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Economic Review of ENP Countries

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Foreword

This is the second issue of the "European Neighbourhood Policy: Economic Review of ENP Countries".[1] It reflects ongoing work in the Unit "Economic Affairs of Mediterranean Countries, Russia and the New Independent States. Economic Aspects of the Neighbourhood Policy" in the Directorate for International Economic and Financial Affairs (DG ECFIN).[2] This report does not necessarily reflect the official views of the European Commission.

In addition to country-specific sections on the main economic developments in 2005, this 2006 issue focuses on economic growth in the ENP countries. The analysis presented in this Occasional Paper is part of the ongoing monitoring of economic developments in the ENP countries. It is intended to be one of the technical inputs for the assessment by the European Commission of progress in the implementation of the economic aspects of the ENP Action Plans. The country chapters are structured along the main areas of reform: macroeconomic developments, trade liberalisation and economic opening, business climate, public institutions and public finance management, and social development and poverty.

This Occasional Paper has been prepared by a team led by José Leandro and Andreas Papadopoulos including Arno Bäcker, Enrico Gisolo, Frank Ø. Hansen, Inmaculada Montero Luque, Agnieszka Skuratowicz, Sirpa Tulla and Lucio Vinhas de Souza. Max Watson provided analytical advice. Klaus Regling and Antonio de Lecea provided management support and offered valuable suggestions. Sophie Bland and Cecilia Mulligan reviewed the report.

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[1] Libya, although an ENP country, has not been included in this issue due to the fact that there are no formal relations with the EU. Russia is not an ENP country, but has a strategic partnership with the EU, based on four "common spaces", including an economic space. Russia is included in this issue, not least because of its economic importance for the CIS region.
[2] Previous DG ECFIN publications on ENP and Mediterranean countries are available on the Europa website at: http://ec.europa.eu/economy_finance/publications/occasionalpapers_en.htm.

Contents

List of tables, boxes and charts

Charts

Economic growth in the European Neighbourhood Policy countries

Algeria

Armenia

Azerbaijan

Belarus

Egypt

Georgia

Acronyms

AA	Association Agreement
AMD	Armenian dram
AP	Action Plan
AZM	Azerbaijanian manat
BEEPS	Business Environment and Enterprise Performance Survey
BFTU	Belarus Federation of Trade Unions
BoI	Bank of Israel
BTC	Baku-Tbilisi-Ceyhan
BTE	Baku-Tbilisi-Erzurum
BUIW	Belarusian Union of Industry Workers
BYR	Belarusian ruble
CBA	Central Bank of Armenia
CBE	Central Bank of Egypt
CBJ	Central Bank of Jordan
CBR	Central Bank of Russia
CBS	Central Bank of Syria
CBT	Central Bank of Tunisia
CFAA	Country Financial Accountability Assessment
CIS	Commonwealth of Independent States
CPI	Consumer Price Index
CU	Customs Union
DZD	Algerian dinar
EBRD	European Bank for Reconstruction and Development
EC	European Community
ECB	European Central Bank
EGP	Egyptian pound
EGPRSP	Economic Growth and Poverty Reduction Strategy Paper
EIB	European Investment Bank
EITI	Extractive Industries Transparency Initiative
EIU	Economist Intelligence Unit
ENP	European Neighbourhood Policy
ENPI	European Neighbourhood and Partnership Instrument
EU	European Union
FDI	Foreign Direct Investment
FEMIP	Facility for Euro-Mediterranean Investment and Partnership
FSAP	Financial Sector Assessment Program
FTA	Free Trade Agreement
GDP	Gross Domestic Product
GEL	Georgian lari
GFCF	Gross Fixed Capital Formation
GFS	Government Finance Statistics
GNI	Gross National Income
GSP	General System of Preferences
GST	General Sales Tax
IBRD	International Bank for Reconstruction and Development
IFI	International Financial Institutions

IFRS	International Financial Reporting Standards
IFS	International Financial Statistics
IPSAS	International Public Sector Accounting Standards
ISMF	The Institutional and Sector Modernisation Facility
ILO	International Labour Organisation
IMF	International Monetary Fund
JOD	Jordanian dinar
LBP	Lebanese pound
MAD	Moroccan dirham
MDL	Moldovan leu
MED	Mediterranean Countries
MEDA	EU's financial instrument for the Euro-Mediterranean Partnership
MENA	Middle East and North Africa region
MFN	Most Favoured Nation
MoF	Ministry of Finance
MPC	Marginal Productivity of Capital
MTDP	Medium-Term Development Plan
MTEF	Medium-Term Expenditure Framework
NBB	National Bank of Belarus
NBG	National Bank of Georgia
NBM	National Bank of Moldova
NBU	National Bank of Ukraine
NGO	Non Governmental Organisation
NHGDP	Non-Hydrocarbon GDP
OECD	Organisation for Economic Cooperation and Development
PCA	Partnership and Co-operation Agreement
PMA	Palestine Monetary Authority
PPP	Purchasing Power Parities
QIZ	Qualified Industrial Zone
SBA	Stand-By Arrangement
SMEs	Small and Medium-sized Enterprises
SOCAR	State Oil Company of the Azerbaijan Republic
SOFAZ	State Oil Fund of the Azerbaijan Republic
SPPRED	State Programme on Poverty Reduction and Economic Development
SSEC	Syrian Securities and Exchange Commission
SYP	Syrian pound
TACIS	EU's financial instrument for Eastern Europe and Central Asia
TFP	Total Factor Productivity
TIFA	Trade and Investment Framework Agreement
TND	Tunisian dinar
UAH	Ukrainian hryvnia
UMA	Maghreb Arab Union
UN	United Nations
UNDP	United Nations Development Program
US	United States
VAT	Value Added Tax
WB	World Bank
WB&G	West Bank and Gaza
WDI	Word Development Indicators
WEO	World Economic Outlook
WTO	World Trade Organisation

Part A

Thematic Issues

Economic growth in the European Neighbourhood Policy countries[1]

- Thanks to some reform progress and a booming world economy, growth has picked up in the European Neighbourhood Policy (ENP) countries. However, recent economic developments may conceal structural weaknesses. Current growth rates may not be sustained and in many countries, in particular in the Mediterranean region, current growth is insufficient to reduce unemployment and the income gap with the European Union (EU) within a satisfactory time horizon.
- Per capita income in the poorest ENP countries is significantly lower than in the EU. The ambition of the 1995 Barcelona Declaration and the European Neighbourhood Policy to reduce this income gap is important for the welfare, stability and security of both the ENP countries and the EU.
- According to standard growth theory, current per capita income gaps can be explained by low capital stocks per person employed and low total factor productivity (TFP). In this framework, the role of TFP is essential because it influences growth directly and also indirectly by stimulating the marginal productivity of capital. Therefore, sustained investment and productivity gains are necessary ingredients for a rapid catching-up process with the EU. This will depend to a large extent on the creation of an investment climate that enables firms to invest, create jobs, innovate and expand.
- Over the past 30 years, growth in the Mediterranean ENP countries has been mainly driven by capital accumulation, while TFP growth has been generally low or even negative in some countries. On the other hand, since the fall of the Soviet Union and the deep economic recession that ensued, GDP growth in eastern ENP countries has relied mainly on productivity gains, while the rate of capital accumulation has been low or negative, reflecting the decline of obsolete capital-intensive sectors of the economy during the transition process.
- Government policies play a key role in shaping the investment climate, and therefore affect the rate of capital accumulation and productivity growth that are the drivers of economic development. The security of property rights and the enforcement of contracts, the quality of the regulatory and tax frameworks, the fight against corruption, the creation of a stable macroeconomic environment, the level of integration in the world economy and the level of support for education, research and innovation, are all important public policy issues that affect total factor productivity and productive investment. Guided by modern concepts of growth theory, this paper demonstrates once again that significant progress will have to be made in these areas in all ENP countries if the income gap with the EU is to be reduced.

1. Introduction

The promotion of economic growth is an underlying aim of the European Neighbourhood Policy (ENP) since the ENP's objective is *to share the benefits* of the enlarged EU with neighbouring countries *in strengthening stability, security and well-being for all concerned*. For the

[1] This article was prepared by Arno Bäcker and Frank Øland Hansen.

Mediterranean partner countries, this aim was already enshrined in the 1995 Barcelona Declaration which sets out the following long-term economic objectives: acceleration of the pace of sustainable socio-economic development; improvement of the living conditions of their populations, increase in the employment level and reduction in the development gap in the Euro-Mediterranean region. Achieving these objectives requires sustainable economic growth.

In the framework of the ENP, the EU and each neighbourhood country agree on an Action Plan (AP), which sets out a list of jointly agreed priorities, to be implemented over a period of three to five years. Enhancing growth and welfare, particularly by improving the investment climate and increasing productivity, is an intrinsic objective of the APs (see Box 1).

Box 1: ENP Action Plans support economic growth

The ENP action plans (AP) are political documents that lay out the strategic objectives of the cooperation between the neighbourhood countries and the EU. APs set out a comprehensive list of jointly agreed priorities to be implemented by the neighbourhood country and the EU. Fostering economic growth through improving the conditions for sustained investment and productivity gains is a major priority in the APs. The following examples of growth enhancing policy measures are among those included in APs:

- Achieve and maintain macroeconomic stability through prudent monetary and fiscal policies
- Develop the framework for financial services, with the aim to improve access to finance, insurance and other financial services important for enterprises
- Address administrative, legislative and regulatory obstacles to the creation and development of firms
- Ensure the security of property rights, contract enforcement and investor protection
- Improve competition policy
- Continue trade liberalisation
- Remove restrictions on capital flows
- Undertake institutional and judiciary reforms, including capacity enhancement
- Support research and development, and improve the quality of education
- Fight against corruption

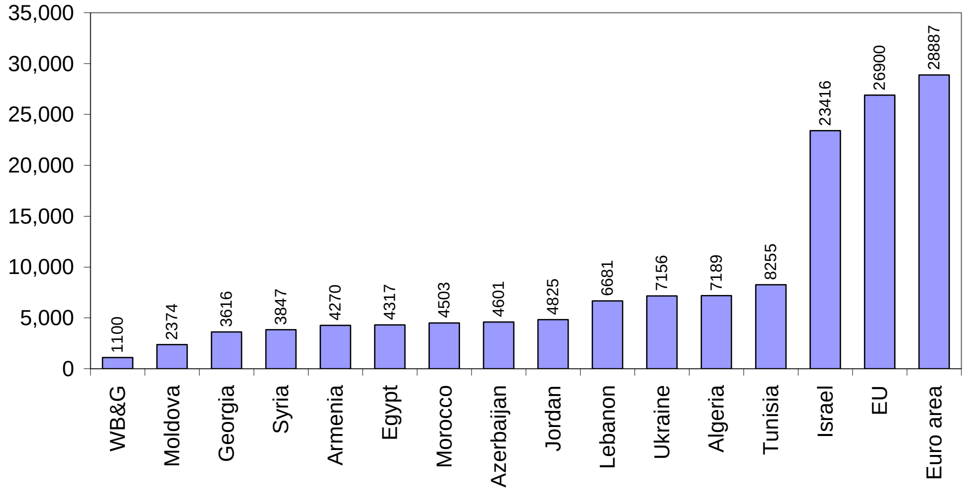
The concern of the ENP about improving economic growth is justified. There is a welfare divide between the EU and the neighbourhood countries. While most EU member states are high-income countries, the World Bank lists most ENP countries as lower-middle income, and Moldova and the West Bank and Gaza as low-income economies. The GDP per capita based on purchasing power parities is more than ten times higher in the EU than in the poorer ENP countries (Chart 1).

This welfare gap can be overcome by an economic catching-up process in the ENP countries.[2] However, recent academic and policy discussions have emphasised that the growth performance of Mediterranean ENP countries has been disappointing since the mid 1980s. The eastern ENP countries, on the other hand, had to cope with a huge contraction in per capita income at the beginning of their transition to market economies in the early 1990s. Most of them have grown strongly since the mid-1990s but except Armenia they have not yet recovered to their pre-transition income levels.

[2] The G-20 (2005a) “Accord for Sustained Growth, Stability, Competition and Empowerment” provides an important orientation for all countries interested in mobilising economic forces for satisfactory long-term growth. The G-20 Accord addresses reforms in three major policy areas which are of crucial importance for growth: monetary and financial stability, domestic and international competition, and empowering the people and reducing poverty.

Chart 1: 2005 GDP per capita

PPP, USD



Source: IMF WEO, April 2006.

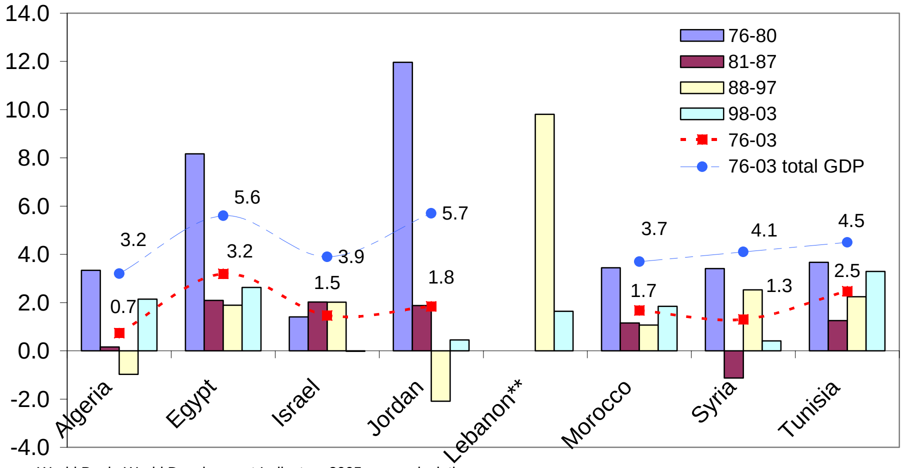
This article aims to determine the main factors that may have held back economic growth: first, by identifying the growth contributions of capital, labour and total factor productivity (TFP) on the basis of the standard neoclassical model, and second by analysing the determinants of capital formation, such as the cost of capital, and of TFP, which according to modern growth theory is determined by politics and institutions, international economic integration and innovation.

The paper is organised as follows: section 2 contains a description of per capita income growth in the ENP countries. While growth in the Mediterranean ENP countries is analysed over the period 1976-2003, the analysis of eastern ENP countries focuses mainly on the transition period (data covers the period 1980-2004) due to data limitations. In section 3, a standard growth accounting framework is applied to identify the contribution of investment and total factor productivity to per capita income growth. Since population growth is assumed to be exogenous for simplification, the analysis focuses on total GDP growth as a determinant of per capita income growth. In section 4, the probable determinants of investment and TFP, which is a key driver of economic development, are discussed. Section 5 provides a short conclusion.

2. Growth performance

Over the period 1976-2003, average annual growth rates of GDP per capita in the Mediterranean ENP countries ranged between 3.2% in Egypt and 0.7% in Algeria. Egypt and Tunisia doubled their income per capita. The growth rates of all countries were highest in the period before the 1981 oil-price peak. In most countries of this group the average growth rates of per capita GDP fell to a low in the following period of falling oil prices and then rebounded, but without ever reaching the original high growth rates. In the early 1990s, GDP in the eastern ENP countries contracted substantially as a result of the Soviet Union disintegrating and the adjustment from central planning to market economies. Despite rebounding growth since the late 1990s, per capita income has not yet recovered to its pre-transition levels.

Chart 2: Annual average GDP per capita growth rates (%)*



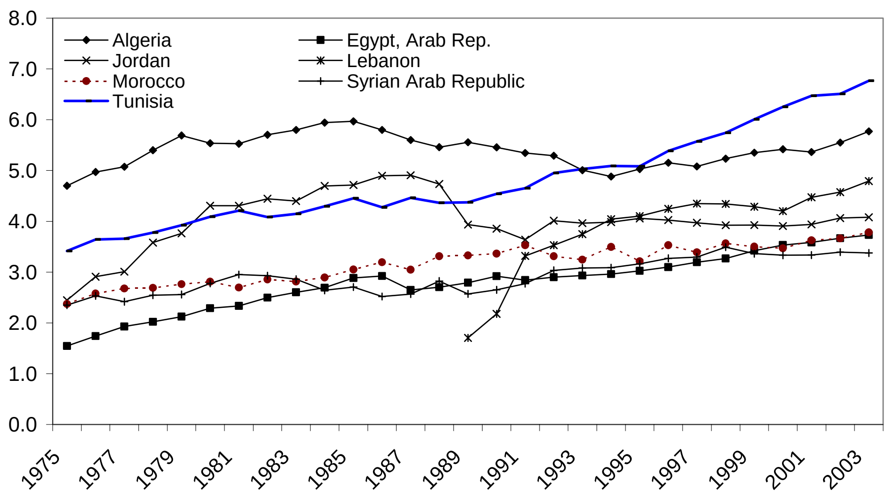
Source: World Bank, World Development Indicators 2005, own calculations.
* Based on GDP at purchasing power parities.
** Calculations based on data from 1989 onwards.

Mediterranean neighbours

Average annual growth rates of GDP per capita at purchasing power parities (PPP) over the period 1976-2003 ranged between 0.7% in Algeria and 3.2% in Egypt (Chart 2). Over this period, the per capita income growth of Egypt, Tunisia, Jordan and Morocco was higher than the EU15 average of about 1.6% per annum. However, the Mediterranean ENP countries lagged behind the dynamic emerging economies, for instance in South East Asia. Growth rates in all countries except Israel were highest in the period leading to the 1981 oil-price peak. Israel started with lower average growth than the others, and stagnated during the last period (1998-2003), which was characterised by increased tension in the context of the second intifada that began in 2000.

In Algeria, Syria and Tunisia the growth of per capita income fell to a low after the first oil price boom and has rebounded since then over the successive sub-periods. However, they never again reached the rates of the period before the 1981 oil-price peak. Tunisia experienced the steadiest recovery. Algeria and Syria, both important oil exporters, had to cope with several years of depression.

Chart 3: GDP per capita in Mediterranean countries
(PPP, constant 2000 USD thousand)



Source: World Bank, World Development Indicators 2005.

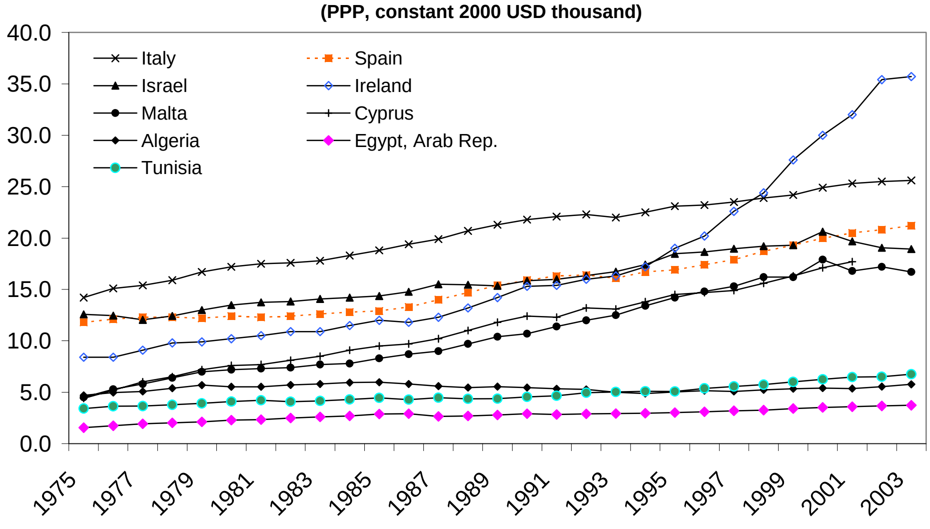
Jordan also experienced a contraction in 1988-1989 which was caused by a financial crisis. In addition, foreign trade with Iraq – an important trading partner – collapsed, and economic relations particularly with the West were damaged by Jordan having maintained relations with Iraq during the first Gulf War. This prolonged the depression of per capita growth in 1991. Algeria's economic performance was held back, inter alia, by years of domestic political conflicts but it has improved significantly in recent years thanks to the recent oil price boom. Lebanon increased its income per capita impressively recovering by the early 1990s from the economic crisis caused by the 1975-90 civil war.[3]

The differences in per capita income growth rates have had important implications for the catching-up process. In fact, the highest and lowest average annual growth rates over the period 1976-2003 implied that it would take 22 years for Egypt to double its per capita income and 100 years for Algeria to do so. In fact, only Egypt and Tunisia achieved this feat (Chart 3).

Most countries in the group made only limited progress in reducing the welfare gap with the EU because of comparatively low GDP growth and high population growth (Chart 2). In the slow-growing countries, the welfare gap with the EU has even widened. Israel, having started with a per capita income that was more than twice the level of Algeria's (the richest Arab country in the group), kept its advanced position despite an average annual per capita income growth rate of only 1.5%. In fact, it is now at level with some southern EU member states (Chart 4).

Despite the rather disappointing growth experience of Mediterranean ENP countries, the performance of some countries demonstrates that the ambitions of the Barcelona Declaration concerning the reduction of the welfare gap with the EU are achievable, if the necessary country-specific policy reforms are effectively implemented.[4]

Chart 4: GDP per capita in Mediterranean and EU countries
(PPP, constant 2000 USD thousand)



Source: World Bank, World Development Indicators 2005.

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[3] Lebanon also suffered from the military campaign of Israel against the resident PLO forces at the beginning of the 1980s, and was occupied by Israeli forces from 1978 until 2000 and by Syrian forces from 2000 until 2005.

[4] Falcetti et al. (2000, pp. 3, 15) find that initial conditions make an important difference for the economic performance of transition countries (in Central and Eastern Europe, the Baltic states, and the Commonwealth of Independent States). However, "the importance [of initial conditions] wanes over time and, after ten years of transition, can no longer be considered the main explanatory factor." Godoy and Stiglitz (2006, p. 16) confirm that "initial conditions seem to have little effect on growth after ten years of transition."

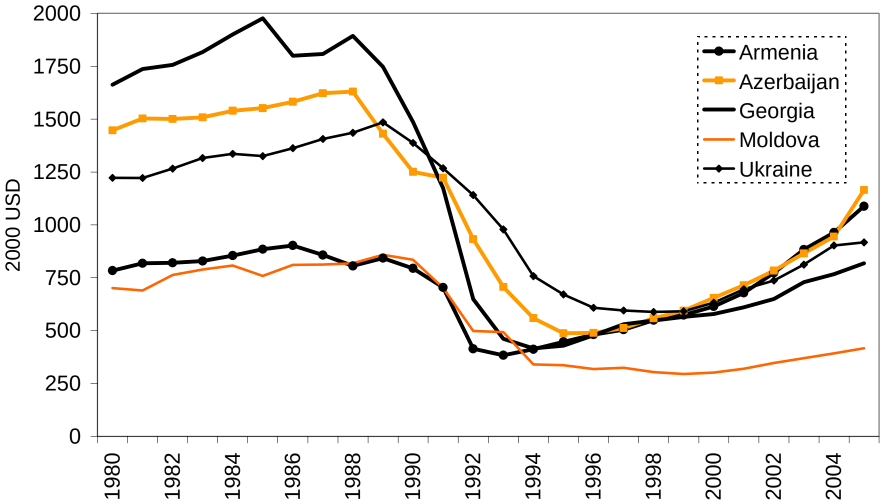
Cyprus and Malta, which shared the same GDP per capita level with Algeria in 1975 (then the richest Arab Mediterranean ENP country), achieved a higher growth path than the other Mediterranean countries from 1976 onwards. By the middle of the 1990s they reached the per capita income level of some southern EU economies. Within the EU, Ireland – once one of the poorest EU member states – has seen a dramatic improvement of living standards. It overtook the other member states (EU15) in terms of GDP per capita (PPP) by the end of the 1990s, and its per capita income is now about USD 10 000 higher than that of Italy or France, while it was around USD 7 000 lower in 1975 (Chart 4).[5]

Eastern neighbours[6]

The five ENP countries to the east of the EU, Azerbaijan, Armenia, Georgia, Moldova and Ukraine all experienced hardship following the collapse of the Soviet Union and embarked on a rapid transition towards a market economy. Within the Soviet Union, GDP per capita varied significantly, with Moldova and Armenia being significantly poorer than the other eastern ENP countries in the 1980s (Chart 5). Growth was robust in all eastern ENP countries in the early 1980s, but the contraction that started in 1988-1989, preceding the collapse of the Soviet Union, and lasting for about seven years, more than halved GDP.

Georgia and Armenia, the countries with the largest and the smallest contraction, had to cope with a GDP per capita reduction of 77% and 57%, respectively (Table 1). Armenia embarked on a steady growth path from 1994 onwards, and thus enjoyed the earliest recovery. While some of the eastern ENP countries initially had a better starting point, all but Moldova converged towards a similar path of recovery, with Azerbaijan now taking the lead. Though having almost the same starting point as Armenia, Moldova's contraction was more prolonged and its recovery much more modest.

Chart 5: GDP per capita in transition countries



Source: Word Bank's WDI 2005, WEO April 2006 and own calculations.

[5] Barry (2004) presents an overview of the reasons for Ireland's success.

[6] The limitations of GDP statistics for transition economies are described by the World Bank (2002, p. 8).

Table 1: Contraction depth and length

	GDP per capita reduction (%)	Years of contraction	Contraction period	GDP per capita growth recovery - 2005 (%)	GDP per capita 2005 USD (estimate)
Armenia*	57 (54)	7 (4)	1986(89) - 1993	165	1017
Azerbaijan	70	7	1988 - 1995	128	1114
Georgia	77	7	1988 - 1995	97	843
Moldova*	63 (66)	7 (10)	1989-1996(99)	33 (43)	422
Ukraine	60	8	1989-1997	60	975

* GDP per capita in Armenia recovered temporarily in 1989, figures for the shorter contraction period starting in 1989 are given in brackets. Similarly GDP in Moldova contracted again in 1998-99 and data for the longer period until 1999 are given in brackets. GDP per capita is in constant 2000 USD.
Source: IMF, World Bank and own calculations.

The transition has altered the sector-composition of GDP. The regime-shift was particularly harsh for the industrial sector, and not least for manufacturing, which couldn't easily accommodate to new demand patterns and increased competition. The service sector was similarly struck by regime collapse in some countries, including Georgia and Armenia. The flipside of the coin is that agriculture's share in GDP increased dramatically in the early 1990s and temporarily accounted for more than 40% of GDP in Georgia, Moldova and Armenia (Chart 6). The subsequent recovery was particularly successful in the service sector while, in general, industry started to increase its share in GDP from around 2000.

Chart 6: Sector decomposition of GDP

Sources: World Bank's World Development Indicators and national statistics.

These developments are now bringing the sector composition in the eastern ENP countries nearer the EU average, where agriculture only accounts for about 2.2% of GDP while services accounts for almost 70%. Ukraine resembles the EU sector composition most with a large service sector[7] (46% of GDP) and a small agricultural sector (14% of GDP), but even Ukraine's dependency on the agricultural sector is high compared with the EU.

Despite the rapid decline in agriculture's share in GDP the share of the labour force engaged in agricultural activities continued to increase until the late 1990s and today represents about 50% of the labour force in Moldova and Georgia, 40% in Armenia and Azerbaijan, and about 20% in Ukraine.[8] As with the sector decomposition of GDP, Ukraine's labour force structure best resembles the EU average, though agriculture in Ukraine still absorbs a far larger share of the labour force than in high income OECD countries where on average less then 4% are employed in this sector.

The sector decomposition reveals that the industrial base is particularly slim in Georgia and Moldova, which are also the two poorest countries. In Azerbaijan, large-scale oil sector investments and oil extraction are accounting for a growing part of the economy and has driven the industrial sector's share in GDP above 50%. While Azerbaijan will experience a period of high oil-driven growth, the future of the other eastern ENP countries is much more reliant on their ability to foster continued growth in the service sector supplemented by a continued restructuring of the industrial base. Manufacturing has been on a downward trend during the whole transition period and is now approaching the EU15 average (19% of GDP).

A demand decomposition of GDP reveals that consumption has made up a high share of GDP during transition in all five countries but Ukraine. Consumption expenditures were higher than GDP in Georgia in 1992-97, in Armenia in 1992-2000 and in Moldova since 2000. In the ECA region and in the high-income OECD countries consumption amounted on average to about 80% of GDP. Investment is more in line with regional and high-income OECD averages (20%-22% of GDP), with the exception of Azerbaijan where the large-scale investments in the oil sector temporarily have driven the investment ratio above 50% of GDP in 2003-2004. The trade balance of goods and services shows substantial deficits (15%-34%) for all countries but Ukraine (+5%), which has benefited from high metal prices.

The main driver of GDP *growth* during the recovery in the five eastern ENP countries has been domestic demand, although exports are becoming an increasingly important growth component (Table 2). Consumption contributed negatively to growth until 1995, but has contributed robustly to demand growth since then. While consumption growth has been steady in Azerbaijan, it has been much more prone to business cycle fluctuations in the other eastern ENP countries with a considerable dip around 1999-2000, following the 1998 Russian crisis. Investment growth was high in the second half of the 1990s in Azerbaijan and Georgia only, but has recently picked up in all countries and is emerging as a driver of demand growth, albeit with great volatility.

Export growth has picked up since 1996, and is becoming an important contributor to growth in all countries, although exports have been somewhat volatile, for instance in Georgia. In Azerbaijan and Moldova import growth rates are outperforming exports and while this is explained by high investments in the case of Azerbaijan, the situation is less promising in Moldova where investment is the slowest growing demand component.

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[7] The service sector in Ukraine is however still influenced by its Soviet inheritance and is only partially market driven.

[8] The latest employment data available from the World Bank's WDI are for 2001 for most of the countries.

Table 2: Growth in demand components

Annual averages (%)	**Armenia**	**Azerbaijan**	**Georgia**	**Moldova**	**Ukraine**
GDP					
1990-94	-14.1	-16.0	-25.2	-16.9	-12.5
1995-99	5.3	2.2	6.0	-3.2	-5.6
2000-04	10.5	10.6	5.8	5.9	8.3
Private consumption					
1991-94	-10.6	-	-	-	-13.7
1995-99	5.3	8.8	5.9	5.8	-2.8
2000-03	7.9	12.1	2.3	11.1	0.4
Public consumption					
1991-94	-1.8	-	-	-	-0.5
1995-99	-1.1	5.9	18.3	-14.2	-5.4
2000-03	4.9	8.1	-6.6	14.5	5.9
Investment					
1991-94	-28.4	-	-49.6	-	-27.0
1995-99	-0.9	40.6	22.2	-8.6	-10.9
2000-03	20.1	40.5	12.8	6.7	5.8
Export					
1991-94	-27.1	-	-	-	-19.0
1995-99	-11.7	3.8	7.0	1.6	2.0
2000-03	22.7	11.7	11.6	16.0	9.4
Import					
1991-94	-20.6	-	-	-	-23.2
1995-99	-6.9	16.0	8.2	6.1	-2.2
2000-03	12.9	25.6	4.0	20.5	9.7

Source: World Development Indicators and own calculations.

3. Growth accounting

Growth accounting helps to explain economic growth by identifying the contributions of factor accumulation and, as a residual component, total factor productivity (TFP). The basics of growth accounting were first presented in Solow (1957). We consider the factors normally applied in growth accounting, which are labour and capital and, as a residual TFP, which captures the efficiency of the economy and is dependent on innovation, politics and institutions and international economic integration (see section 4). The role of TFP is essential because it influences growth directly and also indirectly by stimulating the marginal productivity of capital.[9] The methodology applied is explained in the annex.

In the Mediterranean ENP countries the speed of capital formation slowed down continuously in the period 1976-2003. Capital intensity grew only modestly because high employment growth on the back of rapid increases in population offset the growth of the capital stock. TFP growth rates decreased; in two cases TFP even shrank over the period. In the eastern ENP countries a sharp drop in TFP and a contraction of the capital stock materialised in the wake of the collapse of the Soviet Union. Rebounding growth in the period 2000-04, driven by economic restructuring and factor reemployment, was accompanied by high rates of TFP growth and, in most cases, by a continued contraction of capital intensity.

[9] Therefore, empirical studies which compare only the direct contributions of factor accumulation and TFP to growth tend to underestimate the importance of TFP.

Table 3: GDP growth rates and components

Annual averages (%)	Algeria	Egypt	Israel	Jordan	Morocco	Syria	Tunisia
GDP PPP*							
1976-80	6.5	10.8	3.8	16.2	5.8	6.7	6.4
1981-87	3.3	4.7	3.8	5.8	3.4	2.2	4.0
1988-97	1.3	4.1	5.0	2.4	3.0	5.8	4.1
1998-03	3.7	4.6	2.3	3.4	3.5	2.9	4.5
1976-03	**3.2**	**5.5**	**3.9**	**5.8**	**3.7**	**4.4**	**4.6**
TFP*							
1976-80	1.3	5.3	0.6	9.3	0.3	-0.5	0.6
1981-87	-1.1	-0.6	0.9	0.2	-0.1	-2.0	-0.1
1988-97	-1.8	0.7	1.0	-3.8	-0.1	1.3	0.7
1998-03	0.8	1.3	-0.9	-0.2	0.6	-1.2	1.3
1976-03	**-0.5**	**1.3**	**0.5**	**0.2**	**0.1**	**-0.4**	**0.6**
Capital PPP*							
1976-80	9.0	11.0	4.5	14.6	10.2	15.8	9.3
1981-87	5.3	11.2	3.9	7.9	5.6	6.6	6.3
1988-97	1.6	4.7	4.4	5.7	4.4	5.2	4.4
1998-03	1.4	3.7	3.4	2.8	4.0	4.4	4.3
1976-03	**3.8**	**7.2**	**4.1**	**7.2**	**5.6**	**7.2**	**5.7**
Labour							
1976-80	3.2	2.4	2.5	2.3	3.1	3.1	4.0
1981-87	4.0	2.5	2.3	4.4	2.5	3.2	2.9
1988-97	4.0	2.7	3.7	6.9	2.4	4.1	2.9
1998-03	3.7	3.1	3.1	4.1	2.4	4.0	2.7
1976-03	**3.8**	**2.7**	**3.0**	**4.8**	**2.6**	**3.7**	**3.0**

Source: Data from World Development Indicators 2005, own calculations.

* At purchasing power parities (constant 2000 US dollar).

** Total factor productivity.

Mediterranean neighbours

In all Mediterranean ENP countries, except Algeria, the main contribution to growth over the 1976-2003 period came from an increase of the capital stock which grew at annual average rates ranging from 3.8% in Algeria to 7.2% in Egypt, Jordan and Syria (Table 3). However, the growth rates of the capital stock shrank continuously in all countries (except Israel) after the 1976-1980 sub-period, which ended with the second oil crisis. Employment grew at lower rates of between 2.4% in Morocco and 4.1% in Jordan.

Remarkably, TFP growth was very low or even negative in all countries.[10] This was a major handicap because TFP growth feeds directly into GDP growth but has also a major impact on capital formation through its positive effect on the marginal productivity of capital (Annex). TFP growth was negligible in Jordan and Morocco, and negative in Algeria and Syria. Egypt showed the highest annual average increase in TFP of 1.3%.[11] It was the only country in the group with higher average TFP growth than in the EU (1.0%).[12] Other studies confirm that TFP growth in the Mediterranean ENP countries is exceptionally low. Wolff (1991) estimates that the mean average annual TFP growth rate in the G7 amounted to 0.9% in the period from 1880-1938, and to 2.6% from 1950-1979.[13]

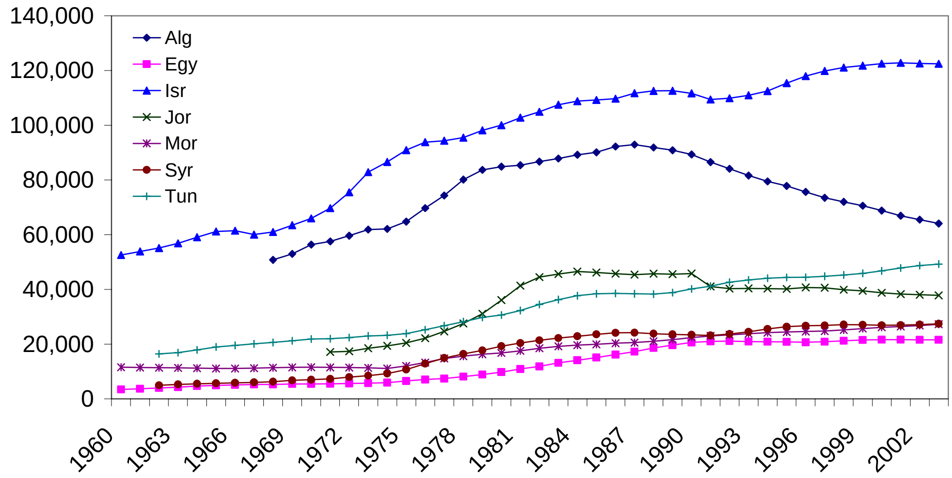
[10] This result is in line with recent IMF findings: Bouhga-Hagbe et al. (2005) on Morocco, and Ivanova (2005) on Egypt.

[11] The shadow economy in the Mediterranean countries is sizeable. “Estimates of informal employment range from a low of 42% of non-agricultural employment in Syria to a high of 55% in Egypt.” (Agénor et al., 2004, p. 5) This should however not affect TFP growth, as long as there are no significant changes in the shadow economy size.

[12] European Economy, Statistical Annex, Spring 2005.

[13] The income level of the poorest Mediterranean countries (Chart 1) compares to the income level of Western Europe at the beginning of the 1900s, calculated by Maddison (2003).

Chart 7: Capital intensity
(capital per person employed, PPP)



Source: Data from World Bank, World Development Indicators 2005, own calculations.

For East Asia in the 1966-1990 period, Young (1995) found that the *ratio of TFP growth to GDP growth* in Korea, Taiwan, and Hong Kong amounted to 16%, 27%, and 31% respectively. In the partially overlapping 1976-2003 period, only Israel, Tunisia (both 13%) and Egypt (23%) can compare with the Asian frontrunners, whereas Morocco and Jordan achieved relatively low ratios of only 3% each. TFP growth in Syria and Algeria was negative and amounted (in absolute terms) to 9% and 16% of GDP growth.

A sustainable increase of the capital stock per worker employed (accompanied by sufficient rates of TFP growth) is a pre-condition for the economic catching-up process of the Mediterranean ENP countries with the EU. So far, only Algeria and Israel (Chart 7) have capital intensities comparable to the endowment of the EU's southern member states as Miketa's (2004) data show. The other Mediterranean ENP countries still have to accumulate sizable productive net investments to reach that level. In 2003 Israel's capital intensity was about twice the size of Algeria's which had the second highest capital intensity among the Mediterranean ENP countries.

The capital intensity almost doubled in the period 1976-2003 in Syria, Morocco and Tunisia, and tripled in Egypt (Chart 7). Most other countries augmented their capital intensity somewhat, though the slowing down of capital stock growth also led to decreasing growth rates of capital intensity. In Algeria and Jordan the capital intensities declined from the end of the 1980s.

The TFP contraction in Syria over the period 1976-2003 by an annual average rate of 0.4% and the almost stagnant TFP in Morocco are important factors explaining why the increases of capital intensity in these two countries were not rewarded by comparative per capita income increases (Chart 3). A relatively low labour participation rate (or high structural unemployment) might also have played a role. Only in Tunisia and Egypt, which doubled their per capita income, did higher capital intensity together with relatively high TFP growth bring about a marked improvement of living standards.

Eastern neighbours

Since the fall of the Soviet Union and the deep economic recession that ensued, GDP growth in eastern ENP countries has relied mainly on productivity gains, while the rate of capital

Table 4: GDP growth rates and components

Annual averages (%)	**Armenia**	**Azerbaijan**	**Georgia**	**Moldova**	**Ukraine**
GDP					
1980-84	3.8	3.2	4.2	4.6	2.6
1985-89	1.2	0.1	-0.9	2.2	2.5
1990-94	-14.1	-16.0	-25.2	-16.9	-12.5
1995-99	5.3	2.2	6.0	-3.2	-5.6
2000-04	10.5	10.6	5.8	5.9	8.3
1980-04	**0.9**	**-0.5**	**-3.1**	**-2.1**	**-1.4**
TFP					
1980-84	0.6	0.4	2.2	2.6	1.1
1985-89	-1.1	-1.8	-2.4	0.8	1.5
1990-94	-13.1	-16.4	-23.4	-16.4	-12.5
1995-99	6.9	1.7	8.0	-1.3	-3.1
2000-04	9.1	8.9	6.7	6.0	8.7
1980-04	**0.1**	**-1.9**	**-2.7**	**-2.2**	**-1.2**
Capital					
1980-84	5.3	5.3	4.3	4.7	3.9
1985-89	3.2	3.2	2.9	3.0	2.7
1990-94	0.5	-1.0	-1.5	-0.5	0.4
1995-99	-1.7	-1.5	-3.1	-2.2	-1.9
2000-04	0.0	0.4	-1.9	-2.3	-1.8
1980-04	**1.2**	**1.0**	**-0.1**	**0.3**	**0.5**
Labour					
1980-84	1.8	1.1	0.5	0.3	-0.1
1985-89	1.7	1.1	0.5	0.2	-0.2
1990-94	-2.2	1.4	-1.8	-0.3	-0.2
1995-99	-1.5	1.9	-1.3	-1.8	-2.9
2000-04	2.4	2.6	-0.3	1.3	0.6
1980-04	**0.4**	**1.6**	**-0.5**	**-0.1**	**-0.6**
Factor contribution*					
1980-84	3.2	2.8	2.0	2.0	1.5
1985-89	2.3	1.9	1.5	1.4	1.0
1990-94	-1.0	0.4	-1.8	-0.4	0.0
1995-99	-1.6	0.5	-2.0	-1.9	-2.5
2000-04	1.5	1.7	-0.9	-0.1	-0.3
1980-04	**0.7**	**1.4**	**-0.4**	**0.1**	**-0.2**

Source: WDI, national statistics, Broeck and Koen (2000) and own calculations.

* The total contribution of capital and labour to GDP growth (calculated as labour and capital growth weighted with capital and labour income shares, or simply as GDP growth minus TFP growth, see also appendix).

accumulation has been low or negative, reflecting the decline of obsolete capital-intensive sectors during the transition process.

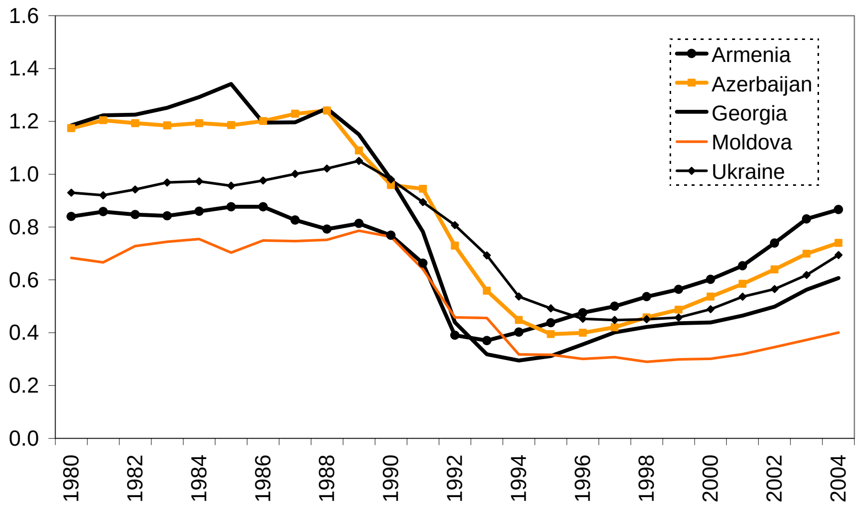
At the end of the Soviet era growth relied mainly on capital accumulation in all the five eastern ENP countries (Table 4). In the early 1980s, unproductive investment with low productivity growth as a result of central planning, and the Soviet "extensive growth" model which aimed at maximising growth by raising industrial investment, was evident mainly in Armenia and Azerbaijan. The economic crisis intensified in the second half of the 1980s with a fall in capital growth in all countries and negative TFP growth in the three South Caucasus countries. Moldova also experienced a slowdown in investment and productivity growth in this period, while output growth in Ukraine was almost unaffected.

After a decade of modest productivity growth a sharp drop in TFP materialised in the early 1990s (Chart 8) in the wake of the collapse of the Soviet Union. The steep productivity fall was largely a result of the adjustment of production from planning to a market economy, with a sudden disruption of trade and production networks, and new market-determined prices, which rendered a major part of the capital stock partly valueless.

The fall in productivity and output in the early 1990s was followed by a prolonged downward adjustment in input factors, while technological progress became more diverse as countries started to recover at different speed. In 1995-99 the three South Caucasus countries made progress mainly driven by resumption in productivity, while the situation in Moldova and Ukraine continued to be dismal.

Since 2000 all the eastern ENP countries have experienced high productivity growth and factor accumulation has in general turned positive (especially labour). Continued depreciation of the large (but unproductive) capital stock inherited from Soviet times has however continued to drag on capital accumulation. With the exception of Armenia, overall productivity has not yet recovered to its pre-transition level. Our finding that the GDP contraction and the following recovery have been driven mainly by shifts in productivity is consistent with results in De Broeck and Koen (2000) and Havrylyshyn (2001).

Chart 8: Total factor productivity



Source: Word Bank's WDI 2005, WEO September 2005, De Broeck and Koen (2000) and own calculations.

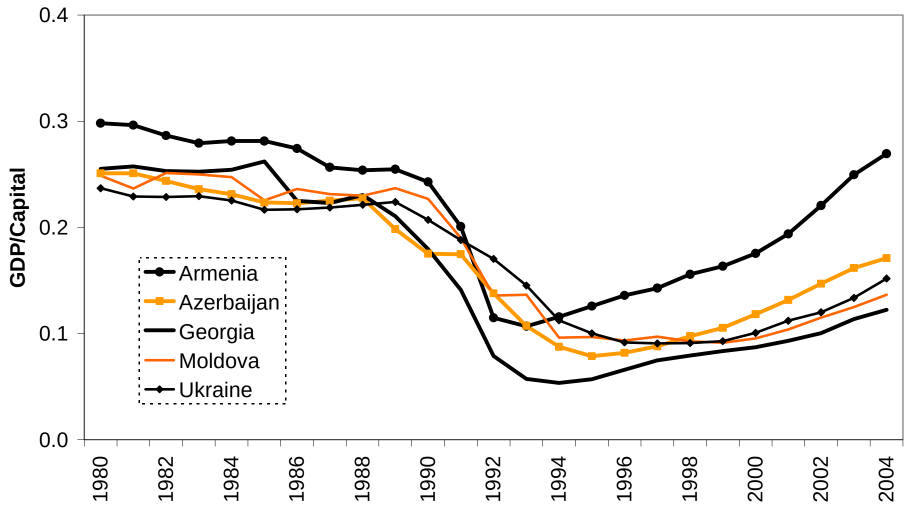
The reduction in productivity during transition in Armenia was less deep and TFP rebounded earlier and somewhat more strongly than in the other eastern ENP countries.[14] Armenia managed to achieve continued and relatively high growth shortly after the collapse of the Soviet Union (growth picked up from 1994, the year the ceasefire was signed in the Nagorno-Karabakh conflict). This was supported by major structural reforms implemented with international assistance, such as (mainly after the ceasefire) a stabilised exchange rate, mass privatisation and resumed energy supply (Ofer and Pomfret, 2004). Employment adjusted downward particularly in Armenia, not least because of the considerable emigration that took place (about 700 000 out of a population of 3.5 million (20%) emigrated after 1988, mainly in 1992-1994), but the impact of this on productivity and growth is difficult to assess. Georgia also showed high GDP and TFP

[14] The recession in Armenia also started early – not least because of the 1988 Spitak earthquake, which affected about 40% of the country's surface area and industrial base.

growth in 1996-97, though this early spur in growth has to be seen in light of the very dramatic fall in Georgia's GDP per capita – about 78% from 1988 to 1994.

GDP growth has been slightly higher in Azerbaijan than in Armenia since 1997, although productivity improvements during this period have been very similar in the two countries.[15] Growth in Azerbaijan has been driven more by capital investment (primarily in the oil sector) adding to an already high capital stock – a pattern that has become particularly apparent in recent years. In contrast, Armenia as well as Moldova have a low capital stock per employee. This difference in transition patterns can also be illustrated by developments in the output-capital ratio (Chart 9). Armenia is a special case with higher output per capital unit, while Azerbaijan's growth is more driven by capital accumulation. Azerbaijan will continue to accumulate a significant capital stock in the oil sector in the years to come.

