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Foreword

This is the third issue of the Economic Review of EU Neighbour Countries[1]. This year the review includes a special focus on a topical issue: the macroeconomic effects of energy price shocks in resource-poor CIS countries (written in collaboration with Tatiana Lysenko from the EBRD). After several years of below market prices for its gas exports to the CIS, Russia has decided to review these arrangements and to significantly increase prices, bringing them closer to the levels applied to the EU. Starting in early 2006 with Ukraine, the renegotiation of gas prices has since then affected also Armenia, Belarus, Georgia and Moldova. This chapter compares the macroeconomic effects of the energy-price shock on growth, macroeconomic stability, budget and balance of payments in these energy-importing countries.

In addition to country-specific chapters, this review includes also two overviews of the recent economic developments in the Mediterranean and the EU Eastern neighbourhood regions. These chapters are structured along the main areas of reform: macroeconomic developments, trade liberalisation and economic opening, business climate, public institutions and public finance management, and social development and poverty.

This Occasional Paper has been prepared by a team led by José Leandro and Andreas Papadopoulos (overview of the Eastern neighbourhood and country article on Moldova) including Nico Beinema (statistics), Enrico Gisolo (Israel, Syria, Tunisia), Frank Øland Hansen (Armenia, Azerbaijan, editorial), Inmaculada Montero Luque (overview of Mediterranean countries, Morocco, Occupied Palestinian Territory), Marga Peeters (Algeria, Egypt, editorial), Agnieszka Skuratowicz (Jordan, Lebanon), Sirpa Tulla (Armenia, Azerbaijan, Georgia, Ukraine), Lucio Vinhas de Souza (energy shocks in the CIS, Belarus, Russia) and Hoda Abdel Ghaffar Youssef (statistics, editorial). Max Watson, Peter Grasmann and Johan Baras offered useful comments. Klaus Regling and Antonio de Lecea provided management support and offered valuable suggestions. Sophie Bland, Francis Flaherty, Douglas Jenks, Jonathan Marten and Sarah Stone reviewed the paper.

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[1] The report covers all countries part of the European Neighbourhood Policy initiative. However, Libya, although a potential ENP country, is not covered as it has no formal relations with the EU. Russia is not an ENP country, but has a strategic partnership with the EU, based on four "common spaces", including an economic space. Russia is included in this issue, not least because of its economic importance for the CIS region.

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Abbreviations

AA	Association Agreement
AP	Action Plan
AZM	Azerbaijanian manta
bcm	Billion cubic metres
BoI	Bank of Israel
BYR	Belarusian rouble
CBE	Central Bank of Egypt
CBR	Central Bank of Russia
CBS	Central Bank of Syria
CBT	Central Bank of Tunisia
CFAA	Country Financial Accountability Assessment
CIS	Commonwealth of Independent States
CPI	Consumer Price Index
EBRD	European Bank for Reconstruction and Development
EC	European Commission
EITI	Extractive Industries Transparency Initiative
ENP	European Neighbourhood Policy
ENPI	European Neighbourhood and Partnership Instrument
EPCA	Emergency Post-Conflict Assistance
EU	European Union
FDI	Foreign Direct Investment
FSAP	Financial Sector Assessment Program
FTA	Free Trade Agreement
GDP	Gross Domestic Product
GEL	Georgian lari
GFS	Government Finance Statistics
GNI	Gross National Income
GSP	General System of Preferences
IBRD	International Bank for Reconstruction and Development
IEA	International Energy Agency
IFI	International Financial Institutions
IFS	International Financial Statistics
ILO	International Labour Organisation
IMF	International Monetary Fund
JOD	Jordanian dinar
LBP	Lebanese pound
MAD	Moroccan dirham
m.c.m.	million cubic metres
MED	Mediterranean Countries
MENA	Middle East and North Africa region
MFN	Most Favoured Nation
MoF	Ministry of Finance
MTEF	Medium-Term Expenditure Framework
NBG	National Bank of Georgia
NBM	National Bank of Moldova
NBU	National Bank of Ukraine
NDF	National Development Fund

NGO	Non Governmental Organisation
OECD	Organisation for Economic Cooperation and Development
OPT	Occupied Palestinian Territory
PA	Palestinian Authority
PCA	Partnership and Co-operation Agreement
PPP	Purchasing Power Parities
QIZ	Qualified Industrial Zone
SMEs	Small and Medium-sized Enterprises
SOFAZ	State Oil Fund of the Azerbaijan Republic
SPPRED	State Programme on Poverty Reduction and Economic Development
TACIS	EU’s financial instrument for Eastern Europe and Central Asia
tcm	Thousand cubic meters
TIFA	Trade and Investment Framework Agreement
TPES	Total primary energy supply
t.o.e.	Tonnes of oil equivalent
UAH	Ukrainian hryvnia
UMA	Maghreb Arab Union
UN	United Nations
UNDP	United Nations Development Program
USD	US dollar
VAT	Value Added Tax
WB	World Bank
WDI	Word Development Indicators
WTO	World Trade Organisation

Part A

Thematic issues

THE EFFECTS OF ENERGY PRICE SHOCKS ON GROWTH AND MACROECONOMIC STABILITY IN SELECTED ENERGY-IMPORTING CIS COUNTRIES[1]

Abstract

After several years of low and stable prices for its gas exports to CIS countries, Russia has decided to review these arrangements and to significantly increase prices, bringing them closer to the levels applied to the EU. The steep increase in energy prices has significant economic implications for the importing countries. So far, the economic analysis has tended to adopt a country-specific focus. We adopt a cross-country perspective instead, comparing the macroeconomic effects of the energy-price shock on growth, macroeconomic stability, budget and balance of payments. The analysis shows that the expected negative effects associated with the gas price shock have not led to a GDP loss in any of the countries studied, mainly due to a combination of counterbalancing factors. However, some of these developments may raise concerns for the future. In particular the steep increase in private and quasi-private external debt observed over 2006 in most countries increases their vulnerability to future exogenous shocks, including further raises in energy prices.

1. Introduction

Until recently, the economic performance of the energy-importing countries in the Western CIS (Belarus, Moldova and Ukraine) and Caucasus (Armenia and Georgia) has not been affected by the surge in the world energy prices observed since the start of the current energy price cycle in 1999 (chart 1). While there are many factors that explain this growth pattern (see Falcetti, Lysenko and Sanfey, 2006), one factor that has been less explored to date relates to the prevailing terms of trade in energy in the region. Indeed, resource-poor CIS countries have imported significant amounts of energy from their resource-rich CIS-neighbours, in particular from Russia, often at prices that have been fixed at below the world market levels. In particular, gas prices charged by Russia to the net energy importers in the Western CIS and Caucasus were far below those charged to Western Europe.[2] Recently, however, these energy trade arrangements began to be revised and all energy-importing countries of this region have been facing substantial increases in the prices for imported energy.

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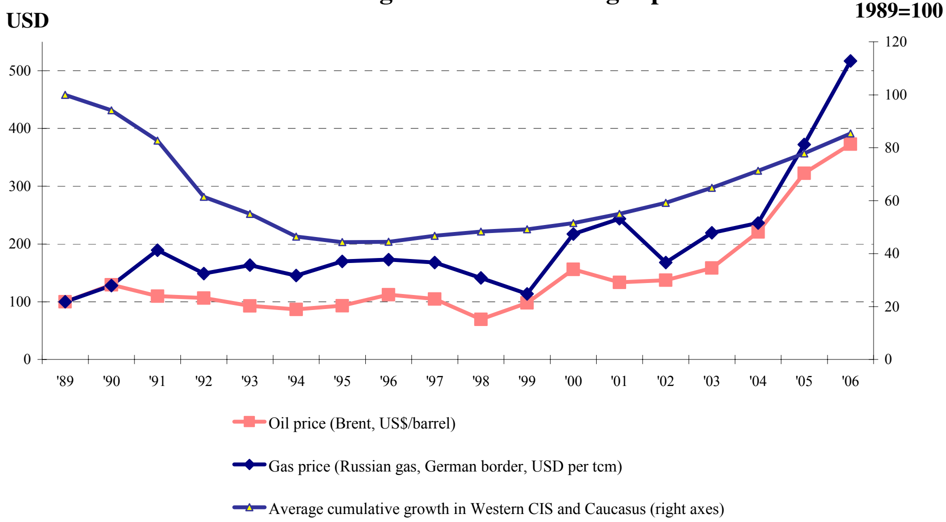
[1] This paper was written by Tatiana Lysenko (EBRD) and Lucio Vinhas de Souza (EC) with contributions and comments from Nico Beinema, Frank Øland. Hansen, José Leandro, Andreas Papadopoulos, Sirpa Tulla (all EC), and Alex Chirmiciu, Elisabetta Falcetti, Samuel Fankhauser, Franklin Steves and Anita Taci (all EBRD).

[2] Unlike crude oil, where the availability of liquid markets means that there is a true world market price, albeit for the different types of crude, in the case of natural gas there is no such comparable world price. Prices are effectively regional, linked to the availability of a (often monopolistic) transport network, and defined as a (variable) mark-up on the production and transportation prices. Therefore, this paper avoids using the term "world prices" for natural gas. The increased amount of natural gas traded as LNG is supposed, at a certain point in the future, to enable the creation of a liquid market with a corresponding true "world price".

Chart 1 - GDP growth and oil and gas prices



Source: EBRD, IMF.

The convergence of domestic energy prices to international levels is expected to be beneficial for these countries in the long run, encouraging economic restructuring and a more efficient use of energy. However, in the short/medium run the adjustment costs of the increases in prices for imported energy ("energy price shocks") can be quite significant, adversely affecting the economic performance of the net energy importers.

The objective of the chapter is to assess the short/medium term impact of the energy price shocks on the macroeconomic performance of the energy-importing countries of the Western CIS and Caucasus.In 2006-2007, these countries were hit by the drastic increases in prices for gas imported from Russia. In April 2006, Armenia faced a doubling in the price for imported Russian gas, to USD 110 per thousand cubic metres (tcm). Georgia was hit with a 75% increase to USD 110/tcm in January 2006 and a further 114% increase to USD 235/tcm in 2007. The prices for imported gas for Moldova were raised three times during 2006-2007, and are currently more than double their end-2005 level. Ukraine experienced two major price increases - a 46% increase to USD 95/tcm on 1 January 2006, and a further 36% increase to USD 130 on 1 January 2007. In Belarus, which enjoyed a price of around USD 47/tcm - the lowest in the CIS until end-2006 - prices more than doubled in January 2007. Further increases are likely in some of the countries, given that prices for imported gas are still below those paid by EU countries.[3]

While there are a few studies on individual countries of the region that have addressed this issue, no study - to the best of our knowledge – has looked at the problem from a regional perspective. Such a regional approach makes sense, as this makes it possible, first, to review in a consistent fashion the different arrangements for energy imports that various CIS countries have had over the last decade; second, to develop a common comprehensive methodology for assessing the impact of energy price shocks in the countries of the region; and finally, to compare the policy responses and adjustment paths in the different countries.

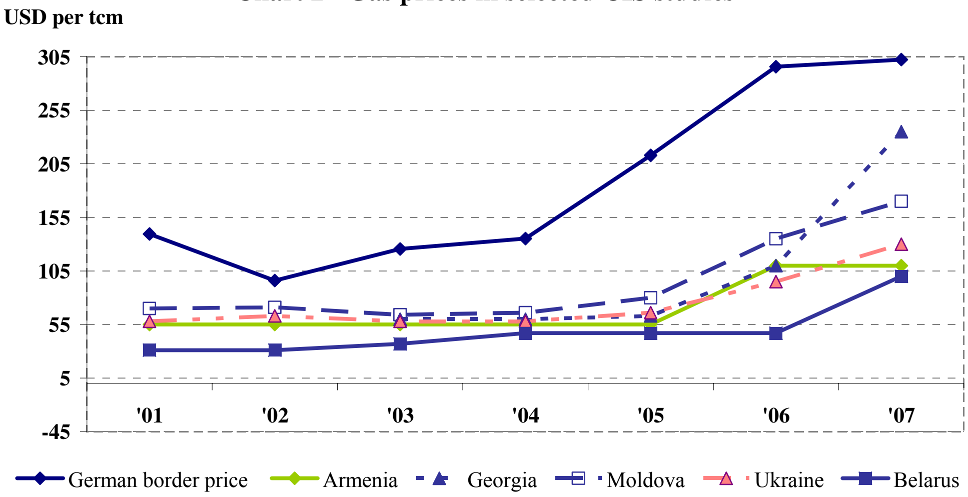
[3] The EU member states in the Baltics (Estonia, Latvia and Lithuania) also faced similar gas price increases: in Estonia, it increased from USD 80/tcm in 2005 to USD 110/tcm in 2006, and to USD 200 in 2007, while in Lithuania, from 1 January 2007 *Gazprom* raised the price to USD 210/tcm, from USD 156 in 2006. In Latvia, gas prices are still somewhat lower, but will increase further as of 2008.

This chapter is laid out as follows. Section 2 reviews the relations in the energy field between Russia and the CIS countries covered in the study. Section 3 estimates the potential vulnerability of the five net energy importers of the region to an energy price shock. It looks at two sources of vulnerability: dependence on imports to cover domestic energy needs and energy intensity. Section 4 describes the impact of energy price shocks on macroeconomic performance. It starts with a theoretical perspective, showing how the shock can propagate through the economy, and continues with an empirical assessment of its macroeconomic effects. First, it estimates the potential GDP losses based on the net imports model. It also investigates the impact on macroeconomic stability, and looks at the other developments in the external sector that mitigated or amplified the shock. Finally, it discusses the impact of energy price shocks on the fiscal position of the government (either through direct fiscal mechanisms or other quasi-fiscal means) and on inflation. This section is followed by a conclusion.

2. Energy relations between Russia and the CIS

Russia is the main exporter of gas and oil to the countries of the Western CIS and Caucasus. As a hold-out from the non-market arrangements that prevailed during the planned economy era, the gas prices charged by Russia to those countries in particular were far below the prices charged to Western Europe.[4] Not only were those prices significantly below the ones charged to the EU countries (implying a significant economic loss to Russia, given the opportunity cost[5]), but in some cases the Russian gas may have been sold below cost-recovery (including transportation) costs, i.e. at a financial loss to the supplier. However, recently this has started to change, with some countries experiencing overnight increases of over 100% in prices for imported gas (chart 2).

Chart 2 - Gas prices in selected CIS studies



Source: National statistics, authors' calculations.

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[4] This paper uses the price for Russian gas at the German border as a benchmark, recognising that it should be adjusted downwards to reflect the difference in transportation cost and market power of the transit countries.

[5] A very rough calculation for 2005, using as a benchmark estimated "netbacks" from the German border price for the CIS countries covered in our study indicates that Russia had foregone almost USD 3.9 billion in export revenues in that year alone. This was a 140% increase over the roughly USD 1.6 billion foregone in 2004 (calculated using the same methodology). Such a significant increase in foregone revenue could partially explain the "robust" price negotiations of *Gazprom* in 2005-2006.

The under-pricing of energy imports, as well as involving actual financial and budgetary losses for the supplier country, also means efficiency losses for the receiving countries. Such artificially low prices have allowed the survival of loss-making, non-optimal economic activities that did not reflect the countries comparative advantage. The raising of energy prices towards international levels is therefore likely to be associated with significant efficiency gains for these countries in the long run. Nevertheless, this in no way excludes the possibility of short-term adjustments which can sometimes be significant and painful.

2.1 Country studies: gas price increases in Armenia, Belarus, Georgia, Moldova and the Ukraine

The countries covered in our sample are essentially dependent on Russia in terms of gas imports. In practical terms, this means that they are dependent on a quasi-monopolistic and state-controlled company, *Gazprom* (see Vinhas de Souza, 2006b). The recent developments in Russia's energy trade arrangements with Armenia, Belarus, Georgia, Moldova and Ukraine are described below.

Armenia

The price of natural gas received by Armenia from Russia doubled to USD 110 per tcm from 1 April 2006. Armenia concluded an agreement with *Gazprom* to temporarily maintain this still relatively low price for natural gas in exchange for the transfer of ownership of parts of the country's energy infrastructure. Under this deal the delivery price and terms will remain unchanged until 1 January 2009. The assets transferred from Armenian to Russian control include a thermal power plant and, reportedly, part of the new gas pipeline to Iran (*Gazprom*, through a joint venture, was granted the concession to build a larger, second pipeline along this route as part of the agreement). Other thermal power plants were transferred to Russia's United Energy System (RAO-UES) in 2002-2003, as part of the debt-for-assets deal that settled Armenia's USD 96 million debt to Russia. *Gazprom* is also expected to increase its share in the Armenian gas transport company *ArmRosGazprom* from the current 45% to 58% (a further 10% is already owned by *Itera*, a Russian energy trading company which is active throughout the former Soviet Union and has ties to *Gazprom*). Therefore, nearly Armenia's entire energy infrastructure is now controlled by Russian companies.

Belarus:

In December 2006, *Gazprom* indicated that it would stop gas supplies via Belarus (the second most important transit country to EU markets, responsible for around 15% of Russian deliveries to the EU), unless a substantial increase in the price paid (the very low USD 46.7 per tcm) and a joint venture with *BelTransGaz*, the Belarusian state-owned gas transmission company, was agreed. An agreement was reached just before the deadline of 31 December 2006, avoiding the suspension of gas supplies. The new agreement covers the period 2007-2011. The gas price for 2007 is USD 100 per tcm. From 2008, this price will be linked to the prices charged to the EU, minus transportation costs. It will be 67% of this price in 2008, 80% in 2009, 90% in 2010 and 100% in 2011.

Transit fees for 2007 were set at USD 1.45, up from USD 0.75 per tcm per 100 km in 2006. *Gazprom* also agreed on a price of USD 2.5 billion for a 50% stake in a joint venture with *BelTransGaz*, to be paid in instalments over the next four years.[6]

Georgia

Russia was Georgia's main gas supplier until 2006. In December 2006, the prices for Russian gas imports more than doubled from USD 110 to USD 235 per tcm. However, the new South Caucasus (Baku-Tbilisi-Erzerum) gas pipeline will enable Georgia to diversify its gas supply: Georgia is expected to receive 250 million cubic metres (m.c.m.) from Azerbaijan through this pipeline in 2007. There is an agreement to increase this amount by 100 m.c.m. per year thereafter. This is likely to lower the average price for Georgian gas imports. Although there is little official information on Georgia's arrangements with its alternative suppliers, Azerbaijan and Turkey for 2007, it is known that since the beginning of 2007 Georgia has been receiving Azeri gas through an older pipeline, reportedly for about USD 120 (as of March 2007, Azeri gas accounted for about 50% of total imports, according to the Georgian Minister of Energy), and Turkey's gas may also play a role, if an agreement to sell part of one of its pipeline quotas is reached.

Moldova:

The gas sector in Moldova is controlled by *Moldovagaz*, 51% of which was transferred to *Gazprom* in return for the cancellation of arrears due by the company (i.e. ultimately, the Moldovan Government) to *Gazprom*. *Gazprom* requested a two-fold price increase as of 1 January 2006, and after extensive negotiations with the Moldovan government, the import price for gas was settled at USD 110/tcm for the first half of 2006. During the second half of that year, prices were again raised to USD 160/tcm (average prices for 2006 were around USD 135). A transit fee of USD 2.5/tcm was charged for transit services provided to *Gazprom* by *Moldovagaz*. In December 2006, *Gazprom* and *Moldovagaz* signed a five-year agreement on gas deliveries to Moldova, valid until 2011. Under this agreement, *Gazprom* raised the price to USD 170 per tcm. For 2007 the contracted volume remains roughly constant at the 2006 level of 2.5 bcm (total imports in 2006 were 2.3 bcm, of which around 0.9 bcm were used by the break-away region of Transnistria, with the result that only around 1.4 bcm is used by Moldova proper). The transit tariff for Russian gas exports via Moldova remains unchanged. Moldova transits on average 20 to 22 bcm of Russian gas annually to Balkan countries (mainly to Romania, an EU member state). Mirroring the situation in Belarus, this five-year agreement with *Gazprom* also stipulates a gradual raising of the price to a "European average price" minus transportation costs. Under this agreement, *Gazprom* will charge Moldova 75% of that price in 2008, 85% in 2009, 90% in 2010, and 100% in 2011. As part of the agreement, Moldova also

[6] Not only did Belarus receive natural gas from Russia at well below the Western European rates; it also benefited from very specific arrangements in the oil trade. Belarus imported crude oil from Russia free of export duties, and exported refined oil products primarily to Western Europe at a large mark-up. According to the terms of a 1995 Treaty, Belarus and Russia were supposed to unify export duties on oil and refined oil products and to share Belarus' export duty revenues: 15% to Belarus and 85% to Russia. However, Belarus charged lower export duties on exports of oil and refined oil products, violating the agreement. Moreover, Belarus did not transfer the corresponding revenue to the Russian budget, in spite of several complaints by the Russian government through the years: in 2005-2006, revenue foregone for Russia is estimated at over USD 1 billion per year. This situation generated substantial profits for some Russian companies who transferred their refining operations to Belarus, and boosted Belarusian exports and fiscal revenues. In December 2006, shortly before gas prices were increased, this "off-shore" tax avoidance scheme with oil duties was ended by Russia. Tensions between the countries escalated in January 2007, and the standoff was only resolved on 12 January 2007.

transferred the ownership of its domestic gas distribution networks to *Gazprom*, as a way to further reduce the remaining accumulated arrears.

Ukraine

In December 2005/January 2006, a very heated dispute arose between Russia and Ukraine concerning a request by *Gazprom* to increase the gas price charged to Ukraine, from USD 50 per tcm to USD 230 in January 2006. Ukraine is the major transit country for Russian gas to its EU markets, and is responsible for about 80% of total deliveries (Ukraine transited about 115 bcm of gas until 2005, and received about 25 bcm worth of gas as a barter payment for that transit. The transit fee paid to Ukraine was USD 1.09 per tcm/100 km; by comparison, the EU transit fee was USD 2.6 per tcm/100 km in 2005). Ukraine rejected *Gazprom*'s offer, leading to the suspension of Russian gas deliveries to Ukraine on 1 January 2006. This briefly affected some EU markets, as Ukraine sought to compensate for the reduction in Russian deliveries by siphoning-off gas destined for the EU. An agreement was reached on 4 January 2006. It is valid for five years, setting prices at an average of USD 95 (for a combined aggregate of Russian and Turkmen gas) for 2006. Ukrainian transit fees were also increased by 47%, to USD 1.6 per tcm/100 km. All gas is now traded on a cash basis and all gas imports into Ukraine are now done via a monopoly, *RosUkrEnergo* (a non-transparent company with headquarters in Switzerland). In late 2006, prices were increased again, to USD 130 per tcm. So far, Ukraine has resisted *Gasprom*'s proposals for the transfer of ownership of its pipeline network.

3. Estimating energy dependency and vulnerability

The impact of the increases in prices for imported energy on a country's economic performance depends both on the magnitude of the price shock and on a country's "energy-import vulnerability"[7], which can be estimated by the share of net energy imports in GDP. This is measured in real terms, as net energy imports in tonnes of oil equivalent per unit of GDP, rather than in the monetary value of imports divided by GDP. This ratio can be broken down into two terms:

(1) net energy imports/GDP = (net energy imports/total energy use)(total energy use/GDP)*

The first term indicates the extent to which a country relies on imports to meet its energy needs. The second term shows the energy intensity, or the amount of energy used to produce one unit of output. This breakdown provides useful insights into the sources of a country's vulnerability to energy price shocks. The dependence on imported energy for the CIS countries is shown in Table 1.

Table 1 - Dependence on imported energy

2004, in thousand t.o.e.	Armenia	Belarus	Georgia	Moldova	Ukraine
Production	746	3624	1287	84	76287
Imports	1480	36248	1647	3329	82172
Exports	-98	-12880	-106	-38	-17873
Stock changes	0	-215	0	8	-254
Total Primary Energy Supply	2129	26776	2828	3384	140333
Share of net imports in TPES	65%	87%	54%	98%	46%

Source: IEA.. Note: Moldova includes Transnistria.

[7] There is no generally accepted term for this indicator. The World Bank uses "vulnerability" (WB, 2005) while the IEA prefers "intensity" (IEA, 2006). In this paper, the term "vulnerability" is used.

Most countries are highly dependent on imports to cover domestic energy needs. This dependency ranges from 46% in Ukraine (which has domestic production of coal, oil and gas, plus hydroelectric and nuclear power stations) to almost 100% in Moldova (which is fully dependent on imports to meet its energy needs).

Energy intensity indicates how much energy is required to produce one unit of output. Making cross-country comparisons in terms of energy intensity is not straightforward, as ideally a comparable measure of output should be found. One widely used measure of energy intensity is a ratio of total energy use in tonnes of oil equivalent (t.o.e.) to GDP at market exchange rates. However, as the domestic prices in the CIS countries have not yet fully converged to world levels, and the gap varies across countries, output measured in market exchange rates may be underestimated, and this complicates cross-country comparisons. One can use purchasing-power parity (PPP) estimates of GDP to arrive at an alternative measure of energy intensity (Table 2).

Table 2 - Energy intensity, 2004

constant 2000 USD, thousands	Armenia	Belarus	Georgia	Moldova	Ukraine	*EU-25*
Energy intensity, t.o.e. per thousand 2000 USD	0.74	1.61	0.71	1.56	3.19	0.20
Energy intensity, t.o.e. per thousand 2000 USD PPP	0.19	0.43	0.24	0.39	0.50	0.19

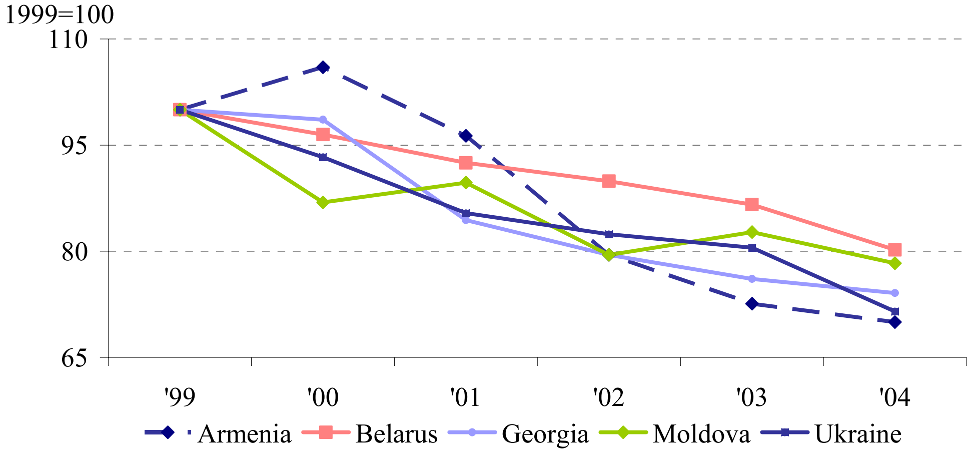
Source: IEA,; Moldova - Author's calculations based on national statistics (excludes Transnistria).

According to the measure based on GDP at market exchange rates, all countries in this group are very energy intensive, when compared to a benchmark of developed economies (here represented by the EU-25 figures). Based on these estimates, Ukraine is the most energy-intensive country in the sample, using almost 16 times more energy per unit of output than EU-25, followed by Belarus and Moldova. Armenia and Georgia are less energy intensive, but the gap with the EU-25 is still large. On the other hand, if energy intensity is calculated using a GDP PPP benchmark, the energy intensity is reduced by an order of magnitude: Armenia and Georgia are at or close to the EU-25 energy intensity level, while Ukraine, the most energy intensive country, is now only 2.5 times more energy intensive than the EU-25.

There are potentially long-term differences between countries in energy intensity that can be explained by a number of factors, either endogenous or exogenous, including the use of more energy-efficient technologies, the share of energy-intensive industries and differences in climate. Therefore, countries are not necessarily expected to converge to the same level of energy intensity in the long run. From a policy perspective, it is important to understand the way energy intensity is changing over time, and what is the potential for reducing the use of energy per unit of output, via improving energy efficiency and/or by a shift from the energy-intensive industries to more efficient industries and services.

The energy intensity in this group of countries has declined steadily in recent years (chart 3). Between 1999 and 2004, energy intensity declined on average by 25%, championed by Armenia, which reduced energy intensity by 30%. To overcome the problem of GDP measures, these figures are calculated based on changes, rather than on absolute values for both energy consumption and GDP. Taking energy consumption and GDP in 1999 as a reference for each country changes are calculated for the level of real GDP and changes in energy consumption over the period 1999-2004. If GDP growth has outstripped the increase in energy consumption over this period, this indicates a reduction in energy intensity.

Chart 3 - Trends in energy intensity



Source: IEA, National statistics, authors' calculations..

Using the estimates of dependence on energy imports and energy intensity, it is possible to calculate a measure of energy-import vulnerability, based on formula (1). This can be understood as a (non-dimensional) index that denotes a country's vulnerability to increases in prices for imported energy. As Table 3 demonstrates, energy-importing Western CIS countries are much more exposed to an external energy price shock than South Caucasus countries. Moldova appears to be the most vulnerable, which stems from its high energy intensity, combined with its heavy reliance on energy imports. Ukraine shows similar vulnerability, being the least dependent on energy imports, but at the same time the most energy intensive economy in this region. Belarus is also highly exposed to an energy price shock due to its reliance on imports and a relatively high energy intensity. In contrast, the two South Caucasus countries show a rather limited vulnerability, mostly due to their low energy intensity.

Table 3 - Vulnerability indicators 2004

	Armenia	Belarus	Georgia	Moldova	Ukraine
Share of net imports in TPES	0.65	0.87	0.54	0.98	0.46
Energy intensity (TPES to GDP, t.o.e. per thousand 2000 USD)	0.74	1.61	0.71	1.56	3.19
Net energy imports to GDP (energy-import vulnerability)	0.48	1.41	0.39	1.54	1.46

Source: IEA, national statistics, authors' calculations

It is also possible to define the vulnerability of an economy to increases in import prices for a particular energy product. For example, the vulnerability of the economy to an external gas price shock can be estimated by the share of net gas imports in GDP. This can be broken down in the way described in (2) below:[8]

(2) net gas imports/GDP = (net gas imports/total gas use)(total gas use/total energy use)*(total energy use/GDP)*

Here, the first term shows the reliance on imports to cover domestic gas needs, while the second term shows the importance of gas as a source of energy, and the third term represents energy intensity.

[8] This is the methodology used by the World Bank, 2005 and 2006.

Similarly, the vulnerability to increases in the prices for imported oil can be measured as the share of net oil imports in GDP, as given by (3) below:

(3) net oil imports/GDP = (net oil imports/total oil use)(total oil use/total energy use)*(total energy use/GDP)*

This chapter concentrates on the vulnerability to a gas price shock. There are a number of reasons for this. First, natural gas is the main energy source for all countries in the sample.[9] At the same time, most of these countries rely wholly on imports to cover their gas consumption needs (except Ukraine, which has its own gas production, but also depends heavily on gas imports). Second, the countries in the study are likely to be more severely affected by the gas price shock than by the oil price shock. The oil price shock is mostly associated with increasing world market prices, a trend that can be reversed; by contrast, a gas price shock is related to the correction of below-market prices that were prevalent in these countries. The magnitude of the gas price shock is therefore much higher, with some countries, as mentioned before, experiencing a 100% price increase overnight. Moreover, the shock is permanent, and the countries that have already been hit by price increases for imported gas are likely to be exposed to further price increases in the coming years. Table 4 shows the estimates of vulnerability to a gas price shock, based on formula (2), as well as sources of vulnerability.

Table 4 - Gas-import vulnerability 2004

	Armenia	Belarus	Georgia	Moldova	Ukraine
Net gas imports/total gas use	1.00	0.98	0.99	1.00	0.79
Total gas use/TPES	0.51	0.62	0.32	0.58	0.47
Energy intensity (TPES to GDP, t.o.e. per thousand 2000 USD)	0.74	1.61	0.71	1.56	3.19
Net gas imports to GDP (Gas-import vulnerability)	0.38	0.98	0.22	0.91	1.18

Source: IEA, national statistics, authors' calculations.

Among the countries in the study, Ukraine shows the highest vulnerability to an external gas price shock, which is mostly due to its very high energy intensity. Moldova and Belarus share a similar position with regard to the importance of gas as an energy source, a total dependence on imports and energy intensity, and therefore a similar vulnerability. Georgia is the least vulnerable to increases in gas prices, due to low energy intensity and a relatively low share of gas in its total energy use (about one third).

4. Macro-economic effects of an energy price shock

Rising prices for imported energy represent a terms-of-trade shock, which in the absence of a policy response or counterbalancing developments would lead to a fall in real income and reduction in demand. The key policy question is whether the shock is temporary or permanent. If there is a reason to believe that the shock is short-lived, then the country can try to smooth the fluctuations in demand by external borrowing and/or reduction in savings. However, should the shock be permanent, the downward adjustment in real income and domestic demand is difficult to avoid.

