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The Unmet Challenge of Interdependence in the EU-MENA Space: A View from the South

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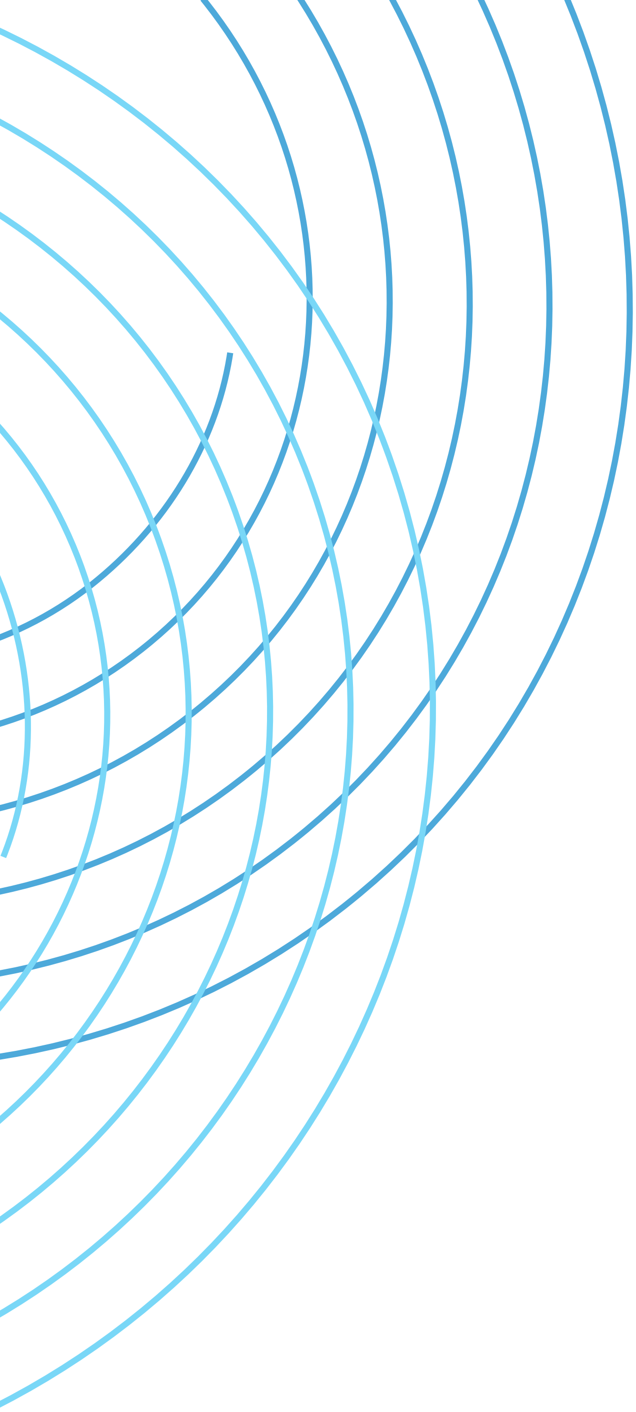

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Abstract

This paper will take stock of the economic performance of Europe and the Arab world, examining how they can do better by working together. The paper pays special attention to the trade, investment, migration and energy linkages between the two regions, as well as those among the Arab countries, as well as how they can be improved to achieve better development. Whereas we present a southern perspective, with Arab countries as main focus, the purpose is to understand the constraints facing both regions, and come up with measures that benefit all parties. The paper begins with a brief overview of Europe and MENA's economic performance compared to their peers. It goes on to examine the linkages between the two regions as viewed by the MENA region. These include trade, in which energy plays an especially important role, migration, both voluntary and involuntary, and investment. The paper then discusses the political preconditions for advancing on reforms, especially on those that exploit the latent synergies between the two regions, and their feasibility. It concludes with some critical policy recommendations.

The Unmet Challenge of Interdependence in the EU-MENA Space: A View from the South

Introduction

The countries of Europe and those to the South surrounding the Mediterranean, as well as those further East in the Levant and stretching to the Arab Gulf, share a long history of commerce, punctuated by alternating periods of crisis and rapid development. Crisis best describes the last decade. In recent years, their economies have shared one salient feature: European and Arab countries have failed to meet the expectations of their citizens by a wide margin. Both regions have experienced lower growth than their peers over the last ten years. All of Europe has suffered from the global financial crisis, but the European countries of the South closest to the MENA region have seen unemployment soar, and some have experienced not just recession, but depression. Meanwhile, the MENA countries have seen the disappointment of their people turn into waves of turmoil and civil conflicts, contributing to even more economic hardship. The crises to the North and South of the Mediterranean have fed on each other, resulting in diminished trade and a sharp increase in migration pressures. Overcoming these difficulties will predominantly depend on domestic political and economic reforms in European and Arab countries. However, their ability to collaborate in dealing with these shared issues matters as well.

Reform programs must recognize the interdependence of the two regions, in terms of security, geopolitics, economics and energy, and aim to turn it into an asset rather than a source of recurrent instability. Even with their own problems, the United States, Japan, China, and the other great economic powers have clearly done a better job than the EU and the Arab world at mitigating the risks of instability and in exploiting the economic synergies with their developing periphery. To be clear, dealing with the challenge of interdependence between the EU and the Arab World will not, on its own, solve the two regions' growth dilemmas—but it will help. From a Southern perspective, urgency is critical, not only because there is little sign that the turmoil and conflicts triggered by the Arab uprising are nearing an end, but also due to the collapse of oil prices. This collapse is creating unprecedented budget pressures across a wide swathe of the region – from Algeria to Saudi Arabia – which had escaped the worst of the turmoil. Moreover, the increasing reluctance of the United States to intervene in regional conflicts, following its failed intervention in Iraq and that of its European allies in Libya, leaves a dangerous vacuum. Russia's intervention in Syria, its escalating tensions with Turkey, Turkey's struggle against Kurdish insurgents, the spread of ISIS into Libya, Saudi Arabia's intervention in Yemen, and the rivalry between Iran and Saudi Arabia make for an unstable mix.

Currently, Europeans view these interconnected events mainly through the prism of the refugee crisis, yet arguably, European countries could be seeing only the tip of the iceberg. While in 2015 European countries have seen the inflow of some 1.3 million asylum seekers (less than 0.3% of the European population), it is estimated that about 7.6 million Syrians have been displaced, of whom 1.7 million are in Lebanon and 629,128 are in Jordan[1], representing respectively 23.6% and 8.3% of their respective populations. The stability of far more populous countries, such as Egypt, is also in question. Should Libya turn into a failed state, it would become a significant security threat to Europe. It would also make it even more difficult to regulate the flow of forced migrants and economic migrants from Sub-Saharan Africa.

I. Europe and the MENA region: An Inadequate Response to the Global Financial Crisis

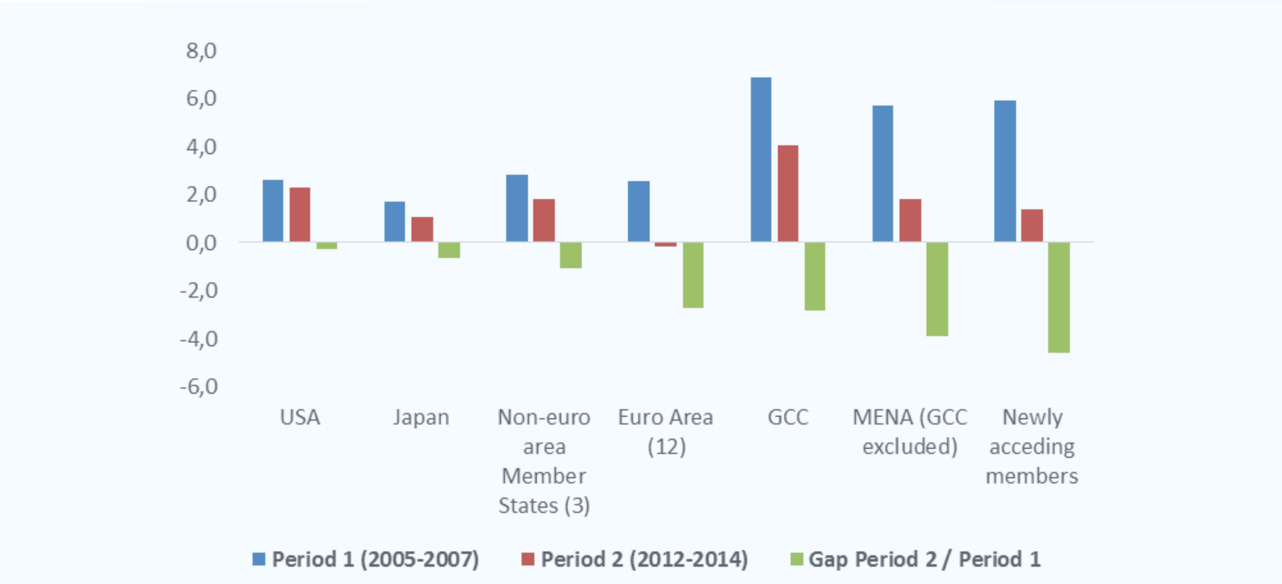
Across the world, many countries are still struggling to recover from the global financial crisis, but Europe and MENA are probably the regions finding it hardest[2]. In this section, we will compare the economic performance of various groups over the three years preceding the global financial crisis (2005-2007), with the three subsequent years (2012-2014). During the crisis, from 2008 to 2011, the global economy suffered one of the sharpest recessions and was followed by an incomplete recovery.

Chart 1 shows the pre-and post-crisis annual growth rates for three groups of EU countries: the Euro-zone, newly joined countries, and the rest of the EU. It also shows two groups of MENA countries: the GCC oil-exporters and the rest (mainly oil importers). For comparison purposes, the US and Japan are included. In the euro area (12 countries)[3], the annual GDP growth in 2012-2014 was 2.7 percentage points lower than in the Pre-crisis period (2005-2007), while it slowed by 1 percentage point in the three main non-euro area member states[4]. The loss of momentum was even more important in the newly joined countries--4.6 percentage points less annual growth.[5] By contrast, the growth rate of the US economy has returned to levels comparable to those of the pre-crisis period. The poor economic performances of European economies were also reflected in trade flows. The average growth rate of goods and services exports dropped by about 11 points between the two mentioned periods in euro area (12) and by 10 points in the 3 main non-euro area member states. Once again, the fall in export growth rate was more pronounced in the newly acceding countries, from an average pace of 22% in 2005-2007 to 2.9% in 2012-2014. This situation was partly due to the reliance of many newly acceding countries on demand from the core European countries.

Against this background, the labor market was affected by the negative externalities of the weak recovery. The unemployment rate in the EU reached 10.2% in 2014 compared to 7.2% in 2007. The euro-zone (19 members) did worse than the average, as its unemployment rate increased from 7.4% to 11.5%. By contrast, the US unemployment rate in 2014 was already approaching pre-crisis levels.

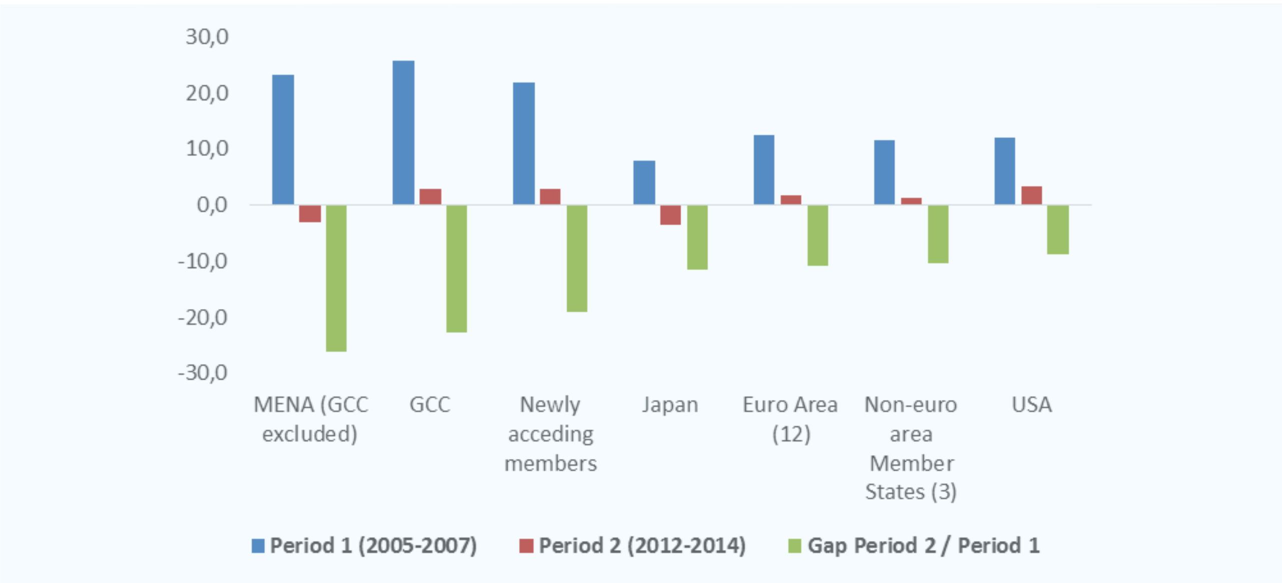
1. According to the UNHCR, the UN refugee agency. June 2015.
2. Countries such as Brazil, Venezuela and Russia are facing even deeper downturns related to the collapse of commodity prices and domestic mismanagement.
3. Belgium, Germany, Ireland, Greece, Spain, France, Italy, Luxembourg, the Netherlands, Austria, Portugal, Finland.
4. Denmark, Sweden, United Kingdom.
5. Cyprus, Malta, Slovenia, Slovakia, Estonia, Latvia, Lithuania, Bulgaria, Czech Republic, Hungary, Poland, Romania, Croatia.

Chart 1: GDP growth during Pre-crisis and Post-crisis (3-years average growth rate in %)



Source: on the basis of WDI database

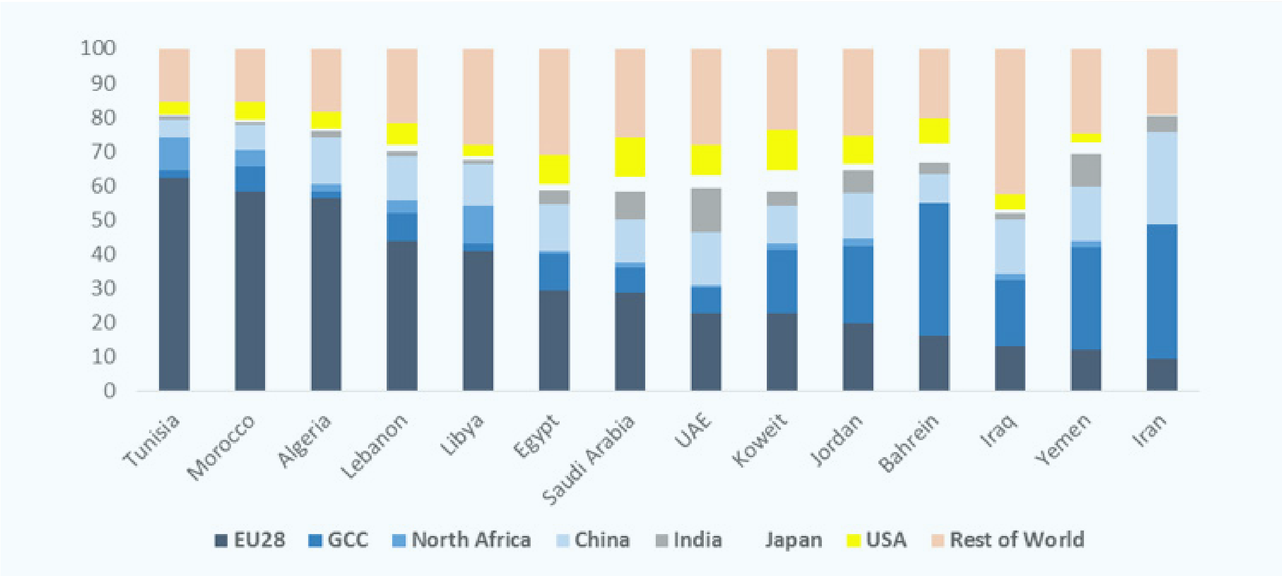
Chart 2: Nominal ($US) export of goods and services growth rate during Pre-crisis and Post-crisis (3-years average growth rate in %)



Source: on the basis of WDI database

The weak performance of the European economies contributed to weak performance in MENA, given the EU's importance as a trading partner for many countries in the region. The EU accounts for more than 60% of total goods exports for Tunisia, 58% for Morocco, 56% for Algeria, 44% for Lebanon, 41% for Libya and 29% for Egypt. In addition, those countries are tied to the EU through migrant remittance flows and tourism receipts. Against this backdrop, all these countries suffered from the weak recovery in Europe essentially through real sector channels. Contagion via financial links was far less important, given the limited development of financial sectors in some economies in the MENA region and the weak integration in international financial markets in others. As for the GCC countries, they are far less dependent on the EU, and their slowdown reflected global factors as well as financial sector spillovers. The sharp slowdown of GDP growth in GCC countries also affected others in the MENA region, in particular Egypt, Jordan, Iran, Yemen and Iraq through trade linkages and remittance flows.

