis also seems modest until now (definitely smaller than in the CEE). It was mostly felt in countries which have higher export, migration and incoming tourism exposure to the Eurozone like Morocco (see IMF, 2013a, Annex 2, p. 83). In addition, as this crisis overlaps in time with the Arab Spring (see below) it is not easy to statistically disentangle the impact of both factors. Nevertheless both crises (that of 2008-2009 and the European one) created a new global environment of slower growth and tighter financial conditions as compared with the 'golden' era of the early and mid-2000s.

The popular uprising called the Arab Spring, which started at the end of 2010 in Tunisia and spread rapidly to Egypt, Libya, Yemen, Bahrain and Syria, directly or indirectly affected the economies of the entire region.

First, the collapse of the previous autocratic regimes has not yet led to the establishment of stable democratic regimes able to ensure responsible economic management. On the contrary, most of the countries directly affected by the Arab Spring suffer from political, economic and social instability and insecurity.

Tunisia is perhaps the only exception as it enjoys a relatively stable democratic government which has started to implement an economic reform program supported by the IMF stand-by loan in June 2013. It also adopted the new democratic constitution on January 26, 2014 (ACRPS, 2014). However, its political transition is not yet complete.

The situation in other countries is much worse: Egypt and Libya struggle with domestic political instability, deep splits of their societies along sectarian, regional, ideological and cultural lines, and tribal insurrections. All of these developments have had a negative impact on current business activity, investment, and incoming tourism in the entire region.

Syria is in the midst of its third year of bloody civil war with no prospects of a fast resolution. The country is in fact territorially divided between pro-government forces and rebels of various ideological and political profiles. The negative economic and political consequences of this conflict, for example, the large number of refugees, blocked transit routes, declining tourism and FDI flows, are affecting neighboring SEMC, especially Lebanon and Jordan (IMF, 2013a, Box 2.1, pp. 34-35). Similarly, the civil war in Libya in 2011 and the following domestic instability have negatively affected neighboring Tunisia and Egypt through a large inflow of refugees and returning migrant workers.

Second, the fear of popular unrest has made all governments in the region reluctant to conduct sorely needed economic reforms such as the reduction or elimination of subsidies, public sector modernization and restructuring, the continuation of privatization, and opening countries to foreign investors. Worse, in the aftermath of the Arab Spring, several governments backtracked on previous

reforms by, for example, increasing energy and food subsidies again, increasing public sector employment, or revising previous privatization deals.

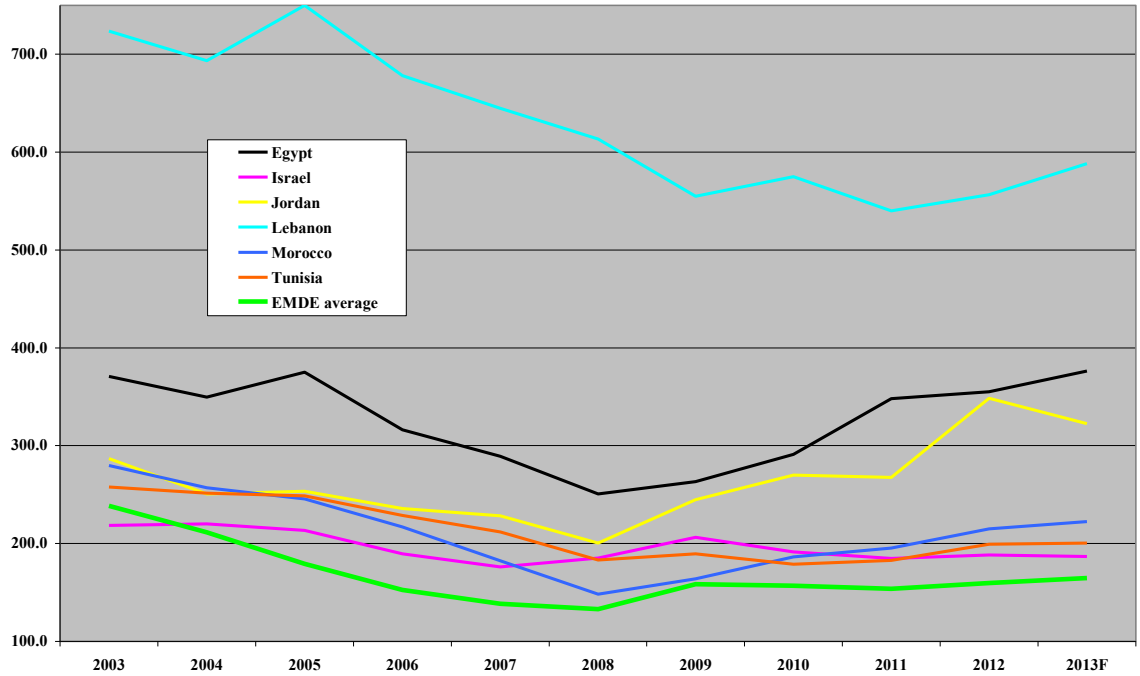
The negative impact of the Arab Spring on economic growth in Tunisia, Egypt, Libya and Lebanon is clearly visible in Table 4. Data on Syria after 2010 are not available and one can only speculate on the scale of economic and social damage (in addition to human losses). The situation in Syria has not helped Jordan to return to a higher growth rate. Again, Tunisia may become the exception: after an evident growth slowdown in 2011, it picked up again to a moderate level of 3+% in 2012-2013.

The period after 2009 has also been marked by higher inflation in several countries: Algeria, Egypt, Jordan, Lebanon and Libya. Data for Syria is not available. Remarkably, Tunisia experienced only a minor increase in inflation after 2010, and it continues to remain at the annual level of 5-6%.