There are several channels through which the adjustment can take place. A rising energy import bill leads to a deterioration in the country's trade account, putting downward pressure on the exchange

[9] Full energy balances for the countries in the sample are presented in IEA (2006a).

rate. The domestic currency is likely to depreciate, which will reduce demand for non-energy imports. Further adjustment depends on the extent to which the increases in import prices are passed on to domestic consumers and producers. If domestic energy prices rise in line with higher import prices, private consumption and investment will be adversely affected. Consumers will face a higher energy bill and will have less money to spend on non-energy goods and services, which will also become more expensive due to firms´ rising input costs. At the same time, enterprises are unlikely to immediately fully pass-through the rising input costs to final prices for goods and services, as this would reduce their profits, thus adversely affecting investment.

If instead the government decides to prevent a full pass-through of the increase in imported energy prices, private consumption and investment will be less affected. However, the increased subsidies will put pressure on government finances, either reducing other expenditures with negative repercussions for domestic demand or, more likely, causing a deterioration in the fiscal position.

Impact on growth: net imports model

Due to the complexity of the channels through which the energy price shock is propagated through the economy, it is difficult to model the economy's response to the shock. However, it is possible to assess the magnitude of the necessary adjustment using a simple univariate equation, based on the ratio of net imports to GDP. Here this ratio is understood in monetary terms, i.e. the net import bill divided by nominal GDP, rather than in real terms as in the previous section (although the two are obviously linked).

In the absence of external borrowing and changes in official reserves, the necessary adjustment in domestic absorption (or a potential GDP loss) will be equal to the change in net energy imports (NI), as given by:[10]

$$(4)\ \Delta\ GDP = -\Delta NI$$

After rearranging, the result is (based on the World Bank, 2005):

$$(5)\ \Delta\ GDP/GDP = \Delta P/P*(-NI/GDP)$$

Where Δ GDP/GDP is the percentage change in GDP, $\Delta P/P$ the percentage change in price for imported energy and NI the net energy imports to GDP (in monetary terms)

Table 5 presents the results of these estimates, as well as the underlying data. The analysis concentrates on the effects of a gas price shock.

For those countries in the sample that experienced a substantial increase in gas prices in 2006 (i.e., all except Belarus), the estimates of potential GDP losses in 2006 according to the net imports model are presented, as well as actual growth figures. The estimates of potential GDP losses in 2007 for the countries that faced another price shock in early 2007 (all except Armenia) are also presented.[11]

[10] This is based on the assumption of a zero price elasticity of energy demand.
[11] In 2007, Armenia has not so far experienced another gas price shock; the second wave of gas price increases in 2007 has been moderate for Moldova and Ukraine, while Georgia and Belarus have been hit with significant price increases.

Finally, some estimates are provided of potential output losses that the countries would encounter if they were charged the full market price. As mentioned before, there is no single market price for natural gas, as transportation cost and the monopoly power of gas transit countries should be taken into account. Here, we have used the price for Russian gas at the German border adjusted downwards (an amount of USD 40 is deducted from it, in line with estimates of "netback" for Belarus and Ukraine) as a benchmark for illustration purposes only.

According to the imports model the potential output losses from gas price increases in 2006 range from 1% in Georgia to 3.2% in Moldova. This broadly reflects the countries energy imports intensity. The potential GDP loss in Ukraine is estimated at 2.1%, but the magnitude of the increase was much less in Ukraine than in the Caucasus countries and Moldova (45% compared with 75-114%). However, actual growth rates in these countries were positive and decelerated only slightly, while in Ukraine, growth actually accelerated from 2.6% in 2005 to 7.1% in 2006. The next section of this chapter presents comments on these developments.[12]

Similar estimates for 2007 show that, following the price increases for imported gas in 2007, the magnitude of a potential contraction ranges from 1.1% in Moldova to 3% in Belarus, reflecting the larger percentage increases for Belarus (110%), compared with a moderate second wave of price increases for Moldova in 2007. More revealing are the estimates of the magnitude of output losses if prices were raised to the regional "parity price" proxied by the German border benchmark adjusted downwards (again, this is an imperfect proxy, and is used here for illustration purposes only). The results show that, in that case, Belarus and Ukraine would have experienced a dramatic loss in output of 11.4% and 7.6%, respectively. Georgia, which already pays almost full parity price, would face only a 2.5% loss, and Moldova and Armenia losses of a 3.5% and 3.7%, respectively.

[12] This difference between estimated losses and outcomes also appears when one uses more complex structural models (see Vinhas de Souza, 2006a).

Table 5 - GDP effects of a gas price shock

	Average price (USD/tcm)	Gas imports (mln USD)	*Gas imports (% GDP)*	Increase in gas price over previous year	GDP loss in net imports model	Actual growth (%)
Armenia						
05	57	97	*2.0*			13.9
06[e]	110	187	*2.9*	93%	-1.8	13.4
07[p]	110	187	*2.9*	0%	0.0	
Full price	250	425	*6.6*	127%	-3.7	
Belarus						
05	47	950	*3.2*			9.2
06[e]	48	990	*2.7*	0%	0.0	9.9
07[p]	100	2080	*5.6*	110%	-3.0	
Full price	250	5283	*14.3*	425%	-11.4	
Georgia						
05	63	91	*1.4*			9.6
06[e]	110	159	*2.0*	75%	-1.0	9.0
07[p]	235*	341	*4.4*	114%	-2.3	
Full price	250	361	*4.8*	127%	-2.5	
Moldova						
05	68	97	*3.3*			7.5
06[e]	135	192	*4.1*	97%	-3.2	4.0
07[p]	170	241	*5.2*	26%	-1.1	
Full price	250	355	*10.9*	85%	-3.5	
Ukraine						
05	66	3946	*4.6*			2.6
06[e]	95	4769	*4.7*	45%	-2.1	7.1
07[p]	130	6527	*6.4*	37%	-1.7	
Full price	250	12551	*12.3*	163%	-7.6	

Source: National statistics, UN's COMTRADE and authors' calculations.
e – estimates
p - projections
** - price for Russian gas; average price should be lower if Azeri gas is taken into account.*

Impact on macroeconomic stability

In the framework of the net imports model, the rise in the net imports bill is compensated by the contraction in domestic absorption, so that external balance is restored. One of the adjustment mechanisms would be depreciation of the domestic currency. In the event of a moderate increase in the energy bill, the necessary adjustment may be limited. However, the estimates show that the countries in the sample have already experienced a rise in their energy imports bills of around 1.8-4.3% of GDP, and may face further increases, which suggests that a sizeable depreciation may be required in order to restore equilibrium in the external accounts. Nevertheless, in recent years the economies of the region have benefited from macroeconomic stability, supported by stable (and often appreciating) exchange rates. Greater confidence of the population in the domestic currency has fostered de-dollarisation and a higher demand for money, resulting in increased monetisation. These positive trends may be reversed, if expectations regarding future exchange rate developments were adjusted downwards.

An exchange rate adjustment, which may be needed to restore the external equilibrium following the terms-of-trade shock, could trigger a loss of confidence in domestic currency, which would result in higher demand for foreign currency from households, and thus further devaluation. The high level of foreign currency borrowing in the region further aggravates the risks. Therefore, developments in the exchange rate market can jeopardise financial stability, leading to uncertainty, falling investment and an overall decline in economic activity. Taking into account these second-round effects, it is understandable that the authorities are reluctant to allow an exchange rate adjustment following the terms-of-trade shock. This is especially true in countries such as Belarus and Ukraine, where the exchange rate has been de-facto fixed over the past years, thereby anchoring expectations.

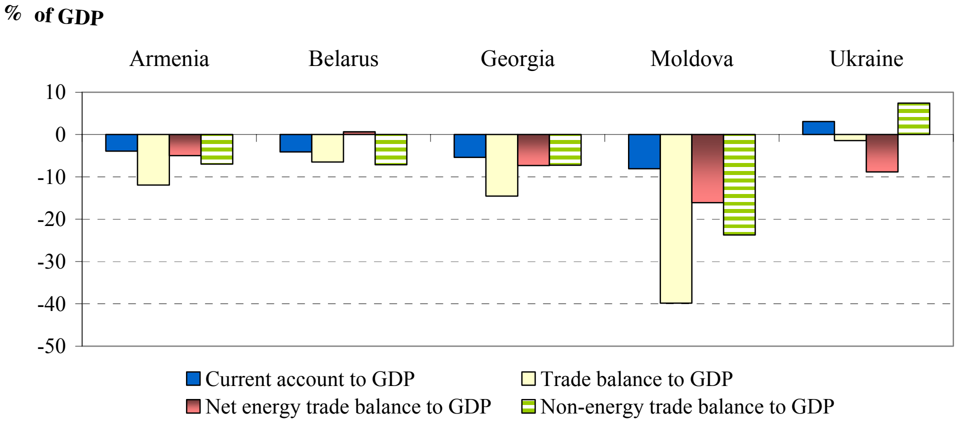
Given the importance of the exchange rate targets in theses economies, the authorities would most likely try to avoid the necessary adjustment, for instance, by accessing international capital markets and using official reserves. This strategy is however questionable. As the shock is likely to be permanent, external borrowing may be used to temporarily cushion the shock, but adjustment at some point is inevitable. Moreover, a delayed adjustment may be more painful due to rising debt service payments.

The external position of the country prior to the energy price shock also matters. A country that runs current account surpluses and has substantial foreign exchange reserves and/or low levels of external debt may be less exposed to the shock than a country with current account deficits, low level of reserves and high indebtedness.

Charts 4a shows the current account and trade balances, broken down into the energy and non-energy trade balances for the countries in the study, prior to a gas price shock. In 2005, only Ukraine ran a current account surplus in 2005, of around 3% of GDP, before the first wave of increases in the imported gas price. All other countries in the sample recorded comparable current account deficits of around 4-5% of GDP. Trade balances were negative for all countries in the study, varying from a moderate deficit of below 2% of GDP in Ukraine to a dramatic deficit close to 40% of GDP in Moldova.

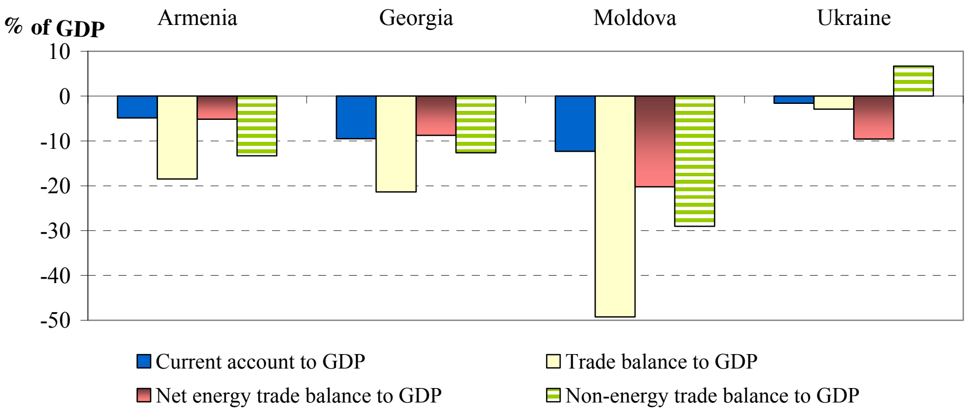
The decomposition to trade into energy and non-energy reveals several interesting trends. First, strikingly, Belarus emerges as a net exporter of energy products in 2006. This reflects the price differentials between Belarus' energy imports (cheap Russian gas and crude oil delivered from Russia free of export duties) and energy exports (refined oil products, sold to Western Europe at market prices, which soared in 2005-2006). Second, Moldova had the largest deficit in energy trade – in excess of 16% of GDP - indicating once again its very high dependence on energy imports, and also in non-energy-trade, at around 24% of GDP. Ukraine is the only country in the group that had a surplus in non-energy-trade; however, its overall trade deficit is determined by its high deficit in energy trade.

Chart 4a - Current account and trade balance prior to gas price shock



Source: Authors' calculations based on national statistics.
Note: Data for 2005, except for Belarus, where the data refer to 2006.

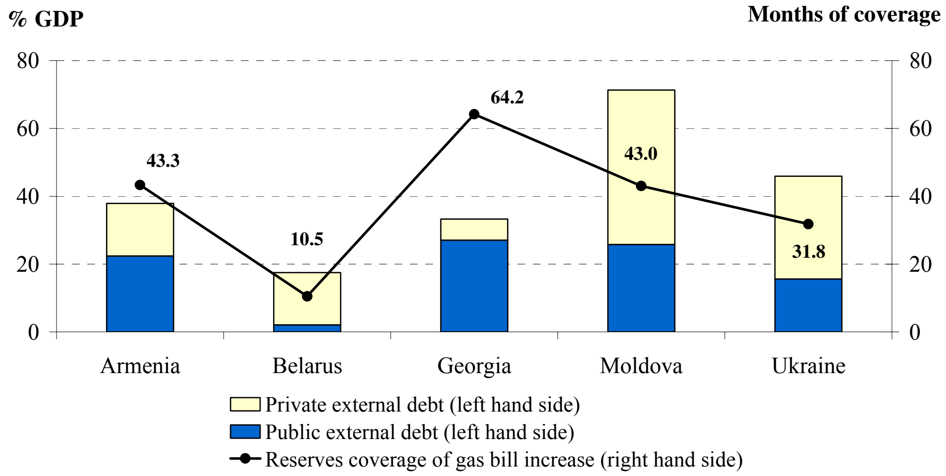
Chart 4b - Current account and trade balance after the gas price shock



Source: Authors' calculations based on national statistics.
Note: Data for 2006.

The level of official reserves and external indebtedness varies widely across countries in the study. Chart 5 shows the level of external debt, both public and private, as a share of GDP as well as the ratio of official reserves to the increase in the gas bill. In other words, it shows the extent to which the authorities could finance the higher gas bill without access to external financing.

Chart 5 - External vulnerability



Source: National statistics, authors' calculations.
Note: Data for 2005, except for Belarus, where the data refer to 2006.

In terms of risks to macroeconomic stability, Moldova and Belarus appear to be the most vulnerable to a gas price shock, albeit for different reasons. Moldova's external debt level, the highest among the countries in the group, exceeds 70% of GDP, which makes further accumulation of debt problematic. Belarus, in contrast, has a very low foreign debt, suggesting scope fur further borrowing. However, the level of foreign exchange reserves in Belarus is low: in the absence of external financing, the authorities will only be able to finance the increase in the gas bill for less than one year.[13] As the country already ran a current account deficit prior to the gas price shock, financed by external borrowing, the short-term risks to macroeconomic stability seem to be highest in Belarus.

Current account and trade balances after the gas price shock

In 2006 the trade deficits widened significantly in Armenia, Georgia and Moldova, by about 7-9 % of GDP (charts 4a and 4b). In Ukraine, the trade deficit widened by 1.5% of GDP in 2006, while the current account swung into deficit. The decomposition into energy and non-energy parts reveals that the widening trade deficits were determined as much by increasing non-energy trade shortfalls as by rising energy trade deficits (or, in the case of Ukraine, by a falling non-energy trade surplus). In fact, non-energy imports rose significantly in all countries in the sample. This happened on the back of appreciating currencies, not only in real terms but also in nominal terms (in all countries apart from Moldova), which is not consistent with the theoretical adjustment mechanism described above.

Other developments in the external sector after the gas price shock

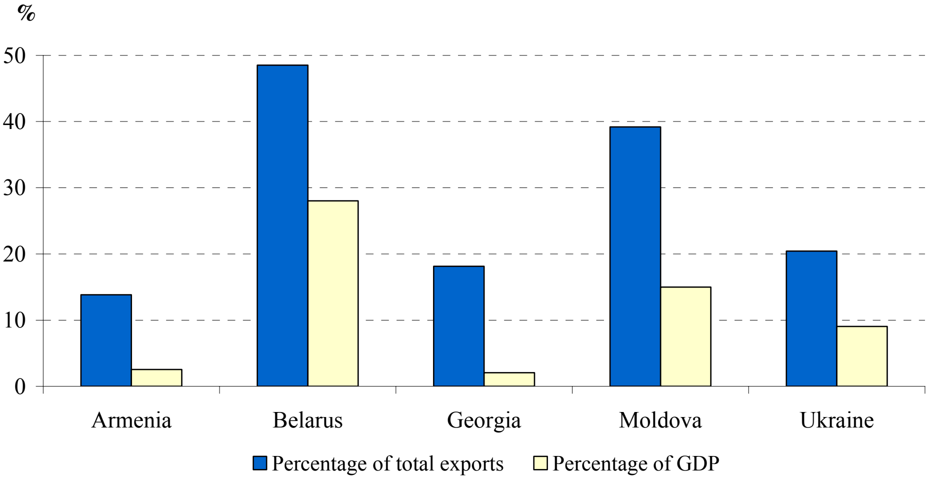
There are other developments in the external sector that have to be taken into account when assessing the impact of the energy price shock on the country's macroeconomic performance, as these may aggravate or mitigate the price shock. Such factors include exports, remittances, FDI and external borrowing. Analysing these developments helps in understanding how the shock has so far actually been absorbed and to explain the difference between estimated and observed outcomes of the simple modelling framework presented above.

[13] This would be even less if an increased oil bill is taken into account (see footnote 6).

Exports

Russia is not only the main energy supplier, but also a very important export market for many countries in the group. As one can see from chart 6, between 2000 and 2005 exports to Russia ranged from a high of almost 50% of total exports (representing close to 30% of GDP) in Belarus to a low of 14% (or 2.5% of GDP) in Armenia.[14] This means that the disputes with Russia over gas supplies may also affect trade in other goods, amplifying the gas price shock. Restrictions imposed by Russia on imports of agricultural products from Georgia and Moldova in 2006 serve as an example. The effects of these restrictions on the economies differ, although Moldova, due to its very high share of exports to Russia (the second highest in our sample, after Belarus) appears to have been affected much more severely than the other countries.[15]

Chart 6 - Trade with Russia, 2000-2005



Source: IMF/DOTS, authors' calculations.

On the other hand, unforeseen positive terms of trade shocks can also play a counterbalancing role for some countries. A case in point is Ukraine, where iron and steel are major export goods. Alghouth prices fell in 2005, they surged in 2006, suggesting that the negative gas price shock in 2006 was more than offset by these developments. Also in Ukraine, exports of natural gas collapsed between 2005 and 2006, from 2.06 bcm to a mere 153 m.c.m. (a 93% fall).

[14] Concerning the data for Georgia presented in Chart 6, EBRD estimates of total exports are more than *twice* the totals presented in the DOTS database. This is because the EBRD data includes estimates for "grey" exports from Georgia's separatist regions. *If* one assumes that this estimation of "grey" exports is correct and that they *all* go to Russia, then Russia's total in Georgian exports (and its share in GDP) increases very substantially.

[15] For Moldova, the IMF estimates that the combined effects of the Russian wine import ban and the gas price shock will have a combined negative effect on growth of 2-3% in 2006-07, and open a gap in the balance of payments of about 6.5-9.5% of GDP in 2006-2007. Roughly two thirds of the shock are attributable to the ban on Moldovan wine exports, and a third to the gas price shock (see IMF, 2007).

Remittances and FDI

Remittances can be a useful short-run adjustment tool for some countries. It is possible that if energy price increases are passed on to households, relatives abroad may increase the financial help to their families in the country. Remittances flows are notoriously difficult to estimate precisely, but it can be assumed that these may have had a particularly significant cushioning effect in Moldova: some surveys put remittances as high as 35% of GDP in 2006 (a jump of 5 percentage points over 2005). Remittances flows are also very significant in Georgia and also in Armenia. Some studies (see IMF, 2006) quote a share of remittances to GDP in Armenia of 20% in 2005, based on surveys.

FDI can become an important mechanism for adjusting to an energy price shock. In the short run, it would provide necessary financing in the short run; in the long run, FDI is likely to increase the export potential of a country, and may also be associated with the introduction of energy-efficient technologies (although any FDI attracted by the low energy costs would be adversely affected). In some cases, an increase in FDI can be directly linked to the energy price shock if a country tries to create a more conducive environment for foreign investors in order to attract much needed financing. On the other hand, an upsurge in FDI inflows may be completely unrelated to higher prices for energy imports. In any event, an increase in FDI will counterbalance the negative effect of the higher energy bill on the balance of payments.

As indicated in Table 6, only Georgia experienced a substantial increase in FDI inflows between 2005 and 2006.[16] Additionally, the above-mentioned IMF study points out that, in some cases, it might in fact be more correct to classify remittances as foreign direct investment, something which may be relevant for Armenia and Moldova.

Table 6 - Net FDI inflows

	2004		2005		2006	
	million USD	% GDP	million USD	% GDP	million USD	% GDP
Armenia	217	6.1	255	5.2	220	3.4
Belarus	163	0.7	303	1.0	351	1.0
Georgia	420	8.2	529	8.3	861	11.0
Moldova	146	5.6	199	6.7	223	6.6
Ukraine	1711	2.6	7533	9.1	5336	5.4

Source: National Statistics, EBRD database.

External borrowing

External borrowing can be used as another potential short-run adjustment tool. It may be a direct policy response of the government in an attempt to cushion the shock. Given its relationship to the fiscal framework, this point will be developed below. At the same time, the accumulation of external liabilities by the private sector can be due to reasons unrelated to the energy price shock, such as borrowing by banks to extend domestic credit). The most significant increases over 2006 in external liabilities, mainly in the private sector (around 5 percentage points of GDP) were in Ukraine and Moldova (Table 7).

[16] At the same time, a very significant jump in FDI inflows happened in Ukraine in late 2005, when the largest Ukrainian steel company, *Kryvorizhstal*, was re-privatised via its sale to Mittal Steel, the world's largest steel producer, for a record amount of USD 4.8 billion. That was the single biggest FDI in Ukraine's history, and part of the inflow was actually saved by the government in 2005 and used in 2006.

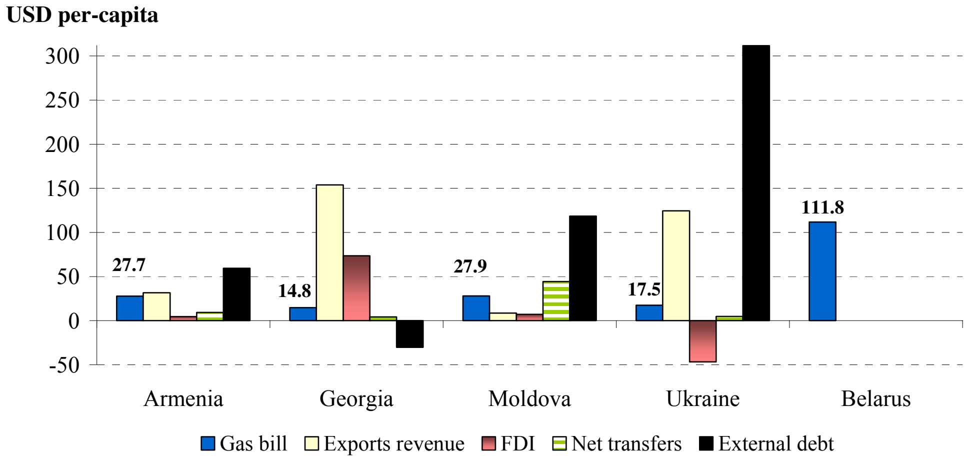
Table 7 - Total external debt (% GDP)

	Armenia		Belarus		Georgia		Moldova		Ukraine	
	2005	2006	2005	2006	2005	2006	2005	2006	2005	2006
Public and private	37.9	32.0	17.5	18.6	33.3	25.6	71.3	76.3	46.0	51.0
Public	22.4	18.8	2.1	1.6	27.1	21.8	25.8	26.4	15.6	12.9
Private	15.5	13.2	15.4	17.0	6.2	3.8	45.5	49.9	30.4	38.1

Source: National Statistics.

Chart 7 summarises the developments in the external sector after the 2006 energy price shock. It shows, without prejudging a direct causal link with the price shock, how the increase in the gas price bill in per-capita terms was counterbalanced by other developments in the external sector (exports, net transfers, FDI), and by the rise in external borrowing.

Chart 7 - Gas price shock and other external developments



Source: EBRD, national central banks, authors' calculations.

Clearly, external borrowing was the main counterbalancing factor, via a significant increase in private and quasi-private external debt. This debt accumulation was particularly strong in Ukraine and Moldova, but this was a common feature of the adjustment for all countries except Georgia (data for Belarus are not yet available). This is an important factor as it may increase vulnerability to future energy price shocks. In Armenia, the shock in 2006 was mitigated by increased remittances (part of which may be FDI, as discussed). Strong FDI in Georgia counterbalanced the shock to the external accounts. In Ukraine, the increase in the gas bill was lower than expected due to a substantial reduction in volumes of gas imports (among other factors caused by a significant reduction in Ukrainian gas exports and some improvements in energy efficiency: the precise magnitude of individual effects needs to be assessed) and was more than offset by additional export revenues related to the increases in prices for steel. In Moldova, neither exports nor FDI were sufficient to offset the shock, so the country had to rely on additional remittances and help from the international financial institutions.

Impact on fiscal accounts and prices

Another cushioning mechanism is the fiscal one, which has both domestic and external dimensions. It should be recognised that there may well be legitimate reasons why a government would wish to use fiscal tools to temporarily cushion the shock: these range from social spending (for instance, income support to protect less well-off households) to industrial policy (for example, to provide important economic sectors with a period of adjustment). In the post-shock period, there is a potential conflict between the price level necessary for a sustainable operation of the companies and social considerations with respect to the customer's ability to pay (the "affordability" issue). This is especially valid in an environment where social safety nets are still deficient. As even in the absence of price shocks the implementation of cost-recovery pricing in the utilities sector has been gradual and has been accompanied by the introduction of means-tested benefits for lower income households, the same should hold true for a period of energy price shocks. On the other hand, the use of fiscal means for industrial policy purposes is much more debatable.

That said, the average headline fiscal deficit of the countries in our sample showed only a relatively minor increase in 2005, when compared to 2004, from -1.1 % to -1.3%, but falling to -1.2% in 2006 (Table 8 below). No country has so far experienced any significant worsening of the headline fiscal position.[17] Belarus actually increased its headline surplus very significantly, deliberately hoarding fiscal revenue in anticipation of the price shock.

Table 8 - Headline fiscal balances (% GDP)

	2003	2004	2005	2006
Armenia	-1.1	-1.7	-2.6	-2.3
Belarus	-1.4	0	-0.6	1.4
Georgia	-1.6	-0.2	-2.4	-2.3
Moldova	0.7	0.8	1.5	-0.3
Ukraine	-0.9	-4.4	-2.4	-2.4
Average	-0.9	-1.1	-1.3	-1.2

Source: IFS from the IMF, National Statistics.

One must note the use of the expression "headline" fiscal deficit. That is because there are also other, far less transparent ways in which a national government can accumulate fiscal liabilities outside the government budget. The most relevant ones for this work are contingent liabilities. Those are potential claims that may or may not become explicit at some future point (for instance, explicit or implicit state guarantees on borrowing by state-owned or state-controlled enterprises, see Catrinescu and Vinhas de Souza, (2006)).

The accumulation of contingent liabilities seems to have become one of the adjustment mechanisms in Ukraine. A considerable amount of contingent fiscal liabilities seems to have been accumulated in the domestic energy company *Naftogaz Ukrainy*, as gas price increases have been only partially passed through to domestic consumers. The external debt of *Naftofaz* reportedly surged by over USD 2 billion over 2005-2006. This is partially reflected in Table 7, which shows that the share of private external debt in Ukraine increased by about 8 percentage points of GDP between 2005 and 2006.

Belarus may follow a similar process to that of Ukraine, after the accumulation of delayed payments to *Gazprom* during the first quarter of 2007. Those delayed payments are expected to be paid via proceeds from the sale of a 12.5% stake in *Beltransgaz* to *Gazprom*. The projected current account

[17] Privatisation in Armenia and Georgia may also have been a source of inflows that partially enabled the cushioning of the social costs of the energy shock in the short run without more significant fiscal pressures.

shortfall is likely to be financed by sizeable external borrowing in 2007 (tapping both international capital markets and official financing from Russia) and perhaps also by a speeding-up of privatisation.[18]

Table 9 - End-year CPI inflation (%)

	2004	2005	2006
Armenia	1.9	-0.2	5.2
Belarus	14.4	8.0	6.6
Georgia	7.5	6.4	8.8
Moldova	12.5	10.2	14.0
Ukraine	12.3	10.3	11.6

Source: IMF/IFS.

Another domestic effect of the energy price shock is inflation. As the pass-through has so far been less than complete in some of the countries in the sample[19], for reasons described above, the inflationary effects have until now been somewhat limited. Nevertheless, consumer prices increased in all countries in the study following the energy price shock (Table 9). The most pronounced rise was in Moldova, where inflation increased from 10.2% to 14% between 2005 and 2006, and in Armenia, where inflation increased from -0.2% to 5.2% (not by accident, as in these countries the price shock was almost completely passed-through to domestic consumers), followed by Georgia, where inflation rose by 2.4%. On the other hand, consumer prices in Ukraine increased by 1.3% only; at the same time, producer prices rose by 4.6%.

5. Conclusions

This chapter has presented an initial estimation of the effects of the gas price shocks in the energy-importing countries of the Western CIS and Caucasus. The results show that the Western CIS countries are more vulnerable to the shock, while the Caucasus countries show limited vulnerability, mostly because of their lower energy intensity. There is a substantial difference between the estimated and actual economic performance. This has happened because, in spite of very significant increases in prices for imported energy, other developments have acted as counterbalancing factors, dampening the expected negative impact on domestic absorption.

Although it is difficult to establish a direct causal link with the increase in energy prices, the main common counterbalancing factor has been the significant increase in private and quasi-private external debt: this was the case in all countries except Georgia. Other country specific factors played also an important role. In Ukraine, the shock to the external accounts was also counterbalanced by a positive terms-of-trade shock. In addition, the volume of gas imports declined substantially in 2006, for the reasons described in section 4. Greater FDI inflows helped to finance the widening current account deficit in Georgia. Moldova was the country most affected, and the shock was only partially

[18] One must also note that what is classified as "private external debt" in Belarus, and similarly in the case of Ukraine, also reflects the accumulation of debt by entities with state-participation in their capital, particularly banks.

[19] The pricing policies vary from country to country and can be quite complex, which makes the evaluation of the inflationary effects of the energy price shock difficult. They vary from an almost complete pass-through of the energy price shock in Moldova (although with a lag), a temporary "natural gas subsidy" to consumers introduced in Armenia (it is expected to expire in 2008), to the partial and differentiated pass-through in Belarus and Ukraine (which include differentiated pricing between different industries and households).

mitigated by increased remittances.[20] In Belarus, the shock took place only recently and the adjustment pattern is still unclear, but is likely to involve a significant increase in external indebtedness.

The inflationary effects have so far been limited in the countries where the price pass-through of the shock was incomplete; however, accumulated fiscal liabilities (including contingent liabilities) in these countries pose a risk to fiscal sustainability.

In terms of policy recommendations, given the permanent nature of the shock, the optimal strategy is to pass it through in full to domestic users. This will provide incentives for a more efficient use of energy and promote economic restructuring. In order to cushion the negative impact on the most vulnerable sections of the population, the increase in energy prices should be accompanied by the development of more efficient and better targeted income support mechanisms. Additionally, the speeding-up of privatisation, to attract FDI and accelerate economic restructuring may be advisable for some countries. From a longer term perspective, continued efforts towards greater energy efficiency should be undertaken, especially by the Western CIS countries.

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[20] And also by larger external support from the IFIs and official creditors: in 2006, Moldova re-scheduled its Paris Club debt and signed a new financing agreement with the IMF. In 2007, it will also benefit from concessional loan and grant financing from the World Bank, the EU (a new Macro Financial Assistance package) and other bilateral donors.

Part B

Regional overviews

OVERVIEW OF RECENT ECONOMIC DEVELOPMENTS IN MEDITERRANEAN COUNTRIES[1]

1. Summary of the overall situation in the region[2]

The economies of Mediterranean countries performed well in 2006. Most economies kept on growing at a good pace, with **real GDP** increasing on average by 4.8% in 2006, up from an average of 4.4% in 2005. The economic performance of the Mediterranean region would have been even better if conflicts had not ravaged the economy of two countries, Lebanon and the Occupied Palestinian Territory (OPT). Lebanon's stagnation in 2006 resulted from extensive damage to its economic and social fabric caused by the military conflict with Israel. In Palestine, the negative economic consequences of the international reaction to the election of the Islamist Hamas party caused a deep economic recession, estimated conservatively at 8% of GDP. On a per-capita basis, the region as a whole grew by an average 1.0% (2.6% excluding the OPT), bringing about an improvement in income levels and reducing the gap with incomes observed in the EU. Accelerated economic growth rates boosted job creation and reduced unemployment for a second year in a row.

Average **inflation** increased in the region during 2006, fuelled by increases in administered prices for transport and energy products in many countries as a result of higher oil prices. Continuing high oil prices resulted in fiscal surpluses in some oil-exporting countries. However, **fiscal balances** also improved in oil-importing countries following renewed efforts in the region towards fiscal consolidation, mainly through public sector reform and tax reform programmes. Improved fiscal balances translated into gradually declining levels of gross government debt in several Mediterranean countries, which, on average, contracted from 84.7% of GDP in 2005 to 81.4% in 2006, a movement in the right direction but still insufficient. Many Mediterranean countries therefore remain quite vulnerable to economic shocks. Finally, the robust growth of the tourism industry in the region, together with record remittances from workers abroad, resulted in marked improvements in the current account balance of several countries, which helped to reduce the overall current account deficit in the region.