Chart 3: MENA Exports structure by destination (in percentage of total exports)

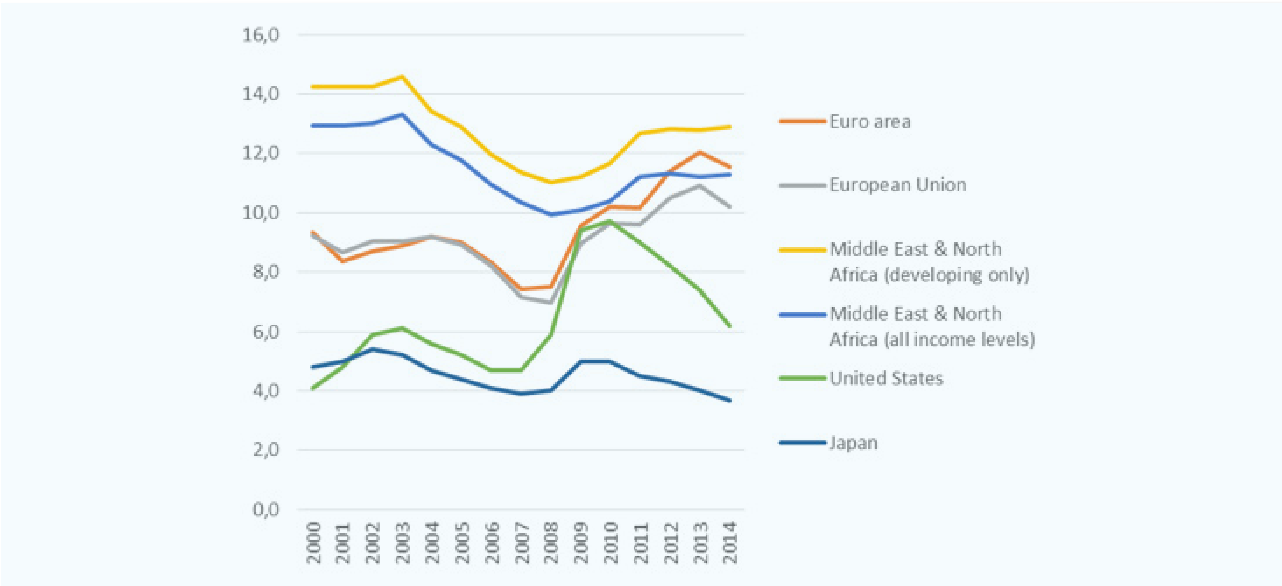


Source: based on UNCTAD database

The MENA region experienced a decline in GDP growth, from 6.9% to 4.1% between 2005-2007 and 2012-2014 in GCC countries and, far sharper, from 5.7% to 1.9% in non-GCC MENA countries. The resilience of the different countries depended on various factors, including the degree of turmoil following the Arab uprising, from 2011 onwards. The effectiveness of the policy measures initiated and initial macroeconomic conditions and buffers also played an important role. For GCC countries, ample reserves and repatriated funds enabled them to respond with monetary and fiscal stimulus (i.e. debt restructuring programs in the UAE helped). In non-GCC MENA countries, countercyclical measures were generally far more modest, given limited fiscal space, international reserves and their access to external sources of financing. Only recently have oil-importing MENA countries, in particular Morocco, Tunisia, Egypt and Jordan, benefited from the fall in oil prices and been able to contain the current account deficits and engage in stimulus packages. By contrast, the GCC countries are now struggling to contain surging fiscal deficits because of the oil price collapse.

The policies of recovery initiated by MENA countries, however, were not sufficient to save them from the negative effects of the crisis on job markets, especially among the youth. The measured unemployment rate in non-GCC MENA countries rose from 11.4% to 12.9% between 2007 and 2014, but the reality was probably worse. Labor force participation rates, which are already low in the MENA region, decreased during the crisis since discouraged workers dropped out of the labor force. These trends exerted even more pressures on social and political stability.

Chart 4: Unemployment rate (%)



Source : WDI database

1. Europe: What is Behind the Persistently Slow Growth?

Slow European growth affects growth in the MENA region. Although this should not be interpreted as a causal relation, it is nevertheless noteworthy that , according to a recent analysis, a one percent slowing in growth in Europe is associated with a one percent decrease in growth for the MENA region (World Bank GEP 2016). Europe's struggles to reignite growth in the wake of the crisis could be attributed not only to limitations on its ability and/or willingness to deploy counter-cyclical policies, but also to several structural impediments, notably an aging and declining labor force in several countries, a failure to innovate in the face of increased competition from China and other lower-wage economies, as well as the faulty workings of an incomplete monetary union and trends in the income distribution which may be impeding demand.

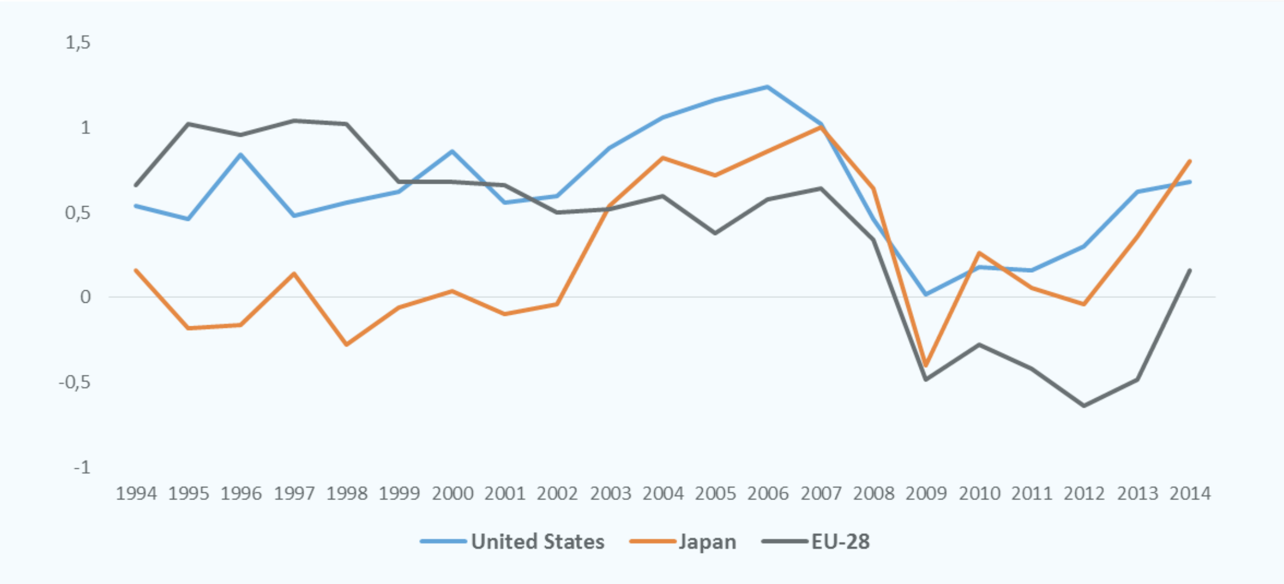
In this section, we look a little more closely at the effects on growth of aging, slow innovation, wage policies and, more broadly, at the detrimental effect of debt- and export-led growth strategies.

Europe is the second most rapidly ageing region in the world after Japan. Total labor supply in the EU is expected to exhibit no growth until 2023, when it then declines steadily until 2060[6]. In 2060, the labor force is projected to be 8.2% lower than in 2023. The projected decline in the euro area is even sharper, equivalent to 9.2% of the labor force in 2023. This downward trend in labor as a factor of production will have negative implications for the EU's growth potential in the long run. One channel will be through savings. Aging and increased dependency ratios will probably result in lower private savings and then lower resources to finance investment and long-term growth. In addition, total investment could also suffer from a deterioration of public savings given the expected increase in age-related public expenditures in Europe. In such a context a sustained improvement of productivity supported by an efficient process of innovation will have to be the main source of growth. Yet, Total Factor Productivity growth is on a declining path, and has underperformed not only the US but also Japan, turning negative since the onset of the global economic crisis. According to the "Innovation Union Scoreboard report 2015", 13

6. Ageing report – European commission, 2015.

EU countries out of 28 exhibited decreasing innovation performance since the crisis. The EU also shows lower innovation performances than South Korea, the US, Japan, and does better than China, whose gap is, however, closing. European innovation is hampered by excessively cautious bureaucracy[7]. The more limited availability of risk capital than in the United States is also a factor. According to the Venture Capital Insights Report by Ernst & Young, during the period 2006 – 2013, about $373 billion was invested in venture capital worldwide, of which almost 70% invested in the US while the share of Europe is much lower (14% of total). Meanwhile, the proportion of Chinese venture capital of the total jumped from an average of 9% during the period 2006-2013, to a share of 18% in 2014.

Chart 5: TFP growth in selected advanced countries (5-years moving average, %)



Source: Elaborated on the basis of The Conference Board Total Economy Database

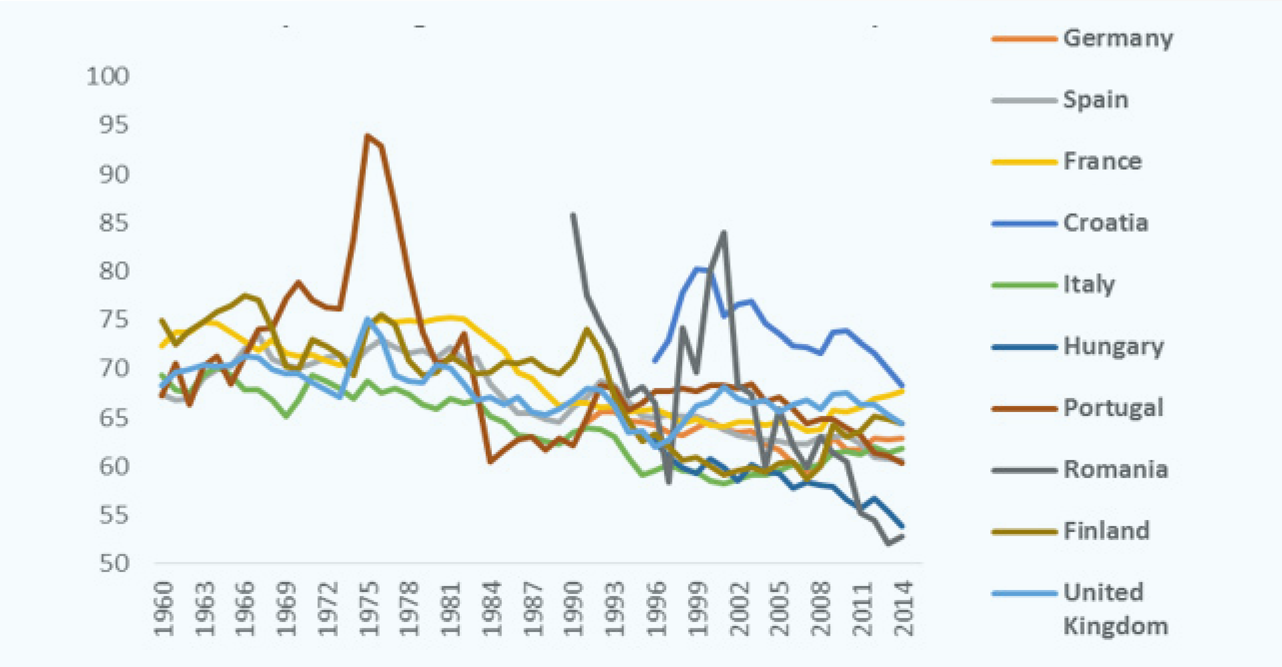
Slow growth in Europe may also be the result of insufficient effective demand, in particular to a share of wages that is too low (Onaran and Obst, 2015). The increase in wage share could have several consequences. First, consumption will rise, since workers who earn wage income have a higher propensity to consume compared to capital owners and higher income groups who earn profit income. The second consequence of the rising wage share is that private investment may decline due to lower profits. Finally, the increase in wages induces higher unit labor cost and a loss of competitiveness causing a fall in net exports. According to (Onaran and Obst, 2015), in the majority of countries, increased wage share would boost aggregate demand through increased consumption, outweighing the decline in private investment and net exports. This outcome is even more likely for large economies with relatively limited openness. The available literature shows that the majority of EU countries are wage-led demand regimes, which means that an increase in the wage share generates a rise in aggregate demand. This is believed to be the case for the UK, Germany, France, Italy, Spain, Greece, Portugal, Sweden, Finland, the Netherlands, and Luxembourg. In addition, recent empirical findings[8] indicate that the EU as a whole is a wage-led economy. Moreover, if wage moderation policies are conducted simultaneously in all the EU members, the relative export prices will change a little between them while the total EU domestic demand will decline. In addition, since intra-EU trade accounts for a large part (63% of total EU exports of goods are intra-EU), the positive impact of EU wage moderation on extra-EU trade will be insufficient to offset the

7. “The precautionary principle” is one example of an approach that sometimes hampers innovation.
8. Onaran and Obst (2015), Stockhammer and Wildauer (2015), Onaran and Galanis (2014), and Stockhammer et al (2011).

negative effect on domestic demand.

Yet, the European Commission has long encouraged wage moderation, advocating real wage growth below productivity growth, to retain competitiveness.This pro-capital distributional policy – which is not unique to European institutions - has been associated with a downturn in the wage share in many European countries (or stagnating share in some others) since the 1980s. The wage moderation in Europe, spearheaded by Germany, may be one of the factors contributing to a sluggish and fragile recovery in Europe.

Chart 6: Adjusted wage share in selected European countries (as percentage of GDP at current factor cost)



Source: AMECO

In order to compensate for the lack of domestic demand, the majority of European economies adopted two alternative growth strategies i.e. debt-led growth and export-led growth strategies. Both these strategies are considered as unsustainable, contributing to inequality according to some recent research findings (Onaran and Obst, 2015; Stockhammer and Wildauer, 2015). In debt-led growth countries, households increase their debt to maintain consumption levels given the absence of sufficient wage growth. This process is possible owing to financial deregulation, expansive monetary policies and financial and property bubbles, amplified by massive capital inflows. The debt-led growth model generated an unstable environment with rising indebtedness of households as one of the factors that induced the recent crisis. The high level of debt also makes the recovery more painful and slow, since it generally requires an important effort of deleveraging. In addition to the USA, a classic example of debt-led growth economies, we can find in the empirical literature several European countries (i.e. United Kingdom, Ireland, Greece, Spain and Portugal). In the export-led model, countries compensate for weak domestic demand by focusing excessively on exports in a beggar-thy-neighbor process, also making them overly dependent on external demand. These Export-led strategies can impede the process of rebalancing within the EU. They also rely on restraint of wages, which will further weaken domestic demand and amplify export dependence in these countries. Among the EU members that are pursuing an export-led growth, empirical findings identify Germany, Netherlands and Austria as extreme cases. France and Italy are classified as intermediate models (Hein and Mundt, 2012).

The issues discussed above contribute to the persistent weakness of growth in the EU and represent a serious challenge. Addressing these problems is key, not only to the EU but also for MENA region, given the systemic weight of Europe as a major partner for many countries South of the Mediterranean basin.

2. The Slow Transformation Process of the MENA Countries

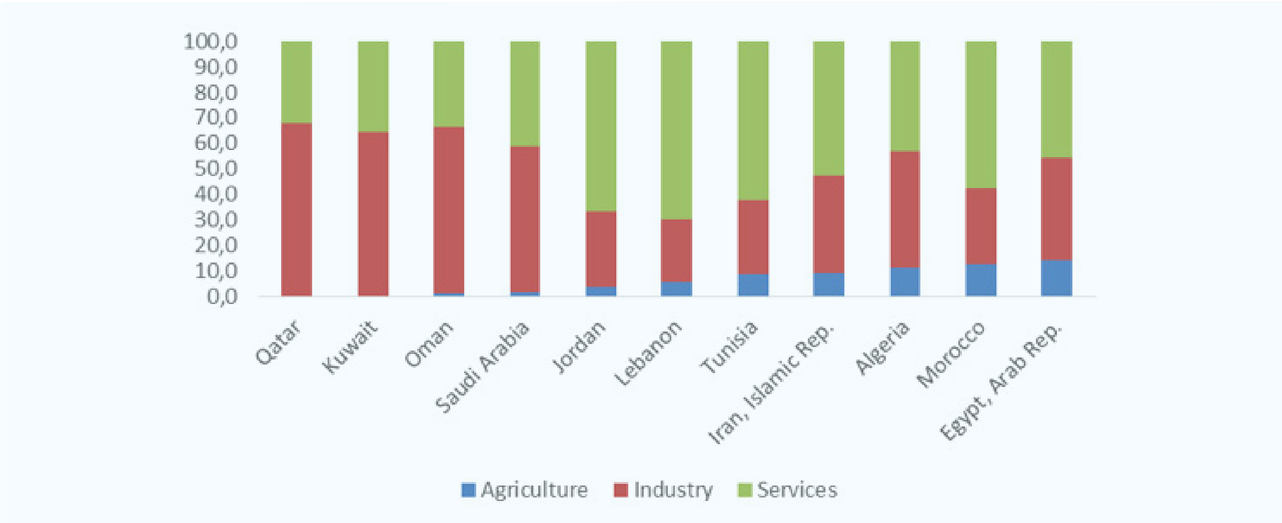
The poor economic performance of the MENA region, and in particular that of non-GCC countries not sheltered by large oil and gas endowments, reflected not only the cyclical forces unleashed by the global financial crisis, but also the accumulated structural deficiencies of their economic systems. These have been widely discussed in the literature. Below, we highlight five aspects which we believe are most important, and each of which has bearing on the unmet challenge of interdependence with the EU. These aspects are: inadequate diversification, insufficient entrepreneurship, failure to exploit human capital, a dysfunctional job market, and insufficient financial development.