3.2 Fiscal trends

As illustrated by Table 4, since 2011, GG balances deteriorated everywhere in the region, even in oil-producing Algeria, unaffected by the Arab Spring. Egypt has recorded high fiscal deficits since at least the early 2000s but they deteriorated after the Arab Spring. In Israel, the fiscal deficit increased to 6.3% of GDP in the crisis year 2009 and remained at the level of 4-5% of GDP in the following years. There is no data for Syria after 2010.

Figure 10. GG gross debt as a % of GG revenue for selected SEMC, 2003-2013



Note: F – forecast; data for EMDE represent the unweighted arithmetic average of the group of 92 EMDE rated by Moody's; data on Jordan, Morocco and Tunisia are limited to the central government.
Source: Moody's Statistical Handbook, November 2013; author's own calculation.

Table 5. GG interest payment as a % of GG revenue for selected SEMC, 2003-2013

Country	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013F
Egypt	21.8	22.2	22.4	19.8	18.7	16.5	15.2	20.5	25.3	26.8	28.4
Israel	13.0	12.7	11.5	10.4	10.3	8.6	9.5	8.8	7.4	7.6	7.4
Jordan	6.8	5.4	7.0	7.7	8.2	8.1	8.8	8.5	7.9	11.5	13.3
Lebanon	73.9	53.7	47.7	53.7	54.3	46.2	45.2	46.4	41.1	37.7	39.9
Morocco	15.5	14.3	12.4	11.7	10.4	8.1	8.1	8.3	8.2	8.6	9.0
Tunisia	11.8	11.8	11.9	11.5	10.9	8.7	8.8	8.0	7.5	7.8	7.7
EMDE	11.5	10.6	9.5	8.6	8.0	7.4	8.4	8.1	7.7	7.9	8.4

Note: F – forecast; data for EMDE represent the unweighted arithmetic average of the group of 92 EMDE rated by Moody's; data on Jordan, Lebanon, Morocco and Tunisia are limited to the central government.
Source: Moody's Statistical Handbook, November 2013; author's own calculation.

The combination of slower growth and higher fiscal deficits has led to an increase in GG debt-to-GDP ratio in most SEMC apart from Algeria and Libya. In 2013 it is expected to amount to 143.1% of GDP in Lebanon, 89.5% of GDP in Egypt, 83.9% in Jordan, 70.4% in Israel, 61.8% in Morocco and 45.5% of GDP in Tunisia (Table 4). These are pretty high numbers for EMDE standards.

Data on gross debt-to revenue ratio (Figure 10) looks equally worrying. Since 2008-2009 there has been a clear reversal of the earlier moderate gains and all of the SEMC perform worse than the EMDE average. The situations of Lebanon, Egypt and Jordan may raise concerns about their long-term sovereign solvency.

The same kind of conclusion can be drawn from Table 5 which presents the interest payment-to-revenue ratio. Interest payment absorbs ca. 40% or more of government revenue in Lebanon, close to 30% in Egypt and above 13% in Jordan. In all countries except Israel and Tunisia, it exceeds the EMDE average and has a tendency to grow.

4. Causes of fiscal imbalances

4.1 Overview of revenue and expenditure

The total GG revenue in the SEMC does not differ or even exceed the EMDE average (Table 6).

Table 6. GG revenue in SEMC, % of GDP, 2001-2012

Country	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Algeria	35.0	35.4	37.1	36.0	40.8	42.7	39.4	46.9	36.7	36.5	40.0	39.5
Egypt	n/a	25.4	26.2	25.6	24.8	28.6	27.7	28.0	27.7	25.1	22.0	22.6
Israel	45.3	45.3	43.7	42.7	42.5	43.1	42.4	39.5	36.7	37.6	37.7	36.2
Jordan	30.3	29.6	34.7	36.6	33.3	32.4	32.3	30.1	26.5	24.9	26.4	22.8
Lebanon	17.7	20.3	22.2	23.2	22.9	25.4	24.1	24.0	24.5	22.7	23.4	23.2
Libya	38.2	49.4	49.4	54.0	60.4	63.0	62.3	68.4	52.9	64.9	50.3	72.3
Morocco	22.5	24.3	23.0	24.0	26.3	27.4	29.9	32.5	29.3	27.5	27.8	28.1
Syria	30.3	26.5	29.9	27.1	23.8	25.2	22.7	20.1	23.9	20.9	n/a	n/a
Tunisia	27.0	27.6	27.1	27.0	26.5	26.6	27.4	29.9	29.6	30.0	31.2	30.7
EMDE	23.7	23.9	24.6	25.5	27.5	28.4	28.6	29.5	26.2	27.0	28.3	28.3

Notes: Yellow field – IMF estimate.
Source: IMF WEO database, October 2013.

Table 7. GG expenditure in SEMC, % of GDP, 2001-2012

Country	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Algeria	31.3	34.3	32.2	30.8	27.1	28.8	33.2	37.8	42.2	36.9	40.4	44.6
Egypt	n/a	36.7	35.2	33.9	33.2	37.8	35.3	36.0	34.6	33.4	31.8	33.4
Israel	51.5	52.9	51.6	48.7	47.4	45.7	44.0	43.2	43.1	42.2	41.9	41.0
Jordan	33.9	32.0	34.5	38.3	38.3	35.9	38.0	35.6	35.4	30.4	33.2	31.7
Lebanon	38.4	36.3	35.9	32.9	31.5	35.9	35.0	33.7	32.8	30.4	29.5	32.2
Libya	38.2	42.2	43.1	42.4	29.1	31.2	33.7	40.1	46.6	47.7	56.9	52.9
Morocco	26.8	29.2	27.3	27.7	32.5	29.4	30.1	31.8	31.1	31.9	34.5	35.8
Syria	28.0	28.5	32.6	31.3	28.2	26.3	25.7	22.9	26.7	28.6	n/a	n/a
Tunisia	29.1	29.8	29.3	29.2	29.3	29.2	29.4	30.5	30.8	30.9	34.6	35.5
EMDE	26.4	27.7	27.5	26.6	26.7	27.0	27.4	28.8	30.3	29.6	29.4	30.0

Notes: Yellow field – IMF estimate.
Source: IMF WEO database, October 2013.