Slow but steady progress towards **trade liberalisation** has been taking place in the Mediterranean region since 2000, with some countries being among the world's top reformers over this period. Association Agreements with the EU are now in force in almost all the Mediterranean Partners and their provisions continue to be implemented, although at a variable rate. Regional negotiations towards services and investment liberalisation started in July 2006 with a group of Mediterranean countries, and further progress towards agricultural trade liberalisation was recorded in several countries. In addition, two new European Neighbourhood Action Plans have recently been concluded with Lebanon and Egypt, paving the way towards deeper economic integration with the EU. However, intra-regional economic integration remains a major challenge for Mediterranean countries. Regional agreements continue to be plagued by

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[1] The terms Mediterranean countries or MED countries in this paper refer, if not stated otherwise, to the Mediterranean countries participating in the Euro-Mediterranean Partnership. These are Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Syria, Tunisia and the OPT.

[2] Reform indicators used in sections 3, 4 and 5 for trade liberalisation, business climate, and public institutions and governance are mainly, although not exclusively, based on the World Bank (2007), *MENA Economic Developments and Prospects. Job Creation in an Era of High Growth.*

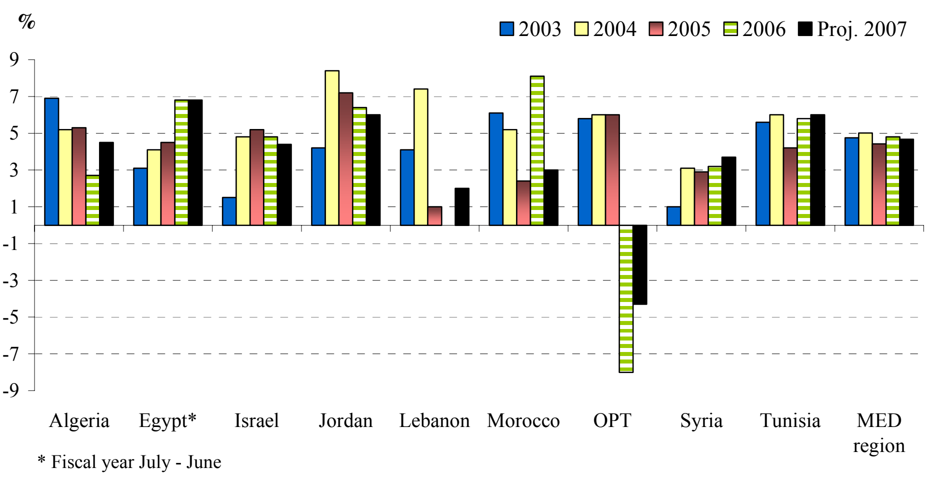
implementation problems, thus revealing a lack of political commitment towards a more integrated regional market.
Regarding the **business environment**, over the period 2003-2006, reforms in the region as a whole progressed in line with the world average, but performance remained unequal between countries. Egypt and Morocco were among the world's fastest reformers, but progress in other countries was below the world average. The region is progressing at a faster pace than the rest of world in some areas key to improving the business environment, such as contract enforcement and starting a business, but average performance is still poor in others, such as closing a business, licensing requirements and court efficiency in solving commercial disputes.

Improving **governance** systems, a complex multidimensional concept, remains particularly important for the MED region. As a whole, the region performs above the world average regarding the quality of public administration, an area where progress has been particularly fast over the past six years. Countries in the region are also improving public sector accountability, a dimension of governance in which the region ranks poorly compared to others. Despite this progress, however, corruption is a problem, civil society in the region is still underdeveloped, and political debate remains constrained in most countries.

2. Macroeconomic developments

On average, the economies of the Mediterranean countries continued to experience high growth rates during 2006. Strong increases in domestic demand, a substantial economic recovery in the EU leading to a better export performance, and the moderation of oil prices in the second half of 2006 boosted the average **real growth rate** to 4.8% from 4.4% in 2005. However, country-specific analysis reveals a mounting disparity in real growth rates, ranging from a remarkable 8.1% in Morocco — mainly due to its extraordinary agricultural output — to a high, although lower than expected contraction in the OPT of about 8%, reflecting the economic consequences of mounting tensions with Israel following the January 2006 elections (chart 1).

Chart 1 - Real GDP growth rate

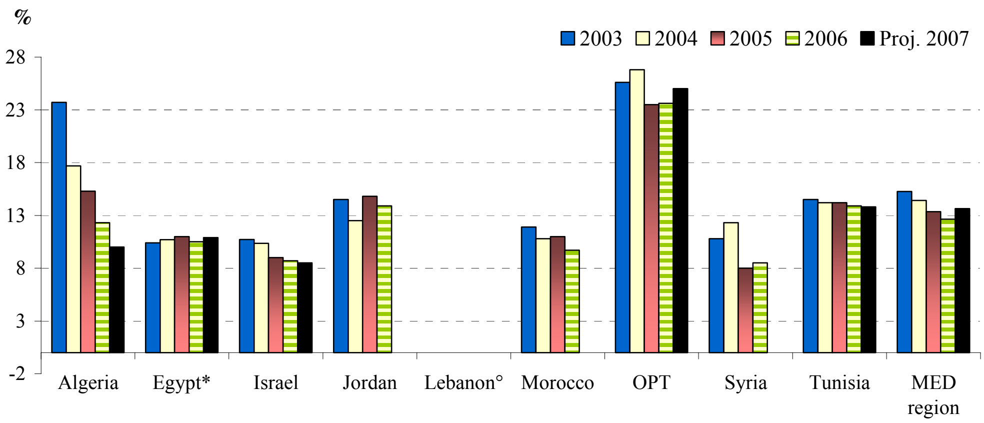


Source: IMF.

Excluding the OPT and Lebanon, where conflict triggered economic recession in the former and stopped growth in the latter, all Mediterranean countries experienced positive growth rates in 2006, with oil-importing countries, particularly Morocco, Egypt and Tunisia, leading the growth-accelerating group of economies in the region. Growth in these countries was due not only to a favourable economic environment, but also to extraordinary tourism revenues, remittances and FDI inflows. Strong rates of growth in Mediterranean countries have led to a fairly small increase in income levels in the region. On a per-capita basis, real GDP grew on average only at 1.0% in 2006

Accelerating economic growth in the Mediterranean countries has boosted job creation and a decline in **the rate of unemployment** (chart 2).[3] The average unemployment rate declined for the second time in a row to 12.6% in 2006, down from 13.4% in 2005 and 14.4% in 2004, even though the labour force grew by 2.2% and 2.5% in 2005 and 2006, respectively. However, despite raising employment growth, unemployment in the Mediterranean region remains high. The problem is particularly acute among the young and the qualified, with mounting frustration among graduate cohorts because of limited job opportunities.

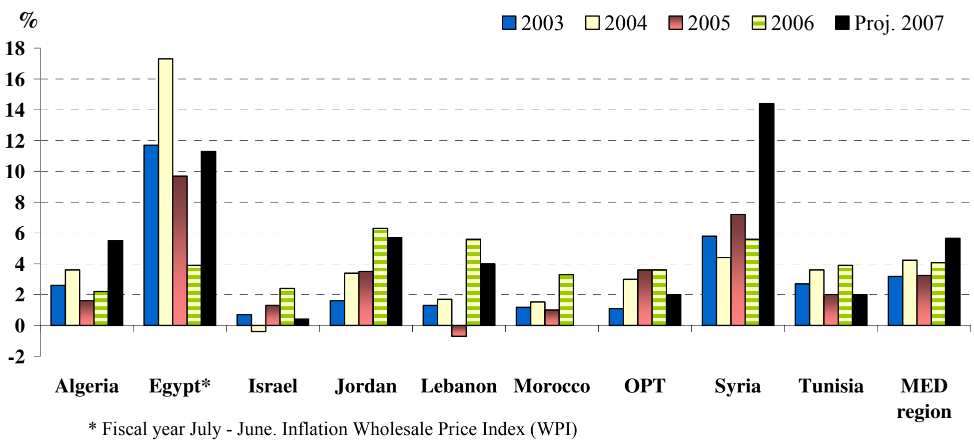
Chart 2 - Unemployment rate



* Fiscal year July - July.
° Data are not available.

Source: IMF.

Chart 3 - Inflation rate



* Fiscal year July - June. Inflation Wholesale Price Index (WPI)

Source: IMF.

[3] The average unemployment rate projection for 2007 is strongly biased by the lack of available estimates in more than 50% of countries considered and by the high estimates of unemployment rates in the OPT in 2007.

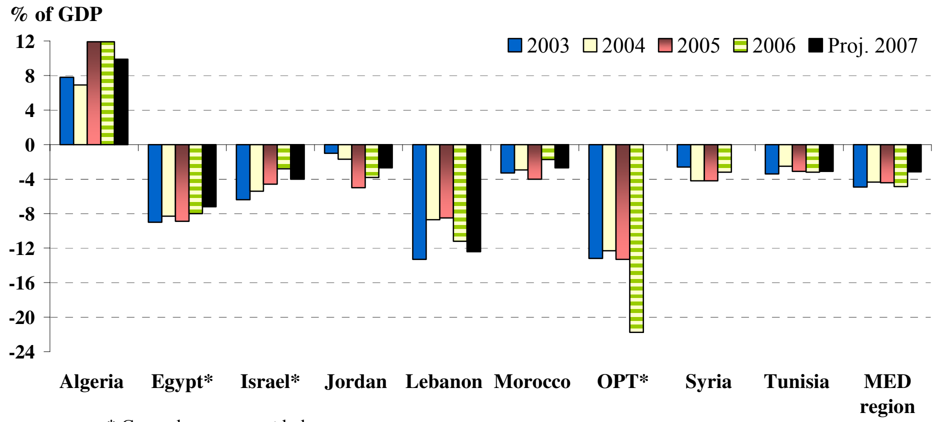
Average inflation (chart 3) remains subdued, but increased in 2006 to 4.1% from 3.2% in 2005. The greatest changes in the region year-on-year were recorded in Lebanon and Egypt. The conflict in Lebanon greatly disrupted economic activities, causing prices to soar and inflation to jump to 5.6% in 2006 from a previous -0.7% in 2005. Following a significant improvement in 2006, inflation in Egypt accelerated sharply during the fiscal year 2007 (starting in July 2006) due to increases in the administered prices for fuel, accelerating economic activity and the impact of bird flu on food prices. Higher consumer prices in 2006 in Jordan, Morocco and Tunisia also reflected government efforts to reduce price subsidies and increases in administered prices for transport and energy products.

The average **general government deficit** deteriorated slightly in 2006, standing at 4.9% of GDP, up from 4.4% in 2005. However, the average data are strongly biased by the emergence of a major fiscal crisis in the OPT in 2006. Excluding the OPT from the average leads to a more favourable picture, with the average fiscal deficit contracting to 2.8% of GDP in 2006 from 3.3% in 2005 (chart 4). Indeed, a majority of Mediterranean economies improved their fiscal balance, with oil-importing countries surprisingly leading the way, particularly Morocco (1.7% in 2006, down from 4.0% in 2005) and Israel (2.8%, down from 4.6%).

In Morocco, fiscal consolidation is the result of a combination of successful reforms on several fronts: a fundamental restructuring of the public administration (including a voluntary retirement programme, which has helped to curb the wage bill), wide-ranging improvements in the budget management system and substantial reform of the tax system to stabilise revenues and improve the fiscal system. This combination bodes well for the long-term sustainability of fiscal consolidation and its impact on growth.

Extraordinary oil revenues have also helped Algeria to maintain a fiscal surplus, amounting to 11.9% of GDP in 2006, which could have been even higher if the government had not subsidised oil prices and allowed for extraordinary expenditure. In sharp contrast with the regional trend in 2006, the fiscal situation collapsed in the OPT with the public deficit standing at 21.8% of GDP, up from an already worrisome 13.3% in 2005.

Chart 4 - Central government balance



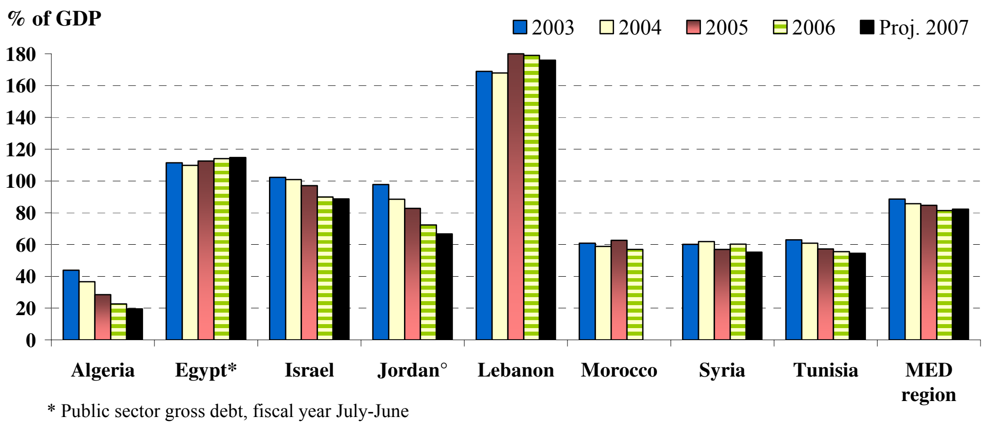
* General government balance

Source: IMF.

Last year's improvements in the fiscal balances of some Mediterranean countries have translated into gradually declining levels of gross government debt in Jordan, Israel and Morocco (chart 5). Consequently, the average gross public debt in the region contracted to 81.4% of GDP in 2006 down from 84.7% in 2005, but still remains too high, particularly when compared with the current average gross public debt of 19.4% of GDP in countries to the East of the EU.[4] Behind the regional average, however, there is a wide variation from country to country. Public debt is by far the highest in Lebanon at 179% of GDP in 2006, followed by Egypt at 114% of GDP in 2006, a level considered to be one of the main constraints on economic growth. At the other extreme, Algeria has substantially reduced its outstanding debt using its oil revenues.

Although progress is being made, the combination of a high public debt and a high budget deficit remains a challenge, particularly in Egypt, Israel, Lebanon and Jordan.

Chart 5 - Total gross public debt



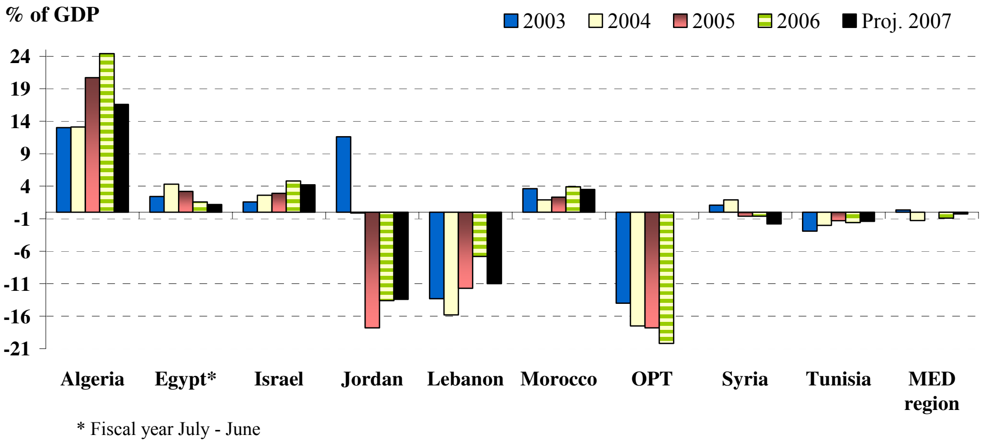
* Public sector gross debt, fiscal year July-June
° Net public debt

Source: IMF.

During 2006, the evolution of the **current account balance** in many Mediterranean countries was favourable. The average current account deficit nearly halved to 1.2% of GDP from 2.2% in 2005. This figure conceals a wide variation between countries (chart 6). Boosted oil revenues in oil-exporting Algeria translated into growing current account surpluses (2006: 24.4%; 2005: 20.7%; 2004: 13.1%). However, the expected deterioration in the current account balances of oil-importing countries did not materialise. Negative trade balances in Morocco and Egypt were offset by record tourism revenues (about 9% of GDP in Morocco and 7.6% in Egypt) and growing remittance inflows, resulting in current account surpluses in both countries (3.9% and 1.6%, respectively). In contrast, high current account deficits were recorded in Jordan, Lebanon and the OPT, with the deficit in the latter now over 20% of GDP mainly due to the limited ability of Palestinian traders to export and due to banking restrictions affecting transfers to the Palestinian Authority. In Lebanon, the military conflict sharply reduced exports and revenues from tourism, although increased transfers and a radical drop in imports helped to limit the increase of the current account deficit in 2006.

[4] The eastern neighbours of the EU under the ENP are Azerbaijan, Armenia, Georgia, Moldova, Ukraine and Russia. See also the overview of this region in the next chapter.

Chart 6 - Current account balance



Source: IMF.

Declining public deficits and gross government debt levels in some Mediterranean countries are intimately related to their efforts to improve their **budget and fiscal management systems**. Progress in this field has been seen mainly in Morocco[5] and Jordan. In the former, fiscal transparency has been increased by improving access to financial information, control over the processes involved in preparing and executing expenditure and the quality of financial data. In Jordan, the establishment of a single treasury account, the modernisation of the budget classification and strengthening of the budget processes have been key elements in the reform of a public finance management (PFM) system. However, few signs of progress can be detected in the remaining countries. In some countries, high oil revenues have acted as a deterrent to public expenditure reforms; in others, the difficult political environment has even reversed some past reforms, as in the case of the OPT, where the single treasury account was discontinued and modern internal audit and control methods were suspended.

The overall situation with respect to PFM in the Mediterranean region points to the need for action to meet the transparency standards of international best practices. Short-term reforms should aim for the gradual expansion of budget coverage and monitoring, the modernisation of government accounting, improvements in financial reporting during the execution of budget law, and the evaluation of fiscal risks.

3. Trade liberalisation and economic opening

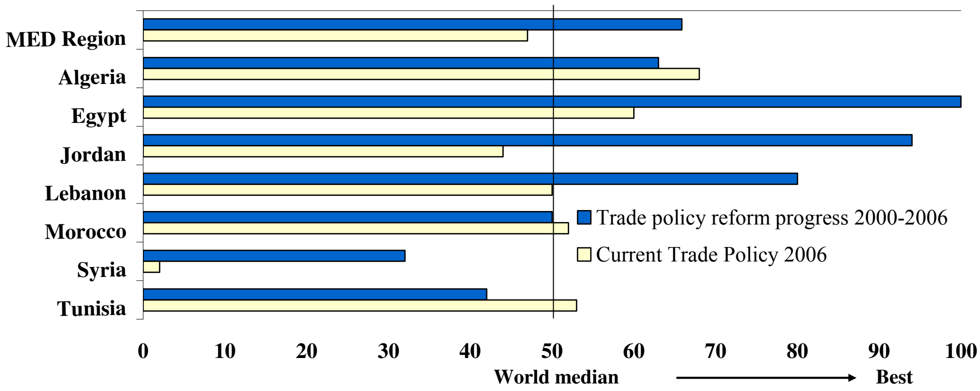
Overall, there has been slow but steady **progress towards trade liberalisation** in the region since 2000, with Mediterranean countries doing significantly better than the world average in adopting more open trade policies (chart 7). In the last six years, for example, Mediterranean countries have managed to narrow the gap with the rest of the world as regards tariff barriers: while in 2000 they had the **highest level of protection in the world** (with simple average tariffs[6] standing at almost 23%, way above the world average of 13.6%), by 2006 average tariffs had fallen considerably to 16.8%, highlighting the

[5] Since the end of 1990s, Morocco has embarked on a process of PFM modernisation. Progress has been achieved in implementing: i) a new performance-based budget approach by, among other things, increasing the transparency of budget laws; and ii) an MTEF, including better quality of financial information and improved access to this information.

[6] This reflects Most Favoured Nation (MFN) tariffs.

growing efforts to moderate the average tariffs applied to goods[7] (see Table 1 in annex). From 2000 to 2006, Egypt abolished import fees and surcharges incompatible with GATT, Jordan joined the WTO and Algeria significantly reduced its maximum tariff rates and rationalised its tax and tariff structure, all of which puts them at the forefront of trade policy reformers in the region. Tariff reductions also continued in Syria, although it has not yet ratified the Association Agreement with the EU.

Chart 7 - Current trade policy vs. reform progress 2000-2006*



* Based on a worldwide ordering of countries (using simple average tariffs and a variety of indicators, respectively), and expressed as a cumulative distribution function ranking economies from 0 to 100 (best).

Source: World Bank 2007.

Trade liberalisation implies, however, much more than reducing tariff barriers. Several milestones in the opening of trade have been reached in the region over the last six years: some Mediterranean countries (Morocco, Israel, Egypt, and Jordan — in July 2006) have adopted the **new Pan-Euro-Mediterranean Protocol of Origin,** which extends the pan-European system of origin cumulation to the Mediterranean region; **Association Agreements** with the EU have entered into force in Algeria, Morocco, Jordan, Lebanon and Egypt, adding to the existing agreements with Tunisia and the OPT;[8] and **Action Plans under the European Neighbourhood Policy (ENP)** have been agreed with Jordan, Morocco, the OPT, and Tunisia. Lebanon and Egypt have recently adopted their Action Plans (in January and March 2007, respectively), paving the way towards deepened economic integration with the EU.

In spite of these efforts, trade in the Mediterranean region is still burdensome in terms of time, costs and the number of procedures involved in trading across borders, with Syria and Algeria topping the list in 2006 on an index measuring difficulty in trading. Nevertheless, progress in **trade facilitation** accelerated in the region during 2006. Egypt, Jordan and particularly Syria have reduced both the number of days and documents needed for imports, and Syria has also reduced the number of days and documents for exports (although still remains among the most difficult countries worldwide to trade with). Trade facilitation efforts have not gone unnoticed by private investors in the region. **FDI in Mediterranean countries** soared in 2006, largely driven by the surpluses generated by the oil-boom revenues in the Gulf countries. Total expected inflows amounted to USD 23 billion in 2006, 35% up from 2005 and more than doubling the levels in 2004. Israel and Egypt accounted for the bulk of the increase, with Egypt receiving over USD 6 billion in the 2006 fiscal year and expecting over USD 8 billion in 2007. FDI reached a record USD 2.8 billion in Jordan in 2006, while Morocco and Tunisia too saw substantial, although declining,

[7] In 2006, the MED region nevertheless again topped the world trade protection list, which reflects the rapid average world progress in this area.
[8] The Association Agreement with Syria remains to be put into force.

FDI inflows in the same period, with Lebanon also receiving a fair share of FDI during the first half of 2006. Gross capital inflows, mainly from Arab Gulf countries, grew by 171% compared to the same period in 2005, reaching USD 6.3 billion.

During 2006, all Mediterranean countries continued to **implement the provisions of the Association Agreements**, including the dismantling of tariffs for industrial products under the free trade agreements (FTAs). New prospects for further trade liberalisation opened up at the Fifth Euro-Med Trade Ministerial Conference in March 2006. A first wave of Mediterranean countries, including Morocco, Tunisia, Israel, Jordan, Lebanon, Egypt and the OPT, opened negotiations with the EU **to expand the present FTA coverage to include services and investment liberalisation**. Negotiations at regional level started in July 2006 on standard provisions for a future services and investment protocol to form the basis for bilateral negotiations. The Trade Ministerial Conference also served to confirm the intention of the Mediterranean countries to deepen **agricultural trade liberalisation** as agreed in the Rabat roadmap. In 2006, progress was made in this area by Morocco, which started negotiations with the EU towards progressive liberalisation of trade in agricultural, processed agricultural and fisheries products, though with some exceptions. Similar negotiations had already been concluded with Jordan, with the agreement entering into force in January 2006. During 2006, Egypt presented a full list of products due to be liberalised in early 2007 and reduced tariffs on processed agricultural products.

Trade openness has exposed Mediterranean countries to increased international competition. A recent study[9] on the **impact of the expiry of the WTO Multi-Fibre Agreement** (MFA) presents evidence indicating that some Mediterranean countries highly depend on the textile and clothing sector (Tunisia, Morocco, Jordan and Egypt) have experienced a drop in their share of the EU export market.[10] Since the removal of the remaining MFA quotas, textiles and clothing exports to the EU by Tunisia, Morocco and Jordan to the EU have declined by 5.8%, 7.4% and 13%, respectively. Egypt, whose exports are well diversified geographically between the EU and US markets, managed to maintain textile exports to the EU, with just a marginal decline of 1% in the value of textiles and clothes. On the other hand, Egypt and Jordan have both performed strongly in the US market after MFA removal. In 2005, exports to the US from the two countries increased by 8% and 13%, respectively, reflecting their preferential access to the US market through their Qualified Industrial Zone Agreements. Tunisian exports to the US also increased in 2005 after the removal of quotas (15.5%), in contrast with a decline of over 20% in Moroccan exports during the same period.

In sharp contrast with the efforts undertaken by Mediterranean countries to increase their economic integration with the rest of the world, **economic integration within the Mediterranean region** is still no more than embryonic and has so far failed to deliver the expected results. Regional initiatives to deepen South-South economic integration, such as the Agadir agreement,[11] continue to be hampered by implementation problems such as aspects related to the exclusion of some agricultural and processed agricultural products, and the modalities to address non-tariff barriers. Some countries have made efforts

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[9] Morocco, Tunisia, Egypt and Jordan after the end of the Multi-Fiber Agreement: Impact, Challenges and Prospects, World Bank, 2007

[10] The impact on the textile and clothing exports of these countries would have been greater if the EU had not reimposed quantitative restrictions on Chinese exports in 10 product categories in June 2005 in accordance with the safeguard provisions of China's WTO accession agreement. In July 2005, the US also reimposed quotas on China in six strategic product categories.

[11] The Agadir agreement aims for the establishment of a free trade area (FTA) between Morocco, Tunisia, Jordan and Egypt.

to improve regional integration, such as Syria, which has signed twelve cooperation agreements with Iran in several areas ranging from energy to agriculture, and Jordan, which has negotiated a free trade agreement with the Gulf Countries including areas such as insurance and banking, agricultural products and the movement of persons.

Clearly, these attempts to deepen regional integration are steps in the right direction, because they help facilitate the movement of goods and services and improve the attractiveness of the region for foreign investors. But the economic benefits of opening domestic markets to neighbours would be much higher if trade liberalisation were to go beyond just free trade in goods and services. This is a key premise of the ENP, which advocates **economic integration including "behind-the-border" issues** such as addressing non-tariff barriers and progressively achieving comprehensive convergence in trade and regulatory areas, such as technical norms and standards and trade-facilitating customs measures, among others.[12] Indeed, boosting the competitiveness of the region will increasingly depend on this type of reform, rather than on comparative advantages based on pay differentials among unskilled workers. Overall, behind-the-border trade reforms have been slow to emerge in the region mainly because they touch upon areas traditionally used as last resorts to protect domestic markets. However, some progress has been seen in Egypt, Algeria, Morocco and Tunisia in the area of customs administration, particularly in the simplification of procedures.

4. Business climate[13]

Creating the number of jobs needed to cope with growing populations and rising numbers of entrants in the labour market greatly relies on maintaining and accelerating the current rates of economic growth and on pursuing further reforms to improve the business environment. This is all the more important in a context characterised by the limited ability of the public sector to further generate employment and by reinforced controls over migration.

For the last three years, the **progress** made by the region in reforming the business environment has been in line with the world average,[14] with reforms concentrating on easing the conditions for starting a business and enforcing contracts. This points to the need to pursue efforts in other areas that remain the greatest obstacles for doing business, such as high licensing requirements and inefficient courts. Within the region, the reform efforts were led by Morocco followed by Egypt and Syria, all performing above the world average.

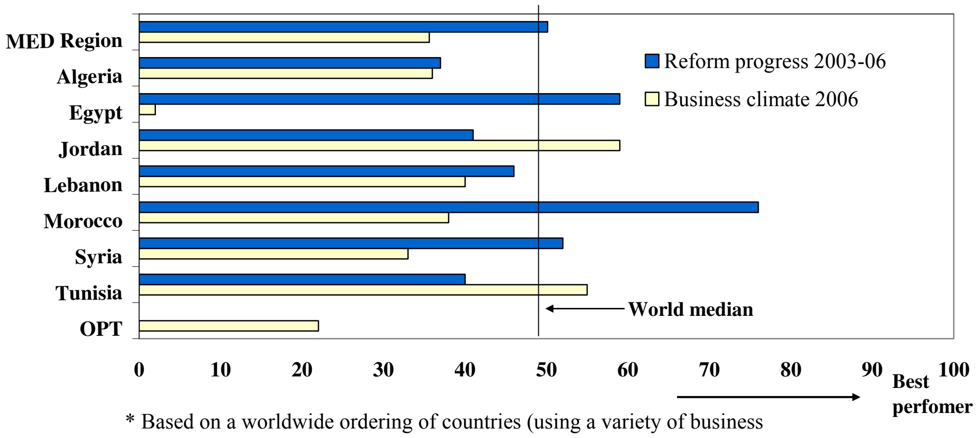
[12] See the Communication from the European Commission on strengthening the ENP, COM (2006) 726 final, 4 December 2006.

[13] This section contains information on all MED countries excluding Israel. Overall, Israel outperforms all other countries in the region in an index measuring the ease of doing business. Including Israel in the regional averages would have greatly distorted the general trends described in this section.

[14] That is to say that these countries ranked on average in the 50^{th} percentile with regard to business environment reform in the period 2003-06, surpassing the reform efforts in other regions such as East Asia and South Asia and high-income OECD countries.

Overall, however, the Mediterranean countries remained under the world average in 2006 in an index measuring the **business environment,**[15] even showing a slight deterioration compared with the situation in 2005. The region still has a few countries ranking among the least business-friendly in the world (Egypt, Syria, the Occupied Palestinian Territory and Algeria). Country-specific analysis shows that only two countries in the region, Jordan and Tunisia, perform above the world average — replicating the situation in 2005 — although their overall performance has deteriorated compared with the situation in 2005, particularly in Jordan, which has lower scores on every indicator in 2006, in stark contrast with the marked improvement in 2005. Year on year, improvements were recorded only in Morocco and Egypt, which reflects their strong reform efforts over the last three years, well above the world average, particularly in the case of Morocco (chart 8). The performance of all the other countries in the region deteriorated in 2006 compared with 2005, the greatest regressions being recorded in Jordan, the OPT and Algeria.

Chart 8 - Business environment in 2006 vs. regulatory reform 2003-2006*



* Based on a worldwide ordering of countries (using a variety of business environment indicators), and expressed as a cumulative distribution function ranking economies from 0 to 100 (best).
Note: Reform progress 2003-06 for OPT is not available.

Source: World Bank, 2007.

One of the fundamental factors behind the poor business environment in Mediterranean countries is **highly restrictive labour market regulation**. Although labour market restrictions decreased in the region in 2006, employing workers remains difficult, particularly in Morocco and Egypt. Region-wide, reform efforts have largely focused on improving the ease with which workers can be hired by expanding the power of businesses to employ temporary workers, but restrictions on firing workers still remain in place.[16] However, the situation in the region varies widely: Morocco still imposes extremely strict regulations on hiring workers (ranking 100th) but has relaxed regulations on firing workers. In 2006, Tunisia and Syria relaxed the rules on hiring workers, although Tunisia still has very rigid labour

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[15] The current status of the business environment in 2006 is measured using a business environment index combining the information contained in ten business environment indicators: 1) ease of starting a business; 2) ease of closing a business; 3) ease of employing workers; 4) ease of enforcing contracts; 5) ease of registering property; 6) ease of paying taxes; 7) degree to which investors are protected; 8) ease of dealing with licenses; 9) ease of getting credit; and 10) ease of trading across borders. The index is expressed as a cumulative frequency distribution, with 100 reflecting "best policies" worldwide and 0 representing "worse policies" worldwide. World Bank (2007) *MENA Doing Business 2007.*

[16] This is the case with Syria and Egypt, where there are no problems hiring workers (ranking 0 in an index measuring the difficulty of hiring) but greater obstacles to firing workers (50th position for Syria and Egypt with a ranking of 100th, meaning total rigidity). Indeed, under Syrian law, only the Prime Minister can fire public sector workers, who make up 90% of the employed population. Firing for redundancy in Egypt is still illegal.

regulation, nearly the strictest in the region, only behind Morocco. However, improving the flexibility of labour markets is not just about changes in the ease with which workers can be hired and fired. Some Mediterranean governments are serious about labour market reforms aimed at stimulating the role of the private sector in employment generation. Morocco's recent labour market reforms should help ease the current rigidity of employment,[17] particularly when the effects of the new labour code come to fruition. Tunisia's recent National Economic and Social Pact, under which real wages will follow productivity growth in the non-oil sector, might also increase the competitiveness of the economy and boost job creation.