2.1. Diversification effort and upgrading process

In a nutshell, the biggest challenge facing MENA countries is upgrading and diversifying their economies to create new employment opportunities for a large and rapidly growing young population. Political and social instability in several countries in the MENA region makes the task even more daunting. Though increasing productivity and creating employment opportunities is an economy-wide challenge, one that concerns non-traded as well as traded sectors, growing the (non-oil) traded sector presents a special challenge. At the same time, MENA countries struggle to absorb technologies prevalent in the most advanced countries, which would otherwise allow them to move up the global value chains and upgrade their systems of production.

MENA has seen some progress, albeit insufficient, in diversification over the last decade. Most countries of the region witnessed a decline in the share of agriculture Value Added in total GDP, while industry and services, which exhibit higher value added per worker, have seen their share increase. Referring to 2014 data, agriculture plays a small role in terms of GDP in oil-exporters but is still a large contributor in countries such as Morocco and Egypt, where it also employs about 40% and 30% of workers, respectively. Services play a much bigger role in GDP of oil importing countries, like Lebanon (70%), Jordan (66%), Tunisia (62%) and Morocco (59%) than among oil exporters. The energy sector, which is included in industry, accounts for the large role that industry plays in oil exporting countries in particular Qatar (68%), Oman (65%), Kuwait (64%), Saudi Arabia (57%) and to a lesser extent Algeria (46%).

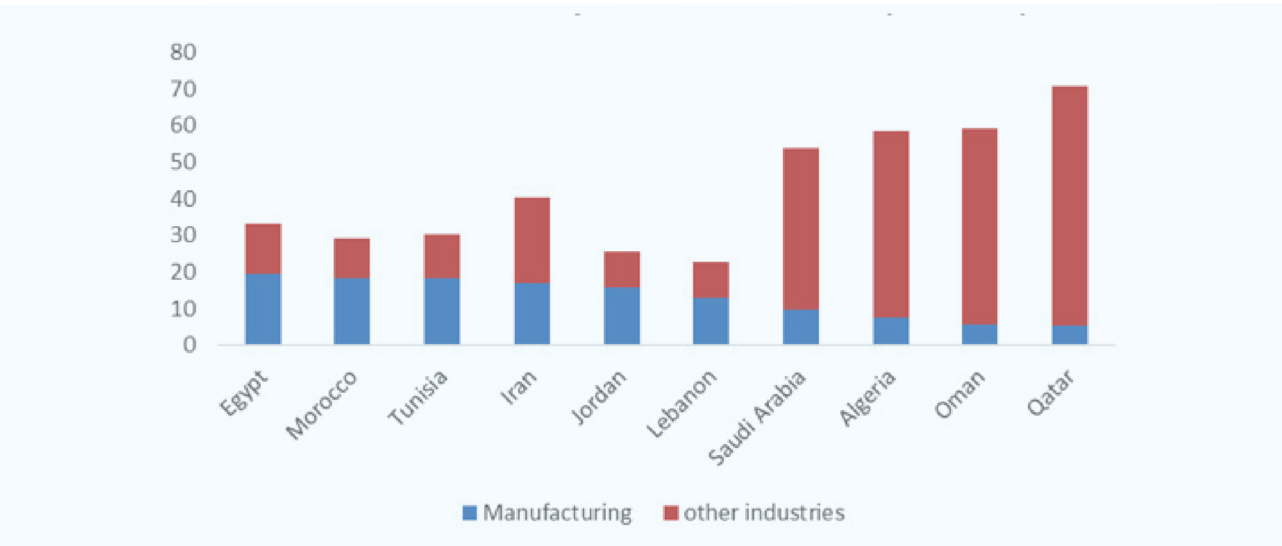
Chart 7: GDP structure in 2014 (value added in % of GDP)



Source: WDI database

However, manufacturing plays only a small role in the GCC countries where it accounts for less than 20% of industry Value Added. Manufacturing plays a larger role in oil importing countries, accounting for some 60% of industry value added, the rest consisting mainly of contruction and utilities. Although, on average across the world, manufacturing is a relatively small sector and is growing slower than services, it nevertheless remains an important source of growth and innovation and is often the source of higher-paying jobs. These trends suggest that in the MENA region, manufacturing opportunities, as well as those in many modern and high-value services remains under-exploited, helping account for the relatively slow process of structural transformation. Moreover, the predominance of capital- and resource-intensive industries in the industrial sector of several MENA countries is far from ideal in those experiencing a rapid growth of the labor force.

Chart 8: Distribution of industry value added in 2014 (% of GDP)



Source: on the basis of WDI database

2.2. Entrepreneurship

MENA countries have made some progress in improving the business environment and encouraging private investment and entrepreneurship in recent years. However, public enterprises remain dominant in many sectors. According to doing business assessment (2016), MENA economies have, on average, made significant progress in several facets of the business environment, including easing procedures for starting a business, dealing with construction permits, access to electricity and taxes procedures. However, economies in the Middle East and North Africa still have an average ranking of 114 of 189 countries, lagging behind Latin America and the Caribbean, East Asia & the Pacific and Eastern Europe and Central Asia. They exhibit particular weakness in issues relating to the rule of law, such as resolving insolvencies, dealing with a variety of legal issues and protecting minority investors. They also perform especially badly in access to credit.

Table 1: MENA countries Doing Business Ranking (2016)

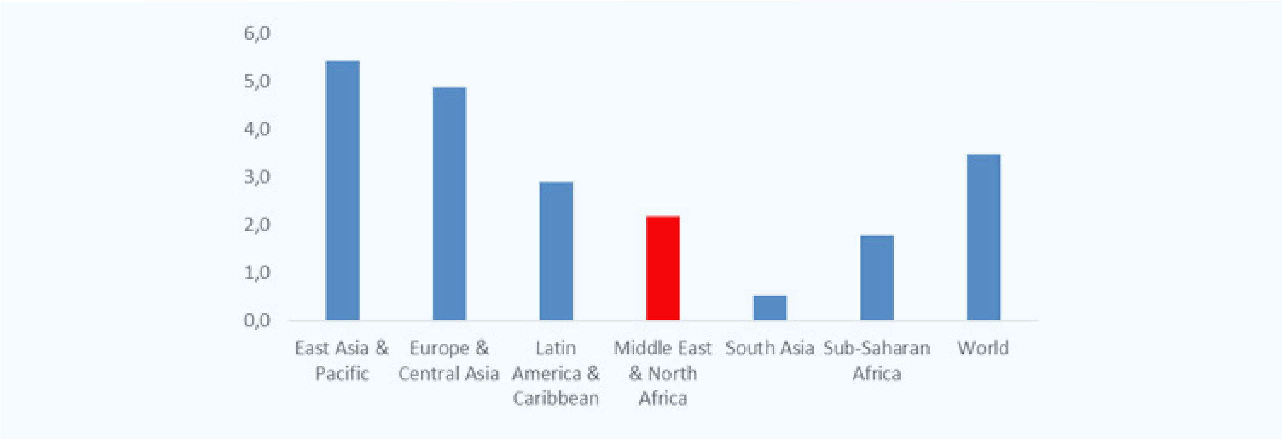
Country	(2016)
UAE	31
Bahreïn	65
Qatar	68
Oman	70
Tunisia	74
Morocco	75
Saudi Arabia	82
Kuweït	101
Jordan	113
Iran	118
Lebanon	123
Egypt	131
Iraq	161
Algeria	163
Yemen	170
Syria	175
Libya	188

Source: Doing Business 2016

MENA countries create too few businesses, as measured by the Average New Business Density Index, well below the world average and that of East Asia, Europe and Central Asia and Latin America-- the other three middle-income regions. The investment to GDP ratio of the MENA over 2010-2014 was above the world average, 24% versus 22%. However, efficiency was relatively low possibly due to the high weight of public investment. The Incremental Capital Output Ratio in MENA countries is still higher, on average, than in some Asian countries, Latin America and Sub-Saharan Africa, while it seems to be more efficient than in Central Europe (World Bank, 2011).[9]

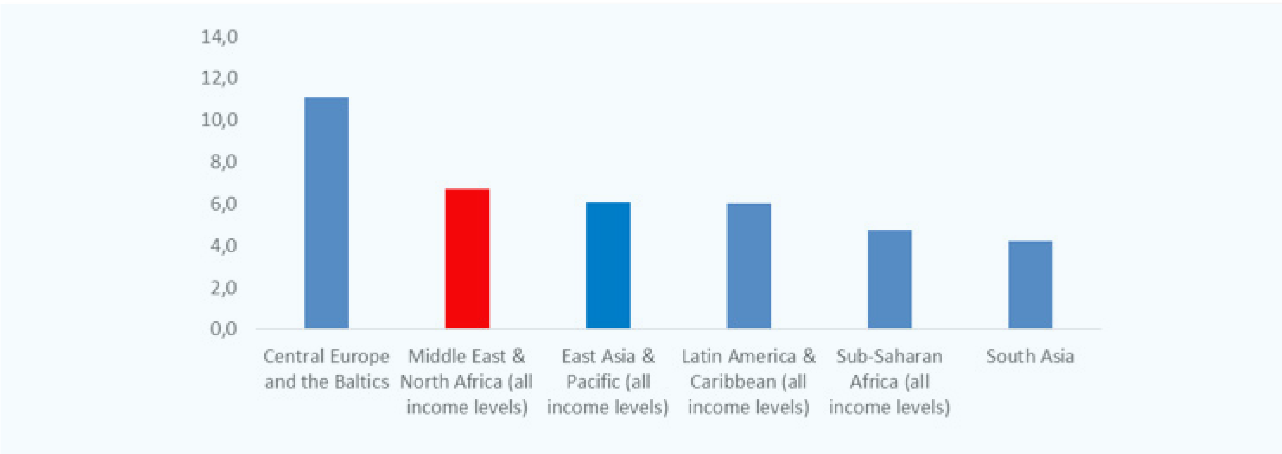
9. Middle East and North Africa Economic Developments and Prospects, September 2011: Investing for Growth and Jobs.

Chart 9: Average new business density 2004-2014 (new registrations per 1,000 people ages 15-64, per year)



Source: WDI database

Chart 10: Incremental capital output ratio (percentage points)

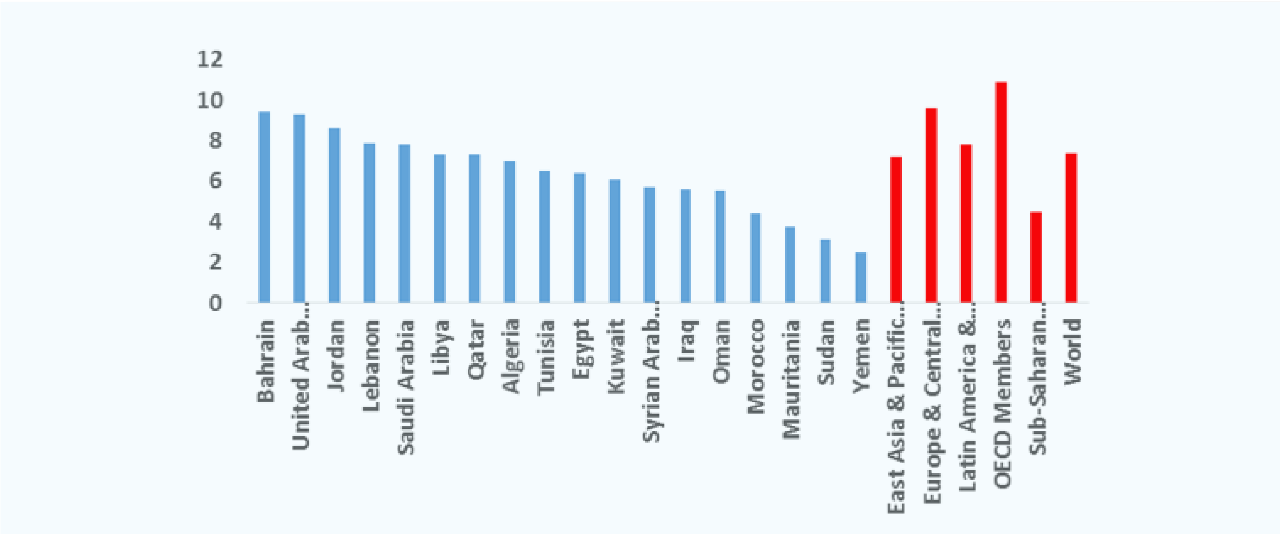


Source: on the basis of WDI data

2.3. Human Capital

The capacity of an economy to assimilate "know-how" depends on its human capital and an environment that encourages innovation. Education, which now accounts for more than 5% of the region's GDP, is clearly key, and substantial progress has been made by the majority of MENA countries in terms of access to education. Net enrolment ratios rose from 86% to 94.2% between 2000 and 2013 for primary schooling and from 62% to 71.7% for secondary education. These gains were especially prominent among girls. In addition, the literacy rate for adult population improved dramatically as it increased from 59% in 1990 to 80.3% in 2010 for the MENA region. However, despite these remarkable achievements, years of schooling remain below those of other developing regions in most MENA countries.

Chart 11: Average years of schooling

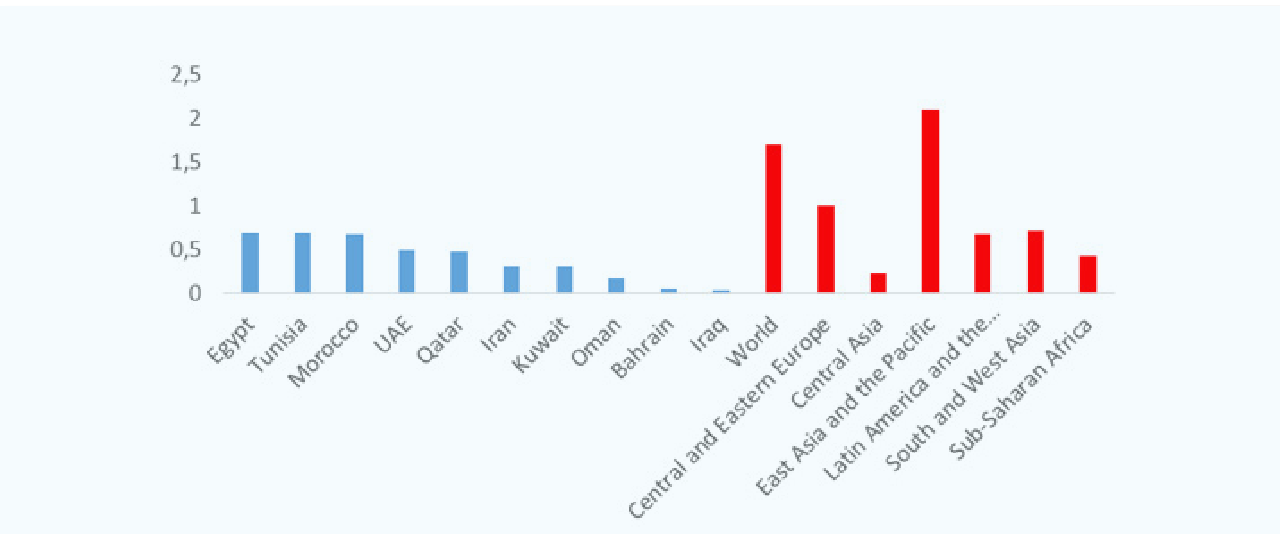


Source: Barro & Lee database

More important still, the quality of education remains problematic. International standardized tests (TIMSS and PISA tests) indicate the low learning outcomes in MENA region on average in comparison to its income level. Besides that, there is a serious problem of mismatch between the skills required by the job market and those taught in the educational system. This mismatch could partly be explained by the traditional role of governments as employers of first choice in the MENA region, since it provides job security and high wages without requiring qualifications relevant to the private sector (The Arab World Competitiveness Review, 2010).

Gaps in education and skills mismatch are in part responsible for the high unemployment among educated people in the region. Deficiencies in terms of skills are also a significant impediment to enhancing productivity in businesses. Firms appear to be slow in assimilating technology absorbed through trade and FDI . The share of R&D in GDP in many economies in the MENA region also lags behind the world's average.