Only Syria and Lebanon record systematically lower levels of GG revenue while Egypt, Jordan and Morocco fall below the EMDE average in individual years. In terms of expenditure, all SEMC record systematically higher levels except for Syria, which falls below the EMDE average in individual years (Table 7).

The lack of cross-country comparative statistics does not allow for conducting a comprehensive analysis of revenue and expenditure structure. Nevertheless, based on existing studies, we will try to figure out the key fiscal challenges and vulnerabilities of the SEMC which are related to generalized price subsidies, employment in the public sector, military expenditure, dependence on hydrocarbon revenue and the impact of political instability.

4.2 Consumer subsidies

The biggest fiscal challenge relates to generalized price subsidies to food and energy (Dabrowski & De Wulf, 2012; Bergasse et al., 2013), which continue to put a huge fiscal burden on several SEMC, especially Egypt, Algeria, Libya, Jordan and Lebanon. Most of this burden relates to energy subsidies, i.e., subsidies to petroleum, electricity, natural gas, and coal. The cost of food subsidies is relatively smaller; it amounts to 0.7% of the GDP of the MENA region according to IMF estimates (2013a, Box 2.4, p. 42). However, in some countries (Libya, Tunisia, and Egypt) they are higher, i.e. in the range of 1 and 2% of GDP.

Consumer subsidies can be measured in two ways: as pre-tax subsidies and post-tax subsidies (see Clement et al., 2013 for details). Pre-tax subsidies are defined as the difference between the value of supplied products and services at either international prices (tradable goods) or cost-recovery prices (non-tradable goods) and domestic prices paid by their consumers, both final and intermediate. Post-tax subsidies are the sum of pre-tax and tax subsidies. The latter are measured as the difference between efficient taxation, which takes sufficient account of externalities (in the case of energy this is, for example, the environmental impact of its production and consumption) and the actual one.

The IMF (2013a, Box 2.4, p. 42) estimated the total cost of pre-tax energy subsidies in MENA countries at the level of USD 236.7 billion, i.e. 8.6% of their GDP and 22% of GG revenue in 2011. About half of this was absorbed by subsidies to diesel and gasoline. In a global comparison, MENA is the region with the highest energy subsidies; they constituted almost half of total pre-tax world energy subsidies in 2011. If one adds implicit tax subsidies, the total post-tax energy subsidies in the MENA region will approach the level of 15% of GDP (Clement et al, 2013).

Table 8. Subsidies for Energy Products in SEMC, 2011, as % of GDP

Country	Petroleum products		Electricity		Natural gas		Coal	
	Pre-tax	Post-tax	Pre-tax	Post-tax	Pre-tax	Post-tax	Pre-tax	Post-tax
Algeria	4.30	6.11	1.08	1.15	5.36	6.07	0.00	0.00
Egypt	6.74	8.60	2.30	2.50	1.60	2.59	0.00	0.05
Israel	0.0	0.00	n/a	n/a.	n/a	0.10	n/a	0.54
Jordan	2.15	5.27	3.81	4.10	n/a	0.34	n/a	n/a
Lebanon	0.07	3.57	4.46	4.61	n/a	0.17	n/a	0.11
Libya	6.40	8.81	1.85	2.33	0.59	1.49	0.00	0.00
Morocco	0.66	2.83	n.a.	n/a	n/a	0.04	n/a	0.33
Tunisia	0.77	2.56	2.23	2.43	n/a	0.70	n/a	n/a

Note: Data for Syria is not available.

Source: Clement et al. (2013), Appendix A, Table 2 and 4.

Tables 8 and 9 present estimates of energy subsidies in individual SEMC and their disaggregation into major energy products. Pre-tax subsidies are the highest in oil- and gas-exporting Algeria and Libya and oil-importing Egypt but also substantial in other SEMC apart from Israel and Morocco. However, the product structure of subsidies differs among countries. Large subsidies to petroleum products are provided in Algeria, Egypt, and Libya and, to a lesser extent, Jordan. The highest electricity subsidies are recorded in Lebanon, followed by Jordan, Egypt and Tunisia. Subsides to natural gas are the highest in Algeria. Coal subsidies are of marginal importance in the analyzed region.

