CEPS POLICY BRIEF

Policy Lessons for Macroeconomic and Financial Crisis Management in the Southern and Eastern Mediterranean

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The 2007-09 global financial crisis led to a virtual collapse in economic activity and increased financial volatility worldwide. For the developing countries, the main channel of transmission has been a drop in external transactions, such as trade, financial and capital flows, and remittances. The southern and eastern Mediterranean countries (SEMC)[1] have also faced declining economic activity, although there seems to be considerable variation in the relative magnitudes and timing of the decline. Most of the economies in the Mediterranean basin have had delayed but longer-lasting consequences as a result of the crisis, driven mostly by their endemic trade and investment ties with the EU[2] and the Gulf Cooperation Council (GCC) countries.

Further to the potential effects of the global financial crisis, the Arab uprisings erupting in 2011 in several of the countries in the region and the resulting political instabilities have added to the socio-economic and financial woes of these countries. The simultaneity and partial causality of the global financial crisis and the Arab uprisings make it especially challenging to disentangle the effects of one from the other.

This Policy Brief therefore tries to draw policy lessons from the combination of the global financial crisis and the Arab uprisings focusing on the domains related to fiscal, monetary and financial policies. It does so by answering the following questions: What has been the impact of the crisis and the uprisings on the fiscal, monetary and financial policies of the SEMCs? What have been the crisis management actions? And what policy lessons can be drawn for crisis management in the future? And how can the EU contribute to this within the Euro-Med Partnership? The

[1] This report analyses 11 countries in the southern and eastern Mediterranean, namely Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, Palestine, Syria, Tunisia and Turkey.

[2] The European Mediterranean countries (e.g. France, Italy and Spain) are among the main exporting partners of almost all 11 SEMCs, except four of the eastern countries. Israel, Turkey and Palestine export relatively more products to some Western European countries and the United Kingdom, whereas Jordan has no strong export relations with any of the EU member states.

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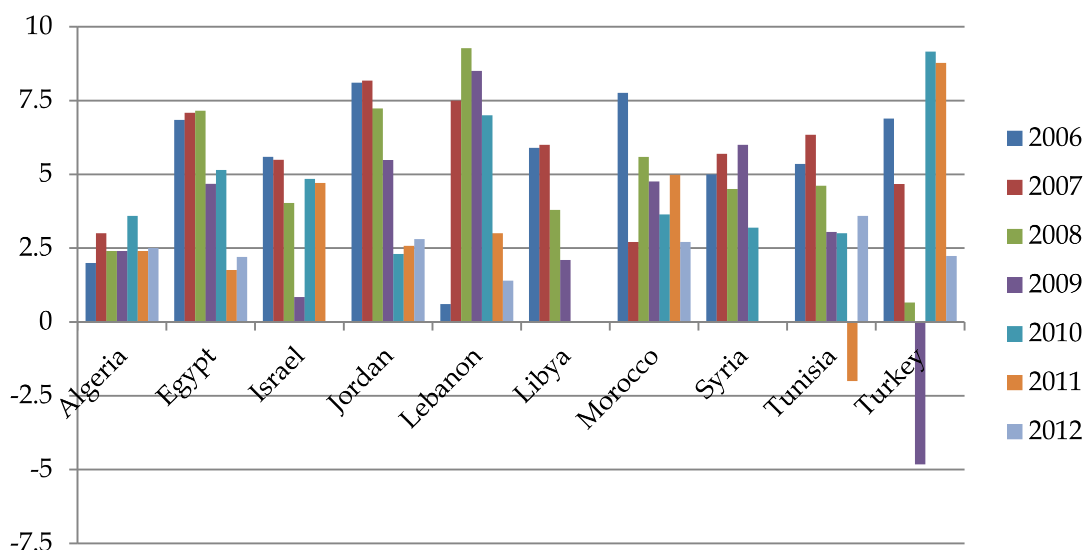
analysis builds on the work of Ayadi (2013), which provides a comprehensive assessment on the macroeconomic and financial impacts of the global financial crisis and the Arab uprisings on SEMCs, paying special attention to the fiscal, monetary and financial policy measures to respond to the negative effects of the crises.