Chart 9: Output - capital ratio in transition countries

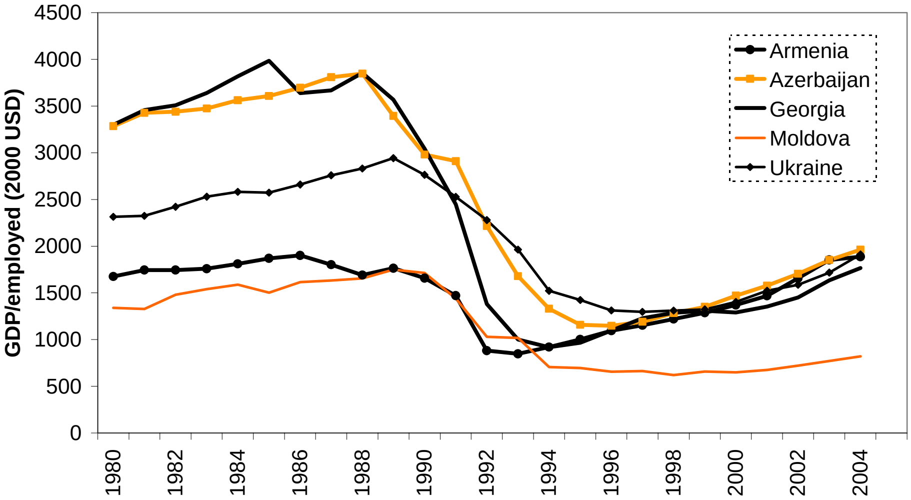


Source: Word Bank's WDI 2005, WEO September 2005, De Broeck and Koen (2000) and own calculations.

Moldova has experienced a delayed and distinctly more modest economic rebound than the other eastern ENP countries. In particular, TFP only started to recover in 2001. Factor accumulation has also been modest and the already low capital stock has continued to decline. In addition, outward migration resulted in a contraction of the labour force in the 1990s (when about 600.000 out of a population of 4.4 million (14%) emigrated). Moldova is in line with the other Eastern ENP countries (except Armenia) with regard to developments in the output–capital ratio during transition, but as it is endowed with a lower capital intensity this results in lower output per employed (Chart 10).

[15] Accumulated growth during 1997-2004 was about 67% in Armenia and 76% in Azerbaijan, while accumulated TFP growth in the same period was 63% and 65% respectively. Azerbaijan's GDP contracted by 11.8% in 1995 and this explains the low average annual growth rate for Azerbaijan in 1995-99 in Table 4.

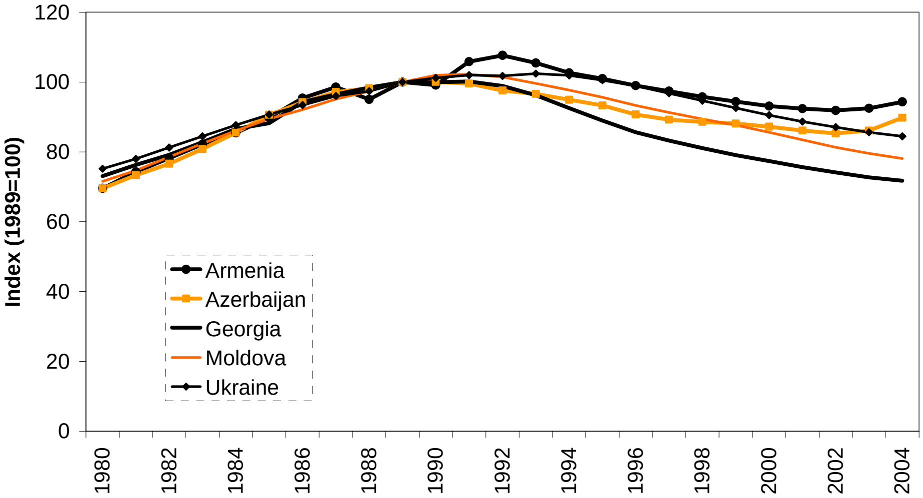
Chart 10: Output per employed



Source: Word Bank's WDI 2005, WEO April 2006 and own calculations.

Capital accumulation was negative in all five countries in the period 1995-1999, and even in 2004 capital accumulation appears to be positive in Armenia and Azerbaijan only (Chart 11). The continued decline in capital stock hinges on the high capital–output ratio implied by the De Broeck and Koen (2000) dataset and the use of a constant capital depreciation rate of 4% throughout the period.[16] The high capital intensity at the end of the Soviet era is supported by studies indicating a tendency to overinvestment in the communist regime, e.g. Easterly and Fischer (1994).

Chart 11: Capital stock in transition countries



Source: Word Bank's WDI 2005, WEO September 2005, De Broeck and Koen (2000) and own calculations.

Several results follow from the growth accounting presented here. First, further productivity growth is needed. Productivity is recovering, but has only reached pre-transition levels in Armenia. However experience also shows that the very high TFP growth rates experienced in all countries in 2000-2004 and driven by the continued transition process are unlikely to be

[16] The large reduction in GDP in the early transition years further increased the capital–output ratio. As a result the capital depreciation as GDP ratio broadly doubled and outweighed the gross fixed capital formation (which in most of the countries was about 20% of GDP), and as a result the net capital stock accumulation turned negative.

sustained for a prolonged period. Therefore there is an additional need to encourage and attract more investment.

The need to attract investment is eminent in Moldova and Armenia, endowed with only about half the capital stock per employee of the other eastern ENP countries. Azerbaijan (or rather Azerbaijan's oil sector) is an exception, as it is already attracting large scale investments. Finally, the willingness of and possibility for part of the population to emigrate and seek jobs abroad can impact on productivity at home, although the scale and even the sign of the impact is difficult to assess. One downside is that emigration may result in an increase in dependency rates, though this does not appear to have happened in practice.[17]

4. Determinants of investment and TFP performance

In Solow's (1956) neoclassical model, investment is inversely related to the marginal cost of capital and capital intensity per worker employed. It depends positively on the output elasticity of capital, and on TFP. Part of the output that growth accounting attributes to capital is, in fact, driven by productivity growth (Annex). Based on this insight, Helpman (2004) summarises convincing evidence that TFP plays a major role (more important than the contribution of factor inputs) in explaining the observed cross-country variation in income per worker and patterns of economic growth. In the following section the determinants of investment and TFP in the ENP countries are discussed.

Modern growth theory explains TFP inter alia by features of innovation, politics and institutions, and international economic integration. Product and process innovations are the drivers of productivity gains. They depend on education and on an environment which is conducive to research and open to changes. The quality of politics and institutions are important because they set the fundamental conditions which affect the incentives for innovation and investment.[18]

Integration with the world economy allows for gains thanks to the exploitation of comparative advantages in production, and access to the full range of specialised intermediate and capital goods. International trade also allows small open economies to grow substantially faster than in the state of autarky because they can overcome the diminishing returns of increasing capital intensity by climbing the quality ladder of production without significantly affecting their terms of trade.[19] The resulting specialisation of production affects the long-run growth rate, which depends on the favoured sectors' potential to reap productivity gains.

International integration also fosters the direct introduction of new technologies and know-how through trade and foreign direct investment. In addition, it may spur or slow down their domestic

[17] Dependency ratios have fallen in all five Eastern ENP countries and for the ECA region as a whole since 1995, partly because of declining life expectancy, in particular in the CIS.
[18] The importance of institutions for growth has been examined intensively in a fast-growing literature. See, for instance, Acemoglu, Johnson and Robinson (2002), Dollar and Kraay (2003), and IMF (2003).
[19] First, since they are not bound by the domestic demand structure, they can overcome diminishing rates of increasing capital stocks by dedicating parts of their production successively to more capital-intensive goods when the capital–labour ratio has reached a certain level. Since they start the production of the new goods with the minimum necessary capital intensity, they can increase the intensity here without diminishing returns until they switch over again to new goods, and so forth. Moreover, unlike large economies, they do not significantly influence their terms of trade, which are largely determined on the world markets. Consequently, their terms of trade do not suffer from increasingly capital-intensive production so that their export revenues in terms of foreign goods do not diminish (see Helpman (2004) pp. 57 ff., and Ventura (1997) pp. 79 ff.). The "Asian tiger economies" have followed this course of development.

research and development (R&D) efforts with a corresponding impact on TFP and long-run growth. Despite the uncertain impact of some individual factors on R&D and on growth, the evidence suggests a negative effect of protection on growth.[20] Finally, global integration makes it possible to finance the implementation of innovations on international capital markets.

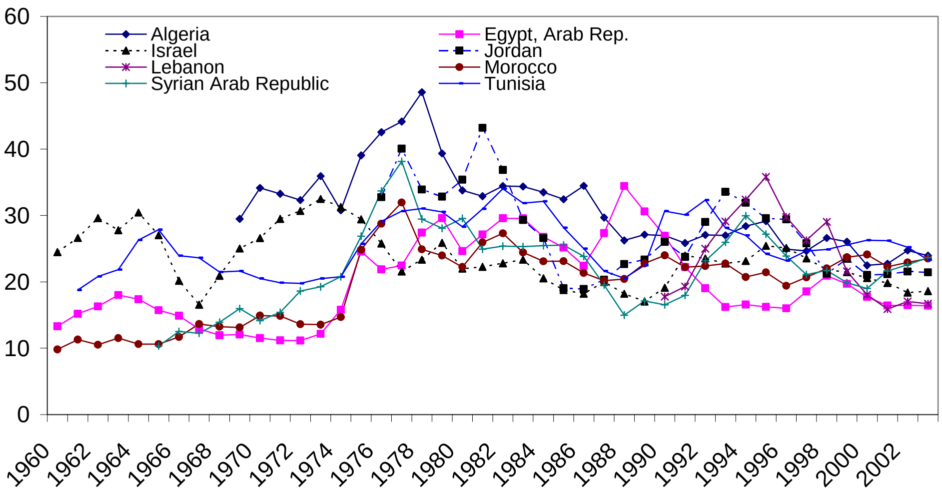
Mediterranean neighbours[21]

Potentially, the Mediterranean ENP countries could have been highly attractive for investment because of relatively low capital intensities. However, in the period 1976-2003 this stimulating factor was offset by low and stagnating, sometimes even shrinking, TFP. In addition, in four countries, real interest rates rose for a substantial period of time against the world trend. The dismal TFP development can be explained, in particular, by protracted domestic and external conflicts, problems related to the rule of law, unsatisfactory business environments, macroeconomic instability, limited international integration, specialisation in the export of raw materials, and relatively low education levels.

A) Investment

Gross fixed capital investment ratios in the Mediterranean ENP countries have stagnated or even declined since the end of the 1970s (Chart 12). The unweighted average investment ratio (excluding the West Bank and Gaza) declined from a maximum of about 33% in 1977 to 21% in 2003, with Egypt, Lebanon and Israel below average (16%, 17% and 19%, respectively).[22] This is mainly explained by low TFP and relatively high real interest rates.

Chart 12: Gross fixed capital formation (% of GDP)



Source: World Bank, World Development Indicators 2005.

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[20] Helpman (2004, pp. 64 ff.) summarizes the respective literature. Access to the world market can encourage research and development (R&D) by raising profit expectations (*market size effect*), and by the need to develop better products in a larger market rather than in a limited domestic environment. However, the impact of increased international competition also depends on whether it reduces profits, which may reduce R&D efforts, or whether technological leaders increase their R&D activities to remain at the top (*competition effect*). Depending on how trade and FDI change the domestic factor price for R&D inputs, R&D may expand or shrink (*price effect*). TFP growth also depends on whether R&D spills over across firms only domestically or internationally.

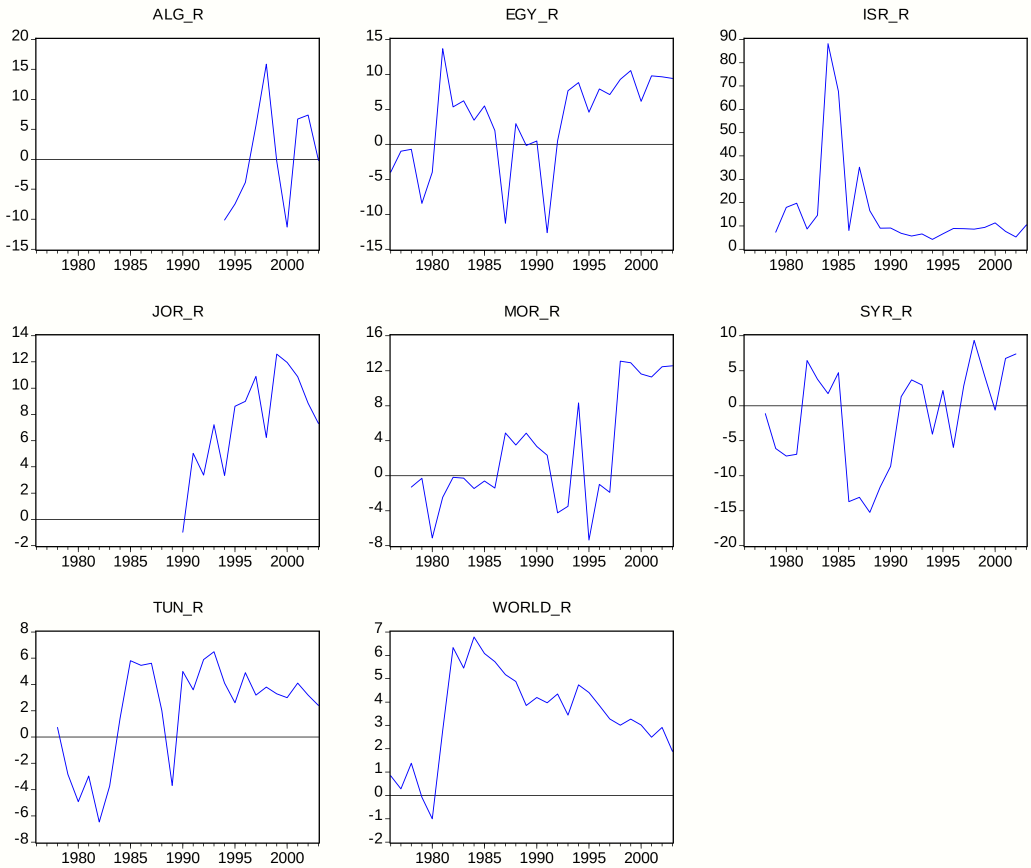
[21] Unless specified otherwise, the source for data in the text is: World Bank, World Development Indicators 2005.

[22] Fischer (1996) advised that growth in the Mediterranean region will not reach its potential "until the rate of investment rises toward 25% of GDP, closer to the 30%-plus common in East Asia". However, the 1997 Asian crisis pointed to the need for a county-specific evaluation of what could be an optimum investment ratio.

The fact that the Mediterranean ENP countries did not catch up by increasing capital intensity towards the average EU level (Annex) can be explained to a large extent by their low and stagnating (and in some cases shrinking) TFP. From 1976 onwards all countries experienced prolonged periods with shrinking TFP (Table 3). In Algeria and Syria TFP growth was negative throughout the whole period. The low TFP levels offset the positive stimulus from low capital intensity on investment.

An upward trend of the real interest rates in Morocco in the period 1976-2003, and during the 1990s in Egypt, Jordan and Syria (Chart 13), also dampened capital formation. In some countries, the volatility of interest rates could also have reduced investment. Incomplete financial markets in the Mediterranean made it difficult to finance long-term investment with matching funds, and investors might have shied away from financing them with uncertain short-term rates.

Chart 13: Real interest rate (%)*



*) Lending rate adjusted by the GDP deflator (Tunisia: money market rate over CPI from 1990 onwards).
Data sources: IMF, World Bank.

The trend increase of real interest rates was a result of increasing scarcity of financial capital.[23] Since Mediterranean ENP countries are yet to be fully integrated in the world capital markets and since their credit supply from international markets is limited by country risk, their real interest rate is determined to a large extent on the domestic market. It is noteworthy that most Mediterranean ENP countries are short of investment grade (Table 5). The supply of financial capital on the domestic markets was restricted by their limited development and efficiency. This

[23] The necessary and successful reduction of sometimes double digit inflation rates also contributed (by definition) to a rise in real interest rates.

Table 5: Country risk ratings (December 2005)

	Algeria	Egypt	Israel	Jordan	Lebanon	Morocco	Syria	Tunisia
Rating	BB	BB	BBB	BB	CCC	BB	CCC	BBB
Rank[1]	41	46	33	46	61	41	64	40

[1] Best rank = 1 (based on 100 countries).
Source: Economist Intelligence Unit (EIU), January 2006.

problem was aggravated in some countries (e.g. Algeria and Egypt) with state-dominated banking systems where financial resources were allocated according to non-economic criteria.[1]

On the demand side, in some countries the legal difficulties involved with using land as collateral (for instance, common ownership), and the lack of land registers or credit registers made it particularly difficult for small and medium-sized enterprises to obtain loans.[2] Furthermore, public sector borrowing increasingly crowded out the private sector. In some cases, capital flight drained the capital markets.

Adverse economic and political developments sometimes had a major impact on domestic lending rates. In 1983-84 interest rates in Israel increased strongly due to a financial crisis. In Algeria, the risk premium paid by prime Algerian enterprises increased from -0.5% in 1994 to 19% in 1995 against the background of domestic policy tensions and terrorist threats. It remained at that level in 1996, decreased to 12.5% in 1997, and to normal levels (1%) only in 1998. These factors contribute to the explanation why Algeria had the lowest average growth rate of the capital stock (and the biggest contraction of TFP) over the last decades.

B) Total factor productivity

Politics and institutions

The importance of *political and economic stability* for economic incentives and activity is evident. Many Mediterranean ENP countries have been riddled with political tensions and military conflicts over long periods of time (Table 6). Domestic and international conflicts drain economic resources for policing or military purposes and limit the possibility of trade and access to the international capital markets.[3] Overall, the observed conflicts are likely to have dampened TFP growth considerably over the period 1976-2003. It is noteworthy that Egypt and Tunisia, which are among the three countries without significant conflicts in that period, experienced the strongest TFP growth (Table 1).

Furthermore, the *rule of law* is evidently one of the most important public goods and a necessary condition for a thriving economy. It requires, inter alia, that the government provides a well-functioning judiciary and police force to enforce the law. It also requires decisions to be made impartially without corruption. Godoy and Stiglitz (2006, p. 16) find that "consistent with earlier

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[1] Fries and Taci (2002) conclude from a panel of 515 banks in central and eastern European countries during 1994-1999 that privatised banks are expanding more rapidly than state-owned banks and that the presence of foreign banks in a banking system has a positive spill-over effect in spurring the real expansion of loans.
[2] Developed domestic financial markets act as an important catalyst for growth, in particular by providing liquidity to small and medium-sized enterprises which form the backbone of the economy. Pissarides (1998) shows this for central and eastern European countries.
[3] Indeed, against the general economic and political background only Tunisia is rated investment grade (Table 2), which helps ease its external financing restrictions and financing costs.

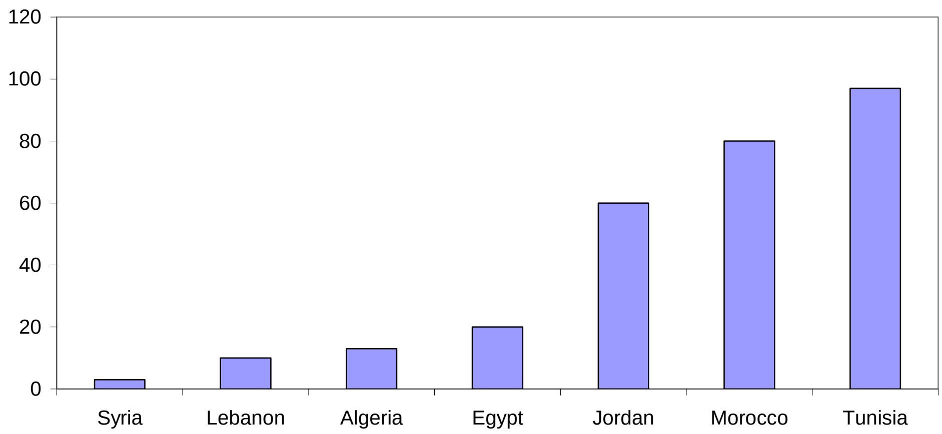
Table 6: Important civil or external conflicts

	Algeria	Egypt	Israel	Jordan	Lebanon	Morocco	Syria	Tunisia	WB&G
1976-80		W77	W78	W76, T79			T79		
1981-87			T84-00, I87-93,		CW 75-90, W82-84		T81, CW82, W82-84		O, T
1988-97	T90,		I00-03	GW		T90	T, GW		I
1998-03	CW 92-98			GW	T, O 98-00		T, GW		87-93, 00-03

Note: CW – civil war, GW – impact from Gulf war, I – intifada, O – occupation, T – tensions, W – war.
Source: www.wikipedia.org.

literature, property rights enforcement has a positive and very significant effect" on growth in transition economies. The fact that many Mediterranean ENP countries still display major weaknesses in this essential area (the related indicators in World Bank, 2005c) is another explanation for their weak growth performance.[27] For instance, it is relatively difficult to enforce contracts in Syria, Algeria, Egypt and Lebanon (Chart 14). Corruption is also a widespread phenomenon.

Chart 14: Quality of enforcing contracts regulations
Index based on a comparison of 100 countries (100 = best)



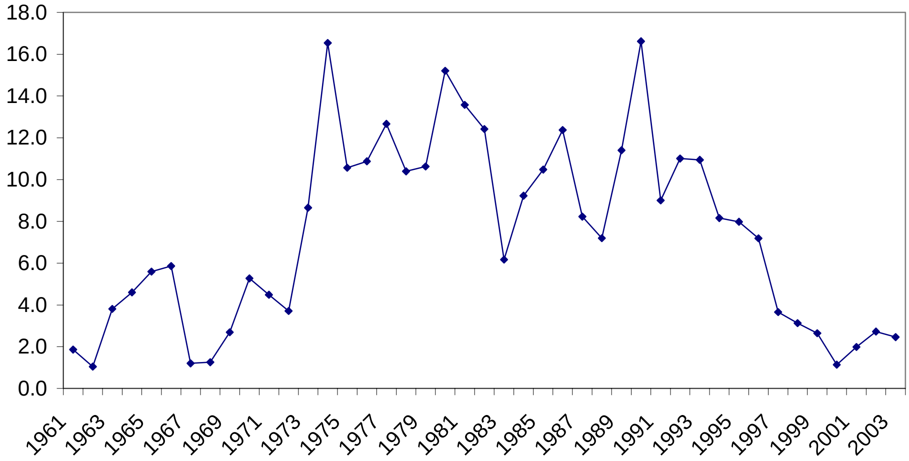
Source: World Bank (2005c, p. 58)

In general, the *regulatory environment* of many Mediterranean ENP countries compares poorly on an international scale. To begin with, there are no effective antitrust institutions to guarantee *competition,* a precondition for an efficient market economy. Hansen (2005) presents a comprehensive overview of regulatory and other impediments to business operations in the Mediterranean ENP countries which stifle TFP growth.

Overall, macroeconomic policies have now improved, but at the beginning of the observation period they had caused significant imbalances and were a source of instability, such as high inflation or distorted exchange rates. In fact, the Mediterranean ENP countries had to live with double-digit inflation rates for almost two thirds of the 1976-2003 period (Chart 15).

[27] This was also the impression reported by many participants of the European Commission's 2005 Euro-Mediterranean Economic Transition Conference in Brussels.

Chart 15: Median inflation rates (%)



Source: World Bank, World Development Indicators 2005.

A dynamic and competitive private sector, free from excessive regulation, is the most important engine for rapid and sustainable economic growth. However, in many Mediterranean ENP countries the public sector, including large state-dominated private companies, continues to play a dominant role. In Algeria, subsidies to loss-making state companies (in the order of 10% of GDP over the last years) have been transferred indirectly through the also state-dominated banking system, thus putting an additional deadweight loss on the financial system.[28] The public sector also absorbed directly large financial resources in Israel, Syria, and Egypt in the middle of the 1980s and correspondingly crowded out the private sector.

Increasing *public debt*, both domestic and international, put an increasing burden on the budget. Whereas 5% of GNI marked the ceiling of public or publicly guaranteed debt service at the beginning of the 1970s, this level marked the floor at the beginning of the 1990s. In the first half of the 1990s Jordan, Morocco and Algeria reached peak debt service ratios in the order of 15% of GNI (Algeria, Morocco) and 20% of GNI (Jordan) respectively. There are also doubts about the returns of the (debt-financed) public investment: "… soaring oil revenues in the 1970s … led to a surge in investment spending and rapid capital stock growth, which could be interpreted as reflecting an accelerated catching up… However, with much spending undertaken by governments, it proved relatively inefficient..." (IMF, 2003, p. 73)

International integration

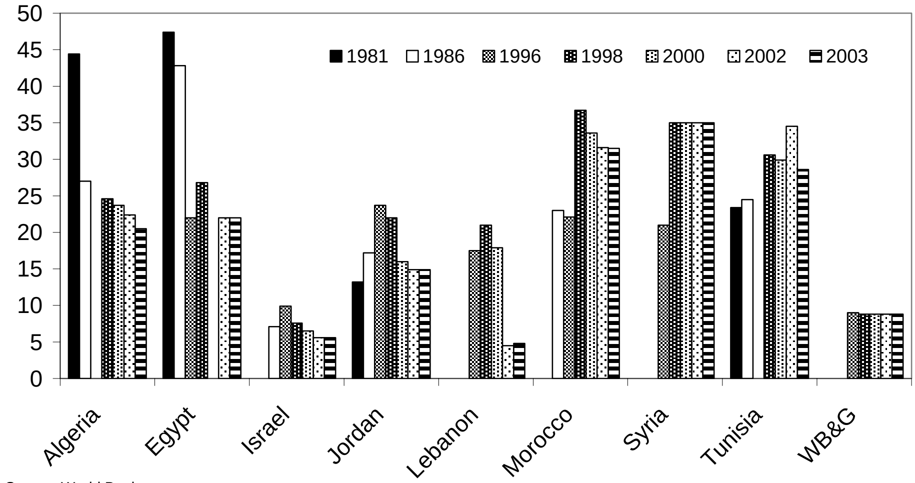
The Mediterranean region's *trade integration with the world economy* has been very limited.[29] In many Mediterranean ENP countries tariff barriers remain among the highest in the world, in particular in Morocco, Syria and Tunisia (Chart 16).[30] The resulting modest trade openness reduced

[28] International Monetary Fund, Staff report for the Article-IV Consultation: 2003, 2004.

[29] For an overview see Bäcker (2005). The even less developed capital market integration is discussed in section 3. These areas are interrelated, for instance because international creditworthiness and FDI depend on trade openness, etc.

[30] The Euro-Mediterranean free trade area envisaged by the Barcelona Declaration in 1995 will not be completed before 2010. Algeria's bilateral agreement with the EU entered into force only in 2005, and the signing of Syria's agreement is impeded by political problems. The complementary trade integration among the Mediterranean countries which is necessary to prevent the disadvantages of an EU-centred hub-and-spokes system, and to make full use of the diagonal accumulation of rules of origin (possible from 2006 onwards) is also still incomplete. A first

Chart 16: Average applied tariffs (%)

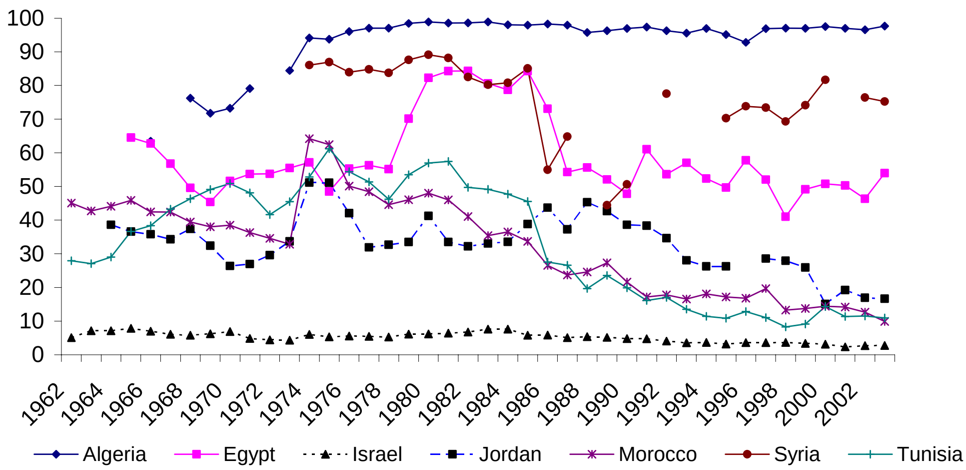


Source: World Bank

Note: All tariff rates are based on unweighted averages for all goods in ad valorem rates, or applied rates, or MFN rates.

the potential for knowledge transfers and limited external competition which is an important incentive for knowledge creation. In addition, trade specialisation in primary goods, fuel and agricultural products in Algeria, Syria and (despite a change towards more refined exports in the middle of the 1980s) Egypt also limited the potential for TFP growth through product and process innovation (Chart 17).

Chart 17: Exports of raw materials (% of merchandise exports)*



*) Agricultural raw materials, ore and minerals, and fuel.

Source: World Bank, World Development Indicators 2005.

FDI is considered a key source for knowledge transfer. However, FDI stocks in Algeria, Lebanon and Syria (10% of GDP in 2003) remained significantly below the developing economies' average of 26% in 2000-2004 – despite an increase on the back of a global FDI surge since the end of the 1990s (Bäcker, 2005, pp. 39 ff.). On the other hand, Tunisia accumulated FDI equal to an exceptional 66% of GDP in 2003. Egypt and Israel also attracted comparably high FDI stocks rising to 30% of GDP by 2003. In Jordan, Morocco and the Palestinian Territories FDI stocks reached levels close to the developing countries' average by 2003.

decisive step towards closer regional integration would be the entry into force of the Agadir free trade agreement between Egypt, Jordan, Morocco, and Tunisia (signed in 2004).

Innovation

Organisational and technological changes which lead to process and product innovation are important determinants of TFP growth. Innovation can be driven by incremental changes or by the introduction of new general-purpose technologies such as the personal computer. Investment in research and development is central to innovation.[31] Investment in innovation, domestic or foreign, depends on a stable economic framework, political parameters, the quality of institutions, and the market size (which determines expected profits). The Mediterranean ENP countries did not perform well in many of these dimensions as described in the previous paragraphs. This helps explain the low TFP growth.

Investment in innovation depends also on a well educated and trained labour force. If the adult literacy rate can be taken as a representative indicator, the level of education and training in the Mediterranean ENP countries improved. However, it was still relatively low in some countries, in particular in Morocco. This could explain the low TFP growth in this country despite its relatively favourable characteristics within the group. Moreover, it is telling that there is no reported data on literacy in Lebanon, the West Bank and Gaza, and (since 1997) Egypt. There are also doubts about the efficiency of educational spending of many countries in the region.

The size of the industrial and services sector can also influence TFP growth because they offer greater potential for product and process innovation than the agricultural sector. In this respect, Egypt increased its scope for TFP growth significantly from the end of the 1970s, whereas Syria experienced a trend increase of the value added to GDP by the agricultural sector. In 2003 the agricultural sector was still relatively large in many countries (except Jordan which has only limited water resources), ranging from 10% of GDP in Algeria to 23% of GDP in Syria. Algeria had the biggest industrial sector (53% of GDP), including the important hydrocarbon industry, and the smallest services sector (35% of GDP).

Eastern neighbours

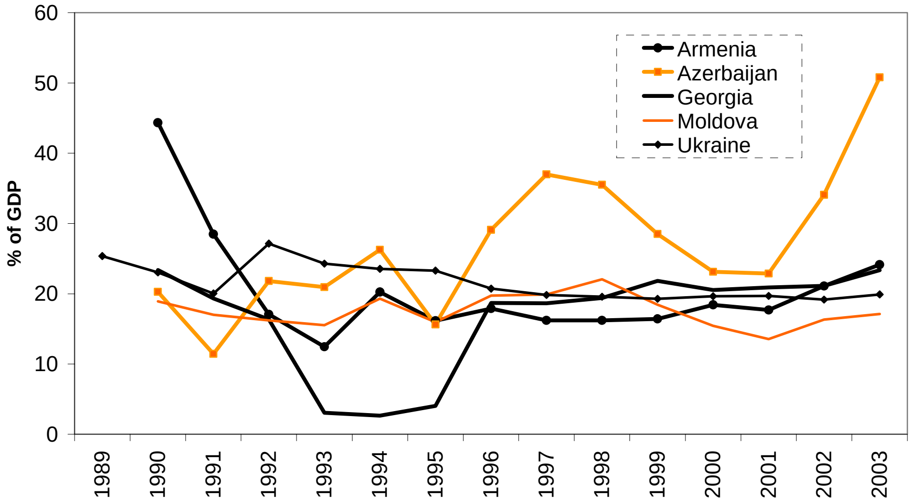
Following the disintegration of the Soviet Union and the transition from central planning to open market economies, the eastern ENP countries had to adjust to a new price system which devalued large parts of their capital stock. Unused capacities due to the depression at the beginning of the transition were reemployed later on. This explains to some extent the slow capital formation and the high rates of TFP growth. However, TFP growth was also propelled thanks to wide ranging reforms. Macroeconomic conditions in the eastern ENP countries are relatively stable, and general education levels are relatively high. However, trade openness is still limited (in an international comparison), and an improvement of the regulatory environment seems to be necessary for sustained TFP growth.

A) Investment

During transition in the eastern ENP countries, net investment has not been as important a driver for growth as productivity gains. This is particularly so for the resource-poor countries. Capital accumulation may have been modest because the nominally large capital stock inherited from the Soviet era might have been oversized. Despite low net investments, their impact on productivity and growth may be large because the new investments are now replacing successively the unproductive old capital stock.

[31] Helpman (2004, ch. 4) presents an overview of the theoretical literature.

Chart 18: Gross fixed capital formation



Source: World Bank WDI.

Gross fixed capital investment ratios were quite stable at around 20% of GDP in the eastern ENP for most of the transition period (Chart 18), which is comparable to the EU average. There are exceptions, however. In Armenia investments plummeted in the early transition years. Azerbaijan, on the other hand, has experienced spectacular investment rates in recent years (about 50% of GDP) driven by foreign investments in the oil and gas sector. In Moldova investment has shown little growth and the investment ratio has been below 18% since 2000.

Real interest rates (on lending) have been on a downward trend in the region from levels of 20% or more in the late 1990s. In Georgia real interest rates are still above 10% and thus clearly hampering investment and growth, but in the rest of the region real interest rates are now in the range of 1% to 6% and have thus become much more accommodative to growth. The reduction in real interest rates reflects increased macroeconomic stability and progress in financial sector development and is likely to continue as further progress in this respect is made.

B) Total factor productivity

Politics and institutions

War and tensions in the region have taken a major toll on the infrastructure, with several borders still closed. Sometimes they have also undermined the political consensus on reforms needed for successful transition. Government effectiveness and rule of law have shown moderate progress since 1996, while political stability has deteriorated, according to the World Bank's governance indicators.[32] It is apparent that further progress is needed across the region in order to create an institutional framework that is conducive to growth.

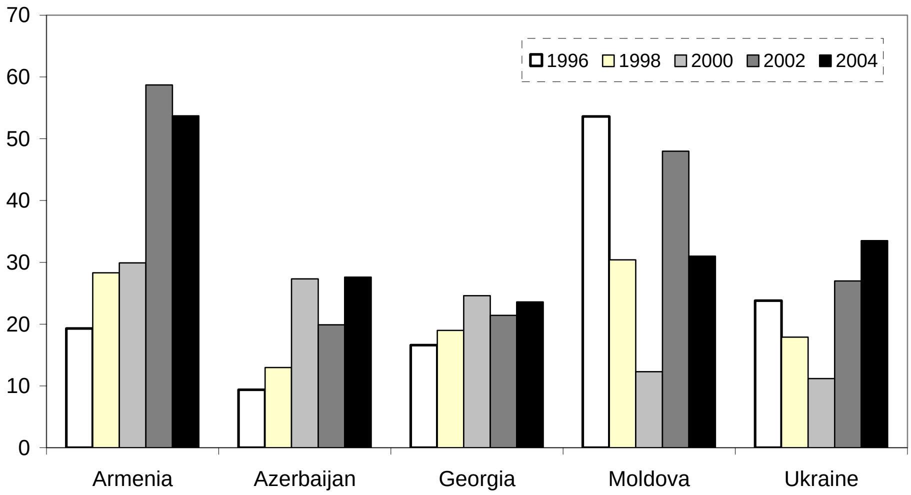
Structural reforms undertaken during the transition towards a market economy appear to be key drivers of growth in the eastern ENP countries (see, for instance, Havrylyshyn, 2001, and Falcetti et al., 2005). This is in line with cross-country results from other regions. Privatisation, price liberalisation and trade liberalisation have taken place on a large scale in the Eastern ENP

[32] The World Bank's governance indicators are relative positions. If a country's percentile rank is unchanged this indicate that it has kept pace with the global tendency for structural reforms (not least in Eastern Europe and Central Asia) since the early 1990s.

countries. The dominance of state companies in key sectors is gradually diminishing, ownership and regulatory roles are being separated, customs legislation improved, anti-corruption laws better enforced and property rights better protected.

Progress in regulatory quality is most evident in Armenia and Azerbaijan (although from a low starting point in the case of Azerbaijan), while the picture is more mixed in Moldova, Ukraine and Georgia (Chart 19). Regulatory improvements may have had a significant growth impact and are likely catalysts of the fast growth in Armenia and in Azerbaijan.

Chart 19: Regulatory quality



Source: World Bank Governance Indicators.
Note: Percentile ranking (100 is best).

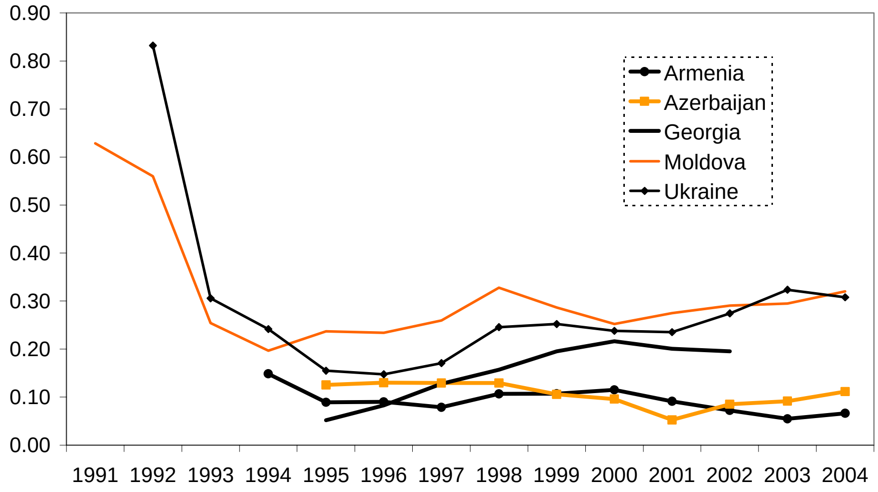
Improvements in other areas of the business climate have also helped to increase productivity and growth in the region. However, important obstacles remain, notably, further progress is needed in areas such as enterprise restructuring, competition policy, access to finance, fighting corruption, infrastructure investment, and reforming adverse tax regimes.[33] Access to finance is crucial for private sector growth because the presence of a well-functioning financial sector is needed to allocate resources to their most productive use.[34]

The financial sector is still underdeveloped in the region, though noteworthy privatisation and financial sector reforms have taken place. Financial depth measured as the ratio of domestic credit to GDP (Chart 20) fell dramatically in the early transition period and a renewed financial deepening only started at a modest pace in Georgia, Ukraine and Moldova from 1995 onwards. The ratio of domestic credit to GDP has now reached about 20% in Georgia (2002), 31% in Ukraine (2004) and 32% in Moldova (2004), which is almost comparable with some of the new EU member states, but is well below the EU15 average of about 120%. Armenia and Azerbaijan have seen very little financial deepening so far and the ratio of domestic credit to GDP stood at just 7% and 11% respectively in 2004.

In particular there is very limited access to finance for investments for small and medium-sized enterprises (SMEs) and in rural areas. The ratio of money supply to GDP, another common measure of financial depth, confirms the picture of subdued financial development in Armenia

[33] See Hansen (2005) for a detailed discussion.
[34] The empirical growth literature has established that financial depth has a positive long-run influence on investment and growth, though it should be noted that a financial deepening can have negative short-run effects, as shown in the strand of literature on banking and currency crises (see Loayza and Rancière, 2004).

Chart 20: Domestic credit to GDP ratio



Source: IMF IFS.

and Azerbaijan (and now also Georgia). Consequently, financial depth does not show positive correlation with GDP growth across the five eastern ENP countries. This may depend on differences in credit composition and the presence of substantial loans to public sector enterprises. On the other hand, other sources of finance have at least to some extent been available, for example remittances in Armenia and FDI in Azerbaijan.

The lack of well-functioning financial intermediation manifests itself in large interest rate spreads and higher real interest rates, which have had a negative impact on investment and growth. Real interest rates are now falling across the region, although Georgia seems to be lagging behind in this respect. But lending to SMEs also require an improved credit environment.

Corruption and the presence of vested interests are an obstacle to efficient investment and productivity growth in the region. Corruption can inflict considerable costs on an economy because it distorts economic decisions and undermines the respect of the law. The result is an inefficient use of resources and usually more bureaucracy and unpredictability. The level of corruption is particularly worrying in Azerbaijan and Georgia, although there are some signs of improvement.[35]

Proper infrastructure is a precondition for generating trade and growth and reducing poverty. In this respect the conflicts and closed borders in the region are likely to have had a negative impact on both investments and productivity growth. There is substantial scope for improvements in infrastructure, including roads, railways, shipping, electricity distribution and telecommunication and progress in this area may help to support future investment and productivity growth.

Heavy taxes can be a burden on incentives to growth, and fiscal reforms need to balance the provision of public goods with the distortions arising from tax collection. Tax revenues as a share of GDP are however relatively low in the region. This phenomenon results primarily from inefficient tax collection, the use of tax exemptions and a large informal economy. Enlarging the tax base and applying moderate tax rates could help to raise revenues without compromising growth.

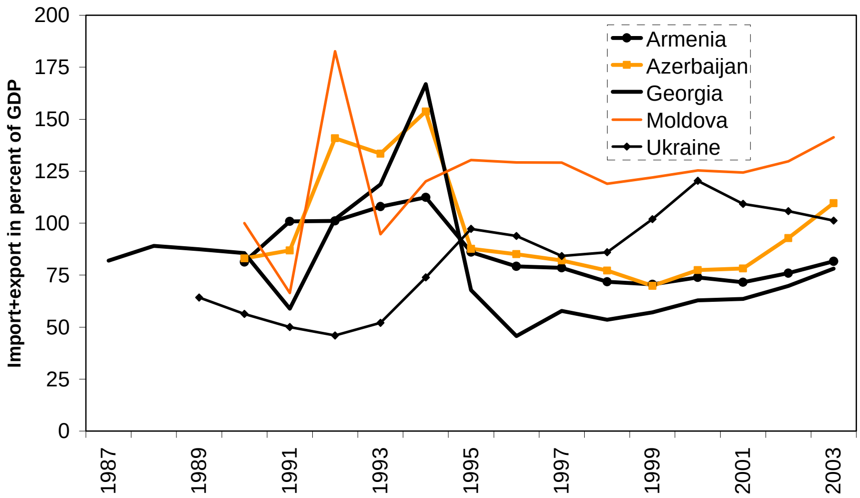
[35] Armenia and Moldova currently rank 88, Ukraine 107, Georgia 130 and Azerbaijan 137 on Transparency International's corruption perception index of 159 countries.

International integration

Initially, the disintegration of the Soviet Union led to severe shocks. The collapse of the institutional links of the centrally planned system disrupted production chains and significantly altered the demand for exports. Moreover, the Russian financial crisis in 1998 had a strong negative effect on the other transition economies in the region because import demand in Russia contracted and trade, finance and payments system arrangements were interrupted. Armenia, Azerbaijan and Ukraine saw their exports to Russia decline up to 70% in the nine months after the crisis.[36] Since 1998, both trade and FDI have been on an upward trend in the region. However, when compared to other countries trade openness is still limited.

All the eastern ENP countries except Ukraine have increased their trade openness since the late 1990s (Chart 21). The erratic development in trade openness in the early 1990s reflects that although trade flows fell significantly in the early transition period, GDP fell even more. Trade became more intra-regional during the early transition years (World Bank, 2006), while there has been a move towards more extra-regional trade in recent years, in particular for exports. Three of the eastern ENP countries are WTO members and Azerbaijan and Ukraine are in the process of negotiating WTO access.

Chart 21: Trade openness



Source: World Bank World Development Indicators.

The eastern ENP countries have relatively liberal investment regimes, but FDI has so far mainly taken place in the natural resources sector. Azerbaijan has benefited particularly from FDI with net FDI inflows temporarily around as much as 30% of GDP in 2003 and 2004. The majority of the FDI in Azerbaijan has been attracted by the oil sector. Though the impact on current growth is impressive (Azerbaijan was the fastest growing country in the world in 2005 and is likely to keep that position in 2006), the longer run growth impact will depend on the ability to attract FDI also for promoting sustainable non-oil-sector growth.[37] FDI inflows has also picked up in Georgia and Armenia, while developments in Moldova and Ukraine have been less promising. Net FDI inflows stood at 3%-8% of GDP in 2003 in the non-oil countries and may have contributed moderately to growth.

[36] See World Bank (2002) for an overview.

[37] The presence of an oil fund – the State Oil Fund of the Republic of Azerbaijan (SOFAZ) – holding assets worth 1.3 billion USD at end 2005 could help to dampen potential Dutch disease effects by smoothing public expenditure, if it is well managed.

Innovation

Research and development expenditures are very low in the region – well below 1% of GDP in all countries – except in Ukraine where it is slightly higher. The same bleak picture emerges from the number of patent applications. During a transition process, with the region being far from the technological frontier in most sectors, this is hardly surprising.

Part of the measured productivity growth in the eastern ENP countries might result from improvements in the quality of labour supply. Improvements in the quality and targeting of education to productive sector employment may be more important than increases in school attendance in the eastern ENP countries where the educational level has historically been quite high (with literacy rates close to 100%), but where its targeting towards productive uses was not always optimal. The educational level and the quality of education in the five eastern neighbourhood countries has gradually improved with increasing spending per student, and increasing enrolment rates for tertiary education. This is especially so in Armenia, Georgia and Ukraine.[38]

5. Conclusion

The growth experience of the Mediterranean countries in the period 1976-2003 was disappointing. The growth accounting shows that capital formation slowed down continuously and that TFP growth rates decreased; in two cases TFP even shrank over the period. In the eastern ENP countries a sharp drop in TFP and a prolonged contraction of the capital stock materialised in the wake of the disintegration of the Soviet Union. Rebounding growth has relied mainly on productivity gains, driven by economic restructuring and reemployment, while the rate of capital accumulation has been low or negative, reflecting the decline of obsolete capital-intensive sectors of the economy during the transition process.

Current growth rates have picked up thanks to some reform progress and a booming world economy but may not be sustained and in many countries, in particular in the Mediterranean region, current growth is insufficient to reduce unemployment and the income gap with the EU within a satisfactory time horizon.

This paper has demonstrated once again that to achieve sustainable economic growth in the ENP countries, driven by productivity increases and capital accumulation, significant reform progress is needed. The reform areas that are emphasised in this paper as having a key role in fostering investment and productivity include macroeconomic stability, institutional and regulatory reform, financial sector reform, innovation and education, infrastructure investment, fighting corruption and international economic integration.

Fostering economic growth and improving welfare is an integral part of the priorities set out in the Action Plans for the implementation of the ENP. These priorities, which lay out the strategic objectives of the cooperation between the neighbourhood countries and the EU, correspond well with the growth enhancing policies emphasised in this paper.

[38] WDI data on education available until 2002.

Annex

Growth accounting

The basics of growth accounting were first presented by Solow (1957).[39] Growth accounting builds on the concept of an aggregate production function $Y = f(A, K, L)$ that combines labour (L) and physical capital (K) to produce a composite good (Y) which is associated with the output of the economy.[40] The level of output is also influenced by the level of technology, or total factor productivity (A) of the factors of production, though this is not explained by the model. TFP growth is at least as important as capital accumulation, not least because of its influence on the marginal productivity of capital, and thus on capital formation.[41]

In the neoclassical growth model, TFP improvements reflect the joint effect of changes in the economy which contribute to output and which are not accounted for by factor accumulation such as physical and human capital. TFP can be interpreted as the result of the overall organisational efficiency of a society.[42] The complexity of this variable and its quantification problems make it difficult to establish a comprehensive empirical growth model which captures the interdependencies of the political, economic, cultural and resulting institutional factors involved. However, the literature has established a certain consensus on a number of dimensions which are decisive for TFP. The modern growth theory presents four very similar categories of interrelated factors which drive TFP: politics and institutions, international economic integration, innovation, and inequality.[43]

Ideally, growth accounting should take into consideration differences in factor quality. However, due to data restrictions we use total employment (persons) and total capital stock as a first approximation. Consequently, the growth effect of quality improvements (such as better education and training), the expansion of arable land and other factors (e.g. energy consumption) are by definition attributed to TFP improvements. Similarly, shifts in working hours or durability of capital will affect measured TFP. Assuming that technical progress is Hicks-neutral[44], the production function can be written as

$$Y = AF(K, L)$$

From this we can derive by differentiation the TFP growth as

$$g_A = g_Y - \eta_K g_K - \eta_L g_L$$

[39] See Barro (1999) for an updated explanation.