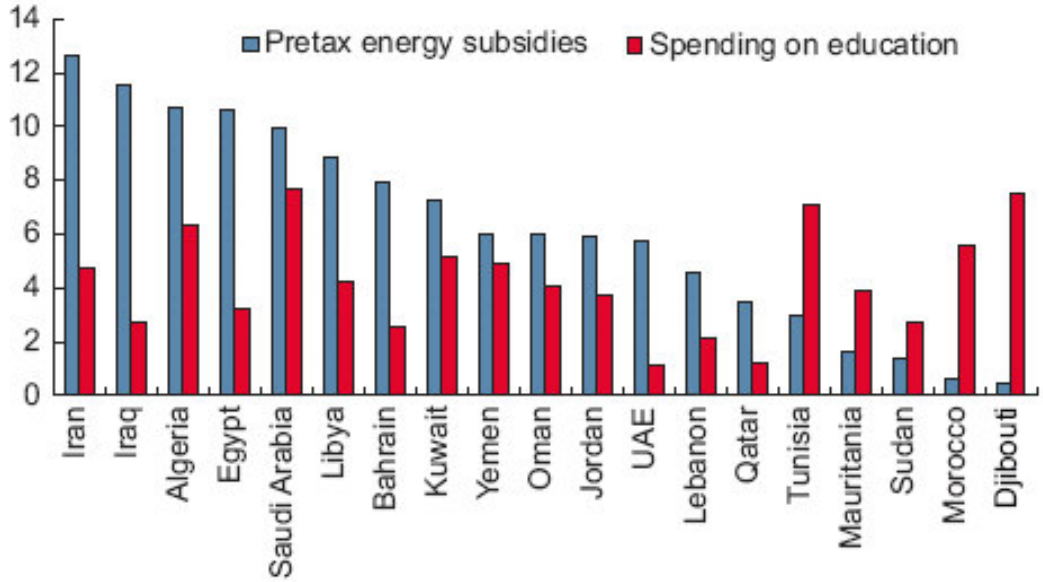
Table 9. Subsidies for Energy Products in SEMC, 2011, as % of GG revenue

Country	Petroleum products		Electricity		Natural gas		Coal	
	Pre-tax	Post-tax	Pre-tax	Post-tax	Pre-tax	Post-tax	Pre-tax	Post-tax
Algeria	10.84	15.40	2.72	2.89	13.52	15.31	0.00	0.00
Egypt	30.61	39.07	10.44	11.35	7.25	11.79	0.00	0.23
Israel	0.00	0.00	n/a	n/a	n/a	0.26	n/a	1.34
Jordan	8.13	19.94	14.41	15.49	n/a	1.30	n/a	n/a
Lebanon	0.32	15.17	18.96	19.59	n/a	0.71	n/a	0.45
Libya	16.64	22.91	4.80	6.04	1.53	3.86	0.00	0.00
Morocco	2.40	10.27	n/a	n/a	n/a	0.13	n/a	1.21
Tunisia	2.42	8.07	7.02	7.66	n/a	2.19	n/a	n/a

Note: Data for Syria is not available.

Source: Clement et al. (2013), Appendix A, Tables 3 and 5.

Figure 11. Pre-tax energy subsidies and spending on education in MENA countries, as % of GDP



Notes: Energy subsidies refer to 2011; education refers to the latest available data.
Source: IMF (2013a), Figure 2.4.2, p. 42.

Generalized consumer subsidies are usually the consequence of government price controls. If a government determines fixed administrative prices on either energy or food products, those prices become almost automatically 'politicized' as the necessity of their upward adjustment may provoke social and political tensions. When the necessity of such an adjustment comes as a result of, for example, higher international prices, a depreciation of the national currency, domestic inflation, etc., the government usually tries to delay setting new higher prices and, consequently, creates a gap between the administratively fixed price and the international or cost-recovery price. When such a gap becomes large there is even less political readiness to close it. However, sooner or later, this must be done and, in the case of a delay, the adjustment becomes more painful socially, economically and politically.

Universal price subsidies are both costly and inefficient as tools to fight poverty (their main social policy justification). In reality, higher- and middle-income groups are the main beneficiaries of those subsidies (Bergasse et al, 2013, Clement at al., 2013). In addition, the subsidies have a devastating microeconomic and structural impact. They discourage producers of the subsidized energy and food products from increasing their output and quality parameters. They stimulate excessive and wasteful consumption, damage the environment, and hinder the development of renewable energy, etc. (see Bergasse et al., 2013 for the analysis of energy subsidies).

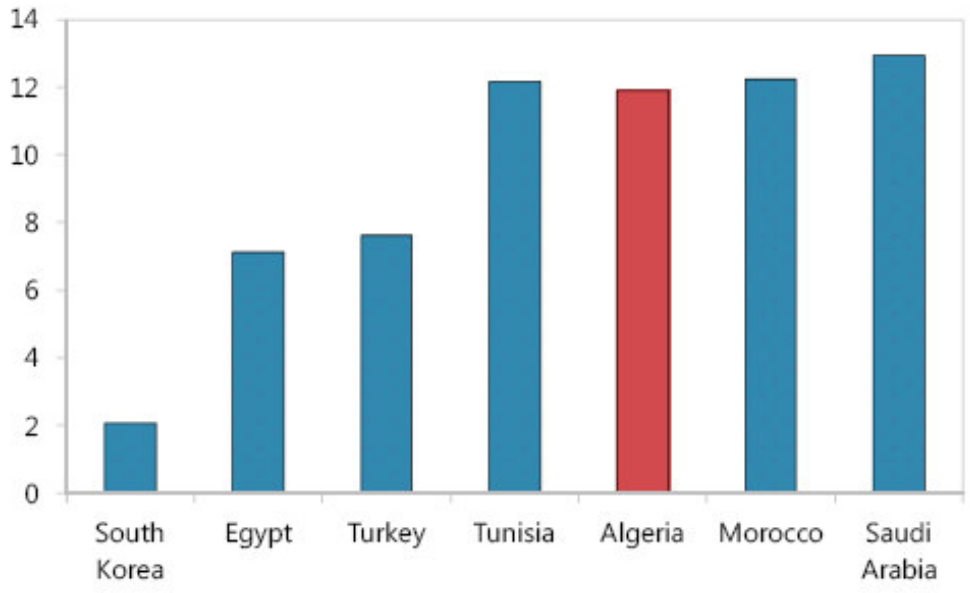
By absorbing a substantial share of fiscal resources (in the case of Egypt half of its GG revenue; in the case of Algeria, Jordan, Lebanon and Libya, between 20 and 30% – see Table 9), energy

and food subsidies crowd out other important expenditures. For example, they may crowd out education expenditures, which can create an important development bottleneck in the region. Figure 11 shows that public spending on education is much lower than energy subsidies in Algeria, Egypt, Libya, Jordan and Lebanon (no data is available for Syria).