1. Crisis transmission channels

The impact of the 2007-09 global financial crisis on the economies in the Mediterranean basin has been relatively limited and delayed. Real GDP growth had been increasing in most of the SEMCs countries in the years just prior to the crisis, as shown in Figure 1. In the first two years of the crisis, the growth levelled off in the SEMCs, except for Israel and Turkey. In fact, these two Eastern Mediterranean economies are relatively more open and have stronger ties with the US, Western European countries and the United Kingdom, which were among the first that suffered from the global financial crisis. And thereafter, from 2009 onwards until recently, economic growth has started to decline, but remained positive in most SEMCs. Hence, as shown in Figure 1, Turkey recorded a negative real GDP growth in the midst of the crisis and the Tunisian economy stalled in 2011, when the Arab uprisings kicked off.

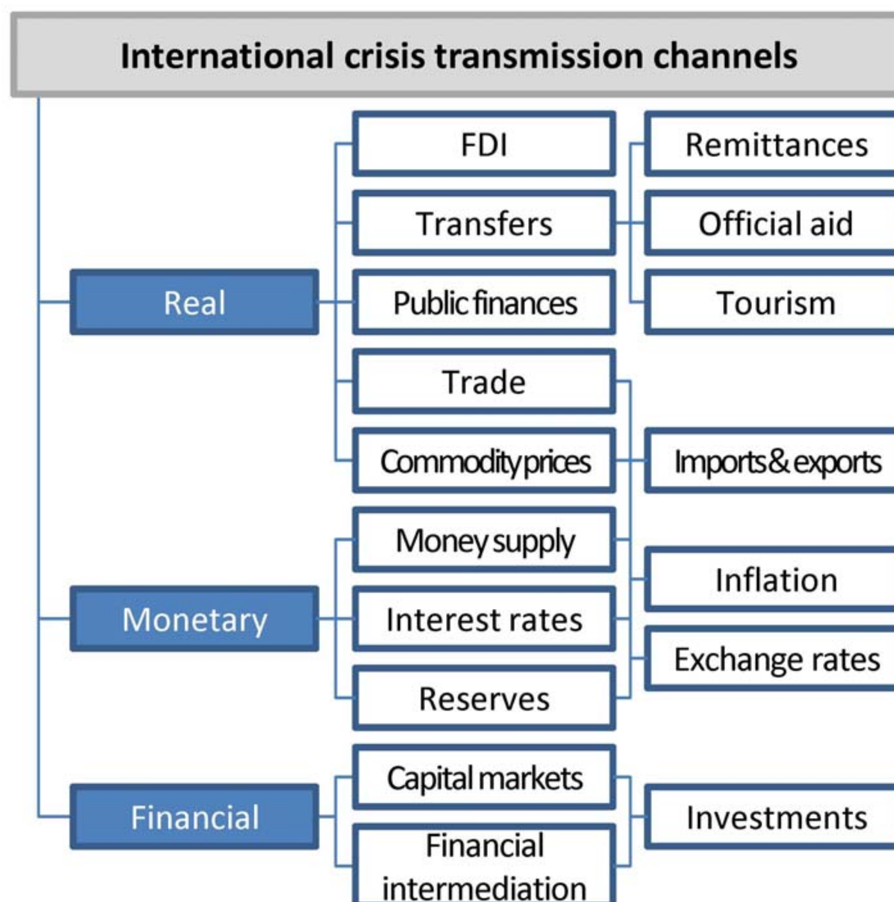
Figure 1. Real GDP growth rates in selected SEMCs, 2006-12



Source: World Bank WDI (2013).