[40] For other approaches which include factors as energy and natural resources consumption see World Bank (2006a).

[41] In fact, it is necessary for advanced economies with increasing capital intensities to overcome decreasing economic growth caused by decreasing marginal productivity of capital. This is a consequence of the standard assumption of a (Cobb-Douglas) production function with constant returns to scale.

[42] Based on the definitions in this paper, TFP also depends on variables such as the qualities of physical and human capital, changes in the working hours (because the labour variable here embodies only the number of persons employed), deviations from the assumed uniform capital depreciation rate, and changes in energy use.

[43] In the analysis we skip questions related to the inequality of the domestic income distribution due to lack of data. The causal link from income distribution to growth is in any case difficult to establish, although it appears mainly to go via the impact of inequality on education and on political instability (two aspects we do consider). That said, reducing inequality is of course important in itself for reducing poverty and improving welfare.

[44] Hicks-neutral technology means that the optimal mix of K and L is independent of productivity changes because the ratio of the marginal productivities of labour and capital is unaffected.

where g indicates growth rates and $\eta_K = (K/Y) \cdot (\partial F/\partial K)$ and $\eta_L = (L/Y) \cdot \partial F/\partial L$ are the elasticities of output with respect to capital and labour. Assuming a standard Cobb-Douglas production function with constant returns to scale and constant elasticities

$$Y = AK^{\alpha}L^{1-\alpha}$$

with $\alpha \in]0;1[$, we get $\eta_K = \alpha$, $\eta_L = 1-\alpha$. If the factors are paid their social marginal products so that the rental price of capital is $r = \partial F/\partial K$, and the wage rate is $w = \partial F/\partial L$, then α and 1-α, respectively, equal the share (s) of each factor payment in the total product. This allows us to derive the estimated rate of technical progress as

$$\hat{g}_A = g_Y - s_K g_K - s_L g_L$$

For the *Mediterranean ENP countries*, we apply a uniform capital income share $s_K^M = 0.34$, which is within the conventional range for low-income countries (Easterly and Fischer, 1994). This specification allows comparability with Miketa (2004). Moreover, we draw on his capital stock data to set the initial capital values, and update the dataset by adding gross fixed capital formation (GFCF) from the World Bank's World Development Indicators (WDI), and by applying an across-the-board capital depreciation ratio of 4.3% in order to bring our own ex-post calculations closely in line with Miketa's data.[45] Employment figures come also from the WDI.

For the *eastern ENP countries*, we apply a capital income share $s_K^E = 0.4$, which is also within the conventional range for low-income countries. The capital stock for the eastern ENP countries is based on capital stock growth rates for 1980-1990 and capital-output ratios in 1990 from De Broeck and Koen (2000). Capital stock growth rates for 1991-2004 are calculated using the perpetual inventory method as in the case of the Mediterranean ENP countries. Here the applied depreciation rate from 1990 onwards is 4%, reflecting a relatively rapid depreciation of capital during the shift from central planning towards market economy. GDP and labour force data are based on the World Bank's WDI supplemented by IMF and ILO data.

Investment and TFP

Investment depends on total factor productivity. This can be explained in the framework of the neoclassical growth model. The first order condition for optimum capital input is that the marginal productivity of capital (MPC) equals its marginal cost. Assuming a standard Cobb Douglas production function, $Y = AK^{\alpha}L^{1-\alpha}$, this means:

$$\frac{\partial Y}{\partial K} = \alpha A\left(\frac{L}{K}\right)^{1-\alpha} = r$$

where *r* is a measure for the real cost of capital (including depreciation). MPC is positively related to the total factor productivity *(A)* and inversely related to the capital stock per person employed (*K/L*). By rearranging it follows that the optimum capital input, and correspondingly investment, depend positively on the total factor productivity.

[45] This is the perpetual inventory method which calculates the capital stock as $K_{t+1} = (1-\delta)\cdot K_t + I_t$, where δ is the rate of depreciation on the existing capital stock and I is GFCF. The depreciation rates commonly used in the literature are around 3%-4%. The growth accounting results here do not change substantially if 4% is used instead of 4.3%.

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Part B

Country Analysis

ALGERIA

- **Real growth fell slightly to 5.7% in 2005 but is expected to rebound in 2006. Key growth factors are the increasing output of the dominant oil and gas sector, the oil price boom, and a very expansive government investment programme.**
- **The budget surplus almost doubled in 2005 to 12.6% of GDP on the back of buoyant oil revenues. However, the non-hydrocarbon deficit remains at a very high level (18.7% of GDP) and is decreasing only slowly. Loss-making public companies drain the budget.**
- **Unemployment dropped from 17% in 2004 to about 14% in 2005, partly thanks to an increase in temporary employment. Youth unemployment stands at 31%. The key to employment creation will be to foster the non-hydrocarbon private sector.**
- **Trade liberalisation is progressing. The Association Agreement with the EU signed in 2002 entered into force on 1 September 2005, and WTO membership is now likely in 2006. Opening the land border with Morocco would be a major regional gain.**

1. Macroeconomic developments

Real sector developments

The Algerian economy depends on the oil and gas sector (about 53% of GDP, 98% of exports). The key challenge remains completing the transition to a market economy and broadening the base for economic growth through diversification of the economy and private investment to create productive jobs and tackle unemployment. In 2005 the economy kept growing at a strong pace (5.7%) thanks to large increases in crude oil and gas production coupled with high hydrocarbon prices, and a pro-cyclical fiscal policy which boosted domestic demand. Nevertheless, growth was slightly lower than in 2004 (5.9%) because of a slowdown in agriculture since the 2003 record harvest.

The government again reported a marked fall in the official unemployment rate, by 2½ percentage points, to 15.3%, from September 2004 to 2005. However, this partly reflects an increase in temporary and public employment (the latter with uncertain productivity gains), and the error margins of this census-based information are not clear. Youth unemployment remains very high at 31%.

Fiscal developments

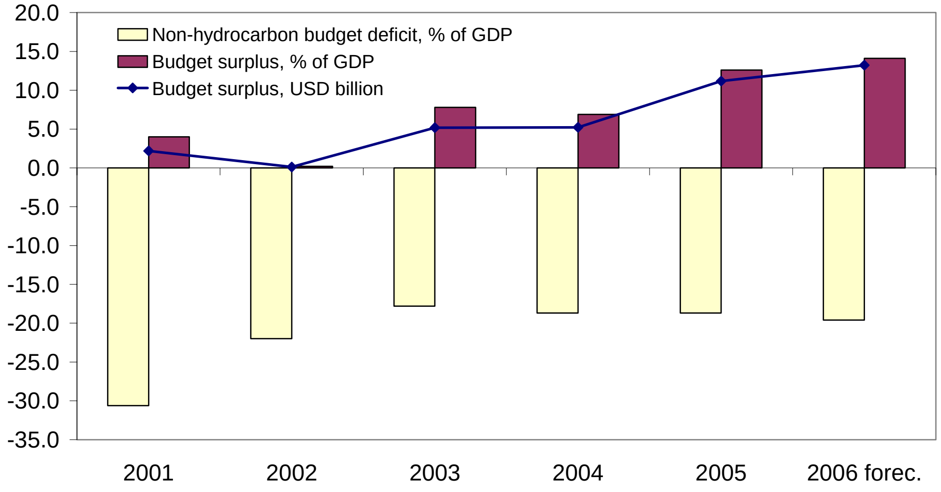
Public finances depend strongly on hydrocarbon revenues. Whereas the total government budget surplus almost doubled in 2005, to 12.6% of GDP, the non-hydrocarbon deficit remained at a very high level, reaching 18.7% of GDP in 2005 (Chart 1). In June 2005, the 2004 Growth Consolidation Plan, which is essentially a public investment programme for 2005-09, was augmented by USD 7 billion to USD 50 billion (55% of 2005 GDP).

Although the planned increase of public investment in education, health and infrastructure is much needed, the concentration of spending in the first years of the programme raises absorption and sustainability concerns, and could fuel inflationary pressures. Government spending in 2005 in fact increased by about 4% of non-hydrocarbon GDP (NHGDP) with the non-hydrocarbon primary deficit increasing by 3.5% of NHGDP to 31.5% of NHGDP.

However, the 2005 budget law represents a turning point in the direction of government finances, since it aims to gradually reduce the non-hydrocarbon deficit over the medium term to a sustainable level. Furthermore, the government reported that it had started to replace the huge quasi-fiscal operations of state banks (to subsidise loss-making state enterprises) by direct transfers which are included in the budget. Nevertheless, the authorities still need to address the problem of contingent liabilities in the local authorities and social security system.

The 2006 budget bill is designed to encourage investment, promote non-hydrocarbon exports, diversify sources of funding for economic activities, combat fraud and money-laundering and counter the underground economy. The overall government budget totals almost USD 44 billion, USD 22.5 billion of which is devoted to infrastructure expenditures (28% more than in 2005).

Chart 1: Algeria - Budget balance vs. non-hydrocarbon balance



Source: IMF 2006.

Monetary and exchange rate developments

The Banque d'Algérie successfully sterilised the rapidly increasing liquidity in the banking sector, inter alia by raising the official interest rate from 0.75% to 1.25% in July 2005. However, the rate remains negative in real terms. The inflation rate fell to 1.9% (from 3.6% in 2004), mainly because of falling food prices, whereas inflationary pressures are increasing due to pro-cyclical government spending and robust investment growth.

The authorities maintain a managed float against the dollar guided by the principle of minimising the deviation of the real effective exchange rate from its end-2003 level. In 2005, the average exchange rate against the dollar and the euro remained broadly stable. The real effective exchange rate appreciated slightly (by about 1%). A law adopted in 2005 requires the central bank to submit to the government monthly reports on its monetary policy, debt management developments and level and composition of foreign-currency reserves.

The spread between the exchange rate on the illegal parallel currency market and the official rate remained large at about 20%, reflecting, inter alia, problems in the implementation of the free convertibility of the dinar for payments and transfers relating to certain current international transactions. There was also limited knowledge among the banks and the public about this free convertibility, which is essential to benefit from the trade opening. Therefore, the authorities have started to work on improvements suggested by an IMF technical assistance mission.

External sector developments

Algeria's current account thrived in 2005 because of the expanding hydrocarbon exports. Moreover, the ratio of export to import prices improved by 21% on the back of high oil prices. The current account reached a new record surplus of 21.1% of GDP, up from 16.8% of GDP in 2004. Hydrocarbon products accounted for more than 98% of export earnings. The current account surplus and rapid growth made it possible to reduce Algeria's external debt ratio from 29.6% of GDP in 2004 to 19.5% of GDP in 2005, and to feed a record expansion of foreign exchange reserves to USD 56.6 billion, 25 months of import cover, at end-2005.

2. Trade liberalisation and economic opening

Despite abundant hydrocarbon resources, Algeria remains a relatively closed economy with a trade-to-GDP ratio of only 61.8% in 2004. The EU is Algeria's main trading partner, accounting for 57.5% of total Algerian trade in 2004. Both EU exports and imports with Algeria have risen steadily over the last years, to EUR 10.4 billion and EUR 20.8 billion respectively in 2005.

The 2001-05 temporary additional duty on some imports (following the comprehensive tariff reform since 2001) is being phased out according to plan. Negotiations towards WTO accession are in their final stages. The Association Agreement with the EU entered into force on 1 September 2005. The agreement envisages the creation of a free trade area by gradually removing duties on industrial imports from the EU during a transitional period of 12 years.

From 2006 onwards, the Pan-European (diagonal) Cumulation System for rules of origin can be extended to Algeria. This will potentially generate significant benefits from the Euro-Mediterranean free trade area, though these will only materialise if free trade arrangements are put in place between Algeria and its Mediterranean partner countries. This regional extension of the free trade area is also necessary to prevent a pure hub-and-spoke free trade system with potentially negative welfare effects. Moreover, it will only be possible to take advantage of these opportunities if the private non-oil sector is strengthened, since it will face increasing international competition from 2007 onwards, and currently suffers from a dismal business environment (Chart 2).

Algeria, Morocco, and Tunisia have agreed to improve bilateral relations and economic integration in the Maghreb region. The opening of the land border between Algeria and Morocco would be a major step for trade and welfare gains in the region.[46] There are also renewed efforts to revive the Union du Maghreb Arabe (UMA), also including Libya and Mauritania, which may foster regional trade integration. Furthermore, negotiations on further liberalisation of agricultural and services trade within the Euro-Mediterranean area are beginning in 2006.

3. Business climate

Privatisation, enterprise restructuring and business environment

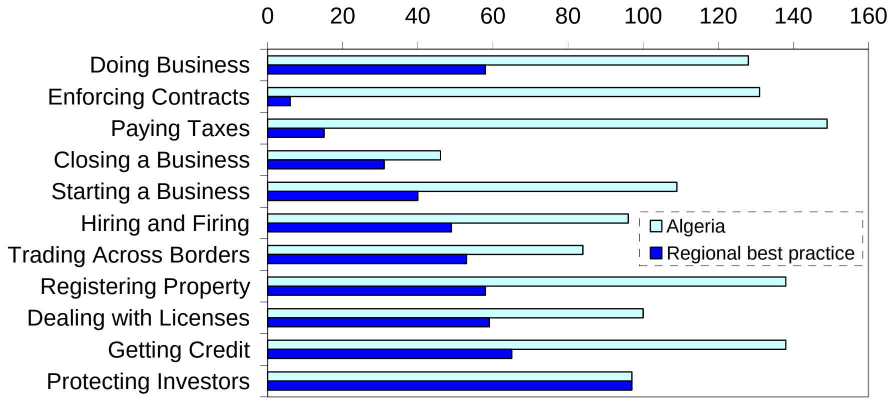
Important steps have been taken to liberalise the hydrocarbon and telecommunications sector. However, much remains to be done in the areas of enterprise restructuring, liberalisation, and the

[46] The land border with Morocco has been closed for several years because of political tensions over Western Sahara.

withdrawal of the state from the productive sector. The reform process in this area is still moving slowly. Prime Minister Ouyahia announced on November 2004 that 1,200 companies would be "proposed for privatisation" during 2005. But actual progress has been limited and strategic companies such as the energy company Sonatrach, the electricity and gas distributor Sonelgaz and rail companies have been excluded from the process. So far, around 200 companies have been sold.

The dominant role of the state is one major reason for Algeria's unsatisfying investment climate. According to the World Bank's "Doing business" indicators the business climate is among the worst in the region (Chart 2). Compared with rest of the region, it is particularly difficult in Algeria to enforce contracts, pay taxes, start a business, register property and – as a result of the inefficient state-dominated banking system – get credit (Chart 2).

Chart 2: Algeria - "Doing business" rankings



The ease of doing business index ranks economies from 1 (best) to 155.
The regional best practice refers to the best ranking Arab country among the Mediterranean ENP countries.

Source: World Bank, 2006.

Financial sector reforms

The Algerian financial system is inefficient and underdeveloped, even in comparison to the low regional standards. The banking system is state-dominated, with public sector banks accounting for more than 90% of total bank assets. The banking sector lacks basic risk management capacity. Financial intermediation consists mainly of politically driven lending, without sufficient credit risk assessments, to loss-making state-owned enterprises. This undermines the stability and efficiency of the banking system and of monetary policy. It also puts severe constraints on the financing of viable private sector projects.

With its 2005 budget law, the government took the first steps to replace bank loans to loss-making public enterprises with explicit budget subsidies. However, there are still large and increasing volumes of non-performing loans, mainly to the public sector. At the end of 2004 the overall non-performing-loan ratio stood at 37.4% of total loans (298% of bank equity) of which 44.6% were provisioned for.[47] However, the enormous expansion of government surpluses thanks to increased hydrocarbon revenue provides an excellent basis for restructuring and putting the banking system and virtually bankrupt state enterprises on a sound basis.

[47] Central bank data showed a credit volume to the economy of DZD 1535 billion (USD 20.8 billion) in December 2004.

In 2005, the new Finance Minister Mr Medelci announced his intention to address the issue of banking reform as a matter of urgency. The chief executives of all of the state-owned banks were replaced, and international investment banks were invited to advise on the sale of Crédit Populaire d'Algérie (CPA), the first public-sector bank to be privatised. Mr Medelci said that a majority stake in CPA would be on offer. It is now essential to complete its privatisation. Two other state-owned banks have been identified for the first wave of privatisation in the financial sector – Banque Nationale d'Algérie and Banque Locale de Développement.

Currently, efforts are being made to introduce a state-of-the-art real-time gross settlement payment system to replace the inefficient and unreliable old system which involved processing times of up to two weeks even for high-value domestic payments. The Algiers Stock Exchange was inaugurated in July 1999, but it remains tiny, and a brokerage network has yet to be established.

The Algerian government had proposed to amend the regulations for the insurance sector in such a way as to support its growth, and on 8 December 2005, the Finance Minister submitted a bill on insurance sector reforms to the National People's Assembly. He also declared that Algeria needed to open its financial sector to international insurance groups so that higher standards of living can be achieved. In 2005, around 17 insurance companies and 400 intermediates were active in Algeria.

4. Public institutions and public finance management

In 2005 the government submitted to parliament an anti-corruption law following Algeria's adoption of the 2003 UN Convention against Corruption. The law contains a broad definition of corruption, introduces a code of conduct for public servants, protects whistle-blowers, and provides for international cooperation. The government should also accelerate budget modernisation and implement the recommendations of the fiscal Report on the Observance of Standards and Codes.

5. Social development and poverty

According to national indicators, poverty in Algeria deteriorated in the early 1990s, from 8% in 1988 to 14% in 1995, but then recovered to 12% in 2000. Per capita income has increased steadily over the last few years, mainly thanks to rising hydrocarbon revenues. This should help to reduce poverty. In 2005, GDP per capita reached USD 2704 (up from USD 2627 per capita in 2004).

The main challenge for the Algerian economy remains to complete its transition to a diversified market economy in order to accelerate growth and reduce unemployment, particularly among the young. The country is currently enjoying optimal financial conditions to implement the necessary reforms and to mitigate potential temporary social costs. The government's medium-term investment programme (Growth Consolidation Plan) for 2005-09 focuses in particular on health, education, housing and infrastructure which should also support poverty reduction.

ALGERIA

Main economic indicators

	2001	2002	2003	2004	prel. 2005
Real sector					
Real GDP growth (% change)	2.6	4.7	6.9	5.9	5.7
Real non-oil GDP growth (% change)	5.5	5.3	6.0	6.2	..
GDP nominal, in USD billion	54.9	55.9	66.5	75.7	88.7
GDP per capita, in USD	1787	1819	2136	2627	2704
Social indicators					
Unemployment	27.3	25.9	21.9	17.0	14.1
Youth literacy (% ages 15 - 24)	89.2	89.9	..	..	..
Adult literacy (% ages 15 and above)	67.8	68.9	..	70	..
Under 5 mortality rate (%)	5.0	4.9	4.1	..	..
Fiscal sector (% of GDP)[1]					
Total revenues	34.9	35.3	37.0	36.2	40.8
Hydrocarbons	23.6	22.2	25.6	25.6	31.3
Non-hydrocarbons	10.9	13.1	11.3	10.5	9.5
Grants	0.4	0.0	0.1	0.0	0.0
Total expenditure	31.5	35.0	29.2	29.3	28.2
Govt. balance	3.4	0.2	7.8	6.9	12.6
Gross public debt	58.7	53.5	43.8	36.6	29.0
Monetary sector					
Inflation CPI (period average)	4.2	1.4	2.6	3.6	1.9
Private sector credit (% change)[2]	..	62.8	6.8	15.1	36.5
Private sector credit (% of total credit	20.5	29.8	32.6	44.7	94.8
Broad money (M2) (% y-o-y)	24.7	17.4	15.6	11.5	13.4
Degree of monetisation (M2/GDP, %)	58.4	65.2	65.2	68.6	65.3
External sector (% of GDP)					
Current account balance	15.6	10.1	15.1	16.8	21.1
Trade balance	14.7	9.9	14.7	16.7	24.0
Foreign direct investment, net	2.1	1.7	1.8	4.6	4.2
Import cover (months)	18.1	19.1	24.3	23.7	25.1
External vulnerability					
External debt (% of GDP)	41.1	40.5	34.9	29.6	19.5
Debt service ratio[3]	22.1	21.1	16.1	13.3	11.5
Gross official reserves (USD billion)[4]	18.0	23.1	32.9	43.6	56.6
Broad money to reserves, %	178.1	157.9	131.9	119.3	102.3
Financial sector					
Short-term interest rate (13 weeks T-bill yield)	5.3	1.7	1.1	1.1	1.1
Exchange rate (per USD, avg)	77.22	79.68	77.39	72.06	73.28
Exchange rate (per EUR, avg)	69.16	75.35	87.54	89.64	91.17
Real effective exchange rate (depreciation -)	2.9	-7.8	-10.7	0.4	-3.6

Source: Algerian Ministry of Finance, Central Bank of Algeria, Eurostat, IMF, EIU.

[1] Central government.

[2] Banking system credit.

[3] Debt service to exports of goods and non-financial services.

[4] According to Bank of Algeria information all official reserves are liquid.

ARMENIA

- **The strong growth record continued in 2005, driven by investment and increased consumer spending. Construction was by far the fastest growing sector. Remittances from abroad continued to contribute significantly to the Armenian economy.**
- **Armenia has advanced with structural reforms, but bureaucracy, corruption and limited access to finance contribute to a weak business climate. There is a need for a more transparent judicial system and better governance.**
- **Armenian government revenues are low and significantly below their potential, due to a weak tax base and significant tax evasion, but noteworthy improvements were achieved during 2005.**
- **Decommissioning of the Medzamor nuclear power plant will have significant fiscal implications. Though costs could partly be covered via a donor conference, the fiscal implications underscore the need for higher government revenues.**

1. Macroeconomic developments

Real sector developments

The record growth seen in recent years continued with 13.9% real GDP growth in 2005. Real GDP is now higher than its pre-transition level. Growth is driven in particular by investment and increased consumer spending, supported by remittances and increased private sector incomes. Construction was the fastest growing sector in 2005, with about 34% growth, not least because of a housing boom in Yerevan. Services and agriculture also performed well, with growth rates of about 16.7% and 10.9% respectively, while industrial production grew by 6.6%. The industrial sector accounts for more than 30% of GDP, while more people are employed in agriculture (almost half the labour force), which accounts for only 21% of GDP. The shadow economy is thriving and estimates put its size at more than 30% of GDP.[48]

Registered unemployment has shown a downward trend since 2003, and fell to 8.9% in 2005 from 9.4% in 2004. Actual unemployment appears to be significantly higher at about 32%.[49] The labour force has been shrinking almost continuously since the early 1990s, due mainly to net migration, but a slow reversal appears to have taken place in recent years. Average nominal wages increased by about 20% in 2005, while the consumer price index (CPI) only increased 1.0%, due to a fall in food prices following a good harvest. The growth momentum is expected to continue at a slightly slower pace in 2006, with inflation projected to increase towards the Central Bank's 3% objective.

Fiscal developments

The central government budget deficit fell to about 1.0% of GDP in 2005 (1.7% in 2004), according to preliminary official estimates. Revenues (including grants) increased from 15.9% of

[48] See Tunyan, B. (2005), *The Shadow Economy of Armenia: Size, Causes and Consequences*, Armenian International policy Research Group Working Paper Series No. 05/01.
[49] Surveys conducted in line with ILO methodology indicate that unemployment fell to about 32% in 2004.

GDP to 16.7% of GDP while total expenditures increased from 17.2% of GDP in 2004 to about 17.7% in 2005. The value-added tax is the most important source of revenue, accounting for more than one third of total tax revenues, while personal income tax accounts for only some 7%.[50] The public sector in Armenia is relatively small compared with other CIS countries. About 2.4% of GDP is spent on general government wages and about 5.5% of GDP on transfers. The public external debt is sustainable and fell as a ratio of GDP to about 29% in 2005 from 33% in 2004.

Monetary and exchange rate developments

Monetary policy has been focused on price stability (an objective of 3% annual inflation) and used monetary aggregates as an intermediate target. In recent years the Central Bank of Armenia (CBA) has often deviated from the programmed monetary indicators in order to ensure price stability. A move from monetary targeting towards inflation targeting was therefore deemed appropriate and took place in early 2006.

The CPI only increased by 1.0% in 2005, but actual inflation is perceived to have been significantly higher. The main problem is that the consumption basket used for the CPI calculation is outdated (from 1997) with a resulting over-representation of basic commodities, which have shown limited price growth. An updated consumption basket that better reflects today's spending pattern is likely to be put in place during 2006.

The Armenian dram appreciated 7.3% against the dollar and 19.5% against the euro during 2005 as a result of high remittances and other capital inflows. The repo rate was reduced slightly from 3.75% to 3.5% during 2005, and the CBA carried out partially sterilised foreign exchange interventions because of appreciation pressures caused by the strong capital inflows. There was a strong increase in money demand and broad money (M2) increased by 30% in 2005. Dollarisation of the economy is still significant. However, if inflation targeting is successful, a law implemented in 2005 requiring that certain transactions are quoted in drams only, should help to support an emerging decline in dollarisation.

External sector developments

The trade deficit narrowed slightly to 12.1% of GDP in 2005 from 12.9% of GDP in 2004, while the current account deficit narrowed to 3.9% of GDP in 2005 compared to 4.6% of GDP in 2004. Exports of goods and services (26% of GDP in 2005) increased by 13.5% while imports (40% of GDP in 2005) increased by 14.0%. Exports of metals and processed foodstuff have performed especially well, whereas the share of manufactured goods in Armenia's exports continues to be small. The real exchange rate appreciation appears to have had little impact on competitiveness so far. Remittances from abroad contributed significantly to the Armenian economy. Transfers officially amounted to 8% of GDP, but unofficial estimates range up to about 26% of GDP.[51] Remittances appear to have been mostly invested in housing, land, education and small businesses.

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[50] See Gelbard, E. et al. (2005), *Growth and Poverty Reduction in Armenia,* IMF.

[51] See Roberts, B. W. and K. Banaian (2005), *Remittances in Armenia: Size, Impacts, And Measures to Enhance Their Contribution to Development*, Armenian International policy Research Group Working Paper Series No. 05/01.

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The trade deficit is likely to increase significantly after Russia raised the price of gas supplied to Armenia from USD 56 to USD 110 per thousand cubic meters in April 2006.[52] The price hike will increase the cost of gas by USD 66 – 80 million in 2006 (1.3-1.5% of GDP), depending on assumptions. Russia is currently the sole supplier of gas to Armenia, but a gas pipeline from Iran to Armenia is under construction and scheduled for completion by the end of 2006.

FDI net inflows increased slightly to about USD 255 million or 5.6% of GDP, while portfolio investment and other investment flows (loans and deposits) bordered on insignificant. Foreign debt increased slightly from USD 1,183 million to USD 1,229 million, but fell as a percentage of GDP from 33% to 27%. Gross international reserves increased by USD 130 million to USD 677 million in 2005, equivalent to about 4 months of imports.

2. Trade Liberalisation and Economic Opening

Armenia has a liberal trade regime with low tariff barriers (average tariffs about 3%). However, the two closed borders are a constraint to further trade. Inefficiencies and corruption in customs also hold back trade. Revenue targeting for customs is one problem as it gives them incentives to "play with prices". A risk-based customs clearance programme was introduced in November 2005. This follows an increased use of transaction prices instead of reference prices for assessment of import declarations. These steps should help to push forward a more efficient and transparent customs clearance. Armenia joined the WTO in 2003.

Negotiations on an Armenia-EU action plan in the framework of the European Neighbourhood Policy were initiated in 2005. The ENP is expected to lead to an increasingly closer relationship between Armenia and the EU and may help, not least by means of legal approximation, to substantially increase both trade and foreign investment.

3. Business Climate

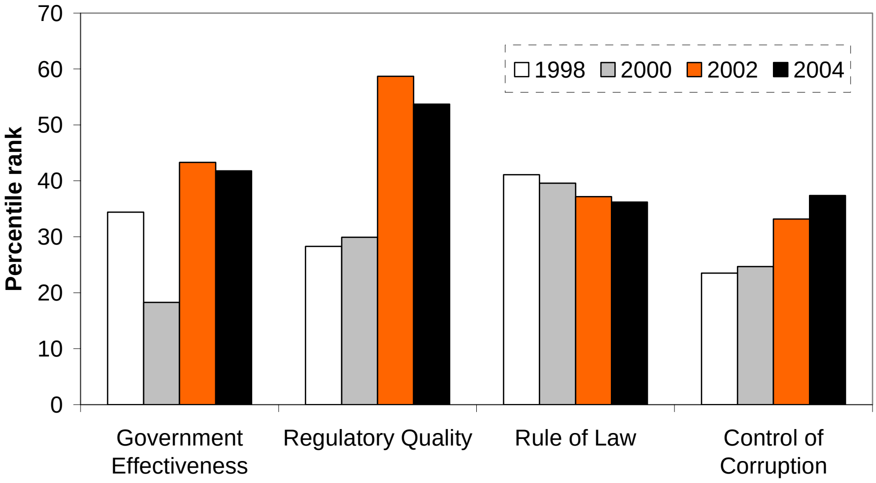
Privatisation, enterprise restructuring and business environment

The pace of privatisations has slowed down during 2005. A number of strategic enterprises, including a few state-owned enterprises in the energy sector, still need to be privatised. The government aims to complete the privatisation process by end 2007.

Armenia has continued to advance with structural reforms, as indicated by EBRD 2005 transition indicators, and regulatory quality has improved.[53] Armenia is indeed in the lead among CIS countries on most dimensions of structural reforms measured by the transition indicators. However, bureaucracy, corruption and limited access to finance are still perceived to damage the business climate, and a common complaint is that the government is doing little to facilitate business development. This is confirmed by the World Bank's governance indicators that show continued problems with the rule of law and government effectiveness. On the other hand, control of corruption has steadily (although slowly) improved (chart 1). The state commission on protection of economic competition is slowly becoming more effective, but competition is still modest in several sectors. The Heritage Foundation in its 2006 Index of Economic Freedom ranked Armenia as "mostly free".

[52] The Armenian government intend to avoid large tariff increases for end-users until January 2009. The implied increase in energy-subsidies will be financed by selling the 5th unit of the Harzdan thermal power plant to Russia.
[53] See EBRD (2005), *Transition Report 2005 – Business in Transition,* EBRD.

Chart 1: Armenia - Governance



Source: World Bank Governance indicators.
Note: A higher ranking implies a better relative score.

There is a need for more political will to combat corruption. The Council of Europe's Group of States against Corruption (GRECO) published an evaluation report on Armenia in early 2006, which concluded that corruption is a major problem in Armenia, particularly so in the judiciary, the police, tax and customs operations and the education and health sectors. The report also states that there is an almost total absence of significant results in prosecuting and indicting individuals involved in serious cases of corruption. Immunity enjoyed by judges, prosecutors, parliamentary candidates, members of electoral commissions, candidate mayors and candidates for membership of the council of elders (local council) is also a matter of concern.

Progress is needed towards a more transparent and trustworthy judicial system. After the referendum on constitutional amendments, the Ministry of Justice announced a large-scale reform in the judicial sector. The reform is targeted at reorganizing the court system; strengthening the judiciary, advocacy and public defence structures; and improving the public's trust in the judicial system.

Financial sector reforms

The minimum capital requirement for banks was raised to USD 5 million from USD 2 million in July 2005, and this seems to have advanced some consolidation. A deposit insurance scheme was also launched in July. Financial depth is increasing, but access to finance is still limited. The efficiency of financial intermediation needs to be improved, as indicated by the interest rate spread, which remains very high, despite falling from 13.7% in 2004 to 12.2% in 2005.

Foreign participation in the banking sector increased during 2005, but is still dominated by HSBC. The large market share of a single foreign bank is an uncomfortable situation in terms of competitiveness and financial stability. The Armenian financial sector has a substantial growth potential, and more foreign banks and insurance companies could bring expertise and increased competition to the sector. Supervision of banks will be upgraded significantly in 2006 in line with the IMF's Financial Sector Assessment Program (FSAP) recommendations. Development of the legal framework for mortgage institutions, the insurance sector and the securities market is also foreseen.

Labour market reforms

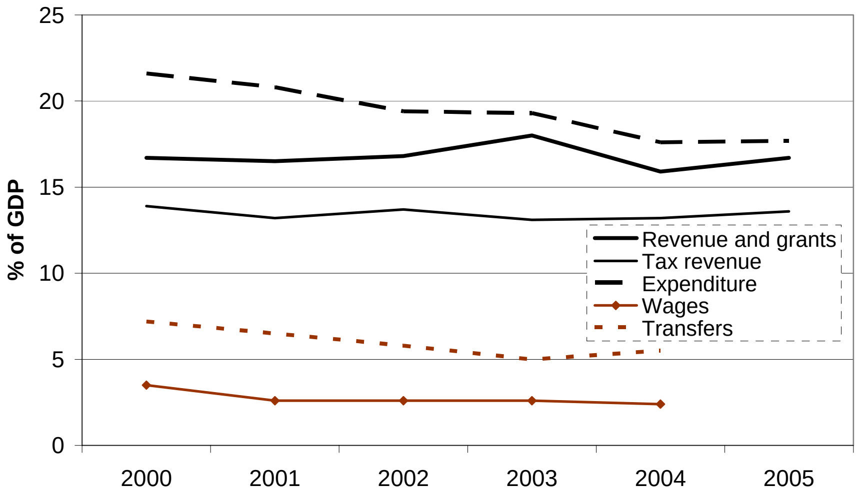
Armenia ratified two ILO core conventions (on forced labour) in 2005, but has still only ratified five of the eight core conventions.[54] Strengthening the institutional capacity in the state labour inspection is a priority. The fraction of companies that see labour skills as a constraint is much lower than the regional average. There is, however, some shortage of qualified workers and a continued need to improve the targeting of the educational system to the needs of the economy and improve the quality of and access to vocational training.

4. Public Institutions and Public Finance Management

Armenian government revenues are low due to a weak tax base and significant tax evasion, but noteworthy improvements were achieved during 2005 (chart 2). A corporate tax rate of 1% of company turnover introduced in January 2005 and a list naming the 300 top tax payers published in April 2005 (the move was aimed at embarrassing the country's wealthiest tax evaders) has helped to boost taxes to an estimated 13.6% of GDP in 2005 from 13.2% in 2004.

An action plan for tax and customs reforms (2005-2006) was adopted in May 2005 aimed at simplifying the tax system, broadening the tax base and reducing tax evasion. A major step forward is mandatory income statements, which are expected to be introduced in 2006. Public procurement and tender procedures are expected to be improved during 2006. Corruption and conflicts of interests have also been mentioned as barriers to raising tax revenues and need to be tackled.

Chart 2: Armenia - Government revenues and expenditures



Source: Economist Inteligence Unit and E. Gelbard (2005)

An operational assessment on the soundness of Armenia's public finance management was carried out in April 2004. The European Commission, assisted by external experts, carried out a follow-up assessment in April 2005, which concluded that significant progress had been made in several areas. An internal audit development unit has been established in the Ministry of Finance and Economy to oversee the implementation of the Government Strategy for Development of Internal Audit System in 2005-2008. The positions of chief auditors, created in 2004, have been

[54] Azerbaijan, Georgia, Moldova and Ukraine have ratified all eight core conventions.

filled in most ministries and a training and certification programme supported by donor-assistance is in place.

The adoption of amendments to the Constitution in a national referendum in November 2005 paves the way for the modernisation of the legal framework for independent external audits by Armenia's supreme audit institution, the Chamber of Control. Other areas of progress include putting in place a regular reporting mechanism for government-owned non-commercial organisations (former budget organisations) on their revenues and expenditure.

Decommissioning of the Medzamor nuclear power plant will have significant fiscal implications and is expected to take place not later than 2012. Decommissioning will take several years and is estimated to cost about USD 0.7 – 1.2 billion and increase the government deficit by about 10% of GDP in 2020.[55] Though some of the costs could potentially be covered via an international donor conference, the fiscal implications underscore the need for a strengthening of the tax base. Further assessments of costs versus risks are also needed.

5. Social Development and Poverty

Gross national income per capita increased to about USD 1450 in 2005 from USD 1120 in 2004. Poverty continues to fall, and extreme poverty - which affected 5.5% of the population in 2003 - may soon be eradicated.[56] However, current pension levels are still below the extreme poverty line. Pension reform is high on the agenda in Armenia, and a shift from the current pay-as-you-go (PAYG) system towards a three-pillar system with mandatory savings is being considered.

Remittances from abroad account for as much as about 16% of household income, and have made a significant contribution to reducing poverty and inequality, as poor households tend to be the main beneficiaries. Private households face a 52% increase in the retail price for gas from 10 April 2006 (following the price hike for gas imports from Russia), and this is likely to have a negative effect on poverty. Official female unemployment rates are more than twice as high (13.6%) as male unemployment rates (5.2%). About 5% of the population still lives in temporary shelters (war refugees and victims of the 1998 earthquake).

The EC is supporting Armenia with a TACIS action programme worth EUR 17 million in 2006 that focuses on improved access to justice, and support for implementation of the national programme for Partnership and Co-operation Agreement.

The US pledged in March 2006 USD 235.6 million over the next five years under the Millennium Challenge Account programme. The aid will be channelled into rural regions (upgrading of irrigation networks, repair of rural roads) that have seen little development. Armenia has also received continuous assistance from the World Bank, the IMF, UNDP, EBRD and bilateral donors. Donor coordination is considered to be good in Armenia.

[55] See E. Gelbard et al. (2005), *Growth and Poverty Reduction in Armenia,* IMF.
[56] Extreme poverty in Armenia is defined by the National Statistical Service based on World Bank methodology as household expenditures of less than USD 16 per month.

ARMENIA

Main economic indicators

	2001	2002	2003	2004	prel. 2005
Real sector					
Real GDP growth (% change)	9.6	13.2	13.9	10.1	13.9
Inflation (period average)	3.1	1.1	4.8	7.0	0.6
GDP nominal, in USD millions	2,120	2,373	2,805	3,558	4,580
GNI per capita, in USD	680	767	902	1,119	1453
Social indicators					
Unemployment (officially registered)	10.4	10.8	10.1	9.4	8.9
Poverty rate (% of population)	51.0	49.0	43.0	---	---
Inequality (Gini index consumption/ income)		0.27/0.45	---	---	---
Fiscal sector					
Total revenues, % of GDP	17.0	18.8	17.8	15.6	16.7
Total expenditure, % of GDP	20.9	19.3	18.9	17.2	17.7
Central govt. balance, % of GDP	-3.8	-0.4	-1.1	-1.7	-1.0
Gross public debt, % of GDP	45.3	46.6	40.9	30.7	28.6
Monetary sector					
Domestic credit to private sector (% of GDP)	8.3	7.2	6.4	7.5	---
Broad money (M3) (% change)	4.3	34.0	10.4	22.3	27.8
Degree of monetisation (M3/GDP, %)	14.5	14.9	14.4	15.1	---
Dollarisation in bank deposits (%)	80	71	71	71	---
External sector					
Current account balance, % of GDP	-9.5	-6.2	-6.8	-4.6	-3.9
Trade balance, % of GDP	-19.8	-15.5	-15.4	-12.9	-12.1
Foreign direct investment (net, % of GDP)	3.3	5.0	5.0	6.1	5.6
Import cover of reserves (months)	3.6	3.7	4.0	3.6	4.0
External vulnerability					
External public debt, % of GDP	42.8	43.2	38.0	31.3	---
Debt service ratio[1]	9.7	9.8	15.6	9.7	5.7
Gross reserves (excl. gold, USD millions)	321	425	510	576	755
Reserves/M3	107	122	125	102	---
Financial sector					
Money market rate	19.4	12.3	7.5	4.2	3.2
Lending rate	26.7	21.1	20.8	18.7	18.0
Exchange rate (drams per USD, average)	555.1	573.4	578.8	533.3	457.7
Exchange rate (drams per EUR, average)	497.2	629.6	653.8	662.3	569.8
Real effective exchange rate (2000=100)	90.6	82.7	77.2	82.2	---

Sources: IMF, EBRD, Armenian authorities

[1] Public external debt service in % of exports of goods and services

AZERBAIJAN

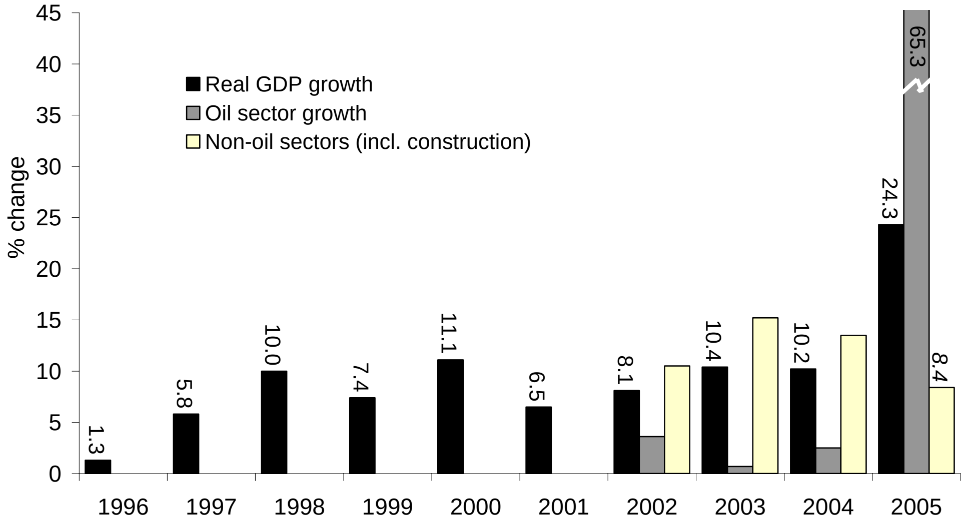
- **Impressive growth performance has been driven by high oil prices and increased oil production. Extraction from the large Azeri-Chirag-Guneshli oilfield began in February 2005.**
- **Inflationary pressures were combated by allowing the manat to gradually appreciate against the USD from February to September 2005 and increasing the National Bank of Azerbaijan's refinancing rate from 7% to 9%.**
- **Corruption remained a significant deterrent to efficient investment and private sector development. The anti-corruption law entered into force in early 2005, but enforcement remains insufficient.**
- **Poverty reduction has been driven by high growth and high public salary increases. The minimum wage was increased by 50% during 2005 and it appears that the percentage of people living below the national poverty line fell below 40%.**

1. Macroeconomic developments

Real sector developments

Real GDP is estimated to have grown 24.3% in 2005, up from 10.2% in 2004. The impressive growth record was driven by high oil prices and increased oil production. Extraction from the large Azeri-Chirag-Guneshli oilfield began in February 2005 and the Baku-Tbilisi-Ceyhan (BTC) oil export pipeline, with a capacity of approximately one million barrels a day, was opened with a ceremony in Baku on 25 May 2005. Delivery of oil from the pipeline to tankers in Ceyhan (Turkey) is expected to begin in the first half of 2006. Together with increased gas extraction and the completion of the Baku-Tbilisi-Erzurum (BTE) natural gas pipeline later in 2006 this is projected to result in another year of extraordinarily high GDP growth, around 25-30%, in 2006.

Chart 1: Azerbaijan - Economic growth



Source: IMF.

Domestic demand rose substantially in 2005 as a result of rising private consumption and increasing investment. Oil pipeline construction slowed down, but an oil-related building boom had positive spillover effects on most other segments of the non-oil sector – in particular the service sector in and around the capital. Non-oil-sector labour productivity has increased markedly in recent years.

Agricultural production increased by about 7.5% in 2005. The agricultural sector's share of the economy has been rapidly decreasing and now only accounts for about 10.4% of GDP, though agriculture and forestry still employ 39% of the labour force (1.5 million people). Industry (including the oil sector) showed about 33.5% growth in 2005 while the service sector also grew by an impressive 23.1%.

The official unemployment rate increased slightly to 1.2% in 2005, but this is far from reality. The real unemployment rate is much higher, as revealed by an ILO survey from 2003 estimating the unemployment rate at 10.7%.

Fiscal developments

The consolidated government balance showed a surplus of about 1.1% of GDP, slightly higher than in 2004, while the non-oil government deficit (in % of non-oil GDP) improved slightly to -15.4% in 2005 from -16.8% in 2004. The initial target for the non-oil fiscal deficit in 2005 was reduced somewhat to fight inflationary pressures.

Azerbaijan has a long-term oil revenue management strategy approved by presidential decree in 2004, but the state budget for 2006, with a planned increase in government expenditure of 62% and an increase in the non-oil fiscal deficit from 12% of GDP in 2005 to 30% of GDP in 2006, is too expansionary to be in line with this. In particular the planned non-oil fiscal deficit is not sustainable in the long term.

A reduction in the non-oil fiscal deficit would also help to limit inflationary pressures and it is likely that the authorities will have to cut expenditures in order to maintain single-digit inflation. The budgeted increase in expenditures is partly a result of planned wage increases. Implicit energy subsidies amounted to about 20% of non-oil GDP in 2005[57], and there are no plans to reduce these in 2006. Explicit energy subsidies total some 5% of non-oil GDP. On the revenue side the budgeted oil price is raised from USD 20-25 to USD 35 per barrel, and all in all this results in a projected increase in the state budget deficit from 0.7% of GDP in 2005 to 1.1% of GDP in 2006.

Oil revenues above the budgeted oil price are transferred to the State Oil Fund of the Republic of Azerbaijan (SOFAZ), which was established by presidential decree in December 1999. The main purpose of the fund is to save oil- and gas-related revenues for future generations. Under the current regulations oil fund expenditures may not exceed inflows in any given year. SOFAZ total assets amounted to USD 1320 million at the end of 2005 compared to USD 970 million at the beginning of the year.[58] The public and publicly guaranteed external debt stood at about 14% of GDP at end-2005, down from 18.5 % at end-2004.

[57] IMF estimate, IMF Article IV (March 2006).
[58] According to SOFAZ 2004 Revenue and Expenditure Statement (non-audited).

Monetary and exchange rate developments

The National Bank of Azerbaijan (NBA) abandoned its informal peg of the manat to the USD in mid-February 2005, allowing a slow appreciation in order to combat rising inflation. The manat then gradually appreciated 6.5% until late September 2005, when the NBA, following a government announcement, reintroduced the de facto peg to the dollar. The real effective exchange rate appreciated further as a result of the USD appreciation against the EUR.

The central bank raised its refinancing rate half a percentage point in May and again in June, followed by a full percentage point increase to 9% in the beginning of October. The refinancing rate had been held unchanged since September 2002. Despite this tightening of monetary policy average annual consumer price inflation increased to 9.6 % in 2005 from 6.7% in 2004. At the end of 2005 price pressure moderated and consumer price inflation came down to 6.2% (year-end). Increased inflationary pressure is likely to materialise in 2006 as a result of a doubling of retail gas prices and could be exacerbated by the expansionary fiscal policy. On the other hand, measures taken by the NBA and reduced pressures from FDI inflows may help to keep inflation down.

The NBA has announced that it is committed to follow a managed float in 2006 with the objective of keeping core inflation in single digits. The NBA is expected to move to a full-fledged inflation-targeting policy framework over the medium term.

Broad money supply (M2) grew by 15.8% year-on-year in 2005, down from 31.9% in 2004. The money supply growth has been driven by capital inflows and supported by fundamentals, i.e. the high GDP and wage growth, and is accompanied by a financial deepening, though the stock of manat money and credit remain low compared to other transition economies. The economy is heavily dollarised and foreign currency savings are substantial. Monetary depth, measured as M2/GDP, fell slightly to 0.07 in 2005, but bank lending grew strongly (domestic credit grew 50.5%), albeit from a low level.[59] Gross official reserves continued to grow and gross international reserves amounted to USD 1.2 billion at end-2005, covering around 2.2 months of imports.

The National Bank of Azerbaijan gradually started putting a new manat into circulation from January 2006. One new manat equals 5 000 old manats, which puts the new manat at an equivalent of about USD 1.1.

External sector developments

The trade balance improved significantly to a surplus of 18.8% of GDP in 2005 from 1.9% of GDP in 2004, due to a jump in export values and a more moderate increase in import values. The export growth has been oil-driven (exports of oil and oil products increased about 85% in 2005), although non-oil exports, which only account for 12% of total exports, also performed well (non-oil exports increased about 25% in 2005). As a result, the current account deficit was reduced to 5.2% of GDP in 2005, down from 30.4% of GDP in 2004.

In previous years the current account deficit was fully financed by foreign direct investment net inflows, but in 2005 there appears to have been a net FDI outflow amounting to about USD 0.7 billion (5.8% of GDP), with the current account deficit instead financed by other investments.

[59] According to IMF IFS.

The foreign debt increased to USD 2.2 billion (17.5% of GDP) in 2005 from USD 1.9 billion in 2004. The completion of the BTC oil pipeline and the BTE gas pipeline will lead to sizeable energy export increases in 2006 and at the same time imports for oil sector development will gradually decrease. As a result the current account will swing into surplus in 2006.