4.3 Oversized public sector

Comprehensive and fully cross-country comparable statistics are not available on public sector structure, employment and current budget spending on public employee salaries. However, the incomplete IMF data (Figures 12 and 13) points to excessive public employment and a related heavy expenditure burden in several SEMC and other MENA countries.

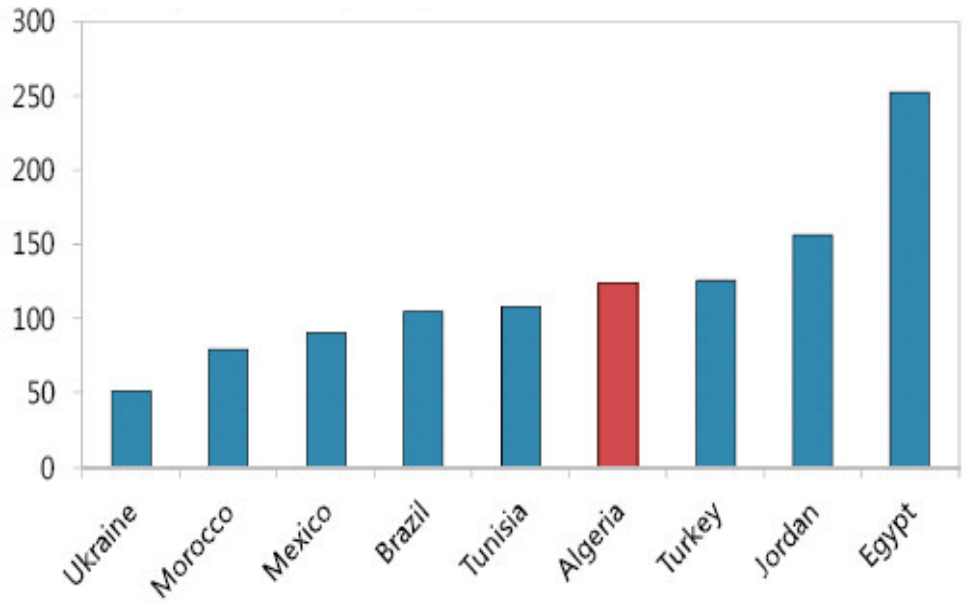
Figure 12. Public-sector wage bill as % of GDP in selected countries, 2011



Source: IMF (2013b), Appendix IV, p. 45.

The low effectiveness of public sector employment is another big challenge. Several SEMC hoard an excessive labor force in both public administration bodies and agencies of various levels. In many SEMC, state-owned enterprises serve as an instrument of social policy, with the aim of reducing high unemployment and providing income support to at least part of the population. In practice, it is a good pretext to employ relatives, friends, political supporters, retired military and law enforcement personnel, or offer jobs in exchange for material goods.

Figure 13. Public employees per 1,000 inhabitants in selected countries, 2011



Source: IMF (2013b), Appendix IV, p. 45.

Needless to say, such policies do not meet their goal: instead of reducing poverty, they put a heavy burden on public finances and the economy. According to the IMF (2013, Annex 4, p. 98-99), countries with a higher share of spending on public sector wages and salaries in total budget expenditure have higher Gini coefficients.

In addition, an oversized, incompetent and often corrupted public service is not able to provide basic public goods and, instead, inhibits private sector development and its ability to provide productive jobs. On the other hand, inefficient public enterprises distort competition and the allocation of resources.

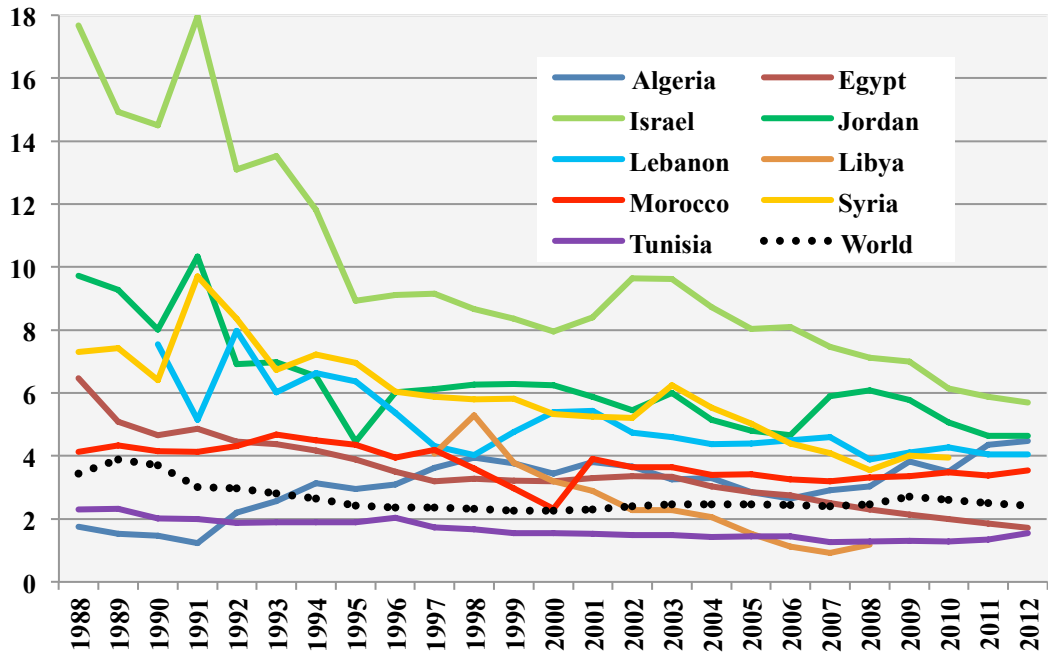
4.4 Military expenditure

Unresolved regional and internal conflicts as well as the authoritarian or semi-authoritarian character of many political regimes in the region are responsible for high expenditures on defense and law enforcement agencies.