Chart 12: R&D (in % of GDP)

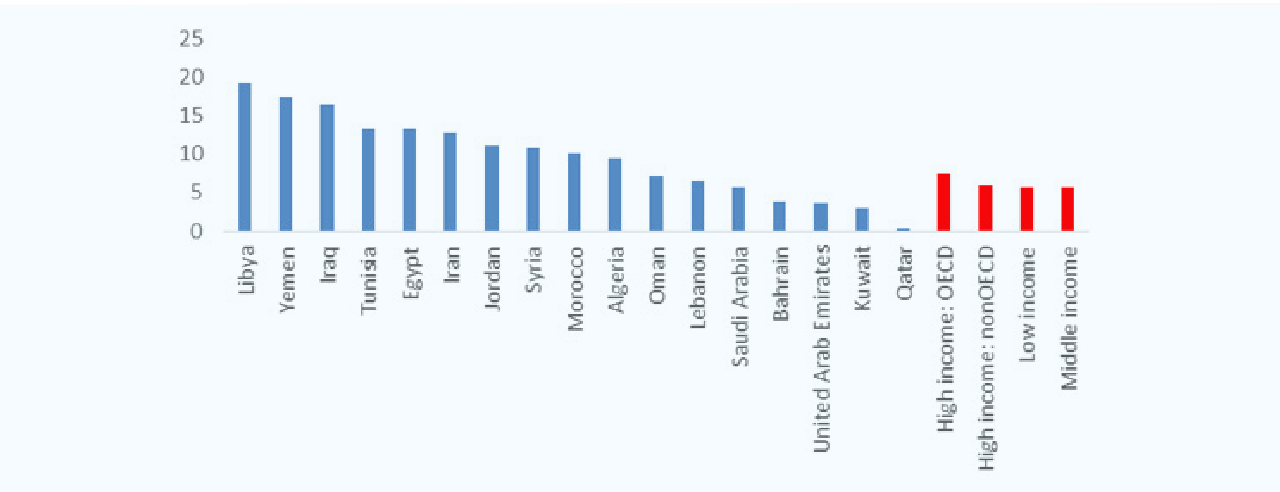


Source: WDI Database

2.4. Job Market

Slow pace of structural transformation combined with inadequate build-up of human capital, have contributed to a dearth of job opportunities to absorb the growing number of young workers. The business cycle has not helped in recent years, but unemployment is above all a structural phenomenon. Except for the GCC countries that use oil rents to sustain massive employment in public sector, unemployment rates in the other MENA countries are significantly higher than the levels prevailing on average in low, middle, and even high-income countries. It is important to stress that long-term unemployment accounts for a large part of unemployed population. The latest estimations from the ILO show that the proportion of long-term unemployment reaches 45% of total unemployment in Tunisia, 64% in Morocco and 88% in Egypt. Moreover, populations that are most concerned by unemployment in MENA region are youth and educated people. Among the potential factors often put forward to explain high unemployment in many countries in the region, rigidity of job market is probably the most cited. However, while this explanation helps account for the failure to employ graduates in formal settings, the problem of unemployment clearly goes deeper, given the presence of large scale informality in MENA countries. Whether simply allowing for more labor market flexibility in the formal sector, without engaging in more fundamental reforms, would improve job opportunities or would create more insecurity and political instability that worsen the investment climate, remains an open question. and a dilemma that policy-makers have to confront.

Chart 13: Unemployment rate (%)



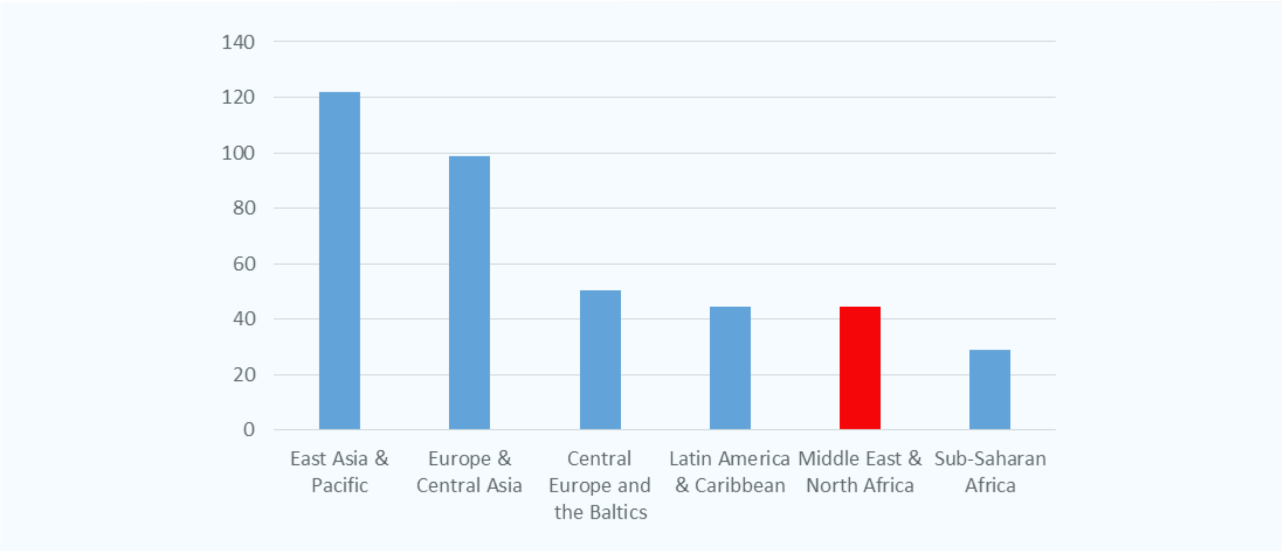
Source : WDI Database

2.5. Financial development

The banking sector in MENA countries is often based on a simple supply model mostly with basic products. Domestic banks are also not sufficiently integrated to international markets, given the non-convertibility of domestic currencies and capital account restrictions. Over the last two decades, most of the MENA countries, at different degrees, initiated various reforms to liberalize and further develop their financial sectors by improving the regulatory framework, enhancing transparency, enlarging access to banking services, privatizing public banks in some countries in the region and via a progressive adhesion to Basel rules. Yet, the majority of MENA countries need to substantially improve the efficiency of their financial sector and the access to credit of all but large enterprises and the public sector.

The financial sector in the MENA region is bank-dominated, while other forms of finance – fixed-income and equity financing –are on average relatively less exploited, in particular for SMEs. The dominance of family-owned businesses generally avoiding dilution of their decision power contributes to this trend. However, bank credit remains insufficient. The ratio of domestic bank credit of the private sector to GDP in MENA region in 2014, is about 44%, a level that is much lower than those observed in East Asia and Pacific (122%) and Europe and central Asia (99%).

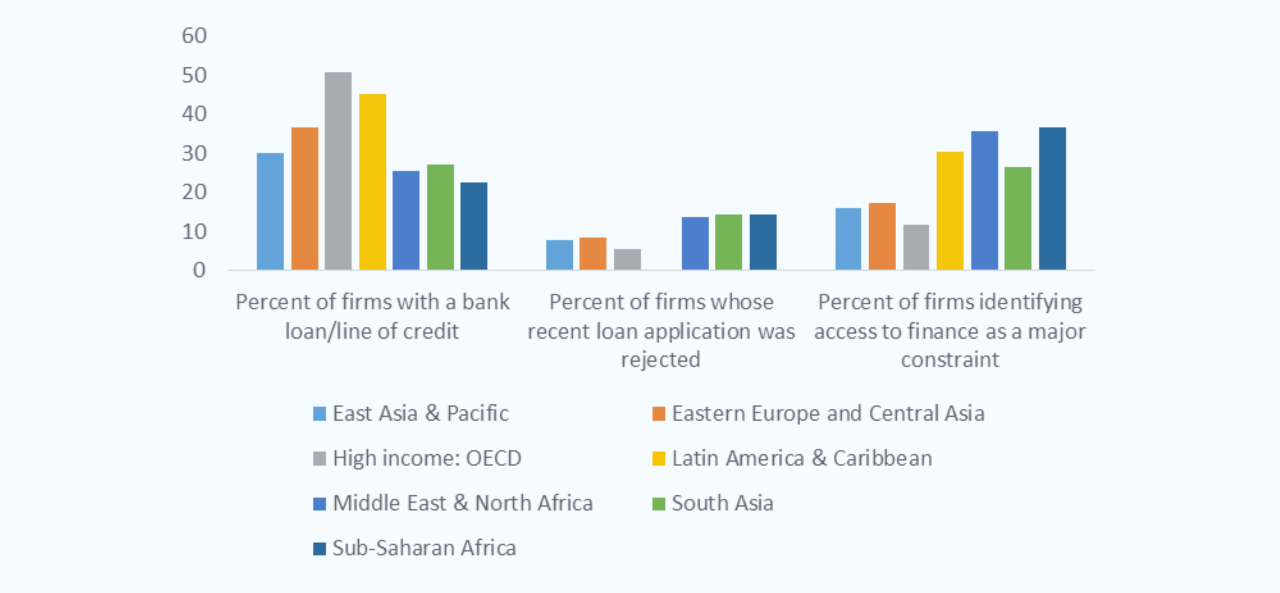
Chart 14: Domestic credit to private sector by banks (% of GDP)



Source: WDI database

Access of firms to bank financing is a serious problem in most of developing countries but the situation is worse in MENA countries. According to the World Bank Enterprise Survey, the percentage of firms having a bank loan in the MENA region is one of the weakest in the World (25%). Only sub-Saharan Africa has a lower percentage. In addition, and by referring to the same source, the proportion of firms identifying access to finance as a major constraint in MENA region (36%) is higher than all regions except sub-Saharan Africa (37%)—while this percentage is only 16% in East Asia and Pacific, 17% in Eastern Europe and Central Asia and 26% in South Asia. The MENA banking sector appears to be more risk averse in particular when it comes to granting credit to SMEs. These are considered as riskier and having insufficient collateral or, in the case of innovative SME, too intangible an asset base to guarantee accessing to loans. Private banks are unable to compensate for the slow but progressive decline of state-owned banks in the region. Paradoxically, and according to Rocha et al. (2011), state banks in MENA region are taking greater risks than private banks in lending to SMEs, accepting a lower ratio of collateralized loans. However, this orientation of state-owned banks is pursued at the cost of a higher portion of non-performing loan problems in some countries.

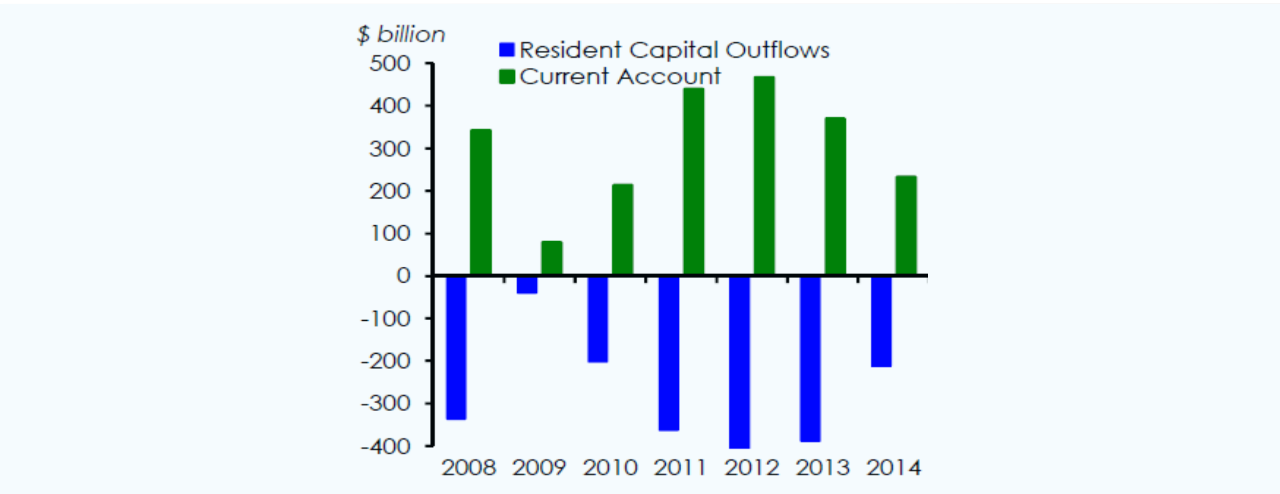
Chart 15: Access of firms to finance in the MENA region (% of total firms surveyed)



Source: World Bank Enterprise Surveys

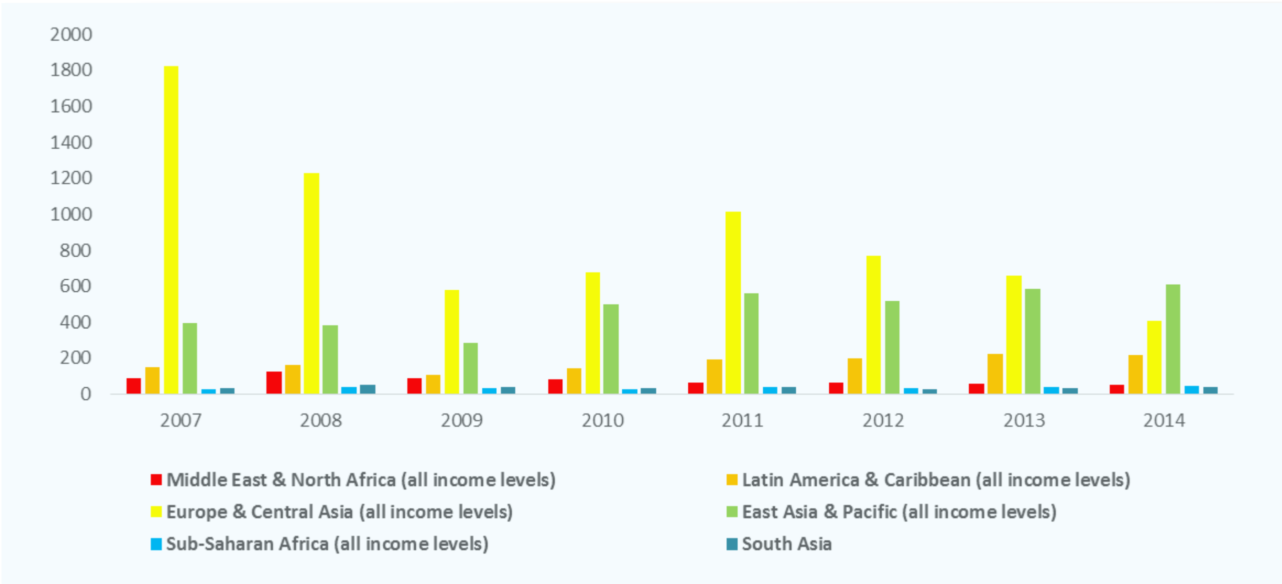
The integration of the MENA region in international financial markets is also both insufficient and lop-sided, mainly characterized by large outflows from the oil exporters. Most of the MENA oil-exporting countries were major exporters of capital until recently, as they witnessed increasing current account surpluses which have picked up to about $470 billon in 2012. However, the decline in oil prices since mid-2014, is eroding current account surpluses in these countries as the oil income is falling while domestic demand is still sustained. These developments could likely be reflected by less FDI and portfolio investment abroad, even towards some oil-importing MENA countries in the future. Besides that, political instability in many MENA countries, the slowdown in advanced economies, in particular in Europe, and in emerging countries like China as well as recent monetary policy orientation in the US, are considered as constraining elements that hinder MENA region's process in terms of integration to the international financial market. FDI Net inflows to the whole MENA region started to fall in 2009, while Portfolio inflows remain volatile. FDI inflows into the MENA region remain tiny compared to other middle-income regions.

Chart 16: Capital outflows of MENA oil exporters



Source : IIF

Chart 17: Foreign direct investment, net inflows (Billions US$)



Source: based on WDI database

II. EU-MENA Links and Synergies

Integration into the global economy is essential for rapid and sustained growth, and no channel of integration is more important than trade. However, the countries of the MENA region remain among those least integrated with each other through trade, and are also under-trading with their neighbor to the North—the world's largest trading block. Intraregional trade is just 10 percent in MENA, compared with one-quarter for ASEAN and two-thirds for the EU. These features, long preceding the Arab uprising and the spreading turmoil, persist despite numerous trade agreements among the Arab countries and between them and the European Union. To be sure, trade agreements can only provide a supporting role to international integration. Successful international integration depends vitally on the wider process of domestic reforms and trade agreements need to be not only ambitious in scope but also effectively implemented.

Unfortunately, these general conditions have been lacking in the MENA region, resulting in weak trade performance that has been extensively documented and analyzed[10]. Though the region has seen modestly increased integration with the rest of the world through trade and foreign investment, with integration contributing to the region's growth, outcomes have been disappointing in comparison to the most successful developing regions and, more importantly, have fallen short of those needed to provide the region's burgeoning young population with good jobs.