The global financial crisis has also had an impact on the other SEMCs. To disentangle the various ways through which the global financial crisis can impact the SEMCs, we have devised a framework for tracing international crisis transmission channels (see Figure 2). These channels have been grouped into three broad categories: real transmission channels (i.e. trade, foreign direct investment – FDI, transfers, public finances, trade and commodity prices), monetary transmission channels (i.e. money supply, target interest rates and reserves) and financial transmission channels (i.e. capital markets and financial intermediation).

Figure 2. Framework for international crisis transmission channels



Source: Authors' own elaboration.

1.1 *Real transmission channel*

The analyses in Chapter 2 of Ayadi (2013) show that both the majority of the positive and negative spill-over effects of the global financial crisis have been transmitted through the real channels. The economies of the SEMCs suffered lower net foreign direct investments (FDI) flows and declining exports, while the impact on transfers, public finances and commodity prices has been more ambiguous.

The net FDI flows of the emerging SEMCs declined in 2009 on average by a third. Moreover, the countries that experienced intense uprisings suffered a second sharp decline. Hence, FDI declined in both Egypt and Tunisia by 1-2% of GDP in 2011, possibly much more in Libya. The exports in the SEMCs have also declined significantly in 2009. Their foreign trade was unable to resist the adverse impact of the drop in demand in the EU, the US and Asia.

Remittances have also declined in 2009, but not so much and with significant variations across countries. In turn, the region's tourism industry has benefited from the world's travellers switching from higher-cost to more modestly priced destinations. Proactive policies oriented towards stimulating tourism demand have been useful as well. However, in 2011 due to political instability, tourism in Egypt and Syria collapsed, and in Tunisia the sector's receipts declined by 40%.

Moreover, the impact in changes of commodity prices on the SEMCs is complex. Despite a short, sharp fall in prices around the middle of the crisis in September 2008, they have rebound since 2007. Yet almost all SEMCs are net importers of food and energy commodities and thus suffer from rising prices. Countries with large oil exports, i.e. Algeria and Libya, are the only exception.

SEMCs have many fiscal challenges concerning deficits, debt reduction and the maintenance of fiscal discipline. However, most countries in the region face some specific fiscal issues, such as relatively high public debt, dependence on some form of aid and financial concession, exposure to fluctuations in hydrocarbon prices, high defence expenditures and weak tax bases. Fiscal consolidation efforts could be a major part of the institutional reforms that might be affected by the global economic crisis and therefore postponed for a few years. The costs of external debt for emerging countries on international financial markets started to increase in July 2007, but it was not until October 2008 that the spreads started rising sharply. Credit ratings began to worsen starting in 2011 with numerous predictable downgrades for Libya, Tunisia and Egypt, which also negatively affected their neighbouring countries' outlooks.

1.2 Monetary transmission channel

Monetary stimulus in the region was quite uniform. During 2008, inflation moved into double digits in several countries linked to the increases in commodity prices. Hence, 25% increase of inflation in SEMCs between December 2005 and December 2007 was caused by international food prices – more than twice the level for the next affected region. The authorities undertook measures to offset the most adverse effects on the poor. These measures included increased subsidies, measures to boost incomes through higher civil service wages, and finally an increase in interest rates in a number of countries to counter the inflationary impulse. The Central Bank of Egypt, for example, increased the key policy rates by 275 basis points between February and September 2008. The short sharp fall in commodity prices thereafter has lessened the concerns over inflationary pressures, which was reinforced by GDP growth below potential. The lower inflation created space for monetary easing. However, in 2011, inflationary pressures started building up again against the background of rising commodity prices.

Interest rates have remained relatively low, both internationally and in the SEMCs since the crisis, which is the result of the easy monetary policy applied in order to stimulate the world economies. Reductions in policy rates have generally been more cautious and to a large extent dictated by exchange rate considerations, because most SEMCs are targeting a steady nominal exchange rate.