We do not have reliable and cross-country comparable data on internal security/ law enforcement expenditures. Thus our analysis will be limited to the WB World Development Indicator statistics on military spending which are, in turn, based on the estimates of the Stockholm International Peace Research Institute (SIPRI). They include all current and capital expenditures on armed forces, including peacekeeping forces, defense ministries and other government agencies engaged in defense.

Although military expenditure in SEMC decreased substantially as a % of GDP from record-high levels in the 1980s and early 1990s, it continues to exceed the world average in all analyzed countries except Tunisia. Israel is the highest military spender in the region and one of the highest in the world followed by Jordan, Lebanon, Syria, Algeria and Morocco. Egypt's expenditures on defense have gone down systematically (in relative terms) from over 6% of GDP at the end of the 1980s to less than 2% of GDP after the Arab Spring.

Figure 14. Military expenditure, % of GDP, 1980-2012



Source: WB World Development Indicators.

In spite of the reported relative decrease in military expenditure, the data in Figure 14 clearly indicate the remaining huge potential of the so-called peace dividend in the region. Further cuts in those expenditures would not only help in restoring the badly needed fiscal balance but would also create room for providing more non-military public goods such as better education or an infrastructure upgrade. Indirectly, resolving existing conflicts could facilitate opening borders and boosting intra-regional trade and economic growth.

4.5 Hydrocarbon dependence

The two large hydrocarbon producers and exporters (Algeria and Libya) are heavily dependent on oil and natural gas-related revenue as seen in Table 10[5]. In particular, the fiscal breakeven oil

[5] One should take into account the consequences of the civil war in Libya on its fiscal performance in 2011 and 2012.

price in Algeria is above 100 USD and continues to grow. That is, the hypothetical level of the oil price at which the fiscal balance would be zero well exceeds the actual export price level.

A substantial dependence on oil revenue (although smaller than in Algeria and Libya) was also reported in Syria before it descended into a civil war. According to the IMF (2010, Table 2, p. 18), oil revenues of the central government were equal to 7.1% of GDP and 29.7% of total revenues in 2005 but then declined to 4.9% of GDP and 21.7% of total revenues, due to a decrease in the volume of oil production.

Table 10. Hydrocarbon dependence of major SEMC oil producers

Country	Non-oil fiscal balance as % of non-oil GDP			Fiscal breakeven oil price in USD		
	2006-2010	2011	2012	2006-2010	2011	2012
Algeria	-43.8	-44.9	-46.7	n/a	109.7	125.6
Libya	-115.9	-117.4	-194.6	46.9	124.0	75.7

Source: IMF (2013), Table 5, p. 106.

The above figures mean that hydrocarbon producing SEMC remain extremely vulnerable to changes in international prices (which are unlikely to grow further and may decline in the next couple of years) and production volume. The latter seems to be stabilizing in Algeria, and is declining in Libya. Syria's oil production will definitely go down even if the country restores internal peace and stability soon, because of the shortage of new deposits.

Algeria created a sovereign wealth fund (called the Revenue Regulation Fund) in 2000 which has cumulated USD 77.2 billion of oil-related fiscal surpluses. The Libyan Investment Authority created in 2006 has accumulated USD 65 billion in financial assets[6]. However, according to the Linaburg-Maduell Transparency Index[7], the transparency of both funds is rated at the lowest level "1" on the scale from 1 to 10.

Before the civil war, Syria also had a Price Stabilization Fund with the same role of cumulating oil-related revenue surpluses.

Overall, although the existence of sovereign wealth funds in hydrocarbon producing countries must be assessed positively, the question remains about whether or not their size is sufficient to provide an effective fiscal buffer for 'rainy' days when either output or prices, or both, go down.

[6] Data as of September 2013 – see http://www.swfinstitute.org/fund-rankings/
[7] http://www.swfinstitute.org/statistics-research/linaburg-maduell-transparency-index/

5. Macroeconomic consequences of fiscal imbalances

Large fiscal imbalances and a high level of public indebtedness have various negative consequences for macroeconomic stability and business climate.

5.1 Fiscal sustainability

The fiscal data presented in Tables 4 and 5 and Figure 10 suggest that Lebanon, Egypt and Jordan, not to mention war-torn Syria may face fiscal sustainability challenges in the near-to-medium-term perspective. This is additionally confirmed by individual countries' sovereign ratings of two major rating agencies as presented in Table 11.

According to both Moody's and Standard and Poor's (SP), only Israel enjoys a solid investment-grade rating despite its continuously high GG deficit and public debt (-5.1 and 70.4% of GDP in 2013, respectively). According to SP, Morocco's BBB-rating is at the lowest end of investment grade category. All other countries in the SP rating and all except Israel in the Moody's rating represent a speculative grade (of various degree). In the analyzed group, Egypt has the worst Moody's rating (Caa1) and Egypt and Lebanon have the worst SP rating (B-), close to default grade territory. Egypt, Jordan, and Tunisia's ratings have deteriorated since 2012.