Substantial reform efforts have been undertaken in the Mediterranean region during the last three years to improve contract enforcement and the ease of starting a business**,** with some Mediterranean countries performing well above the world average. As regards **contract enforcement**, Egypt, Jordan and Morocco have been among the top reformers since 2003, but enforcing contracts still remains very difficult in half of the countries considered.[18] As for the **ease of starting a business**, Morocco and Jordan are leading the efforts in the region. The former has reduced the number of procedures, the average time and the average minimum capital for starting a business, resulting in a sharp increase in business start-ups. In 2005, Egypt established a 'one-stop shop' to reduce the time and number of procedures and cut registration fees for new businesses by 40%, which has facilitated investment. In 2006, however, three-quarters of the countries in the region still ranked in the bottom third of countries worldwide in the ease of starting a business. Furthermore, Mediterranean countries still have a long way to go to reduce the time and cost of **closing a business.** Overall, the reform efforts in the region are well behind the world average, far short of those undertaken by OECD countries. Lebanon has been at the head of the reformers for the last three years in closing businesses, but progress seems to have come to a standstill in Jordan and Syria over the same period. During 2006, only two countries improved their ranking world-wide compared with the situation in 2005: Tunisia and Algeria, with the later having reduced the time needed to close a business from 3.5 years to 2.5 years. Tunisia, in the 90th percentile, remains one of the best countries worldwide for closing a business. Improved bankruptcy laws in Egypt should allow this country to significantly ease business closure procedures in the near future.

Mediterranean countries are also pursuing efforts to strengthen the efficiency and prudential standards in the financial sector, which will make it easier for the private sector **to get credit**. Reform efforts have mainly been undertaken by those countries with the lowest scores to date. In Morocco, for instance, banks have developed internal rating systems and now store credit information on a centralised database common to all credit institutions; Tunisia has also improved its credit appraisal techniques. Algeria has modernised its payment system and introduced performance contracts in public banks and Egypt is implementing a broad financial sector reform, including the privatization of some state-owned banks.

[17] The voluntary retirement programme introduced by the government in 2005 aims to encourage public officials to move to the private sector, thus mitigating pressure on the public sector. Other measures to boost the dynamics of the labour market include, for instance, the Moukawalati programme aiming to create 30 000 SMEs by 2008 and the reorganisation of the Agency for Employment Promotion (ANAPEC).

[18] The average time to enforce a commercial contract in the region is 640 days, among the highest in the world, with Egypt and Syria being the extreme cases (1010 and 872 days respectively) and Tunisia scoring best (21 days).

5. Public institutions and governance systems

Governance is a very complex concept encompassing multiple dimensions, including the rule of law, controlling corruption, public sector efficiency and public participation, among others. Countries make efforts to improve the governance of the public sector because empirical evidence suggests that macroeconomic reforms have a greater chance of success in boosting economic growth and job creation when they take place in the right context, i.e. when they are put in place by a competent and clean public administration and when citizens can hold politicians accountable for the results. Indeed, cross-country growth accounting studies conclude that differences in the quality of the institutional framework explain a large part of the differences in economic development.[19]

The ultimate goal of governance reforms is to build capable and accountable states that can devise and implement sound policies, provide public services, set the rules governing markets, ensure oversight of how public resources are used, and subsequently support development and economic growth.[20] The Mediterranean countries have made considerable efforts to **improve the internal accountability of their governments**, notably by increasing the quality of their public administration. The current status of the Mediterranean countries as measured by an index for the quality of the public service shows that, on average, the region ranks nearly on a par with the world average, with Morocco, Jordan and Tunisia enjoying the best public administrations in the region, well above the world average (chart 9). Some Mediterranean countries are among the world's top reformers and have made substantial efforts to improve the **effectiveness of public administration**. Morocco and Egypt are both making faster progress than 90% of countries worldwide, backed by a strong government commitment towards improving the quality of services delivered by the public administration.[21] However, public administration reform is a slow process that will only show results over time: reforms to bureaucracies generally take quite a while to improve government performance.

Progress is still needed on other indicators of the quality of the public administration, such as the degree of **transparency** that governments exhibit towards the general public. For instance, no Mediterranean country guarantees citizens the right to information and some countries even repress that right. Public access to national accounts has improved, however: the Ministers of Finance in most countries have eased access to key economic and financial information and substantially shortened the delays in making updates available. However, the lack of economic transparency is still a problem in Mediterranean economies, particularly in the banking sector. Substantial bank assets are still controlled by state-owned institutions, a situation that undermines competition, increases the opacity of bank operations and often leads to excessive and misused government spending. Efforts to improve banking efficiency and to control corruption in lending by privatising state-owned banks and passing banking regulatory laws aimed at increasing the transparency of banking operations (public disclosures of financial data, for instance) have been recently undertaken by Morocco,[22] Egypt,[23] Algeria[24] and Jordan.

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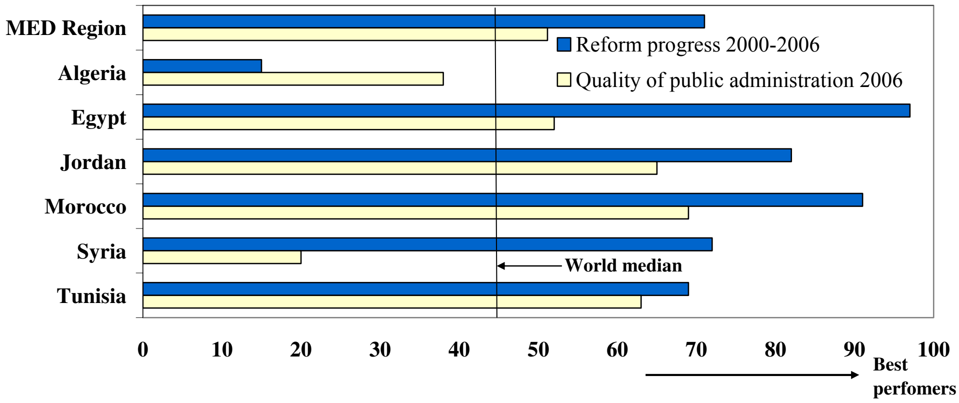
[19] See Barro and Sala-i-Martin (1995) and Hall and Jones (1999).

[20] *Strengthening World Bank Group Engagement on Governance and Anti-corruption*, World Bank 2007.

[21] In Morocco, the public administration reform put in place in 2003 has helped improve the efficiency of public service delivery and public service management. More details on this reform are given in the section dealing with fiscal developments.

[22] Morocco has restructured two major state-owned banks, the Crédit Immobilier et Hôtelier (CIH) and *Crédit Agricole du Maroc* (CAM). Following restructuring efforts, two leading financial institutions, the Moroccan *Caisse de Dépôt et de Gestion* and the French *Caisse Nationale des Caisses d'Epargne Française*, now participate in the capital of the CIH.

Chart 9 - Quality of public administration in 2006 vs. reform progress 2000-2006*



* Based on a worldwide ordering of countries (using a variety of governance indicators), and expressed as a cumulative distribution function ranking economies from 0 to 100 (best).

Source: World Bank, 2007.

Controlling corruption is another indicator of the quality of the public administration. Public administrations that combat corruption effectively are generally more attractive to foreign investors and can thus count on additional resources to spur growth. However, perceived levels of corruption are still high in the majority of Mediterranean countries. In 2006, only two countries in the region, Israel and Jordan, scored above the world average in a corruption perception index.[25] Compared with 2005, scores deteriorated in most Mediterranean countries with substantial improvements recorded only in Algeria and Lebanon (which however continue to score under the world average). The notable deterioration in the perceived level of corruption in Jordan might be the result of a delay in adopting some of the provisions in the UN Convention against Corruption, such as establishing an anti-corruption commission, whistle-blower protection and freedom of information laws. However, Jordan's performance in 2006 should not mask its positive overall performance in the fight against corruption over the last decade. A relative liberal stance on political and social affairs and numerous new laws based on international standards still makes Jordan the cleanest country in the region (coming only after Israel).

However, the country scores should be interpreted with caution, as they are based on current perceptions. The domestic reforms currently ongoing in some Mediterranean countries will take time to affect future scores, which may hide somewhat present efforts to combat corruption. Indeed, several countries are taking serious steps to limit the extent of corruption within their public administrations. In April 2005, Morocco announced a plan to fight corruption, including one measure requiring all senior office holders to make a formal disclosure of their assets and net worth before and after holding public office. In early 2007, the Moroccan government also adopted a law on money laundering and consolidated transparency in the process of awarding government contracts. In January 2006, Algeria enacted an anti-corruption law, including a code of conduct for public servants and protection for whistle-blowers. In contrast, other

[23] Egypt has announced plans to privatise the *Bank of Alexandria* in 2007. Further privatisation of state-owned enterprises is planned to continue in the fiscal year 2007 at a similar pace as in 2006.

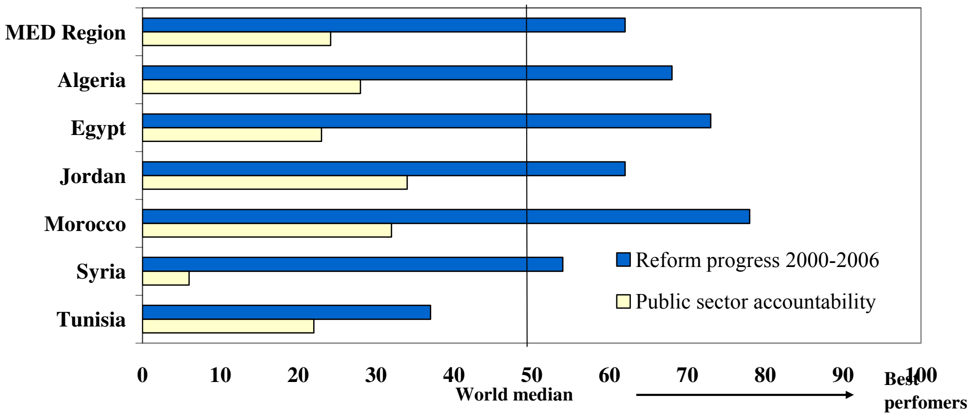
[24] The privatisation of the first public bank, the *Crédit Populaire d'Algérie*, is planned in the short term and two other banks, *Banque Nationale d'Algérie* and *Banque Locale de Développement*, have been identified as candidates for privatisation.

[25] The Corruption Perception Index produced annually by Transparency International ranges between zero (very corrupt) and ten (clean).

countries have not made enough progress in this field; for instance, the OPT has not yet adopted a national anti-corruption strategy and anti-corruption measures have been intermittent.

The protection of property rights and other **regulations affecting the business environment**, such as the ease (or difficulty) of enforcing contracts are also the responsibility of public administrations. The reforms carried out by Mediterranean governments to improve the conditions under which the private sector operates have been analysed in detail in the previous section and make a fundamental contribution to economic governance. On average, efforts to improve the legal framework for commercial activities have intensified in the Mediterranean region. Progress in easing conditions for contract enforcement has been recorded in some countries (Egypt, Jordan and Morocco), although reform efforts slowed down in the region in 2006. Registering property remains particularly difficult in Algeria, Egypt and the OPT, seriously hindering the role of the private sector as the future main source of employment generation in the region. The transparency of financial markets and institutions is also important to the private sector because this largely determines the framework in which it carries out its activities. In general, major financial sector reforms have been under way in some Mediterranean countries since 2000, including the reduction of government involvement in the financial sector and the modernisation of the banking sectors. Morocco has recently approved a new banking law to help reinforce the supervisory and regulatory work of its Central Bank (BAM). Algeria modernised its payment system in 2006 and strengthened the supervision of public banks, mainly through on-site inspections. In contrast, financial sector reforms are still embryonic in Egypt and Syria, which are still dominated by state-owned banks.

Chart 10 - Public sector accountability in 2006 vs. reform progress 2000-2006*



* Based on a worldwide ordering of countries (using a variety of governance indicators), and expressed as a cumulative distribution function ranking economies from 0 to 100 (best).

Source: World Bank, 2007.

In line with the improvements made in the Mediterranean region as regards internal accountability, the last six years have also seen substantial progress in **external accountability,** i.e. public oversight of politicians and policy-makers. On average, Mediterranean countries have done substantially better than the world average in improving government accountability, heading the reform efforts worldwide (chart 10). Morocco and Egypt again lead the region: in February 2006, the Moroccan parliament adopted a new Political Parties Law, which has helped to consolidate the credibility and efficiency of political parties and institutions. Also during 2006, Egypt pushed forward democratic reforms by holding a referendum on 34 constitutional amendments. However, the reform efforts of recent years continue to contrast greatly with the absolute ranking of Mediterranean countries in terms of public sector accountability, which was on average the lowest world-wide. Jordan enjoyed the highest ranking, slightly above the bottom third

(34th percentile), but still well below the world average. Syria continues to be an extreme case in the region (6th percentile), not having seen any progress in public sector accountability over the last six years. In general, reforms to strengthen political accountability through political competition and the transparency and regulation of political parties are conspicuous by their absence. Mediterranean countries have not made sufficient effort to open up the political space and allow for greater accountability in public policy. Restrictions on civil liberties, opposition parties and civil society organisations are still widespread in Mediterranean countries. In Algeria, for example, public demonstrations are frequently banned and the right to strike has disappeared. Region-wide, journalists are still sentenced to prison on charges of criticising the government, violating therefore the freedom of the press. Reforms to ensure a more accountable public sector are therefore badly needed in the region.

4. Concluding remarks

Overall, 2006 can be considered a good year for the Mediterranean region. Economic growth accelerated with the support of a favourable external environment. Greater demand in export markets enhanced the export performance of many countries in the region (particularly in the tourism sector), which boosted economic growth, generated employment and helped to maintain the declining trend in average unemployment rates in the region.

Notwithstanding recent accomplishments, job generation remains one of the major challenges in the Mediterranean region, particularly in the light of two main factors: on one hand, many countries in the region are involved in fiscal consolidation processes making it increasingly difficult for governments to absorb labour market entrants by expanding public employment; on the other hand, growing restrictions on immigration into neighbouring EU countries are increasingly limiting the ability of Mediterranean economies to export unemployment, thus making it all the more necessary to speed up urgent reforms to increase the flexibility of labour markets and encourage the role of the private sector in domestic job generation.

As pointed out in this document, many encouraging results are emerging in the four areas studied. Some Mediterranean countries are reforming fast, faster than any other country in improving aspects of the business environment and improving the quality of their public administrations. Some are determined to stick to planned macroeconomic reforms aimed at enhancing the role of markets, fostering fiscal consolidation and further integrating within the global economy, with the ultimate objective of achieving higher growth rates. However, others are still riding the wave of the oil boom, which is already showing signs of slowing with the stabilisation of international oil prices. The current high global growth and the acceleration of the economic activity in the EU, the Mediterranean region's main trading partner, offer a favourable environment to accelerate macro and structural reforms.

Long-term growth prospects throughout the region continue to depend on the progress made in building sustainable conditions for stronger economic growth and job creation through implementing broad-based structural reform. The EU, through a renewed European Neighbourhood Policy, remains committed to stimulating the reform process and can use a wide range of instruments to support reforms. The EU hopes that the present document can contribute to further advance the discussion among MED partners on recent economic reforms and on ways to improve MED countries' performances in the four topics covered.

Annex

Table 1 - Mediterranean countries: main economic indicators

	2003	2004	2005	2006 prel.	2007 proj.
		Real sector			
Real GDP growth (% change)					
Algeria	6.9	5.2	5.3	2.7	4.5
Egypt	3.1	4.1	4.5	6.8	6.8
Israel	1.5	4.8	5.2	4.8	4.4
Jordan	4.2	8.4	7.2	6.4	6.0
Lebanon	4.1	7.4	1.0	0.0	2.0
Morocco	6.1	5.2	2.4	8.1	3.0
OPT	5.8	6.0	6.0	-8.0	-4.3
Syria	1.0	3.1	2.9	3.2	3.7
Tunisia	5.6	6.0	4.2	5.8	6.0
MED region	***4.7***	***5.0***	***4.4***	***4.8***	***4.7***
Nominal GDP (USD, billion)					
Algeria	68.0	85.0	102.4	124.1	137.2
Egypt	81.4	78.8	89.5	103.3	111.8
Israel	0.1	122.5	129.8	137.1	142.1
Jordan	10.2	11.4	12.7	14.3	16.0
Lebanon	19.8	21.4	21.4	22.6	23.5
Morocco	49.8	56.4	58.9	65.9	62.6
OPT	3.2	3.6	4.1	4.5	4.4
Syria	22.7	24.7	27.3	29.4	30.3
Tunisia	25.0	28.1	28.7	29.2	29.5
MED region (sum)	***280.2***	***432.0***	***474.8***	***530.4***	***557.4***
GDP per-capita (USD)					
Algeria	2136	2627	3097	3698	4027
Egypt	1197	1137	1265	1432	1520
Israel	17802	18560	19248	19878	19150
Jordan	1961	2131	2317	2544	2778
Lebanon	5657	6114	6114	6457	6715
Morocco	1656	1887	1944	2145	1989
OPT	1221	1372	1398	1271	
Syria	1285	1360	1464	1534	1542
Tunisia	2531	2811	2829	2924	3180
MED region	***3938***	***4222***	***4408***	***4654***	
Inflation (average, %)					
Algeria	2.6	3.6	1.6	2.2	5.5
Egypt	11.7	17.3	9.7	3.9	11.3
Israel	0.7	-0.4	1.3	2.4	0.4
Jordan	1.6	3.4	3.5	6.3	5.7
Lebanon	1.3	1.7	-0.7	5.6	4.0
Morocco	1.2	1.5	1.0	3.3	
OPT	1.1	3.0	3.6	3.6	2.0
Syria	5.8	4.4	7.2	5.6	14.4
Tunisia	2.7	3.6	2.0	3.9	2.0
MED region	***3.2***	***4.2***	***3.2***	***4.1***	

Table 1 - Mediterranean countries: main economic indicators (continued)

	2003	2004	2005	2006 prel.	2007 proj.
			Social indicators		
Unemployment rate (%)					
Algeria	23.7	17.7	15.3	12.3	10.0
Egypt	10.4	10.7	11.0	10.5	10.9
Israel	10.7	10.4	9.0	8.7	8.5
Jordan	14.5	12.5	14.8	13.9	
Lebanon	n.a.	n.a.	n.a.	n.a.	
Morocco	11.9	10.8	11.0	9.7	
OPT	25.6	26.8	23.5	23.6	25.0
Syria	10.8	12.3	8.0	8.5	
Tunisia	14.5	14.2	14.2	13.9	13.8
MED region	***15.3***	***14.4***	***13.4***	***12.6***	
			Fiscal sector		
General government budget balance (% GDP)					
Algeria	7.8	6.9	11.9	11.9	9.9
Egypt	-9.0	-8.3	-8.9	-8.0	-7.2
Israel	-6.4	-5.4	-4.6	-2.8	-4.0
Jordan	-1.0	-1.7	-5.0	-3.8	-2.7
Lebanon	-13.3	-8.7	-8.5	-11.2	-12.4
Morocco	-3.3	-2.9	-4.0	-1.7	-2.7
OPT	-13.2	-12.3	-13.3	-21.8	
Syria	-2.6	-4.2	-4.2	-3.2	
Tunisia	-3.4	-2.5	-3.1	-3.2	-3.1
MED region	***-4.9***	***-4.3***	***-4.4***	***-4.9***	
Total gross public debt (% GDP)					
Algeria	43.8	36.6	28.4	22.6	19.5
Egypt	111.4	109.9	112.5	114.1	114.8
Israel	102.3	100.9	97.0	89.9	88.7
Jordan	97.7	88.5	82.8	72.4	66.7
Lebanon	169.0	168.0	180.0	179.0	176.0
Morocco	60.9	58.8	62.7	57.0	
Syria	60.1	61.9	57.0	60.2	55.2
Tunisia	63.0	60.9	57.3	55.6	54.5
OPT	n.a.	n.a.	n.a.	n.a.	
MED region	***88.5***	***85.7***	***84.7***	***81.3***	
			External sector		
Current account balance (% GDP)					
Algeria	13.0	13.1	20.7	24.4	16.6
Egypt	2.4	4.3	3.2	1.6	1.2
Israel	1.6	2.6	2.9	4.8	4.2
Jordan	11.6	-0.1	-17.8	-13.6	-13.4
Lebanon	-13.3	-15.8	-11.7	-6.8	-11.0
Morocco	3.6	1.9	2.3	3.9	3.5
OPT	-14.0	-17.5	-17.8	-20.2	
Syria	1.1	1.9	-0.6	-0.6	-1.8
Tunisia	-2.9	-2.0	-1.3	-1.6	-1.4
MED region	***0.3***	***-1.3***	***-2.2***	***-0.9***	***3.0***

Table 1 - Mediterranean countries: main economic indicators (continued)

	2003	2004	2005	2006 prel.	2007 proj.
FDI (net,% GDP)					
Algeria	0.9	0.7	1.0	1.2	0.9
Egypt	2.8	2.6	3.9	5.6	6.5
Israel	3.4	1.4	4.3	6.6	2.1
Jordan	4.2	5.4	10.0	6.8	9.1
Lebanon	8.7	10.9	12.3	12.0	7.6
Morocco	4.9	3.0	5.2	4.7	
OPT	n.a.	n.a.	n.a.	n.a.	
Syria	0.7	1.1	2.0	2.5	
Tunisia	2.2	2.1	2.5	9.5	
MED region	***3.5***	***3.4***	***5.2***	***6.1***	
External vulnerability					
External public debt (% GDP)					
Algeria	34.3	25.7	16.8	4.3	3.8
Egypt	36.1	37.9	32.4	30.3	25.0
Israel	63.3	61.0	61.3	57.6	58.7
Jordan	74.5	66.2	56.1	49.8	44.2
Lebanon	79.0	86.0	89.0	90.0	89.0
Morocco	26.4	23.1	22.2	19.7	
OPT	n.a.	n.a.	n.a.	n.a.	
Syria	18.1	19.7	25.0	22.6	
Tunisia	64.8	63.8	57.2	56.8	55.7
MED region	***49.8***	***48.6***	***44.7***	***41.4***	

Note: These statistics correspond with the main economic indicators in the country articles. For all exceptions and details, see the country articles. Unless otherwise stated, the reported "MED region" statistics are simple averages.

Table 2 – Current trade policy and trade policy reform

	Current trade policy	Trade policy reform progress	Average tariff	
	2006	***2000-2006***	***2000***	***2006***
Algeria	68	63	24.0	18.7
Egypt	60	100	21.4	9.1
Jordan	44	94	23.1	11.8
Lebanon	50	80	10.7	5.4
Morocco	52	50	30.5	26.2
Syria	2	32	21.0	19.6
Tunisia	53	42	29.1	26.9
MED	***47***	***69***	***23.8***	***16.8***
World	***50***	***50***	***13.6***	***9.8***

Source: World Bank 2007.

Table 3 - Current business climate and business climate reform

	Current business climate		Business climate reform indices
	2005	***2006***	***2003-06***
Algeria	38	36	37
Egypt	1	2	59
Jordan	63	59	41
Lebanon	42	40	46
Morocco	37	38	76
OPT	26	22	
Syria	34	33	52
Tunisia	56	55	40
MED	***37***	***36***	***50***
World	***50***	***50***	***50***

Source: World Bank 2007.

Table 4 – Current status of governance and governance reform progress

	Quality of public administration		Public sector accountability	
	2006	Reform progress 2000-2006	2006	Reform progress 2000-2006
Algeria	38	15	28	68
Egypt	52	97	23	73
Jordan	65	82	34	62
Lebanon				
Morocco	69	91	32	78
Syria	20	72	6	54
Tunisia	63	69	22	37
MED	***51***	***71***	***24***	***62***
World	***50***	***50***	***50***	***50***

Source: World Bank

OVERVIEW OF RECENT ECONOMIC DEVELOPMENTS IN THE EU EASTERN NEIGHBOURHOOD[1]

1. Summary

The EU's Eastern Neighbourhood remains one of the fastest growing regions in the world. Average GDP growth in the seven countries of the region accelerated in 2006 to 7.5%. In the majority of the countries, growth is driven principally by domestic demand. Higher growth has resulted in the creation of more jobs and a decline in registered unemployment to just 5% of the labour force. It has also led to a substantial reduction of poverty.

Fiscal positions improved in most countries during 2006. This result reflects strong revenue performance coupled with prudent spending policies. Part of the windfall revenue from energy exports is being saved in fiscal stabilisation funds. Declining fiscal deficits are allowing the countries of the region to reduce their public debt.

Despite persistent inflationary pressures due to strong inflows of foreign exchange – resulting from either trade surpluses of private transfers or capital movements – inflation continued its slow downward trend in 2006. This trend reflects the gradual shift of monetary policies of several central banks in the region towards more inflation targeting at the expense of currency stability. The continued appreciation of real exchange rates may lead to a loss of competitiveness.

Trade and current account balances deteriorated in most countries of the region in 2006. However, this deterioration was partly offset by increasing capital inflows. External public debt was reduced or at least controlled, while the external indebtedness of the non-government sectors increased rapidly in Russia and Ukraine.

Trade liberalization and further integration in the world economy is still one of the priorities. All countries of the region are now either members of the WTO or seeking to join it. Also, they are in the process of preparing an upgrading of their trade relations with the EU. However, the excessive role of the State and non-tariff barriers is hindering the development of trade.

Most of the countries of the region are still far from having established a business environment that is conducive to investment and sustained growth. Armenia and Georgia are the two countries where business conditions are seen as the most satisfactory.

On average, the region has made only limited progress in improving governance and controlling corruption. One particular area where most countries have launched reforms, often with support from the EU, is public finance management.

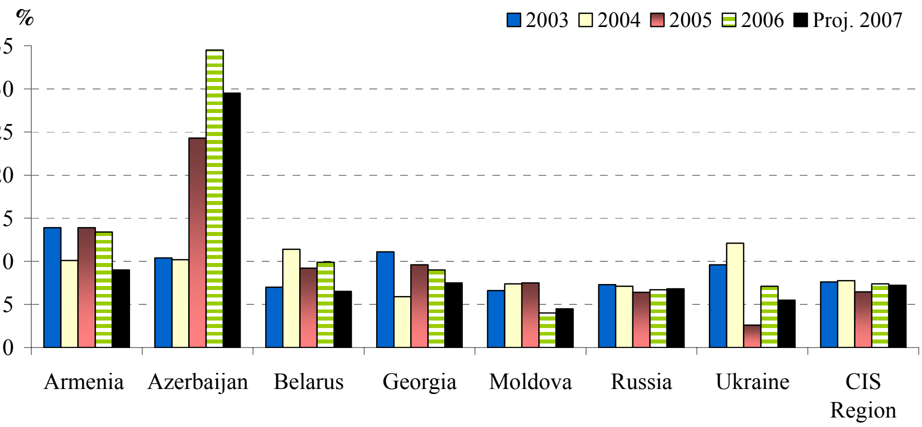
[1] The EU's eastern neighbourhood comprises six countries of eastern Europe and Caucasus covered by the ENP (Ukraine, Belarus, Moldova, Armenia, Georgia and Azerbaijan) and Russia. They are referred to in this overview as CIS region.

2. Macroeconomic developments

Growth, poverty and employment

In 2006 the combined **GDP growth** of the EU's Eastern Neighbourhood was approaching 7.5%, against global growth of just 5.1% (chart 1). The seven countries of the region are, together with the former Soviet republics of Central Asia, the second fastest growing region in the world, after emerging Asia. Russia, which alone accounts for some 85% of the combined output of the region at market exchange rates (and about 75% at PPP exchange rates) maintained its growth momentum, on the back of further increases in oil prices in the first half of the year (Russia is the world's second largest oil exporter and the largest gas exporter). In 2006, real GDP growth in Russia was 6.7%, up from 6.4% in 2005: nominal Russian GDP is now close to the benchmark of USD 1 trillion (comparable to Spain).

Chart 1 - Real GDP growth rate



Source: IMF and national statistics.

In the majority of the countries of the region (including Russia) **growth is essentially driven by domestic rather than external demand**. In Russia, private consumption is still the largest contributor to growth even if investment and government spending were the most dynamic components of domestic demand in 2006; contribution to growth of net exports was strongly negative, despite high external demand. Exports contribute to the positive dynamics of Russia's economy mostly by generating profits for enterprises and fiscal revenue for the State; this, combined with the expansion of credit and rising real wages, boosts domestic demand. The reason for Ukraine's much improved growth performance (real GDP there increased by 7.1% in 2006, against 2.7% in 2005) lies primarily in strong consumption demand, also fuelled by high real income growth and rapid credit expansion, and by the pick-up in fixed capital investment after a slowdown in 2005.

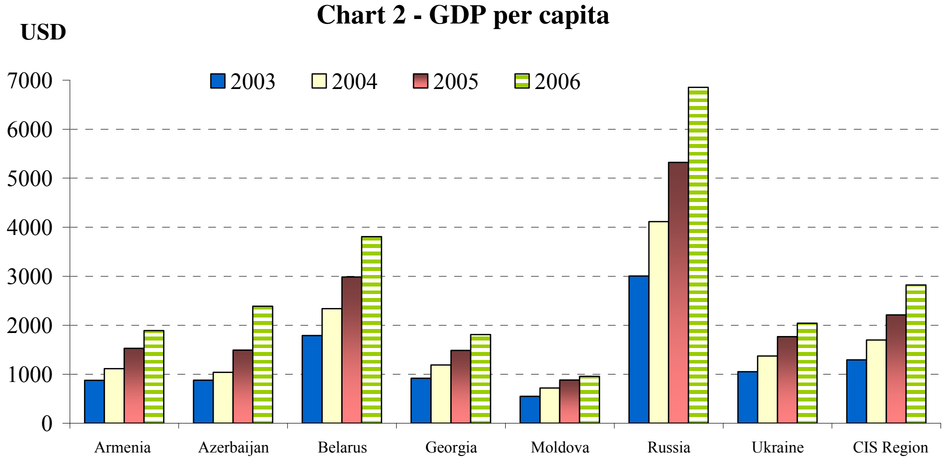
Exports remain the main driver of growth only in Azerbaijan, where the export-oriented hydrocarbon sector increased its output in 2006 by 60% (resulting in an exceptionally high real GDP growth of 34.5% - the highest in the world); the same was also true, to some degree, in Belarus. The strength of growth in Belarus (where GDP increased by nearly 10% in 2006) is chiefly due to the country's special arrangement with Russia on oil products trade, which has become a contentious issue since the beginning of 2007.

In the other economies of the region, growth was once again mainly driven by household demand, fuelled by large and increasing flows of remittances from workers abroad, mostly in Russia and the EU. Strong growth performances by Armenia (more than 13%) and Georgia (9%) are also explained by increased confidence in the economy brought about by the recent acceleration of reforms. Several economies in the region – Ukraine, Moldova, Armenia and Georgia – faced a strong increase in prices of gas imports from Russia in 2006. In the case of Moldova and Georgia, the gas price shock was aggravated by severe trade restrictions (also introduced by Russia). Moldova suffered most from these shocks, but it still ended the year with GDP growth of 4%.

The sectors where output has grown most are construction and services. In Russia, construction and financial services increased their production by 14 and 11% respectively. In Armenia, growth in the construction sector was as high as 37%. At the same time, industrial and agricultural output is growing at a much slower pace, so the **composition of growth in the region is gradually shifting from tradables to non-tradables**. While part of this process reflects the still incomplete transition to the market economy, it is also the result of poor investment conditions, which are not attractive enough to encourage investments with longer returns, as in industry.

Strong real GDP growth, appreciation of exchange rates (see below) and the decrease in population (moderate in the larger countries of the region and much faster in the smaller and poorer countries) have led to a very **significant increase in GDP per-capita** (chart 2). Between 2003 and 2006, GDP per-capita (in current USD) increased by 75% in Moldova, nearly doubled in Georgia and Ukraine, and more than doubled in the other countries of the region (including in Russia, where GDP per-capita almost reached 7000 USD). The steep increases in GDP per-capita have led to a very substantial fall in poverty. Probably the most spectacular reductions in poverty have been registered in Moldova, where between 1999 and 2004 it dropped from 70% of the population to 26.5%. However, poverty in Moldova increased again in 2005 (and may have done so in 2006), and it remains the poorest country in Europe. Since 1998, poverty in Russia has been halved, but one out of six Russians was still considered poor in 2004.

Chart 2 - GDP per capita



Source:IMF and national statistics.