1. Stylized Facts on Trade

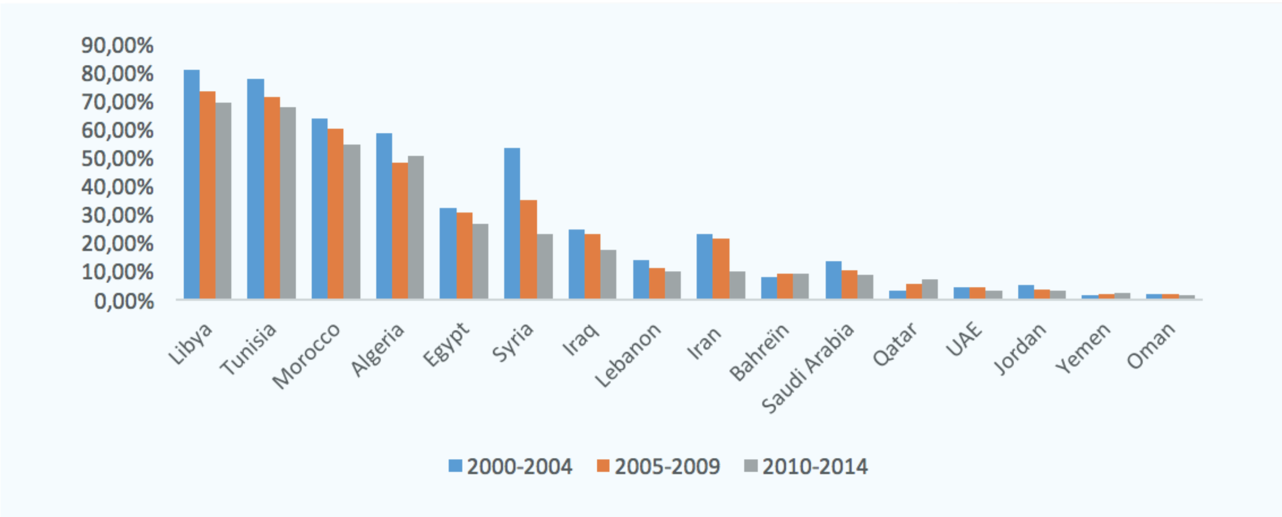
Research shows that the MENA region could be engaging in significantly more trade, both within the region and without. For example, using gravity models, which predict countries' trade flows as a function

10. Most recently in a comprehensive review by Chauffour (World Bank, 2013) and also by Rouiss and Tabor (World Bank, 2013).

of their economic size and distance, Ferragina et. al (2005) conclude that the volume of trade between the European Union (EU) and the MENA countries could be 3.5 to 4 times larger than it currently is. This is conditional on the two regions reaching the EU's level of integration. Intra-regional trade within MENA is also low relative to the gravity model predictions and worse than that in sub-Saharan Africa.[11] The latter finding has been recently questioned by Freund and Jaud (2015), who find that countries in the region may actually be over-trading with each other—mainly because they under-trade with the EU reflecting trade impediments between the two regions. Behar and Freund (2011) estimate that, overall, MENA under-traded by about 60-70 percent in the 2000s.

The EU is by far the most important trading partner of countries in North Africa. It attracts more than half of the exports of Algeria, Libya, Morocco and Tunisia, and accounts for a large share of Egypt's exports. Syria, Iraq and Lebanon are the countries of the Levant that export most to the euro-zone, with average shares around 10-20%. On the other hand, the Gulf oil exporters are increasingly oriented towards Asia, with less than 10% of their exports directed to the EU. The share of the EU in the exports of nearly all countries of the MENA region, whether exporters of energy or diversified exporters, has been steadily declining since 2000, mainly on account of the faster growth of Asia and the effects of the global financial crisis.

Chart 18: Shares of MENA region's exports to the EU (averages)



Source : UNCTAD-stat

Although the energy exports of the MENA region are mainly directed to Asia, mineral fuels and lubricants nevertheless dominate exports from the MENA region to the EU, representing 68% of the total in 2014. On the other hand, manufactures represent just 6% of the total, and agriculture 3%, the rest being petro-chemicals and other minerals. The largest exporters of oil, gas, LNG and other oil products to the EU are Algeria, Saudi Arabia, Libya Iraq, and the UAE, in that order. In 2014, the energy exports of these countries amounted to 101 billion $. With the resumption of oil exports from Iran following the lifting of sanctions, increased energy sufficiency in the United States, and the possibility of increased exports from Iraq and Libya should their internal conflicts abate, the sources of oil and gas and the orientation of exports are likely to shift significantly in coming years, in a way that is difficult to predict. Two things are likely however. First, the value of oil and (to a smaller degree) of gas exports has dropped precipitously

11. Behar & Freund (2011) The Trade Performance of the Middle East and North Africa, F.R.E.I.T Working paper 321 (forthcoming World Bank working paper); Behar, A. and P Manners (2010) "Distance to Markets and sub-Saharan African Exports", African Development Review.

with the decline in oil prices and will not return to anywhere near previous levels over the next several years. Second, the EU will remain heavily dependent on the MENA region for its energy imports, which currently account for nearly 40% of its consumption of oil and gas.

Indeed, though this feature is sometimes overlooked, energy trade is arguably the most important channel governing the economic interdependence of the two regions. For Algeria and Libya, which are large gas exporters, there are no short-term alternatives to this source of revenue, and vice versa, no comparatively cheap alternatives for the energy needs of Spain and Italy, their respective clients. Throughout most of Europe, natural gas provides the essential fuel for space heating and for electricity generation, increasingly replacing coal. Given the geopolitical uncertainties associated with Eastern Europe's large gas imports from Russia, ability to import gas from North Africa or potentially from Iraq via Turkey represents an important present and future pillar of Europe's energy security, especially if measures to integrate the continent's electricity grid continue to advance.

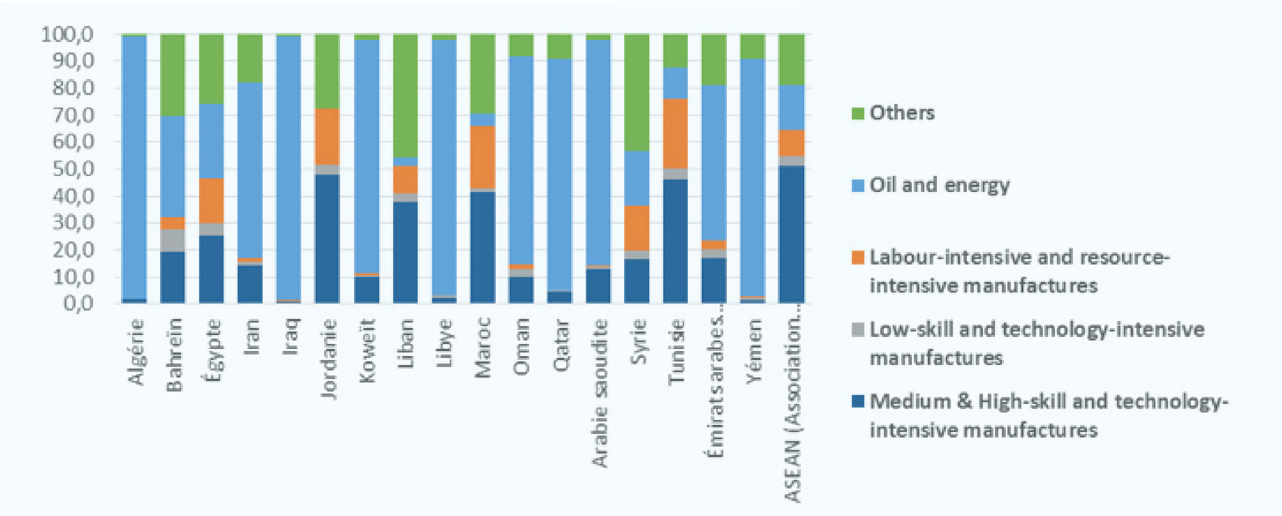
Europe and the MENA region also depend crucially on each other in the oil sphere. Whereas the MENA region holds most of the world's oil reserves, Europe accounts for some 15% of global oil consumption, and there is currently no comparably cheap substitute for oil in its transportation sector and industrial uses. However, since, unlike natural gas, the oil trade is global, the interdependence of Europe and the MENA region is mitigated to some degree by the ability of global markets to cushion supply and demand shocks. Still, Europe has a strong interest in avoiding oil supply disruptions that might result from internal or international conflicts in the Gulf or from conflicts surrounding the Suez Canal. Such oil shocks have, on at least three occasions in the last fifty years, been the harbinger of recessions and bouts of higher inflation, prompting understandable concerns about energy security.

The growing awareness of the risks posed by climate change and the determination to respond by encouraging development of clean and renewable sources of energy, notably wind and solar power, also contribute to raising the stakes on energy cooperation between the two regions. Countries such as Morocco and Libya, which have an abundance of sunshine and open space, have a comparative advantage as providers of solar power to Southern Europe. The welfare gains from these linkages could become even more evident in the future as the cost of providing solar power continues to decline and there is more progress in integrating the European electricity grid.

Compared to energy, the trade between the MENA region and Europe in manufactures and agricultural products, plays a relatively small role. Europe could exist without relying on this trade. However, oil and gas exporters such as Saudi Arabia and Algeria have a strong interest in diversifying their export base and creating more labor-intensive activities, while the MENA region's oil importers depend on their exports of manufactures, agriculture and services for their livelihood. Moreover, the MENA countries offer considerable opportunities for European firms to establish regional value chains, which can make them more competitive on a global scale. Although analysis of the complementarity of the export structures of the MENA countries with that of the import structure of the EU suggests that the complementarity is modest, reflecting a gradual process of diversification.

This process has been too slow, however, especially among oil exporters. Comparing MENA countries with ASEAN, the technology and skills content of exports is low. Two-thirds of MENA countries display export concentration significantly above predicted levels, given income (Diop, Marotta & de Melo, 2012)[12]. Only in oil importing countries, such as Jordan, Lebanon, Morocco and Tunisia, do they achieve shares near those of ASEAN (around 51%). This type of manufacture only accounts for 25% of total exports of Egypt. Oil exporting countries, as expected, are more concentrated on energy exports while the share of High/ Medium tech and skills manufactures is very low—particularly in Algeria, Iraq, Libya, and Yemen. Yet some GCC countries are doing better than others, as it is the case of UAE and Bahrain.

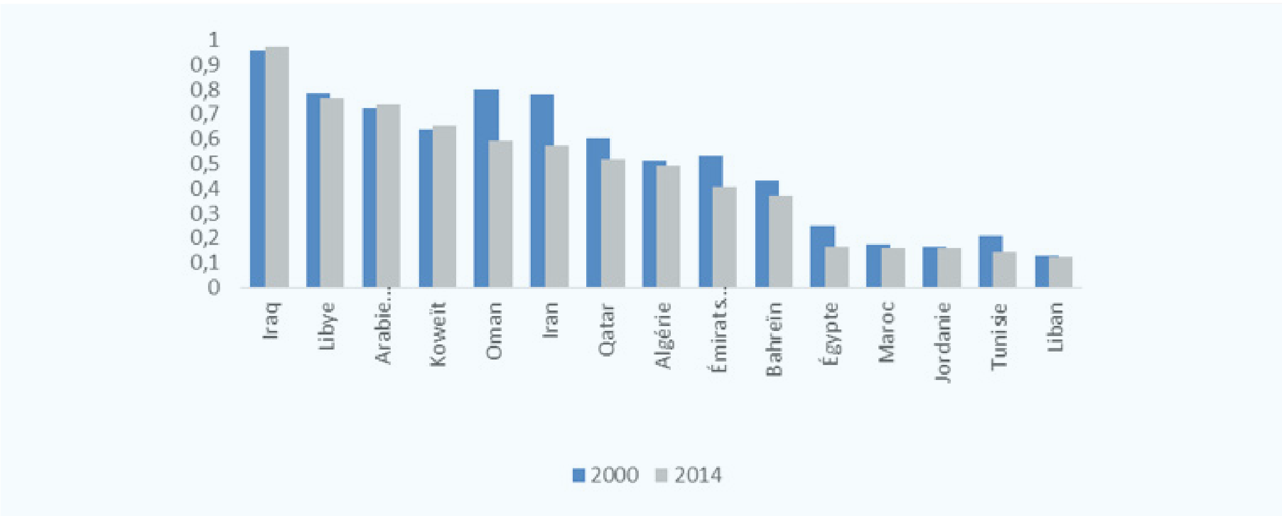
Chart 19: Skill and technology content of exports (in % of total exports)



Source: on the basis of UNCTAD database

More generally, MENA exports are less diversified. As measured by the Herfindahl-Hirschmann Index, there has been little change during the period 2000-2014 for many countries in the MENA region. Despite the fact that countries such as Oman, Iran and Qatar have made more progress on exports diversification than others, they remain highly concentrated.

Chart 20: Export concentration Index of selected MENA countries



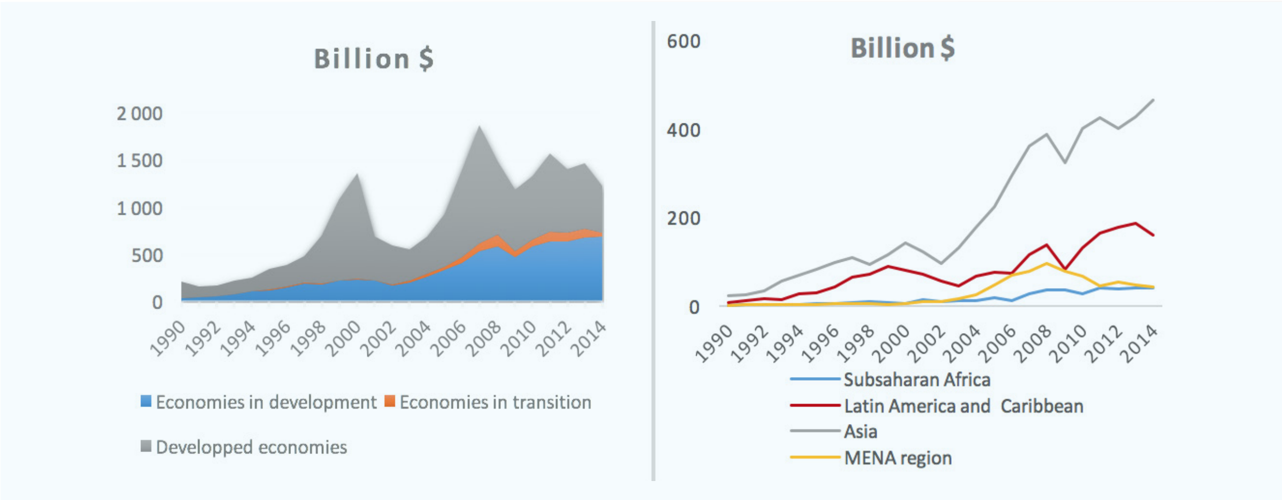
Source: UNCTAD

12. MENA trade agreement, World Bank.

2. Foreign Direct Investment

Global FDI has grown rapidly over the last quarter-century, reaching an estimated $1.7 trillion in 2015, the highest level since the global economic and financial crisis of 2008/2009. Strong growth in inflows was recorded in the European Union (EU) as well as in the United States. In developing countries, inflows of FDI reached $741 billion in 2015. Developing Asia remained the largest FDI recipient, accounting for one third of global FDI inflows. In Africa and Latin America, flows have stagnated recently reflecting the sharp drop in the prices of their main commodity exports.

Chart 21: Evolution of FDI inflows



Source: UNCTAD

A number of studies have examined the impact of FDI on economy and have recognized its role as a factor for growth, through the creation of positive externalities such as accumulation of physical capital, transfer of technology, and job creation.Scatter diagrams give an indication of the association between inward FDI stocks, GDP, and trade. The diagrams, based on a panel data from 17 MENA coutnries[13], reprensented by the dots, between **1980** and **2014**, point to positive relationship between FDI stocks, economic growth (Chart 22) and trade (Chart 23). In fact, both graphs show a positive growing trend line (red line) through time, leading us to this conclusion.

13. Algerie, Bahrain, Egypt, Iran, Iraq, Jordan, Kuwait, Lebanon, Libya, Morocco, Oman, Qatar, Saudi Arabia, Syria, Saudi Arabia, Yemen.