Table 11. SEMC's sovereign rating, November 2013

Country	Moody's	Standard and Poor's
Egypt	Caa1	B-
Israel	A1	A+
Jordan	B1	BB-
Lebanon	B1	B-
Morocco	Ba1	BBB-
Tunisia	Ba2	B

Source: Moody's Statistical Handbook, November 2013;
http://www.standardandpoors.com/ratings/sovereigns/ratings-list/en/us

Please note that Algeria, Libya and Syria do not have sovereign ratings. Algeria and Libya do not need to borrow internationally, at least now.

5.2 Monetary and inflationary consequences

In countries which have experienced fiscal strain in recent years (Egypt, Jordan, Lebanon, Morocco, and Tunisia), part of the increasing public debt has been monetized either directly (with the central bank lending to the government) or indirectly (through increasing the central bank's credit to commercial banks enabling them to lend to government). Most probably, monetary financing has also become the main source of covering government expenditure in conflict-ridden Syria.

The partial monetization of fiscal deficit and public debt must lead to either the depletion of official reserves of central banks used to sterilize increasing net domestic assets (see Section 5.3) or to an increase in inflationary pressures, or both. Inflationary pressure is also boosted by the contribution of fiscal deficits to growing domestic demand.

The data in Table 4 confirms that after 2009, all SEMC except Israel and Morocco have experienced either continuous or periodic inflation pick up.

5.3 External vulnerability

Fiscal imbalances also put pressure on the external accounts of individual SEMC. The data presented in Table 4 signal either a deterioration of current account balances (Algeria, Egypt, Lebanon, Libya, Morocco, Tunisia and, most probably, Syria) or their stabilization on high deficit levels (Jordan). This suggests the possibility of the phenomenon of twin deficits when fiscal imbalances lead, via higher internal demand, to balance-of-payment problems. On the other hand, adverse shocks generated by political instability in the region may simultaneously impact both the balance of payments and fiscal accounts.

In the cases of Algeria and Libya, the deterioration of current accounts has led to a reduction of their previously large current account surpluses. Egypt's small current account surplus in the past has been replaced by a modest current account deficit. In other countries, current account deficits have rapidly increased, sometimes to two-digit levels (in terms of their share in GDP) as in the case of Lebanon, or have remained the same (Jordan).

In the countries affected, directly or indirectly, by the negative consequences of the Arab Spring (Tunisia, Egypt, Libya, Lebanon and Jordan), capital accounts have also deteriorated due to decreasing FDI inflows and, in some cases, capital outflows.

The negative balance-of-payment trends have had a negative impact on both the size of gross international reserves (Table 12) and exchange rates (Table 13). Since 2010, gross international reserves have decreased in Egypt, Morocco, Tunisia and, temporarily, in Jordan (in 2012). In the case of Egypt, this decline has been dramatic in spite of support provided by the Gulf countries. Exchange rates have depreciated in Algeria, Egypt and Tunisia. Those depreciations have contributed to higher inflation (see Section 5.2).

Table 12. Total reserves in SDR million, end of period, 2009-2013

Country	2009	2010	2011	2012	2013 Q3
Algeria	95,266	105,787	119,277	124,663	125,708
Egypt	20,659	21,910	9,800	7,651	10,351[a]
Israel	38,663	46,043	48,769	49,389	52,085
Jordan	7,471	8,493	7,484	5,279	7,816
Lebanon	18,887	20,786	22,300	24,518	24,566
Libya	63,137	64,865	68,391	77,173	79,985[a]
Morocco	14,567	14,708	12,743	10,667	11,218
Tunisia	7,061	6,150	4,862	5,445	4,702

Note: [a] - August 2013.

Source: IMF International Financial Statistics.

Table 13. Market Rate, National Currency per SDR, end of period, 2009-2013

Country	2009	2010	2011	2012	2013 Q3
Algeria	114,02	115,42	116,77	120,04	124,89
Egypt	8,58	8,92	9,24	9,69	10,63[a]
Israel	5,92	5,47	5,87	5,74	5,43
Jordan	1,11	1,09	1,09	1,09	1,09
Lebanon	2363,29	2321,60	2314,42	2316,91	2312,63
Libya	1,93	1,93	1,93	1,93	1,93[a]
Morocco	12,32	12,87	13,17	12,96	12,68
Tunisia	2,07	2,21	2,30	2,38	2,53

Note: [a] - August 2013.

Source: IMF International Financial Statistics.

Table 14. GG Foreign Currency & FC-Indexed Debt/GG Debt, 2003-2012

Country	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Egypt	28.1	23.4	21.0	19.5	18.6	18.4	18.9	16.9	15.4	14.7
Israel	25.5	25.5	26.2	25.1	22.6	19.8	18.5	17.1	17.4	15.9
Jordan	76.7	72.0	69.2	65.3	58.7	38.7	35.3	36.6	31.0	28.0
Lebanon	49.1	53.4	51.9	53.3	54.6	48.5	45.2	42.5	42.4	45.7
Morocco	27.2	23.9	21.1	19.7	20.0	21.0	22.8	24.0	23.1	23.7
Tunisia	64.8	63.5	64.2	60.1	58.6	61.2	58.7	60.9	58.3	60.9

Note: Data on Jordan, Lebanon, Morocco and Tunisia are limited to central government.

Source: Moody's Statistical Handbook, November 2013.

Increasing external imbalances may limit opportunities to finance public debt on international bond markets. On the other hand, depreciating exchange rates increase the domestic currency value of foreign currency denominated and indexed debt and its relation to GDP. Fortunately, among SEMC, only Tunisia and Lebanon have a large share of such debt in their total public debts (Figure 14).