EU was the main trading partner for Azerbaijan both for imports (32%) and for exports (59%). Oil products and chemicals made up 88% of Azerbaijan's exports, while the main non-oil export commodities were food, metals and textiles. Imports of machinery and equipment for the oil and gas sector accounted for 40% of total imports in 2005. Other notable imports are metals and food.

2. Trade liberalisation and economic opening

Azerbaijan's trade liberalisation efforts are encouraged by a Partnership and Co-operation Agreement (PCA) with the EU, which was signed in 1996 and entered into force in 1999.[60] Azerbaijan is also a beneficiary country of the EU's Generalised System of Preferences (GSP). However, total EU preferential imports from Azerbaijan are heavily concentrated in a few products. Although an EU-Azerbaijan FTA is not currently being considered, the future development of the EU-Azeri trade and economic relations depends very much on the implementation of the Action Plan. Azerbaijan's WTO accession negotiations are ongoing; the 3rd Working Party on Accession took place on 30 June 2005.

3. Business climate

Privatisation, enterprise restructuring and business environment

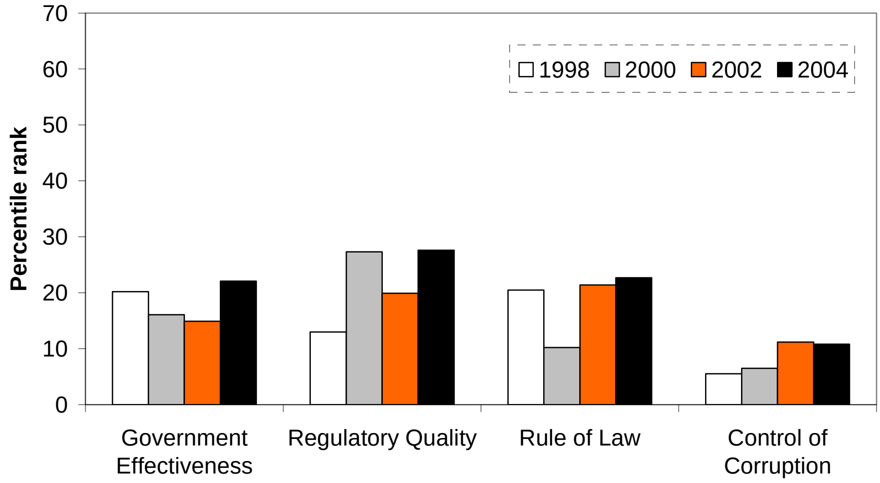
The privatisation process has slowed down now that most small and medium-sized enterprises have been privatised, but there is still a need to privatise and restructure large and inefficient state companies. Privatisation tenders for the two large fixed-line telecommunication companies were announced in 2005, while restructuring plans for gas and water sectors stalled. It is planned to turn railway and shipping companies into joint-stock companies ahead of privatisation.

Azerbaijan's authorities are working to improve its legislative and regulatory framework and to bring it closer to European standards. This is a major task, as indicated by Azerbaijan's position on the edge of the lowest quartile in the World Bank's indexes for regulatory quality, rule of law and government effectiveness in 2004 (chart 2). Starting a business is still complicated, procedures are lengthy, contract enforcement is expensive and investor protection is limited. As a result there is a large informal economy.[61]

[60] Azerbaijan also initiated the process towards WTO membership in 1997, though the accession negotiations are still at an early stage.

[61] According to the State Statistical Committee the informal economy is estimated at 18-20% of GDP, which is comparable to the average for OECD countries. Other estimates suggest a larger informal sector.

Chart 2: Azerbaijan - Governance



Source: World Bank Governance indicators.
Note: A higher ranking implies a better relative score.

Corruption remains a significant deterrent to efficient investment and private sector development. Azerbaijan is ranked 137th out of 159 countries on Transparency International's Corruption Perception Index, indicating substantial problems. An anti-corruption law entered into force in early 2005, but enforcement remains insufficient. There is a need to simplify what is currently a complex and fragmented way of dealing with corruption.

Financial sector reforms

Financial sector development in Azerbaijan has been slow compared to other transition economies and state ownership still dominates the banking sector. The depth of bank intermediation activity is gradually improving but is still lower than the CIS-7 average. Growth in credit to the private sector has been very strong in 2005 (50.5% growth), but low ratios of bank deposits to GDP (0.12) and private sector credit to GDP (0.10) signal that the provision of financial services to households and the private sector is still very limited.[62] Despite this the pace of credit expansion might have put pressure on some banks' capacity to assess credit risks. A credit register was established in 2005.

Increased competition in the banking sector, as a result not least of privatisation of the dominant International Bank of Azerbaijan (IBA), is necessary to facilitate financial deepening and foster balanced economic growth. The privatisation of the two state-owned banks, IBA and Kapital bank (former BusBank), was revived by decree in March 2005, but has yet to take place. IBA controlled 51% of the total assets of the banking system (and 62% of deposits) while Kapital Bank controlled 5% at end-2005.

Minimum capital requirements for new banks were doubled (to AZM 50 billion) in January 2006 and will be doubled for existing banks in mid-2007. This move may help to facilitate some consolidation among the present 42 relatively small private banks. Financial supervision has improved with several laws on prudential regulation approved in 2005 in line with the IMF's Financial Sector Assessment Programme (FSAP) recommendations. Enforcement and monitoring capacity has however remained relatively weak and needs to be further improved.

[62] Estimates based on IMF IFS.

Labour market reforms

A National Employment Strategy for 2006-2013 was signed by the President in October 2005, and includes a National Action Plan on Employment (NAPE), developed in cooperation with ILO and focusing in particular on vocational education and training, development of small and medium-sized enterprises (SMEs) and social protection.

The minimum wage was increased by 25% in January and by another 20% in October 2005 to AZM 150 000 (about EUR 28) per month. Despite these increases, which followed even larger increases (in percentage terms) during 2004, the minimum wage is still below the national absolute poverty line of AZM 194 000 (the cost of a minimum consumption basket). Many public sector employees have their wages linked to the minimum wage and some groups, e.g. teachers, received higher salary increases.

Most private sector employees have salaries well above the minimum wage and the average monthly wage in the economy stood at about AZM 577 000 (EUR 99) in the first 9 months of 2005 – an increase of 22% compared with the same period a year before. Wage inequalities in Azerbaijan are the highest in the CIS region.[63] The very low official unemployment rate, 1.2% in 2005, reflects the fact that few take advantage of unemployment benefits, which are very low.

4. Public institutions and public finance management

The budget preparation process was improved in 2005 and a transition towards programme budgeting is expected in the medium term. Several steps targeting improved quarterly monitoring of the budgets of state-owned enterprises, including the State Oil Company of the Azerbaijan Republic (SOCAR), have been implemented during 2005. Azerbaijan participates in the Extractive Industries Transparency Initiative (EITI).

5. Social development and poverty

The 3-year State Programme on Poverty Reduction and Economic Development (SPPRED) expired in 2005, but is followed by a 10-year SPPRED for 2006-2015. Some success in poverty reduction has been observed, driven in particular by high growth and the high public salary increases. It appears that the percentage of the population living below the national poverty line (defined as the value of a minimum consumption basket worth AZM 195000 (EUR 29) in 2004), which was reduced to 40.2% in 2004 from 49% in 2003, was well below 40% in 2005.[64] The IMF estimated extreme poverty at 17% in 2004. Poverty is most widespread in rural areas and in particular in the western part of the country.[65]

A legal framework for targeted social assistance was prepared during 2005 to be in place from January 2006. There has previously been little targeting of social benefits, with the poorest deciles receiving little more than the richest. A large number of internally displaced persons continue to live in tent camps.

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[63] World Bank (2005), *Enhancing Job Opportunities in Eastern Europe and the Former Soviet Union*, World Bank.

[64] Azerbaijan Ministry of Economic Development (2005), *State Programme on Poverty Reduction and Economic Development 2003-2005, Azerbaijan progresses toward the achievement of the millennium development goals*.

[65] Baschieri, Angela and Falkingham, Jane (2004). *Creating a Poverty Map for Azerbaijan*, S3RI Applications and Policy Working Papers, A04/12.

AZERBAIJAN

Main economic indicators

	2000	2001	2002	2003	2004	prel. 2005
Real sector						
Real GDP growth (% change)	11.1	9.9	8.1	10.4	10.2	24.3
Inflation CPI (period average)	1.8	1.5	2.8	2.2	6.7	9.7
GDP nominal, in USD (billions)	5.2	5.7	6.3	7.3	8.7	12.6
GDP per capita, in USD	653	701	759	880	1041	1493
Social indicators						
Unemployment[1]	---	---	---	10.7	---	---
Public expenditures on health, % of non-oil GDP	1.2	1.2	1.3	1.1	1.3	1.7
Life expectancy at birth, years	65.2	65.2	65.2	---	---	---
Enrolment ratio for basic school (class 5-9)	86.5	89.6	88.8	---	---	---
Earnings inequality (GINI-coefficient)	50.6	50.1	---	---	---	---
Poverty (% living below national poverty line)[2]	---	49.6	46.7	49.0	40.2	---
Fiscal sector						
Total revenues, % of GDP[3]	21.2	18.7	22.0	21.2	22.4	24.0
Total expenditure, % of GDP	20.8	18.7	22.4	23.0	21.4	21.5
Central govt. balance, % of GDP	-0.8	-0.4	-0.5	-0.8	1.0	2.7
Public external debt, % of GDP	22.2	20.2	20.1	19.7	18.5	14.3
Monetary sector						
Base money, % yoy	18.8	-8.7	33.9	27.0	31.5	13.8
Broad money (M2), % yoy	27.1	1.6	20.4	27.6	31.9	15.8
Private sector credit (% change)	-1.7	-17.5	16.7	28.6	26.0	50.5
Degree of monetisation (M2/GDP, %)	7.0	6.3	6.7	7.4	8.2	7.6
External sector						
Current account balance, % of GDP	-3.6	-0.9	-12.3	-27.8	-30.0	-5.2
Trade balance, % of GDP	4.9	10.2	7.7	-1.4	3.2	18.7
Foreign direct investment net inflows, % of GDP	2.8	5.1	17.2	31.5	26.8	-5.8
Import cover (months)	5.3	5.9	4.0	3.5	3.9	2.8
External vulnerability						
External public debt, % of GDP	19.8	20.2	20.1	19.7	18.5	14.3
Debt service ratio[4]	4.6	4.9	4.4	5.2	3.6	1.9
Gross reserves (excl. gold, USD billions)	0.68	0.73	0.72	0.80	1.07	1.18
Reserves/M2	9.3	10.3	8.7	7.6	7.7	6.8
Financial sector						
Short-term interest rate (NBA refinancing rate)	9.5	8.4	8.6	6.9	7.0	9.0
Exchange rate (per USD, end of period)	4565	4775	4893	4923	4903	4593
Exchange rate (per EUR, end of period)	4238	4229	5080	6195	6681	5416
Real effective exchange rate (2000=100)	100	94	87	77	75.5	---

Source: IMF, EBRD, National Bank of Azerbaijan and own calculations.

[1] ILO labour market survey.

[2] The national absolute poverty line is defined by a minimum consumption basket valued at AZM 175 000 monthly for 2002 and AZM 195 000 for 2004. Poverty figures for 2001 and 2002 are not directly comparable due to changes in methodology

[3] Includes grants

[4] Public external debt service in % of exports of goods and services.

BELARUS

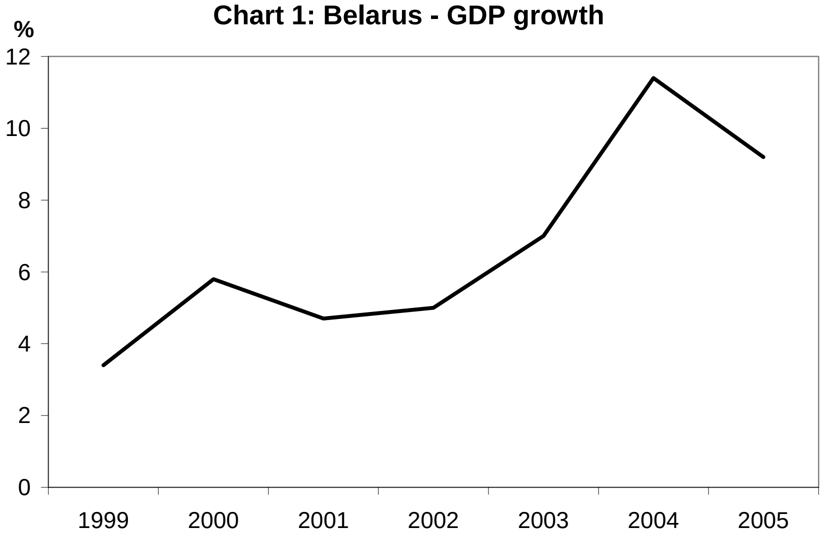
- **The role of the state in the economy remains large, due to limited progress with liberalisation and structural reforms. In the current political environment this is unlikely to change.**
- **Strong economic growth was largely due to external factors such as the special relations with Russia, including direct and indirect subsidies, and increased refined oil export revenues. Fundamental reforms are necessary to achieve sustainable private sector-led growth.**
- **Several fiscal expansion measures have been undertaken, not least in the run up to the presidential elections, and are threatening fiscal consolidation. Both expenditures and revenues are close to 50% of GDP.**
- **The country is still very exposed to external shocks, in spite of the substantial improvement in the trade, current account and foreign reserves situation in 2005, which may be of a temporary nature.**

1. Macroeconomic developments

Real sector developments

In 2005, the GDP growth rate was a high 9.2%, albeit less than in 2004 (11.4%). That is above both the CIS and the Russian average growth during the period 2004-05. The cumulative growth since 1999 was 55%, and that on top of one of the shallowest "transitional recessions" observed in the CIS (partially due to the avoidance of structural reform, with the consequent forestalling of short run losses).

Chart 1: Belarus - GDP growth



Source: IPM, IMF IFS

A substantial part of this economic performance is related to Belarus "special relations" with Russia. Belarus has a free trade agreement (FTA) with Russia, the country benefits from direct and indirect transfers (notably through subsidised energy prices) and there are no border controls between the two countries (a sizable share of the Belarusian labour force is estimated to be employed in Russia, contributing with remittances). A "Union State" between the two countries has long been mooted. It must be noted that the long-run sustainability of the current rather positive economic performance of Belarus, in the absence of significant structural reforms, essentially lies on the continued Russian willingness to bankroll the Belarusian economy.

The output of all major industrial sectors grew more slowly in 2005, a result of the continued loss of competitiveness of Belarus vis-a-vis Russia, its single main external market. Industry's contribution to GDP growth in 2005 was 1.4% less than in 2004, amounting to 4.2%. The two industrial sectors with the highest growth rate in 2005 were electricity – linked to the availability of cheap gas supplies by Russia, and which is partially exported to Poland – and machinery and metal working, a traditionally strong sector in the Belarusian economy. Private consumption is estimated to have grown by 8% in 2005. Investment reached 23.3% of GDP, an 8% increase on 2004 (and almost 5% GDP points above the investment rate observed in Russia). In spite of favourable international price developments, which contributed to the increase of exports in value terms, the *volume* of exports decreased. On the demand side, GDP growth is driven mainly by private consumption and investment, supported by wage and credit expansions.

Fiscal developments

Belarus has undertaken a substantial fiscal adjustment since the early 2000s, from a deficit of around 3% of GDP in 1999 to 0.6% in 2005. Expenditures and revenues as a share of GDP are very high, close to 50%, significantly above the averages of CIS and other "transition" economies, which reflects the dominant role of the state in the economy.

In December 2005, new edicts amended the 2005 budget, increasing expenditures for agricultural support. These changes caused the planned fiscal deficit of the Central government to rise by BYR 1.8 trillion or 2.8% of GDP. However, as the Government used its deposits at the Central Bank of Belarus (NBB) to finance the budget deficit, the fiscal effects of this were limited. Also, in early 2006 the president of Belarus signed an edict by which the state will restructure the debts of state-owned enterprises, excluding agricultural ones, which had losses as of October 1, 2005. According to this decree, the overdue accounts payable of some 300 loss-making enterprises will be given a 5-year payment extension. Estimates put the amount of overdue accounts payable to be restructured at around 0.8% of GDP. About 50% of these debts are to the Belarusian government, 13% to banks, and 23% to energy companies. Public debt to GDP is rather low and on a decreasing trend, estimated at below 9% in 2004.

Monetary and exchange rate developments

Parallel to the fiscal consolidation indicated above, Belarus has observed a relatively slow but steady disinflation process (from over 100% in 2000 to 8% in 2005). The exchange rate was unified in the early 2000s, and the operational independence of the central bank, the NBB, increased at the same time. These developments were mostly linked to the preparation of the Belarusian monetary authority towards an eventual currency union with the Russian Federation, which has been repeatedly postponed. Belarus follows a dual exchange rate targeting of the Russian rouble and the US dollar, targeting each one of those currencies at different frequencies (namely, smoothing variability to the USD at low frequencies, and to the RUR at higher frequencies).

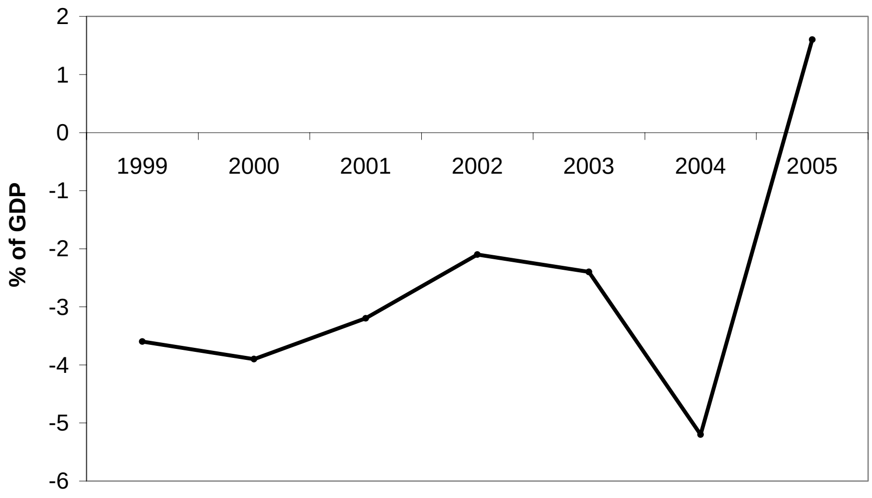
The monetary base grew by 73.7% in 2005. The main determinant of this very significant increase in the money supply was the government's withdrawal of practically its entire savings from the accounts in the NBB, amounting to BYR 976.2 billion. The NBB increased the volume of hard currency sold on the domestic market, which partially sterilized the money supply increase. Commercial banks also increased their reserves in NBB (in NBB securities and NBB deposits). The hard currency component of the monetary base also increased considerably, due to a Russian intergovernmental loan in the amount of USD 146 million in late 2005. By end 2005, foreign exchange reserves stood at USD 1.3 billion, equivalent to less than a month of imports (twice as long as in 2004).

External sector developments

Overall external trade is still concentrated, with Russia as its main trading partner, albeit recent developments have substantially increased the EU share of its exports (44%, compared with Russia's 36%, in 2005). The EU share of Belarus' imports remains around 22%.

During 2005, merchandise exports amounted to USD 18.2 billion and imports to USD 17.9 billion. The exports growth rate exceeded that of imports. As a result, the trade balance posted a surplus of USD 296.4 million (1% of GDP), as opposed to the USD 1.5 billion deficit of 2004 (or -6.5% of GDP). The merchandise trade deficit with Russia reached USD 4.4 billion, far above the 2004 value of around USD 3.9 billion. This was mainly due to a fall in exports to Russia, reflecting the continued loss of competitiveness of Belarus vis-a-vis Russia. Exports to non-CIS countries increased by 67.3%, to around USD 8.5 billion. This was mostly driven by the export of refined oil products to the EU: exports of oil products to non-CIS countries increased in value terms by 48.3%. The current account deficit was 5.2% in 2004, and swung to an estimated surplus of 1.6% of GDP in 2005, on the back of the increased oil products export revenues.

Chart 2: Belarus - Current account balance



Source: IPM, IMF IFS

One of the reasons why trade in oil products is so profitable for Belarus is that Russia waives crude export fees on exports to Belarus. Also, Belarusian export duties on refined oil products are twice as low as in Russia's – which contradicts the terms of the planned Russia-Belarus customs union (CU), as this stipulates common external tariffs. In December 2005, export duties in Belarus were raised, but not for oil products. Foreign debt is low, at less than 22% of GDP at end 2005, and falling.

2. Trade Liberalisation and Economic Opening

The core of Belarus external trade relations remains the FTA, and the planned finalization of a CU with Russia, as part of a future "Union State" between the two countries. Belarus has applied for WTO membership in 1995, the Working Party process is still ongoing. The EU granted GSP preferences to the country in the mid 1990s, but a process that might lead to the temporary suspension of such preferences, due to alleged infringements to the freedom of association, is currently ongoing, with conclusion expected by mid 2006.

3. Business Climate

Privatisation, enterprise restructuring and business environment

Belarus suffers from a pervasive government interference in the economy, ranging from direct ownership of most large enterprises to a so-called "golden share" rule, which enables the government to interfere with all already privatised enterprises, to the administrative allocation of credit, wage growth targets and price controls, all of which point to a slow progress towards the implementation of market economy mechanisms.

As a consequence, the Belarus economy has one of the lowest shares of private enterprises in the CIS region, at below 25% of GDP. Little progress was made in privatisation in 2005. According to the EBRD, shares in six companies were sold to domestic buyers from a list of 89 joint-stock companies for sale. Some 145 enterprises are incorporated into joint-stock companies, but they remain state-owned. In 2005, 136 of these incorporated enterprises were prepared for privatisation. By year end, however, only nine had been sold off. In the meantime, the state has increased its stake in a number of enterprises and banks.

Accordingly, using World Bank "Doing Business in 2006" data, to launch a business in Belarus entrepreneurs can expect to have to go through 16 steps, each taking 79 days on average, at a cost equal to 22.9% of gross national per capita income (GNI). They must also deposit at least 42.8% of GNI per capita in a bank to obtain a business registration. These indicators are worse than in Russia. Belarus has a very low level of FDI, even among CIS countries. On the other hand, it consistently scores among the best performers in CIS countries concerning the perception of corruption.

Financial sector reforms

No major new developments were observed in the financial reform field, beyond a new decree abolishing the legal requirement to provide collateral for loans. Additionally, the NBB abolished the privileges for banks resident in the Free Economic Zones existing in Belarus, concerning the size of the authorized fund and banks' capital requirements.

Foreign participation in the banking sector is rather limited, with the share of foreign capital in total bank capital currently at approximately 10% –well below the current limit of 25% imposed by the legislation– and all major banks remain under state control. There are presently 31 commercial banks operating in Belarus, down from 40 in 1995. The four largest majority state-owned banks (Belarusbank, Belagroprombank, Belpromstroibank and Belvnesheconombank) account for around 70% of assets, equity and customer deposits in the banking sector. The two largest banks, Belagroprombank and Belarusbank, are 100% state-owned and hold 55% of all banking sector assets. The third largest bank and largest private bank is Priorbank (with around 12% of assets), a member of the Austrian Raiffaisen group. In terms of net profits, Priorbank accounted for a full 1/3 of the net profit of the whole banking system. The fourth largest bank, Belpromstroybank, was recently re-nationalised. Belvnesheconombank has recently been privatised, the state now directly owning only 48.3%, but it is still considered as state-controlled.

Labour Market reforms

No major new developments were observed in the labour market reform field. State salaries in Belarus have growth targets in dollar denominated values (and above labour productivity growth). In 2003 the trade unions at nine state enterprises merged to form the Belarusian Union of Industry Workers (BUIW), which subsequently became a member of the state-supported BFTU (Belarus Federation of Trade Unions). The authorities and directors of state enterprises placed significant pressure on workers to join the BUIW. In June 2003, the International Labour Organization's (ILO) Standards Committee included the country in its special paragraph on trade union violations for a second consecutive year. In November 2003, the ILO approved the establishment of a Commission of Inquiry to investigate alleged violations of workers' rights in the country. This is the basis of the current investigation that could potentially lead to the withdrawal of GSP trade preferences by the EU.

In 2004, the government introduced short-term work contracts for all state employees (80% of the Belarusian work force works directly or indirectly for the State). Although contracts may be concluded for a period of five years, most expire after one, therefore allowing the government to fire workers annually.

4. Public institutions and Public Finance Management

In November 2005, a presidential decree stated that the President now has greater powers to grant benefits to firms and investors (tax credits and benefits, subsidies and capital investment etc.). In addition, he now has the right to confirm state programmes in the areas of agriculture, forestry and the environment. Additionally, the decree granted the exclusive right to amend parts of legislation that can affect the revenue or expenditure components of the budget. This decree effectively unifies previously existing legislation. Nevertheless, some progress has been made in fiscal consolidation, with the incorporation into the budget of the Social Protection Fund in 2004, and of the Innovation Fund in 2005.

5. Social Development and Poverty

Belarus has one of the lowest official unemployment rates in Europe, currently at below 2%. Part of this is related to hidden unemployment, as un-restructured enterprises are kept afloat via government bail-outs and via the preferential access to the Russian market. Also importantly, the free access of Belarus workers to the large and growing Russian market (there are no passport controls between the two countries) helps to keep unemployment low.

Government social policy is geared towards the maintenance of a comprehensive social safety net, financed through high tax levels (government expenditure is close to 50% of GDP) and direct and indirect Russian transfers (which, given the high level of state ownership in the economy, are *directly* captured by the Belarusian government). Since the late 1990s, more than two million Belarusians (over 20% of the population) have been lifted out of poverty, following a similar CIS-wide strong trend towards the simultaneous reduction of poverty and inequality. The poverty rate fell from 33% in 1998 to 12% in 2002, with further falls estimated since then.

BELARUS

Main Economic Indicators

	2001	2002	2003	2004	2005
Real Sector					
Real GDP Growth (% change)	4.7	5.0	7.0	11.4	9.2
Inflation CPI (e-o-y)	46.0	35.0	25.0	14.0	8.0
GDP Nominal, in USD million	12.1	14.5	17.7	23.1	29.5
GDP per capita, in USD ths.	1,214	1,461	1,791	2,338	2,986
Social Indicators					
Unemployment	2.3	3.0	3.1	1.9	1.5
Life Expectancy	--	68.2	68.2	--	--
Under 5 mortality rate, %	--	--	17.0	--	--
Literacy, total	99.7	99.7	--	--	--
Fiscal Sector					
Total Revenue, % of GDP	44.7	44.6	45.8	44.2	48.3
Total Expenditure, % of GDP	46.8	46.4	47.2	44.1	48.9
Central Government balance, % of GDP	-1.9	-1.8	-1.4	0.0	-0.6
Gross Domestic Public Debt, % of GDP	6.1	5.4	5.5	5.7	5.8
Monetary Sector					
Private Sector Credit (% change)	-7.8	7.7	25.4	61.2	48.7
Private Sector Credit as % of total credit	48.9	52.2	56.3	67.6	74.6
Broad Money (M3), % yoy	62.2	50.3	56.8	44.1	42.0
Degree of Monetization (M3/GDP, %)	15.2	15.1	17.2	17.7	19.7
External Sector					
Current Account Balance, % GDP	-3.2	-2.1	-2.4	-5.2	1.6
Trade Balance, % of GDP	-3.5	-3.7	-4.0	-6.5	1.0
Foreign Direct Investment, % of GDP	0.8	1.7	1.0	1.1	1.0
Import cover (months)	0.5	0.8	0.6	0.5	0.9
External Vulnerability					
External Public Debt as % of GDP	24.8	27.0	23.7	21.4	18.0
Debt Service/Exports Ratio	3.4	2.6	2.2	--	--
Gross Reserves (excluding gold)	347	457	474	770	1,297
Reserves/M3	4.8	3.6	5.1	5.3	4.5
Financial Sector					
Short Term Interest Rate	47.0	36.9	24.0	16.9	11.4
Exchange rate (per EUR, eop)	1,392	1,989	2,695	2,956	2,550
Exchange rate (per USD, eop)	1,580	1,920	2,156	2,170	2,152
Real Effective Exchange Rate (2000=100)	0.67	0.69	0.67	0.65	0.64

Sources: Ministry of Statistics and Analysis of Belarus, Ministry of Finance of Belarus, NBB, WDI, IMF, EBRD, IPM and own calculations.

EGYPT

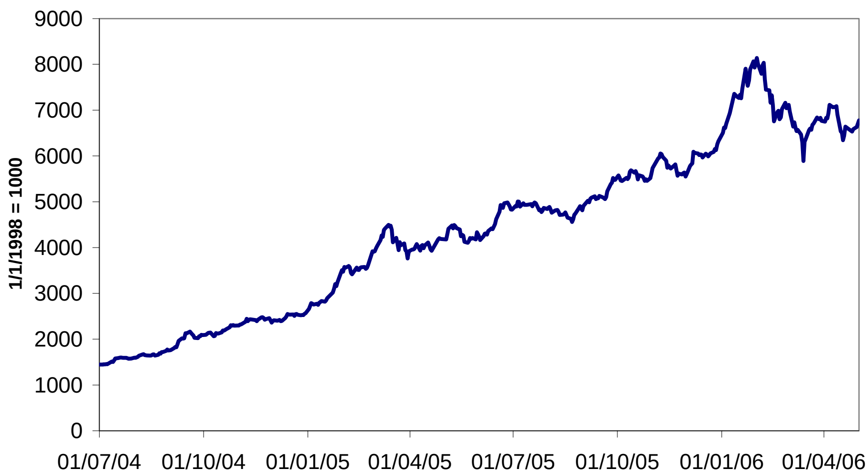
- **Economic growth accelerated from 4.2% in fiscal year 2003-04 (FY04) to 5.1% in FY05, driven by strong growth in exports in goods and services, in particular tourism, and backed by increasing confidence thanks to vigorous reforms.**
- **Egypt needs to implement a consolidation strategy to tackle its relatively high budget deficit and public debt. The general public deficit widened to 7.1% of GDP in FY05 (6.6% in FY04) due to tax and tariff cuts, rising energy subsidies and public wages.**
- **In the first half of FY06 foreign reserves grew by USD 2.6 billion, up from USD 0.7 billion in the first half of FY05. Thanks to services and transfer revenues, the current account was in surplus of USD 1.1 billion, despite a USD 5.9 billion goods-trade deficit.**
- **Egypt has achieved impressive economic reforms, greater monetary stability, and economic growth. The Action Plan which Egypt is currently negotiating with the EU should support further necessary reforms, particularly to foster the private sector.**

1. Macroeconomic developments

Real sector developments

Economic growth accelerated to 5.1% in fiscal year 2004-05 (FY05) – up from 4.2% in FY 04 – driven by strong growth in exports in goods and services.[66] Investment and consumption also picked up thanks to increased business and consumer confidence on the back of vigorous reform policies which were launched by the new government in the second half of 2004.

Chart 1: Egypt - Stock Exchanges Index



Source: Cairo & Alexandria Stock Exchanges.

Growth was supported, inter alia, by improved monetary and exchange-rate policies (including the establishment of a smoothly functioning foreign-exchange market), abundant liquidity, privatisation, strong foreign demand, in particular from neighbouring oil-exporting countries,

[66] The fiscal year runs from July to June.

and record remittances of USD 4.3 billion in FY05 (4.7% of GDP). Having reached 6.1% in the second quarter of FY06, overall growth is expected to reach about 5.9% in FY06 based on dynamic development in the tourism, construction, and energy and merchandise exports sectors.

The increasingly positive sentiments towards Egypt's economic policy and performance fuelled an excellent performance of the Cairo and Alexandria Stock Exchanges Index (Chart 1) supported by net portfolio inflows of USD 2.8 billion in the first half of FY06. The index reached a record high of 7117 on 1 March 2006. It then underwent a correction, but thereafter seems to have resumed its growth trend. On 2 May 2006 it stood at 6775, 38% higher than at the beginning of FY05, and 366% higher than when the new government was sworn in (7 July 2004).

Fiscal developments

The general public deficit (augmented fiscal balance) widened to 7.1% of GDP in FY05 (up from 6.6% in FY04) despite increased economic growth. The central government deficit widened markedly to 8.9% of GDP in FY05 (up from 5.9% in FY04) on the back of increased energy subsidies (+50%), public wages (+20%), and tax and tariff cuts designed to improve the medium-term growth perspectives. Increased spending also contributed to the huge deficit. Public consumption rose by 4% in FY05 (against 2.0% in FY04). Whereas external government debt was reduced by 1.4% of GDP to 19.6% in FY05, total domestic public debt rose by 5.5% of GDP to 95.2% of GDP. The government relies heavily on monetary financing from the Central Bank, which increased by around EGP 12 billion to net EGP 35.1 billion in FY05 (68.3% of government domestic financing).

According to an April 2006 IMF statement, Egypt needs an "ambitious and credible medium-term fiscal consolidation strategy that puts public debt as a share of GDP on a firmly declining path". Towards this end the authorities agreed with the IMF on a comprehensive spending reduction programme, aimed at rationalising and increasing the productivity of spending, and improving the targeting of subsidies for the poorer strata of the population.

Nevertheless, in FY06 the central government deficit could rise to 10.9%. Whereas customs receipts are likely to grow more strongly – following the sharp decline in FY05 due to tariff cuts – import volumes are rising robustly as domestic demand increases along with accelerating growth. However, income tax receipts are likely to fall because of lower personal and corporate tax rates. Spending will also rise further not least due to government pledges to raise public wages by 75%-100% in the coming six years and by extending the social safety net to 650 000 families.

Monetary and exchange rate developments

In an important monetary policy statement of June 2005, the Central Bank of Egypt (CBE) reconfirmed its "primary and overriding objective" of price stability and its commitment to improve its strategy, first and foremost by introducing inflation targeting. This will provide a nominal anchor instead of the exchange-rate peg given up in 2004. In the transition period the CBE is relying mainly on short-term interest rates to fulfil its objectives. To better synchronise data releases and monetary policy decisions, the Monetary Policy Committee (MPC) decided that starting Thursday April 6, 2006, its meetings would be held every six weeks.

Box 1: Monetary Policy Statement of 2 June 2005 (excerpt)

Monetary Policy Objective
The 2003 law on the "'Central Bank, Banking Sector and Monetary System' entrusts the Central Bank of Egypt (CBE) with the formulation and implementation of monetary policy, with price stability being the primary and overriding objective. The CBE is committed to achieving, over the medium term, low rates of inflation which it believes are essential for maintaining confidence and for sustaining high rates of investment and economic growth. The Government's endorsement of the objective of price stability and its commitment to fiscal consolidation is quite important for achieving this objective."

Monetary Policy Framework
"The CBE intends to put in place a formal inflation targeting framework to anchor monetary policy once the fundamental prerequisites are met. … In the transition period, the CBE will meet its inflation objectives by steering short term interest rates, keeping in view the developments in credit and money supply, as well as a host of other factors which may influence the underlying rate of inflation. The CBE strongly believes that real negative interest rates are inconsistent with the ongoing effort to reduce inflation rates."

Monetary Policy Implementation
"Monetary policy decisions are taken by the CBE's Monetary Policy Committee (MPC), which has nine members comprising of the Governor of the CBE, the two Deputy Governors, and six members of the Board of Directors. Decisions are implemented through a set of policy instruments and procedures. The CBE will use two standing facilities (an overnight lending facility and an overnight deposit facility) as its main policy instruments, providing the outer bounds of a corridor within which the overnight inter-bank rate will fluctuate. The CBE will continue to manage market liquidity through its open market operations."

Source: Central Bank of Egypt

On 6 April 2006, the MPC decided to reduce the overnight deposit rate to 8% from 8.25% and the overnight lending rate to 10% from 10.25%. This decision was based on an assessment of recent economic developments, in particular inflation rates which are holding up at moderate levels. In addition, the acceleration of economic growth was not inflationary given the existence of unutilised capacity in several economic sectors. Wholesale price inflation, which is believed to be more representative than existing incomplete consumer price indices, fell from 16.1% in FY04 to 4.7% in FY05. As a result of improved macroeconomic and structural conditions the exchange rate of the Egyptian pound stabilised in the course of FY05 and appreciated against the dollar and euro (appreciation of 4.7% and 17.4%, respectively, at the end of December 2005).

External sector developments

In the first half of FY06, the current account was in surplus thanks to services and transfer revenues. International reserves grew by USD 2.6 billion (about 2% of GDP), up from USD 0.7 billion during the corresponding period of FY05. The current account displayed a surplus of USD 1.1 billion, due to the surplus on the services balance and the increase in net transfers, which offset the trade deficit. The 15.1% rise in the trade-of-goods deficit to USD 5.9 billion was an outcome of the greater increase of merchandise imports (which rose by USD 3.0 billion to USD 14.4 billion) than that of merchandise exports (which by about USD 2.2 billion to USD 8.6 billion). Imports of intermediate and investment goods accounted for 53.9% of total imports. Export growth was driven by ballooning exports of oil and liquefied gas which rose by 87.6% to USD 1.1 billion.

Tourism and remittances led to a significant services surplus, which reached USD 4.2 billion mainly thanks to the rise in tourist revenues by 12% to USD 3.9 billion and in Suez Canal tolls by 10% to USD 1.8 billion. Investment income receipts also increased. Net transfer revenues rose by 13.2% to USD 2.7 billion. This was ascribed mainly to a 35.1% rise in private transfers from Egyptians working abroad.

A remarkable increase in foreign direct investment contributed to a surplus in the capital and financial account, which recorded a net inflow of USD 2.8 billion during the first half of FY06 (compared to a net outflow of USD 0.4 billion during the corresponding period of FY05). Net FDI inflows increased to USD 3.3 billion (3.9% of GDP), up from USD 1.4 billion during the corresponding period of FY05). In addition, Egypt attracted net portfolio investments of USD 2.8 billion (up from USD 0.1 billion).

2. Trade liberalisation and economic opening

Egypt made further progress with implementing the bilateral trade concessions under the Association Agreement with the EU by continuing to dismantle tariffs for industrial products (with a first list of products due to be fully liberalised by the beginning of 2007) and reducing tariffs on processed agricultural products starting from the beginning of 2006. Egypt has adopted the new PanEuroMed Protocol on rules of origin, which will allow new competitive trading patterns through diagonal cumulation of origin within the area from 2006.

With EU-Egypt bilateral trade already at an average of EUR 10 billion in 2000 and steadily increasing since the entry into force of the Association Agreement in 2004, bilateral trade with the EU hit a record in 2005, with a total of some EUR 13.3 billion, and sustained its upward trend in 2006. The enlarged EU is Egypt's most important trading partner, accounting for nearly 40% of its total trade.

Egypt will increasingly benefit from the Euro-Mediterranean free trade area, thanks for instance to free trade agreements signed with other Mediterranean partners, such as the Agadir Agreement with Morocco, Tunisia and Jordan and the agreement signed with Turkey. Such South-South agreements are highly desirable in order to achieve the objective of a fully fledged free trade area by 2010 including the possibility of the diagonal cumulation of origin, rather than a pure hub-and-spoke free trade system with potentially negative welfare effects.

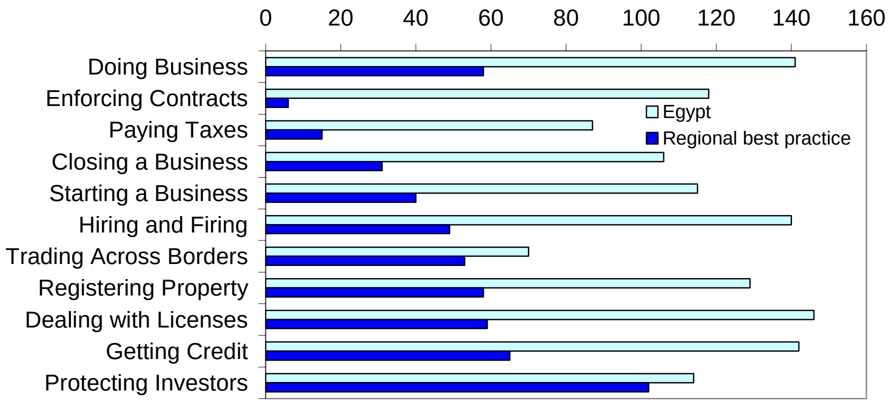
Furthermore, the EU and Egypt have decided to upgrade the Euro-Mediterranean free trade area by negotiating further liberalisation of agricultural products and services trade – including investment in agriculture and manufacturing sectors – as of 2006. It will only be possible to fully reap the advantages of trade liberalisation if the private non-oil sector is strengthened in order to face increasing international competition from 2007 onwards, primarily by improving the currently dismal business environment (Chart 2).

3. Business climate

Privatisation, enterprise restructuring and business environment

The government has made impressive progress with its privatisation programme. Privatisation receipts increased from EGP 31 million in FY 04 to EGP 1 billion in FY05. One important upcoming project is the intended sale, announced in March 2006, of a 70%-80% share in the Bank of Alexandria, one of the four largest state-owned Egyptian banks, by initial public offering. This is part of the planned restructuring of the banking sector and would be the first sale of a large public bank. Its assets are currently estimated at around USD 7 billion.

Chart 2: Egypt - "Doing business" rankings



The ease of doing business index ranks economies from 1 (best) to 155.
The regional best practice refers to the best ranking Arab country among the Mediterranean ENP countries.

Source: World Bank, 2006.

Despite impressive reform progress since July 2004, improving the business climate remains a major challenge, in particular with regard to enforcing contracts and paying taxes. The business climate in Egypt ranks 141st in a worldwide comparison of countries, whereas the best performing country in the region ranks 58th (Chart 2). The medium-term Action Plan which Egypt is currently negotiating with the EU on the basis of the European Neighbourhood Policy should help to foster economic reforms in this important area.

Financial sector reforms

Financial intermediation in Egypt is still relatively weak, in particular due to an inefficient, state-dominated banking system. Consequently, access to finance is reportedly one of the most serious constraints for private businesses. Therefore it is satisfying to note that banking sector reform is moving at a pace exceeding expectations, with the Bank of Alexandria flotation marking an important turning point. The government is also enforcing consolidation and strengthening in the sector by raising minimum capital requirements. On 20 October 2005 the Cairo and Alexandria Stock Exchanges initiated same-day-trading in 17 stocks. In November 2005, the CBE signed a partnership and cooperation agreement with the European Central Bank to develop and implement a state-of-the-art banking supervision system.

4. Public institutions and public finance management

In the fiscal area there has been some progress in strengthening the tax and customs regimes and bringing more transparency and efficiency to budgetary operations. Structural reforms took also place in budget preparation, presentation, and audit. Budgets are now presented according to the IMF Government Finance Statistics Manual. Indirect subsidies have been included in the budget for FY06. It has been decided to move towards a performance-based budgeting system as a result of the findings of the Public Expenditure Review conducted with World Bank assistance.

5. Social development and poverty

Fighting poverty remains one of the most important challenges of economic policy. In 2000, 17% of the population lived below the national poverty line. However, the acceleration of growth over the last years is expected to have led to a reduction in poverty incidence. Increasing Egypt's economic growth is imperative for employment and poverty reduction. Egypt will need to achieve sustained real GDP growth rate of at least 7% annually for unemployment to decline to more manageable levels. Current official estimates place unemployment at 9.5% (although it is widely believed to be higher), and labour-force growth at around 3% annually, or about 550 000 new entrants per year.

EGYPT

Main economic indicators

	2002/03	2003/04	2004/05	for. 2005/06
Real sector				
Real GDP growth (% change)	3.0	4.2	5.1	5.9
Inflation WPI (% change) [1]	---	16.1	4.7	3.8 [2]
Unemployment rate (%)	9.9	10.0	9.5	9.5
GDP per capita (USD)	1,178	1,061	1,053	1,250
Fiscal Sector (% of GDP)[3]				
Total revenues	27.7	26.8	24.7	---
Total expenditure and lending	30.1	29.2	30.4	---
Balance	-2.4	-2.4	-5.7	---
Augmented fiscal balance[4]	-7.1	-6.6	-7.1	-8.0
Gross public debt[5]	116.1	110.7	114.8	---
Monetary sector				
Reserve money (% change)	12.4	12.6	12.5	15.1 [7]
Broad money (M2) (% change)[6]	9.3	12.6	17.4	12.6 [7]
Credit to the private sector (% of total credit, eop)	55.3	52.9	48.9	48.9 [7]
Stock market index (local currency, eop)	776	1,440	4,332	6,775 [8]
External sector				
Current account balance (% of GDP)	2.4	4.3	3.3	0.3 [9]
Remittances (% of trade balance)	44.8	38.3	41.8	40.0 [9]
Trade balance (% of GDP)	-8.1	-10.0	-11.6	-3.3 [9]
Net foreign direct investment (% of GDP)	0.9	0.5	4.4	2.0 [9]
External Vulnerability				
External debt (% of GDP)	42.5	38.1	31.2	27.1 [9]
of which short-term debt (% of total)	6.3	6.6	6.4	5.9 [9]
Debt service ratio (%)	12.1	10.8	9.4	8.8 [9]
Net int. reserves, import cover (months)	9.1	7.6	7.2	7.6
Financial sector				
Short-term interest rate (eop i.e. June)[10]	8.3	8.4	9.9	8.05[11]
Exchange rate (per USD, mid FY)	4.59	6.10	6.06	5.78
Exchange rate (per EUR, mid FY)	4.81	7.70	8.25	6.82
Real effec. exchange rate (% change, - depreciation)	-20.1	-21.6	---	---

Source: Central Bank of Egypt, IMF, Worldbank, own calculations.

[1] The Wholesale Price Index (WPI) reflects inflation more accurately than the incomplete consumer price indices.

[2] November 2005.

[3] General government, unless otherwise indicated.

[4] Balance incl. other debt creating operations of public institutions (for instance, from the National Investment Bank).

[5] Total domestic public debt and government external debt.

[6] Excluding exchange rate valuation effects. Broad money less foreign currency deposits.

[7] January 2006.

[8] 2 May 2006.

[9] First Quarter FY06.

[10] 91-day treasury bills.

[11] 2 March 2006.

GEORGIA

- **The strong economic growth of recent years has not yet significantly reduced either unemployment or poverty as economic restructuring and retrenchment in the public sector have not been matched by private sector job creation.**
- **Owing to privatisation and improved tax collection the government is now in a much better position to address its expenditure priorities. The authorities need to press ahead with the development of a Medium-Term Expenditure Framework as a policy tool.**
- **Georgia benefits from GSP+ export opportunities to the EU. The authorities need to focus on improving trading practices while pursuing entry into new markets and developing Georgia's growth strategies.**
- **Consultations between Georgia and the EU on a European Neighbourhood Policy Action Plan started in November 2005, focusing on the economic sphere i.e. tax and customs reforms, energy and transport and regulatory alignment with the EU.**

1. Macroeconomic developments

Real sector developments

According to preliminary estimates, real GDP growth accelerated to 9.3% in 2005 compared to a revised real GDP growth rate of 5.9% for 2004. Construction and manufacturing performed particularly strongly (22.3% and 14.3% growth respectively) while the agricultural sector (accounting for about 15% of GDP) also recovered after the harsh weather conditions of 2004 (12% growth). The large oil and gas pipeline projects continued to have spillover effects in the services sector which nevertheless remains relatively small. Financial intermediation is currently growing at a rapid pace, starting from a very low base.

Growth is driven by domestic demand (mainly private consumption but increasingly also investment) while net exports remain negative. Despite relatively strong economic growth, unemployment increased to 13.8% (January-September 2005) from 12.7% in the corresponding period of 2004 (ILO methodology), largely because of downsizing of the public sector. According to official estimates nearly 30% of economic activities remain in the shadow economy.[67]

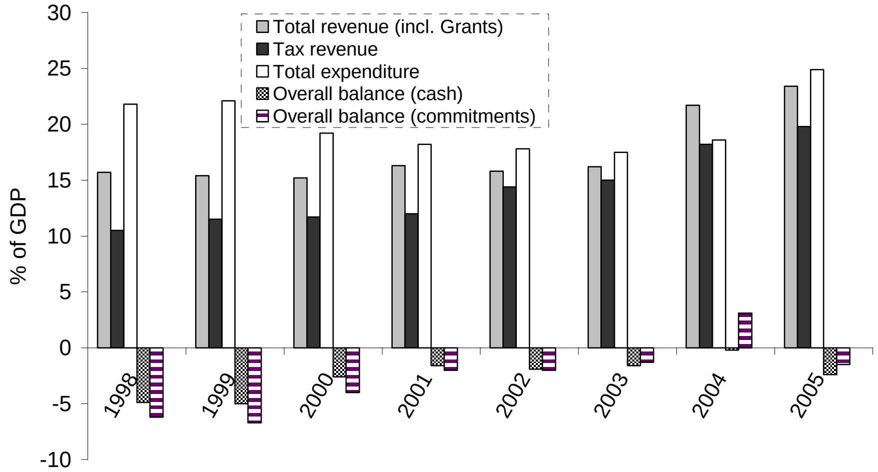
Fiscal developments

The authorities eased the fiscal stance in 2005 against a backdrop of continued strong performance in tax revenue collection and the projected windfall of privatisation revenues. The fiscal balance reached -2.4% of GDP against -0.2% in 2004. Because of inflationary pressures (consumer price inflation reaching 9.4% year-on-year in the first half of 2005), the government decided, however, to delay the payment of remaining domestic expenditure arrears until 2006. Tax revenues as a percentage of GDP continued to increase, reaching about 19% of GDP, despite the lower tax rates introduced in the new tax code, which became effective in January 2005.