Chart 23: Correlation between inward FDI stocks and GDP for countries of the MENA region between 1980 and 2014, in millions dollars

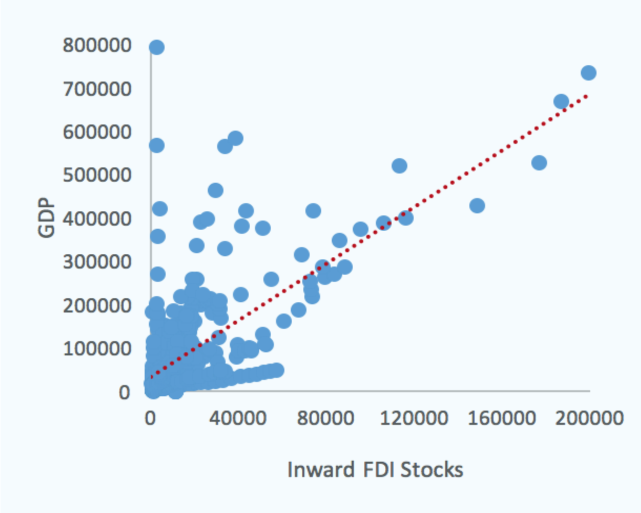
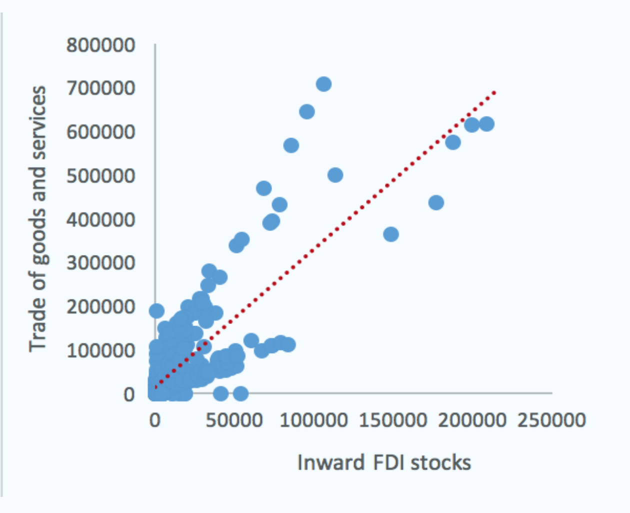


Chart 24: Chart 22: Correlation between inward FDI stocks and trade for countries of the MENA region between 1980 and 2014 in millions dollars



Source: Author's calculations

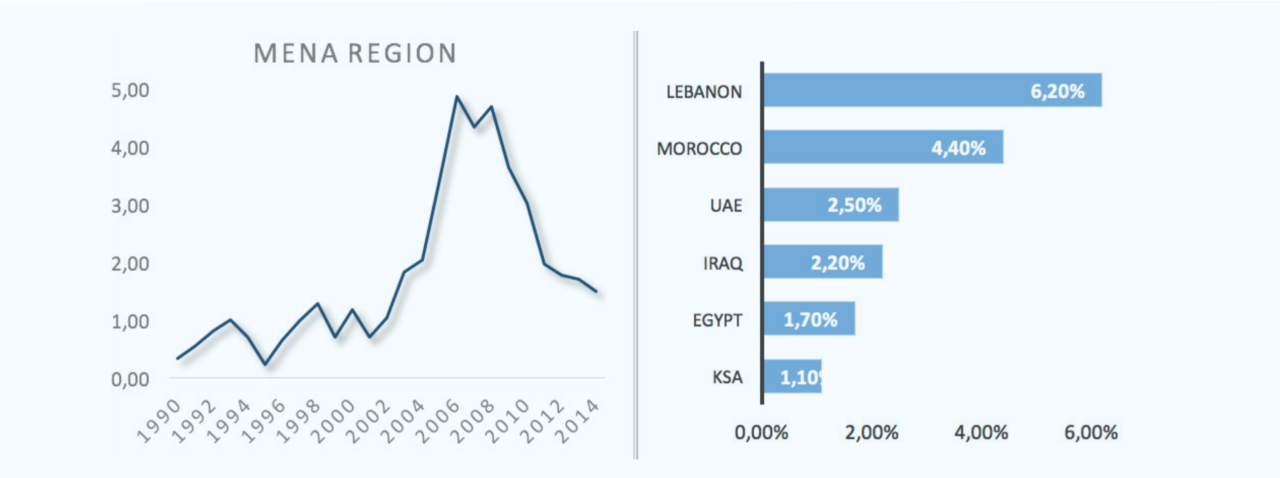
Still, according to numerous researchers, the MENA region did not fully exploit its potential in trade and FDI, helping to explain the low GDP growth rates (Sekkat, 2004). Lagging economic reforms in Egypt, Algeria and Iran on trade and liberalization of foreign exchange markets present a special deterrent to FDI. However, Tunisia, Morocco and Jordan have done better. In several MENA countries FDI has been deterred by inadequate physical infrastructures.

Not surprisingly, the MENA region attracts small amounts of FDI compared to other developing regions. However, it has seen a substantial increase of FDI flows since the 2000s, both in absolute terms and as a share of GDP, reaching a record level of $99 billion in 2008 compared to $5.6 billion in 2000. This trend was temporarily reversed in 2009, with the outbreak of the global financial crisis, and the subsequent outbreak of turmoil due to the Arab uprising. Still, countries such as Egypt, Jordan, Lebanon, Morocco and Qatar saw inflows increase recently. In 2014, FDI into Egypt and Morocco grew by 14 % and 9 % respectively. Relative to GDP, FDI inflows are highest in Lebanon, 6.2% of GDP, followed by Morocco and the UAE.

The distribution of FDI is very uneven across the MENA region. In 2014, over 70% of these flows are concentrated in 5 countries: the UAE, which accounted for 22% of inward FDI flows, followed by KSA, Egypt, Iraq and Morocco; while the lowest beneficiary countries include those in conflict, such as Libya, Syria and Yemen. The majority of FDI inflows have gone into petroleum-related activities—the case of Egypt, Libya and the GCC. In Morocco and Lebanon, FDI was mostly oriented toward the service and tourism sector (finance, catering, telecommunications and transport). Algeria has mostly attracted FDI in the construction sector and Tunisia in public services (electricity, gas and water). Little FDI has gone into the manufacturing sector, limiting the extent to which the region participates in global value chains. Recently, Morocco has shown to be one of the few exceptions to this trend in the region with investments in automobiles and aerospace.

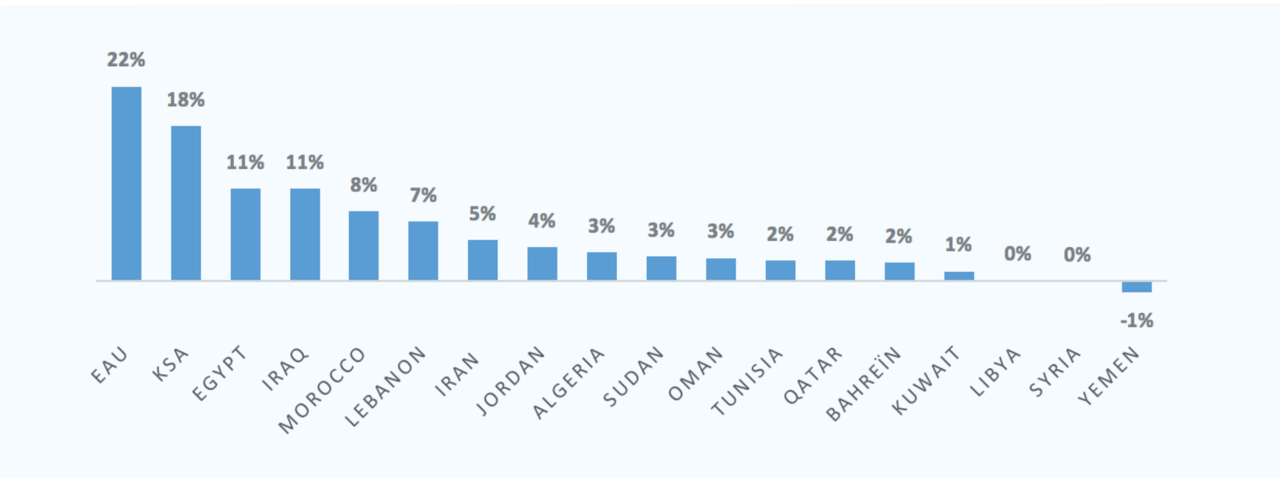
Chart 24: FDI inflow in the MENA region as a share of GDP

Percentage share between 1990 – 2014 *(b) Percentage shares in 2014*



Source:UNCTAD Source: World Investment Report 2015

Chart 25: Distribution of FDI among the countries of the MENA region in 2014, $ billion



Source: WDI-Database

The share of FDI stock issued from the EU reached $190 billion in 2012, representing nearly 26.6% of the total inward stock of FDI in the MENA region. Among the EU countries, the main holders of outward FDI stocks to the MENA region were Great Britain (22.1%), France (17.8%) and Italy (17.5%). The majority of stocks from the EU - an estimated 41.1%- benefited the Gulf countries, followed by North Africa (38.4%) and the Middle East countries outside the Gulf countries (20.4%).

In their quest to attract FDI, MENA countries have concluded 622 Bilateral Investment Treaties worldwide in 2010, nearly 22% of all the BITs concluded, which include 81 with other MENA economies (OECD, 2010). These agreements typically accord national treatment (non-discrimination) to foreign investors and also include dispute-settlement procedures. Much less frequently, they include market access, or rights of establishment of foreign investors in specific sectors. Market access by foreign investors, on the other hand, tends to be decided as part of autonomous reforms, rather than as part of international agreements. Even so, a significant number of BITs signed by MENA worldwide are not enforced because the internal constitutional procedures of ratification have not been fully conducted. In parallel with the increase of

BITs negotiations, MENA economies have concluded over 50 bilateral trade agreements containing FDI provision. The table below includes several existing bilateral investment-related agreements between the EU and the MENA economies.

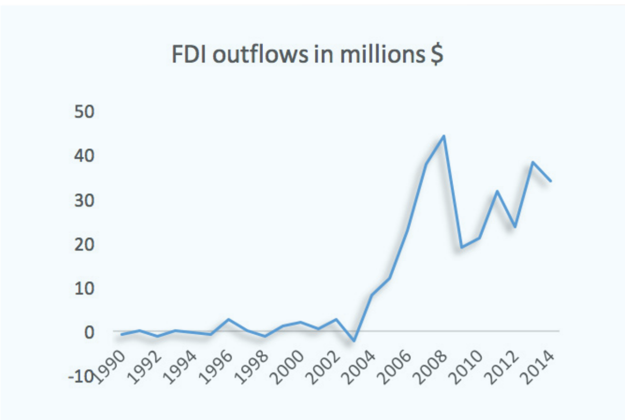
Table 2: Bilateral investment-related agreements (including EU) signed by MENA economies

Parties	Short Title	Date of Signature	Date of Entry into Force
EU – Iraq	EU – Iraq Cooperation Agreement	11/05/2012	-
EU – Lebanon	EC – Lebanon Association Agreement	17/06/2002	01/04/2006
EU – Algeria	EC – Algeria Association Agreement	22/04/2002	01/09/2005
EU – Egypt	EC – Egypt Association Agreement	25/06/2001	01/06/2004
EU – Yemen	EC – Yemen Association Agreement	25/11/1997	02/07/1998
EU – Jordan	EC – Jordan Association Agreement	24/11/1997	01/05/2002
EU – Morocco	EC – Morocco Association Agreement	26/02/1996	01/03/2000
EU – Tunisia	EC – Tunisia Association Agreement	17/07/1995	01/03/1998
EU – GCC (Gulf Cooperation countries)	EU – GCC Cooperation Agreement	15/06/1988	01/01/1990

Source: Unctad, Investment Policy hub

FDI outflows originate predominantly in the GCC countries, including Kuwait, Qatar, Saudi Arabia and the UAE. The UAE topped the list of greenfield projects, mainly in the real-estate sector, with 243 projects in 2014—well above other countries in the MENA region like Saudi Arabia (30 projects) and Qatar (23 projects)

Chart 26: FDI flows emitted by the MENA region (1990-2014) and ranking of the number of Greenfield projects issued in 2014:



Source: UNCTAD

Countries	Project numbers
United Arab Emirates	243
Saudi Arabia	30
Morocco	25
Qatar	23
Kuwait	11
Lebanon	11

Source: fDi Markets

3. Trade Agreements

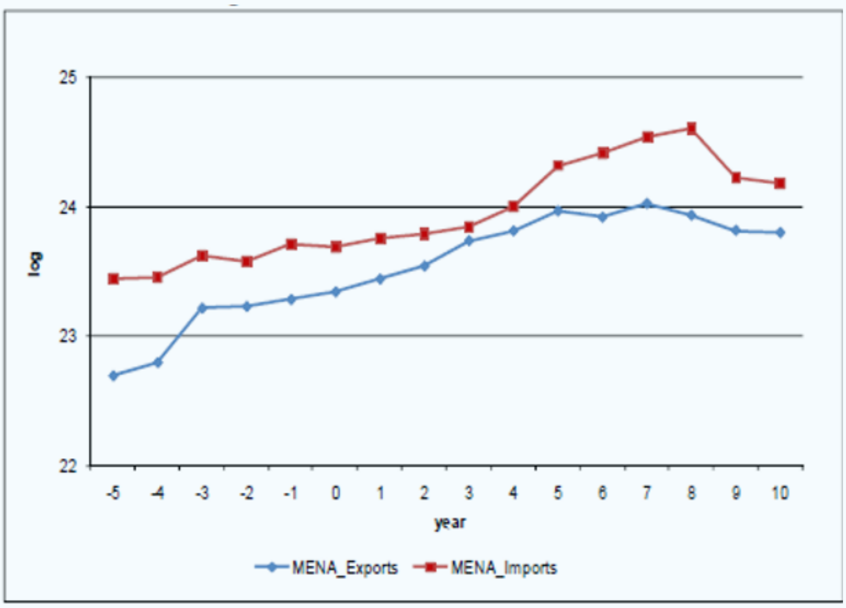
The trade agreements of Egypt, Jordan, Morocco and Tunisia with the EU, have largely failed to deliver on their promise. Though these agreements form part of a broader Mediterranean initiative to foster the region's integration (see table), they are widely recognized to be low-ambition, partial deals, failing to address some of the region's main impediments to successful integration.

Table 3: Euro-Mediterranean Association Agreements

Country	Agreement Signed	Entry into Force
Tunisia	Jul-95	Dec-97
Israel	Nov-95	Jun-00
Morocco	Feb-96	Mar-00
Jordan	Nov-97	May-02
Egypt	Jun-01	Jun-04
Algeria	Apr-02	Sep-05
Lebanon	Jun-02	Apr-06

In the rest of this section, we will focus on the trade record of Egypt, Jordan, Morocco and Tunisia; countries where the Arab Spring has triggered a process of rapid if uneven political transformation. We will refer to them as countries in transition, or CT for short. An examination of the CT's trade performance to 2007, preceding the global financial crisis and the Arab uprisings which made the trade picture very murky, shows that after their respective association agreements with the EU came into force, their exports to the EU accelerated only marginally (with the exception of Morocco).

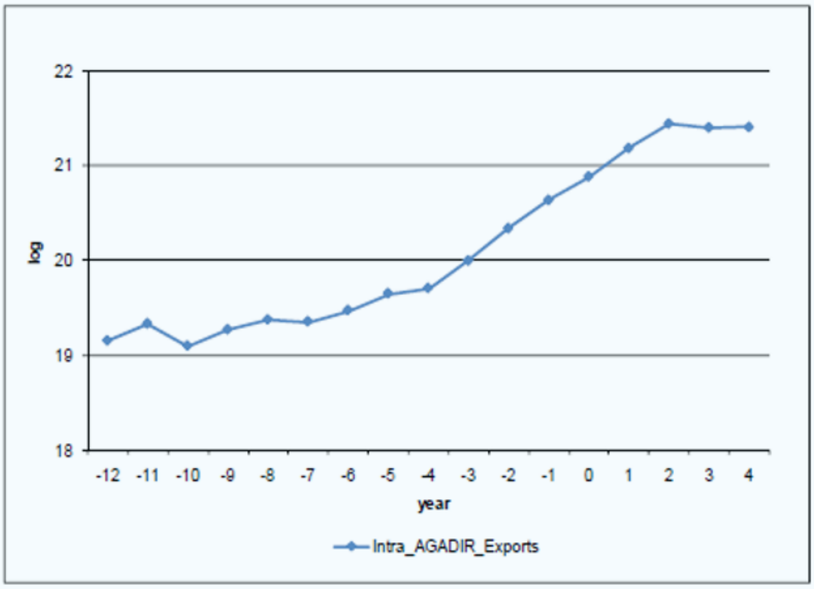
Chart 27: EU-MENA Preferential Trade



Year 1 is the first year of implementation of the preferential trade agreements.
MENA partners included in the figure are Tunisia, Morocco, Jordan, Lebanon, Egypt and Algeria.

Source: MENA working paper serie n°55, 2012

Chart 28: Trade among AGADIR Members



Year 1 is the first year of implementation of AGADIR.
AGADIR members included in the figure are Egypt, Jordan, Morocco and Tunisia

Source: MENA working paper serie n°55, 2012

Moreover, over 1997-2007, CTs' exports to the EU increased slightly less rapidly than those to the rest of the world. CTs' total exports and (especially) total imports also grew less rapidly than the developing country average. Moreover, Europe's Eastern partners—the largest recently-acceded EU countries ("accession countries") the Czech Republic, Poland, and Hungaryand those that have not acceded ("non-accession countries") and have no free trade agreement with the EU, Belarus, Moldova, and Ukraine — outpaced its Mediterranean partners in export growth over 1997-2007, by a wide margin. Furthermore, minerals, fuels, and lubricants accounted for the lion's share of CT export growth over the relevant period, mainly resulting from higher prices for Egypt's large exports of these products. In more recent years (2007-2014) there has been a deterioration in the export performance of CTs relative to the rest of the world and relative to the accession countries.

Although foreign direct investment (FDI) in the CT's increased significantly and grew more rapidly than that in most developing regions, they attracted much less FDI —both in absolute terms and as a share of GDP—than the EU accession economies. Over 1997 to 2007, FDI inflows to the MPs grew handsomely by over 40 percent on average annually and amounted to about $73 billion. However, over the same period FDI inflows to accession countries were more than 4 times that size and accounted for 6.7 percent of GDP—twice the GDP share of the MPs. Not surprisingly, in recent years, FDI has largely shunned the countries most affected by the uprisings.