6. Main directions of fiscal reform

Most of the SEMC must urgently undertake far-reaching fiscal reforms to avoid the potential risk of public debt insolvency and macroeconomic instability. The elimination or substantial reduction of energy and food subsidies, especially pre-tax subsidies, should be considered the number

one task in all countries except Israel. It can offer relatively quick and substantial fiscal gains, which would allow for the restoration of fiscal and macroeconomic equilibrium and increase room for fiscal maneuver in the medium and long-term.

Price subsidies should be replaced by targeted social safety nets, including targeted cash transfers following, among others, the experiences of CEE or Turkey (see Clements et al., 2013 for a broader overview of experiences related to subsidy reforms). They would absorb part of the resources economized as a result of the elimination/reduction of subsidies. Another part of budget savings would remain and would help reduce the fiscal deficit or increase expenditure for priority public goods such as education, healthcare and transport infrastructure.

The results of the World Bank's survey in four SEMC (see Table 15 and Silva et al., 2013) suggest that there is social understanding and readiness to accept such a subsidy reform. This means that a lot will depend on the determination of individual governments, their political skills, and their administrative capacity in implementing the proposed policy changes[8].

Table 15. Subsidy reform survey

	Egypt	Jordan	Lebanon	Tunisia
Question: If the government were to remove the subsidy on the price of diesel, should the government…?				
			(In percent)	
Distribute that money to the poor	32	50	32	38
Distribute that money to all families except the wealthy	3	19	11	6
Distribute that money to all families including the wealthy	2	3	1	1
Distribute a portion of that money to the poor and spend the rest on healthcare and education programs for all	57	10	56	50
Don't know/refused (volunteered response)	7	19	1	4

Source: IMF (2013c), p. 23 based on Silva et al (2013).

The second direction of fiscal adjustment should focus on the reform of public administration and state-owned enterprises. The oversized public service must be reduced in terms of the number of employees. However, the remaining staff should be better paid and selected on the basis of professional competence rather than political and personal relations. The subsidization of public sector enterprises has to end or at least be substantially reduced and loss-making firms should either be closed down or restructured. The SEMC should continue to privatize their state owned financial and non-financial corporations in an open, competitive and transparent manner. Revenue from privatization can contribute to the reduction of the public debt burden.

[8] See Clements et al. (2013) and Silva et al. (2013) for a broader discussion of possible strategies and tactics in implementing subsidy reforms, including their sequencing and various flanking measures.

Other fiscal reforms involve simplifying tax systems, eliminating tax exemptions and loopholes, ensuring better coverage of VAT and higher energy taxation (the elimination of tax subsidies – see Section 4.2 and Table 8).

The elimination of other fiscal vulnerabilities will depend on changes in the economic structure of individual countries (economic diversification), unlocking entrepreneurial potential (by improving business and investment climate) and progress in resolving various internal and regional conflicts (by decreasing military expenditure and unblocking intra-regional trade and investment flows). Obviously, all of these requires more time and, in the case of regional conflicts, international political effort.

In countries directly affected by the Arab Spring, prospects of fiscal adjustment and other economic reforms will greatly depend on the outcome of the political transition and their ability to build stable democratic regimes. A review of the experience of countries that managed a successful transition to democracy suggests that growth declined by about 3% during the transition, but recovered the pre-transition rate within two years. The investment took about five years to recover (MENA, 2011, p. 2). The important lesson of this analysis suggests that with the right policies, the dip in growth rates in some SEMC can be temporary and that the long term growth trend can be resumed.

Similar conclusions are offered by Khandelwal & Roitman (2013). According to them, macroeconomic performance thus far in Arab countries in transition has remained broadly in line with other political transition experiences in Africa, Asia, Latin America and Eastern Europe, except for fiscal balances. Here, the performance of Arab countries is consistently worse both in the pre-transition and in the transition periods.

7. Summary and conclusions

Our analysis clearly demonstrates that all SEMC except the large hydrocarbon producers (Algeria and Libya) suffer from serious fiscal imbalances and fragilities. These imbalances have been built up over decades but have become more visible and acute since 2008, when a combination of adverse economic and political shocks (global and European financial crises, Arab Spring) hit the region. In an environment of slower growth and higher public expenditure pressures, fiscal deficits and public debts have increased rapidly, leading to a deterioration of current accounts, a depletion of official reserves, the depreciation of some currencies and higher inflationary pressure. If not addressed in time, deteriorating fiscal and macroeconomic equilibria may lead to serious problems, including potential public debt and balance-of-payment crises.

To avoid the worst-case scenario, bold fiscal adjustments and structural and institutional reforms are urgently needed. Among them, the subsidy reform, especially with respect to energy products is the most important issue. This is a priority task for all SEMC (except Israel), including Algeria and Libya. It can bring substantial fiscal gains and several other positive effects such as improving social targeting (when generalized price subsidies are replaced by targeted cash transfers and other social assistance tools), reducing the excessive energy-intensity in the SEMC, eliminating structural distortions and negative environmental effects, creating incentives to develop alternative energy production, reducing the shadow economy, and unblocking fiscal resources for human capital and environmental investment.

Another reform priority concerns public administration and public sector enterprises, including their further privatization. In the longer term perspective, economies and public finances of SEMC may benefit from improving business climate, more trade and investment openness, sector diversification and peace dividend.

Economic and fiscal reform perspectives will depend on the pace of the political transition in the region and its results, i.e. the ability to build stable democratic regimes that are resistant to populist temptations and support more rational policies. The experiences of political and economic transitions in other regions, such as Asia, CEE and the former USSR, Africa and Latin America, may offer an useful guidance in building more effective governments and economies in the SEMC.

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