[67] See also IMF (2006), *Georgia Selected Issues*. The demand-for-cash approach applied by the IMF provides evidence of a contraction in the shadow economy following the political changes in late-2003.

Given the robust economic growth, actual revenue collection outperformed expenditure growth, and the initially projected fiscal deficit (on a cash basis) of 4.8% of GDP was reduced to 2.4%. Domestic public debt was reduced to about 9% of GDP (10.6% in 2004) as the government increased access to concessional external financing, notably from the World Bank. The Ministry of Finance and the National Bank of Georgia (NBG) look for ways to develop a government bond market, starting with a conversion of existing government debt to the central bank into marketable securities. This would also help develop the central bank's monetary policy instruments. The government did not borrow from the National Bank of Georgia last year and legislation is being amended to prohibit government borrowing from the NBG under all circumstances.

Chart 1: Georgia - General government operations in 1998-2005



Source: 2006 IMF Article IV consultation

Monetary and exchange rate developments

Supported by re-monetisation, the NBG has maintained a prudent monetary policy stance.[68] In 2005 the Georgian lari remained broadly stable in nominal terms against the US dollar after a sharp appreciation in 2004. 12-month consumer price inflation peaked at 10.3% in April 2005 but then decelerated to 6.2% in December 2005 (7.5% in December 2004). Following increases in oil and food prices, the authorities became concerned with the inflationary risks in mid-2005 and introduced measures to limit fiscal expansion and tighten monetary policy in the second half of the year. As is typical for many transition economies, dollarisation is persistent though declining in Georgia (72% of total deposits at end-2005 against 86% in 2003). Gross international reserves of the NBG increased substantially during 2005, but still covered only about two months of imports at the end of the year.

External sector developments

An increase in the current account deficit was initially expected in 2005 given the high import demand for the construction of oil and gas pipelines as well as other infrastructure investments. The increase in the trade deficit (now estimated at around 14% of GDP) was, however, offset by

[68] Georgia's monetary policy framework is described in Kakulia and Gigineishvili (2005), The Primary Objectives and Priorities of Monetary Policy in Georgia, *Problems of Economic Transition*, vol. 48, no. 4, pp. 30-42.

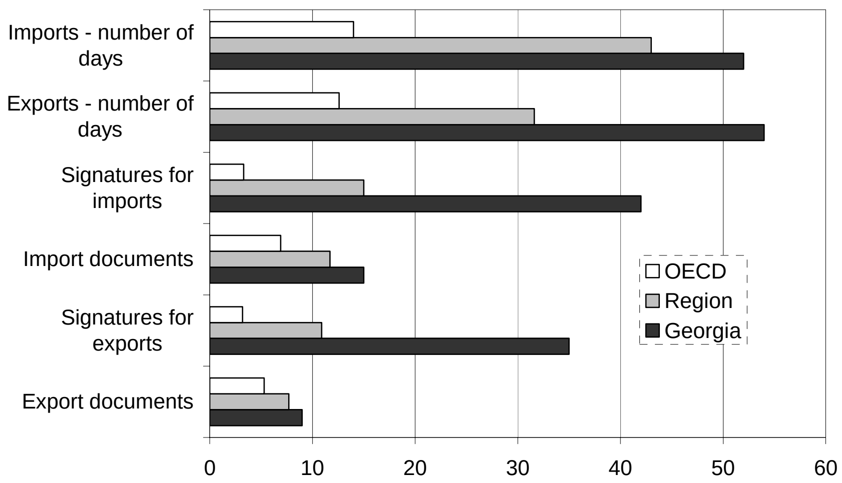
strong growth in workers' remittances, most of which originate from Russia. According to preliminary estimates, the current account deficit was about 7.4% of GDP (8.3% in 2004).

Georgia's external debt decreased in nominal terms to USD 1.7 billion at the end of 2005, and decreased as a ratio of GDP from 35.8% (2004) to about 27% (2005). Georgia has concluded agreements with nearly all bilateral official creditors in line with the July 2004 Paris Club agreement which reduced significantly Georgia's debt service over three years. The Paris Club creditors have expressed their willingness to consider a debt treatment under the Evian Approach on terms tailored to Georgia's debt situation after the current agreement expires (2007), provided that Georgia has demonstrated a satisfactory track record by that time. Given its present access to concessional loans, the government has refrained from all commercial borrowing.

2. Trade liberalisation and economic opening

The import tariff structure was simplified in line with WTO accession commitments in January 2005, and a further reduction in the number of tariff bands and maximum tariff rates is planned for 2007/2008. Having faced import barriers to Russian markets recently, Georgia is actively seeking new markets for its wine and other exports. A new Customs Code was submitted to the parliament in September 2005, but has not yet been adopted, while work on secondary legislation on customs administration is continuing. The new Customs Code is expected to reduce hurdles in transit trade, which is an important service sector in Georgia.

Chart 2: Trading in Georgia in international comparison



Source: World Bank, Doing Business database

3. Business climate

Privatisation, enterprise restructuring and business environment

In July 2005 the parliament adopted a law on the privatisation of agricultural land. As a next step, a functioning land market is needed to help farmers increase the size of their land holdings, which is now one of the major obstacles for rural development in addition to access to financing. Privatisation of large state-owned enterprises accelerated, with the result that total privatisation proceeds reached approximately 3.6% of GDP in 2005 (0.9% in 2004). The hasty privatisations were, however, often criticized for their lack of transparency and incoherent management, which can be partly ascribed to the weaknesses of the privatisation law. Foreign direct investment was still dominated by the oil and gas pipelines, but the banking and tourism sectors also started to attract some FDI in 2005.

Privatisation of several energy companies in power generation and distribution is planned for 2006 as part of a wide-ranging strategy to find solutions to the country's very difficult energy situation, suffering as it does from many years of under-investment and neglect of maintenance. The most pressing situation is in the gas sector where technical and financial viability is particularly weak. The government has indicated that the state subsidies introduced as a response to the increase in gas import prices in early 2006 will be targeted carefully. It will also need to ensure efficient and transparent use of the oil and gas that will be received as transit fees from the oil and gas pipelines.

The IMF estimates that the energy sector's quasi-fiscal deficits declined to about 4% of GDP in 2005 owing to improving metering and payment discipline which boosted tariff collection. Tariff methodologies are also being reviewed by the regulatory commission (GNERC). Legislation is being prepared to address the debt overhang of state-owned energy sector entities.

A national anti-corruption strategy was adopted in 2005 focusing on reforms in the civil service, procurement, internal and external audit, tax administration and regulatory barriers faced by businesses as well as the functioning of law enforcement bodies. Georgia’s score in the Transparency International 2005 Corruption Perception Index improved slightly, from 2.0 to 2.3 (in comparison to a score of 9.5-9.7 for the best performing countries). Other recent indicators, for instance in the EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS 2005) do show, however, substantial improvement in tax and customs administration in particular. Annual sales reported by companies for tax purposes increased significantly from about 60% of estimated total sales in 2002 to about 90% in 2005.

Financial sector

In preparation for Georgia’s future access to international capital markets, the authorities deemed it appropriate to obtain a sovereign credit rating. In December 2005, the Standard & Poor’s rating agency assigned a B+ long-term rating to Georgia with a positive outlook. S&P stated that Georgia’s rating is supported by the government’s strong political commitment to prudent financial policies and market-oriented structural changes, though it is constrained by the short track record of political and economic stability, “together with uncertainties connected with regional conflicts that may endanger the pace of reform or decrease investor interest in the region”. Further consolidation in Georgia's banking sector can be still expected and recent legislative amendments (allowing 100% ownership of a commercial bank by a single legal entity) facilitate ownership restructuring.

Regulatory reforms

During its second year in office the new post-Rose-Revolution government continued to make progress in structural reforms, presenting a growing legislative agenda to the parliament. A new licensing law was passed in July 2005, drastically reducing the number of licensed business operations – from 900 to 150. The law on entrepreneurship was amended to streamline registration requirements for new businesses and eliminate court interference in the process. Corruption and smuggling in customs and the tax administration were addressed. Now the initial progress on enforcement needs to be consolidated through a comprehensive reform process so that a significant reduction in the shadow economy is achieved.

4. Public institutions and public finance management

In the Treasury reform process, an important target was reached in January 2006 when a fully-functioning single treasury account became operational. An accounting reform strategy has been prepared in order to transform the old Soviet accounting system into a cash-based system compliant with International Public Sector Accounting Standards (IPSAS). While tax revenues have increased rapidly over two years, from 14.5% of GDP to nearly 20%, the government took steps in 2005 to put in place a medium-term expenditure framework (MTEF) to improve the allocation of resources on the basis of sector expenditure strategies. A reform process for the external and internal audit functions has also been initiated.

The public administration has been significantly downsized since the Rose Revolution of November 2003. Recurring ministerial reshuffles have added to uncertainty as to the course of the civil service reforms. Staff cuts, however, have allowed substantial increases in public sector salaries so that the government is now in a better position to attract professional staff less prone to corruption. The consolidation of the public administration reform process will nevertheless take time, especially in the judiciary.

5. Social development and poverty

After an increase over the period of 2001-2003, the poverty headcount index declined in 2004 from 54.5% to 52.7%, mainly owing to the timely payment of social transfers and public sector wages. The present methodology for poverty monitoring has a number of shortcomings, however, and needs to be revised. The improvement in tax revenue collection allowed a significant clearance of pension and other expenditure arrears by end-2005. The government intends to put in place a new better-targeted poverty benefit system as of mid-2006 after a comprehensive needs assessment has been completed.

GEORGIA

Main economic indicators

	2001	2002	2003	2004	prel. 2005
Real sector					
Real GDP growth (% change)	4.7	5.5	11.1	5.9	9.3
Inflation CPI (period average)	4.7	5.6	4.8	5.7	8.3
GDP nominal, in USD millions	3,201	3,392	3,984	5,193	6,410
GDP per capita, in USD	695	741	876	1,203	1,845
Social indicators					
Unemployment (ILO strong criterion)	11.1	12.6	11.5	12.6	---
Poverty rate (% of population)	51.1	52.1	54.5	52.7	---
Social sector spending (% of GDP)	8.1	8.3	7.3	7.1	8.1
Inequality (Gini index for consumption)	0.38	0.39	0.38	---	---
Fiscal sector					
Total revenues, % of GDP	16.3	15.8	16.2	21.7	23.4
Total expenditure, % of GDP	18.2	17.8	17.5	18.6	24.9
General govt. balance, % of GDP, cash basis	-1.6	-1.9	-1.6	-0.2	-2.4
Gross public debt, % of GDP	68.4	67.4	60.8	46.4	41.1
Monetary sector					
Domestic credit to private sector (% of GDP)	7.4	8.3	8.9	9.5	14.5
Broad money (M3), % yoy	18.5	17.9	22.8	42.6	26.4
Degree of monetisation (M3/GDP, %)	11.0	11.6	12.4	15.2	16.5
Dollarisation in bank deposits (%)	85.7	84.9	86.1	74.3	71.6
External sector					
Current account balance, % of GDP	-6.4	-5.8	-7.4	-8.3	-7.4
Trade balance, % of GDP	-15.2	-12.9	-15.0	-13.8	-14.1
Foreign direct investment (net flow,% of GDP)	3.2	4.0	8.4	9.7	6.5
Import cover of reserves (months)	1.4	1.7	1.3	1.7	1.9
External vulnerability					
External Public Debt, % of GDP	51.7	52.4	46.4	35.8	27.1
Debt Service Ratio[1]	19.6	24.3	12.6	11.6	8.5
Gross reserves (excl. gold, USD millions)	159	198	191	383	475
Reserves/M3	44.9	50.4	38.7	48.6	44.5
Financial sector					
Deposit rate	7.8	9.8	9.3	7.2	7.6
Lending rate	27.3	31.8	32.3	31.2	21.6
Exchange rate (lari per USD, average)	2.07	2.2	2.15	1.92	1.79
Exchange rate (lari per EUR, average)	1.85	2.42	2.43	2.38	2.26
Real effective exchange rate (1996=100)	107.7	100.2	93.8	101.0	103.2

Sources: IMF, EBRD, Georgian authorities

[1] Public external debt service in % of exports of goods and services

ISRAEL

- **The Israeli economy performed well in 2005, continuing the recovery begun after the recession of 2002-2003. GDP growth reached 5.2% compared to 4.3% in 2004. Growth was led by the production sector, in particular by high-tech exports.**

- **Public debt has been reduced below 100% of GDP and is under control, thanks to reinforced fiscal discipline and increased revenues. The government deficit stood at 1.9% of GDP, much lower than the planned 3.4% of GDP for 2005.**

- **Structural reforms are progressing: a new regulation of the capital market is reshaping the mutual fund industry by separating it from banks; the tax reform, started in 2003, was accelerated in 2005 and a new central bank law has been approved.**

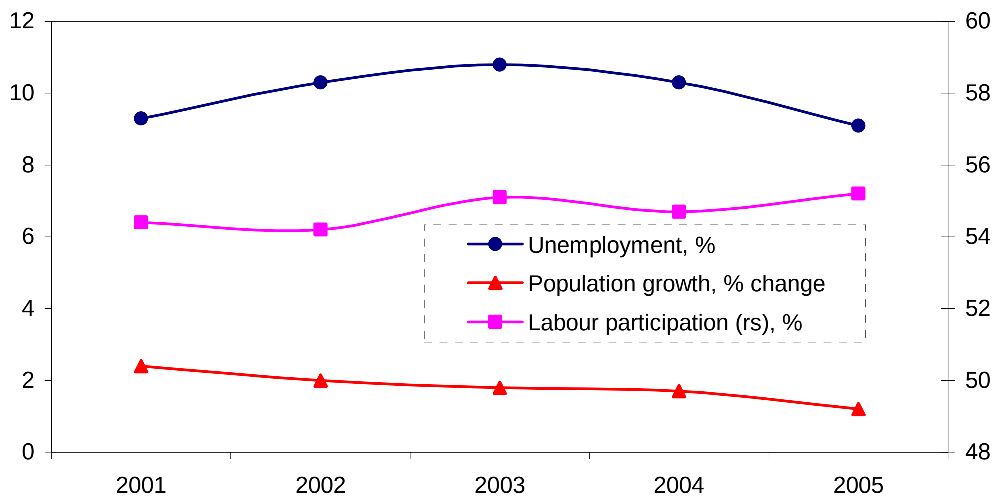
- **Social disparity increased in 2005 and the social gap has widened. The measures taken to increase participation in the labour force (standing at 55%) have reduced unemployment, but also increased the number of people living in poverty.**

1. Macroeconomic developments

Real sector developments

After a strong performance in 2004, economic expansion picked up in 2005, supported by high-technology exports, investment, and prudent economic policies. The relatively favourable global economic environment as well as an improvement in the security situation contributed to this expansion. In 2005 inflation was slightly higher than the year before, but remained under control, while unemployment continued to fall, albeit from a high level (see Chart 1).

Chart 1 - Unemployment and labour participation



Source: IMF

The expansion of global demand boosted Israel's industrial exports, particularly as regards hi-tech products. In 2005, Israel's total exports rose by 7.7%, while rising internal demand for both consumer and industrial goods increased imports by 9.9%. In 2005, hi-tech products accounted for 46% of Israel's industrial exports. Tourism has traditionally been the most prominent activity of Israel's services sector, even though the outbreak of violence in recent years had caused a sharp fall in the number of tourists. A significant recovery has however recently taken place: from January to November 2005, tourist arrivals amounted to around 1.6 million, an increase of 27% from the same period of 2004.

Fiscal developments

Public finances in 2005 benefited from the new budgetary framework intended to ensure medium-term fiscal consolidation, in order to achieve a meaningful reduction in the large outstanding public debt and to seize the opportunity to consolidate the public finances in a context of relatively strong growth.

The public debt to GDP ratio decreased to 99% (102.9% in 2004) thanks to a fiscal deficit of only 1.9% of GDP, as compared with the planned 3.4% (the deficit target level exceeded the annual ceiling of 3% of GDP in order to allow for the expected costs of withdrawing from Gaza). Lower-than-projected expenditure and stronger-than-expected revenue helped to bring down the deficit. Of the estimated 1.5% of GDP improvement in the fiscal deficit relative to the budget target, about 1.2% of GDP was attributed to lower expenditure and 0.3% to higher revenue.

The lower-than-expected expenditure mostly reflected reduced interest costs, while the larger-than-anticipated revenue reflected GDP growth exceeding projections. The risks related to public sector external debt (currently at about 25% of GDP) are mitigated by two key factors: about 80% of this debt is held by the Jewish Diaspora or backed by US government guarantees, while short-term external public debt remains low, at around 2% of GDP.

Monetary and exchange rate developments

Given the renewed emphasis on fiscal consolidation, and with inflation within the Bank of Israel's (BoI) target range, monetary policy has been relatively accommodative. Notwithstanding recent progressive increases in the policy interest rate (25 basis points in October and November, 50 basis point in December) inflation has been rising, albeit gradually, while inflation expectations have remained within the BoI target range. By the end of 2005, the policy rate was 4.5%.

The recent prolonged rise in oil prices has increased the risk of pass-through from oil prices to wages and consumer prices. In light of the recent depreciation of the shekel, and its historically strong pass-through to inflation, this could have pushed the monetary policy stance towards a possible tightening. However other factors, such as high unemployment and excess capacity in key sectors, particularly housing and construction, have prevented the BoI from tightening it aggressively over the near term. The extent to which the structural reforms over the past decade have helped lower the natural rate of unemployment and raise the potential growth rate of the economy is still unclear.

Israel has an established inflation-targeting framework, twinned with a floating exchange rate. The new Bank of Israel Law approved in 2005 should, when it comes into force, strengthen the independence of the central bank and increase the effectiveness of monetary policy decisions (see Box 1). The shekel, usually a highly volatile currency, remained broadly stable in 2005 when compared to the historical trend, balanced by strong economic activity on one hand and relatively low interest rates on the other.

External sector developments

In 2005, as well as in the two previous years, Israel achieved a current account surplus (after ten consecutive years of current account deficits). The surpluses largely reflect the strong recovery in exports and should continue over the medium term, driven by past gains in productivity and competitiveness. Foreign reserves, totalling about USD 27 billion (22% of GDP), cover roughly 90% of total gross short-term external debt or about five months of imports.

The EU is Israel's largest trade partner: excluding diamonds, total trade with the EU amounted to USD 22 billion in 2005, and represented 35% of Israel’s total trade. Israel’s trade deficit with the EU amounted to USD 4 billion, or 45% of its total trade deficit. Foreign direct investments in Israel totalled USD 5.7 billion, or 4.6% of GDP, in 2005, more than twice the 2004 level. Portfolio investments from abroad amounted to nearly USD 4 billion. Outflows of capital are also increasing and are characterised by investments in labour-intensive industries willing to reduce labour costs. In 2005, Israeli institutional investors reduced the share of their investments abroad.

2. Trade liberalisation and economic opening

According to the most recent data available, Israel's weighted average tariff rate is 2%, down from 4% a decade ago. Efforts have recently been made to reduce prominent non-tariff trade barriers, for example technical standards. As a consequence, Israel’s trade policy has been significantly liberalised. Israel has been a member of WTO since April 1995. In 2005, the tax on the capital gains for foreigners investing in "qualifying research and development companies" or in tradable securities was removed.

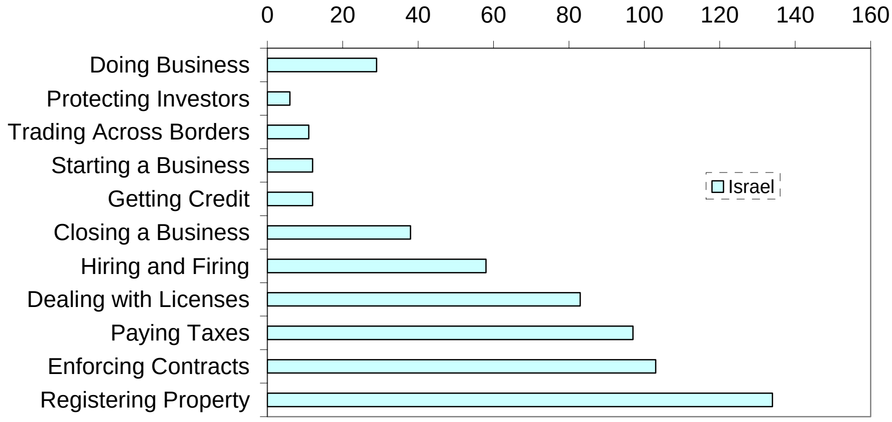
3. Business climate

Privatisation, enterprise restructuring and business environment

Privatisation is at an advanced stage and progressing. The government has actively promoted foreign investment in Israel, creating incentives for foreign companies including significant government funding for information technology and research projects, grants for foreign investments in fixed assets, subsidies for job creation in depressed areas and fiscal benefit. A highly skilled labour force has contributed to attract foreign capital, especially in the hi-tech sector.

According to the World Bank’s "Doing business in 2006" indicators, Israel ranks 29th in the world. The country is particularly attractive for investor protection legislation, and for ease in trading across borders, getting credit and starting a business (chart 2). The situation of the labour market, however, is not considered particularly attractive due to existing regulations and the relatively high labour costs. The procedures related to registering properties, enforcing contracts and dealing with licences are comparatively discouraging factors. Israel ranks 36 in the 2006 index of economic freedom, and is thus considered, economically, a mostly free country.

Chart 2: Israel - "Doing business" rankings



The ease of doing business index ranks economies from 1 (best) to 155.

Source: World Bank, 2006.

Financial sector reforms

Against the background of the economic recovery and of the increasing volumes and level of complexity of the financial activities pursued by intermediaries, the surveillance authorities have taken measures designed to increase competition in the financial market and protect investors. These include raising the capital requirements for banks in the spirit of Basle II and a better focus on the group-wide and cross-border dimensions of oversight activities (especially in the light of the prominent international dimension of provisioning which characterises Israeli banks).

A package of regulatory reforms was introduced in the first half of 2005, in order to promote a sound and competitive financial system and to create thicker capital markets. The measure of highest impact introduced in 2005 requires the banks to divest their shares in the mutual fund industry. Other recently introduced regulations have aimed to reduce the banks' exposure to credit risk (including by increasing the required provisions), and further limiting both the concentration of banks' exposure to large corporate borrowers and the total indebtedness of the six largest borrowers.

The preliminary results of the reform appear to be mixed. The provision forcing banks to divest themselves of mutual and provident funds led to a faster-than-expected (less than three months) sale of these kinds of assets by banks, thanks also to the good financial market environment. Overall, reforms in the capital markets have rapidly led to the introduction of new kinds of financial intermediaries trading new products under new rules. As a consequence, however, the risk profile of many intermediaries has changed, creating further challenges for regulators and increasing the need to properly advise and protect investors.

Labour market reforms

The commitment of the authorities to increase employment, by removing disincentives to join the labour market, has continued to yield positive results: the participation rate has risen and employment has increased. A number of active labour market policies to address the high unemployment, especially among low-skilled workers, were launched in 2005. The most notable, named Wisconsin Plan, consisted of the creation of four pilot offices (employment centres) in areas characterised by high unemployment. The centres, established by four international companies from the US, the Netherlands and the UK who won a public bid, operate in partnership with local counterparts and offer the full range of employment services to recipients of income allowances. The compensation paid by the government to the foreign companies is results-oriented and related to the number of former welfare recipients successfully employed.

Besides the Wisconsin Plan, a wage subsidies program for jobs created in the south of the country has been launched: the government will subsidise up to 20% of the wages of 200 new jobs created in the target area. An overall reduction of welfare spending has been coupled with the attempt to address some of the distortions that affect the labour market: some specific measures increased the size of welfare devoted to low-skilled workers. The welfare reform related to the labour market tightened eligibility conditions for access to unemployment benefits and cut unemployment benefits for people participating in religious training and other benefits (such as the child allowance). Overall, however, the social transfer system is relatively generous when compared to EU countries.

In 2005 wage increases averaged 2%. Full-time positions, according to official data, increased as a share of employment. Increases in wages were recorded primarily in the public sector, which employs 30% of the workforce. The welfare reforms marginally increased the supply of labour by increasing labour force participation from 54.9% in 2004 to 55.1 % in 2005, which is, nonetheless, far below the OECD average of 65%. Thanks to the robust economic activity, Israel's unemployment rate fell from 10.4% in 2004 to 9.1% in late 2005.

4. Public institutions and public finance management

The new budgetary framework, approved in 2004, came into force in 2005. The framework is based on two rules: a cap on the growth rate of budgeted real expenditures of 1% a year and a ceiling on the deficit of 3% of GDP. When growth is weak, as was the case when the framework was adopted, the framework is binding. However, when growth is strong, the deficit ceiling becomes non-binding and opens the possibility to use over-performance revenue to either reduce the stock of public debt or cut taxes. This possibility arose early in 2005. As a consequence, on July 25, the Knesset approved a tax plan covering the next five years.

The plan expands some of the measures introduced in the 2003 tax reform and its stated goal is to stimulate private sector growth, reducing taxes. The key measures of the tax-cutting plan, to be pursued by 2010, are the following: a) lowering the top marginal income tax rate from 49% to 44%; b) cutting the corporate tax rate from 34% to 25%; c) reducing the VAT rate of 0.5% to 16.5%; d) establishing a uniform 20% capital gains tax rate, and e) widening the tax base and strengthening fiscal discipline. The fiscal cost of the tax plan is estimated at nearly 0.4% of GDP annually over the five-year period that could be financed through the increase in tax receipts stemming from stronger economic growth.

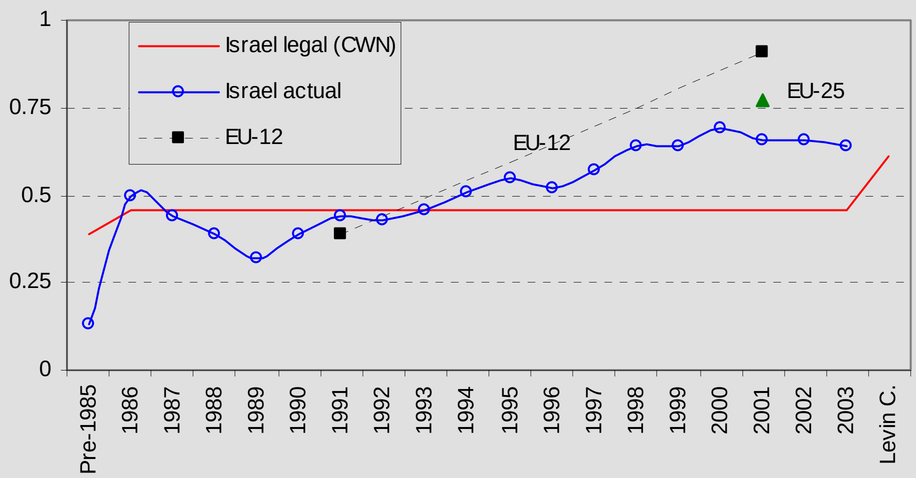
5. Social development and poverty

The incidence of poverty increased in 2005 due, in part, to cuts in social spending, despite the sustained economic recovery. The erosion of welfare benefits hit the allowances paid to the working-age population, in line with the aim of the government to promote a higher level of participation to the labour force. However, in general the new mechanisms lower the efficacy of the safety net to protect children, the elderly, and the disabled. The share of households living below half the median disposable income, assumed as the poverty threshold, increased to 20.5% in 2005. This confirms the upward trend of the poverty gap and income inequality recorded over the past five years. As a consequence, the reduction of poverty appears to be one of the main challenges of Israeli policy makers. An inter-ministerial seven-year plan to fight poverty has been proposed: the overall cost of the plan is estimated at 2.5% of the annual GDP.

Box 1: Central Bank Independence

The degree of actual independence that the central bank of Israel enjoys is higher than what the law would suggest. A suitable measure of central bank independence is the weighted index used in Cuckierman, Webb and Neyapti (CWN, 1992).[69] The index features a normalised average of 16 characteristics ranging from 0 (lower independence) to 1 (highest independence). More recently, Cuckierman analysed the degree of actual independence enjoyed by the Bank of Israel year by year, as well as the legal score in the original charter of 1954, after the relevant amendment of 1985 and after the implementation of the modifications proposed in 1988 by the *Levin Committe* (Chart 3). The Committee was composed of independent experts appointed by the Israeli Prime Minister in 1987 to issue recommendations aimed to align the central bank statute to the best international practice. The Committee recommended, among other things, that price stability be set as the overriding goal for monetary policy.

Chart 3: Israel – Central Bank: legal vs. actual independence



Source: Our calculations based on data from Cuckierman

The issue of the independence of the central bank of Israel also came to the attention of the European Central Bank (ECB), which was requested to evaluate an amendment proposed by the Ministry of Finance (*Draft Bank of Israel Law, amendment No. 20, 5762-2002*), in the context of the Association Agreement between the EU and Israel. The ECB assessment stated that the Bank of Israel Law and the amendment proposed would have been basically inconsistent with the EU Treaty and the ESCB Statute. Also the IMF, in its 2004 *Article IV Consultation,* highlighted the need to amend the law to "reflect international best practice regarding monetary policy objectives and procedures, along the lines of the recommendations of the Levin Committee".

In 2005, after years of unsuccessful attempts, a proposed new Bank of Israel law was finally drafted by the government. Parliamentary approval is still pending and is expected shortly after the elections. Key principles of the proposed new law include the creation of a monetary committee responsible for interest rate decisions; the formation of a management board responsible for oversight of administrative matters and the establishment of price stability as a primary policy objective. The proposed law should finally reconcile *de facto* and *de jure* central bank independence and fulfil the recommendations of the Levin Committee.

[69] See Cuckierman, Webb, Neyapti (1992), *Measuring the Independence of Central Banks and its Effect on Policy Outcomes*, World Bank Economic Review, Vol. 6, n. 3 (September).

ISRAEL

Main economic indicators

	2001	2002	2003	2004	prel. 2005
Real sector					
Real GDP growth (% yoy, avg)	-0.9	-0.7	1.3	4.4	5.2
Inflation CPI avg, % yoy	1.4	6.5	-1.9	1.2	2.4
GDP nominal, in USD billion	113.6	10.3	110.2	117.2	122.7
GDP per capita, in USD	17,505	15,773	16,400	17,200	20,800
Social indicators					
Unemployment, %	9.3	10.3	10.8	10.3	9.1
Labour participation (rs), %	54.4	54.2	55.1	54.7	55.2
Population growth, % change	2.4	2.0	1.8	1.7	1.2
Fiscal Sector					
Central gov. revenues, % of GDP	37.2	39.2	37.1	37.0	37.3
Central gov. expenditure, % of GDP	41.6	43.0	42.7	40.8	39.2
Central gov. balance incl. grants, % of GDP	-4.4	-3.8	-5.6	-3.8	-1.9
Central gov. balance escl. grants, % of GDP	-6.5	-6.3	-8.1	-6.1	-2.7
General gov. balance incl. grants, % of GDP	-4.1	-4.5	-6.4	-4.3	-2.2
General gov. debt, % of GDP	95.8	104.5	106.4	105.4	101.8
Monetary sector					
Private sector credit (% change)	13.1	7.2	-5.5	3.9	10.7
Broad money (M3), % yoy	15.5	6.1	2.2	4.6	8.7
Narrow money (M1), % yoy	14.2	15.6	0.5	18.0	21.3
External sector					
Current account balance, % of GDP	-1.4	-1.2	0.7	1.3	0.8
Trade balance, % of GDP	-2.7	-3.5	-2.0	-1.6	-3.1
Foreign direct investment flows, % of GDP	3.2	1.7	3.5	1.4	3.4
Import of good and services (% changes)	-4.9	-1.7	-1.7	11.8	4.4
Export of good and services (% changes)	-11.5	-2.4	7.5	17.4	7.0
Financial sector					
BoI policy rate (average)	6.8	6.8	7.5	4.2	3.7
Nom. effective exch. rate (per USD, average)	0.7	-13.5	-7.0	-5.0	-1.3
Real effective exch. rate (per USD, average)	-0.2	-10.0	-7.9	-7.1	-0.8
Terms of trade (2000=100; index level)	99.2	99.3	97.8	95.9	92.7

Source: Bank of Israel, Israeli Ministry of Finance, Israeli Central Bureau of statistics, IMF, World Bank.

JORDAN

- **The robust performance experienced in recent years continued in 2005 with a real GDP growth of 7.2%. However, in the absence of significant fiscal consolidation and structural reforms, the economic situation is likely to deteriorate in the medium term.**

- **Notwithstanding fiscal adjustment in 2005 under a strategy centred on eliminating fuel subsidies the budget deficit (including grants) for 2005 is estimated at 5.2% of GDP (2004: 1.7%) as external oil grants dropped sharply and oil prices continued to rise.**

- **The current account deficit (including grants) deteriorated considerably in 2005 to 18% of GDP (2004: 0.1%) but was more than financed by capital inflows, primarily from the region, which allowed the Central Bank to sustain the level of its external reserves.**

- **The National Agenda sets ambitious objectives for economic reforms. These reforms are essential, but might be insufficient, to respond to the pressing adjustment needs resulting from current and potential real and nominal shocks.**

1. Macroeconomic developments

Real sector developments

The robust economic performance experienced in the last years continued in 2005 with an estimated real GDP growth of 7.2% (2004: 7.7%). The fastest-growing sectors were manufacturing (11.3%), construction (9%) and services (8.8%). Domestic demand was the main driver behind the expansion, fuelled by record high levels of remittances from the Gulf (about 22% of GDP) and Iraqi reconstruction. Domestic investment still represented about 24% of GDP. Unemployment was officially estimated at 15.7% (2004: 12.5%) but some institutions indicated that it might be as high as 25%.

The economy remains vulnerable to external shocks and largely dependent on the situation in the region. Although real growth is expected to remain strong in 2006, the medium-term macroeconomic outlook is unfavourable due to widening twin deficits and inflationary pressures on the back of declining external oil grants, persisting high oil prices and a terms-of-trade loss. Maintaining the currency peg in these circumstances while ensuring external competitiveness will require careful macroeconomic management and an acceleration of structural reforms aimed at increasing flexibility in product, labour and capital markets.

Fiscal developments

The budget deficit (including grants) for 2005 is estimated at 5.2% of GDP (2004: 1.7%) as external grants dropped sharply[70] and oil prices continued to rise. Excluding grants, however, the deficit is estimated to fall in 2005 to 10.1% of GDP from 12.5% of GDP in 2004. The authorities intensified fiscal adjustment in the second half of 2005 under a strategy centred on eliminating fuel subsidies and maintaining expenditure restraint. Although the phasing out has begun, fuel

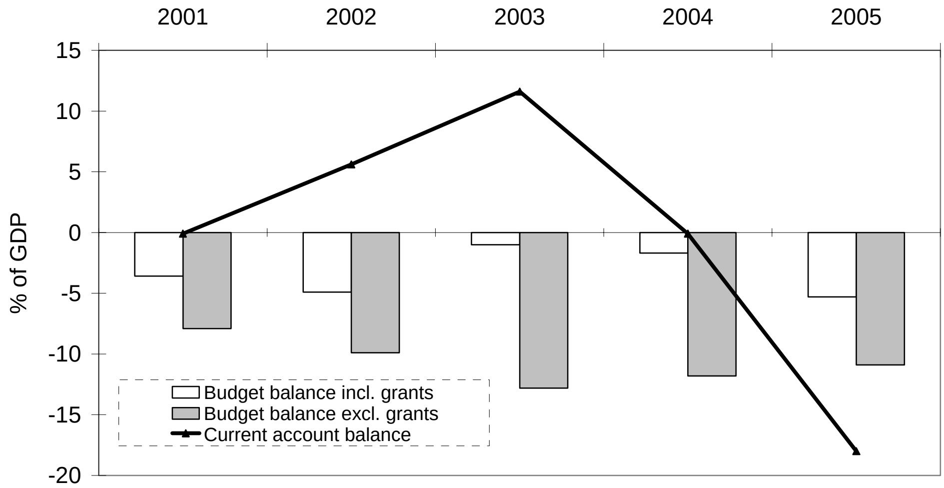
[70] The revenue from grants decreased from approximately 11% of GDP in 2003 and 2004 to their pre-Iraqi war long-term average level of 5% due to phasing out of oil grants from the Gulf countries.

subsidies continue to be a large burden on the budget.[71] Tax collection was propped up by buoyant general sales tax revenues from robust economic activity and a hike in the GST rate from 13% to 16% mid-2004, and benefited from improvements in tax administration.

The 2006 budget targets a deficit of 4.5% of GDP including pledged grants (based on an oil price of USD 60 per barrel and GDP growth and inflation at 5-6%). Excluding foreign assistance, the deficit is foreseen to reach 6.9% of GDP reflecting a significant fiscal tightening and building on strong tax and non-tax revenues. It is planned to be financed partly by privatisation proceeds but mainly by domestic bank financing.

While the public debt-to-GDP ratio has been reduced over the last few years, it remains relatively high at 83.7% at end 2005 (2004: 87.6%).[72] The share of external debt in the total public debt decreased from 91% in 2000 to 69% in 2005 and represented 57.9% of GDP in 2005 (2004: 65.5%).

Chart 1: Jordan - Twin deficits



General government balance (including non-budget accounts)
Source: IMF (2005) and Ministry of Finance (2006)

Monetary and exchange rate policy

The central bank continued to focus on maintaining price stability supported by a fixed peg of the Jordanian dinar to the US dollar. Monetary policy was tightened with multiple hikes of interest rates throughout 2005 and in 2006 in line with the US Federal Reserve and in response to inflationary pressures. Broad money growth remained strong in 2005 corresponding to the pace of nominal GDP. It mainly reflected a sharp increase in credit to the private sector and government. The central bank sustained the level of its external reserves thanks to a large inflow of private capital from abroad.

Inflation remained moderate in 2005 at 3.5% (2004: 3.4%) but is likely to increase, fuelled by robust domestic demand and boosted by surging valuations for real estate assets on the back of low interest rates and large financial inflows from Iraqi expatriates. The reduction in oil and food price subsidies, which was started in 2005 and is planned to continue in 2006 and 2007, has put

[71] Government fuel subsidies reached 6% of GDP in 2005, corresponding to 18% of current expenditure.
[72] The government aims at reaching the ambitious targets mandated by the 2001 Public Debt Law, which sets ceilings for total and external public debt respectively at 80% and 60% of GDP by end 2006.

upward pressure on prices. The weakness of the US currency, to which the Jordanian dinar is pegged, contributed to higher import prices, especially for imports from the euro area.

External sector developments

The current account deficit (including grants) for 2005 is estimated at 18% of GDP compared to a balanced position in 2004 and a surplus of 12% in 2003. The trade deficit widened to 38.8% of GDP (2004: 29.6%) on account of a 27% (2004: 43%) increase in imports reflecting strong domestic demand growth, higher oil prices and a high import content of exports, especially from the Qualified Industrial Zones (QIZ). The growth of merchandise exports, although still robust, decelerated from 26% in 2004 to an estimated 10% in 2005. Growth of exports is likely to further slow down as the initial impact of the QIZ wanes and competition from Asian textile producers toughens.

Lower oil grants also contributed to the widening of the current account deficit, which was, however, more than financed by capital inflows, including foreign direct investments and portfolio inflows, primarily from the region. At the same time, while the terms of trade have deteriorated, mainly reflecting higher oil import prices, the real effective exchange rate is expected to appreciate after years of depreciation, putting additional pressure on the competitiveness of the Jordanian economy.

Box 1: National Agenda for Reforms

Jordan has developed a comprehensive strategy for reforms. The National Agenda, presented in November 2005, develops a set of priorities in the political, social and economic fields and commits the authorities for ten years. The National Agenda orientations are fully in line with the content of the ENP EU-Jordan Action Plan and it is clear that both documents can reinforce each other. Implementation of the economic programme starts in 2006.

The priorities identified in the National Agenda are (1) political reforms, (2) legislation and justice, (3) domestic investment development, (4) fiscal discipline and financial services, (5) employment support and vocational training, (6) social welfare, (7) education, higher education, scientific research and innovation, and (8) infrastructure upgrade. It sets ambitious macroeconomic objectives:

- Average annual growth rates of 6% for the first five years and 7% for the following five years;
- Unemployment rates down to 9.3% from the current 15.7% by 2012 and 6.8% by 2017 (implying a net creation of over 500 000 new jobs);
- Public debt down from 83% to 36% of GDP by 2017;
- Budget deficit excluding grants down from 11.8% to 1.8% by 2017.

The National Agenda includes key performance indicators and detailed measures, including more liberal lending to SMEs and development plans for potential driving sectors such as pharmaceuticals, as well as financial reform, tax reform (simplification, introduction of a single, flat corporate income tax to be levied on all sectors to replace the current system within which rates vary from 15% to 35% depending on the sector; simplification of personal taxation abolishing numerous exemptions and deductibles; penalties for tax evasion), investment promotion, reducing the size of the civil service, reforming the government pension scheme, improving the management of public debt, reduction of budget support for over 100 government institutions (including state-run universities).

The National Agenda differs significantly from previous planning strategies: (i) it was prepared on the basis of a major consultation process involving civil society and the private sector, (ii) the cost of the reforms appears to be better linked to the budget, (iii) it will be measurable, with performance indicators, and will be subject to regular progress reports. For 2006, the Government of Jordan has allocated Jordanian dinar (JOD) 150 million for the implementation of the National Agenda (out of total estimated costs of JOD 320 million).

2. Trade liberalisation and economic opening

While the effects of the end of the Multi-Fibre Agreement quotas on Jordanian exports of textile and clothing remain uncertain, steps were taken in 2005 to further liberalise the trade regime. Export and import licensing, except for security-related products, has been abolished. The EU and Jordan concluded negotiations on the liberalisation of agricultural products in February 2006.[73] Progress has been made on the construction of a new natural gas pipeline between Egypt and Jordan, which will reduce dependence on costly petroleum products for power generation.

Israel and Jordan approved the decision to upgrade their trade agreement (about two thirds of tariff lines are subject to dismantlement). The two countries are now able to cumulate rules of origin under the system of Pan-Euromed cumulation of origin and benefit from duty-free access on joint products exported to the EU. This agreement complements the QIZ established in the late 1990s between Jordan and Israel and benefiting from the exemption from US tariffs and quotas on joint production. However, as a result of the free trade agreement between Jordan and the US, which allows for duty-free exports from Jordan to the US without Israeli inputs, Jordan's trade with Israel is likely to have decreased in 2005 for the first time in six years.

3. Business climate

Privatisation, enterprise restructuring and business environment

The implementation of the privatisation programme accelerated in 2005. The plan to complete privatisation of Jordan Telecom and the Jordan Phosphate Mines Company in 2006 is well advanced. The government will allocate a 3% stake for the benefit of Jordan's military forces and military retirees – a move that is now planned as a regular part of all privatisations.[74] Preparations for divestment in the electricity sector have also moved forward.

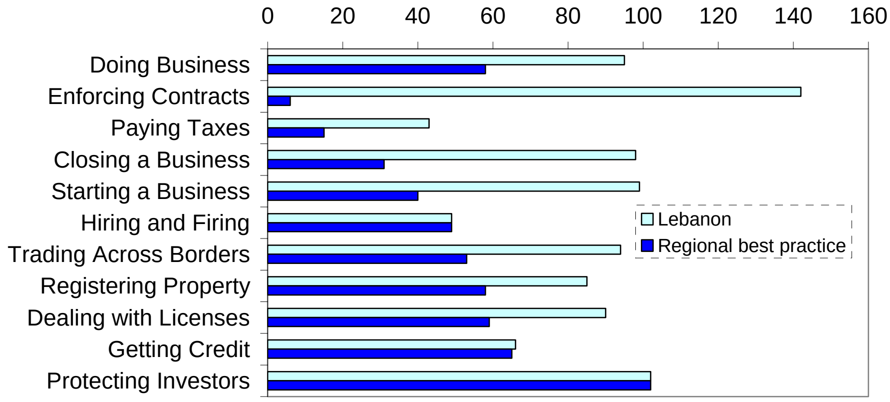
The World Bank's 2005 "Doing Business" report reveals that Jordan's investment climate is generally more favourable than that in most of the MENA (Middle East and North Africa) region but still below the regional best practice (Chart 2). Compared to 2004, however, its relative position deteriorated as other countries in the region achieved more progress in improving the business environment.

In the last two years, the government has enacted four new investment promotion laws to improve the business environment and attract foreign investors (the investment promotion law, the exemptions law, the investment environment development law and the entrepreneurship development law). The one-stop-shop service, introduced in 2004, allowed to decrease from 98 to 36 the number of days needed to start a business. The implementation of the Investment Laws package and the rationalisation of the investment incentives scheme still need to be accelerated.

[73] As a result, Jordan received greater access to EU markets with the exception of seven products (fresh cut flowers, new potatoes, garlic, cucumbers and gherkins, citrus fruits, strawberries, virgin olive oil), which would be subject to duty free quotas.

[74] The sale of Jordan Telecom was originally envisaged as a direct share sale to the members of the forces and retirees, but it then became obvious that this approach would be impractical with as many as 340 000 people eligible for shares. The government is now considering the establishment of a fund that could hold the shares and provide interest-free loans for house purchases, educational purposes and other socially valuable uses.

Chart 2: Jordan - "Doing business" rankings



The ease of doing business index ranks economies from 1 (best) to 155. The regional best practice refers to the best ranking Arab country among the Mediterranean ENP countries.

Source: World Bank, 2006.

Financial sector reforms

The banking sector in Jordan is characterised by high liquidity, market fragmentation and conservative policies. Obtaining credit for start-ups and small companies is difficult, and lending is essentially asset-based with high collateral requirements. Although banks remain profitable, some analysts describe Jordan as over-banked, which points to relatively limited competition. The authorities are pursuing efforts to strengthen and improve the efficiency of the banking system, e.g. through the introduction of the Jordan inter-bank offer rate. Banking regulation and supervision is being progressively strengthened through a methodical effort led by the Central Bank of Jordan. Steps are being taken to deepen the financial system, including the introduction of new debt instruments, and lengthening the maturity structure of the government debt allowing for a more effective management of domestic monetary conditions.

Labour market reforms

The unemployment rate increased to 15.7% in 2005 (2004: 12.5%) despite high and sustained growth rates. Rigidities on the labour market, the mismatch between the skills taught in the educational system and those demanded in the economy, and high demographic growth continued to be among the main reasons for these high unemployment rates.

The Labour Ministry revealed plans to create new jobs for Jordanians while reducing the number of foreign workers in the country. Consequently, the work permit fees for foreign workers are likely to be raised. The additional funds generated in this way would be used to improve the salaries and health benefits and lower the transport costs and social security payments of Jordanians willing to undergo training for jobs in sectors such as textiles, construction, healthcare, transport and tourism, where foreign workers dominate[75].

[75] There are currently 248 000 foreign workers officially registered with the Ministry of Labour, about 50% of whom are Egyptians (the other home countries are Syria, Iraq, India, the Philippines, Sri Lanka and Malaysia). Jordanian authorities estimate the number of illegal workers at 100 000.

4. Public institutions and public finance management

The simultaneous decrease in oil grants and increase in oil prices has put additional pressure on Jordan to progress with fiscal reforms. The National Agenda foresees revenue-enhancing measures as well as expenditure rationalisation. In 2005, the government accelerated the phasing out of oil subsidies on a discretionary basis (increase in fuel prices for private consumers in July and September 2005, and April 2006). The subsidies would disappear after 2007. It is estimated that the ongoing fuel price adjustments will save the government a total amount of more than JOD 200 million in fuel price subsidies annually.[76] The reduction of subsidies will be accompanied by one-off compensation payments to all low-income groups in society to help cope with the effects of the price hikes. To further cut expenditure, the government aims to end all subsidies over the next years (including support for institutions that are self-sufficient, such as public universities, as well as support for animal fodder and wheat prices).

Jordan's heavy dependency on foreign grants and vulnerability to their possible decline highlight the need to ensure solid revenues from taxation. Direct income taxation is a complex and inequitable system, with widespread exemptions and tax privileges. Reforms are needed to develop a system that avoids distortion among the different sectors of the economy[77], that minimises tax evasion and that simultaneously encourages Jordan's competitive strengths in business to flourish. The government submitted a draft income tax law to the parliament addressing some of these issues. After the parliament rejected it, an amended version is under preparation. Measures to improve the tax administration continued to be implemented in 2005. As a result, tax collection is said by the authorities to have improved by 25% over the last year.

The current budget management system provides a broadly satisfactory level of functionality and compliance, also thanks to the reforms implemented in recent years or still ongoing. Progress is being made on the implementation of the Financial Management Reform Strategy 2004-07 led by the Ministry of Finance as part of the broader public sector reform programme.