Strong growth has also resulted in an increase in job creation and a **decline in unemployment**. The average rate of unemployment[2] in the seven countries of the region has been declining since 2003. Low unemployment numbers also reflect low levels of labour force participation and massive emigration. The

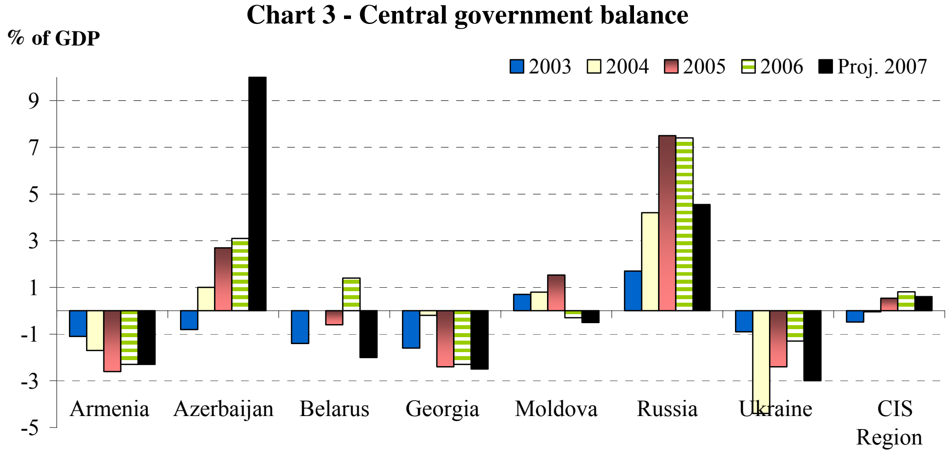
[2] The quality of unemployment statistics differs from one country of the region to another, which makes cross-country comparisons particularly difficult.

poorer countries are all countries with massive emigration. At the same time, labour surveys may not fully take account of the large informal labour markets and high self-employment. In Georgia, self-employment is estimated to be 65% of total employment.

Fiscal policies

General government balances in 2006 ranged from a deficit of 2.4% (Ukraine) to a surplus of 7.4% (Russia). As chart 3 shows, budget deficits were reduced as a share of GDP in all countries except Moldova. Russia's strong headline fiscal surplus was achieved on the back of high energy prices, and despite fiscal expansion ahead of the 2007-2008 electoral cycle. At the same time, Russia's non-oil deficit widened in 2006 to nearly 7% of GDP, from less than 6% in 2005. Azerbaijan, the second major energy exporter of the area, continued its fiscal expansion. The general government balance increased further in 2006 (to more than 3% of GDP), but this result was achieved at a time when fiscal revenue increased by a massive 88%. Also, the assets of the Azerbaijan State Oil Fund, where part of the oil windfall is accumulated, rose by far less than nominal GDP and, at the end of 2006, the size of the Oil Fund was just 7% of GDP, down from about 11% the year before. At the same time, a similar oil fund in Russia increased at a much faster pace and exceeded 9% of GDP.

Chart 3 - Central government balance

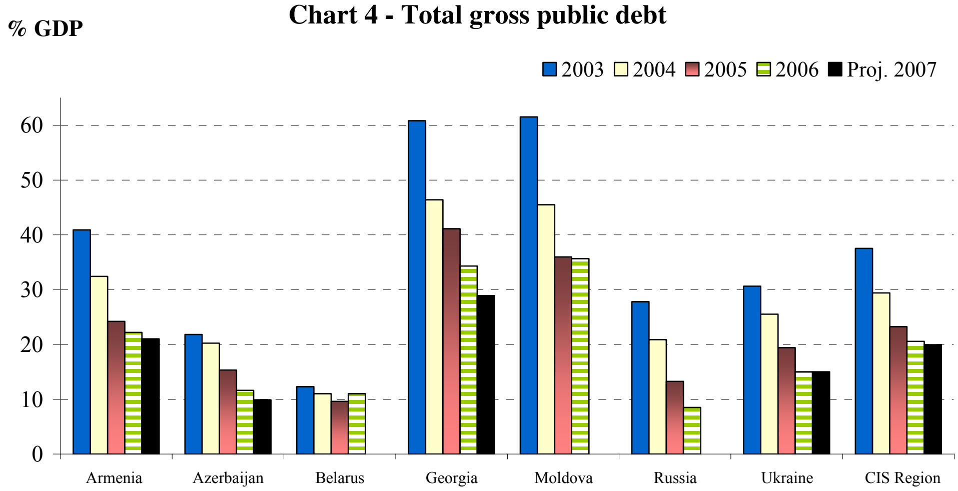


Source: IMF and national statistics.

Fiscal policies in the other countries remained more prudent. In Ukraine, the government took advantage of a stronger revenue performance to reduce the fiscal deficit by one percentage point from the 2005 figure. In Belarus, the government saved most of the fiscal windfall generated by exports of refined oil products in its own stabilisation fund (called the National Development Fund), in view of the expected (and confirmed) end of the special arrangements with Russia on exports of oil products. The general government accounts of Armenia and Georgia changed very little from 2005. Moldova was actually the only country of the group where the general government balance deteriorated (by 2 percentage points of GDP). However, this deterioration reflects primarily the increase in debt servicing payments to Moldova's official creditors following the Paris Club agreement in May 2007.

The persistence of fiscal surpluses or low fiscal deficits, financed mostly by official external assistance (often in the form of grants) for the poorer countries, translated into substantial **reductions of government** debt. At the end of 2006, total public debt in the countries of the region ranged from under 9% of GDP (Russia and Belarus) to about 35% (Georgia and Moldova). Compared to 2003, the average debt-to-GDP ratio had been almost halved by the end of 2006. The public debt of Belarus, which increased by 3 percentage points of GDP in 2006, may well increase further to compensate for the expected reduction in fiscal revenue following the discontinuation of the special export regime for oil products.

Chart 4 - Total gross public debt



Source: IMF and national statistics.

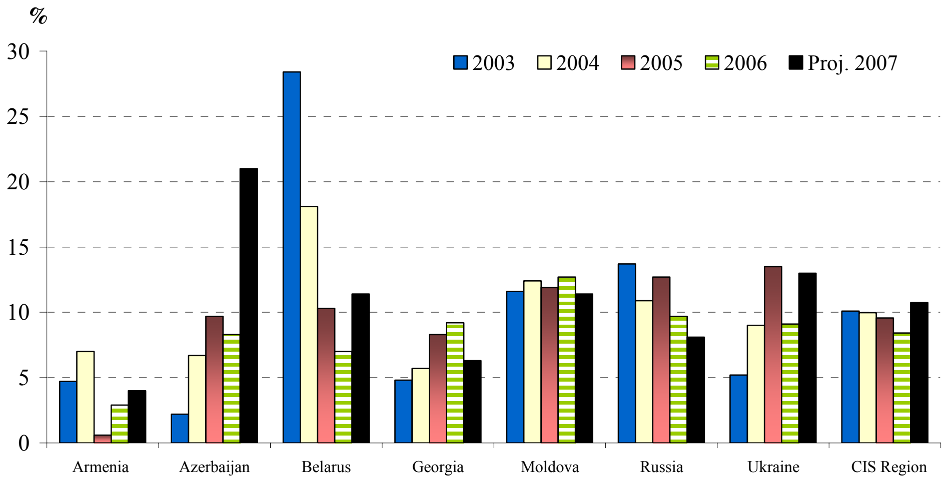
Inflation, monetary and exchange rate policies

Average **inflation continued its gradual decrease** in 2006 to stay at slightly above 8% (chart 5). However, this average reflects considerable differences among countries. Inflation slowed down in Russia and Belarus (where consumer price rises were below 10% for the first time since the beginning of the transition), Azerbaijan and Ukraine. At the same time, average inflation accelerated in Armenia, Georgia and Moldova - all countries affected by sharp rises in the gas import price. The acceleration of price rises in 2006 is better illustrated by statistics of end-of-period inflation, which is also on the rise in Ukraine.

In 2007, average inflation is set to accelerate in several countries of the region. The strongest price rises are anticipated in Azerbaijan, in response to an expansionary fiscal policy.

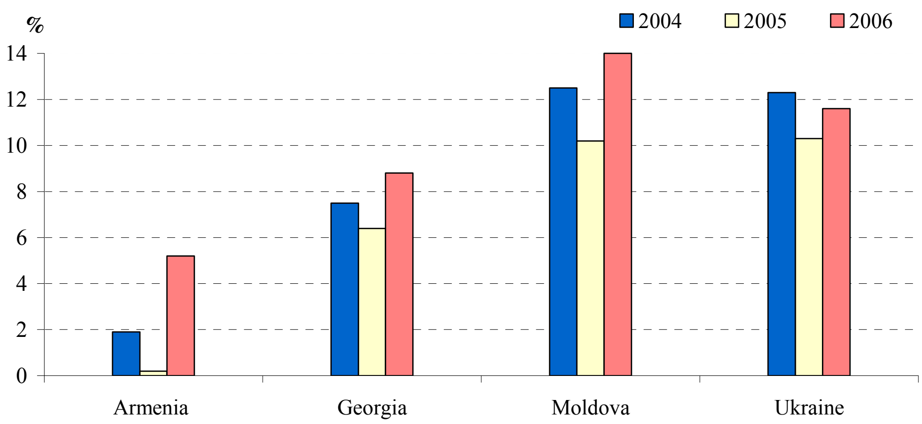
The main origin of inflationary pressures in the energy exporting countries is monetary expansion resulting from strong inflows of foreign exchange, themselves resulting from high trade and current account surpluses. Foreign exchange inflows also lead to the accumulation of international reserves (in 2006, Russia became the holder of the third largest reserves in the world, after China and Japan) and to appreciating exchange rates. For energy importers facing higher import prices, inflation primarily reflects the rises in domestic utilities tariffs, since increasing input costs are passed on to the final consumers. For the smaller countries of the region, inflationary pressures can also come from foreign exchange inflows relating to private transfers (e.g. remittances). In this case, they may be accompanied by an appreciation of nominal exchange rates, as in the energy exporting countries.

Chart 5a - Average inflation rate



Source: IMF and national statistics.

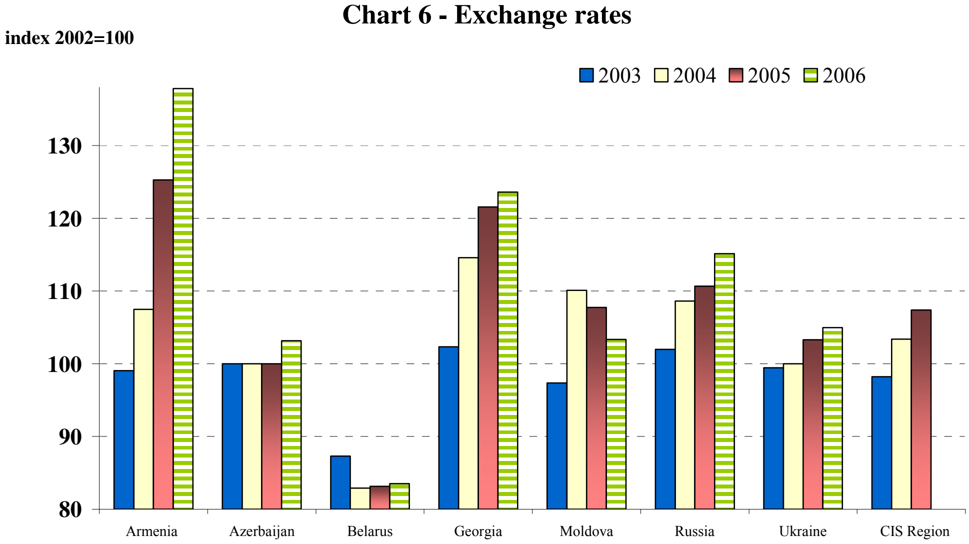
Chart 5b - End-of-period inflation rate



Source: IMF and national statistics.

The **appreciation of nominal exchange rates** is a common feature in the region. Between 2002 and 2006, nominal exchange rates (against the USD, which is used in most countries as a benchmark for foreign exchange policy) appreciated in all countries except Belarus. In 2006 alone, nominal appreciations ranged from 0.4% in Belarus to 10.0% in Armenia (4.0% in Russia). The only currency that depreciated in nominal terms was the Moldovan leu. However, since the beginning of 2007, the leu has started to strengthen again.

Chart 6 - Exchange rates



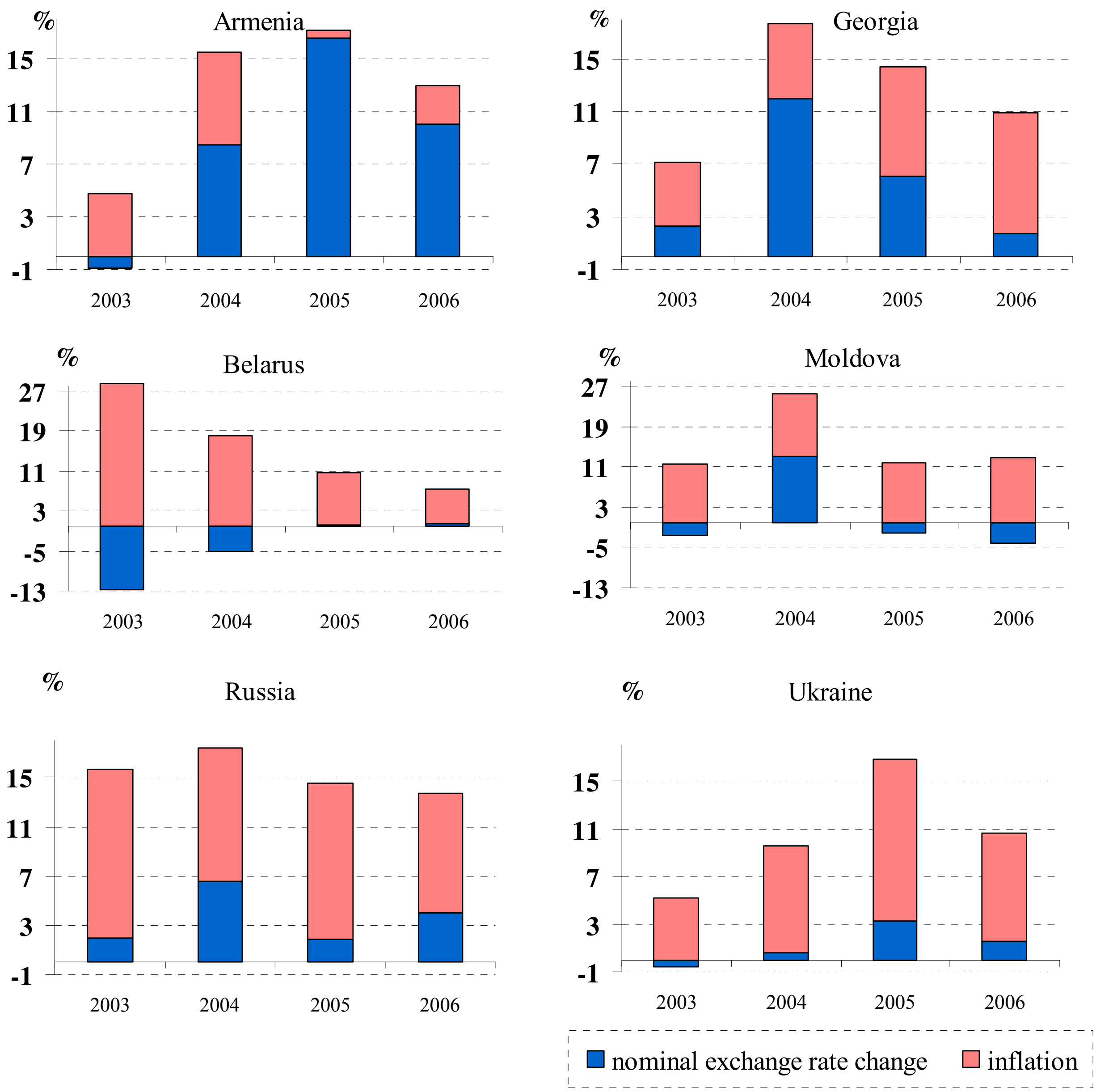
Source: IMF and national statistics.

Persistent – albeit decelerating – inflation, together with the appreciation of the exchange rates of most of the region's currencies, reflects the medium-term tendency towards an **appreciation in real exchange rates**. Real appreciation may be partly due to strong domestic demand in the context of easy domestic monetary conditions in this case, it may lead to a deterioration of the competitiveness of the domestic economies. However, it may also be the by-product of favourable productivity differentials, which is a common phenomenon in catching-up in transition economies, and is usually referred to as the Balassa-Samuelson effect. According to this hypothesis, faster growth of productivity in these economies is reflected in higher inflation and real appreciation of the exchange rates, but does not adversely affect competitiveness. The majority of studies conducted on the countries of the region (mainly Russia and Ukraine) suggest that the appreciation of the real exchange rates is primarily the result of the catching-up process. At the same time, there are already fears that the currency appreciation may be greater than is warranted by productivity gains alone and is already leading to a loss of competitiveness in selected sectors of the region's economies.

The differences in the breakdown of the real exchange rate appreciation between nominal appreciation and inflation[3] reflect the differences in the priorities of the **monetary and exchange rate policies** followed by the central banks in the region (chart 7). Indeed, most of them follow some form of managed float exchange regimes, with soft pegs to either the USD (e.g. Ukraine) or to USD-EUR baskets (e.g. Russia). However, the focus of central banks' policies is gradually shifting from exchange rate stability to inflation. This is already the case in Armenia which, not surprisingly, had the lowest inflation and the strongest exchange rate appreciation in the region. In 2007, several more countries have put control of inflation at the centre of their monetary policies. This is the proclaimed goal of the Central Bank of Russia, which plans to introduce a floating exchange rate-cum-inflation targeting regime. The lifting of all remaining restrictions on capital account movements announced in July 2006 is seen as one of the prerequisites for this new monetary policy framework. In Ukraine, the national bank is more cautious about switching to more explicit inflation targeting, given the perceived public sensitivity of the exchange rate issue.

[3] In the absence of data for the majority of the countries of the region, a proxy constructed as a sum of average nominal exchange rates vs. USD and average inflation is used here.

Chart 7 - Exchange rate changes and inflation



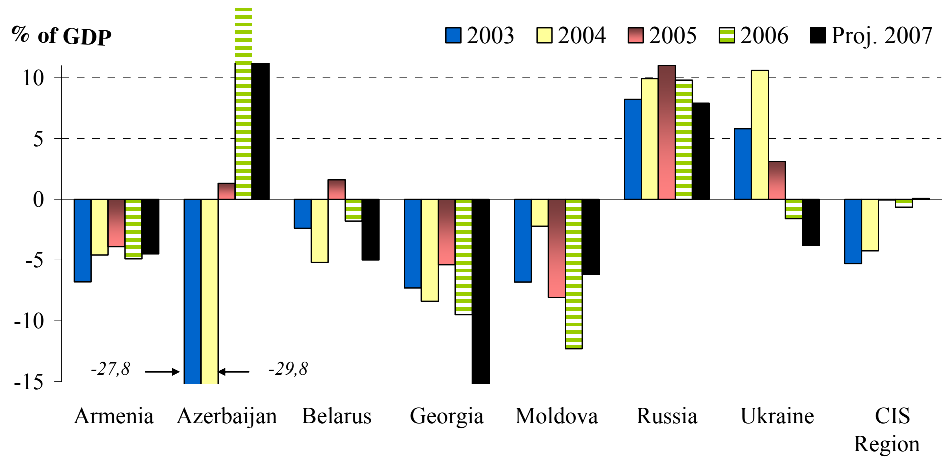
An increase (a decrease) in the exchange rate reflects an appreciation (depreciation) of the domestic currency vis-à-vis the USD.

The developments in 2006 show that monetary policies in the region are most successful when they are supported by appropriate fiscal policies. Thus, Russia's fiscal oil stabilisation fund has become a major tool in helping to sterilize huge inflows of foreign exchange. However, supportive fiscal policies are not sufficient unless the central banks also dispose of adequate instruments of monetary policy proper. This is particularly true for interest rates, whose effectiveness is limited in view of the abundant liquidity on the inter-bank market. Also, the central banks' leading interest rates are generally low, and sometimes negative in real terms (strongly negative in the case of Russia). Another complication for the conduct of the monetary policy in the region is the high level of financial dollarisation.

Current account developments

In 2006, the contrast in **trade performance** between the energy exporters and importers, already striking in 2005, increased still further. Azerbaijan's trade surplus grew from 26% of the country's GDP to 40% (chart 8). Russia's trade surplus widened in dollar terms, but fell as a share of GDP (by one percentage point). The trade balances of all the other countries of the region deteriorated: the trade accounts of Ukraine and Belarus moved from moderate surpluses into (still moderate) deficits; the trade deficits of the three other countries widened more significantly, with Moldova's deficit approaching 48% of GDP. The deterioration in the trade accounts primarily reflects continuing rises in energy prices (including gas prices, charged by Russia to its trading partners) and sustained domestic consumer demand, met increasingly by imports rather than by domestic production. This tendency may reflect the deterioration of competitiveness in a number of sectors of the economies in the area.

Chart 8 - Current account balance



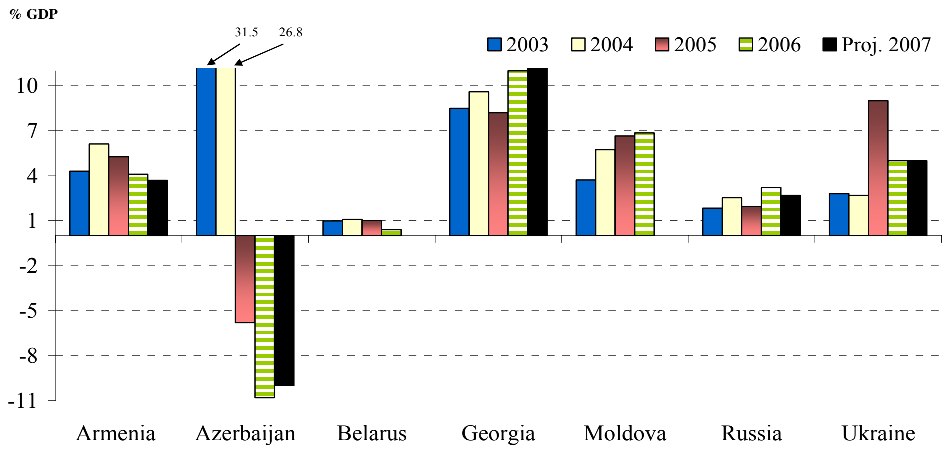
Source:IMF and national statistics.

Azerbaijan, the only country of the region to register a meaningful improvement of its trade account, was also the only one whose current account surplus increased as a share of GDP (from a mere 1.3% in 2005 to nearly 16% in 2006). Russia's **current account surplus** was reduced from 11% of GDP in 2005 to 10%; it is set to fall further in the near future, reflecting the much faster growth of imports compared to exports. As with their trade balances, the (previously positive) current accounts of Ukraine and Belarus switched to small deficits. The current account deficits of Armenia, Georgia and Moldova all widened - moderately in the case of Armenia, but much more substantially for the other two countries. However, the widening in current account deficits was much less severe than the widening of their trade deficits, reflecting the growth of private transfers, particularly remittances, which continued to be a substantial and stable source of foreign currency. In Moldova, in particular, remittances - estimated to be at least 36% of GDP in 2006 - were the major source of foreign exchange to finance the trade deficit. In Armenia, remittances were supplemented by large private capital transfers, and - in Georgia – by foreign investment.

FDI flows and other capital transactions

For several years, **FDI** flows in the EU's Eastern Neighbourhood were very limited. The situation seems to be changing somewhat, but cumulated FDI remains modest in all countries of the region Azerbaijan being the sole exception (chart 9). In 2006, FDI to Russia more than doubled in dollar terms. This corresponds to only 3.2% of GDP, although this is comparable to FDI flows to the other major emerging economies (e.g. China). FDI to Ukraine was reduced from the, exceptionally high, 9% of GDP in 2005 (the result of the re-privatisation of the country's largest steel mill) to 5%. In both Russia and Ukraine, the corporate sector attracts also more and more foreign capital in the form of bank credits, linked to strong domestic credit expansion. As a result, **capital inflows** in general **are picking up** and the external debt of the corporate sector in both countries is growing fast – it is now close to 30% of GDP. The increasing level of private debt stands in contrast to the decline in public debt, particularly in Russia and Ukraine.

Chart 9 - Net FDI



Source: IMF and national statistics.

In the other countries of the region, FDI remained modest in absolute terms, but can be significant as a share of GDP (e.g. Georgia 11%, Moldova nearly 7%). Net FDI to Azerbaijan was strongly negative as a result of repatriation of investments by the foreign oil companies involved in the development of major oil and gas extraction and transportation facilities.

External indebtedness of the smaller countries of the region has been reduced substantially in the past few years. Yet, for Moldova and Georgia the external financial situation remains fragile. In 2006, Moldova concluded a debt restructuring agreement with the Paris Club and in this way normalised its relations with the international financial community (for several years, Moldova had been in arrears with its official creditors).

3. Trade liberalisation and economic opening

All seven countries of the EU's Eastern Neighbourhood have opened up their economies to international trade and established fairly **liberal trade regimes**, with low levels of tariff protection. The EU has become the main trading partner of all the countries of the region, with the exception of Belarus whose trade is still centred on Russia, with whom it has established a (still incomplete) customs union. Yet, a combination of the excessive role of the State, non-tariff barriers and inefficient border procedures is hindering the development of trade in the region.

Armenia, Georgia and Moldova are all members of the **World Trade Organisation** (WTO), and the four other countries are currently negotiating accession to the WTO. Ukraine's accession is expected to be the first to be completed; Russia's prospects of entering the WTO before the end of 2007 are still unclear.

The EU applies Most Favoured Nation (MFN) treatment in its trade relations with the countries of the region. It has also granted trade preferences to all the countries under the General System of Preferences (GSP); however, Belarus was recently excluded from the system. In addition, in the context of the strategic partnership with Russia and the European Neighbourhood Policy, the EU is currently developing closer trade links with the countries of the region which should eventually lead to the establishment of **deep and comprehensive free trade agreements**.

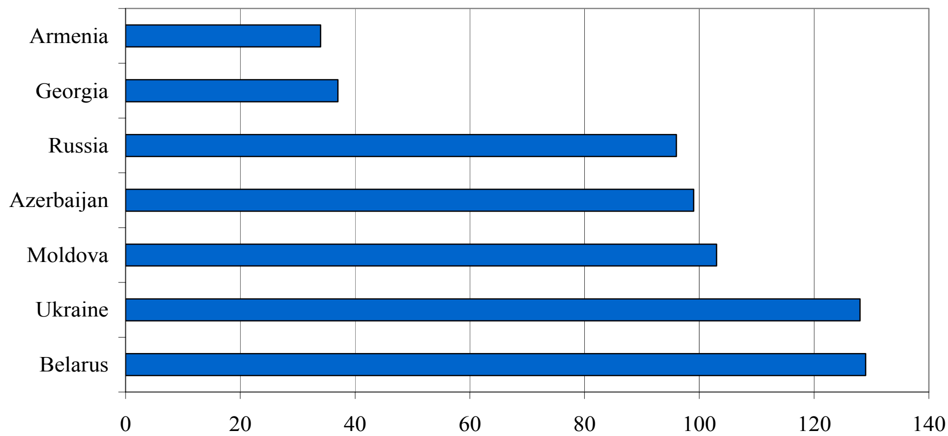
4. Privatisation, enterprise restructuring and business environment

Most countries in the region long ago completed the first generation of market reforms, such as price and trade liberalisation or privatisation of the main State assets. However, even the most reform-minded have still not advanced very far in establishing open and competitive functioning market economies and in creating a friendly environment for businesses and investors, both domestic and foreign.

The improvement of the **business environment** in the region has proved to be a bumpy and uneven process, with both successes and setbacks. For instance, Russia, where business regulations were substantially streamlined and improved at the beginning of the current decade, virtually ceased all further privatisation after 2004 in an apparent drive to extend the government's role in the economy. In the same period, the government of Moldova, whose widespread intervention in the economy at the beginning of the decade had resulted in a substantial reduction of both private investments and official external aid, is now making progress to speed up reforms, e.g. by launching a broad review of all business regulations.

Progress in this area was very uneven across the region in 2006 (chart 10). The biggest improvement in deregulating the economy seems to have been achieved in Georgia, which began implementing an ambitious reform programme as early as 2004. The result of these reform efforts was an impressive improvement of Georgia's ranking in the World Bank's Doing Business indicators – to 37th place among 175 countries from the 112th place which it had occupied just one year before. Georgia came very close to the region's leader– its neighbour Armenia - (in 34th place in the Doing Business ranking). Armenia also leads the CIS countries according to the EBRD 2006 transition indicators. Business conditions in the other countries are considered to be much less advantageous. So, Russia (which is the third best) ranks only 96th. Belarus and Ukraine have the worst Doing Business rankings. The main obstacles to businesses are still uncertain investor protection, tax pressure (often arbitrary), excessive red tape and dysfunctional judicial systems.

Chart 10 - Doing business rankings 2006

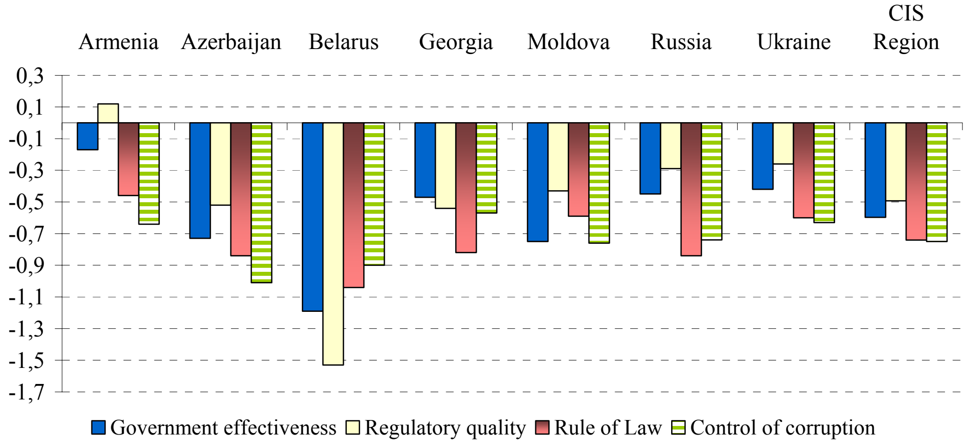


Source: World Bank, 2007.

5. Public institutions and public finance management

A business environment that is conducive to investments and economic growth is only one aspect of good governance, which can be defined as the transparent and accountable management of human, natural, economic and financial resources for the purpose of equitable and sustainable development. The World Bank governance indicators offer a good picture of the **quality of governance** and the **control of corruption** in the region (chart 11).

Chart 11 - Selected governance indicators 2006



Source: IMF and national statistics.

This picture is very clear: when it comes to the improvement of governance and the fight against corruption there is still a substantial amount of unfinished business. Indeed, the point estimates of four indicators (government effectiveness, regulatory quality, rule of law and control of corruption) for 2005 (the latest year available) are all very low and negative for all seven countries, with one exception – namely the quality of the regulatory environment in Armenia. The situation as regards the control of corruption remains the least satisfactory, despite anti-corruption programmes adopted in virtually every country. Armenia is once again the best performer in the region and Belarus the worst performer.

One particular area of economic governance where most countries of the region have launched reform programmes is **public finance management** (PFM). Reform agendas of PFM in the region aim to improve medium-term budget planning, transparency, accountability and external oversight in the management of public resources. They comprise, inter alia, the reform of the budget processes, with a gradual shift to medium-term expenditure frameworks (which already exist, in various forms and degrees of sophistication, in Armenia, Georgia, Moldova and Russia), attempts to improve the effectiveness of budget spending (still particularly low in a number of countries, including Russia) and reform of the systems of internal and external controls and audits. The European Commission is, together with the World Bank, among the most active in promoting and supporting economic governance reforms in the region including PFM.

Increasingly the focus of the European Union's programmes of **macro-financial assistance** (to Georgia and Moldova) and budget support (to the latter two, plus Armenia, Azerbaijan and Ukraine), which are either being already implemented or are under preparation, is on support to public institutions and reform of public finance management.