In general, the levels of official reserves remained stable during 2009 and similar to pre-crisis levels, but they fell slightly in certain countries in 2010-12 (e.g. Egypt, Jordan, Morocco, Syria and Tunisia). The situation even became critical in Egypt in 2012 with the central bank attempting to prevent the Egyptian pound from depreciating, and allowing the level of official reserves in the country to fall under the internationally acceptable threshold of 3 months worth of imports. More recently, through the help of Libya, Qatar and later Saudi Arabia and the United Arab Emirates, the Egyptian official reserves improved slightly, but they still stand at only $15 billion, which isn't really sufficient and leaves little room for central bank manoeuvres.

1.3 Financial transmission channels

Most of the SEMCs were spared the negative impact experienced elsewhere from the crisis on their banking and capitals markets during the initial phase between

2007 and 2008. Banks in the region had little direct exposure to the toxic products that weakened the balance sheets of many banks in the US or the EU and were relatively well-capitalised before entering the crisis. However, some vulnerability in certain banking sectors was revealed in countries that were more integrated in the global financial markets, such as Turkey and Israel. Capital-market contagion effects were equally very limited in the SEMCs (again with some exceptions for Israel and Turkey), confirming the low level of interconnectedness between these and global financial markets.

Hence, no major financial institutions in the SEMCs failed in the immediate aftermath of the crisis. In addition, credit growth has remained positive, in line with the subdued decrease in output. The region's mainly bank-based financial systems were well-capitalised and avoided significant exposure to US subprime or other structured securities. Moreover, reinforcing confidence, Jordan instituted a guarantee on bank deposits, while Egypt reiterated an existing implicit guarantee and in 2009 even announced plans to launch an explicit deposit insurance fund scheme.

Portfolio investments have generally decelerated too, reflecting the slump in the global stock market and in the Middle Eastern bourses, as discussed below. As of 2013, they still remain lower than in other developing and emerging markets. The SEMCs followed this general trend, and the decline in stock prices is visible both in the Figure 3. The concrete policy recommendations are explained in greater detail in what follows.

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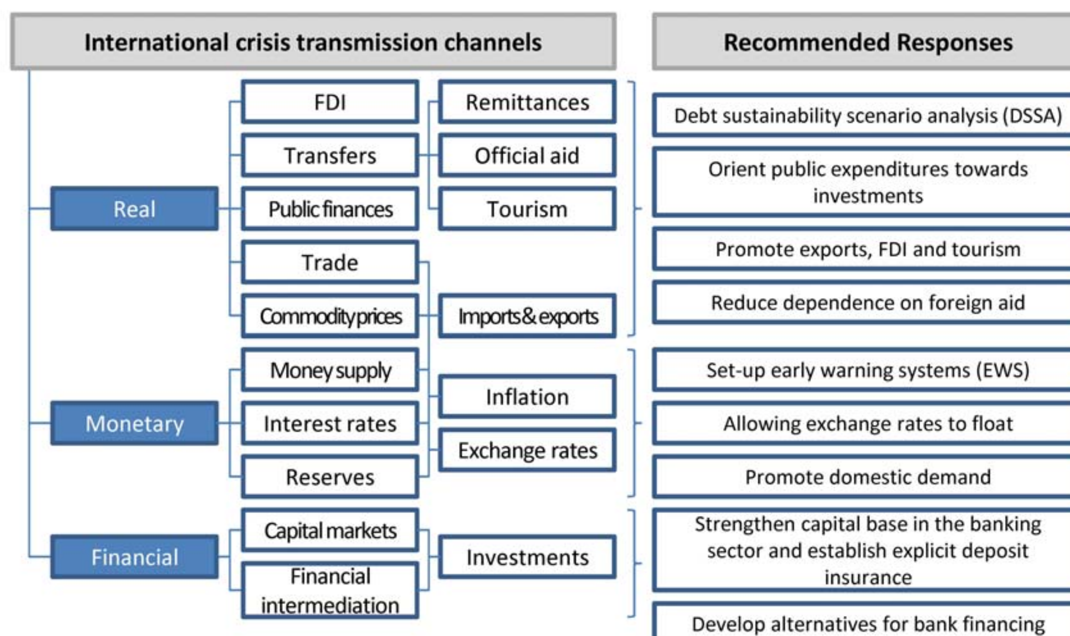
main index performance and in the overall market capitalisation. Since March 2009, SEMCs' financial markets have begun to turn around with partial recovery after the large drop in the major stock market indices. Markets in the region have generally outperformed the MSCI Emerging Market Index, except for Egypt and Morocco in 2010 and 2011.