5. Social development and poverty

Overall living conditions remain relatively favourable in Jordan. The country achieved high levels of "human development" compared to regional averages (with a score of 90, it is currently ranked second best in the UNDP Human Development index among non-oil Arab countries), largely owing to its achievements in reducing poverty and illiteracy. Considerable progress has been made in reducing poverty, with the share of the poor dropping from 21.3% in 1997 to 14.2% in 2003. Despite an encouraging macroeconomic performance, however, problems of poverty and social development remain significant. The National Agenda tackles some of the poverty problems (e.g. it envisages health insurance coverage to all citizens by 2012). The government is also focusing on the potential social costs brought by the implementation of some economic reforms (e.g. reduction of food and oil subsidies) and is taking measures to improve the efficiency of social safety nets.

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[76] The actual amount of saving in fuel price subsidy, however, is decided by the changing gap between the subsidised domestic fuel price and the world market price (Chen, D. (2006), *Distributional Impact of Fuel Price Liberalization and GST Realignment. Assessment and Recommendations*, prepared for USAID/Jordan and the Ministry of Finance, February 1).

[77] Jordan has four tax rates: 0% for agriculture, 15% for manufacturing, 25% for service sector and 35% for banks.

JORDAN

Main economic indicators

	2001	2002	2003	2004	prel. 2005
Real sector					
Real GDP growth (% change)	5.3	5.7	4.1	7.7	7.2
Inflation CPI (period average)	1.8	1.8	1.6	3.4	3.5
GDP nominal, in USD billions	9.0	9.6	10.2	11.5	12.9
GDP per capita, in USD	1,732	1,794	1,854	2,043	2,219
Social Indicators					
Unemployment	14.7	15.3	14.5	12.5	15.7
Life expectancy (years)	---	72	72	72	---
Literacy total (% of ages 15 and above)	---	91	---	90	---
Literacy female (% of ages 15 and above)	---	85.9	84.7	---	---
Fiscal Sector[1]					
Total revenues, excl grants % of GDP	26.0	24.5	23.2	25.5	27.7
Total expenditure, % of GDP	33.9	34.5	35.9	38.0	37.8
Budget balance, incl. grants % of GDP	-3.6	-4.9	-1.0	-1.7	-5.2
Budget balance, excl. grants % of GDP	-7.9	-9.9	-12.8	-12.5	-10.1
Net public debt, % of GDP	94.9	97.2	98.1	87.6	83.7
Monetary sector					
Private sector credit (% change)	11.5	3.2	3.5	17.3	30.3
Private sector credit as % of total credit	84.2	81.3	79.5	79.2	---
Broad money (M3), % yoy	5.8	7.0	12.4	11.7	17.0
Degree of monetisation (M3/GDP, %)	123.6	124.2	131.4	129.5	---
External sector					
Current account (incl. grants), % of GDP	-0.1	5.6	11.6	-0.1	-17.8
Trade balance, % of GDP	-22.2	-17.7	-19.6	-29.6	-38.8
Foreign direct investment flows, % of GDP	1.3	0.7	4.2	5.4	10.0
Import cover (months)[2]	5.3	6.7	6.5	5.1	4.8
External Vulnerability					
External public debt, % of GDP[3]	86	89.1	74.8	65.5	57.9
Debt service ratio[4]	20.4	17.9	17.8	15.1	12.6
Foreign exchange reserves (USD billions)	2.6	3.5	4.7	4.7	4.7
Reserves/M3	30.3	38.1	46.4	42.8	35.5
Financial sector					
Short-term interest rate[5]	5.2	4.0	2.8	2.5	---
Exchange rate (per USD, eop)	0.71	0.71	0.71	0.71	0.71
Exchange rate (per EUR, eop)	0.63	0.75	0.87	0.96	---
Real effective exchange rate (eop, 2000=100)	---	103.3	95.8	92.1	91.9

Source: IMF, World Bank

[1] Covers the central government and budgetary agencies. Includes non-budget account net spending.

[2] International reserves in terms of months of imports of goods and non factor services.

[3] Total government external debt incl. Government guaranteed external debt

[4] Public external debt service in % of exports of goods and nonfactor services.

[5] Average time deposit rate.

LEBANON

- **In 2005 Lebanon experienced a period of political uncertainty and economic stagnation after a 10-year high of 6% in 2004. Economic sluggishness affected almost all sectors. The exceptions were the banking and external sectors.**
- **Severe imbalances in the public finances, with a deficit at about 8% of GDP in 2005 (8.5% in 2004) and a debt ratio of 175% of GDP, remain the main sources of economic vulnerability.**
- **Rapid implementation of structural reforms is necessary to increase the country's growth potential and to stabilise the debt dynamics. The ENP Action Plan, currently under negotiation with the EU, provides a support to Lebanon's stabilisation plan.**
- **The weak institutional environment marked by overlapping powers and responsibilities, clientelism and limited accountability and transparency hampers the implementation of economic and social reforms.**

1. Macroeconomic developments

Real sector developments

Following the assassination of former Prime Minister Rafik Hariri, growth slowed down sharply, stagnating in real terms in 2005 after reaching a 10-year high of 6% GDP growth in 2004. The economic sluggishness affected almost all sectors, with private and public consumption as well as domestic investment contracting. The exceptions were the banking sector, which increased its net profitability by 3.7%, and the external sector which, with sustained demand coming from Gulf countries, continued to support economic activity.

A recovery with a moderate growth of 2-3% is expected in 2006 provided the political situation stabilises. The unemployment rate varies between 6% and 30% depending on the age group. The informal economy represents 34% of GNP compared to the regional average of about 36%.

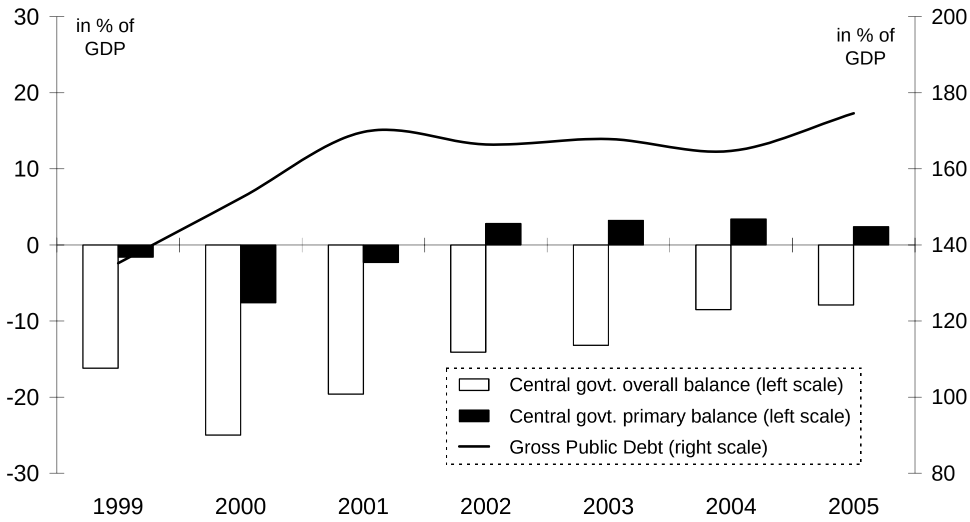
Fiscal developments

The severe imbalances in public finances remain the main source of economic vulnerability. In 2005, in the absence of a budget law (since it was approved only retroactively in February 2006), the government continued to apply the rule of "the provisional twelfth"[78], which resulted in a decrease in the deficit to about 8% of GDP (2004: 8.5%).[79] On the expenditure side, debt servicing costs fell as a percentage of GDP to 10.3% (2004: 12%), offsetting a pick-up in non-debt spending and reflecting among other things below-market financing by the Central Bank and higher rates in previous years.

[78] Most expenditure categories were effectively frozen in nominal terms. The absence of a budget law means that new expenditure commitments are not permitted, which resulted among other things in a considerable compression of investment expenditures.
[79] According to the World Bank, which includes in the accounts the central budget and the Treasury as well as foreign-financed capital expenditures, the deficit dropped in 2005 to 8.8% of GDP from 9.9% in 2004.

The fiscal situation has been weakened by the growing gap between domestic energy prices faced by consumers and international oil prices and higher subsidies for Electricité du Liban (EdL). Financial assistance to EdL from the government and the central bank amounted to over 4% of GDP or USD 1 billion (compared to 2.3% in 2004). To maintain the cap on retail gasoline prices introduced in May 2004, the Treasury had to further reduce petroleum excise taxes in the face of rising world prices. The primary surplus decreased to 2.4% of GDP (2004: 3.4%). The budget for 2006, still not approved, is expected to target a primary surplus of 4.5% (compared to the IMF no-policy-change scenario of 1.4%). The outturn will depend, however, on the government's ability to proceed with economic reforms.

Chart 1: Lebanon - Fiscal developments



Source: IMF

Gross public debt grew by 7.4% to USD 38.5 billion (174.6% of GDP) over 2005, building on a 10.5% increase in domestic debt and a 4.4% increase of external debt[80], and is expected to further increase in 2006. Its sustainability remains dependent on the willingness and capacity of the commercial banks to extend new finance and roll over the maturing foreign debt. The rapid adoption and implementation of structural reforms are necessary to stabilise the debt dynamics.

The government aims to bring the debt down to 138% of GDP and the budget deficit to 3% of GDP by 2010. The strategy is based on a five-year programme of reforms which simultaneously embraces fiscal, structural and social measures. It also addresses short-term threats to stability and long-term structural challenges. The comprehensiveness of the programme should allow synergies to develop between its different pillars and help ensure the success of the stabilisation plan, which targets i) an increase in the primary surplus; ii) a restructuring of the public debt through privatisation proceeds and international assistance; and iii) a reinforcement of the growth potential of the economy to invert the public debt growth dynamics.

The government intends to organise an international donors' conference ("Beirut I") in support for its reform programme. The international community has stressed, however, that Lebanon needs to come to the conference table with a timeline, modalities, and deliverable targets for reforms.

[80] Adjusted for the indebtedness of the public institutions and societies and the arrears of the government, the stock of public debt is approaching USD 50 billion. Domestic debt reached USD 19.3 billion, or 50.2% of total debt. The external debt amounts to USD 19.2 billion, or 49.8% of total debt (2004: 51.2%).

Monetary and exchange rate policy

Despite the political turmoil in 2005, the central bank was able to maintain the stability of the currency and its peg to the dollar[81] as well as the liquidity necessary to meet the government's financing needs. In the immediate aftermath of the assassination of Prime Minister Hariri, the economy witnessed two months of intense pressure, leading to net conversions of local currency to foreign exchange of the equivalent of USD 6 billion and an outflow of capital. In spring 2005, the rate of dollarisation reached 80%, the highest level since 1992, but stabilised thereafter at approximately 73%.

The period of turmoil was relatively short. By May 2005 the central bank began rebuilding its foreign exchange reserves towards their pre-crisis level of around USD 10 billion (45% of GDP and 12 months' worth of imports) boosted in part by a return to growth of foreign currency deposits within the banking sector and a rebound in foreign capital inflows on account of high liquidity in the region. The interest rates on deposits have also increased, partly reflecting tightening monetary conditions in the US. Inflation is estimated to have decreased to an average annual rate of 0.3% in 2005 (2004: 3%) on account of economic stagnation and effective sterilisation of capital inflows by the central bank. Subsidy payments are also offsetting the impact of high oil prices on consumer prices.

External sector developments

The external sector, also affected by the unstable political situation, experienced a contraction in the first five months, followed by a recovery as confidence improved. Overall, exports increased by 7.6% year-on-year. Imports stagnated[82] reflecting weaker aggregate demand. As a result, the trade deficit decreased by 7.6% compared to the same period in 2004. Consequently, notwithstanding a drop in the number of tourists by 11% and higher oil prices, the current account deficit also decreased, to 12.7% of GDP (2004: 18.2%). Foreign direct investment recovered in the second half of 2005. Gross capital inflows grew by 5% to over USD 8 billion. As a result, Lebanon recorded a balance-of-payments surplus of USD 747 million in 2005 (2004: USD 169 million).

2. Trade liberalisation and economic opening

Structural reforms have been postponed since Lebanon's bilateral trade relations with neighbouring countries remain vulnerable to the political situation in the region.[83] The free trade agreement with Bahrain is still awaiting ratification. Lebanon concluded new agreements with Kuwait and Algeria to diversify the sources of gas and oil supply and decrease its import bill[84] and signed a free trade agreement (FTA) with the Gulf Cooperation Council. Lebanon is also continuing its efforts towards full membership of WTO although there have been delays in adopting and enforcing the corresponding legislation.

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[81] The central bank drew around USD 1.5 billion from its reserves to keep the Lebanese pound within its official band of LBP 1 501-1 514 per USD.

[82] Official statistics report a slight drop of 0.6%. This figure turns, however, even to a drop of 7.6% when adjusting for oil prices and the EUR/USD exchange rate variations (Bank Audi (2005), *Quarterly Report*, third quarter).

[83] For example, Syria blocked at its borders vehicles arriving from Lebanon for several weeks, which resulted in considerable economic loss to Lebanese exporters.

[84] With Algeria, the agreement allows a supply of 1.1 million tonnes of fuel oil and 1 million tonnes of gasoil over 3 years, starting from 2006. The agreement should save EdL USD 40 million annually (10% of its annual losses). The deal with Kuwait, worth USD 800 million, foresees imports of 600 000 tons of diesel oil per year.

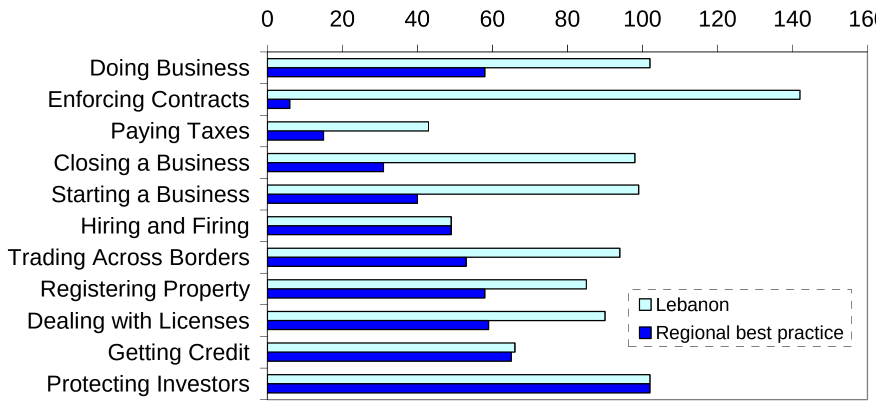
Following ratification by all the countries concerned, the Association Agreement with the EU entered into force on 1 April 2006, replacing the Interim Agreement which covered only trade issues and had been in place since March 2003. Negotiations of the ENP Action Plan (AP) with the EU were launched in April 2006. The economic chapter of the AP supports Lebanon's macroeconomic stabilisation programme to bring the fiscal position to a sustainable basis while reducing the debt burden and improving public finance management. With regard to structural reforms, the measures included in the AP respond to the national reform objectives to improve business conditions to enhance growth, increase investment and create jobs. High priority is attached to the implementation of the privatization programme and to the improvement of the transparency of the process. The AP also raises attention to the necessary accompanying measures to address the social consequences of economic reforms.

3. Business climate

Privatisation, enterprise restructuring and business environment

The government, in power since July 2005, wants to focus on the implementation of a comprehensive privatisation programme with the dual aim of raising funds for debt reduction and improving the efficiency and quality of service in key sectors.[85] The privatisation efforts have stalled, however, as a result of numerous political deadlocks.

Chart 2: Lebanon - "Doing business" rankings



The ease of doing business index ranks economies from 1 (best) to 155.
The regional best practice refers to the best ranking Arab country among the Mediterranean ENP countries.

Source: World Bank, 2006.

There is also little sign of progress as far as the business environment is concerned. Lebanon was downgraded in the World Bank "Doing Business in 2006" Report, which ranked it 142nd out of 155 countries in the effective enforcement of contracts and 98th and 99th in terms of entry and exit of firms (Chart 2). The government announced a series of measures aimed at improving the investment climate in the country as part of the National Investment Reform Agenda (establishing a general income tax system, reducing red tape, reforming commercial legislation to facilitate the entry and exit of companies and encourage start-ups). In addition, a new bankruptcy law and judicial procedures for contract enforcement and commercial disputes are being prepared. Lebanon is also in the process of enacting a Code of Tax Procedures which will

[85] Telecommunications, power production and distribution of the national company Electricité du Liban (EdL), management of national ports at Beirut and Tripoli, several refineries, Régie du Tabac, regional water authorities.

define taxpayers' rights and responsibilities. A comprehensive law on consumer protection, addressing unfair competition, was adopted in February and entered into force in May 2005.

Financial sector reforms

The financial sector was the fastest domestic sector to recover from the period of political turmoil, because it was able to effectively capture some of the portfolio outflows from the Gulf countries. Banks increased slightly their liquidity ratios to 82.7% (2004: 82%), and their profitability rose by about 13%. The exposure to the sovereign sector increased, however, in 2005, to 54.1% of banks' assets from 52.7% in 2004. The gradual unwinding of this exposure is likely to require both consolidation within the banking sector and a strategic shift by the stronger banks towards private sector lending. The banking sector assets reached 320% of GDP, one of the highest ratios according to international standards.

The capital markets seem to be unaffected by short-term instabilities, which are counterbalanced by the country's favourable medium- to long-term outlook (exceptional performance of the Lebanese stock market) and high regional liquidity. Total capitalisation remains small (20% of GDP) even by regional standards.[86]

Lebanon remains committed to implementing Basle II in 2006 and 2007 to ensure better transparency in the banking sector: reducing risks by commercial banks through a series of measures such as increasing the paid-up capital and investing more money in training of staff to handle operational risks.[87]

Labour market reforms

It remains difficult to monitor labour markets rigorously in the absence of up-to-date economic statistics on households' living conditions, wages and unemployment. Increased labour costs in some sectors are expected after a new work permit obligation was introduced in 2005 for Syrian workers in Lebanon. The Ministry of Labour is set to open special border posts at which they will be obliged to register and will be issued work permits for an unspecified fee. There will be no quotas on the number of Syrians allowed in, but they will be subject to the same income tax levied on other foreign workers.

4. Public institutions and public finance management

The public finance management system suffers from significant weaknesses. According to the main findings of the recent World Bank Country Financial Accountability Assessment (CFAA), the budget does not cover all the central government activities. Many financial activities are not transparent to the government itself. There is a dual budget system in operation. The first budget is the regular one prepared by the Ministry of Finance (MoF) and approved by parliament; it covers central government spending, executed by budget line entities. The second budget is the Foreign Financed Investments budget, prepared by the Council for Development and Reconstruction and approved by the government.

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[86] Solidere, the real estate holding company which owns much of Beirut's central district, accounts for over 60% of total capitalisation, and banks for most of the rest.
[87] Not all Lebanese banks may be able to meet the tough conditions, which require additional investment and higher capital, as well as developing an internal banking supervision.

The CFAA recognised that major efforts had been made by the MoF since 2001 in increasing transparency, namely by disclosing all public finance, debt and trade information. The government intends to move over time from GFS-1986 standards to a GFS-2001-compliant framework, which could also support a move (over five to ten years) to performance-based budgeting, and a phased migration from the current modified cash-based accounting system to a full accrual basis, as recommended by the IMF. Establishing and implementing modernised internal control systems remains a major challenge for the government.

A number of reforms in the tax administration are under way. Tax collection remains poor. It is estimated that about 44% of registered taxpayers are not paying taxes.[88] A general plan to reform the tax system was formulated, the major objective of which is to implement in 2006 a general income tax. An Organic Budget Law is being prepared to streamline and broaden the coverage of the budget process: the budget planning, budget execution, budget accounting and classification, and audit and control.

The Frazer Institute's Index of Economic Freedom in the Arab World ranked Lebanon 1st among countries surveyed in the region.[89] Lebanon ranked 7th in the Heritage Foundation Index of Economic Freedom.[90] Despite these relatively high average rankings, the weak institutional environment, marked by overlapping powers and responsibilities, clientelism and limited accountability and transparency, hampers the implementation of economic and social reforms.

5. Social development and poverty

The government has not given much attention so far to tackling the deteriorating social situation. The lack of reliable statistics on the social situation and poverty hampers the effectiveness of policy making and analysis. The most recent source of statistical information on income and consumption dates back to 1997 and focuses only on the Greater Beirut Area. There is also no official poverty line in Lebanon. The differences in development between Lebanese regions remain considerable.[91] Poverty is concentrated in city suburbs and remote rural areas. A general framework policy for regional and sustainable development does not exist.

The social security system, characterised by a dual nature (separate schemes for civil servants and the military on the one hand, and the private sector on the other), is a source of high costs and implicit liabilities for the budget, and restricts labour mobility. In addition, only 26% of the labour force are covered by a pension scheme (including the 6% of the labour force made up of civil servants and military personnel), which is below the regional average of 30%. Informal networks and NGOs continue to be the sole complements to the insufficient and badly targeted existing state welfare schemes. Discussions on social security reform and the establishment of an efficient and properly targeted social safety net are ongoing in the context of preparations of the government comprehensive programme of economic and social reforms.

[88] Schneider, F. and R. Klinglmair (2004), *Shadow Economies around the World: What do We Know?*, IZA Discussion Paper, No. 1043, March.

[89] The factors taken into account are size of the government, legal structure and the security of property rights, access to sound money, freedom to trade, and regulation of credit, labour and business. Lebanon achieved the best results in the size of government due to its low ratio of subsidies to GDP and its low top marginal tax rate. However, it was ranked joint last with Algeria and Syria for the legal structure and the security of property rights.

[90] This index takes into account factors which are trade policy, fiscal burden of government, government intervention in the economy, monetary policy, capital flows and foreign investment, banking, wages and prices, property rights, regulations and black market activity. The scores on property rights, informal market and regulation continue to hold back Lebanon's overall results despite improvements in trade policy and fiscal burden.

[91] The incidence of extreme poverty is considered to range from 22% in Hermel to 0.7% in Beirut.

LEBANON

Main economic indicators

	2001	2002	2003	2004	prel. 2005
Real sector					
Real GDP growth (% change)	4.2	2.9	5.0	6.0	1.0
Inflation CPI (period average)	-0.4	1.8	1.3	3.0	0.3
GDP nominal, in USD bn	17.1	18.5	19.9	21.8	22.0
GDP per capita, in USD	4,728	5,049	5,370	5,799	5,799
Social Indicators					
Unemployment	---	---	---	---	---
Life expectancy	---	71	71	---	---
Under 5 mortality rate, (per 1,000 children)	---	32	31	---	---
Urban population	---	87	---	---	---
Fiscal Sector					
Total revenues, incl. grants % of GDP	18.2	21.0	22.0	22.8	22.3
Total expenditure, % of GDP	36.7	35.1	35.2	31.3	30.2
Central govt. balance, % of GDP	-18.5	-14.1	-13.2	-8.5	-7.9
Gross public debt, % of GDP	165.9	166.4	167.8	164.7	174.6
Monetary sector					
Private sector credit (% change)	-0.4	2.5	0.3	5.2	1.9
Private sector credit as % of total credit	*45.0*	55.6	54.3	49.9	47.2
Broad money (M5[1]), % yoy	7.4	6.4	15.4	12.3	3.5
Degree of monetisation (M5/GDP, %)	--	237.7	254.6	261.3	266.9
External sector					
Current account balance, % of GDP	-19.2	-15.4	-15.2	-18.2	-12.7
Trade balance, % of GDP	-34.6	-26.9	-26.2	-32.7	-31.1
Foreign direct investment flows, % of GDP	8.9	7.5	7.8	6.8	7.6
Import cover (months)	5.7	6.0	10.2	9.9	
External Vulnerability					
External public debt, % of GDP[2]	61.6	75.5	78.3	84.4	85.7
Debt service ratio[3]	13.3	12.8	17.2	---	--
Gross reserves (excl. gold, USD billions)	4.4	5.1	10.2	9.5	9.8
Reserves/M3	12.5	13.5	23.9	20.5	
Financial sector					
Average L£ deposit rate	--	10.3	7.8	6.8	7.7
Average USD deposit rate	--	4.2	3.6	3.6	4
Exchange rate (per USD, eop)	1,508	1,508	1,508	1,508	1,508
Exchange rate (per EUR, eop)	1,341	1,580	1,884	2,051	1,815
Real effective exchange rate (1992=100)	213.9	215.9	208.2	207.4	--

Source: IMF, World Bank

[1] Broad money is defined as M3 (currency + resident deposits) + non-resident deposits

[2] Debt denominated in foreign currency

[3] In percent of exports of goods and services.

MOLDOVA

- **Strong growth continued in 2005, driven mainly by domestic demand fuelled by workers remittances (more than 30% of GDP). Both household consumption and investments increased. Residential construction was the fastest growing sector.**
- **Trade and current account deficits widened, reflecting sustained domestic demand and high energy prices. In 2006 Moldova is facing a substantial balance-of-payments shock resulting from the strong increase in the natural gas price charged by Russia.**
- **Despite a seemingly comfortable fiscal situation, public finances are fragile in view of external debt arrears. Settlement of debt arrears is expected in the context of the economic programme agreed with the IMF.**
- **Progress in macroeconomic management and structural reform made possible an agreement with the IMF on a new programme, but substantial weaknesses remain in the key areas of governance and business environment.**

1. Macroeconomic developments

Real sector developments

Moldova's economic recovery continued in 2005, with real GDP growth remaining slightly above 7%, the average growth rate for the last five years. Since the resumption of growth in 2000, the country's GDP has increased by more than 40%. The 2005 result is comparable to that of the previous year (7.4%); it is nevertheless somewhat disappointing as growth was significantly faster in the first three quarters of the year (8.4% year-on-year).

Strong growth performance is driven by export demand for the country's traditional commodities (mostly agriculture and food industry products, e.g. wine) and, more substantially, by household demand fuelled by booming workers' remittances. Not surprisingly, as preliminary data on the sectoral breakdown of GDP suggests, growth was particularly strong in the sectors most directly reflecting household demand: residential construction (23% in 2005) and retail trade (13%). At the same time, the industrial production increased by a more modest 6.3% and the agricultural production stagnated (1.0% growth). On the demand side, while private consumption increased by about 8.5%, the most promising development was a faster increase in capital investment – by about 9%. The robust growth in investment demand is good news, indicating prospects for sustained medium-term growth, much needed given that the gross capital formation in the Moldovan economy is, at 18% of GDP, one the lowest in Eastern Europe.

Unemployment was reduced from 8.1% of the total labour force in 2004 to 7.3% in 2005. At the same time, total employment continued to shrink: according to official statistics, only 42% of the population was economically active in 2005, a decrease of 14 percentage points over 2000.

Monetary and exchange rate developments

Inflation accelerated in the last months of 2004 and the first months of 2005 reflecting continued large inflows of remittances and active interventions of the National Bank of Moldova (NBM) on the foreign exchange market. The twelve-month consumer price index increased from 10.7% in September 2004 to 14.2% in April 2005. Later in the year, inflation moderated gradually to an end-year figure of 10.0%. This was largely the result of a sharp increase in the sterilisation efforts by the NBM, supported by a restrictive fiscal policy. The gradual easing of inflationary pressures allowed a moderate depreciation of the nominal exchange rate of the leu (by a little less than 3%, against the US dollar). The real effective exchange rate that had appreciated by about 2.5% in the first months of 2005 came down to its end-2004 level.

For 2006, the NBM intends to put more emphasis on controlling inflation while maintaining a competitive exchange rate and continuing to build up reserves to approach the target of three months of import coverage; at the end of 2005 official reserves had reached USD 600 million, but were still quite far from target level.

Fiscal developments

Already in 2004, due to a strong revenue performance and despite a considerable fiscal loosening in the run-up to the March 2006 parliamentary elections, the budget surplus increased to nearly 1% of GDP. In 2005, fiscal revenue increased further, primarily reflecting a sharp rise in the revenue from VAT on imported goods. As a result, and despite further increase in public spending – by more than 25% in nominal terms over 2004 – the general government surplus widened to an estimated 1.7% of GDP.

Despite a seemingly comfortable fiscal position, public finances remains extremely fragile given that the country is not fully servicing its external debt obligations. While Moldova continued making interest payments on its Paris Club debt (interest payments to the official creditors were resumed in July 2004), arrears on principal repayments continued to build up. The stock of arrears to the Paris Club at the end of 2005 was estimated at about USD 55 million, or nearly 2% of GDP. The settlement of arrears remains a precondition for restoring relations with the international financial community after the default of 2002. In view of the agreement with the IMF in early 2006 on a new financing arrangement expected to be approved in May 2006, this now seems within reach.

In addition to the expected fiscal cost of the settlement of the Paris Club debt, the 2006 budget will bear the cost of increased utility tariffs following the increase of the natural gas import prices in January 2006 (see below). This cost, which reflects in particular the general government energy bill and income support, is estimated to be at least 0.4% of GDP; it may be substantially higher if gas prices rise further.

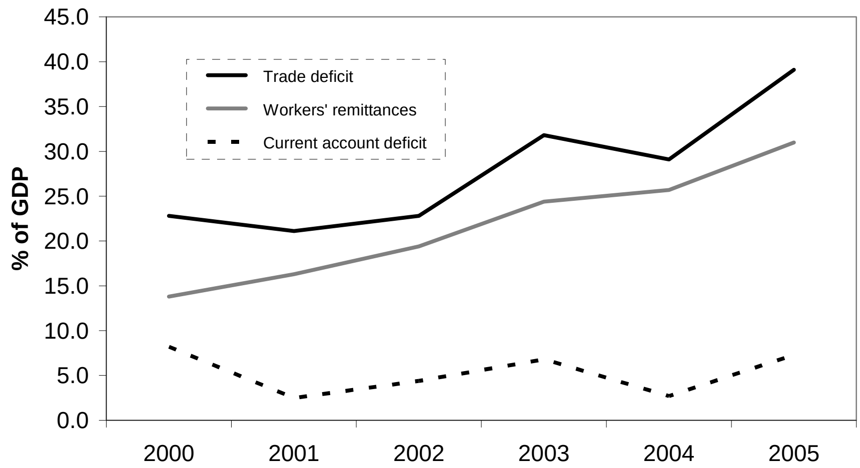
External sector developments

Growth in exports continued, albeit at a slower pace than in 2004 (an estimated 11%, in current dollar terms, against more than 23% in 2004). The relatively disappointing export performance can be explained by the loss of competitiveness of the Moldovan products following a strong real exchange rate appreciation (in 2004 and in the first half of 2005, the real effective exchange rate of the leu appreciated by nearly 15%, before a partial reversal of the trend), and by difficulties in traditional export markets, notably Russia (for e.g. alcoholic beverages) and the EU (for animal products that do not meet EU sanitary and phytosanitary norms). At the same time, the value of imports increased by 31%, reflecting higher energy prices and an increase in domestic demand. Imports of goods approached 80% of GDP in 2005.

As a result, the trade deficit widened to 41% of GDP (up from about 30% in 2003-2004), the largest part of which was again covered by the continuously growing flow of remittances. In 2005, the officially registered remittances increased by nearly one-third, to 31.4% of GDP. This did not, however, prevent a substantial widening of the current account deficit, which rose to 9.8% of GDP, up from 2.0% of GDP in 2004. Foreign direct investments continued to grow and reached some USD 225 million in 2005 (7.7% of GDP), nearly three times their trough two years earlier.

The trade balance is likely to deteriorate further in 2006, reflecting in particular a hike in the price of the natural gas imports from Russia in January 2006 (from USD 80 per thousand cubic meters to USD 110). The impact of this first price rise (that may be followed by further increases at the end of 2006 or 2007 given that the price paid by Moldova is still much lower than that charged on Russia's gas sales to the Central and Western European countries) is about 1.5% of GDP. External vulnerability has been further exposed more recently by the Russian ban on Moldovan wine exports.

Chart 1: Moldova - Current account deficit



Source: IMF, National Bank of Moldova

Pending a possible Paris Club debt consolidation agreement, Moldova continued the gradual reduction of its external indebtedness. While in 2004 it had concluded a number of bilateral debt reduction deals (with non-Paris Club official and private creditors), in 2005 the reduction of the debt stock was the result of regular principal repayments, not matched by new disbursements. At the end of the year, Public and publicly guaranteed external debt was below USD 800 million, some 26% of GDP (down from 34% one year earlier and about 60% in 2002). The non-publicly guaranteed external debt is substantially higher – about USD1.2 billion. Total debt servicing still represents some 20% of exports of goods and services.

2. Trade liberalisation and economic opening

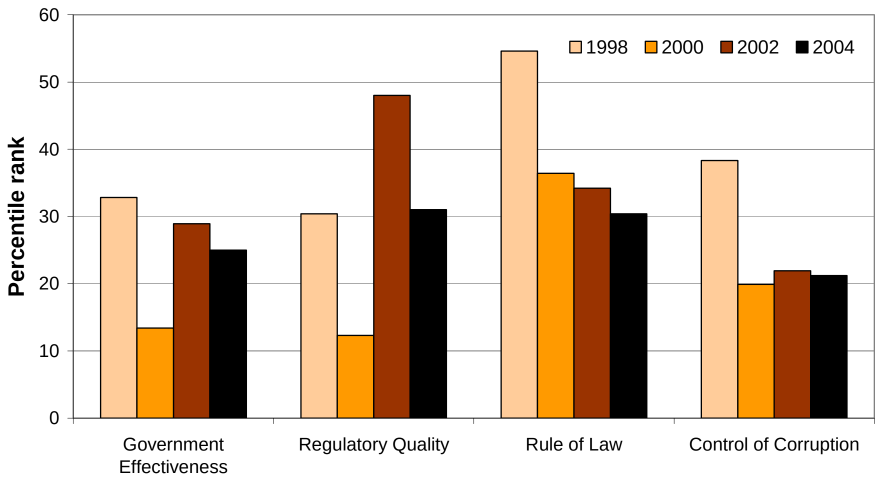
Moldova was one of the first former Soviet Republics to join the World Trade Organisation – it has been a WTO member since July 2001. In general, Moldova has a fairly liberal trade regime, but there are still informal restrictions on exports of some key commodities (e.g. wheat, sunflower seeds). In addition, inefficient and costly border procedures are a significant impediment to businesses wishing to conduct trade operations. Elimination of restrictions on grain trade (e.g. the obligation for exporters to pass through the commodity exchange or to use one particular means of transport) is one of the government's commitments under the future IMF-supported programme.

3. Business climate

Privatisation, enterprise restructuring and business environment

The resumption of economic growth in the early 2000s coincided with a virtual standstill in structural reforms. During this period, the government's failure to achieve any significant progress in privatisations and enterprise restructuring together with its excessive administrative interference in the economy, led to a marked deterioration in the business climate. Moldova's poor and deteriorating record in the area of governance in the last few years is reflected in the World Bank governance indicators (cf. Chart 2 below; lower ranks represent deterioration).

Chart 2: Moldova - Governance



Structural reforms re-appeared on the government agenda in 2004. One important step in this direction was the adoption of the Economic Growth and Poverty Reduction Strategy Paper (EGPRSP) in May 2004, setting medium-term priorities for government action. A sound business environment is identified in the EGPRSP as one of the key prerequisites for sustainable growth. The Government's commitment to reforms has been reinforced by its stated European aspirations, confirmed by the adoption in early 2005 of the EU-Moldova European Neighbourhood Policy Action Plan. The Action Plan, aiming to establish an increasingly close relationship between the EU and Moldova, seems to be a very powerful driver for reforms.

In 2005, in the area of business environment and enterprise reform, the authorities started the implementation of the Regulatory Governance Action Plan, aimed at improving and streamlining the regulatory environment for enterprises. In this context, the government has been using the so-called "guillotine approach" consisting in a comprehensive review of more than 1 000 business regulations with a view to cancelling most of them and streamlining the rest. Licensing and inspection costs have already been reduced substantially and are expected to be cut further when the review of the regulatory framework is completed. In addition, the Parliament adopted amendments to company law, streamlining ownership and corporate governance regulations. In the area of privatisation and public enterprise management, the only noticeable development was the completion by government of the inventory of state asset holdings, with a view to resuming a privatisation process at a later date.

Despite progress achieved in the last couple of years, the business environment in Moldova is still characterised by the presence of major barriers related to regulation, tax administration and state interference. This is the assessment contained in the 2005 Business Environment and Enterprise Performance Survey (BEEPS) of the EBRD and the World Bank, and in the World Bank "Doing Business" survey on business regulations and their enforcement.

Financial sector reforms

Strengthening of the banking system continued in 2005, with a 35% increase in the banks' consolidated assets, compared to 25% in 2004. As a share of GDP, bank assets increased from 42 to 49%. The monetisation of the economy progressed further: the broad money-to-GDP ratio reached 43%, up from 37% in 2004.

The Financial Sector Stability Assessment (FSAP) completed by the IMF in January 2005 concluded that the banking sector is fundamentally sound, in view of its comfortable levels of revenues, capitalisation and liquidity and low levels of non-performing loans. Yet, the FSAP identified a number of structural weaknesses in the banking sector, including governance issues related to government interference and lack of ownership transparency. Recently adopted amendments to the Law on Financial Institutions aim at correcting some of these, but much still needs to be done to improve the efficiency of the banking sector.

The fragility of banks was highlighted in 2005, with the decrease in the banks profitability reflecting the decrease in interest rates. One of the main challenges still to be tackled by the authorities is the opening up of the banking sector to competition, including that from reputable foreign banks. Restructuring – and later privatisation – of the Savings Bank, the country's largest financial institution, to which the government committed in the agreement with the IMF, would facilitate this task. The development of a competitive environment for the more slowly growing insurance sector will be another short-term task in the area of financial sector reform.

Labour market reforms

The rigidity of the labour market, characterised by structural, territorial, occupational and professional imbalances, is seen as one of the major obstacles to economic growth. So, while Moldova ranks 83rd (out of 155 rated countries) in the overall ranking in the World Bank's "Doing Business" survey, it is only 135th in the labour regulations ranking, the last of all the New Independent States. The rigidity of the labour market is also reflected in a very long average duration of unemployment, estimated at more than two years in 2005. It inevitably leads to withdrawal of discouraged people from the labour market and, ultimately, to emigration. Official statistics estimate that about 370 000 Moldovans or 28% of the economically active population were working abroad in 2005. Other estimates suggest that more than 40% of the economically active population have worked abroad at some point during the year.

The distribution of employment by sector is changing slowly. The agricultural employment that still accounted for 50% of total employment in 1999 decreased to 41% in 2004. The services sector accounted for 47% of total employment. It is estimated that 78% of all the employed were working in the formal sector, 13% in the non-formal sector and 9% were engaged in household production.

4. Public Institutions and Public Finance Management

The EGPRSP incorporates a comprehensive reform agenda in the areas of public administration reform, public financial management, the judicial system and the fight against corruption. Indeed, corruption remains a serious concern, despite a perceived improvement: Moldova's position in Transparency International's global Corruption Perception Index improved from the 114th place in 2004 (of 146 ranked countries) to the 88th place in 2005 (of 159 countries). Moldova's index was still only 2.9 on the scale of 0 to 10.

The public administration reform launched in 2005 involves streamlining and reforming the public administration, aims at increasing the efficiency of the central administrative apparatus, at developing institutional capacities and human resources management and at improving the decision making and interaction of the administration with the civil society. In the framework of the implementation of this agenda, the Government approved a Strategy of Reform of the Central Public Administration and adopted an Implementation Plan in 2005.

The public administration reform runs in parallel with the strengthening of public financial management that has emerged as an area with serious commitment to reform. In particular, the authorities are making progress in strengthening the tax administration and broadening the tax base, essentially through the reduction of tax privileges; at the same time personal income tax rates are being gradually reduced. In addition, the Medium-term Financing Framework, aimed at a better use of government financial resources, is gradually incorporating all elements of the public budget.

5. Social Development and Poverty

With a GDP per capita of about USD 812 (estimate for 2005), Moldova is the poorest country in Europe. In 1999, more than 70% of its population was considered poor and about 60% as extremely poor. Since 2000, poverty rates have decreased constantly, such that by 2004, only 26.5% of Moldovans were poor and only 14.7% extremely poor. The sharpest reduction in poverty took place in 2002-2003, while the poverty rates remained largely constant in 2004. Moreover, preliminary indications suggest that poverty may have risen again in early 2005. The recent likely deterioration of poverty indicators may reflect a drop in revenues in the agricultural sector following a drought (more than two thirds of the poor live in rural areas).

The decrease in inequality in recent years has been rather modest, but followed a similar pattern. The Gini coefficient, measuring the distribution of consumption across the population, decreased rather significantly in 2002-2003 and rose again in 2004. Inequality in Moldova is among the highest in the region.

The government is pursuing a pension reform programme aimed at replacing the system based on wage levels by one based on actual contributions, while refraining from introducing new pension privileges. It has also initiated the reform of the social assistance benefits system with a view to switching from the current targeting of specific categories of population to one based on actual income.

MOLDOVA

Main economic indicators	2001	2002	2003	2004	2005 est.
Real sector					
Real GDP growth (% change)	6,1	7,8	6,6	7,4	7,1
Inflation CPI (period average)	9,8	5,3	11,7	12,5	11,9
GDP nominal, in billion USD	1,481	1,662	1,981	2,598	2,917
GDP per capita, in USD	408	459	548	721	812
Social Indicators					
Total employment (thousand)	1.499	1.505	1.357	1.310	1.319
Unemployment rate	7,3	6,8	7,9	8,1	7,3
Real wages, % change	21,6	20,9	15,4	10,2	6,9
Poverty - % of population below poverty line	67,8	67,8	67,8	67,8	67,8
Inequality - Gini coefficient (consumption)	0,388	0,372	0,356	0,361	---
Fiscal Sector					
Total revenues, % of GDP	29,2	29,6	34,0	35,4	39,5
Total expenditure, % of GDP	29,4	31,5	33,3	34,6	37,9
Central govt. balance, % of GDP	-0,4	-1,4	0,2	0,8	1,7
Gross Public Debt, % of GDP	80,1	74,8	60,3	47,2	39,0
Monetary sector					
Credit to the economy (% change)	35,4	35,2	44,4	22,2	35,0
Credit to the economy as % of total credit	60,6	66,7	76,9	76,2	87,8
Broad money (M3), % yoy	36,4	36,0	30,7	37,7	35,0
Degree of Monetisation (M3/GDP, %)	25,1	28,9	30,8	36,6	43,1
External sector					
Current account balance, % of GDP	-1,8	-4,2	-7,1	-2,0	-9,8
Trade balance, % of GDP	-21,3	-22,7	-31,5	-29,0	-40,8
Workers' remittances, % of GDP	16,4	19,4	24,4	27,0	31,4
Foreign direct investment flows, % of GDP	6,9	8,0	3,9	5,8	7,7
Import cover (months)	2,1	1,9	1,7	2,1	2,2
External Vulnerability					
External Public & Private Debt, % of GDP	113,1	109,3	97,2	72,8	67,8
Debt Service as % of exp. of goods/services	24,6	27,9	19,8	21,3	20,2
Gross reserves (excl. gold, million USD)	228,5	268,8	302,3	470,0	597,0
Reserves/M3	62,5	57,1	47,0	50,0	48,4
Financial sector					
Short-term interest rate (NBM base rate, eop)	13,0	9,5	14,0	14,5	12,5
Exchange rate (per USD, eop)	13,09	13,82	13,22	12,46	12,84
Exchange rate (per USD,per. average)	12,87	13,57	13,94	12,33	12,60
Exchange rate (per EUR, eop)	11,60	14,45	16,74	16,96	15,20
Real effective exchange rate (1999=100)	99,2	90,4	94,5	105,7	105,1

Source: National Bank and National Bureau of Statistics of Moldova, IMF, World Bank.

MOROCCO

- **A hefty decline in agricultural output, high oil prices, and the abolition of textile quotas led to a considerable slowing down of economic growth in 2005. Nevertheless, growth reached 1.8 % because of dynamic transport, communication and tourist sectors.**
- **The central government deficit 2005 increased to 4.7% of GDP due to spending on the early retirement of 38 000 civil servants which will benefit future budgets. Simplifying the tax system and widening the tax base are key fiscal policy reform needs.**
- **Morocco's central challenge for welfare improvements is increasing its low productivity growth. In 2005 promising reforms were completed and initiated. It is crucial to press on with improving the business environment.**
- **In 2006 the Pan-European Cumulation System for rules of origin will probably be extended to Morocco. Therefore, Morocco can tap much bigger benefits from the Euro-Mediterranean free trade area, if the country liberalizes trade with its neighbours.**

1. Macroeconomic developments

Real sector developments

A decline in agricultural output, high oil prices and the abolition of textile quotas led to a considerable slowing down of economic growth in 2005 (1.8%, down from 4.2% in 2004). The primary sector contracted by 12.5% mainly because agricultural industries were adversely affected by bad weather.[92] The manufacturing sector growth also slowed down whereas transport, communication and tourism were buoyant. Overall, non-agricultural growth reached 4%. The official unemployment rate remained high at 11%, with about 20% in urban centres.

Fiscal developments

The current fiscal situation with high deficits is not free of medium-term risks. However, the government follows a strategy of medium term consolidation with a target deficit ratio of 3% of GDP. In October 2005 Finance Minister Oualalou presented the 2006 appropriation bill to the House of Representatives with the notion of a 3.2% of GDP deficit (4.2% excluding privatisation revenues). This is based on a growth expectation of 5.4% of GDP and therefore requires a recovery of agriculture. The central government deficit in 2005 amounts to 4.7% of GDP (6.2% excluding privatisation). This result was influenced by lower economic growth, higher petroleum subsidies and extraordinary spending in relation to the early retirement of civil servants.

Monetary and exchange rate developments

Despite high oil prices, CPI-inflation in 2005 is expected to decrease by ½ a percentage point to 1%. It was anchored by the exchange rate peg and thanks to a prudent monetary policy against a background of a substantial slowing down of the economy. In 2005 the monetary policy

[92] Over the last couple of years the agricultural sector contributed on average more than 20% to GDP, while the industrial and services sectors contributed about 35% and 43% respectively.

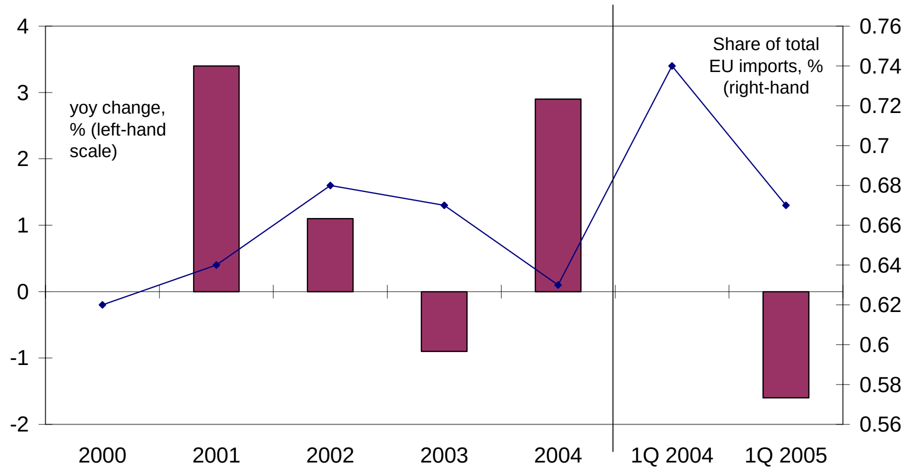
framework was improved by new central bank statutes entering into force in 2006. They define price stability as the primary objective of monetary policy and render the central bank more independent. Under these terms, the board of Bank Al-Maghrib determines the intermediate targets and the operational framework of monetary policy. Furthermore, it sets the interest rates applied to the bank's operations, determines the monetary reserves and lays down the conditions for the issue of central bank debt instruments.

External sector developments

Morocco has enjoyed current account surpluses since 2001 thanks to high and stable tourism revenues and worker remittances (in 2004 7.8% and 8.4% of GDP, respectively). However, the current account shifted from a surplus of 2.2% of GDP in 2004 to a deficit of 0.9% of GDP in 2005, mainly because of higher oil prices and stagnating exports. There is evidence that textile exports suffered because of the end of the Multifibre Agreement in 2004, but less than expected. In contrast, remittances, tourism revenues and foreign direct investment were buoyant in 2005.

The fall in exports to the EU in the first quarter of 2005 followed a strong increase in 2004, leaving the market share near its medium-term average (Chart 1). In general, the proximity to important EU markets provides Morocco with a competitive advantage in the international division of labour, especially in the textile sector. Therefore, the country has a strong trade potential, for instance with regard to the outsourcing strategies of European industries if labour qualification requirements are met.

Chart 1: Morocco - EU imports from Morocco



Source: European Commission.