Annex

Table 1 – CIS countries: main economic indicators

	2003	2004	2005	2006 prel.	2007 proj.
Real Sector					
Real GDP growth (% change)					
Armenia	13.9	10.1	13.9	13.4	9.0
Azerbaijan	10.4	10.2	24.3	34.5	29.5
Belarus	7.0	11.4	9.2	9.9	6.5
Georgia	11.1	5.9	9.6	9.0	7.5
Moldova	6.6	7.4	7.5	4.0	4.5
Russia	7.3	7.1	6.4	6.7	6.8
Ukraine	9.6	12.1	2.6	7.1	5.5
CIS region	***7.6***	***7.8***	***6.5***	***7.4***	***7.2***
Nominal GDP (USD, billion)					
Armenia	2.8	3.6	4.9	6.4	7.3
Azerbaijan	7.3	8.7	12.6	21.2	33.0
Belarus	17.7	23.1	29.5	36.9	40.4
Georgia	4.0	5.1	6.4	7.8	9.3
Moldova	2.0	2.6	3.0	3.2	3.6
Russia	431.2	591.9	763.8	979.0	1193.3
Ukraine	50.1	64.9	82.9	106.1	115.0
CIS region (sum)	***515.1***	***699.9***	***903.1***	***1160.6***	***1401.8***
GDP per-capita (USD)					
Armenia	874	1114	1528	1892	2350
Azerbaijan	880	1040	1493	2390	3800
Belarus	1791	2338	2986	3808	4119
Georgia	919	1188	1486	1810	2150
Moldova	548	721	883	957	1055
Russia	3007	4116	5322	6854	8469
Ukraine	1053	1372	1766	2041	2160
CIS region	***1296***	***1698***	***2209***	***2822***	***3443***
GNI per-capita (PPP, current prices, USD)					
Armenia	3780	4310	5060		
Azerbaijan	3400	3810	4890		
Belarus	6080	6990	7890		
Georgia	2630	2890	3270		
Moldova	1770	1950	2150		
Russia	8760	9680	10640		
Ukraine	5460	6330	6720		
CIS region	***4554***	***5137***	***5803***		
Inflation (average, %)					
Armenia	4.7	7.0	0.6	2.9	4.0
Azerbaijan	2.2	6.7	9.7	8.3	21.0
Belarus	25.0	14.0	10.3	7.0	11.4
Georgia	4.8	5.7	8.3	9.2	6.3
Moldova	11.6	12.4	11.9	12.7	11.4
Russia	13.7	10.9	12.7	9.7	8.1
Ukraine	5.2	9.0	13.5	9.1	13.0
CIS region	***10.1***	***10.0***	***9.6***	***8.4***	***10.7***

Table 1 – CIS countries: main economic indicators (continued)

	2003	2004	2005	2006 prel.	2007 proj.
Social indicators					
Unemployment rate (%)					
Armenia	10.1	9.6	8.1	7.4	7.0
Azerbaijan	1.4	1.5	1.4	1.4	1.4
Belarus	3.1	1.9	1.5	1.2	1.8
Georgia	11.5	12.6	13.8	13.7	13.0
Moldova	7.9	8.1	7.1	5.6	
Russia	8.9	7.6	7.7	6.9	6.4
Ukraine	9.1	8.6	7.2	6.9	6.5
CIS region	***7.4***	***7.1***	***6.7***	***6.2***	
Fiscal sector					
General government budget balance (% GDP)					
Armenia (Central Gov)	-1.1	-1.7	-2.6	-2.3	-2.3
Azerbaijan	-0.8	1.0	2.7	3.1	10.0
Belarus (Central Gov)	-1.4	0.0	-0.6	1.4	-2.0
Georgia	-1.6	-0.2	-2.4	-2.3	-2.5
Moldova	0.7	0.8	1.5	-0.3	-0.5
Russia (Central Gov)	1.7	4.2	7.5	7.4	4.6
Ukraine	-0.9	-4.4	-2.4	-1.3	-3.0
CIS region	***-0.5***	***0.0***	***0.5***	***0.8***	***0.6***
Total gross public debt (% GDP)					
Armenia	40.9	32.4	24.2	22.2	21.0
Azerbaijan	21.8	20.2	15.3	11.6	9.9
Belarus	12.3	11.0	9.6	11.0	
Georgia	60.8	46.4	41.1	34.3	28.9
Moldova	61.5	45.5	36.0	35.6	
Russia	27.8	20.9	13.2	8.5	
Ukraine	30.6	25.5	19.4	15.0	15.0
CIS region	***36.3***	***28.5***	***22.4***	***19.4***	
Monetary sector					
Degree of monetisation (M2/GDP. %)					
Armenia	13.7	13.6	14.5	18.2	
Azerbaijan	14.3	17.6	15.4	21.1	
Belarus (M3/GDP)	17.2	17.7	19.7	22.1	
Georgia (M3/GDP)	12.4	15.2	16.5	19.5	21.0
Moldova	20.4	25.4	29.5	28.3	28.2
Russia	29.9	31.1	33.4	38.1	
Ukraine	29.9	32.0	37.7	44.4	
CIS region	***19.7***	***21.8***	***23.8***	***27.4***	
Dollarisation in bank deposits (%)					
Armenia	70.8	74.8	63.6	58.5	54.5
Azerbaijan	49.1	54.5	56.9	51.2	
Belarus					
Georgia	86.1	74.3	71.6	69.4	68.0
Moldova	50.1	44.7	41.8	49.1	
Russia					
Ukraine	32.2	36.5	34.2	38.0	
CIS region	***57.7***	***57.0***	***53.6***	***53.2***	

Table 1 – CIS countries: main economic indicators (continued)					
	2003	**2004**	**2005**	**2006 prel.**	**2007 proj.**
External sector					
Trade balance (% GDP)					
Armenia	-17.9	-14.8	-13.2	-18.5	
Azerbaijan	-1.3	1.9	26.3	39.8	
Belarus	-4.0	-6.5	1.0	-4.5	-6.5
Georgia	-16.0	-17.6	-14.5	-21.4	-24.4
Moldova	-33.8	-30.0	-40.6	-49.3	
Russia	13.9	14.5	15.4	14.3	10.0
Ukraine	2.6	7.7	0.8	-2.9	
CIS region	***-8.1***	***-6.4***	***-3.5***	***-6.1***	
Current account balance (% GDP)					
Armenia	-6.8	-4.6	-3.9	-4.9	-4.5
Azerbaijan	-27.8	-29.8	1.3	15.7	27.4
Belarus	-2.4	-5.2	1.6	-1.8	-5.0
Georgia	-7.3	-8.4	-5.4	-9.5	-15.3
Moldova	-6.8	-2.2	-8.1	-12.3	-6.2
Russia	8.2	9.9	11.0	9.8	7.9
Ukraine	5.8	10.6	3.1	-1.6	-3.8
CIS region	***-5.3***	***-4.2***	***-0.1***	***-0.7***	***0.1***
FDI (net, % GDP)					
Armenia	4.3	6.1	5.3	4.1	3.7
Azerbaijan	31.5	26.8	-5.8	-10.8	-10.0
Belarus	1.0	1.1	1.0	0.4	
Georgia	8.5	9.6	8.2	11.0	12.3
Moldova	3.7	5.7	6.6	6.9	
Russia	1.8	2.5	2.0	3.2	2.7
Ukraine	2.8	2.7	9.0	5.0	5.0
CIS region	***7.7***	***7.8***	***3.8***	***2.8***	
External vulnerability					
External public debt (% GDP)					
Armenia	39.1	33.3	22.6	19.0	17.0
Azerbaijan	19.7	18.5	14.3	10.6	8.8
Belarus	1.9	2.1	1.9	2.3	
Georgia	46.4	36.2	27.1	21.8	18.0
Moldova	50.9	33.9	25.9	27.0	
Russia	22.8	16.4	9.3	4.6	
Ukraine	21.6	19.2	14.7	12.2	11.0
CIS region	***28.9***	***22.8***	***16.5***	***13.9***	

Note: These statistics correspond with the main economic indicators in the country articles. For all exceptions and details, see the country articles. Unless otherwise stated, the reported "CIS region" statistics are simple averages.

Part C

Country Analysis

ALGERIA

- **Real GDP-growth was low at 2.7% in 2006 due to a temporary decline in hydrocarbon extraction caused by construction-related disruptions. The expectations are that economic growth will accelerate to 4.5% in 2007.**

- **In 2006 twin surpluses were sustained on the current account and fiscal balance, even buoyantly at two digits. Loss-making public companies continue however to be a drain in the budget, and the non-hydrocarbon primary balance is -39% of GDP.**

- **Public revenues have continued to increase. At the same time, high government spending has put additional pressure on domestic prices. This loose fiscal policy has been accompanied by a rather loose monetary policy.**

- **The current favourable economic conditions should be seized to accelerate structural reforms and improve the business environment in order to foster private investment, economic growth and employment.**

1. Macroeconomic developments

Real sector developments

The Algerian economy depends on the hydrocarbon sector. The key challenge remains that of completing the transition to a market economy and broadening the base for economic growth through diversification of the economy and private investment to create productive jobs, in particular for those under the age of 30 (who make up 70% of the unemployed). Over the last few years the country has been on a steady steep economic growth path, apart from 2006, which saw a slight slowdown. The main driving forces underlying the economic growth are activities in the non-hydrocarbon sector. Growth has come mainly from a pro-cyclical fiscal policy that boosted the construction sector, as well as from agriculture.

In 2006, real GDP growth, at around 3%, was lower than in previous years due to maintenance work in the hydrocarbon sector. Economic growth in the hydrocarbon sector was negative, but this was fully compensated by the high economic growth in the non-hydrocarbon sector.

Fiscal policy

Public finances depend strongly on the revenues from hydrocarbon. In 2006, the primary non-hydrocarbon fiscal balance was -37.6% of GDP while the overall government balance reached almost 12% of GDP. The buoyant hydrocarbon revenues financed high government spending (around 30% of GDP).

The Growth Consolidation Plan for 2005-09, which is basically a public investment programme was maintained. Civil service wages were raised by about 15-16% on average. The rise compensates past inflation. Due to the additional expenditures the non-hydrocarbon primary deficit has widened. The corporate tax rate decreased from 30 to 25%. The higher civil service wages are also expected to lead to additional domestic spending, and consequently to upward inflationary pressure.

New rules were introduced for the governing of the hydrocarbon stabilisation fund aiming at a higher investment return. This *Fonds de Régulation des Recettes* is a sub-account of the government at the central bank that allows for a direct financing of the non-hydrocarbon deficit and amortization of government debt. Hydrocarbon budgetary receipts above the equivalent of USD 19 per barrel flow into the fund, as also taxes on profits realized by foreign partners. Transparency in the use of the revenues has augmented.

Monetary and exchange rate policy

CPI-inflation reached 2.2% in 2006. The central bank Algeria kept its 7-day official interest rate at 1.25% since July 2005, while the 3-months official interest rate was increased in January 2006 to 2.00% from 1.90% and later decreased to 1.70%. Real interest rates therefore became negative. The nominal effective exchange rate stabilized somewhat in 2006. Credit to the economy slowed down. In 2006 the central bank drained the liquidity in the banking system through deposit auctions because of the fiscal stimulus and the rapidly growing bank deposits of the national oil company Sonatrach.

The continuation of government spending on investment projects and the recent government wage increases will put upward pressure on consumer prices. Transmission channels for interest rate policy are weak, still preventing inflation from being steered adequately. The exchange rate regime is a managed float with no pre-announced path. This gives the central bank discretion to intervene in the foreign exchange rate market. Exchange rate policy can therefore be helpful in achieving the appropriate monetary conditions, whenever necessary.

Subsidies on energy prices should gradually be phased out by raising domestic energy prices. These subsidies are still giving rise to inefficiencies, encourage energy consumption and give rise to smuggling to neighbouring countries. The phasing out of these subsidies should be done gradually in order not to raise inflation too rapidly, and to protect the vulnerable groups in the society.

External sector developments

External developments are strong and favourable, mainly due to high hydrocarbon prices. However, exports remain undiversified. The current account surplus increased to more than 24% of GDP in 2006, but is expected to decline in 2007 due to a raise in imports.

Gross external reserves are on a steep climbing path from USD 56.2 billion in 2005 to USD 74.6 billion in 2006. The expectations are that they will approach USD 100 billion in 2007. In months of imports´ cover they reached the record of almost 30 months in 2007, offering a solid buffer in case of exchange rate shocks. Official external debt was prepaid in 2006 ahead of schedule. External debt reached 4.3% of GDP at the end of 2006, down from almost 17% in 2005.

2. Trade liberalisation and economic opening

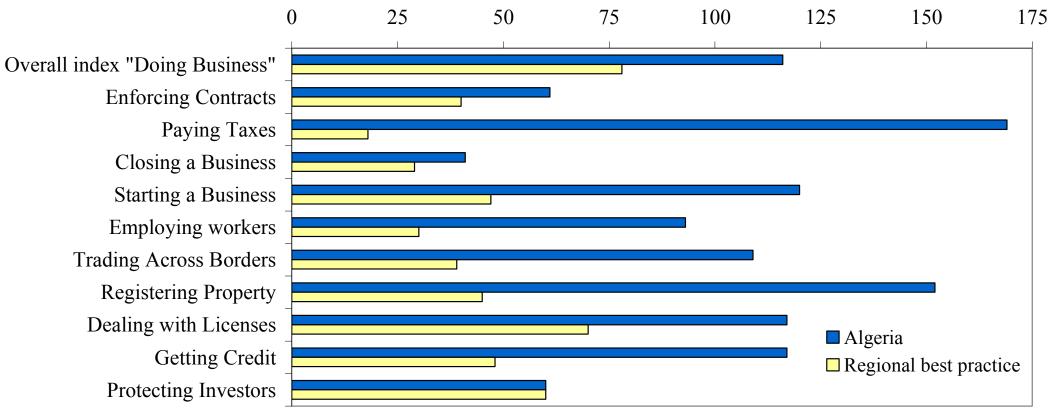
It is still too early to assess the benefits of the Association Agreement with the EU that entered into force on 1 September 2005. Expectations are that positive effects will result for Algeria from the gradual reduction in duties on trade with the EU during a transitional period of twelve years. Negotiations towards WTO accession are still ongoing.
Renewed efforts are under way to revive the Arab Maghreb Union, which includes Algeria, Morocco, Tunisia, Libya and Mauritania. In early 2006 negotiations started on a further liberalisation of trade with the Euro-Mediterranean area. The implicit subsidies that Algeria provides on its energy products on the (regional) international markets will be abolished gradually. The fact that the land border with Morocco remains closed due to political tensions over Western Sahara still hampers external trade. Overall, inward investment is generally free of restrictions. Outward flows are controlled on other capital account payments and transfers.

3. Business climate

Privatisation, enterprise restructuring and business environment

The business climate in Algeria compares poorly with the regional average, though Algeria has the best regional scores on protecting investors (chart 1). Algeria scores particularly low on paying taxes, registering property and starting a business. Concerning the latter, the creation of a more flexible labour market should make it easier for small and medium sized businesses to exploit opportunities. On the one hand, it has become easier to get credit, with the ranking rising 26 places, from 143 in 2005 to 117 in 2006. On the other hand, it has become more difficult to trade across Algeria's borders. Making the banking system more efficient by further reducing state involvement will improve the opportunities for private businesses.

Chart 1 - Algeria "Doing business" rankings



The ease of doing business index ranks economies from 1 (best) to 175. The regional best practice refers to the best ranking Arab country among the Mediterranean ENP countries.

Source: World Bank, 2007.

The Euro-Mediterranean Charter for enterprise, endorsed by Algeria in 2004, offers an umbrella for enterprise policy and contains ten principles of good governance in support of the development in the private sector. Reforms along these principles would improve the business climate further, notably via inward FDI.

Financial sector reforms

Reform in the banking sector is ongoing. Measures are taken to improve the soundness of the banking system and to obtain a higher degree of competitiveness and efficiency. The privatisation of the first public bank, the *Crédit Populaire d´Algérie*, is foreseen by the end of 2007. Two other banks (*Banque Nationale d'Algérie* and *Banque Locale de Développement*) have been identified as candidates for privatisation in the first wave of privatisation in the financial sector. These privatisations should lead to a reduction of the high level of non-performing loans. The payment system was modernised in 2006. The governance of the remaining public banks is being strengthened and supervision has become more active, mainly through on-site inspections.

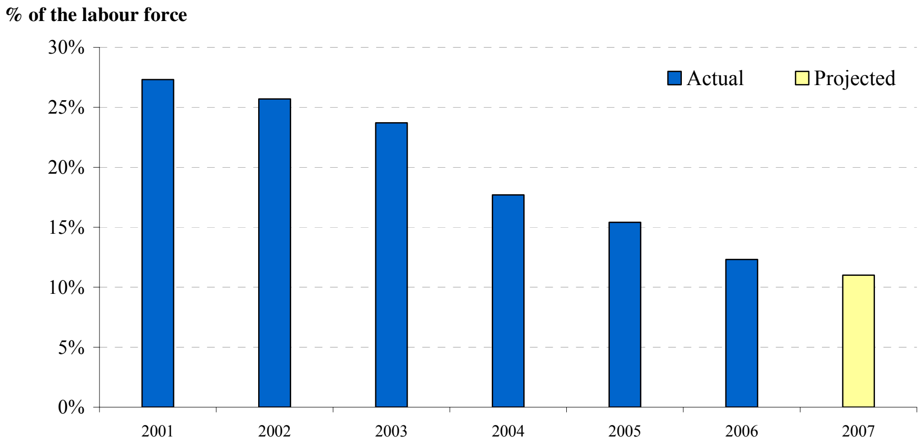
A state-of-the art real-time gross settlement payment system replaced the inefficient and unreliable old system which involved processing times of up to two weeks for domestic payments. The Algiers Stock Exchange that was inaugurated in July 1999 remains though thin, and a brokerage network has yet to be established. Modern know-how is being injected by foreign shareholders. Financial intermediation can be improved by greater competition, i.e. a fair level playing field. The government has proposed to improve insurance sector regulations. The Algerian Insurance Company (CAAT) reported that, in 2005, around 17 insurance companies and 400 intermediates were active in Algeria. There is a need to open the sector to international insurance groups.

Labour market reforms

Unemployment has fallen steadily for many years in a row (chart 2a), from a peak of almost 30% in 2000 to 12% in 2006. Despite the lower economic growth in 2006, unemployment was reduced by 3.1 percentage points. However, most jobs created recently are temporary, or created at home. For this reason the lower unemployment rate may therefore not be easy to maintain. [1] Also, youth unemployment remains high (chart 2b). More than 25% persons of the labour force below the age of 20 were unemployed in 2006. Overall, 70% of the jobless were under the age of 30.

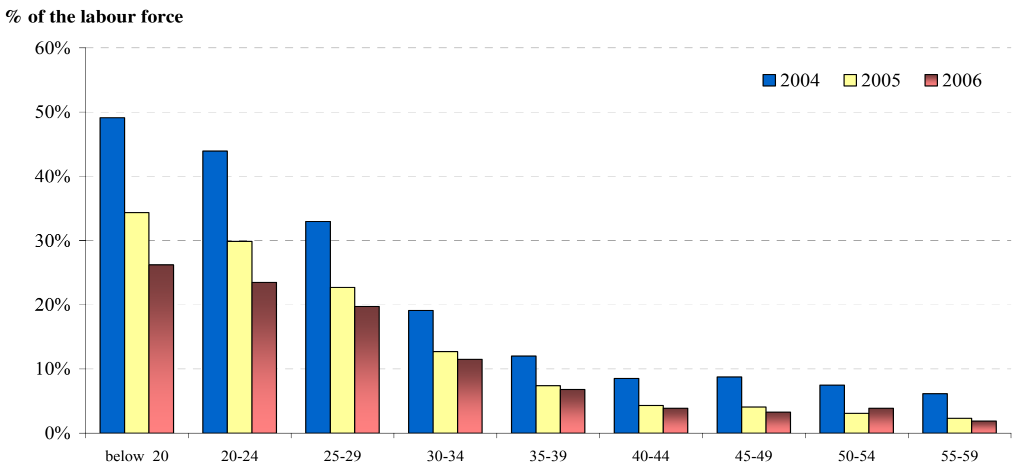
[1] See also *Algeria: Selected Issues* (2007) that describes the reasons behind the reduction in unemployment and the still high level of unemployment.

Chart 2a - Algeria: Unemployment rate



Source: Office National des Statistiques www.ons.dz, Algeria, and IMF.

Chart 2b - Algeria: Unemployment per age group



Source: Office National des Statistiques www.ons.dz, Algeria.

A National Economic and Social Pact between the government, employer's organizations and trade unions was agreed in 2006. According to this new Pact real wages will follow productivity growth and economic performance in the non-hydrocarbon sector. Wage adjustments will therefore take place more gradually instead of incidentally and are therefore expected to distort the economy less. A decentralisation of wage negotiations is underway. These new developments are likely to directly improve competitiveness.

One main challenge for the future is to create jobs, first and foremost in the non-hydrocarbon and non-government sector. Improvements in the domestic business climate are key issues for stimulating investment and creating jobs. Absorbing the unemployed into the working labour force will give, in turn, a great impulse to economic activity.

4. Public institutions and public finance management

Key reforms to be addressed remain the improvement of public finance management and the gradual elimination of state-owned enterprises. The government should continue the acceleration of budget modernisation and the implementation of the fiscal Report on the Observance of Standards and Codes.

Furthermore, in January 2006 an anti-corruption law was enacted following Algeria's adoption of the 2003 UN Convention against Corruption. The law contains a broad definition of corruption, introduces a code of conduct for public servants, protects whistle-blowers, and provides for international cooperation. Also, the customs administration is being modernised and the tax system is to be streamlined. Modern managerial know-how from abroad can further improve the finance management in public and private institutions.

5. Social development and poverty

A main obstacle to the reduction of poverty is the high level of unemployment, particularly among the young. In order to tackle this problem the National Youth Employment Supporting Agency set up more than 81000 small businesses in Algeria and generated 231000 jobs nationwide in 2006. The government's medium-term investment programme, the Growth Consolidation Plan for 2005-2009, may help to relieve poverty. Its focus is on health, education, housing and infrastructure. This plan should be accompanied with a careful planning of public expenditures and structural reforms should lead to a more diversified private sector.

ALGERIA

Main economic indicators

	2003	2004	2005	2006 prel.	2007 proj.
Real sector					
Real GDP growth (% change)	6.9	5.2	5.3	2.7	4.5
Real GDP non-hydrocarbon (% change)	6.0	6.2	5.1	4.5	5.4
Inflation (average)	2.6	3.6	1.6	2.2	5.5
GDP nominal (USD, billion)	68.0	85.0	102.4	124.1	137.2
GDP per-capita (USD)	2136	2627	3097	3698	4027
GDP (dinar, billion)	5264	6127	7519	9227	11324
Social indicators					
Unemployment (officially registered, %)	23.7	17.7	15.3	12.3	10.0
Youth unemployment (%)	45.5		31.0		
Fiscal sector					
Total revenues (% GDP)	37.0	36.2	41.0	41.9	42.2
Non-hydrocarbon (% GDP)	11.3	10.5	9.7	9.2	10.2
Total expenditure (% GDP)	29.2	29.3	29.1	30.0	32.3
Central govt. balance (% GDP)	7.8	6.9	11.9	11.9	9.9
Non-hydrocarbon primary balance (% GDP)	-24.3	-28.0	-33.5	-37.6	-39.2
Gross government debt (% GDP)	43.8	36.6	28.4	22.6	19.5
Monetary sector					
Credit to the economy (% change)	8.9	11.2	15.8	-5.5	10.8
Money and quasi money (% change)	15.6	11.5	10.7	12.7	17.9
Liquidity ratio (M2/GDP, %)	63.8	61.1	55.1	55.7	60.9
External sector					
Current account balance (% GDP)	13.0	13.1	20.7	24.4	16.6
Import cover of reserves (months)	18.1	21.0	25.7	24.4	27.6
Net FDI (% GDP)	0.9	0.7	1.0	1.2	0.9
External vulnerability					
Total external debt (% GDP)	34.3	25.7	16.8	4.3	3.8
Gross reserves (USD, billion)	32.9	43.1	56.2	77.8	97.7
Financial sector					
Rediscount rate central bank (%, end-of-period)	4.5	4.0	4.0	4.0	
Lending rate (%, end-of-period)	8.0	8.0	8.0	8.0	
Exchange rate (dinar per USD, average)	77.22	79.68	77.39	72.06	
Real effective exchange rate (% change)[1]	-9.5	0.7	-3.9	0.7	

Sources: Algerian authorities, IMF, EC staff calculations.

[1] An increase (a decrease) reflects an appreciation (a depreciation) of the Algerian dinar.

ARMENIA

- **The Armenian economy continues to show strong growth driven by structural reform and the inflow of remittances from abroad. However, growth remains narrow based as construction accounts for about half of the expansion in 2006.**

- **Exports of processed diamonds fell substantially in 2006 as a result of a slowdown in world demand. Total export growth has therefore been negligible while imports increased by 21%, leading to a significant widening in the trade deficit. Further export diversification is necessary.**

- **Armenia is in the lead among CIS countries with regard to progress on structural reforms. There is still considerable room for improvement, however, with regard to competition policy, the rule of law, and fighting corruption and bureaucracy.**

- **The ENP Action Plan for Armenia was adopted on 14 November 2006. The Action Plan, which supports balanced and pro-poor growth, sets out a list of priorities to be addressed as part of Armenia's cooperation with the EU over the next five years.**

1. Macroeconomic developments

Real sector developments

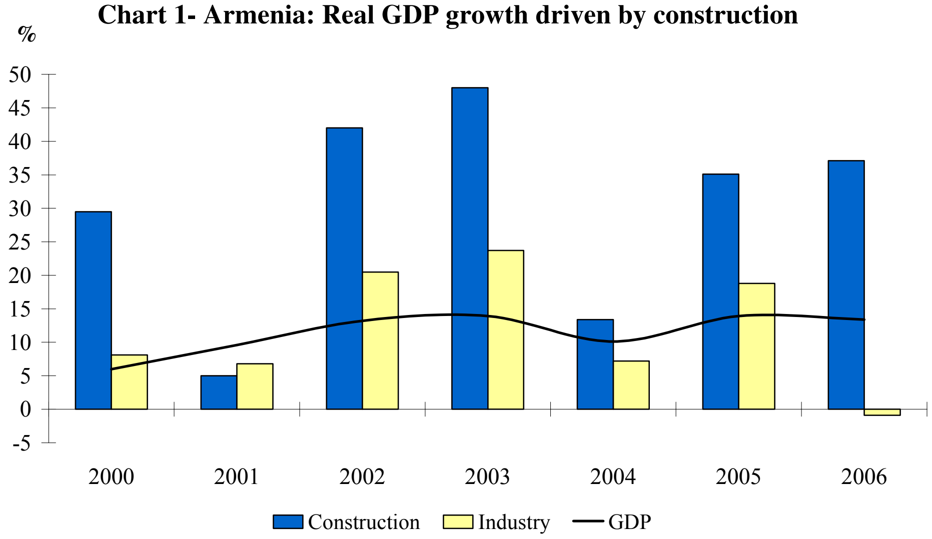
The Armenian economy continued to perform well during 2006. Real GDP increased by 13.4% and is now at about USD 2000 per-capita, well above its pre-transition level. Growth is driven in particular by domestic demand, fuelled by remittances and increased private sector incomes, while export growth has been minor. A successful reform process, which has given rise to increased confidence in the economy, also appears to be a key driver of the impressive growth record. Most of the economic growth has been geographically concentrated around Yerevan, while progress in the rest of the country is more modest and income disparities have increased.

Almost half of the total GDP growth can be attributed to the construction sector, which grew by as much as 37% in 2006, not least because of a housing boom in Yerevan (chart 1). Services have performed well with a healthy growth rate of about 20% while industrial production fell by about 1% and agricultural output remained broadly unchanged. Although the shadow economy is still thriving (it is estimated at above than 30% of GDP[1]), a shift of profits into the official economy as a result of improved tax collection may explain part of the growth recorded in the real economy.

The growth momentum is expected to persist in 2007, although at a slightly slower pace. The lack of growth in the industrial sector has caused increasing concern about the sustainability of the current economic boom and risks are building up, in particular with regard to the sustainability of the expansion in the construction sector.

[1] See B. Tunyan, (2005), *The Shadow Economy of Armenia: Size, Causes and Consequences*, Armenian International Policy Research Group Working Paper Series No. 05/01.

Chart 1- Armenia: Real GDP growth driven by construction



Source: National Statistical Service of the Republic of

Official unemployment has shown a downward trend since 2003, and fell to about 7.6% in 2006 from 8.2% in 2005. Actual unemployment, however, appears to be significantly higher.[2] The labour force has been shrinking almost continuously since the early 1990s, due mainly to net emigration, but a slow reversal appears to have taken place in recent years as the diaspora population has started to return. Since the collapse of the Soviet Union at least 20% of the population has left Armenia, mostly for Russia.

Fiscal policy

The Government had programmed a budget deficit of 2.3% of GDP in 2006 to accommodate a rise in spending on social programmes and infrastructure, though the actual budget deficit came in lower at about 0.6% due to the higher than expected economic growth which boosted revenues. The budget revenue increased by as much as 18% and the budget expenditures increased by 14.6%. Expenditures on pensions grew 22% and on family allowances 25%. Expenditure on education was increased by 30% while public health expenditure was increased by 27% to make primary medical care free.

Monetary and exchange rate policy

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

External sector developments

The current account deficit increased to about 5% of GDP in 2006 from 4% in 2005, mainly as a result of a deterioration of the trade balance. The trade deficit increased substantially, to 18% of GDP in 2006 from 13% in 2005, as a result of high import growth and negligible export growth. The lack of export growth can be attributed to a fall in refined diamond exports, partly caused by a downturn in foreign demand. The

[2] Surveys conducted in line with ILO methodology indicate that unemployment fell to about 32% in 2004.

non-diamond exports increased about 6%. Import volumes increased by 20% in 2006 and non-diamond imports increased by as much as 28%. The large trade deficit is to some extent financed by the inflow of remittances.

The appreciation of the Armenian dram, driven partly by the inflow of remittances, has made it somewhat harder for Armenian goods to stay competitive. The European Union remains Armenia's number one trading partner, accounting for 30% of imports and 44% of exports.
FDI from abroad (net) has decreased from 5.1% to 4.4% of GDP. Gross international reserves increased slightly to USD 1.07 billion.

Box 1 – Armenia: ENP Action Plan supports growth in Armenia

The EU-Armenia ENP Action Plan was adopted in November 2006. The action plan sets out a comprehensive set of priorities to be addressed as part of Armenia's cooperation with the EU over the next five years. Particular attention is given to eight priority areas: strengthening democracy and the rule of law; enhancing respect for human rights; continuing economic development and enhancing poverty reduction efforts; improving the investment climate and strengthening private sector-led growth; convergence of economic legislation and administrative practices; development of an energy strategy that includes the early decommissioning of the Medzamor nuclear power plant; working towards a peaceful resolution of the Nagorno-Karabakh conflict; and enhanced efforts in the field of regional cooperation.

Implementation of these eight key priorities and the complementary actions and objectives included in the ENP Action Plan will be supported by implementation programmes and the process will be monitored and assessed in regular progress reports. Financial support will be available from the new European Neighbourhood and Partnership Instrument.

As part of the ENP a feasibility study for the establishment of a Free Trade Agreement with Armenia will be undertaken. The study will assess the benefits of different types of FTA and will try to indicate where "quick wins" could be achieved, by identifying goods/sectors where an immediate opening up could have significant positive short-run effects for Armenia.

The ENP supports pro-poor growth. In Armenia this goal will be furthered through the implementation of a catalogue of economic policies including a comprehensive programme to improve the business climate; modernisation of the tax administration; strengthening of the customs administration; reforms of the health and educational sectors; reforms in the field of labour, social security and social protection, and continued implementation of the existing poverty reduction strategy.

The European Commission and the Armenian authorities started drafting the EU-Armenia ENP action plan in 2005 based on a detailed country report drawn up by the European Commission earlier that year.

2. Trade liberalisation and economic opening

Armenia has a liberal trade regime with low tariff barriers (average tariffs are about 3%). However, the two closed borders are a constraint on further trade, as are inefficiencies and corruption in customs. Opening the closed borders could help re-establish Armenia's role as a transit country.

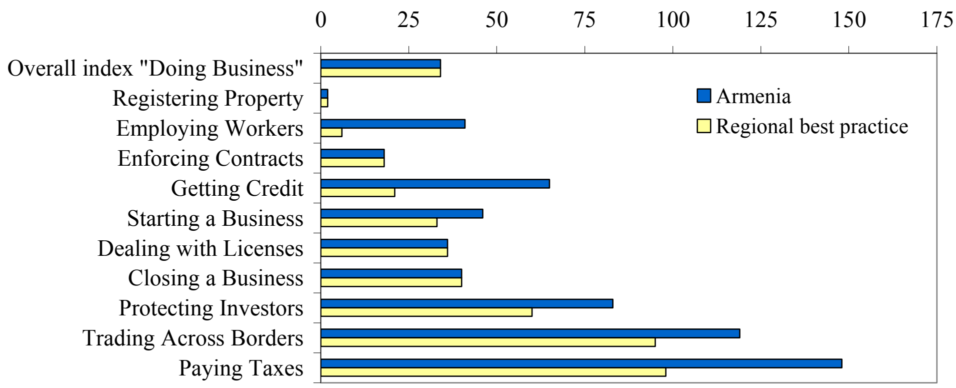
The European Commission has, in accordance with the ENP action plan, launched a feasibility study on the possible establishment of an EU-Armenia free trade agreement. The study will try to identify goods/sectors where an immediate opening up could have significant positive short-run effects for Armenia.

3. Business climate

Privatisation, enterprise restructuring and business environment

The privatisation process is close to completion, but a number of strategic enterprises, including a few state-owned enterprises in the energy sector, still need to be privatised. The privatisation programme for 2006-2007, approved in June 2006, aims to privatise 45 medium and large enterprises before the process is considered completed at end-2007.

Chart 2 - Armenia: "Doing business" rankings



The ease of doing business index ranks economies from 1 (best) to 175. The regional best practice refers to the best ranking country in the eastern neighbourhood region.

Source: World Bank, 2007.

Armenia continued to advance with structural reforms in 2006, and although the reform process has slowed down it is still in the lead among CIS countries according to the EBRD 2006 transition indicators[3]. Further improvement is needed in particular with regard to competition policy, financial sector development and infrastructure reform. The business climate is perceived to be among the best in the CIS with efficient contract enforcement, licensing and property registration. Bureaucracy, corruption and insufficient rule of law is however perceived to harm the business climate considerably. Bureaucracy is particularly pronounced in tax collection and cross-border trade. Competition is still modest in several sectors, although the state commission on the protection of economic competition is slowly becoming more effective.