Why have the results from trade agreements been so disappointing? Prior to the current set of EU-Med trade agreements, the CTs already had largely free access to European markets in manufactures, which account for the majority of their trade. They also enjoyed a small margin of preference vis-à-vis most other large exporters under GSP arrangements. Therefore, the impact of the agreements on CT exports to the EU was naturally small. In fact, the agreements' big trade liberalization measures were all on the CTs' side.

Moreover, a variety of impediments, including subsidies, quotas, reference prices, and seasonal barriers, continue to hobble exports in the areas where CTs have a clear comparative advantage, notably agriculture, while a schedule for moving toward free trade was set for manufacturing, in which the EU has a comparative advantage. According to the OECD, EU support to farmers accounted for 24 percent of gross farm receipts and around 50 percent of value added, on average, annually over 2007-2009. For the CTs, access to the EU is especially important in goods such as fruits, vegetables, and vegetable oil. The CT agricultural sector supports a significant part of GDP and an even larger share of employment. For example, in 2009, agriculture accounted for 14 percent of value-added in Egypt and 16 percent in Morocco. In addition, it accounted for 31 percent and 41 percent of employment respectively.

Restrictive rules of origin and limited accumulation further restrict the CTs' effective market access to the EU. Diagonal accumulation only exists across a subset of countries[14] and ROOs differ across some Euro-Med countries. The ROOs for Egypt are not the same as those for Tunisia and Morocco, for example. Adherence to specific and complex ROOs places a burden on exporters who may not be familiar with the specific rules and requirements. Studies suggest that the presence of restrictive ROOs account for the failure to utilize preferences.[15] For example, over 1996-2006, as much as 18 percent of Jordan's exports to the EU, which should have been duty-free, paid duties, possibly because of the high costs of obtaining certificates of origin.[16] If properly applied, the new Pan-European-Mediterranean ROO system, introduced in 2011, could help remedy some of these problems.

Another major shortcoming of the current EU-CT agreements is related to the temporary movement of workers (as distinct from permanent migration, which is covered in the next section). The EU-CT association agreements essentially reaffirm both groups' very general obligations under the WTO GATS, making no commitments on the number of skilled (or unskilled) workers allowed to work temporarily in the EU. The agreements with Morocco and Tunisia include commitments on non-discrimination with respect to working conditions and social security for their nationals legally working in the EU. Those with Algeria and Jordan contain somewhat more liberal provisions, including limited movement of intra-corporate transferees or key personnel within one organization.[17]

The aid flows associated with the EU trade agreements with the CTs are tiny compared to the needs and to what became available to accession countries, as are the mutual reform commitments. For example, the Czech accession agreements provides for incorporation into the EU's Common Agricultural Policy, giving Czech producers subsidies comparable to farmers in existing members and making agricultural exports into the EU free but conditioning production by a system of quotas or by various reference prices. Other regulations include, allocation of structural funds amounting to €26.7 billion (18 percent of 2010 GDP) over 2007-2013, adoption of the EU rule book (acquis communotaire) in behind-the-border reforms (including the adoption of community-wide standards), adoption of the lower EU common external tariff, formally unrestricted access to service producers (subject to domestic regulations), freedom of investment and general movement of capital, and the free movement of people.

14. The agreement with Maghreb countries allowed limited cumulation. Diagonal cumulation refers to the use of inputs from other member countries toward the value-added target.
15. UNCTAD (2004), Trade Preferences for LDCs: An early Assessment of Benefits and possible Improvements: www.unctad.org/Templates/webflyer.asp?docid=4293&intItemID=1397&lang=1&mode=toc
16. Ayadi, Rym et. Al (2009)
17. "Key Personnel" defined as persons working in a senior position within an organization" or "persons working within an organization who possess uncommon knowledge essential to the establishment's service."

It is also worth noting that the EU agreements are less far-reaching than the corresponding US agreements. For example, the U.S.-Morocco FTA covers all agricultural products and the United States has committed to phase out all agricultural tariffs. Although schedules differ by product, all tariffs will be phased out over fifteen years. Intra-regional trade has, overall, performed worse relative to benchmarks than extra-regional trade. Non-tariff barriers remain big obstacles. Most tariffs in the region have been removed under the two major preferential agreements in the region–the Pan-Arab Free Trade Area (PAFTA), which came into force in 1998 and allowed duty free access to its 17 member countries' markets; and the Agadir agreement, between four countries, which came into force in 2007. Nevertheless, red tape, poor logistics, lack of transparency, and complicated customs clearance continue to hamper regional trade.[18] For example, the region's exporters occasionally have to obtain special import permits to relieve themselves of preferences that should be automatic under trade agreements.[19]

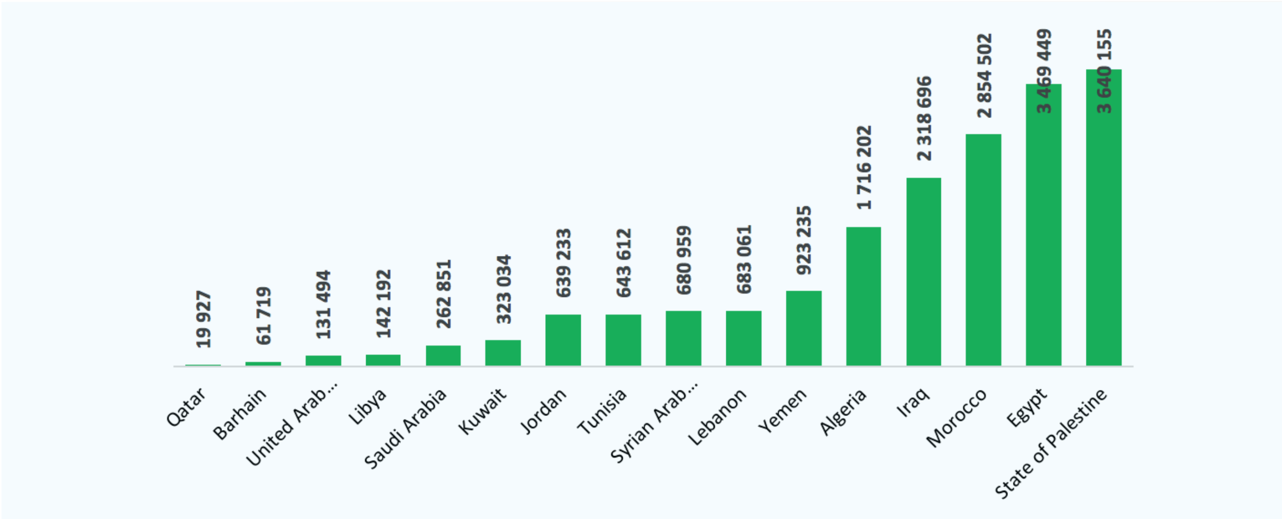
4. Migration Flows

In 2013, at least 18 million people born in the Middle East and North Africa resided outside their country of origin, representing 4.4% of the population of that region—a larger proportion than the world average, which is near 3%. The vast majority of MENA's migrants reside in Europe, especially in France, Italy, and Spain, followed by a large contingent in the oil-rich MENA countries, and a relatively small group in the United States, the largest destination country for migrants. Though the estimates vary, this number has increased sharply in 2014 and 2015 with the ongoing outflow of refugees from Syria, Iraq, and Libya, to neighboring countries and to Europe. According to UN statistics, over 2011-2015, four MENA countries—Syria, Morocco, Libya and Egypt, in that order—were among the world's 20 largest emigration countries, while all five of the EU's largest economies were among the 20 largest immigration countries. Among these groups, Syria saw a cumulative exodus of 1.5 million people, and the UK and Italy saw a cumulative inflow of 900,000 people.

In 2013, the largest number of migrants in absolute terms, with well over a million, originated in Palestine, Egypt, Morocco, Iraq, and Algeria in that order. At the time of writing, migration from Syria – traditionally not a country of large emigration—has probably overtaken that of Algeria.

18. Zarrouk, Jamal Eddine (2003): A survey of Barriers to Trade and Investment in Arab Countries, in Galal, Ahmad, Hoekman, Bernard (Eds.): Arab Economic Integration between Hope and Reality, Washington 2003, p. 48 - 60.
19. Sadi, Salam (2011), Potential Effects of the World Economic Crisis on the MENA's Foreign Trade and Regional Economic Integration, Institute of Economics, University of Erlangen-Nurnberg.

Chart 29: Distribution of the diaspora in the MENA region



Source: United Nation Development Program (UNPD), 2013

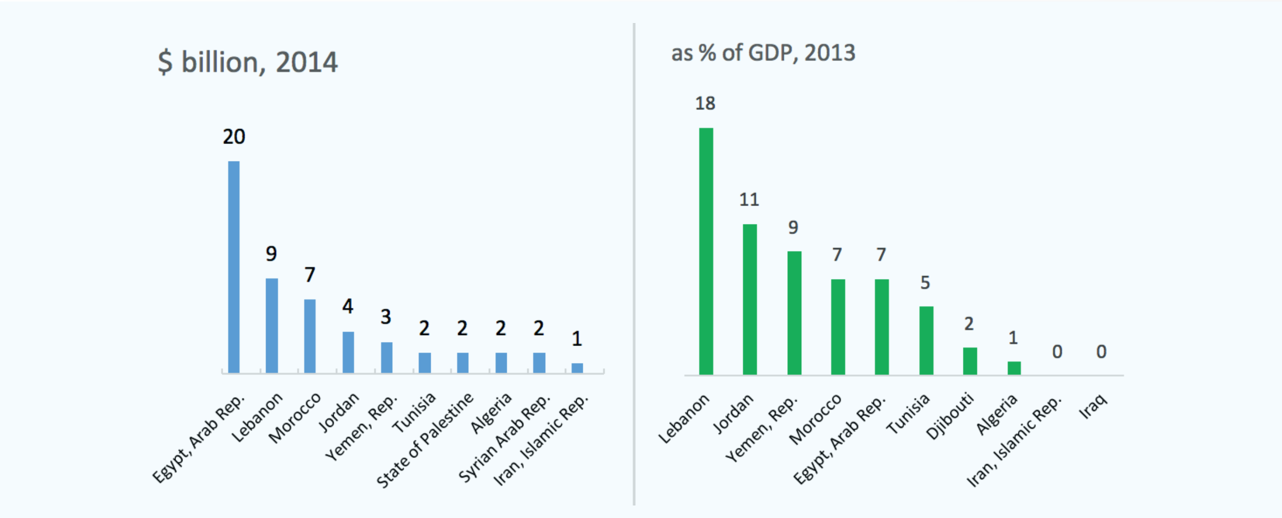
Though the oil-rich Gulf countries attract migrants from the rest of the MENA region, few people originating in the Gulf migrate.

Migrants and the much larger associated diasporas (which includes children and relatives residing abroad who were not born in the country of origin of their parents but retain links with it) are all the more important as vehicle for international integration in the MENA region, in light of the region's relatively low integration through the trade channel. At a time when the productivity gap between advanced and low-income economies is in the range of 20 to 1, and between advanced and middle-income economies around 5 to 1, the diaspora can significantly facilitate the process.

In examining the impact of Diasporas, the spotlight has naturally been placed on migrant remittances ($436 billion in 2014 according to the World Bank), given their importance as source of foreign exchange in developing countries and sustenance for tens of millions of poor families (see figure 2 and 3). In 2014, it is estimated that the 18 million migrants from the MENA region sent home some $53 billion of remittances and that countries such as Lebanon and Jordan had remittances in excess of 10% of GDP (see figure 2)—well in excess of what those countries spend on education, health care, and defense combined. For Morocco, a country with a much larger population than Lebanon and Jordan, it accounts for 7% of GDP[20], an amount comparable to its foreign currency earnings from exporting manufactures.

20. World Development Indicators Database, World Bank.

Chart 30: Top recipients of remittances



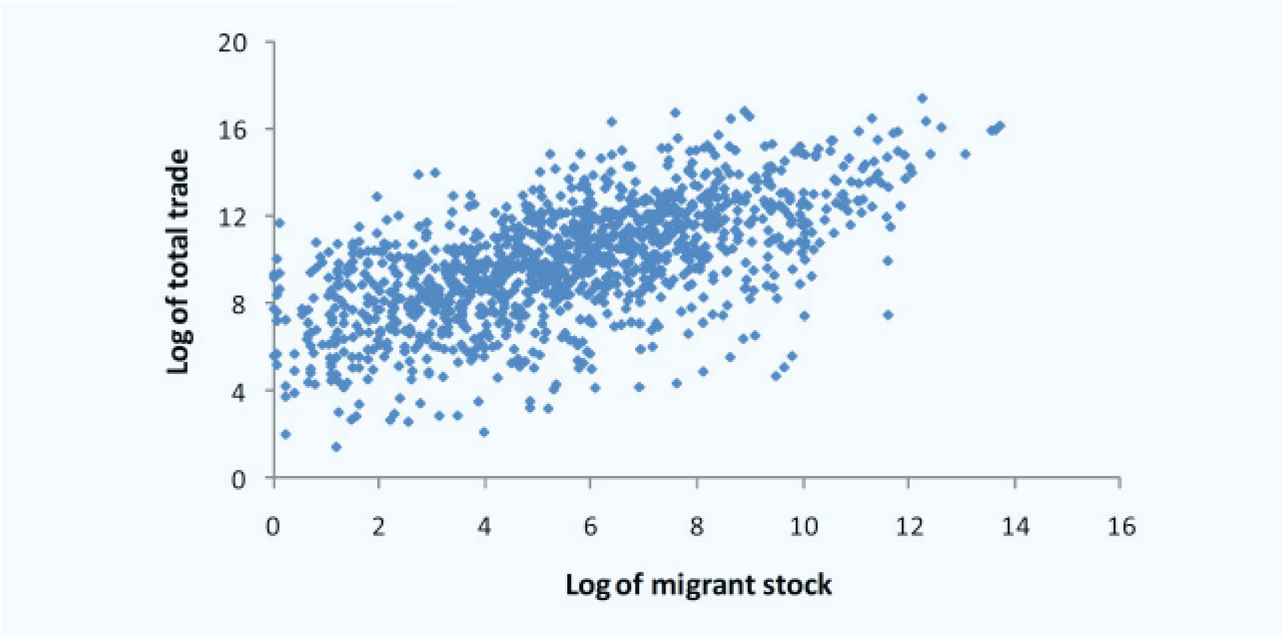
Source: World Bank (2014), "Migration and Development Brief 23", October 2014

However, important as they are, remittances constitute far too narrow a prism through which to view the effect of diaspora on development and poverty alleviation.[21] Compared to a country that has a small and disconnected diaspora, a country tightly interacting with its large diaspora can rely on their help when times at home are hard. Personal remittances, for example, tend to be a stable source of foreign exchange, sometimes rising in times of crisis. Moreover, a country with close links to its diaspora may also experience a multiplier effect in the form of increased trade and investment links when its reforms succeed.

The recent and growing literature on the diaspora provides considerable evidence that it plays an important role in international integration. One study shows that a large diaspora is significantly associated with a higher intensity of bilateral trade between the country of origin and destination (see chart 31) (World Bank, 2012). It also shows that the effect is much more pronounced in the case of trade in heterogeneous or differentiated products than in homogenous products such as primary commodities (Rauch and Trindade, 2002).

21. Dadush (2016)

Chart 31: Migration and Trade go hand in hand: African and OECD countries



Source: Data on the stocks of migrants are taken from the Bilateral Migration Matrix 2010 (World Bank 2011). The trade data are for 2007 from the World Integrated Trade Solution. Note: Bilateral trade (2007) and migrant population (2010) between OECD and Africa. Each dot represents a migrant corridor (Kenya-UK, Morocco-France, etc.)

This suggests that links to the diaspora can help overcome the information asymmetries and non-tariff barriers that are known to play a large role in inhibiting trade. Along similar lines, diasporas are found to be significantly associated with the intensity of international investment flows, especially with bilateral FDI flows rather than with (more homogenous and less information intensive) portfolio flows (Leblang, 2010).

Systematic empirical studies of links between trade, investment and diasporas are supported by numerous anecdotes or case studies. The most cited example is the development of the Indian IT industry, now employing some 3.5 million and representing a large share of India's exports. This industry mainly relied on the two-way flow of talent, money, ideas and contacts, between Bangalore and the Indian diaspora in Silicon Valley as well as other technology corridors in the United States. Moroccans residing in the United States represent only a small minority of the Moroccan diaspora but they account for 25% of patents filed by Moroccans abroad. However, perhaps the most important diaspora links in terms of their effect on international trade come from China, with its large expatriate communities throughout East Asia, the United States, and increasingly Africa (Rauch and Trindade, 2002). Hong Kong and Singapore, with their large concentrations of overseas Chinese, are the largest sources of FDI into China.