2. Trade liberalisation and economic opening

The implementation of the Association Agreement with the EU is progressing according to schedule. Moreover, in 2006 the Pan-European (diagonal) Cumulation System for rules of origin will probably be extended to Morocco, allowing the country to considerably increase its benefits from the Euro-Mediterranean free trade area. However, the exploitation of these sizable benefits depends on the realisation of free trade arrangements between Morocco and its Mediterranean partner countries. While the Moroccan Parliament ratified the Agadir Agreement for a complementary free trade area between Morocco, Tunisia, Jordan and Egypt, it is now awaiting promulgation by the King. It could enter into force in 2006.

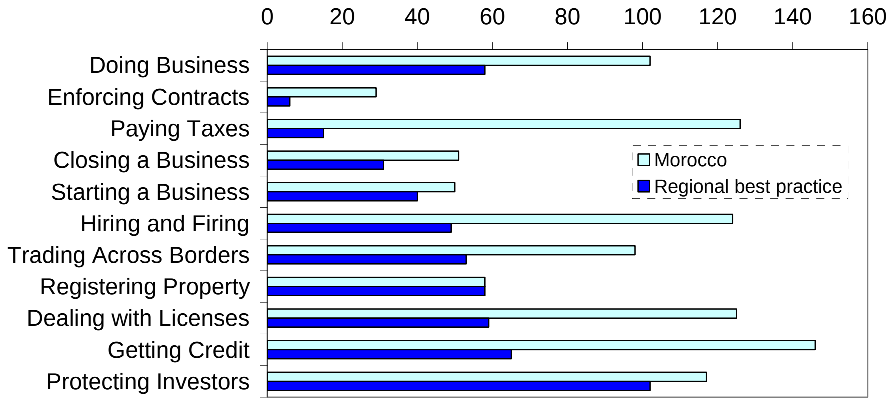
Morocco, Algeria and Tunisia have also agreed to improve bilateral relations and economic integration amongst the Maghreb countries. A respective conference for trade facilitation was held in Algiers in November 2005 and ended with a conclusion on setting up working groups and follow-up meetings. The opening of the border between Morocco and Algeria would be a major step for trade and welfare gains in the region. There are also renewed efforts to revive the Maghreb Arab Union (UMA) which also includes Libya and Mauritania. Furthermore, the EU is ready to open negotiations on further liberalising agricultural and services trade within the Euro-Mediterranean area. Finally, the free trade arrangement with the USA entered into force on 1 January 2006.[93]

3. Business climate

Privatisation, enterprise restructuring and business environment

Privatisation is ongoing with strong annual revenues between 2.3% and 2.9% of GDP since 2003. The authorities have made significant progress in improving the business environment in certain areas, notably in the telecommunications sector, which is flourishing. In other areas reforms have been initiated but many of them still need to be effectively implemented. It should become a top priority to improve the regulations for paying taxes, hiring and firing of workers, cross-border trading, dealing with licences, and access to credit of small and medium-sized enterprises, which represent the core of the Moroccan private sector (Chart 2).

Chart 2: Morocco - "Doing business" rankings



The ease of doing business index ranks economies from 1 (best) to 155.
The regional best practice refers to the best ranking Arab country among the Mediterranean ENP countries.

Source: World Bank, 2006.

The main structural constraints to credit access include problems related to property rights, contracts enforcement, the information systems in enterprises and the lack of financial management skills in the enterprise sector. Other major impediments for private sector development include the tax administration, dealing with licenses, the labour market regulations (see below), investor protection, and hurdles for cross border trading such as complicated tariff structures and the lack of efficient port services.[94]

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[93] The FTA proposes eliminating tariffs on 95% of bilateral trade in consumer and industrial products immediately and on the remaining 5% over a period of nine years. It will be underpinned by a law that allows US firms to create stock companies in Morocco which are not governed under Moroccan regulations in order to attract more FDI.
[94] The average tariff rate was 26% in 2004. There were eight multilateral tariff lines which varied from 0% to 50% for non-agricultural and non-food products.

Financial sector reforms

In 2005 the Banking Act was changed, strengthening the competences of the central bank which has now the responsibility for granting licences to credit institutions, drawing up the regulations for the banking system and supervision. Bank Al-Maghrib was also entrusted with the creation of a crisis prevention system and with managing the process of financial recovery for institutions in difficulty. In parallel with the liberalisation of banking activity, the central bank strengthened prudential rules by bringing them more in line with international standards. In addition to increasing the minimum capital for banks, the solvency ratio was raised to 8%. Moreover, limits on foreign currency risk were limited, and new accounting schemes, internal controls, external audit rules, and minimum rules against money laundering were adopted.

Labour market reforms

The new labour code adopted in 2004 is expected to improve labour relations and flexibility in the labour market. The code emphasizes equality and the combating of all forms of discrimination. It consolidates specific protection measures for women, and prohibits child labour under the age of l5. However, the code has yet not been fully implemented. Equal treatment of women in employment relations and combating illegal child labour remain major challenges.

4. Public institutions and public finance management

In 2006 the authorities intend to initiate a tax reform, in particular of the VAT, and have published a tax expenditure report with the 2006 budget to raise awareness about the inefficiency of the tax system. The proliferation of tax exemptions (which represented almost 15% of total tax revenue in 2004) and a growing direct tax revenue-to-GDP ratio suggest an increasing tax burden on a narrow tax base. The VAT system, with five tax rates and widespread exemptions, is complicated and difficult to administer. The government has also extensively overhauled the public finance management and budgetary process, including the phasing in by 2007 of a medium-term budgetary planning.

The government continues with the no net new hiring strategy, and the implementation of modern resource management and remuneration systems in order to reduce the wage bill and render the public administration more efficient. The 2005 early retirement programme for some 38 000 public employees will result in significant wage savings in the medium term. In general, the accountability of government, a reliable policy environment, the efficiency of government services and regulatory quality remain among the main challenges for policy reform.

5. Social development and poverty

Despite improvements, the fight against poverty remains an important challenge in Morocco. The improvement of GNI per capita in recent years (from USD 1 310 in 2003 to USD 1 520 in 2004) is probably neither evenly spread across the population nor sufficient to bring about significant improvements of living standards. In 2003, infant mortality was still more than nine times higher than the EU average. The main instrument and challenge for poverty reduction is the increase of productivity growth. Strategic reforms have recently been introduced which should lead to such productivity increases in the medium term.

There are several poverty reduction programmes in Morocco, supported, inter alia, by the United Nations and the World Bank, and which address related issues. However, there is evidence that better coordination and more focusing on the need to increase productivity would improve the efficiency of some of them.

MOROCCO

Main economic indicators

	2001	2002	2003	2004	prel. 2005
Real sector					
Real GDP growth (% change)	6.3	3.2	5.5	4.2	1.8
Inflation CPI (period average)	1.8	0.6	-0.1	1.5	1.0
GDP nominal (USD billion)	33.9	36.1	43.8	50.0	..
GDP per capita (USD)	1220	1270	1520	1710	..
Social indicators					
Unemployment	12.8	12.5	11.4	10.8	11.0
Literacy total (% of ages 15 and above)	..	50.7	..	..	..
Literacy female (% of ages 15 and above)	..	38.3	..	..	..
Under 5 mortality rate (%)	..	4.3	3.9	..	..
Fiscal sector (% of GDP)					
Total revenues[1]	25.0	24.7	24.5	25.1	26.4
Total expenditure, excl. Hassan II Fund	31.1	29.6	29.9	30.5	31.6
Central govt. balance	-5.6	-4.5	-4.9	-4.6	-6.2
Central govt. balance[2]	-5.7	-4.7	-5.3	-4.9	..
Central govt. balance[3]	0.4	-4.5	-2.5	-2.6	..
Total government debt	74.7	71.4	68.5	66.4	69.9
Monetary sector					
Private sector credit (% change)	4.0	3.8	8.3	8.6	9.1
Private sector credit (% of total credit)	70.9	70.8	72.5	75.2	77.9
Broad money (M3) (% change)	14.2	6.3	8.6	7.6	5.8
Degree of monetisation (M3/GDP, %)	85.5	87.7	90.1	93.7	94.3
External sector					
Current account balance (% of GDP)	4.8	4.1	3.6	2.2	-0.9
Trade balance (% of GDP)	-8.9	-8.5	-9.9	-13.0	-16.0
Foreign direct investment flows (% of GDP)	8.0	1.3	5.3	1.6	2.5
Import cover (months)	8.2	9.1	10.4	10.0	8.6
External vulnerability					
Total external debt, % of GDP	47.8	40.9	35.1	30.8	30.2
Debt service ratio[4]	16.2	16.5	14.2	12.8	10.6
Gross reserves (USD billions, eop)	8.4	10.1	13.8	16.3	16.0
Reserves/M3	28.4	31.3	34.2	35.1	..
Financial sector					
Short-term interest rate[5]	4.4	3.0	3.2	2.4	..
Exchange rate (per USD, avg.)	11.3	11.02	9.57	8.97	..
Exchange rate (per EUR, avg)	10.1	10.4	10.8	11.0	..
Real effective exchange rate (1992=100)	112.1	111.4	109.5	112.4	..

Sources: Bank Al-Maghrib, Ministry of Finance and Privatisation, IMF, World Bank, EIU.

[1] Includes tariffs earmarked for food subsidies and revenues of the road fund.

[2] Including Hassan II Fund.

[3] Including Hassan II Fund and privatisation revenues.

[4] Percentage of exports of goods, nonfactor services and MRE (Public and publicly guaranteed debt, excl. early amortization on account of debt swaps.

[5] Average money market rate, %.

RUSSIA

- **High energy prices will continue to drive growth in the medium run, albeit with a diminishing contribution. Sources of growth need to be diversified to the non-energy sectors of the Russian economy.**
- **The fiscal position is strong. Nevertheless, the fiscal expansion observed in 2006 is expected to continue during the election cycle of 2007-08, and may pose future sustainability questions.**
- **Structural reforms broadly stagnated in 2005, with the exception of specific sectors (for instance, banking and finance). Particularly pressing is the need to reform the gas sector.**
- **The current expansion of the role of the government in the economy to sectors such as oil and aerospace seems set to continue. Privatisation has not only stopped, but in some cases, reversed.**

1. Macroeconomic developments

Real sector developments

Economic growth in Russia remains strong, albeit showing signs of gradual deceleration. In 2005 real GDP growth was 6.4%, down from 7.2% in 2004. In 2006-2007 growth is likely to be at around 6%. Industrial production growth in 2004 was 7.3%, but declined to just 4% in 2005. The weakening growth performance despite the continuing high prices of Russia's main exports (Russia is the world's second biggest oil exporter and the world's number one gas exporter) is explained by production costs increasing faster than productivity and by relatively low investment and growing capacity constraints.

This reduction in growth is also a reflection of a disappointing performance in the energy sector, whose growth more than halved between 2004 and 2005. During the second half of 2005, a slowdown in investment (domestic and foreign) was reversed, and growth was more investment than consumption- driven in the latter part of 2005. Yet, for 2005 as a whole, domestic consumption was still the main growth driver.

Fiscal developments

Russia's fiscal position has substantially improved since 1998. The federal budget swung from a deficit of almost 6% of GDP to a surplus of 7.4% in 2005, far above the initial government forecast – which some analysts say was deliberately conservative – of 1.5% of GDP for that year (indeed, the revised 2005 Budget Law forecasted a surplus of 6.9% of GDP).

The 2006 budget also projects a substantial surplus of 3.2% of GDP, though this represents a 60% fall when compared to the 2005 surplus (this forecast is once again based on a conservative oil price assumption – 40 USD per barrel – while oil prices have already overshot 70 USD per barrel).

A much lower forecasted fiscal surplus reflects a strong fiscal expansion, which may fuel inflation and threaten fiscal sustainability, especially if it continues in 2007-2008 (which is quite likely, in view of the starting election cycle). Indeed, budgetary expenditures are foreseen to increase by 42% in nominal rouble terms. This substantial fiscal easing will be concentrated on social expenditures (health care, pensions) and on public sector salaries, as well as on the military sector and on investment in public infrastructure. In view of substantial financing needs, for example to upgrade public infrastructure, there is clearly scope for a large increase in public spending in Russia. However, the public finance management system in the country does not currently provide an adequate framework for efficient and effective fiscal spending. So unspent funds can be as high as 30% of the budgetary allocations in some areas. Additionally, the funds actually spent are not necessarily spent effectively.

The share of central government expenditure in GDP at end-2005 was around 16%. However, since Russia is a federal nation the unified regional budgets add another 14% to these previous figures, bringing total government expenditure in Russia close to 30% of GDP. And unlike the federal government, the Russian regions posted only a marginal surplus in 2005 (0.2% of GDP).

Monetary and exchange rate developments

Inflation fell from almost 85% in 1998 to around 11% in 2005, and it has been stuck at the low two-digit level for some time.

The Central Bank of Russia (CBR) follows a managed exchange rate regime, with parallel and sometimes incompatible inflation and exchange rate targets. The rouble is pegged to a dollar-euro basket. In February 2005 the CBR started targeting a currency basket of initially 0.9 dollar and 0.1 euro, with the CBR progressively increasing the euro share to reflect its share in Russia's foreign trade. In early 2006, the euro share was 40%. The medium-term aims of the CBR are the full liberalisation of the capital account and the introduction of a floating exchange rate *cum* inflation targeting regime.

At the beginning of 2005 the CBR aimed to reduce inflation towards a 2005 target range of 7.5%-8.5%, in parallel to a target of rouble real appreciation of no more than 8%. In the light of negative price developments during 2005, it increased the rouble appreciation target to 10% in June. Actual inflation for 2005 was 10.9%, while real appreciation of the exchange rate reached 10%.

High oil prices keep boosting the current account surplus, which in 2005 again reached around 10% of GDP. The current account surplus for 2005 was a record USD 84.3 billion. This results in continued upward pressure on the exchange rate, which the CBR tries to prevent, in order to avoid undermining the competitiveness of the manufacturing sector. This, however, means that the CBR has to buy up the excess foreign exchange by selling roubles, with the consequence of excessive rouble liquidity on the market, and thereby inflationary pressures: by end 2005, the hard currency reserves at the CBR exceeded USD 190 billion (or over 18 months of imports), and reached USD 218 billion by mid-April 2006, making Russia the 4th. largest holder of hard currency reserves on the planet.

While institutional (for instance, the limited set of sterilisation instruments available to the CBR) and structural factors have limited the effectiveness of monetary sterilisation, much of the rouble expansion generated by higher oil prices was sterilised through the accumulation of the fiscal

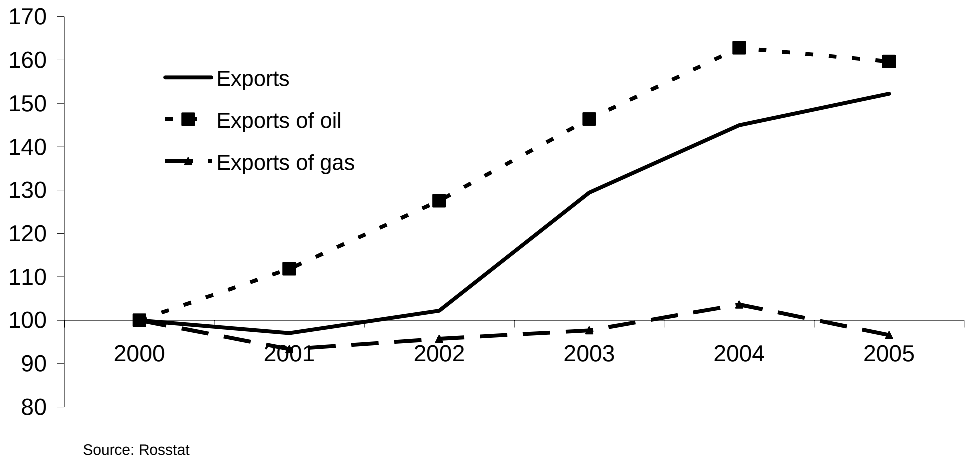
Stabilisation Fund (at the end of 2005, the Fund had accumulated the equivalent of around USD 50 billion).

The cut-off price for revenue from oil exports accrual to the Stabilisation Fund was raised from USD 20 to USD 27 in 2006, but given the record high oil prices observed in 2006 (over USD 70 per barrel in mid April 2006), it is not clear if this "strike price" should not be raised even further. Another question concerning the Stabilisation Fund is the continued political pressure to use the reserves accumulated in the Fund for additional fiscal expenditures, which have so far been resisted. A related question is how to invest the amounts accumulated in the Fund: by late April 2006, a decision to liberalise its investment procedures – extending it to include triple AAA rated securities of OECD countries – was announced.

External sector developments

In 2005, the *value* of exports increased very strongly, at around 33.7% (an almost identical growth rate – 35% – was observed in 2004), on the back of further increases in oil and gas prices. The value of imports increased slightly less – by around 30% (in 2005). As a comparison, the growth rate of export volumes fell by more than half in 2005, to around 5%. The *volume* of oil sector exports actually fell in 2005 (but still with an accumulated growth of around 60% since 2000). Natural gas exports also fell in volume terms (by around 3.5% during the whole 2000-2005 period). The other major export sectors have contributed relatively little to overall export volume growth (see Chart 1).

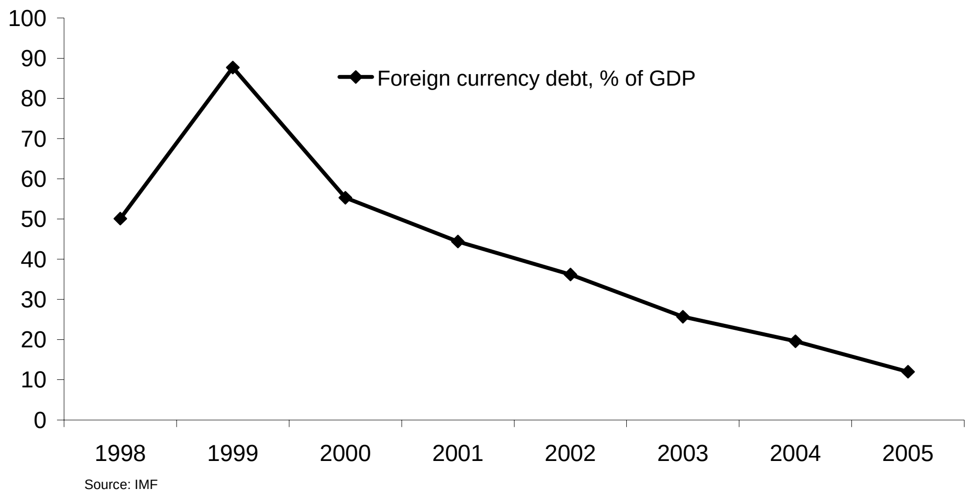
Chart 1: Volume of exports (2000=100)



Foreign direct investment also increased from USD 2.7 billion to 14.6 billion between 2000 and 2005 (it would have reached around USD 20 billion in 2005, if part of the payment made by Gazprom to the Russian owner of Sibneft were not counted as a FDI outflow), and net FDI increased from USD -453 million to USD 1.5 billion. Nevertheless, the largest change in the item "Financial Account" was in the "Other Investment" component, which swung from a negative USD -7 billion in 2004 to a positive USD 11.5 billion, largely due to a strong increase in loans received by Russian companies (see next paragraph).

The official external debt to GDP ratio decreased to around 12% in 2005, from 89% in 1998. This was the result of strong GDP growth, the strengthening of the Russian rouble and accumulated current account surpluses, which enabled early repayment of the total debt owed to the IMF and several tranches of the Paris Club debt (see Chart 2). In total, USD 3.3 billion of the assets in the Stabilisation Fund were used to fully repay the Russian debt to the IMF in 2005, and a further 15.1 billion USD were used to pre-pay part of the USD 40 billion Russian Paris Club debt in 2005. Further early repayments of Paris Club debt (around USD 12 billion) were announced in early 2006.

Chart 2: Official external debt to GDP



At the same time, corporate and private sector external debt (which includes debt owed by state-controlled companies such as Gazprom), fuelled by very strong growth of external borrowing by companies, increased by USD 40 billion in 2005 alone, bringing the total accumulated private debt to USD 126 billion by end-2005 (or around 17% of GDP). In addition, the current account component "Net Errors and Omissions" actually almost doubled between 2004 and 2005, to almost USD 12 billion: this item effectively lumps together the "grey" channels through which Russian companies export capital. This may mean that any talk about a lasting change in the traditional Russian net capital outflow could be premature.

2. Trade liberalisation and economic opening

Russia applied for WTO membership in 1993. Negotiations on the terms of accession are still ongoing, in spite of a breakthrough in dealings with the EU in mid-2004. The main remaining questions are related to pending requests from the United States concerning the opening up of the services sector.

3. Business climate

Privatisation, enterprise restructuring and business environment

An apparent drive towards the extension of the government role in the economy has not only reduced, but sometimes even reversed the process of privatisation in the Russian economy. The demise of Yukos has increased the already substantial role of enterprises with state participation in the energy sector, and moves are being considered in other areas (for instance, in the aircraft sector) to create state-supported "national champions". Limits on foreign participation in key sectors of the economy are being considered. As a result, the share of the private sector in GDP has fallen from 70% in 2004 to 65% in 2005.

Concerning enterprise restructuring, a particular problem is presented by the gas sector, where the market structure inherited from the Soviet period has essentially been preserved. Prices are regulated, exports are monopolised and the domestic market is dominated by a state-controlled, vertically integrated monopoly, Gazprom. The reform of Gazprom is a pressing question.

Russia's at best mixed performance in improving its business environment is reflected in the results of the EBRD–World Bank Business Environment and Enterprise Performance Survey (BEEPS). The survey shows that between 2002 and 2005 private sector perceptions of the level of effectiveness of the judiciary, the level of corruption and labour regulation worsened – substantially in the case of corruption. At the same time, perception of customs and trade regulations, business licensing and permits and tax administration improved.

The World Bank's *governance indicators* present a somewhat different picture. According to them, between 2002 and 2004 an improvement was observed in “government effectiveness”, “rule of law” and “control of corruption”, whereas “regulatory quality” and “voice and accountability” worsened. The quality of Russia's business environment compares relatively favourably with that of the other major emerging economies.

According to the World Bank survey of business regulations and their enforcement, “Doing Business 2006”, Russia ranks 79th out of 155 countries, well above countries like Brazil, China and India. The areas where Russia performs worst are licensing requirements (“Dealing with Licences”) and financing (“Getting Credit”). Somewhat surprisingly, on the item “Rigidity of Employment”, Russia outperforms not only the CIS average but also the OECD.

Financial sector reforms

The banking sector in Russia has largely recovered from the 1998 crisis, and from the minor crisis of the summer of 2004. It is now developing at a fast pace, on the back of strong economic growth and improving public finances, which result in rapid credit growth. In 2005 retail deposits grew by over 30% and domestic credit amounted to around 20 % of GDP (at the end of the year).

The fast-growing banking sector remains relatively small: at mid-2005, the total Russian banking sector assets amounted to roughly 44% of GDP, up from 33% at end-1999. The banking sector is still characterised by structural weaknesses, notably the large number of under-capitalised ‘pocket’ banks, the dominant position of state-owned banks, notably Sberbank (which has the CBR as a majority shareholder), a small share of foreign banks and a still-deficient regulation and supervision framework. The previously mentioned recent substantial increase of banking-intermediated foreign liabilities of firms may also be a subject of concern.

Reform in the banking sector has gained momentum since 2002. The adoption of a law on the insurance of deposits in 2003 was arguably the most important element in the banking reform, and is expected to promote more transparency in bank ownership and improve banks’ liquidity, solvency and capital adequacy, as well as discipline in banking operations. Having screened all the banks that applied to join the scheme, in September 2005 the CBR announced which had been accepted: as of October 1, 2005, 924 banks, or approximately 73% of the total number of credit institutions in Russia (accounting for nearly 99% of all household deposits) had access to the deposit insurance scheme.

A strategy for banking sector development 2004-2008, jointly developed by the Government and CBR, was approved in 2005. It aims to enhance the sector's role in financial intermediation and developing the competitive environment and to improve its transparency so as to be able to fully exploit the potential of the sector as a factor for economic growth. Banking and finance reform is expected to remain a central element in the Russian Government's economic liberalisation programme. Major issues for reform in the near future include the actual implementation of the International Financial Reporting Standards (IFRS) – IFRS are now compulsory for banks – and Basle II implementation.

The equity market in Russia grew in value from USD 325 billion in early 2005 to USD 857 billion by the end of the first quarter of 2006, or from 53% to around 110% of GDP. This is far above the EU average of 75% of GDP. In 2002, the total capitalisation of the equity market in Russia stood at 25% of GDP. A very substantial part of this is the result of the increase in market value of energy-sector companies, and the stock market flotation of the state-owned ones: for instance, Gazprom increased its market valuation between mid-2005 and the first quarter of 2006 from USD 70 billion to USD 265 billion.

Labour market reforms

No substantial developments in terms of education or labour market reforms were observed in Russia in 2005, although education is one of the priority sectors in the 2006 budget. Unemployment, although lower than the over 13% level reached in 1998, remains stubbornly high at about 8% of total labour, in spite of the consistently high growth rates of the economy.

Russian population is both ageing and shrinking, although life expectancy seems to have started to increase again, from 64.3 years in 2004 to 65.8 years in 2005, as has fertility. Mortality rates are still very high in Russia, particularly among working-age males. The rate of population increase in Russia is the world's second lowest: -0.6%, just above Ukraine's -0.8%. The UN forecasts a population fall in Russia during the period 2004-2050 of 22% (from 144 to 112 million).

In order to fully compensate this fall, an annual inflow of about 1 million working-age migrants would be necessary. As there is no visa regime among the CIS countries (with the exception of Georgia), formal immigration flows have indeed been quite substantial, especially in the last few years: the Russian Federal Migration Service issued 650 000 work permits to foreigners in 2005 only, and it estimates that there may be up to 14 million – legal and illegal- foreign workers in the country (or close to 10% of the whole Russian population). According to census data, until 2002 most of the decline in the Russian population (5%) was compensated by a net increase in immigration of 3.8%. Given the large amount of unregistered migration, it may even have fully compensated the population fall.

This large number of foreign workers is relatively recent, corresponding to the later stages of the Russian growth resumption: the item "compensation of employees" in the Russian current account only became negative in 2003, but since then it jumped by 13 times by 2005, reaching USD -1.9 billion (while, conversely, the item "remittances" increased from USD -421 million in 2001 to over USD -3 billion in 2005, with the bulk of the increase – over 160% – observed between 2004 and 2005, and with the share of remittances towards CIS countries growing from around 50% to over 80%).

4. Public institutions and public finance management

Reforms have stalled in Russia since 2004. Public administration reform, although announced as a priority, has stagnated, since the reorganisation of federal executive bodies that took place in March 2004. Judicial reform has also stagnated, and corruption remains a serious cause for concern.

The budgetary procedures seem to be slowly moving towards a shadow MTEF (Medium-Term Expenditure Framework), with three-year indicative programmes, which would increase predictability in the fiscal sphere. The first fiscal financial plan covers the period 2006-2008.

In the area of fiscal federalism, a key concern for Russia, the Russian Ministry of Regional Development has been working on a new "Strategy for the Socio-Economic Development of Regions or the Russian Federation" that could signal a new policy orientation. The draft Strategy seems to propose a shifting away from the current regional "equalisation" scheme towards concentrating on promoting the development of areas of accelerated economic growth.

5. Social development and poverty

Following the CIS-wide trend of strong poverty reduction and the decrease in income inequalities, the poverty rate in Russia fell from 36% in 1999 – in the aftermath of the 1998 financial crisis – to 19% in 2002 (with further gains assumed since), so that over 18 million Russians were lifted out of poverty in the space of a few years. There has also been a small reduction in *inequality*, with the Gini index falling from its post-1998 high of 0.37 to 0.34 in 2002, although it is not clear if this reduction trend continued afterwards.

The first major social policy reform in Russia in several years was the decision in 2004 to replace many in-kind social benefits with cash payments, the deficient implementation of which led to widespread protests in early 2005.

More recently, in the area of housing policy reforms, the new "Housing Code" came into force on 4 March 2006. Its aim is to ensure that Russians cover the total cost of housing-related services. These services are currently partly covered by the state budget and include maintenance, garbage collection, and utility services. A law calling for *regionally set* limits on housing-related tariffs and rents was approved in late 2005 (a federal law set a national limit for housing-related costs at 22% of a household's income).

Housing also happens to be one of the four "national projects" (the others being education, health and agriculture) selected by President Putin as part of his (and the governing Party's) pre-election economic programme, with roughly 20% of the total funds allocated to "national projects", mostly in the form of credits to subsidise residential mortgages. Limited rental housing possibilities are also considered to be one of the factors preventing the Russian labour force becoming more mobile.

RUSSIA

Main Economic Indicators

	2001	2002	2003	2004	2005
Real Sector					
Real GDP Growth (% change)	5.1	4.7	7.3	7.1	6.4
Inflation CPI (e-o-y)	18.6	15.1	12.0	11.7	10.9
GDP Nominal, in USD billion	296.7	340.8	449.7	611.6	750.5
GDP per capita, in USD ths.	2,033	2,345	3,109	4,241	5,230
Social Indicators					
Unemployment	9	7.1	8.9	7.6	7.7
Life Expectancy	..	65.8	65.7	..	
Under 5 mortality rate, %	..	..	21	..	
Literacy, total	99.6	99.6	..	..	
Fiscal Sector					
Total Revenue, % of GDP	17.9	20.5	19.5	20.6	23.7
Total Expenditure, % of GDP	14.8	18.8	17.1	15.7	16.2
Central Government balance, % of GDP	3	2.3	1.7	4.2	7.4
Gross Public Debt, % of GDP	48.98	41.34	..	..	14.25
Monetary Sector					
Private Sector Credit (% change)	19.4	6.9	15.3		
Private Sector Credit as % of total credit	64.4	66.2	75.8		
Broad Money (M3), % yoy	26.6	25.2	27.8	25.2	26.6
Degree of Monetization (M3/GDP, %)	23.9	26.4	29.9	31.6	36.5
External Sector					
Current Account Balance, % GDP	11	8.5	8.2	10.3	11.2
Trade Balance, % of GDP	16.2	13.6	13.3	14.3	16
Foreign Direct Investment, % of GDP	0.8	1	1.8	2.5	2
Import cover (months)	8.2	9.4	12.1	15.5	17.5
External Vulnerability					
External Public Debt as % of GDP	44.4	36.2	25.7	18.3	12.5
Debt Service/Exports Ratio	9.8	8.2	8.5		
Gross Reserves (excluding gold)	36.6	47.8	76.9	124.5	182.2
Reserves/M3	2	1.9	1.7	1.5	1.5
Financial Sector					
Short Term Interest Rate	10.1	8.2	3.8	3.3	2.7
Exchange rate (per EUR, eop)	26.5	33.1	36.8	37.8	33.9
Exchange rate (per USD, eop)	30.1	31.8	29.5	27.7	28.8
Real Effective Exchange Rate (1992=100)	118.7	122.7	127	137	150.7

Sources: Rosstat, Ministry of Finance of Russia, CBR, WDI, IMF, EBRD and own calculations.

SYRIA

- **The economy remains in a fragile balance. However, soaring inflation, degradation of the current account, declining crude oil production, and pressures in the labour market might weaken the macroeconomic stability sustained so far.**
- **Over the medium term, Syria will face two interrelated challenges resulting from the expected depletion of oil resources by the late 2020s: to maintain financial stability and fiscal sustainability and to boost growth and diversify the economy.**
- **The reform of the public administration is a precondition for reform in all the other sectors given the widespread government intervention in the economy and the considerable distributive function of the state.**
- **The government approved the 10th five-year plan which included a reform agenda aiming at generating investment-led growth in the non-oil sector leading to average annual real GDP growth rates of 7% by 2010.**

1. Macroeconomic developments[95]

Real sector developments

According to the Syrian authorities, real GDP growth reached 4.5% in 2005 compared to IMF estimates of 3.5% (2004: 3.4%) on account of high oil prices and positive spillover from the Gulf countries. Economic activity was supported by private investment (including in the real estate sector), exports and increased inflows of tourists. Output growth was nevertheless characterised by irregularities resulting from the political uncertainty. Unemployment is estimated at 20% in 2005 with an increasing upward trend.

The increasing range of targeted US economic sanctions and international pressure in the context of UN Security Council resolutions (1559, 1595, and 1636) put Syria in a very delicate economic position. It is still difficult to assess the economic consequences of the Syrian withdrawal from Lebanon (such as the return home of Syrian workers or the withdrawal of some Syrian deposits from Lebanese banks, which could have benefited the newly established Syrian private banking system[96]).

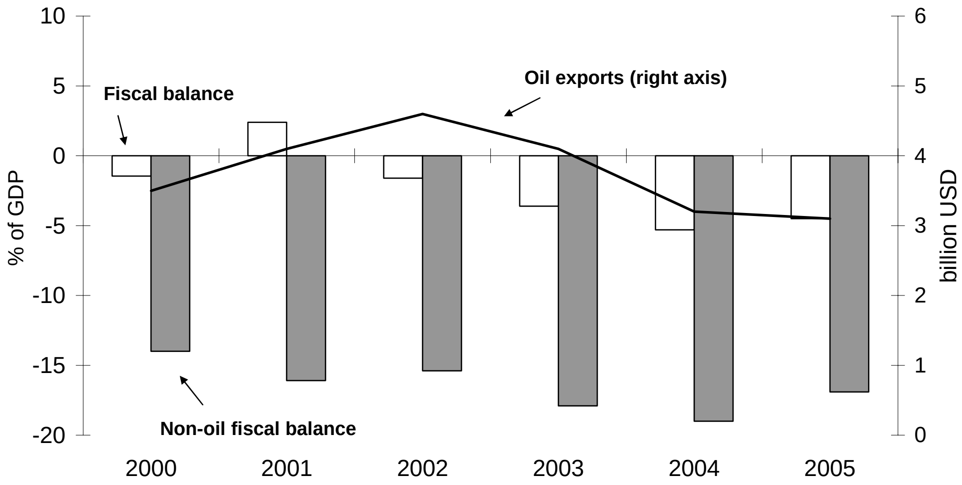
The economy is expected to continue expanding in 2006. In the medium term, however, declining oil production will affect industrial output (the oil sector contributes 20% of GDP) and lead to a substantial contraction of exports (two thirds of exports are oil-related products).[97] The uncertain political environment also undermines growth prospects. On the other hand, high oil prices may partially offset these negative trends.

[95] Statistical data in Syria tend to be incomplete and unreliable. Moreover, official data is only reported with a substantial lag. Preliminary balance of payments and monetary statistics are available up to 2004, while national income and fiscal accounts are available only up to 2003. The most recent budget outturn figures available are those for 2003. Data reporting on 2005 had not yet released at the time of writing.
[96] While total estimates of the amount of the deposits are close to USD 12 billion, there is speculation that withdrawals of more than USD 4 billion took place in March 2005.
[97] At the beginning of 2006, oil extraction was estimated at around 400 000 barrels/day compared to an average of around 425 000 in 2005 and a high of close to 600 000 barrels/day in the late 1990s.

Fiscal developments

High oil prices contributed to a slight improvement in the fiscal position in 2005 compared to 2004. The increase in revenues might be also interpreted as the first positive results stemming from fiscal reforms implemented since 2003. The deficit target for 2006 represents 4.4% of GDP compared to an estimated 4.5% in 2005 (2004: 5.3%). The 2006 budget foresees a nominal increase in current expenditure of 7.1%. Total revenue is expected to expand by 22.4% owing to large increases in taxes and duties and in the "surplus on state activities" which presumably represents oil revenues based on a higher price assumption than in 2005.

Chart 1: Syria - Fiscal developments



Source: IMF (2005)

Syria's public debt remains at a sustainable level. Following the restructuring of the old Soviet-era debt in late 2004 and early 2005, external debt is estimated at 26% of GDP (USD 6.5 billion), while total debt accounts for 41.4% of GDP.

Monetary and exchange rate policy

The Syrian pound (SYP) maintained its relatively stable exchange rate against the US dollar over 2005. Only following the mounting international pressure related to Security Council Resolution 1636 at the end of the year did it depreciate by around 10% against the US dollar. The situation culminated by a government decision to close down most of the non-official exchange "offices" and imprison around 500 black market exchange brokers.

In December 2005 the Credit and Monetary Council raised interest rates by 0.5 percentage points in an effort to sustain confidence in the Syrian pound after its open market value slipped amid growing anxiety about the political situation. The exchange rate stabilised in December and January 2006. The trend to further simplify the exchange rate system continues. The number of official exchange rates, determined by the Ministry of Economy and Foreign Trade, has been reduced to two (the State and Public Sector Rate and the Free Rate).

As there are no Treasury bills, the Central Bank of Syria (CBS) lacks one of the basic tools of monetary policy.[98] It also continues to act de facto as a banker and a fiscal agent, which seriously

[98] The government is envisaging setting up a T-bill market by the end of 2006.

hampers monetary policy implementation and complicates the policy mix. In order to redress the situation and strengthen its independence, a revision of the Central Bank Law is planned. In September 2005 the central bank announced an increase in the bank's base rate and the introduction of Certificates of Deposit with the specific aim of encouraging people to save in Syrian pounds.

Inflation picked up considerably in 2005 to reach a yearly average of 10% (2004: 4.6%). The appreciation of the euro vis-à-vis the US dollar during 2005 and the increase in consumer lending together with a rapid expansion in the demand for real estate have contributed to inflationary pressures. The Ministry of Economy and Trade enforced temporary administrative price control measures in an effort to subdue inflation.

External sector developments

Syria's external trade balance continued to worsen over the last two years illustrating the lack of diversification and competitiveness of the economy. This deterioration reflects a simultaneous surge in imports in line with the trade liberalisation process,[99] a stagnation of non-oil exports at around 15% of GDP and a progressive decline in exports of mineral fuel and oil products as a result of the gradual depletion of oil reserves (although partly compensated in value by the sustained pick-up in international oil prices).[100] The government has issued no data on its foreign reserve position or on the foreign asset position of the Commercial Bank of Syria, the country's dominant state-owned financial institution.[101]

2. Trade liberalisation and economic opening

Syria continued its efforts to diversify its trade relations with eastern European and Asian countries (Ukraine, Malaysia, Iran, etc.). A free trade agreement has recently been signed with Turkey. The government is also trying to boost cooperation with Russia and give Syrian products preferential treatment on the Russian market. The Great Arab Free Trade Agreement entered into force in January 2005. The country has also recently renewed its application to join the World Trade Organisation (WTO). The EU-Syria Association Agreement, initialled in October 2004, will help the application process due to its numerous WTO-compatible references.

The trade regime remains restrictive with prohibitive tariff rates, pervasive non-tariff barriers, a complex exchange rate system, and restrictions on capital transfers, public trade monopolies and cumbersome trade licensing procedures. The continuing presence of the state in the export sector through over-regulation is a significant impediment to growth in trade. Private importers are given considerable, but not complete access to the official foreign exchange market.

In the last few years the government has made commitments towards progressive reform of its trade system and made trade liberalisation a key element of the reform agenda. Steps to be taken in order to facilitate trade activities include a move to liberalise the constraining exchange rate system, removing some public trade monopolies, simplifying and harmonising customs valuations in accordance with international practices and reviewing import/export procedures.

[99] Also linked with credit expansion, an increase in the demand for imported cars as well as other consumer durables and non-durables is observed, putting pressure on the trade balance and the exchange rate.
[100] Syria may become a net oil importer within a few years and oil resources are likely to be depleted by the late 2020s.
[101] In early 2004 the CBS controlled foreign assets of USD 11.8 billion.

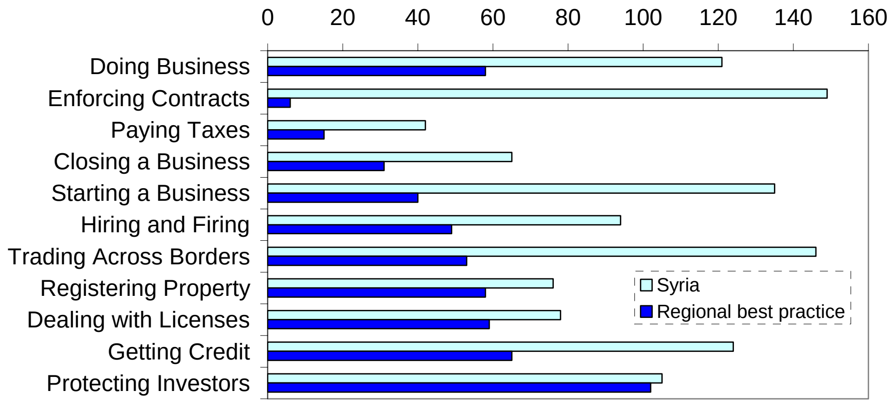
An export promotion agency was created within the Ministry of Economy and Trade in 2005. The government also intends to further liberalise current account transactions and as a first step it adopted a new exchange law which will allow private foreign exchange dealers. The central bank eased foreign exchange controls established in the 1960s, so that Syrians are now able to open bank accounts in foreign currencies and to trade in foreign denominations. The authorities allowed the import of a number of products that had been banned since the 1980s when Syria faced a severe foreign currency crisis. The recent dramatic reduction of custom duties on imported cars has further demonstrated the willingness of the government to progressively fulfil key provisions of the Association Agreement.

3. Business climate

Privatisation, enterprise restructuring and business environment

There is no consensus within the ruling elite over the need for or direction of economic reforms, particularly on sensitive measures such as cuts to the subsidy system or restructuring the country's highly inefficient state-owned enterprises. Options for privatisation are still not on the agenda. The 10th five-year plan, which contains an extensive reform agenda aiming at generating investment-led growth in the non-oil sector, was adopted by the government in January 2006, and in May approved by parliament and ratified by the president.[102]

Chart 2: Syria - "Doing business" rankings



The ease of doing business index ranks economies from 1 (best) to 155.
The regional best practice refers to the best ranking Arab country among the Mediterranean ENP countries.

Source: World Bank, 2006.

State-owned enterprises continue to play an important role in the economy, accounting for 30-35% of GDP (though only 7% of employment). The private sector remains underdeveloped due to the constraints of the regulatory framework and the overall business climate: pervasive controls, an unpredictable bureaucracy, poor infrastructure, high hidden costs of doing business, etc. (Chart 2). Private sector development has been restrained by limited access to credit due to very high interest rates, the lack of appropriate banking sector services, capital markets and related capital venture operations. Syria is exposing its private sector to more intense

[102] The plan targets an average annual real GDP growth of 7% (compared with an official estimated growth rate of 3.1% over 2001-2005) and aims at bringing down the unemployment rate from 20% at present to 8%. The role of industry in driving growth and employment is set to increase. However, the plan depends on the government's decision to pursue the Association Agreement with the EU, which would require a serious commitment to open up the economy.

international competition but without a comprehensive strategy to build the necessary skills, capabilities, infrastructure and institutions that are necessary to withhold higher competitive pressure.

There are nevertheless some positive signs. The government has completed the first review of the draft corporate law. The Higher Council for Investment has discussed the new investment law which is to be adopted soon. Two private airlines inaugurated aviation services at the beginning of 2006.

Financial sector reforms

Deep-rooted deficiencies of a regulatory and an institutional nature remain numerous in the banking system, which explains its poor financial intermediation role. Credit continues to be predominantly centrally allocated and the banking sector is still dominated by public institutions. The liberalisation of the financial sector continued in 2005 with the establishment of new private banks increasing the competitive pressure on public banks. The Syrian banking sector is undergoing a gradual transition from state-operated banks, designed primarily to serve the state sector, to a combination of smaller private banks and reoriented state banks. Over the past few years, a multitude of regulations have been put into effect to facilitate financial sector development. Repatriation of foreign exchange has been eased, transaction fees and stamp duties have been cut, and banks have been permitted to open branches throughout the country. Other legislative decrees have been issued allowing greater flexibility in the operations of state banks. Regulations on bank accounting, liquidity management, and internal audits have been adopted, and CBS's supervision capacity strengthened, although poor accounting standards used by some of the banks continue to impair the effectiveness of proper supervision. An Islamic banking law was adopted in 2005 authorising the establishment of Islamic banks.[103] Also in 2005, banks were granted permission to set their exchange rates within a narrow band around the fixed CBS rate. In November 2005, the Central Bank issued a regulation to allow inter-bank lending.

At the beginning of 2006, and the first time in 40 years, seven private insurance companies, with investors from Lebanon and Gulf countries, were granted licences from the Syrian Committee for Insurance Surveillance (there was previously only one state-owned Syrian Insurance Company).[104] The authorities expect that the insurance sector will attract up to USD 500 million over the next five years. In February 2006, the Syrian Securities and Exchange Commission (SSEC) was nominated – the first step towards a law on the establishment of a stock exchange in Syria. The SSEC has as a mandate to launch a Syrian Capital Market during 2006.

The US decided to ban transactions with the Commercial Bank of Syria in March 2006. This bank, which is the largest in Syria and one of the largest Arab banks, was alleged by the US to be involved in financing terrorism and money laundering. The decision prohibits any US financial institution from opening or maintaining a correspondent account for or on behalf of the Commercial Bank of Syria. The Syrian authorities have denied the charges.

[103] An EIB internal study (2006) revealed that 34% of enterprises had never requested a bank loan, for religious reasons.

[104] The firms are expected to start operations in the second half of 2006. They are required by law to offer a portion of their capital for public subscription. Unlike the law regulating the banking sector, which imposes a ceiling of 49% on foreign shareholders, there are no such restrictions for the insurance sector. However, an institutional investor is not allowed to owe more than 40% of the firm and an individual investor no more than 5%.

Labour market reforms

Job creation remains one of the main challenges for economic policy given Syria's demographic structure (40% of the population are below the age of 15). Estimates put the unemployment rate at around 20% in 2005 with an increasing upward trend. Labour market reforms have been disappointing and the labour market still displays many elements of rigidity. These include limiting the employer's right to lay off workers for economic reasons, and large non-wage benefits in the public sector that discourage mobility.

4. Public institutions and public finance management

The reform of the public administration is a precondition for reform in all the other sectors given the widespread government intervention in the economy. An overstaffed and underpaid civil service (representing 18% of total employment) remains a major impediment to effective economic management. The restructuring and merging of some ministries is on the government agenda, as is the reduction of bureaucracy and the devolution of power to local administrations. The authorities have signalled a shift towards greater transparency and have improved the timeliness of the data they publish, and authorised for the first time the publication of the IMF Article IV report.

Fiscal policy reflects the distributive function of the state budget through sizeable provision for employment in the civil service and military forces alongside subsidies on food, petroleum products and basic utilities (price subsidies represent close to 15% of GDP). Public enterprises, operating under a soft budget constraint, continue to drain public resources. The absence of a medium-term expenditure framework undermines the appropriate planning of current and investment expenditure in accordance with concrete policy objectives and priorities.

The current fiscal framework could rapidly become unsustainable in view of the prospective depletion of oil-related fiscal revenues, which continue to represent more than 45% of the total state budget. With the tax burden assessed at around 19% of GDP, it is clear that there is a need to overhaul the tax system to streamline tax administration, broaden the overall tax basis and ultimately alleviate dependence on oil revenues. The consumption and income tax laws adopted in 2003 and 2004 have simplified direct taxation but the tax regime remains complex, with widespread exemptions and tax liabilities which are subject to negotiations between tax collectors and taxpayers. The general sales tax (or VAT) which is expected to be introduced in 2008 should gradually replace income from customs duties and trade taxes as a key source of revenue.

SYRIA

Main economic indicators[1]

	2001	2002	2003	2004	prel 2005
Real sector					
Real GDP growth (% yoy, avg)	3.8	4.2	2.6	3.4	3.5
Inflation CPI (avg, % yoy)	3.0	0.6	5	4.6	10.0
GDP nominal, in USD billions	19.8	22.0	23.1	24.8	26.3
Unemployment rate, %	10.3	11.7	12.0	16.0	20.0
GDP per capita, in USD	1168	1189	1195	1282	1300
Social Indicators					
Life expectancy	…	70.3	70.9	73	
Literacy total (% of ages 15 and above)	…	82.9	…	83	
Literacy female (% of ages 15 and above)	…	74.2	…	…	
Fiscal Sector					
Total revenues, % of GDP[2]	32.1	29.8	30.4	27.9	28.4
Total expenditure, % of GDP[3]	29.7	31.4	33.1	33.2	33.0
Consol. budget balance, % of GDP[2,3]	2.4	-1.6	-3.6	-5.3	-4.5
Non-oil fiscal balance, % of GDP	-16.1	-15.4	-17.9	-19.0	-16.9
Total debt, % of GDP	26.1	29.8	30.6	31.8	41.4
Monetary sector					
Money and quasi money, % change	23.5	18.5	7.7	10.3	11.8
Credit to the private sector, % change	0.4	0.7	3.1	3.8	4.3
Credit to the private sector, % of GDP	8.3	8.3	10.3	12.0	13.7
Degree of monetisation, M2/GDP	73.1	81.3	83.9	82.3	80.5
External sector					
Current account balance, % of GDP	6.1	8.9	6.0	1.9	0.2
Balance of goods and services, % of GDP	5.0	8.7	5.2	2.1	...
Net foreign direct investment, % of GDP	0.5	…	…	…	...
Import cover (months)	7.0	8.0	9.4	…	...
External Vulnerability					
External debt, % of GDP[4]	18.6	18.8	19.3	20.7	25.9
Debt-to-export ratio	73.2	…	…	…	...
Debt service ratio	19.5	16.3	15.5	13.4	16.9
Banking system's net foreign assets, USD bn	13.6	15.9	16.9	16.0	...
Gross reserves (excl. gold, USD billions)			18.5	18.9	19.1
Financial sector					
Short-term interest rate[5]	7.0	7.0	6.0	…	...
Official exchange rate (per USD, av.)	46.5	46.5	46.5	48.7	55
Market rate (Beirut, Amman) av.	50.4	52.5	52.8	52.3	...
Exchange rate (per EUR, av.)[6]	41.7	44.0	52.5	60.5	...
Real effective exchange rate (1995=100)	113.3	…	…	…	...