[3] See EBRD (2006), *Transition Report 2006 – Finance in Transition*.

Armenia ratified the UN convention against corruption in October 2006 and has continued to make progress in fighting corruption. Nevertheless, the number of convictions for corruption and related offences is still very low and does not reflect the perceived level of corruption. Operational cooperation among different law enforcement bodies should therefore be further improved and efforts to investigate and prosecute corruption offences should be stepped up further.[4] Transparency International ranks Armenia 93rd out of 163 countries in 2006, which indicates a lack of progress over the previous year.

The Heritage Foundation has ranked Armenia as "mostly free" while Freedom House has classified it as "partly free".

Financial sector reforms

Financial depth is increasing, but despite private credit growth of nearly 30% in 2006 it is still lower than in most other CIS countries. Bank deposits have also shown high growth, about 16%, but still only amount to about 11.5% of GDP. The financial sector is concentrated in banking, which accounts for as much as 95% of total financial sector assets.

The banking sector continued to consolidate in 2006 and at the end of the year the number of banks was down to 21. Foreign participation in the banking sector has increased with the entrance of banks from other CIS countries, but is still dominated by HSBC. The Armenian financial sector has substantial growth potential, and more foreign banks and insurance companies could bring expertise and increased competition to the sector. Supervision of banks will be upgraded significantly in 2007 in line with the IMF's Financial Sector Assessment Program recommendations. Development of the legal framework for mortgage institutions, the insurance sector and the securities market is also in the pipeline.

There is a strong need to develop the mortgage market. Mortgage loans are not widely available – in particular outside Yerevan – and have so far been limited to short-term loans (5-7 years) with high interest rates (11-17%). The German KfW has pledged to allocate credit of EUR 12 million for mortgage loans in Armenia in 2007. These loans will be of at least 10 years' duration, and they are intended to be targeted at the middle class.

Labour market reforms

Armenia ratified several international labour conventions in early 2006 on minimum working age, child labour, minimum wage and freedom of association. In total Armenia has now ratified 29 labour conventions. Average nominal wages increased by as much as 23.5 % in 2006, while the consumer price index increased by only 2.9%.

4. Public institutions and public finance management

Reforms in recent years have been aimed at increasing the tax base, strengthening tax administration and reducing loopholes in the tax policy. As a result, VAT and profit taxes have noticeably increased. Armenia's overall tax-to-GDP ratio reached 14.7% in 2006, up from 14.4% the year before, but still well below regional standards. Further improvements in tax collection systems are needed in order to finance

[4] See OECD (2006), *Armenia Monitoring Report, Anti-corruption Network for Eastern Europe and Central Asia.*

increasing government expenditure. A continuation of reforms and increases in tax revenues is envisaged for 2007. A more progressive tax system could be achieved by introducing elements such as property and land taxes. Gas subsidies should be phased out and replaced by targeted social benefits.

Armenia's reform agenda aims to improve fiscal discipline, and efficiency of allocation and operation. A PEFA assessment has identified that weaknesses are most prevalent in budget execution and in internal and external audit. Decommissioning of the *Medzamor* nuclear power plant will have significant fiscal implications and is expected to take place not later than 2012. Decommissioning will take several years and is estimated to cost about USD 0.7 to 1.2 billion.[5] Though some of the costs could potentially be covered via an international donor conference, the fiscal implications underscore the need to strengthen the tax base.

5. Social development and poverty

Poverty continues to fall, and extreme poverty may soon be eradicated.[6] Despite this there appears to have been an increase in income inequality. Yerevan has experienced an economic boom while development in remote marses (counties) has been modest. Social transfers are still small and pension levels continue to be below the poverty line.

Remittances from abroad account for a considerable part of average household income, and have made an important contribution to reducing poverty. They may however have done little to reduce inequality since the share of receiving households appears to have been slightly increasing with household income, and richer households have tended to receive higher amounts.[7] At the macroeconomic level remittances have had a significant positive effect on investment and GDP, but have resulted in exchange rate appreciation with a consequent negative impact on export competitiveness.[8]

The ENP Action Plan has made poverty reduction a key priority. This is to be achieved through implementation of targeted reforms in a number of areas including sustainable reform of social security and social protection; health sector reform and reform of the educational and vocational training system; labour market reform and strengthened capacity of the Public Employment Services and social services agencies. The ENP action plan for Armenia emphasises the need to improve the welfare of the most vulnerable groups and also supports the existing PRSP framework. Implementation of the ENP action plan will be supported by the new ENPI. Budget support will remain among the preferred development instruments for Armenia in areas where it is appropriate.

In March 2006 the US pledged USD 235.65 million over the next five years under the Millennium Challenge Account programme. The aid will be channelled into rural regions (upgrading of irrigation networks, repair of rural roads) that have seen little development. Armenia has also received ongoing assistance from the World Bank, the IMF, UNDP, EBRD and national donors. Donor coordination is considered to be good in Armenia.

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

[6] Extreme poverty in Armenia is defined by the National Statistical Service based on World Bank methodology as household expenditures of less than USD 16 per month.

[7] See A. Monsoor and B. Quillin (2007), *Migration and Remittances*, World Bank.

[8] For a discussion see IMF (2006), *Republic of Armenia – Selected Issues*.

ARMENIA

Main economic indicators

	2003	2004	2005	2006 prel.	2007 proj.
Real sector					
Real GDP growth (% change)	13.9	10.1	13.9	13.4	9.0
Inflation (average)	4.7	7.0	0.6	2.9	4.0
GDP nominal (USD, billion)	2.8	3.6	4.9	6.4	7.3
GDP per-capita (USD)	874	1114	1528	1892	2350
Social indicators					
Unemployment (officially registered, %)	10.1	9.6	8.1	7.4	7.0
Poverty rate (% population)	42.9	39.0			
Inequality (Gini ind. consumption/income, %)	33.8				
Fiscal sector					
Total revenues (including grants, % GDP)	17.8	15.4	15.7	17.4	16.8
Total expenditure (% GDP)	18.9	17.1	18.3	19.7	19.2
Central government balance (% GDP)[1]	-1.1	-1.7	-2.6	-2.3	-2.3
Gross public debt (% GDP)	40.9	32.4	24.2	22.2	21.0
Monetary sector					
Domestic credit to private sector (% GDP)	5.7	7.0	8.0		
Broad money (M2, (% change)	10.4	22.3	27.8	32.9	
Degree of monetisation (M2/GDP, %)	13.7	13.6	14.5	18.2	
Dollarisation in bank deposits (%)	70.8	74.8	63.6	58.5	54.5
External sector					
Current account balance (% GDP)	-6.8	-4.6	-3.9	-4.9	-4.5
Trade balance (% GDP)	-17.9	-14.8	-13.2	-18.5	
FDI (net, % GDP)	4.3	6.1	5.3	4.1	3.7
Import cover of reserves (months)	4.1	3.9	4.0	3.6	3.9
External vulnerability					
External public debt (% GDP)	39.1	33.3	22.6	19.0	17.0
Debt service ratio (%)[2]	15.6	9.7	5.7	4.2	
Gross reserves (excl. gold, USD, million)	502.0	547.8	669.5	1070	
Reserves/M2 (%)	0.8	0.9	1.1	1.0	
Financial sector					
Money market rate (%)	7.5	4.2	3.2		
Lending rate (%)	20.8	18.6	18.0		
Exchange rate (drams per USD, average)	578.8	533.5	457.7	416.0	
Exchange rate (drams per EUR, average)	653.2	662.4	569.2	522.0	
Real effective exchange rate (% change)	-2.6	6.5	7.4		

Sources: IMF, WB, Armenian authorities, EC staff calculations.

[1] On commitment basis.

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

AZERBAIJAN

- **The impressive growth performance has been driven by high oil prices and increased oil production following the opening of the Baku-Tbilisi-Ceyhan oil pipeline. Another year of very high growth is expected as the natural gas pipeline to Erzurum opens in 2007.**

- **Fiscal expenditures increased by as much as 77%. Fiscal revenues increased even more, but the expansive fiscal policy, with a substantial increase in the non-oil fiscal deficit, raises concerns about inflationary pressures and long-term sustainability.**

- **The business climate needs to be substantially improved in order to secure a balanced and sustainable growth path. Regulatory quality and government effectiveness has improved, but the rule of law is an increasing concern. Corruption is still widespread.**

- **The EU-Azerbaijan ENP Action Plan was adopted in November 2006. The Action Plan, which supports balanced and pro-poor growth, sets out a list of priorities to be addressed as part of Azerbaijan's cooperation with the EU over the next five years.**

1. Macroeconomic developments

Real sector developments

Real GDP is estimated to have grown 34.5% in 2006, the world's highest rate. The impressive growth record was mainly driven by the opening of the Baku-Tbilisi-Ceyhan oil export pipeline, with a capacity of approximately one million barrels a day. Delivery of oil from the pipeline to tankers in Ceyhan in Turkey began in late May 2006. The Baku-Tbilisi-Erzurum (BTE) natural gas pipeline was finalised in late 2006 and started to deliver gas from the Shah-Deniz gas field to Europe via Turkey in early 2007. As a consequence of this it is anticipated that 2007 will be another year of extraordinarily high GDP growth.

While non-oil-sector real growth stood at 12% in 2006, the oil and gas sector grew as much as 60% and now accounts for about 54% of GDP. Domestic demand rose as a result of rising public and private consumption. Fiscal expenditures increased by 77% in nominal terms. Oil pipeline construction slowed down, but an oil-related building boom had positive spillover effects on most other segments of the non-oil sector – in particular the service sector in and around the capital. The construction sector itself now accounts for as much as 7.5% of GDP. Non-oil-sector labour productivity has increased markedly in recent years.

The agricultural sector's share of the economy has been rapidly decreasing and now only accounts for about 7% of GDP, down from 11% the year before. Agriculture and forestry still employ 1.5 million people, however, as they did in 2000, despite the major changes in the economy. Agricultural production increased by about 4.4% in 2006.

The official unemployment rate increased slightly to 1.5% in 2006, but the actual unemployment rate is much higher, as revealed by an ILO survey from 2003 that put the unemployment rate at 10.7%. The shadow economy accounts for 18-20% of GDP according to the State Statistical Committee, while others put the figure at more than 40%.

Box 1 – Azerbaijan: ENP Action Plan supports growth in Azerbaijan

The EU-Azerbaijan ENP Action Plan was adopted in November 2006. It sets out a comprehensive set of priorities to be addressed as part of Azerbaijan's cooperation with the EU over the next five years. Particular attention is given to ten priority areas: supporting balanced and sustained economic development with a particular focus on improving the business and investment climate, particularly by strengthening the fight against corruption; diversification of economic activities, development of rural areas and poverty reduction; strengthening the protection of human rights and the rule of law; strengthening democracy; further convergence of economic legislation and administrative practices; strengthening EU-Azerbaijan energy cooperation and regional transport cooperation; enhancing cooperation in the field of justice, freedom and security; improving functioning of customs; working towards a peaceful resolution of the Nagorno-Karabakh conflict; and enhancing efforts in the field of regional cooperation.

Implementation of these key priorities and the complementary actions and objectives included in the ENP Action Plan will be supported by implementation programmes and the process will be monitored and assessed in regular progress reports. Financial support will be available from the new ENPI.

The ENP supports balanced and pro-poor growth. In Azerbaijan this goal is to be achieved through the implementation of a catalogue of economic policies including a comprehensive programme to improve the business climate; strengthening of the fight against corruption; diversification of economic activities; strengthening of customs administration; reforms of the health and educational sectors; reforms in the field of labour, social security and social protection, and continued implementation of the State Programme on Poverty Reduction and Sustainable Development.

The European Commission and the Azerbaijan authorities started drafting the EU-Azerbaijan ENP action plan in 2005 based on a detailed country report drawn up by the European Commission earlier that year.

Fiscal developments

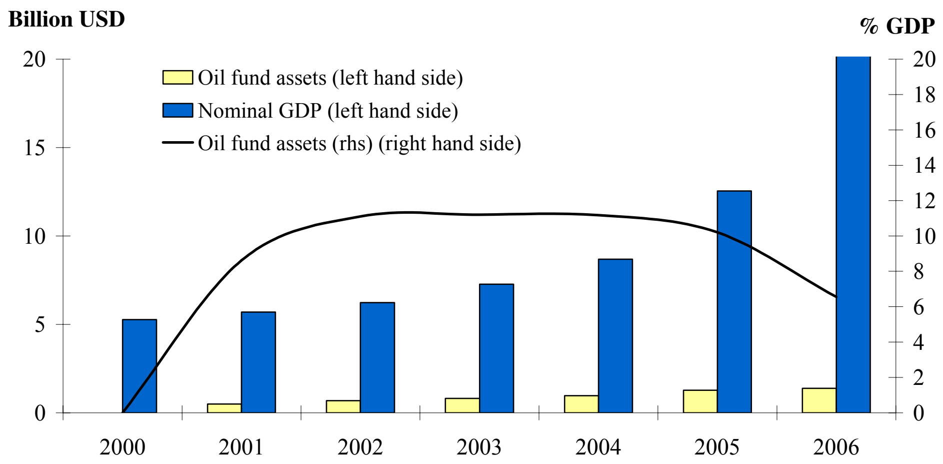
Fiscal revenues increased 88% in 2006 driven in particular by the high oil sector growth, while fiscal expenditures increased by 77% in nominal terms. The oil and gas sector now accounts for about half of the budget revenues. The consolidated government balance improved to a surplus of about 3.1% of GDP. The public and publicly guaranteed external debt stood at about 11.6% of GDP at end-2006, down from 15.9% at end-2005.

Azerbaijan has a long-term oil revenue management strategy approved by presidential decree in 2004. However, the expenditure increase of 77% in 2006 is far too expansionary to be in line with this and the resulting increase in the non-oil fiscal deficit is clearly not sustainable in the long term. As an immediate result inflationary pressures are mounting. The government has recognised the threat of higher inflation and has introduced a number of temporary measures such as price controls. However, rather than using market-distorting measures the authorities should seriously consider cutting public expenditure growth. Budget spending is in fact set to increase further by up to 42% in 2007, according to the approved state budget.

The increase in expenditure is partly a result of substantial infrastructure investments and wage increases. Wages, pensions and benefits account for about 30% of the budget. The government has also sharply increased the military budget in recent years and in 2006 it roughly tripled from about USD 300 million in 2005 to about USD 900 million (2.6 % of GDP). The president has announced plans to raise the military budget further to at least USD 1 billion in 2007.

Oil revenues above the budgeted oil price of USD 35 per barrel are transferred to the State Oil Fund of the Republic of Azerbaijan (SOFAZ), which was established by presidential decree in December 1999. The main purpose of the fund is to save oil- and gas-related revenues for future generations. Under the current regulations oil fund expenditures may not exceed inflows in any given year. SOFAZ total assets amounted to USD 1454 million at the end of 2005 compared to USD 1320 million at the beginning of the year.[1] Transfers to the oil fund reached about USD 857 million in 2006, but a similar amount was then transferred to the state budget or spent directly on improvement of social conditions of refugees and internally displaced persons.

Chart 1 - Azerbaijan: State oil



Source: IMF.

Monetary and exchange rate developments

Inflationary pressure materialised in 2006, mainly as a result of the expansionary fiscal policy. During the year consumer price inflation increased steadily, from 5.4% in December 2005 to 11.4% in December 2006. Independent analysts suggest that actual inflation is significantly higher. An increase in energy and utility prices in January 2007 implies an additional temporary rise in inflation by 3-4%.

[1] This holds according to SOFAZ, 2006, *Revenue and Expenditure Statement* (non-audited).

The National Bank of Azerbaijan abandoned its informal peg of the manat to the USD in mid-February 2005, allowing a slow nominal appreciation in order to combat rising inflation. In 2006 the manat appreciated 5.4% against the USD. A new manat was put into circulation in January 2006 with one new manat being equivalent to 5 000 old manats. The NBA raised its refinancing rate once from 9% to 9.5% on 3 June 2006.

The NBA appears committed to a managed float with the objective of reducing core inflation and is expected to move to a fully-fledged inflation-targeting policy framework over the medium term.

Broad money supply (M3) grew by 87% year-on-year in 2006, up from 22.1% in 2005. The money supply growth has been driven by capital inflows and is accompanied by a financial deepening. The economy is heavily dollarised and foreign currency savings are substantial. Monetary depth, measured as M3/GDP, increased to 13.8% in 2006, and bank lending grew strongly (domestic credit grew 75%), albeit from a low level.[2] State banks' share in domestic credit fell to 46.1% while private banks accounted for 51% and nonbank credit organisations 2.9%. Gross official reserves grew rapidly in 2006 and gross international reserves amounted to USD 2.5 billion at end-2006, up from USD 1.2 billion.

External sector developments

The current account surplus increased massively to 16.7% of GDP in 2006 up from 1.3% of GDP as a result of the completion of the Baku-Tblisi-Cayhan oil pipeline. The trade balance improved significantly to a surplus of 39.8% of GDP in 2006 from 26.3% of GDP in 2005, due to a 60.7% jump in export values, far exceeding the more modest 4.5% increase in imports. The foreign debt was reduced to USD 1.9 billion (9.9% of GDP) in 2006 from USD 2.2 billion in 2005.

The EU was the main trading partner for Azerbaijan both for imports (32%) and for exports (59%). Oil products and chemicals made up 88% of Azerbaijan's exports, while the main non-oil export commodities were food, metals and textiles.

2. Trade liberalisation and economic opening

Azerbaijan's trade liberalisation efforts are encouraged by a Partnership and Cooperation Agreement with the EU, which was signed in 1996 and entered into force in 1999.[3] Azerbaijan is also a beneficiary country of the EU's Generalised System of Preferences. However, total EU preferential imports from Azerbaijan are heavily concentrated in a few products.

A feasibility study for an EU-Azerbaijan FTA is expected to take place in the context of the EU-Azerbaijan Action Plan. The future development of the EU-Azeri trade and economic relations depends very much on the implementation of relevant aspects of this Action Plan. Azerbaijan's WTO accession negotiations are ongoing although the government should pursue WTO accession more vigorously. The latest meeting of the Working Party took place in March 2006 and bilateral negotiations on market access based on revised offers in goods and services are under way.

3. Business climate

[2] See the IFS (IMF).

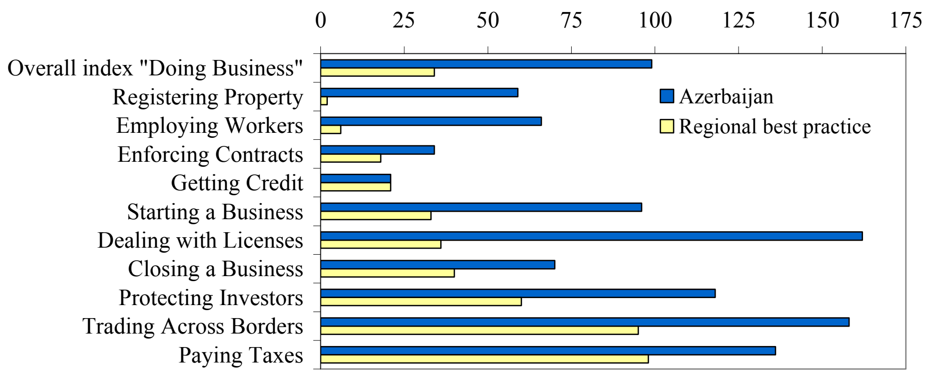
[3] Azerbaijan also initiated the process towards WTO membership in 1997, though the accession negotiations are still at an early stage.

Privatisation, enterprise restructuring and business environment

The privatisation process has slowed down, but there is still a need to privatise and restructure large and inefficient state-owned companies. Many state-owned companies operate as monopolies in network industries like gas, electricity, sea and air transport. In these companies better governance, transparency and accountability is required. About 3200 small enterprises were privatised and 12 joint-stock companies were founded in 2006.

Azerbaijan's authorities are working to improve the business climate and bring its legislative and regulatory framework closer to European standards, in line with the EU-Azerbaijan Action Plan. This is an important task that needs to be undertaken in order to support balanced and sustainable growth. As the World Bank's doing business indicators show, progress is slow and there is still a long way to go (chart 2). Azerbaijan is well below the regional best practice on most of the indicators and in particular in relation to property registration, starting a business and dealing with licenses. Doing business is still too complicated, procedures are lengthy, contract enforcement is expensive and investor protection is limited. As a result there is a large informal economy.[4]

Chart 2 - Azerbaijan: "Doing business" rankings



The ease of doing business index ranks economies from 1 (best) to 175. The regional best practice refers to the best ranking country in the eastern neighbourhood region.

Source: World Bank, 2007.

The World Bank's 2006 governance indicators present a similar picture. Regulatory quality is improving and is slightly above the regional average, but Azerbaijan is ranked in the worst quartile worldwide on most indicators. The 'rule of law' and 'voice and accountability' are a particular concern with an apparent deterioration in the conditions for freedom of speech. The presence of a small elite of politically well-connected businessmen who benefit from artificial monopolies is a major problem for the development of a thriving private sector.

Corruption remains a significant deterrent to efficient investment and private sector development. Azerbaijan is ranked 130th out of 163 countries on Transparency International's Corruption Perception Index 2006, indicating substantial problems. Although an anti-corruption law has existed since early 2005 enforcement remains insufficient. There is a need to simplify what is currently a complex and fragmented way of dealing with corruption.

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

Financial sector reforms

Financial sector development in Azerbaijan has been slow compared to other transition economies and state ownership still dominates the banking sector. The depth of bank intermediation activity is gradually improving. Growth in credit to the private sector was very strong in 2006 (75.4% growth), but relatively low ratios of bank deposits to GDP and private sector credit to GDP signal that the provision of financial services to households and the private sector is still incomplete. Despite this the pace of credit expansion might have put pressure on some banks' capacity to assess credit risks.

Increased competition in the banking sector is necessary to facilitate financial deepening and foster balanced economic growth. The privatisation of the dominant *International Bank of Azerbaijan* (IBA) will be an important step in this direction. However, while the privatisation of the IBA and the other state-owned bank, *Kapital Bank* (former *BusBank*), was revived by decree in March 2005, since then little has happened. Together the two banks control over half of the assets in the sector. The state holds a 50.2% stake in the capital of IBA, while *Kapital Bank* is 100% state-owned.

Minimum capital requirements for new banks were doubled (to AZM 50 billion) in January 2006 and will be doubled for existing banks in mid-2007. This move may help to facilitate some consolidation among the present 42 relatively small private banks. Financial supervision has improved, although enforcement and monitoring capacity has remained relatively weak.

Labour market reforms

Wage inequalities in Azerbaijan are the highest in the CIS region.[5] The very low official unemployment rate, 1.5% in 2006, reflects the fact that few take advantage of unemployment benefits, which are low. A second ILO labour market survey was undertaken in mid-2006.

4. Public institutions and public finance management

The European Commission has "support for democratic development and good governance" as a key priority in its National Indicative Programme 2007-2010 for Azerbaijan and support for this will be available from the ENPI. The ambitious long-term goal is to "develop a modern state geared towards meeting the needs of citizens and capable of managing future oil and gas wealth in an accountable, transparent and efficient manner". Projects on public administration reform and public finance and tax management, including public internal control and external audit, take place in cooperation with other donors including the World Bank. Azerbaijan participates in the Extractive Industries Transparency Initiative.

5. Social development and poverty

The 3-year State Programme on Poverty Reduction and Economic Development expired in 2005, but has been followed by a 10-year SPPRED for 2006-2015. Some success in poverty reduction has been observed, driven in particular by high growth and the high public salary increases. It appears that the percentage of the population living below the national poverty line (defined as the value of a minimum

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

consumption basket worth EUR 29 in 2004), which stood at 40% in 2004, was reduced to 21% in 2006.[6] Poverty is most widespread in rural areas and in particular in the western part of the country.[7]

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

[6] Azerbaijan Ministry of Economic Development (2005), State Programme on Poverty Reduction and Economic Development 2003-2005, Azerbaijan progresses toward the achievement of the millennium development goals. Recent figures come from the State Statistical Committee.

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

AZERBAIJAN

Main economic indicators

	2003	2004	2005	2006 prel.	2007 proj.
Real sector					
Real GDP growth (% change)	10.4	10.2	24.3	34.5	29.5
Inflation (average)	2.2	6.7	9.7	8.3	21.0
GDP nominal (USD, billion)	7.3	8.7	12.6	21.2	33.0
GDP per-capita (USD)	880	1040	1493	2390	3800
GNI per-capita (PPP, current prices, USD)	3400	3810	4890		
Social indicators					
Unemployment rate (officially registered, %)	1.4	1.5	1.4	1.4	1.4
Poverty rate (% population)	39.7	28.5	24.0		
Fiscal sector					
Total revenues (% GDP)	21.2	22.4	24.0		
Total expenditure (% GDP)	23.0	21.4	21.5		
General government balance (% GDP)	-0.8	1.0	2.7	3.1	10.0
Gross public debt (% GDP)	21.8	20.2	15.3	11.6	9.9
Monetary sector					
Domestic credit to private sector (% GDP)	8.2	11.1	12.2		
Broad money (M2, % change)	30.8	46.1	21.8		
Degree of monetisation (M2/GDP, %)	14.3	17.6	15.4	21.1	
Dollarisation bank deposits (%)	49.1	54.5	56.9	51.2	
External sector					
Current account balance (% GDP)	-27.8	-29.8	1.3	15.7	27.4
Trade balance (% GDP)	-1.3	1.9	26.3	39.8	
FDI (net, % GDP)	31.5	26.8	-5.8	-10.8	-10.0
Import cover of reserves (months)	2.0	2.0	2.1		
External vulnerability					
Total external debt (% GDP)	31.1	33.6	47.5	38.6	32.4
Of which: public external debt (% GDP)	19.7	18.5	14.3	10.6	8.8
Debt service ratio (%)[1]	5.2	3.6	1.3		
Gross reserves (excl. gold, USD million)	803	1,075	1,178	2,500	.
Reserves/M2 (%)	1.3	1.4	1.6		
Financial sector					
Short term interest rate (%, end of period)	7.0	7.0	9.0	9.5	
Lending rate (%, end of period)	15.5	15.7	17.0	17.9	
Exchange rate (manta per USD, average)[2]	(0.98)	(0.98)	(0.95)	0.89	
Exchange rate (manat per USD, average)	(1.11)	(1.22)	(1.18)	1.12	
Real effective exchange rate (% change)[2]	-10.8	-3.5	6.6		

Sources: IMF, WB, national authorities.

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

[2] Recalculation for the new manta=5000 old manta.

BELARUS

- **2006 was another year of strong growth, but the end-2006 double energy "price shock" (gas prices and oil duties increases) will necessarily have very significant effects on Belarus's future growth performance.**

- **Slower but still robust forecast GDP growth is likely in 2007, with the bulk of the slowdown possibly delayed until 2008. The new external environment may lead to some limited structural reforms.**

- **The twin external shocks are likely to considerably worsen Belarus' already vulnerable external position. The inevitable adjustment may take place via an increase in external indebtness in the short-run, facilitated by the current very low debt level.**

- **The state continues to play a dominant role in all sectors of the economy (it is responsible for around 75% of GDP), due to so far very limited progress in liberalisation and structural reform. Especially given the revision of preferential relations with Russia, the long term economic outlook will depend on significant progress in market-oriented reforms.**

1. Macroeconomic developments

Real sector developments

GDP growth in 2006 was very high at 9.9%, accelerating from the robust 9.4% observed in 2005. Industry contributed with an estimated 4.7% of this performance, up from 4.1% in 2005 (in other words, the whole of the growth acceleration in 2006 is attributable to the improved performance of the industrial sector). Of industry's total contribution to growth, the fuel industry (refining) was responsible for almost half. While manufacturing grew by 11.3% in 2006, the fuel industry grew by 23.1%: fuel is now responsible for almost a quarter of the whole industrial output (from slightly more than 4% in 1995). Agriculture grew by 6.1%, while services (responsible for almost 2/3 of Belarus' GDP) grew by 9.7%. From the demand side, investment was the most dynamic component of GDP, increasing by a hefty 31.4% in 2006, from 20% in 2005: investment, mainly public, now constitutes almost a quarter of GDP, far above the OECD average. Unemployment fell to 1.2% in 2006, while real salaries rose almost twice as fast as productivity growth. Nevertheless, this was not yet reflected in prices, as CPI inflation fell.

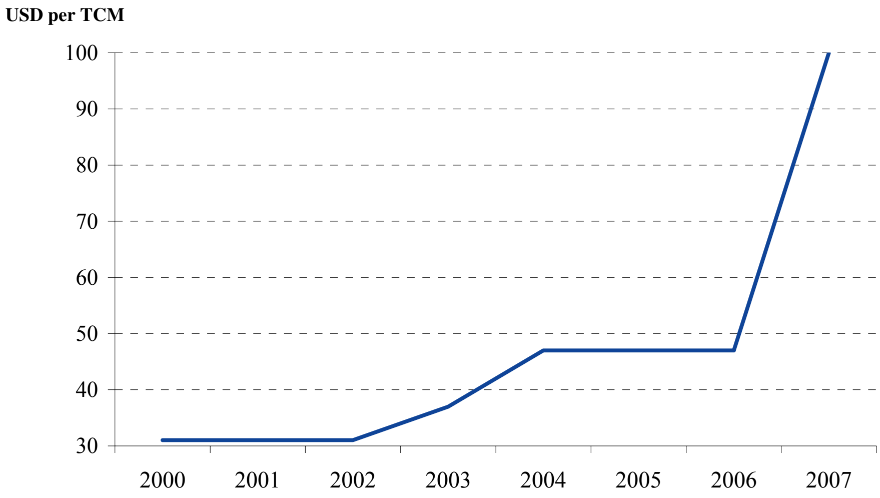
This robust growth is mainly linked to Belarus's "special relations" with Russia, and chiefly with its energy sector: not only received Belarus natural gas at far below EU rates (in a similar fashion to other CIS countries) but in addition – and more importantly in economics terms – during 2004-2006 it benefited from very specific arrangements in the refined oil trade.[1] Russian oil companies that exported refined crude from Belarus were able to effectively evade Russian export fees. Belarus – according to the terms of the Russia-Belarus customs union – imported crude oil from Russia duty-free, but did not charge export duties on refined oil products and did not transfer the corresponding revenue to the Russian budget, in spite of several complaints by the Russian government through the years, which claimed that Belarus was in breach of its legal obligations towards the Russian Federation (a 1995 Treaty stipulated an

[1] In 2006, Belarus imported around 21 million tonnes of Russian crude oil, and exported around 14 million tonnes of oil products, overwhelmingly to the EU market.

85-15% split of the export duty for Russia and Belarus respectively: revenue foregone for Russia is estimated at over USD 1 billion per year). This situation generated substantial profits for specific Russian companies who transferred their refining operations to Belarus, increasing economic activity in those sectors in that country, and resulting in very significant direct and indirect fiscal revenues for the Belarusian state.

In December 2006, gas prices were increased (chart 1) at the same time that the "off-shore" tax avoidance scheme with oil duties ended (Box 1). The combined short-run effects of the two "shocks" are estimated at over USD 2 billion, or almost 6% of Belarus's GDP, with the overwhelming majority of this coming from the changes in the oil trade.

Chart 1- Belarus: Evolution of gas prices



Source: DG ECFIN.

The sector effects of the changes in the oil trade are relatively clear and straightforward: the excess profits of the refining sector in Belarus – reportedly at an astonishing 60% in 2006, far above the industry average of 15.6%[2], which is expected to fall to 10% in 2007 – will be taxed away, and the sector growth rate will slow down very substantially. The macroeconomic effects are somewhat less clear, as most analysts forecast a relatively mild short-run slowdown in GDP growth (of 2%-3% from 2006 rates, i.e., to 6.5%-7.5%), with most of the adjustment postponed to 2008, but with great uncertainty in the forecasts. The fiscal and monetary effects of these changes will be described below.

Fiscal policy

Official figures published for 2006 indicate a budget surplus of 1.4% of GDP, compared with a 0.6% deficit in 2005. Fiscal revenue as a share of GDP is very high, close to 49% in 2006, although expenditure has been significantly reduced, to around 47%, compared with almost 49% in 2005. Part of this relative fiscal retrenchment seems to have stemmed from forward-looking behaviour on the part of the Belarusian government (as Russia had clearly demonstrated its dissatisfaction with the energy situation throughout 2006), who saved part of its fiscal revenue in a so-called "National Development Fund" (NDF). The NDF is currently estimated at USD 600 million in assets (around 1.6% of GDP), which can be used to partially cushion external shocks like the recent energy shock.

[2]This relatively high average is of course inflated by the oil industry itself: 55.8% of Belarusian industrial enterprises are either loss-making or have a profitability level below 5%.