In the specific context of the MENA region, a crucial benefit of migration is that it provides a crucial exit route for the region's large number of young unemployed[22]. In fact, the most prevalent motive for migration is economic—as distinct from forced migration resulting from political upheaval or persecution –which, however, has prevailed in the region in recent years.

22. A large diaspora is not an unalloyed benefit for the country of origin, however. Reliance on remittances can increase the exposure to external shocks emanating from sharp recessions in the country of destination, and for countries most at risk of brain drain (typically small and poor island economies) a large diaspora can facilitate the emigration of a country's best and brightest.

Despite the political controversy surrounding migration from poor to rich countries, numerous studies of the economic effects of migration to conclude that it can generate large benefits. Many of these studies are based on detailed examination of instances of mass migration (such as the Cuban exodus to Miami, the return of settlers from colonies after their independence), while others consist of statistical analyses of the effect of migration on native wages over long periods. Migration has also been studied using models that simulate the way the economy adjusts to a large increase in the immigrant labor force, and through models that calculate the contribution of migrants to tax revenues and how much they draw on welfare benefits and on public services. These studies do not always agree on everything, but most agree on the following: immigration from low-income to high-income countries boosts investment and output in the host country, more so if the investment climate in the host country is good and the population is aging. Immigration tends to raise the wages of skilled workers and to reduce the costs of many services, such as those of caregivers and household help, freeing more natives to work. However, immigrants also tend to depress the wages of those who compete directly with them, which usually in high-income countries are themselves previous immigrants.

These studies also generally concur that immigrants have a small positive impact on the government budget, mainly because they are younger than the native population and so pay more in taxes and use less public services, especially healthcare. Migrants draw less on pensions and many pay into social security but leave without collecting benefits. Studies have also concluded that migrants tend to boost productivity because they are readier to move to remote localities to find work. Other studies find that migrants can function as shock absorbers for the native labor force, as they are the first to be fired in a downturn.

It is understood that these beneficial effects of migration depend on whether migrants are allowed to work and are not inhibited by extremes of racism and discrimination. In the United States, which has a long tradition of immigration, the children of migrants generally do as well or better than the children of natives from the same socio-economic extraction. In contrast, the children of immigrants to Germany and France, and even their children, do less well than natives of the same socio-economic extraction.

5. The Special Case of Refugees

The flow of refugees from Syria and Iraq (and more recently, Libya) is a human catastrophe of the first order—the cause of the uprooting of millions of families and of journeys that have led to thousands of deaths. It has become a politically divisive issue across the Levant and Europe. Because the conflicts are endemic, and families have been divided and need to be reunited, the displacement flows are unlikely to abate soon. Certainly, there is no imminent possibility of migrants returning to their homes in the vast majority of cases.

Though much of the international press commentary is focused on the islands of Lampedusa and Lesbos and on the state of Bavaria, which are carrying a disproportionate burden, the greater challenges lie elsewhere. In general, refugees represent only a small minority of the migrant inflow into advanced countries, and a minuscule share of their population. It is in the Northern regions of Jordan, the Beqaa valley in Lebanon, Kurdistan in Northern Iraq, and in the Turkey-Syria region where the crisis is far more evident. These regions, which have per capita incomes about 1/5 of the European average, are overwhelmed by refugees and, in the case of Kurdistan, internally displaced from the rest of Iraq. According to Frontex, in the first 9 months of 2015, 710,000 refugees have crossed into the EU, representing less than 0.2% of the population. Italy a country of 60 million has seen the arrival of 129,000 refugees, of whom many have found their way to Northern Europe. By contrast, Lebanon, a country of some 5 million, is host to some 1.2 million Syrian refugees. Syria itself counts some 8 million internally displaced people and Iraq 3 million. It is estimated that 360,000 Libyans have fled their homes. [23]

Similar, though less dire, situations exist in a number of other localities across the Levant and North Africa. The migrants are placing enormous pressure on all forms of government services and infrastructure, from schools to health, water to electricity, and solid waste disposal. The World Bank has assessed the new infrastructure needs to run into several billion dollars, concluding that the vast majority of refugees are poor and, without help, vulnerable to starvation and infectious disease. UN agencies, which support migrants directly through cash transfers or by providing services in refugee camps, have seen increased funding but nowhere near enough to deal with the inflow.Thus, they are having to cut aid to families. In most of the impoverished regions where the migrants have settled, it is not realistic to speak of a local, long-term development solution to the refugee problem. The solution must lie in their gradual assimilation in cities near-by or far, most likely in other countries where economic opportunities exist. Whether refugees end up returning to their homes or settling in another country will make a big difference in long-term economic losses and gains from the migrant crisis.

Though economic studies of migration from poor to rich countries suggest that large welfare gains are possible, the gains to be had from migration between countries of similar income levels, such as between Syria and Jordan, for example, are much less evident. After all, moving a worker from a low productivity region to another low productivity region is unlikely – other things equal – to increase global output. Few studies have looked specifically at the gains from South-South migration (see for example Ratha and Shaw, 2007), and they conclude that the gains are smaller across the board than those from South-North migration. The migrants themselves may gain little if not lose. Their remittance flow is likely to be small and native workers in the host country may see large downward pressure on their wages, especially if the inflow consists mainly of unskilled workers who speak the same language, as in the case of Syrian refugees in Jordan. While the overall economic effects of forced migration form one poor country to another are almost certainly negative, there may be some modest partial benefits. Even in a poor region, inflows of migrants can boost output and investment, and raise the return to capital and entrepreneurship. Moreover, once the situation stabilizes and some return to their country of origin, opportunities from trade and reconstruction are likely to materialize. Even these modest positive effects may fail to materialize, however, if the large inflow of refugees causes the country of destination to see rising ethnic tensions and political instability.

III. Policy Implications

1. MENA countries

The structural transformation process is going at a different pace in the MENA countries. MENA countries with large domestic markets should not excessively rely on exports, but should instead pursue a balanced model including domestic demand. This will reduce vulnerability to external shocks, to which countries in the region are especially prone. .

23. A fuller treatment of the refugee crisis can be found in Dadush (2016)

MENA countries must intensify efforts to work harder to move up the value chain and diversify further towards medium and high technology, manufacture skills, and modern services. Besides, diversification should also be implemented in geographical terms by multiplying trade partners, which could enhance resilience to external and asymmetric shocks as well as excessive reliance on European markets.

The transformation towards high productivity sectors with higher technological content could have some negative effects on large parts of the population during the transition, many of whom still rely on agriculture. Where the resources are available, and to mitigate the risk of more instability, it may be appropriate for the governments to enhance social safety nets for the disadvantaged populations.

Improving the business environment is necessary to strengthen the role of the private sector. Among other steps, this means fighting corruption and rent-seeking, enhancing investors' protection, and ensuring better access to credit, in particular for SMEs. Many countries in the The MENA region has already initiated some reforms to facilitate the access to funding for SMEs, mainly through specialized Guarantee Funds. Much more has to be done, including the development of alternative sources of funding, whether through venture capital or business angel networks, that are more adapted to small innovative projects.
Public investments in infrastructure should increase and should target telecommunications and transport logistics. There may be opportunities to attract more FDI through the creation of ready-to-use and integrated industrial zones or platforms. To invest more efficiently and to contain the effects on under strain government budgets, countries should promote Public-Private Partnerships.

Countries should favor those foreign investments likely to have a large impact on employment and that generate large spillovers onto domestic firms.

Promoting education in terms of quality and compatibility with job market requirements is a vital issue. Sciences, technology, and languages are among the most important aspects to focus on. In addition, vocational training should be further developed to facilitate the access to the job market. It is important to recall that improving skills could guarantee better assimilation of technology and know-how. Besides, public and private sectors should collaborate more in terms of identifying R&D areas of common interest but also in terms of research funding.

Finally, maintaining sustainable macroeconomic balances while preserving the capacity to engage in counter-cyclical policies is critical. Oil-exporting countries currently have to run their reserves down to deal with the effects of lower oil prices. But, in the medium term, they must rebuild sovereign funds that can be used as a diversification and stabilization tool.

2. Europe

European economies need t target investments in advanced infrastructure, R&D and innovation—central pillars of long-term growth strategy. The focus would be to further upgrade production systems in Europe and to improve non-price competitiveness and productivity. It is even more important, for the most advanced EU-members that are already established at the technological frontier, to accelerate growth based on a knowledge-based economy. Enhancing non-price competitiveness of European countries would also mitigate the sensitivity of their exports' performance to cost components and would be more consistent with higher wages. To improve innovation and productivity, enhancing government incentives of R&D projects, including by embarking on public private partnerships could be helpful. The regulatory framework should be better balanced between risk-appetite, which encourages innovation, and precaution, whivh preserves the public's interests. That means that European countries should adopt a neutral approach based on rigorous scientific assessment in order to decide wether each innovation sould be undertaken or not. Europe also needs to further develop alternative sources of funding that are more adapted to innovative projects (such as venture capital), making them able to support the translation of research outcoumes into marketable products and services.

3. Trade

What would it take to engineer a step forward in the integration of EU-MENA trade and of intra-regional integration in MENA? Three aspects appear especially important:

- *Autonomous Reforms*: As the historical record amply illustrates, successful international integration cannot be driven externally – it can only be achieved if it is grounded in a predictable political and economic context and driven by a wide-ranging process of domestic reforms designed to enhance the nation's productivity and competitiveness. At the heart of these reforms are the four Cs: Confidence, since, first and foremost, investors look for rule of law, security, macro-economic and political stability; Connectivity with the world, which includes opening the trade regime as well as good logistics and communications; Capacity, which includes investing in skills; and Cost, which includes maintaining a realistic exchange rate and effective regulations.

- *Ambition*: Trade agreements can provide a secondary but important supporting role to the domestic reform process, provided they are ambitious in scope. Trade agreements that only make changes at the margin achieve, by definition, little directly and provide no political leverage for the reform-minded to push the development agenda. Trade agreements must therefore address the real barriers to integration facing the MENA region – agricultural subsidies and tariffs, enforceability of provisions against non-tariff barriers, restrictive rules of origin, draconian restraints to labor mobility, financing of transport infrastructure, the modernization of customs, and so on. The largely successful EU treaties of accession go well beyond what can be envisaged for the MENA countries in the political dimension, but they also show what is possible in the economic sphere– including, for example, the benefits of a customs union, the free movement of capital and labor, and of real disciplines to drive institutional reform, as well as the importance of structural funds which can amount to 3-4% of GDP a year.

Global Reach: The EU's geographical proximity and historical and economic ties to the Arab world give it a special role in the region. The United States also has a long-standing interest in the region's security and its energy resources. However, the interests of other oil importers, such as Japan, China, and India also loom large and those of China – the world's largest exporter--have been advancing at a rapid pace. The Gulf countries also have a vital stake in the stability of their Arab neighbors. African countries with burgeoning populations and large natural resources provide significant market opportunities. Potential partners in trade, investment and development for the CTs exist beyond Europt. Therefore, trade policies in the CTs must recognize that closer links with the EU and with each other must be used to leverage reciprocal liberalization with the rest of the world, and should not come at the cost of restricting competition and access of goods originating in the rest of the world.

4. FDI

Short-term FDI prospects for the MENA region are subject to many risks as a result of armed conflicts and political and social tensions in a number of countries, as well as modest global and regional growth prospects and low oil prices. Despite those risks, countries such as Morocco, Egypt, and the United Arab Emirates are likely to attract rising amounts of FDI in coming years

New structural reforms should be implemented to promote diversification, greater openness and competition in key economic sectors and well-functioning labor markets. A transparent regulatory and legal framework is also important to attract FDI, as is investing in the logistics and communications infrastructure.Deepening intra-regional economic integration would increase the region's attractiveness to foreign investors and an integrated region would expand the size of the market. In addition, the diversification of FDI into high growth/high value added sectors is especially important.

5. Migration

Countries should make more effort in strengthening their links to diasporas. This tends to boost trade, foreign investment and remittances.

Forced migration flows which are mismanaged, as is is the case now, create large negative externalities for the surrounding region and even for the world. There is no perfect scheme for allocating the burden due to the absence of political solutions to conflicts. Any scheme must envisage increased numbers of refugees settling in the North, redoubled efforts to integrate refugees in their country of asylum, and increased development aid for the countries in the South with the largest numbers of refugees. Such a scheme is more likely to materialize if it is based on voluntary – rather than compulsory – targets to welcome refugees and provide aid, and if a new comprehensive framework for dealing with refugees is adopted.

Conclusion

This paper has argued that both the European and MENA countries have disappointed their citizens in recent years. The resulting crisis took very different forms in different countries, ranging from isolationism, deterioration in the business climate, to revolution and open conflict, but is palpable across the region. The failure to exploit the potential growth synergies in the EU-MENA space is only one reason for the weak outcomes. Domestic reforms that address these problems represent the more important agenda, but much remains to be done in the quest of common solutions too.

Both regions are confronted with important structural issues impeding their growth. But, while Europe is contemplating future shortage of workers, short of demand, and short of renewable and non-renewable energy, the MENA region contemplates one of high and rising youth unemployment, unsatisfied needs, and abundant energy supplies. The exchange opportunities between the two regions are immense and can be exploited in various ways – through trade, foreign investment, migration, and transfers of know-how. Exploiting these opportunities requires the elaboration of more effective frameworks for cooperation, ranging from deeper and more comprehensive trade agreements to security treaties. More important still are the domestic reforms that will boost each region's growth prospects and make their exchange even more valuable.

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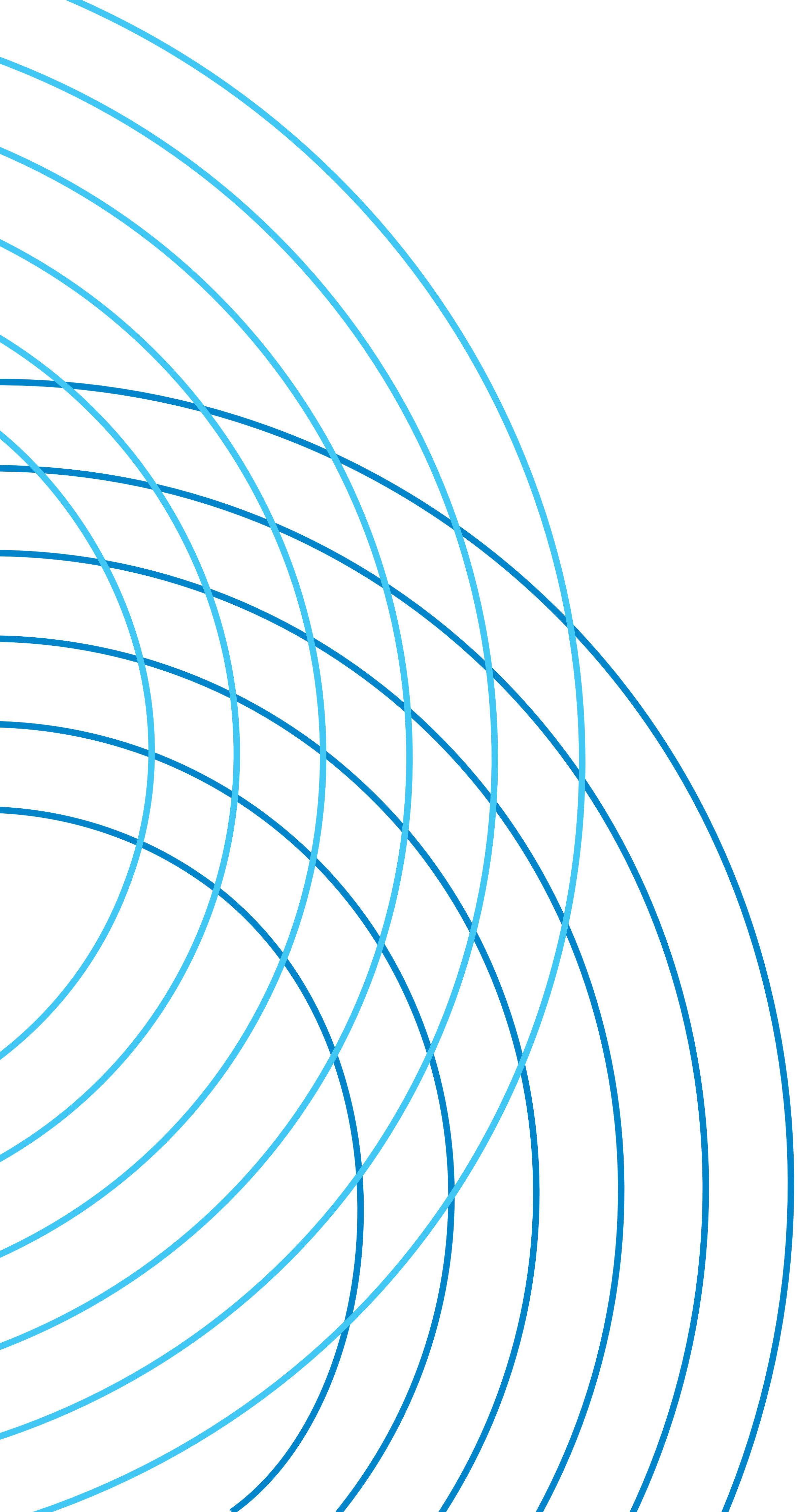

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