Source: IMF, Audi Bank.

[1] Statistical data in Syria display major weaknesses and is fragmented. Moreover, official data is only reported with a substantial lag.

[2] Including grants.

[3] Including the operations of the Price Stabilisation Fund (PSF).

[4] Officially acknowledged debt.

[5] 6-month deposit rate.

[6] Calculated cross rate.

TUNISIA

- **Despite some recent economic progress, Tunisia faces some serious economic challenges. Growth needs to be accelerated in order to reduce unemployment, which is increasingly affecting university graduates.**
- **In order to promote private investment, the business climate needs to be improved; in particular stable and transparent rules should be established and political and economic governance strengthened.**
- **Political priority should be given to strengthening the banking and financial sector and further reducing the level of non-performing loans (which recently picked up after a steady downward trend).**
- **Notwithstanding the fact that Tunisia has signed several preferential bilateral trade agreements the overall trade regime remains protectionist, due to the complexity of the tariff structure and the high level of some tariff rates.**

1. Macroeconomic developments

Real sector developments

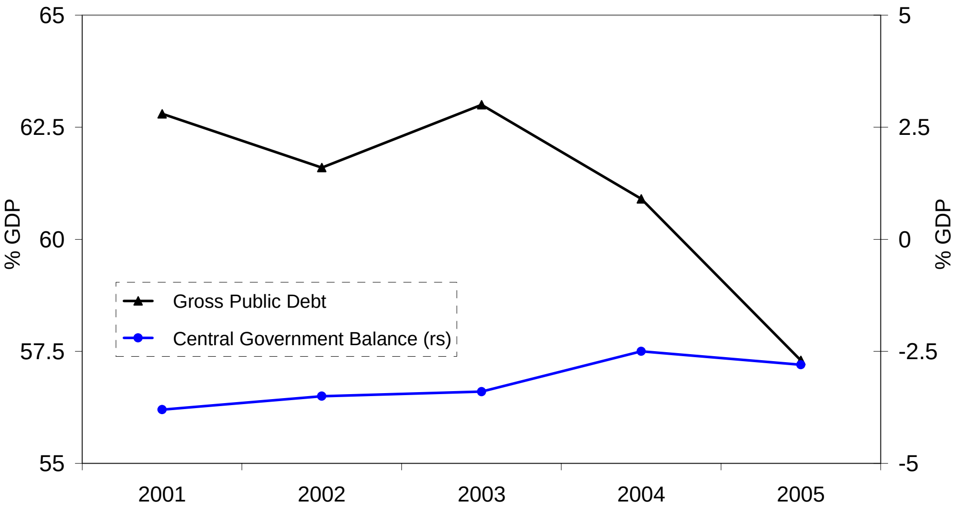
The decline of GDP growth recorded in the second half of 2004 continued during the first quarter of 2005; since then it has made a sharp recovery. The acceleration of growth in the last months of 2005 made it possible to achieve a growth rate of nearly 5% in 2005, slightly less than the ambitious growth target rate of 5.8% set by the government. Sectors which are more exposed to aggressive global competitors, however, have recorded a negative performance, notably agriculture (-9.0%) and some industrial sectors (mainly textile and clothing, -2.7%). Some industrial sectors, however, as mechanics and electricity (7.7%) and some services (particularly tourism and transport) have enjoyed strong positive growth. According to government data, consumer prices increased by 2.9% in 2005 (3.6% in 2004). 13.8% of the workforce were officially unemployed in 2005.

Fiscal developments

The continued fiscal consolidation experienced in recent years, despite recent difficulties related to high oil price and a long-lasting weakness in tax collection, allowed a reduction of the public debt ratio to less than 60% of GDP in 2005, consistent with the government goal of reducing it to below 50% in the medium term.

Notwithstanding higher oil prices (and the resulting increase in subsidies) and the recent increase of civil service wages, the central government budget deficit, excluding grants, privatisation receipts and social security accounts, stood below 3% of GDP in 2005 (Chart 1). The authorities continued to raise the administered retail petroleum prices in order to reduce the effects of higher oil prices on the budget, limited other spending and took action to improve revenue collection. The budget law for 2006, based on an oil price assumption of USD 60 per barrel, allows for an increase in the fiscal deficit to 3.6% of GDP.

Chart 1: Tunisia - Fiscal improvements



Source: International Monetary Fund. Note: in percent of GDP.

Monetary and exchange rate developments

The first half of 2005 was marked by a tightening of bank liquidity with a restrictive effect exerted, notably, by the reduction recorded in net assets abroad. To partly offset this tightening, the central bank of Tunisia injected liquidity. As a result the money supply, in terms of M4 aggregate, rose to Tunisian dinar (TND) 24.1 billion (11.1% during 2005).

At the end of 2005 the Tunisian authorities modified the statute of the central bank: its primary objective will now be maintaining "price stability" rather than exchange rate stability. This move accompanies Tunisia's opening of the economy. The monetary base, which is the operational variable in the new framework, therefore played a much more important role in the conduct of monetary policy in 2005 than in the past.

The Tunisian dinar, after a prolonged depreciation, finally stabilised in March 2005. In 2005 as a whole it depreciated by 10.9% against the dollar, a development which supported external competitiveness. Greater exchange rate flexibility, both upward and downward, is now needed to achieve a deeper international integration of the Tunisian financial market.

External sector developments

In 2005 the increase of exports was sustained (8.6%). Nevertheless the trade deficit remained high (TND 2.3 billion or 6.1% of GDP) due to the high cost of imported energy products and the import of industrial equipment and components.[105] Overall imports increased by 5.6% in 2005. The increase in exports has been related mainly to the mechanics and electricity industries, while the textile and clothing sector has remained virtually unchanged.

A gradual strategy of liberalisation of the external capital account, with the aim of making the dinar fully convertible, has been implemented. This has included gradually opening the Treasury bill market to non-residents, easing the conditions on borrowing abroad and eliminating

[105] Tunisia produces the equivalent of 6.5 million tonnes of oil per year, while it consumes the equivalent of 7.4 million tonnes of oil, a figure that is increasing by nearly 6% per year.

authorisations for certain foreign investment operations. Further steps will involve fully liberalising inward foreign direct investment (FDI) and Tunisian investments abroad and opening the economy to all foreign portfolio investment. These results can be achieved only in tandem with greater exchange rate flexibility and financial sector reforms.

2. Trade liberalisation and economic opening

The implementation of the Association Agreement with the EU is progressing according to schedule. Moreover, in 2006 the Pan-European (diagonal) Cumulation System for rules of origin will probably be extended to Tunisia, which will therefore be able to considerably increase the benefits it derives from the Euro-Mediterranean free trade area. However, this will depend on free trade arrangements to be signed between Tunisia and its Mediterranean partner countries. The Agadir Agreement for a free trade area between Morocco, Tunisia, Jordan and Egypt will enter into force in 2006.

The second US-Tunisia Council on Trade and Investment envisioned under the Trade and Investment Framework Agreement (TIFA) signed in October 2002 took place in Tunis in June 2005 and can be considered a significant step towards a Free Trade Agreement (FTA) between Tunisia and the US. In addition, Morocco, Algeria and Tunisia have recently committed themselves to improving bilateral relations and economic integration amongst the Maghreb countries.

The Tunisian government actively encourages selected FDI through the Foreign Investment Promotion Agency, particularly for export-oriented industries, while screening out potential FDI that could have a severe impact on domestic competitors and employment. Foreign investment in manufacturing industries producing for export has so far been the major generator of jobs in Tunisia and has attracted the bulk of FDI.

Notwithstanding the fact that Tunisia autonomously reduced and simplified its tariff structure and rates in 2004 and 2005, the trade regime remains generally protectionist, according to a recent evaluation by the WTO. The participation of the country in different preferential trade agreements makes the regime non-transparent, while a simplification of the tariff structure, as well as reduction of the tariff rates, is needed.

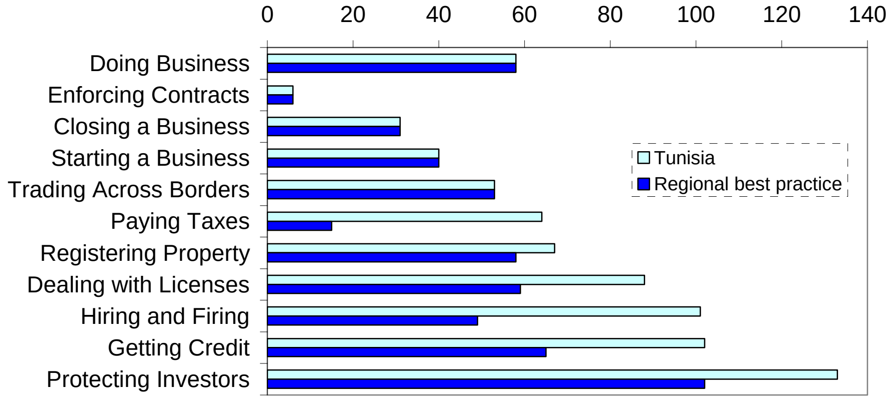
3. Business climate

Privatisation, enterprise restructuring and business environment

The government has privatised about 200 state-owned enterprises since the privatisation programme was launched in the late 1980s. However, although the programme is supported by the national association of trade unions, the government has moved carefully in order to avoid social conflict.

The business climate generally is relatively good. The World Bank's "Doing Business" indicators rank Tunisia as the best performer among the Arab countries of the European Neighbourhood (Chart 2). It is particularly attractive for ease of enforcing contracts and starting and closing a business. However, it should improve the availability of local credit and investor protection. More than 1,600 export-oriented joint venture firms operate in Tunisia to take advantage of relatively low labour costs and preferential access to nearby European markets. Economic links are closest with European countries.

Chart 2: Tunisia - "Doing business" rankings



The ease of doing business index ranks economies from 1 (best) to 155.
The regional best practice refers to the best ranking Arab country among the Mediterranean ENP countries.

Source: World Bank, 2006.

Financial sector reforms

Although noticeable progress has recently been made towards a better and sounder financial system in Tunisia, many constraints, particularly the high level of non-performing loans (NPLs), could hamper the effective integration of Tunisia in the global economic and financial marketplace. Improving the financial sector environment is also a prerequisite for raising private investment, which remains relatively low, while the high share of NPLs (above 10%) may constrain credit for small and medium enterprises.

The following measures have been taken by the authorities to address the situation: banks have been prohibited from distributing dividends when they have insufficient provisions, a law has been enacted to improve the security of financial transactions (by consolidating financial transparency and fostering good corporate governance), the code of commercial and civil procedure has been amended to facilitate the court-ordered sale of assets and shorten debt collection delays, the banking law has been amended to strengthen bank governance and give boards of directors the capacity to ensure appropriate oversight over the management and full tax deductibility of provisions in 2006.

The gradual withdrawal of the government from the banking sector has continued with the finalised privatisation of *Union Internationale des Banques* and the advanced stage of privatisation of *Banque du Sud*. Other small banks are scheduled for privatisation in 2006. Finally, a new law on dematerialisation of shares, Treasury bills and certificates of deposits has been approved in order to modernise the capital markets, and financial regulatory rules have been adapted and systematised accordingly. The modernisation, consolidation and development of the financial sector will also improve the effectiveness of monetary policy, facilitate the transition to inflation targeting, and set the stage for the full liberalisation of capital transactions, reducing systemic risk and financial instability.

Labour market reforms

One of the most prominent problems in the Tunisian economy is the high level of unemployment, especially among skilled workers and young people. In 2005, the Tunisian authorities started active policies to make it easier to hire new staff, notably by creating new types of temporary contracts. However, to be completely effective, this policy will need to be flanked by measures to ease the rigid regulations and procedures governing dismissals.

Building on the experience of the National Solidarity Fund created in 1992 (see below), a further initiative, the National Employment Fund, also known as the "21-21 Fund" after its bank account number, was launched in 2000 for the purpose of mobilising resources and creating employment opportunities. From its establishment until September 2005, the National Employment Fund disbursed total allowances of TND 446 million to 528 000 beneficiaries (with an average allowance of TND 844 per beneficiary). Approximately 76% of the beneficiaries of this fund have primary, 16% secondary and 7% higher education qualifications.

4. Public institutions and public finance management

Wide-ranging and comprehensive tax and public finance management reforms are being considered by the Tunisian authorities. On the revenue side, there are proposals aimed to modernise and simplify the current framework, which is based on that established by France before Tunisia became independent. These proposals include: expansion of the corporate income tax base and reduction of tax rates, simplification of VAT by reducing the number of regimes, revision of tax incentives and closer alignment of on-shore/off-shore regimes and reorganisation of the tax administration to boost effectiveness. The implementation of new information technologies in the fiscal/budget domain is facilitating the process.

On the expenditure side, the strategy the authorities are pursuing is focused on a more efficient use of energy and the progressive elimination of subsidies related to the consumption of oil and oil-derived products, with the aim of complete price liberalisation by 2008. Tunisia has also announced its intention to introduce objective-based budgeting. This will require, inter alia, the development of a medium-term expenditure framework, the introduction of programmatic budget classification and performance indicators. So far progress in implementation is rather slow.

5. Social development and poverty

Official figures show that the poverty rate in 2005 has decreased to 3.9% from 4.1% in 2003, the middle-class has enlarged to encompass nearly 80% of the population, per capita disposal income has been constantly on the rise, most households own their own home, and basic amenities and modern communication means are available to most citizens.

In 1992 the President decided to create a National Solidarity Fund, commonly known as the "26-26 Fund". Its purpose was to improve living conditions in marginal areas of the country, carry out basic infrastructure projects (roads, rails, electricity, drinking water, schools, health care centres, youth centres, leisure areas), grant micro-credit to promote small private projects in agriculture, fishing, handicrafts and trade, and improve living conditions and housing standards. The creation of the Tunisian Solidarity Bank and the establishment of a micro-credit system have also helped made it possible to finance small entrepreneurship projects.

TUNISIA

Main economic indicators

	2001	2002	2003	2004	prel. 2005
Real sector					
Real GDP growth (% change)	4.9	1.7	5.6	5.8	5.0
Inflation CPI (period average)	1.9	2.8	2.7	3.6	2.9
GDP nominal, in USD billion	20.0	21.3	25.0	28.2	30.6
GDP per capita, in USD	2068	2181	2535	2822	2924
Social Indicators					
Unemployment	15	14.9	14.7	13.9	13.8
Life expectancy	---	72.7	---	---	73.1
Under 5 mortality rate, ‰	---	26.0	---	---	21.1
Literacy, total	---	73.2	---	---	77.1
Fiscal Sector					
Total revenues[1], % of GDP	29.5	29.2	29.5	29.7	28.9
Total expenditure[2], % of GDP	32.3	31.4	32.8	32.2	31.7
Central govt. balance[3], % of GDP	-3.8	-3.5	-3.4	-2.5	-2.8
Gross public debt[4], % of GDP	62.8	61.6	63.0	60.9	57.3
Monetary sector					
Private sector credit (% change)	10.8	5.1	6.5	4.6	5.3
Broad money (M3), % yoy	10.3	4.5	6.3	10.3	9.2
Degree of monetisation (M3/GDP, %)	60.6	61.3	61.7	61.3	64.0
External sector					
Current account balance, % of GDP	-4.3	-3.5	-2.9	-2.0	-1.8
Trade balance, % of GDP	-12.0	-10.1	-9.1	-8.7	-7.9
Foreign direct investment, % of GDP	2.2	3.8	2.2	2.2	2.3
Import cover (months)	2.3	2.7	3.0	3.5	3.6
External Vulnerability					
External public debt, % of GDP	58.1	65.2	64.8	63.8	57.2
Debt service ratio[5]	15.6	17.2	15.1	16.2	15.6
Gross reserves (excl. gold, USD billions)	2.3	2.7	3.0	3.5	3.3
Financial sector					
Short-term interest rate[6]	5.94	5.91	5.00	5.00	5.0
Exchange rate (per USD, eop)	1.468	1.340	1.209	1.200	1.359
Exchange rate (per EUR, eop)	1.301	1.401	1.531	1.634	1.614
Real effective exchange rate (1992=100)	97.2	93.7	90.5	87.0	84.2

Sources: Tunisian Ministry for Economic Development, Central Bank of Tunisia, WB, IMF.

[1] Total revenues excluding grants.

[2] Total expenditure and net lending including social security accounts (CSS).

[3] Consolidated government balance excluding grants, privatisation receipts and social security accounts.

[4] External and domestic debt including social security funds' debt and public enterprises' debt.

[5] Total debt service in % of exports goods, services & income.

[6] Discount rate.

UKRAINE

- **The short-term macroeconomic challenges in Ukraine, which need to be addressed as a matter of urgency, include bringing inflation down to single digits and putting in place a sustainable fiscal framework.**
- **The external balance is vulnerable to a further fall in metal and other export prices in addition to the impact of higher gas and oil prices on imports, which are likely to lead to a deficit in the current account in 2006.**
- **Prospects for foreign direct investment are positive, provided that WTO accession, currently expected in 2006, gives fresh impetus to improving the business climate. This will also depend on the reform-focus of the new government.**
- **Preparations for negotiating an Enhanced Agreement between the EU and Ukraine (including a Free Trade Agreement), are under way now that political conditions – free and fair parliamentary elections – have been met.**

1. Macroeconomic developments

Real sector developments

A negative change in the terms of trade (import prices of energy increased while world market prices on Ukraine's steel exports tumbled) combined with sluggish investment in an uncertain policy environment led to a hard landing in 2005. Real GDP growth declined sharply to 2.6% against 12.1% in 2004. This is the lowest growth rate since 2000, when economic recovery started, and is way below the average growth rate of 8.4% in 2000-2004.

On the production side, the deceleration of growth last year derived from a reduction in value added in construction and trade (respectively -6.7% and -8.5%) and only modest growth in manufacturing (2.0%) and agriculture (0.4%). The decline in trade can be attributed to the elimination of artificial wholesale schemes while retail trade continued to grow, boosted by a strong increase in real incomes (about 20% year-on-year). Oil refining, coke production and metal production were worst affected by the economic slowdown, while food and chemical industries enjoyed more stable growth. On the demand side, private consumption drove growth as net exports turned negative in 2005. The investment/GDP ratio declined to 19%, exacerbated by cuts in planned public investments.

According to the World Bank, the price increase on imported gas as of 2006 is likely to depress economic growth by about 2 percentage points from the baseline projection, implying economic growth in a range of 1.5 to 3.5% in 2006. The gas price shock highlights the urgency of a strategy aimed at reducing energy inefficiency and diversifying sources of growth.

Fiscal developments

The fiscal gap brought about by increases in public expenditures (notably pensions and social benefits prior to the November 2004 presidential elections) was closed by the new authorities through strong growth in tax revenues, and, towards the end of 2005, substantial privatisation proceeds financed the deficit comfortably. Public investment was also cut as part of the fiscal consolidation process. The fiscal deficit for the general government was limited to just below 3% of GDP (4.4% in 2004) while the tax revenues to GDP ratio increased markedly from 30% (2004) to about 35%. On the other hand, there is a risk that some shadow economic activities will remain undeclared due to the increase in the tax burden.

The Pension Fund's expenditures doubled in 2005 following increases in minimum pensions so that pension outlays as a percentage of GDP are now – at nearly 16% – among the highest in the world. Transfers from the state budget covered the Pension Fund's deficit of around 4% of GDP. The Pension Fund's imbalance is also effectively constraining efforts to reduce payroll taxes. Public debt continued to decline at 19% of GDP at end-2005. There are, however, underlying sustainability issues that need to be addressed.

Monetary and exchange rate developments

Monetary policy remained accommodative despite an increase in the discount rate, and after the hryvnia revaluation of April 2005, the National Bank of Ukraine (NBU) continued a policy of *de facto* pegging the currency to the US-dollar, though now at the new level of 5.05 hryvnia per dollar. The accommodative monetary conditions, combined with an expansionary fiscal policy under which increases pensions, wages and social benefits continued, resulted in a boost to demand that fuelled inflation.

Average consumer price inflation rose to 13.5% in 2005 (from 9.0% in 2004), though the 12-month inflation rate decelerated somewhat towards the end of the year, reaching 10.3% in December, down from 14.4% in mid-2005. One factor contributing to the overall increase in inflation was that neither domestic supply nor imports met the increase in demand in food products – which constitute a large share of the CPI – ensuing from the government's expansionary fiscal policy. Another was increases in utility and transportation tariffs.

In 2005 the NBU took steps to liberalise foreign currency regulations. In April the mandatory sale of 50% of export proceeds was abolished. In September inter-bank foreign currency trading was further liberalised and a forward market was established. Nevertheless, a special duty of 1.5% on non-cash currency exchange operations (collected for the pension fund) impinged on the market's further development.

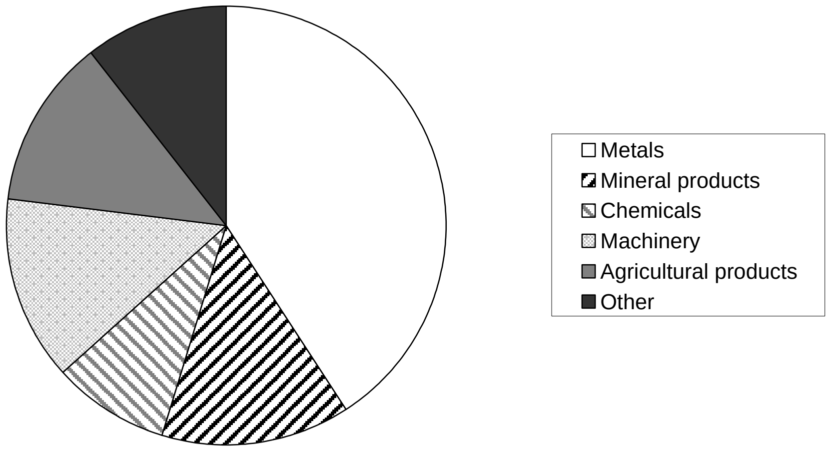
External sector developments

The merchandise trade balance turned negative and the current account surplus narrowed from 10.5% in 2004 to 3% of GDP in 2005. Exports of goods increased by 5% (41% in 2004), and imports by 25% (26% in 2004). As China became a net exporter of steel last year, world market prices for Ukraine's most important export commodity declined. Other factors contributing to the negative trade balance were higher oil prices, appreciation of the hryvnia (in nominal and real terms), liberalisation of imports of consumer goods and robust growth in households' disposable incomes.

Ukraine's total external debt increased in 2005 (+27%) to around 49% of GDP as the private sector took advantage of better access to external financing while the public external debt further declined to a sustainable level of about 16% of GDP. Ukraine's precautionary stand-by arrangement (SBA) with the IMF expired at the end of March 2005 (in fact it was off-track since the autumn of 2004 due to slippages in fiscal policy), and the country did not pursue active discussions with the Fund on any successor arrangement. The rating agencies, however, maintained Ukraine's sovereign rating at BB (with stable outlook) due to the low government debt and good external liquidity.

The acquisitions of the Kryvorizstahl steel plant and the Aval Bank by foreign investors boosted foreign direct investment (FDI) in 2005, which reached a record total of USD 7.3 billion. The cumulative FDI inflows (1989-2005) in per capita terms increased from USD 168 to USD 349 in one year. In the absence of a substantial improvement in the investment climate, though, this increase in FDI inflows may prove to be a one-shot phenomenon.

Chart 1: Ukraine - Commodity structure of exports (2005)



Source: State Statistics Committee of Ukraine

2. Trade liberalisation and economic opening

Ukraine's accession to the WTO, which was initially expected to take place at the Hong Kong WTO ministerial meeting in December 2005, was delayed inter alia as the Verkhovna Rada (the parliament) rejected some important pieces of new legislation and bilateral negotiations with the United States were not finalised. Significant progress was made with bilateral market access negotiations in early 2006, particularly with the conclusion of negotiations with the United States in March 2006. Ukraine is now aiming to join the WTO sometime in 2006. Ukraine's WTO offer is a very open one for goods and services with a broad coverage of services sectors and very few restrictions. The economic impact of Ukraine's WTO accession is deemed to be largely positive, notably owing to the liberalisation of FDI in services in addition to tariff reductions and improved market access.[106] Looking forward, the European Commission aims at negotiating a deep Free Trade Agreement between the EU and Ukraine, involving substantial regulatory alignment with the EU, as a part of a future Enhanced Agreement between the EU and Ukraine. The economic impact of a deep FTA option has been estimated as positive in a recent study.[107]

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[106] Institute for Economic Research and Policy Consulting. See www.ier.kiev.ua.
[107] Emerson et al (2006), *The Prospects of Deep Free Trade between the European Union and Ukraine*, CEPS.

3. Business climate

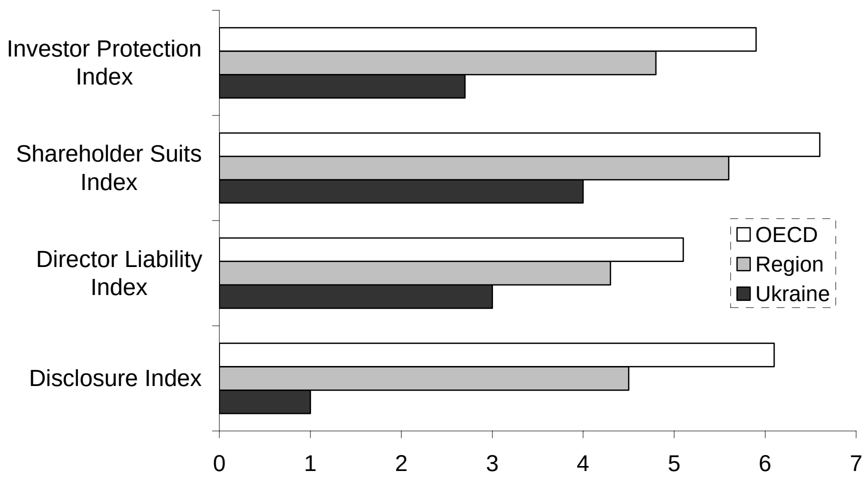
Privatisation, enterprise restructuring and business environment

According to the latest EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS 2005), more than 50% of surveyed Ukrainian firms mention as problems for doing business: (i) macroeconomic instability; (ii) uncertainty about regulatory policies; (iii) tax rates and (iv) cost of financing.[108] Corruption and tax administration were also prominent on the list but depict some improvement since the previous survey of 2002. Other recent surveys also reveal that Ukraine lags behind well behind international standards in terms of investor protection and corporate governance.[109]

In September President Yushchenko dismissed the first post-Orange Revolution government, led by Yulia Timoshenko, which was marred by internal divisions. The political situation remained uncertain in anticipation of the March 2006 parliamentary elections and the parliament's no-confidence vote on the Yekhanurov's government at the beginning of 2006 added to the pre-election tensions. The stated intentions of the new government to improve the business climate were effectively undermined by questions such as the extent of "re-privatisation" (reacquisition and resale of privatised assets which had been sold under non-transparent deals to insiders).

Pre-occupied by the review of past privatisations, the government made only modest progress with new privatisation deals, especially as the parliament barred a number of potential cases. However, encouraged by the successful public auction of the Kryvorizstahl steel plant in October 2005 (after its 2004 privatisation had been ruled void by courts), the authorities are now cognisant that privatisation deals be prepared in a transparent fashion because of the substantially higher revenue prospects that this could entail.

Chart 2: Ukraine - Protecting Investors



Source: World Bank, Doing Business database

[108] See also EBRD (2005), *Transition Report 2005 – Business in Transition*.
[109] See for instance www.doingbusiness.org.

Regulatory reforms

Key economic legislation such as the Joint Stock Company Law is still before parliament pending adoption. The persistent problems with VAT refunds to exporters were tackled and the outstanding stock of arrears was reduced, though a more transparent management of the VAT refund system needs to be put in place. In December 2005, the European Commission concluded that Ukraine had met the technical criteria for market economy status in the context of anti-dumping investigations. This decision followed the government's commitment not to interfere in pricing mechanisms and clarifications on the application of bankruptcy legislation. New legislation was proposed to allow branches of foreign banks to operate more freely in Ukraine in line with Ukraine's future WTO commitments. EU banks are increasingly interested in entering the Ukrainian market.

Recent import price increases on gas and oil are likely to accelerate reforms in the energy sector, having highlighted structural weaknesses and a high energy intensity which were overlooked for years. Reforms should not be limited to adjusting utility prices to cost-recovery levels and providing appropriate social safety nets, but should also cover a broad sweep of other important issues such as coal sector subsidies, corporate governance and private sector participation.

4. Public institutions and public finance management

The fight against corruption and reform of the public administration were important priorities for the authorities in 2005, which started by tackling the reform of the customs administration. The constitutional changes which became effective in January 2006 strengthened the Accounting Chamber's authority for external audits, paving the way for modernising its audit practises in line with international standards. In May 2005 the government adopted a concept of development of state internal financial control, an area of public finance management reform which had largely been overlooked before.

The government's programme also recognised the need to develop a medium-term framework for budget preparation but no progress was made as short-term considerations dominated the fiscal agenda in 2005. An overhaul of Ukraine's tax system was also initiated but any decisions are on hold pending the outcome of the parliamentary elections. There is also growing interest in fiscal decentralisation and, parallel to possible changes in the tax systems, more effective formula-based transfers to local governments will need to be developed.

5. Social development and poverty

Ukraine's population continues to decline (at an average rate of -0.8% over the recent years) and reached 47 million at end-2005, of which the urban population accounts for 68% and the rural population 32%. Since 2001 there has been a manifest reduction in poverty incidence from about 30% to 19% of the population (2003). Poverty has become an increasingly rural phenomenon as agricultural restructuring has not been accompanied by an increase in other employment opportunities in rural areas, where the population is also ageing rapidly. Agriculture represents about 25% of total employment (14% of GDP). The land market is stalled as a moratorium on agricultural land sales has been imposed until 2007 and there is a strong lobby in the country against lifting the ban.

UKRAINE

Main economic indicators

	2001	2002	2003	2004	prel. 2005
Real sector					
Real GDP growth (% change)	9.2	5.2	9.6	12.1	2.6
Inflation CPI (period average)	12.0	0.8	5.2	9.0	13.5
GDP nominal, in USD billions	38.0	42.4	49.5	65.1	82.9
GDP per capita, in USD	780	880	1050	1370	1760
Social indicators					
Unemployment (ILO definition)	10.9	9.6	9.1	8.6	7.2
Average monthly wages (% change)	27.7	17.0	24.4	27.7	44.9
Population, millions	48.6	48.0	47.6	47.3	46.9
Fiscal sector					
Total revenues, % of GDP	33.5	36.0	35.9	35.0	39.7
Total expenditure, % of GDP	35.1	35.5	36.8	39.4	42.7
General govt. balance, % of GDP	-1.6	0.5	-0.9	-4.4	-2.9
Gross public debt, % of GDP	38.6	35.7	27.7	25.1	19
Monetary sector					
Domestic credit to private sector (% of GDP)	14	19	26	27	29
Private sector credit (% change)	40.5	47.3	63.4	31.2	29.5
Broad money (M3), % yoy	41.9	41.8	46.5	32.3	54.8
Degree of monetisation (M3/GDP, %)	22.4	28.7	35.6	37.3	46.5
Dollarisation in bank deposits	32.9	32.6	32.2	36.5	35.0
External sector					
Current account balance, % of GDP	3.7	7.5	5.8	10.5	3.0
Trade balance, % of GDP	0.5	1.7	-0.5	5.7	-1.4
Foreign direct investment (net flow, % of GDP)	2.0	2.0	3.0	2.6	9.0
Import cover (months)	1.7	1.9	2.4	2.7	4.8
External vulnerability					
External Public Debt, % of GDP	26.6	24.0	21.6	19.2	15.6
Debt Service Ratio[1]	6.7	5.4	6.2	4.8	4.8
Gross reserves (excl. gold, USD billions)	3.1	4.4	6.9	9.5	19.4
Reserves/M3	36.5	36.1	38.7	40.1	50.3
Financial sector					
Lending rate	32.3	25.4	17.9	17.4	16.1
Exchange rate (hryvnia per USD, average)	5.4	5.3	5.3	5.3	5.1
Exchange rate (hryvnia per EUR, average)	0.0	0.0	0.0	6.6	6.4
Real effective exchange rate (2000=100)	100.4	95.1	85.1	81.1	89.4

Sources: IMF, EBRD, Ukrainian authorities.

[1] Public external debt service in % of exports of goods and services.

WEST BANK AND GAZA

- **The economy depends entirely on political and security conditions and related restrictions imposed by Israel on the movement of people and goods. The economic recovery has been interrupted by the political crisis following the 2006 elections.**
- **Having not renounced on violence, Hamas' election victory in January 2006 triggered a suspension of the monthly clearance-revenues transfer by Israel, an interruption of foreign aid and subsequently a liquidity crisis of the Palestinian Authority.**
- **In 2005 GDP remained about 30% below its 1999 level. In the absence of a resumption of regular external assistance and tax revenue transfers, as well as an easing of the closure policy imposed by Israel, a collapse of the local economy is expected in 2006.**
- **Inflation remained relatively low in 2005 (3.5%) but individual prices fluctuate strongly and external trade may crumble in 2006 in relation to closures. The precarious state of the economy translated into high unemployment (23.8% in 2005) and poverty rates.**

1. Macroeconomic developments

Real sector developments

Real GDP continued to rebound between 2003 and 2005 from the effects of the second *intifada* with an average annual growth rate of about 6% per year. This was sustained in part by a large fiscal stimulus in 2005. Nonetheless, GDP remained about 30% below its 1999 level because of the volatile security situation, Israeli restrictions on the movement of people, goods, and services, and a poor business climate. Unemployment remained high at 23% in 2005.

Box 1: Core points of the November 2005 Agreement on Movement and Access (AMA)

- Palestinians in charge of Rafah (border with Egypt) crossing, but authority limited
- Israel can monitor crossing on television screens
- Israel can object to particular travellers, but cannot veto passage
- Imports from Egypt must go via Israeli checkpoint at Kerem Shalom
- Palestinian bus and lorry convoys between Gaza and the West Bank
- Gaza sea port to be constructed

The economy's recovery has been interrupted in 2006 by political and security developments following the election victory of Hamas in January. By refusing to accept Israel’s right of existence, the road map to peace, and to officially renounce on violence, Hamas triggered the isolation of the Palestinian Authority and a disruption of external aid from long-standing donor countries. The policy stance of Hamas also made the implementation of the November 2005 agreement by Israel and the Palestinian Authority on the lifting of some restrictions of movement over the medium-term even more difficult than before (see Box 1). The movement restrictions, in particular cross border movements, have actually become more severe in the first four months of 2006, compared to the time before the November 2005 agreement.

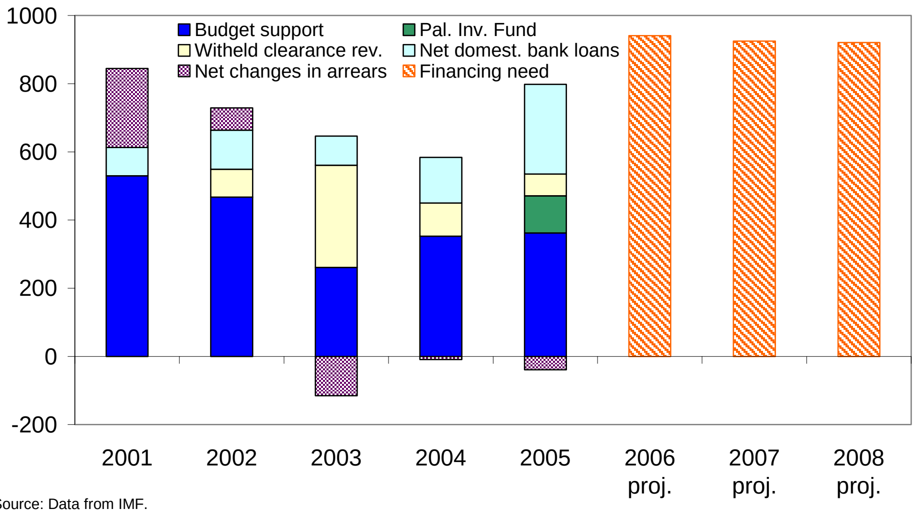
Even in a generally favourable scenario of improving security and business conditions, GDP growth was expected to slow down to around 4% per year in 2006 and 2007 because of necessary fiscal stabilization measures. However, under the current political and economic scenario, the Palestinian economy might well be facing a serious downturn in which GDP per capita is expected to decline by 27% in 2006; unemployment could increase to 40% of the active population and the poverty rate could approach 70%.

Fiscal developments

Despite around USD 350 million annual external support to the budget of the Palestinian Authority, its financial situation has become increasingly unsustainable during 2005 mainly as a result of uncontained government spending, in particular a rapidly rising public sector wage bill, expanding social transfers and rising net lending.

A number of key reforms to be implemented by end-October 2005 were missed by the Palestinian Authority. This led to the temporary suspension of the fifth tranche of multi-donor budget support channelled through a World Bank trust fund), and amounting to USD 59.7 million. Only in March 2006, USD 42 million (of which EUR 17 million came from the EU) were released against the background of an increasing liquidity crisis. The Palestinian Authority's 2005 budget deficit reached about USD 800 million (17.7% of GDP) of which USD 340 million were financed by donors in the form of budget support. The remaining deficit was financed through a combination of commercial bank borrowing and liquidation of Palestinian Authority assets held in the Palestinian Investment Fund.

Chart 1: West Bank and Gaza - Financing the budget deficit
(USD million, scenario of unchanged policies)



Source: Data from IMF.

Due to Hamas's unchanged policy stance since they came to power, financial support of important long-standing donor countries has been subsequently suspended. Struggling to uphold basic services and to finance the salaries of the Palestinian Authority and its security forces, revenues on which an estimated one third of the population depends, Hamas is seeking support in particular from Arab countries to substitute other funds. Even in the event of a reliable rapid resumption of budget support, fiscal challenges will remain daunting, in particular due to the consequences of the public wage bill increases of 2005.[110]

Monetary and exchange rate developments

Overall, the CPI increased by 3.5% in 2005. Prices in the West Bank and Gaza depend to a large extent on the political and security situation and related movement restrictions which can have a strong impact on supplies. Increased closures in 2006 have caused a fall of export-substitute goods prices, whereas the prices of import goods such as wheat have risen. These price developments have offset each other to some extent such that the overall consumer price index has been less affected.

The Israeli and Jordanian currencies are valid legal tender while the US dollar remains an important parallel currency for business transactions, and as a reserve asset. The Palestinian Monetary Authority (PMA) has only limited functions.[111] Israel, maintaining a floating exchange rate, applies inflation-targeting, whereas Jordan maintains a fixed peg of the Jordanian currency against the US dollar.

External sector developments

The Palestinian economy depends largely on external trade. In 2005, trade reached nearly USD 3.4 billion (83% of GDP). External trade (like the domestic movement of goods) is restricted by Israeli controls.[112] These restrictions have become more severe since January 2006. The implementation of the November 2005 agreement on the easing of border crossings (Box 1), which was difficult since the outset, is now collapsing. The agreement committed Israel, for instance, to allow at least 150 daily truckloads of cargo to be exported from Gaza into Israel by the end of 2005, rising to 400 truckloads a day by the end of 2006. The only border crossing between Gaza and Israel (Karni) has been closed for about half of the time in 2006. In the first quarter of 2006, the number of daily truckloads leaving Gaza averaged only 19. The number of trucks into Gaza (daily 82) was below the average of 149 in 2005, the minimum number necessary to cover the bare needs in the Gaza strip.

The trade balance of the West Bank and Gaza records high deficits due to aid financed imports of goods and services, with limited potential for exports due to the economic problems, and trade and movement restrictions. In 2004 the value of commodity trade increased by 24% to USD 2.6 billion. The trade deficit widened as imports grew more rapidly than exports. In 2005, the trade deficit reached about USD 3 billion (up from USD 1.9 billion in 2004), of which two thirds were covered by net factor income and net transfers. This led to a current account deficit of USD 1 billion (22% of GDP). In the absence of a facilitation of the movement of goods and people, trade will crumble in 2006.

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[110] A tentative IMF plan of politically sensitive adjustment measures (developed at the end of 2005, before the suspension of donor support in 2006) aimed at limiting the annual deficit over 2006-2008 from more than USD 900 million to around USD 715 million in 2006, USD 480 million in 2007, and USD 280 million in 2008.

[111] It is responsible for licensing, supervising and inspecting banks; determining the liquidity requirements on all deposits held by banks operating in the self-rule areas; and managing foreign exchange reserves and foreign currency transactions. The PMA also has the power to regulate and supervise capital activities in the self-rule areas, including the licensing of capital market institutions, finance companies and investment funds. The PMA does not have the right to issue currency or to conduct independent monetary and exchange rate policies.

[112] The Palestine Authority does not control a single import border and, in principle, only one export border (Rafah).

2. Trade liberalisation and economic opening

Despite difficult trade conditions due to the dependence on Israel as a transition country, the West Bank and Gaza experienced an upward trend of trade with the EU in the last years.[113] EU exports and imports increased to EUR 46 million and EUR 10 million in 2005, respectively. The West Bank and Gaza can adopt, in principle, the system for Pan-European (diagonal) Cumulation of rules of origin, which has been approved by the European Council in November 2005. Provided, that the trade restrictions imposed by Israel are lifted, this would lead to greater gains from the Euro-Mediterranean free trade area. Another precondition for enjoying these benefits is the realisation of free trade arrangements with its Mediterranean partner countries.

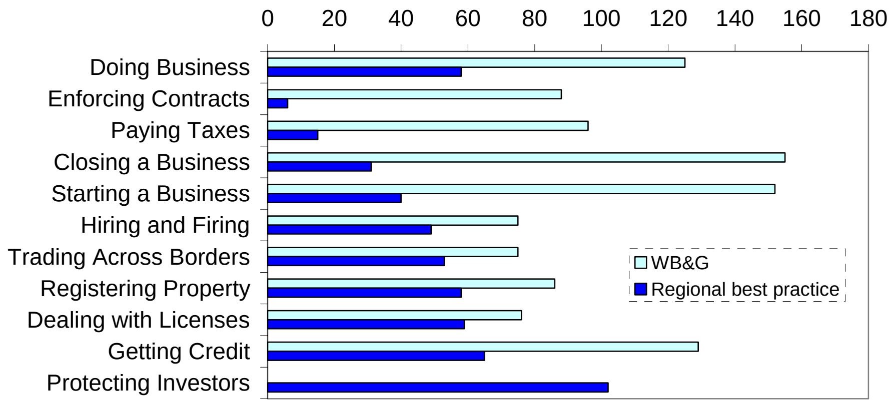
The latter is also necessary to prevent a pure hub-and-spokes free trade system with potentially negative welfare effects. Moreover, taking advantage of these opportunities depends on strengthening the private sector, which currently suffers from an unsatisfying business environment (Chart 2). In principle, the EU is also ready to discuss further liberalisation of agricultural and services trade with its Mediterranean partner countries.

3. Business climate

Privatisation, enterprise restructuring and business environment

The Palestinian private sector is dominated by small businesses – some 90 % of all Palestinian firms employ five workers or less. These firms have managed to survive through the Intifada period and could provide the basis for recovery. However, in addition to a further lifting of movement restrictions, policies to improve the business environment are necessary for firms to invest, create jobs and expand.

Chart 2: West Bank and Gaza - "Doing business" rankings



The ease of doing business index ranks economies from 1 (best) to 155.
The regional best practice refers to the best ranking Arab country among the Mediterranean ENP countries.

Source: World Bank, 2006.

Currently, poor security, the lack of a reliable judicial system and of a land registry, and a weak government capacity, represent significant obstacles to private sector development. Low access to credit by small and medium enterprises remains an issue despite the fact that the Palestinian

[113] Israel does not recognise the EU-Palestine interim Association Agreement concluded in 1997.

banking system seems to enjoy abundant liquidity. It is likely that the Palestinian banks will reallocate their assets more in favour of private domestic businesses once basic economic conditions have improved.

Financial sector reforms

In 2005, the Palestinian banking system seems to have enjoyed abundant liquidity. In July 2005 only USD 1 billion out of USD 5.5 billion of total bank assets was lent to private domestic customers. At the same time, about USD 2.6 billion were invested in foreign assets. It is imaginable that the Palestinian banks will reallocate their assets more in favour of private domestic businesses once basic economic conditions have improved.

New legislation in the US ("Palestinian Anti-Terrorism Act") adopted after the January 2006 elections threatens financial institutions with criminal prosecution if they deal with the Palestinian Authority. This is a major reason why foreign banks have cut their ties with Palestinian financial institutions. Israeli banks, in particular, have suspended financial transactions with the West Bank and Gaza notwithstanding their importance for the payments system there. The Jordan based Arab Bank, which handles the Palestinian Authority's treasury account, has also come under pressure to stop working with the Hamas-led administration. All this leads to significant interruptions in the payment systems and higher transaction costs.

4. Public institutions and public finance management

In 2005 the Palestinian Authority continued to make progress on public finance reforms. The unified pension law, which increases the efficiency and transparency of the pension system, was approved in June and its by-laws approved in October.[114] An audit of the Palestinian Authority's payroll for civil servants was completed by end-June, and an audit of security personnel in September. The Ministry of Finance procurement procedures were enhanced, and new financial regulations for ministries and public establishments were approved in August 2005.

5. Social development and poverty

In 2005, around 43 % of the population lived in absolute poverty (on less than USD 2 per day), including 15% which were not able to meet subsistence needs. Nearly all institutions – schools, health care, and security bodies – rely on foreign aid. Cushioned by unprecedented amounts of donor assistance (USD 1 billion per year, which equals about a quarter of GDP, from 2001 to 2003), the Palestinian society has withstood the economic shocks of the last years and the resulting widespread poverty without disintegration.

With the economic development and financial aid now almost entirely dependent on the political situation, there is a risk of a severe worsening of poverty. The unstable political conditions will also make it more difficult to implement the three-year development programme agreed between the Palestinian Authority and the World Bank. Import restrictions by Israel in 2006 have led, inter alia, to an exhaustion of wheat reserves (which provide up to 60 days of grain supply).

[114] Although, not to the satisfaction of the World Bank Trust Fund Guidance Committee. Further investigation found that several previously agreed suggestions to safeguard the governance structure of the pension system, independent management of pension assets and the financial sustainability of the future pension system had not been incorporated in the final text of the approved by-laws

Rationing was put into effect in early 2006, and the World Food Programme was required to bring in emergency food supplies. Faced with the possibility that the current political crisis might trigger a humanitarian crisis, international donors are preparing to increase their humanitarian and emergency contributions in order to cushion the impact of the economic restrictions on the Palestinian population.

WEST BANK and GAZA

Main economic indicators

	2001	2002	2003	2004	prel. 2005
Real sector					
Real GDP growth (% change)	-15.4	-9.4	5.9	6.0	6.0
Inflation CPI (annual average)	1.2	5.7	4.4	3.0	3.5
Unemployment rate[1]	25.5	31.3	25.6	26.8	23.8
GDP per capita, in USD	1142	929	1032	1122	1204
Fiscal Sector (% GDP)					
Revenue[2]	7.3	9.4	21.0	23.4	25.7
Expenditure[3]	29.9	32.4	35.6	37.4	42.4
of which: public sector wage bill	18.1	20.4	20.5	21.3	22.4
Balance before budget support[4]	-22.6	-23.0	-14.6	-14.1	-16.7
Budget support	14.2	14.8	7.2	8.7	8.0
Balance incl. budget support[5]	-8.4	-8.2	-7.4	-5.4	-8.7
External sector					
Current account balance, % of GDP	-8.9	-7.5	-16.7	-21.5	-22.0
Trade balance[6], USD million	-2141	-2065	-2381	-2731	-2998
Exports[6], USD million	560	465	465	535	615
Imports[6], USD million	2701	2530	2846	3266	3613
Financial sector					
Israeli Shekel (per USD, eop)	4.40	4.75	4.37	4.34	4.59
Israeli Shekel (per EUR, eop)	3.94	4.49	4.94	5.40	5.71
Jordanian Dinar (per USD, eop)	0.71	0.71	0.71	0.71	0.71
Jordanian Dinar (per EUR, eop)	0.64	0.67	0.80	0.88	0.88

Source: Palestine Central Bureau of Statistics, IMF, World Bank, EIU, UNCTAD.