Much like their peers elsewhere, the economies in the region have implemented various initiatives to respond to the crises and control the negative impacts. To a large extent, fiscal and unconventional monetary measures have been the preferred choice, owing partly to the limited policy space for manoeuvre that the authorities have in these countries. While these policies appear to have been successful, they have also put additional strain on existing and future fiscal and monetary pressures. The following section looks at the impact of the global financial crisis and the region's policy responses.

2. Lessons in crisis management

Knowing the channels through which the 2007-11 global financial crisis impacted the SEMCs and the responses to it from governments and national monetary authorities, this section draws some lessons for effective crisis management in the future. The main policy responses have been summarised and linked to the three broad groups of transmission channels in

Figure 3. Recommended policy responses by transmission channel



Source: Authors' own elaboration.

Notwithstanding the fact that the global financial crisis was an exogenous shock to the SEMCs, Ayadi (2013) also confirm that while the economic slowdown has been modest, most of the SEMCs are likely to experience a slow recovery. Limited external financing, little space for fiscal stimulus, sluggish receipts from tourism and remittances and increasing commodity prices in the future will all continue to be a drag on growth for some time. Thus, the weaknesses in the short term are expected to persist, due largely to the slow improvement in the world economy. Nevertheless, there is room to improve the foundation of fiscal, monetary and financial policy-making and the policies itself.

2.1 *Fiscal policy*

To achieve fiscal sustainability, governments in the SEMCs have to undertake scenario analysis when determining their fiscal position and future policy measures in terms of introducing fiscal stimuli. As has been outlined in Ayadi et al. (2013), when applied to the Egyptian and Tunisian cases, tax revenues are forecasted based on highly optimistic assumptions that do not take into account the possibility of a lower level of private investment and therefore lower level of tax revenue. The direct implication of such an optimistic assumption is an increase in the budget deficit and in the debt ratio, beyond the level the government expected. Therefore, it is strongly recommended that governments, in particular in Egypt and Tunisia where efforts have been made, should adopt a pessimistic approach to forecasting revenue to be on the safe side and should make their expenditure plans based on careful revenue assumptions.

However, to respond to the crisis and subsequent demands by their citizens in the period following the Arab uprisings, all governments succumbed to the temptation to increase expenditures (e.g. increasing wages and hiring in the public sector). Such actions will have dramatic implications for the future and will be a heavy weight to

carry for years to come. Therefore, it is strongly recommended to avoid unnecessary current expenditures; and to try to minimise and rationalise all areas of spending, like subsidies and purchases of goods and services. If any kind of public expenditure is required to stimulate growth, it should be oriented mainly towards capital expenditure (i.e. government investment), particularly in infrastructure projects that could yield significant impact on growth, and preferably oriented towards Public-Private Partnership (PPP) projects that could also stimulate domestic private investments.

With the continuing sharp decreasing of global FDI flows, SEMCs continue to be directly affected by this trend. Competition to attract FDI will become even tougher and countries in the region are advised to implement policies aiming at improving their private investment environment, in particular legal certainty and investor protection. In that respect, political stability, good governance and the rule of law diminish the risks for foreign investors, reducing the volatility of FDI flows.

The financial crisis has impacted the external sector through a slowdown of exports, which is expected to continue as long as growth and unemployment figures in trading partners remain gloomy. To tackle this, SEMCs are recommended to implement policies aiming at diversifying exports markets and facilitating export procedures. Embassies and commercial bureaus of SEMCs in different countries can seek proactively to open new export markets in emerging countries that have the potential of absorbing new exports, which will contribute to diversifying trade away from conventional trading partners. This can also be done through organising seminars for producers and exporters, participating in international fairs to advertise their products and services, as well as negotiating active trade agreements with new partners.

Tourism and remittances proved resilient during the financial crisis, but with global recession persisting and wealth effects settling in, and continuing political instability and its detrimental economic consequences, countries in the region might not be able to sustain high GDP growth. Accordingly, they are recommended to put in effect policies to promote tourism demand, as for example Egypt has done. As far as remittances are concerned, the resilience shown could be due to the fact that migrants who have lost their jobs return home with their stock of accumulated savings, which helps to compensate for the reduced flows of remittances. This compensation however, might come to an end as it is a onetime event. Hence, SEMC's are recommended to develop close links with countries in need of workers to fill gaps in the labour market in the host countries and/or to provide incentives to returning migrants to develop new activities in their home country.

2.2 *Monetary policy*

Central banks in the SEMCs have opted to pursue an accommodative monetary policy by means of unconventional monetary tools, much like their counterparts elsewhere. In the absence of an early warning system, however, such interventions may become disruptive and at a minimum, fail to produce the expected outcome. It is therefore recommended to establish an early warning system (EWS) and effective early prevention system as was developed in Bakardzhieva & Kamar (2013) to prevent systemic risks and crises. Such a system is built on i) macroeconomic resilience factors, ii) factors of bank fragility (CAMELS ratios) and iii) macro-prudential factors.

With the decline in interest rates and inflation worldwide and also the decline in inflation in all our sample countries, there is room for adopting an expansionary monetary policy through decreasing interest rates to stimulate domestic demand.

Encouraging credit to the private sector will also contribute to enhancing investment and consumption. In particular, credit targeting the housing sector can act as a driver of growth. However, the authorities need to carefully assess the risks of overheating posed by excessively high growth of credit to the private sector, and be ready to react with different monetary policy tools, such as increasing interest rates and introducing required reserve ratios. Maintaining exchange rates close to their equilibrium levels will enhance competitiveness while controlling inflation.

Finally, it is clear that the exchange rate could be an issue for debt sustainability. On the one hand, maintaining a fixed exchange rate at an overvalued level is harmful for the whole economy and is obviously unsustainable. On the other hand, devaluation of the currency can lead to serious implications for debt sustainability. The case of Egypt is worth mentioning. Indeed, the sharp decline in the official reserves in Egypt, combined with an appreciation of the real effective exchange rate over the past ten years, point to the urgent need for an exchange rate correction.

The recent depreciation is a step in the right direction, but the continuous interventions from the Central Bank are both irrational and harmful. The Gulf countries' deposits in the Central Bank are systematically absorbed by the market, leading to the need for more borrowing. The mismanagement of the exchange rate in Egypt is only leading to higher debt without any stabilisation of the market. Therefore, and in the absence of alternatives, the Central Bank should allow the exchange rate to float and depreciate. This will increase the debt ratio, indeed, but it will avoid accumulating more and more foreign debt, and ultimately the need to devalue the currency, which would result in an even higher debt.

2.3 *Financial policy*

The collective assessment of the regulatory and supervisory structures of the SEMCs against European Mediterranean standards in the pre- and post-crisis gives a mixed picture, as was detailed in Ayadi & De Groen (2013). Despite some improvements in capital requirements stringency, key weaknesses remain in deposit insurance, entry obstacles and the strength of legal rights. Moreover, some disparities have also become more apparent, especially in the potential for political interference and private monitoring. Therefore, the countries are strongly advised to continue the reforms towards reaching full regulatory convergence on international best practices.

Looking ahead, ongoing initiatives to diversify financing channels away from banks need to be pursued. In particular, policy-makers should increasingly see value in developing alternatives to bank financing, such as local debt markets for large corporations, thus allowing banks to concentrate more on financing small- and medium-sized enterprises, which create private-sector jobs and more diversified economies. At the same time, this would attenuate the adverse impact of banking distress on the provision of credit and will help enhance corporate governance as debt issuance will demand more rigorous financial disclosure and transparency.

3. Contribution to the future of the Euro-Mediterranean Partnership

Notwithstanding the negative impact a more open economy experiences in times of a global financial crisis, more-intensive international relations ultimately contribute to socio-economic development. It is therefore a particularly worrisome prospect that the region is slowing down progress on institutional reform and its pursuit of a strategy of openness. In that context, the

Euro-Mediterranean Partnership[3] should not be seen as a narrowly defined trade and investment relationship but as a much broader strategy for sustainable and inclusive socio-economic development. To that end, the Euro-Mediterranean partnership can serve to diversify the economies in question by putting in place a long-term socio-economic co-development strategy that will be able to respond to the key challenges the region faces.

Several actions can be developed such as encouraging Public Private Partnerships using BOT (Build, Operate, Transfer) and BOOT (Build, Own, Operate, Transfer) between European/local companies, local/foreign investors and the government. Public investments in infrastructure are a key policy tool for dealing with the crisis, but they can be limited by the available fiscal capacity. Public Private Partnerships like BOT and BOOT in building infrastructure can be an attractive alternative, as they can also stimulate private investments.

Within the Euro-Mediterranean Partnership, private European companies can take part in this process as partners with the domestic private sector and the government. In this case, the European companies can enhance their business and improve their profitability, with a positive effect on their economies. Domestic private investors will benefit as well in the same way, but will also be exposed to the expertise of the European companies. The governments will benefit from the infrastructure projects without having the burden of adding to the fiscal deficit. The Euro-Med agreement can provide the framework through which European firms can be privileged to gain these BOT and BOOT contracts.

Moreover, limited fiscal space and the need to maintain stimulus expenditures can lead to significant financing pressures. As seen in the recent example of Greece, an increase in the cost of borrowing can create an unsustainable fiscal stance. One way to avoid a situation in which interest rates on government borrowing increase sharply is to show the markets that cheaper financing is available. Seeking the IMF's assistance is one option, but it is usually an indicator that the economy is unable to create a solution on its own.

Creating a Euro-Med Fund for financial assistance can be an alternative. The idea of a Mediterranean Monetary Fund was first launched by the economist Bassem Kamar in 1999 as a way to contain speculative attacks against any Mediterranean currency. During an ongoing crisis, a pool of reserves like the East Asian Chiang-Mai initiative[4] can provide immediate liquidity to country members, which has the particularity of reassuring the markets and making financing through the markets available at reasonable interest rates.

4. Final remarks

In the aftermath of the 2007-09 global financial crisis and the 2011 Arab uprisings, the SEMCs have reached a turning point in their history. This Policy Brief has assessed the crisis management response in the fiscal, monetary and financial domains with the aim of drawing key lessons for its future, which holds many uncertainties. To give a broad range of insights on how these opportunities and challenges facing the region today can develop under various scenarios in the period up to 2030, we refer the reader to the large body of research carried out under the Mediterranean Prospects (MEDPRO) project, funded under

[3] For background on the Partnership, see http://ec.europa.eu/trade/policy/countries-and-regions/regions/euro-mediterranean-partnership.

[4] Launched in 2010, the initiative involves a multilateral currency swap arrangement among the 10 members of the Association of Southeast Asian Nations (ASEAN), the People's Republic of China (including Hong Kong), Japan and South Korea.

the 7th Framework Programme of the European Commission.[5]

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