The fiscal outlook for 2007 is rather uncertain: fiscal revenue has actually been increased by the imposition of Russian-level export duties on oil sub-products, while, at the same time, the different fiscal compensation schemes designed for the oil industry, plus the increase in the Government's own gas and oil bills, will raise expenditures. The original 2007 budget had foreseen an increase in gas prices of only 15% (and no changes in the oil taxation), with a planned maximum deficit of 1.5% of GDP. Current estimates forecast that the additional expenditures of USD 1.5 billion with tax offsets for the oil industry and the increased energy bill (included in this case the continued subsidisation of households, the agricultural sector and certain energy-intensive industries[3]) will only partially be offset by the increased revenue from oil duties, transit fees and the sale of *BelTransGaz*, resulting in a forecast budget deficit of 2% of GDP for 2007.

Box 1 - Belarus: Twin energy price shocks in Belarus

Concerning gas prices, *Gazprom*, after threatening to stop gas supplies via Belarus (the second most important transit country from Russia into EU markets after Ukraine, responsible for around 15% of Russian deliveries) reached an agreement with Belarus just before the deadline of 31 December 2006, increasing the price for 2007 to a still relatively low USD 100 per 1000 m3 (the previous price was USD 46.7), while from 2008, this price will be linked to the EU price minus transportation costs. It will be 67% of the EU price in 2008, 80% in 2009, 90% in 2010 and 100% in 2011. The gas transit fees paid to Belarus for 2007 have been set at USD 1.45 per 1000 m3/100 km, from USD 0.75 in 2006. *Gazprom* also acquired 50% of *BelTransGaz* from the Belarusian government – the remainder of the gas transit network in Belarus, beyond the *Yamal-Europe* pipeline, which it already owned – for USD 2.5 billion, to be paid in instalments over the coming four years (or USD 625 million per year).

Concerning the oil trade, Russia will now impose a reduced export duty on all the crude oil it exports to Belarus. In 2007, the rate of crude oil export duty charged by Belarus will be 29.3% of the Russian duty; in 2008 it will be 33.5% and 35.6% in 2009. At Russia's crude oil export duty of USD 180 per tonne, which was charged until late 2006, the Belarus rate would be USD 52.7 per tonne. Belarus also agreed to increase its own oil export duties to Russian levels, or USD 135 per tonne of light refined oil products, and USD 72.2 for heavy oil products. This seeming double taxation is arguably related to the apparent lack of confidence on the part of Russian Government that Belarus would actually transfer to the Russian budget its share of any single export duty set at the Belarusian border – as a matter of fact, this was publicly stated by the Russian Prime Minister, Mikhail Fradkov. The resulting tax distortion for the oil refining industry in Belarus –moving almost instantaneously from far below the Russian level of taxes to far above those– is to be resolved by compensating additional fiscal measures by the Belarusian government (namely, VAT refunds, reduction and elimination of other taxes and the raising of the domestic oil price).

[3] Imports prices increased by 114%, while domestic gas prices for the industry were raised by 89% already on 1 January 2007, to USD 120.3 (households faced a much smaller increase, 20%). Electricity prices for industry were also raised by 21% (20% for households), as was heating, by 41% (12%).

Monetary and exchange rate policy

Belarus follows a dual exchange rate targeting of the Russian rouble and the USD, targeting the two currencies at different frequencies (namely, smoothing variability to the USD at low frequencies, and to the RUR at higher frequencies).

Inflation remained moderate, to a large degree as a result of administrative price controls. Inflation in 2006 was 6.6%, falling from the 8% observed in 2005. This performance was possible largely due to administrative constraints in price formation, the strengthening of the Belarusian rouble against the USD (on which many consumer imports are priced: Belarus is a small open economy, imports plus exports are worth around 100% of GDP) and the non-repetition of the 2005 massive liquidity increase by the Government,[4] which was only partially sterilised by the NBRB. On the other hand, in December 2006-January 2007, households and firms increased their purchases of USD, selling Belarusian roubles, in the wake of the energy dispute. It is unclear if this increase in the monetary base will prove permanent. The outlook for 2007 is for a increase in inflation to 9%, due to the gas price shock pass-through to the economy.

Reserves at the end of 2006 were USD 1.38 billion, a similar level to that registered in 2005, USD 1.29 billion, or less than a month of imports. The energy dispute with Russia and the associated increase in the import bill plus a surge of capital outflow swiftly reduced reserves during December 2006 and January 2007. The NBRB stopped publishing reserve figures during January 2007, allegedly in order to avoid a panic that lead to a fully fledged collapse of the currency, and increased its refinancing rate. The Belarusian Government invited an “informal” IMF mission to the country in early February 2007 to discuss possible policy options.[5]

External sector developments

The trade balance worsened very considerably during 2006, even before the twin energy shocks: it swung from a (rare) surplus of 1% of GDP in 2005 to a deficit of 4.5% in 2006. This was due to a significant increase in the value of imports (33.2%), compared to a 22.5% increase in that of exports. Beyond the strong increase in imports of both intermediate (including crude oil for processing) and consumer products, this was the result of a reduction of primary products exports (namely, potassium fertilizers, exports of which to major consumers like China and India almost stopped during 2006) and the continued loss of market share for Belarusian manufactured goods in Russia (mainly to Chinese competition). Stripped of the increase in exports of processed oil products (which grew from 25% to 32% of Belarus’ total exports), exports value growth was a mere 13%, or just 40% of the overall imports’ growth rate. The current account saw a similar worsening, from a surplus of 1.6% of GDP in 2005 to a 1.8% deficit in 2006 (data until October 2006).

[4] In late 2005, the Government withdrew practically its entire savings from the accounts in the National Bank of the Republic of Belarus, the Central Bank, amounting to BYR 976.2 billion. This was done to support additional expenditures before the Presidential elections held early mid-March 2006 (that were duly won by the incumbent, Alexander Grigoryevich Lukashenko, with a *disputed* 83% of the vote).

[5] In late February 2007, German Gref, Russia’s Minister of Economic Development and Trade, indicated that the Belarusian government had approached the Russian government with a request for a USD 1.5 billion “stabilization loan”, and that Moscow would be willing to grant it, subject to terms to be negotiated.

FDI not only remains very low, but fell from 1% of GDP in 2005 to around 0.4% in 2006, due to the limited privatisation of the economy. On the other hand, external public debt is very low, at a mere 2% of GDP in 2006, which allows some leeway to increase external indebtness to finance the foreign deficit (during 2006, the Belarus Government was reportedly consulting Fitch Ratings about the possibility of a sovereign rating for the country, which would in principle enable it to access international private capital markets: five Belarusian banks, including the two largest state-owned ones, are already rated by Fitch). Another complementary possibility is to speed up the stalled privatisation process.

The external trade remains very concentrated, with Russia as the main trading partner, responsible for 60% of Belarus' imports though only for 35% of its exports. The oil trade caused a significant increase in exports to the EU (to around 45% of total Belarusian exports in 2006, of which processed oil products represent almost 60%). However, given the artificial nature of Belarus oil exports, this increase is likely to be unsustainable.

2. Trade liberalisation and economic opening

In spite of the current tensions, Belarus's external trade relations are still centred in Russia and in its (incomplete) customs union with this country: a new trade cooperation and harmonisation treaty was even signed with Russia in March 2007. Nevertheless, some signs of potential opening towards the EU were demonstrated during January and February 2007, including the proposal by the Belarusian Government to create an EU-Belarus "Energy Dialogue" (the EC accepted to hold preliminary technical talks).

Belarus applied for WTO membership in 1993 and the last Working Party meeting took place in May 2005. The accession process of Belarus is not moving at the moment due to the low level of engagement by Belarus. A Russian WTO accession in 2007 may put the country at a further disadvantage in the Russian market. The EU granted GSP preferences to the country in the mid 1990s, but this was withdrawn after an investigation concerning infringements to the freedom of association, with effect from 20 June 2007. Around USD 530 million of Belarus's 2006 exports to the EU (around 6% of the total, but closer to 12%, if the oil-related trade is excluded) benefited from the GSP scheme. The removal of the GSP should nevertheless not be over-estimated, as it would not halt Belarus' exports to the EU but simply reinstate standard tariffs, under the Most Favoured Nation regime.

3. Business climate

Privatisation, enterprise restructuring and business environment

Belarus still suffers from comprehensive government interference in the economy, ranging from direct ownership of most large enterprises to a so-called "golden share" rule, which enables the government to interfere with all *already* privatised enterprises (with the exception of banks), to the administrative allocation of credit, "recommended" interest rate ceilings, wage growth targets and price controls.

Belarus has one of the lowest shares of private enterprises in the CIS region, at around 25% of GDP. No progress was made in privatisation during 2006. 30 enterprises were prepared for sale in 2006, but none was actually privatised. Additionally, a presidential decree to renationalise 82 privatised but loss-making enterprises was signed in August 2006.[6]

[6] In late February 2007 some reports appeared about a privatisation plan being drafted by the Belarusian Ministry of Economy, envisaging privatization of the country's largest state-owned enterprises including oil refineries, truck makers and sugar plants.

The World Bank "Doing Business 2007" survey ranks Belarus in 129th place, far below the CIS average of 96 and above only Tajikistan and Uzbekistan in this group. The Belarus' Business Climate Indicator, calculated by the NBRB based on a diverse sample of 1886 companies in several sectors, fell by 8.3% during 2006. Not surprisingly, the worsening was concentrated in November-December, because of the dispute with Russia.

Financial sector reforms

A series of amendments to the Banking Code were adopted in July 2006, strengthening the supervisory role of the NBRB and streamlining licensing procedures. The amended Code also bans direct financing of the budget by the NBRB, bar a direct Presidential decision concerning this. In August 2006 a Presidential decree abolished the "golden share" rule for the banking sector, thereby preventing the Government from interfering with managerial decisions in privatised banks.

Foreign participation in the banking sector is limited, with the share of foreign capital in total bank capital currently at approximately 12%. The four largest majority state-owned banks (*Belarusbank*, *Belagroprombank*, *Belpromstroibank* and *Belvnesheconombank*) account for around 70% of assets, equity and customer deposits in the banking sector. The two largest banks, *Belagroprombank* and *Belarusbank*, are 100% state-owned and hold 55% of all banking sector assets. The third largest bank overall and the largest private bank is *Priorbank*, a member of the Austrian *Raiffaisen group*. Three small state-owned banks are slated for privatisation in 2007.

Private sector credit has been growing at or above 50% rates since 2004: this performance was repeated in 2006, with a growth rate of 53%. Nevertheless, credit to GDP is still a mere 26%, indicating a low financial depth.

Labour market reforms

Real salaries and wages rose by 18.2% in 2006 – state salaries have government-set and USD-indexed growth targets, which is almost twice as fast as productivity growth (9.7% in 2006). In absolute terms, the average wage was around 220 EUR in 2006. Unemployment fell to 1.2% in 2006, from the already extremely low 1.5% in 2005. This reflects the continued strong economic growth, the comprehensive social policies of the government – the private sector generates a mere 20% of total employment – and the unrestricted flow of Belarusian labour towards the booming Russian economy (estimates are as high as half a million workers, in a country with a 10 million population).

4. Public institutions and public finance management

The most significant change in fiscal institutions during 2006 was the creation of the "National Development Fund" (NDF). The fiscal process is very centralised in the Presidential administration, and the share of the state in GDP is very high, at 75%, with fiscal revenue at almost 50% of GDP. The budgetary process would benefit from a greater level of transparency.

5. Social development and poverty

Belarus has one of the lowest official unemployment rates in Europe. The government social policy is geared towards the maintenance of a comprehensive social safety net, and the share of direct social expenditures in the 2007 budget – approved before the energy shocks – is a very high 40%, financed through high tax levels and direct and indirect Russian transfers (which, given the high level of state ownership in the economy, are directly captured by the Belarusian government). Since the late 1990s, more than three million Belarusians (almost 30% of the population) have been lifted out of poverty, following a similar CIS-wide strong trend towards the simultaneous reduction of poverty and inequality: the share of the population with incomes below the minimum subsistence income fell to 18% in 2004, from 47% in 1999, and the share of the population with incomes below 50% of the minimum subsistence level was a mere 1% in 2004. The poverty rate fell to 11% in 2004, with further falls estimated since then. The Gini index was a low 0.25 in 2004.

The EU has relatively small programmes in Belarus, given the political situation and the limited progress in structural reform in the country. The Tacis programme 2005-2006 earmarks EUR 10 million to be used to support the civil society, education and training, and Chernobyl-affected areas. The overall priority areas of cooperation are *"support for institutional, legal and administrative reform"*, while addressing the Chernobyl consequences is classified as *"support in addressing the social consequences of transition"*.

BELARUS

Main economic indicators

	2003	2004	2005	2006 prel.	2007 proj.
Real sector					
Real GDP growth (% change)	7.0	11.4	9.2	9.9	6.5
Inflation CPI (%, end of period)	25.0	14.0	10.3	7.0	11.4
GDP nominal (USD, billion)	17.7	23.1	29.5	36.9	40.4
GDP per-capita (USD)	1791	2338	2986	3808	4119
GNI per-capita (PPP, current prices, USD)	6080	6990	7890		
Social indicators					
Unemployment (%)	3.1	1.9	1.5	1.2	1.8
Life expectancy (years)	68.5	69.0			
Under 5 mortality rate (%)	9.9	9.1			
Literacy (total, %)	99.7	99.7			
Fiscal sector					
Total revenue (% GDP)	45.8	44.2	48.3	48.3[1]	47.9
Total expenditure (% GDP)	47.2	44.1	48.9	46.9[1]	50.2
Central government balance (% GDP)	-1.4	0.0	-0.6	1.4[1]	-2.0
Gross domestic public debt (% GDP)	10.4	8.9	7.7	8.7	
Gross public debt (% GDP)	12.3	11.0	9.6	11.0	
Monetary sector					
Private sector credit (% change)	25.4	61.2	48.7	52.4	
Private sector credit (% total credit)	56.3	67.6	74.6	74.9	
Broad money (M3, %)	56.8	44.1	42.0	39.3	
Degree of monetization (M3/GDP, %)	17.2	17.7	19.7	22.1	
External sector					
Current account balance (% GDP)	-2.4	-5.2	1.6	-1.8[2]	-5.0
Trade balance (% GDP)	-4.0	-6.5	1.0	-4.5	-6.5
FDI (net, % GDP)	1.0	1.1	1.0	0.4[3]	
Import cover (months)	0.6	0.5	0.9	0.7[1]	
External vulnerability					
External public debt (% GDP)	1.9	2.1	1.9	2.3[3]	
Debt service/exports (%)	2.0	2.0			
Gross reserves (excluding gold, USD, million)	474	770	1297	1383	1000
Reserves/M3 (%)	5.1	5.3	4.5	16.3	
Financial sector					
Short term interest rate (%)	24.0	16.9	11.4	12.9	
Exchange rate (rouble per EUR, end of period)	2695	2956	2550	2812	2926
Exchange rate (rouble per USD, end of period)	2156	2170	2152	2140	2200
Real effective exchange rate (2000=100)	83.1	78.8	76.3	74.0[1]	

Sources: Ministry of Statistics and Analysis Belarus, NBRB, UNDP, WDI, IMF, Raiffeisen, EC staff calculations.
[1]Jan-Nov 2006.
[2]CA figures for 2006 report for Jan-Sep.
[3]FDI figures for 2006 report for Jan-Oct.

EGYPT

- **Economic growth accelerated from 4.6% in fiscal year 2004-05 (FY05) to a record 6.8% in 2005-06 (FY06[1]) underpinned by investment, especially FDI, and exports of goods and services.**

- **Despite the strengthening of economic growth and the sale of (semi-)state-owned enterprises, the general public deficit hardly narrowed. The unemployment rate also remains persistently high, around 10%.**

- **Inflation declined to less than 4% in FY06 after some years in double digits. There are however strong upward inflationary pressures in FY07. Fiscal dominance needs to be alleviated before a formal inflation targeting regime can be launched.**

- **The current economic conditions offer an opportunity to accelerate reforms. The EU-Egypt ENP Action Plan, adopted in March 2007, offers a good road map for much-needed reforms. At the same time, the high government debt should be reduced and price stability should be achieved.**

1. Macroeconomic developments

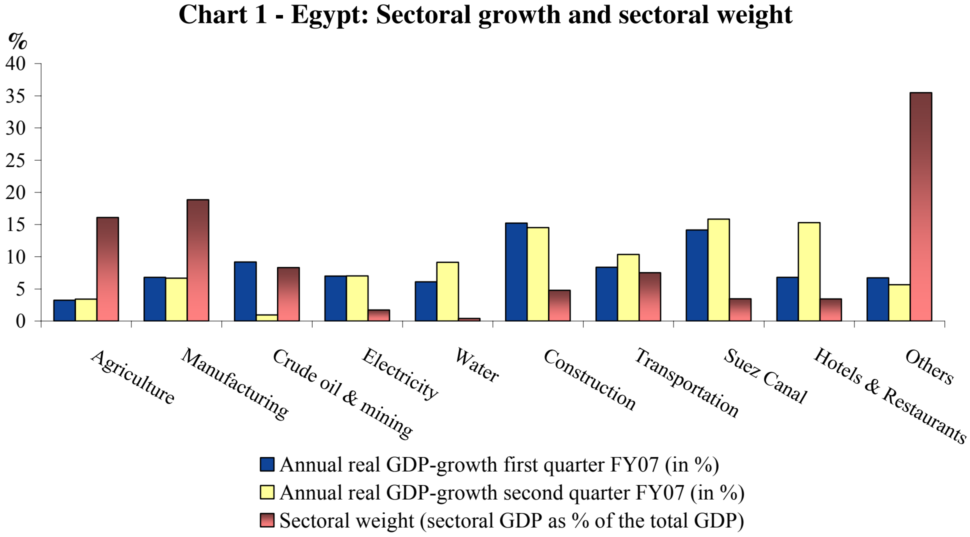
Real sector developments

Economic growth accelerated in FY06 to a record high of 6.8% from 4.6% in FY05 fuelled by investment, especially FDI, and exports of goods and services. In FY06 final consumption contributed 84% to GDP, investment 19% and exports of goods and services 31%. Imports of goods and services were 34% of GDP. Government consumption was high, at 12% of GDP. FDI and tourism have been expanding rapidly, despite the bombings in Red Sea resorts in recent years. Egypt attracted 9 million tourists in FY06 and at the current trends the target of 14 million tourists is achievable in 2011. Many jobs have been created in the tourist sector, and this trend is expected to continue strongly.

GDP-growth in the first and second quarter of FY07, i.e. July-September 2006 and October-December 2006, was particularly high in the sectors of construction, the Suez Canal and the hotels and restaurants (chart 1). Overall, total annual growth for FY07 reached 6.8%. Chart 1 shows that the largest sectoral weight is provided by the sector "others".[2] This sector includes wholesale and retail activities, insurance and social securities, real estate, educational and health and personal services, and the public government.

[1] The fiscal year runs from July until June, so FY06 refers to July 2005 until June 2006.
[2] See the website of the Ministry of Finance, http://www.mof.gov.eg/English/Reports/monthly/2007/jan07/t1.pdf.

Chart 1 - Egypt: Sectoral growth and sectoral weight

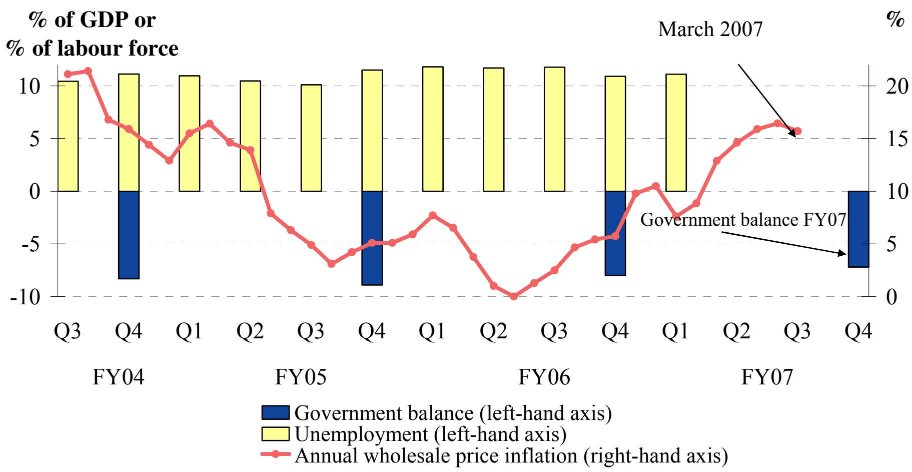


Source: Egyptian Ministry of Economic Development, www.mop.gov.eg

Fiscal policy

The government deficit reached almost 8% of GDP in FY06 despite the high economic growth and one-off revenues. The high fiscal deficit and the high government debt burden are major concerns. The excess government spending fuels inflation (chart 2), there is only limited space for discretionary expenditure so that the economy is becoming more vulnerable to macro-economic shocks. The government should adhere to its commitment to reduce the deficit by at least 1% of GDP in each of the next five years, where FY07 will be the first year.

Chart 2 - Egypt: Fiscal, monetary and unemployment developments



Source: Egyptian Ministry of Economic Development and Central Agent for Public Mobilisation and Statistics, www.mop.gov.eg

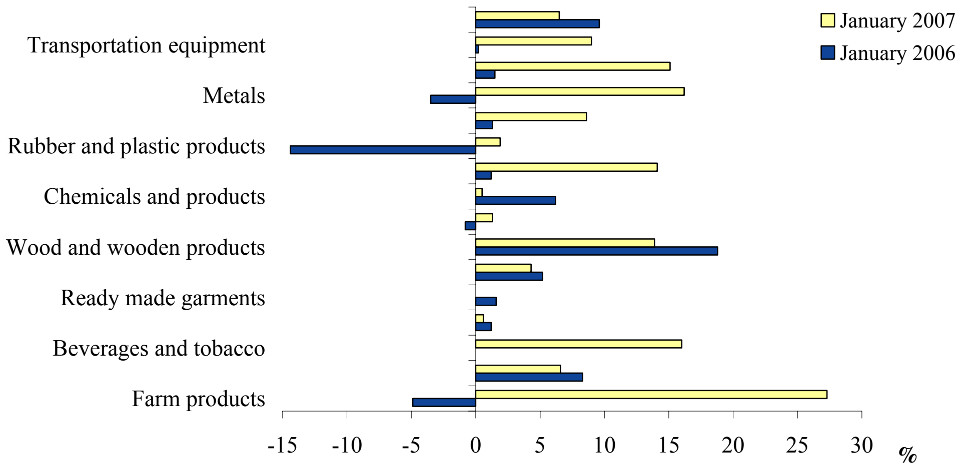
Egypt is now starting to feel the benefits of the key reforms that started in FY05, including the overhaul of customs to lower duties and the simplification of procedures. A unified tax law reducing corporate and personal income tax was implemented. There are spending plans for upgrading the railway system and to bail out non-performing loans of the *Banque du Caire*. Subsidies, wages and interest payments account for 75% of total expenditure. Since 2004, the government is still paying 30% of all wages. A massive system of state subsidies costs the government almost 10% of GDP. A reduction of fuel subsidies took place in July 2006.

The pension system and the health insurance system are being overhauled. One aim is to widen the base of beneficiaries without adding a financial burden to the budget. Further reforms in public spending are needed to curb the government deficits and the high government debt-to-GDP ratio. In view of a growing public debt and the demographic developments that show rising dependency ratios, fiscal reform is indispensable to keep government finances sustainable in the long run.[3] Policies should be directly geared at reducing the high unemployment rate and, at the same time, augmenting the labour participation further by gradually increasing the retirement age.[4]

Monetary and exchange rate policy

Inflation soared in FY07, in February 2007 even to 16.4% (chart 2). The prices of goods and services rose due to increases in administered utility prices, the outbreak of bird flu in February 2006, and the demand effect on economic growth. The Central Bank of Egypt tightened monetary policy several times in the first half of FY07. On 2 November the CBE raised interest rates by 50 basis points and on 14 December by a further 25 basis points. Since that moment, the CBE has maintained its overnight key interest rates at 8.75% for deposits and 10.75% for lending. The still rather loose policy stance – negative real interest rates coupled with a large fiscal deficit – is a main concern. Inflationary pressures remain and the high inflation will harm economic growth (chart 2 and 3).

Chart 3 - Egypt: Disentangling annual inflation



Source: Egyptian Ministry of Economic Development, www.mop.gov.eg

Egypt has pursued a floating exchange rate regime since 2003. In the period January 2006 to January 2007 the Egyptian pound appreciated by 0.5% against the USD and depreciated more than 7% against the Euro. These developments reflect, next to the further strengthening of the Euro on the international markets, the strengthening of the Egyptian pound.

[3] See also *Egypt – Searching for Binding Constraints* from Klaus Enders, IMF, WP/07/57 where the high public debt is explicitly mentioned as a binding constraint to economic growth.

[4] See *Pensions in the Middle East & North Africa: Time for Change*, by David Robelino, 2005, World Bank.

The CBE aims to introduce inflation targeting as the monetary policy regime soon. For this purpose a CPI core measurement development is underway. Indeed, one of the preconditions for launching an IT regime is the accurate and timely measurement of price developments of all the items in the basket of goods and services. Another precondition is the absence of fiscal dominance.

External sector developments

The trade balance continued to record a deficit. However, the balance of payments remained positive. The trade deficit is compensated by inflows in the prosperous tourist sector, remittances, and large inflows of remittances and foreign investment - direct as well as portfolio. The total amount of net FDI in FY06 was more than USD 6 billion. More than 50% of the FDI went to greenfield investment. The oil and gas sector only accounted for 30% of total FDI, which is in sharp contrast to the almost 70% in the past. Net FDI in the first half of FY07 already reached USD 7.2 billion. Egypt should ensure that these types of investment will lead to durable job creation.

International reserves are increasing and reached almost USD 23 billion in FY06. Meanwhile (March 2007) the foreign exchange reserves mounted to USD 27.1 billion.

2. Trade liberalisation and economic opening

As in previous years, Egypt has continued implementing the bilateral trade concessions under the Association Agreement with the EU by dismantling tariffs for industrial products, with a full list of products due to be fully liberalised by the beginning of 2007. In February 2007 ambitious tariff customs reform took place. Bilateral trade with the EU steadily increased since the entry into force of the AA in 2004 (EUR 11.6 billion in 2004, 13.4 in 2005 and 16.3 in 2006).

On March 6, 2007 an EU-Egypt Action Plan was adopted. Building upon and complementing the already existing close ties through the Barcelona process and the EU-Egypt AA, this provides a framework for deepening economic and trade relations via further reduction of trade barriers, increased access to mutual markets and approximation of economic legislation. The AP sketches in broad lines the plans to stimulate economic development and reform in Egypt, notably the move to a market economy.

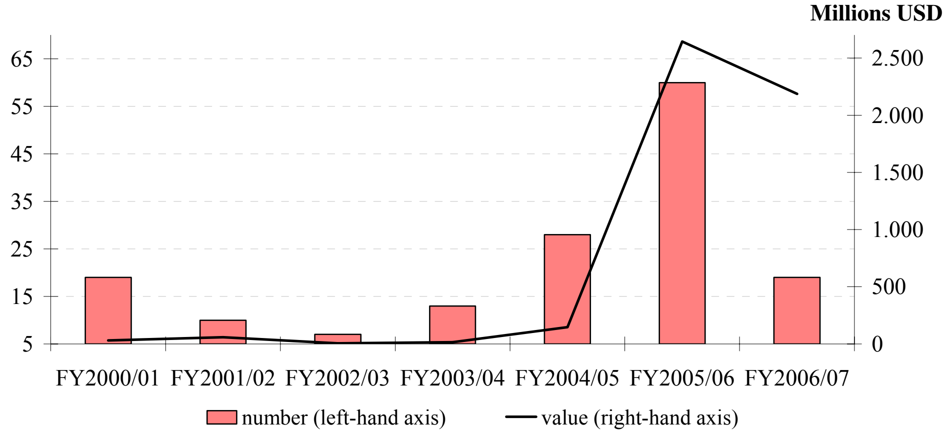
3. Business climate

Privatisation, enterprise restructuring and business environment

Egypt is booking good progress in privatisation, enterprise restructuring and the private business sector. Privatisation of the *Bank of Alexandria* is taking place in FY07. This bank accounts for 80% of the total expected revenue of privatisations in FY07. The privatisation of state-owned enterprises worth more than USD 3 billion, are planned in FY07, while FY06 saw 49 privatisations worth almost USD 2 billion. In value the stream of privatisations has therefore steeply risen (chart 4). However, privatisation in the textile sector – spinning and weaving – has provoked a stream of strikes. This may slow down the reform process.

Stock market capitalisation recovered from a correction in 2006 and increased significantly thereafter. At the end of 2006 the stock market was almost back at the same level of its peak at the beginning of 2006. There are thus ample financing opportunities for businesses. Apart from financing opportunities, there is a need for improvements in the business climate nonetheless. Governance can be strengthened and rules and regulations can be reduced.

Chart 4 - Egypt: Privatisations (state owned and semi-state owned)



Note: FY07 are estimates

Source: Egyptian Ministry of Economic Development, (www.mop.gov.eg) and JP Morgan

The EuroMediterranean Charter for enterprise, endorsed by Egypt in 2004, builds an umbrella for enterprise policy and contains ten principles of good governance in support of the development of the private sector. The recent reforms will have contributed to the higher levels of FDI in FY06. A further implementation of the Charter´s principles will improve the enterprise and business climate.

Financial sector reforms

Financial intermediation in Egypt has been relatively weak so far, in particular due to the inefficient, state-dominated banking system. On the positive side, however, the country is making progress in the reform of the financial sector including restructuring the banking sector and tackling the major problem of non-performing loans. A significant number of non-performing loans is being rescheduled. A further consolidation in the banking sector could reduce the number of banks from around 60 to 34 by the end of calendar year 2007, which should lead to an improvement in the solidity of the banking system. The state-owned *Bank of Alexandria* has meanwhile been privatised. All in all, the expectations are that the restructuring and reform in the banking sector will take two to three years before completion. The government is also enforcing sectoral consolidation and strengthening by raising minimum capital requirements.

The market value of these companies augmented almost 20%. The developments in the credit market are also positive. Growth in credit to the private sector recently exceeded growth in deposits, for the first time in seven years. This tendency is to be maintained and a further intensification is needed. Only a small number of SMEs has access to formal credit. SMEs have the majority share in employment. More and better financing opportunities will lead to more job creation and this will be conducive to economic growth.

Labour market reforms

Unemployment has remained persistently high despite the acceleration in GDP growth since 2004. More than 10% of the labour force is still unemployed (chart 2). The relatively high population growth seems to be one reason for the persistent unemployment. The Egyptian population increased from 55 to 70 million during 1992-2006. Employment in this period also increased strongly from about 14 million to almost 20 million jobs. But many more jobs will have to be created in order to absorb the continuing high annual inflow into the labour force and the pool of existing unemployed.

4. Public institutions and public finance management

In FY06 some progress was made in strengthening the tax and customs regimes and bringing more transparency and efficiency to budgetary operations. Budget preparation, presentation and audit also improved. The introduction of a Treasury Single Account system is expected to improve cash management.

5. Social development and poverty

The majority of the Egyptian population lives on or below the poverty line. There are no tangible benefits of improvements for the poor. Youth unemployment is high, even among males. At the same time poverty among senior citizens is growing, a serious problem as the number of people in this age group is expected to overtake the number of young people for the first time in Egypt´s history by the year 2050. The revision of the pension law, the so-called “unified social insurance” law, aims to improve the financial position of pensioners, the permanently physically disabled and widowers and workers in the informal sector. This affects seven million people.

The current government subsidies on food and energy prices, that will have to be phased out in the medium to long term, should be geared to those groups of consumers with the lowest living standards. Only this way of subsidising and redistributive policies can lead to the achievement of a sustainable socio-economic development, at the same time where an overall fiscal consolidation takes place

EGYPT

Main economic indicators

	FY03	FY04	FY05	FY06 prel.	FY07 proj.
Real sector					
Real GDP growth (% change)	3.1	4.1	4.5	6.8	6.8
Inflation (average)[1]	11.7	17.3	9.7	3.9	11.3
GDP per-capita (USD)	1197	1137	1265	1432	1520
GDP (nominal Egyptian pounds, billion)	418	485	537	595	665
GDP (nominal USD, billion)	81.4	78.8	89.5	103.3	111.8
Social indicators					
Unemployment (officially registered, %)	10.4	10.7	11.0	10.5	10.9
Life expectancy at birth males/females (years)				68.8/73.2	69.2/73.6
Domestic population growth (%)	2.0	1.9	2.0	1.9	1.9
Fiscal sector[2]					
General government revenues (% GDP)	26.2	25.6	24.7	28.3	26.1
General government expenditures (% GDP)	32.2	31.6	31.7	35.7	32.1
General government balance (% GDP)	-9.0	-8.3	-8.9	-8.0	-7.2
General government primary balance (% GDP)	-3.3	-2.6	-3.3	-2.4	-1.7
Gross public debt (% GDP)	111.4	109.9	112.5	114.1	114.8
Monetary sector					
Broad money M2 (% change)	21.3	14.4	11.3		
Degree of monetisation (M2/GDP, %)	88.2	89.2	91.0	91.0	
External sector					
Current account balance (% GDP)	2.4	4.3	3.2	1.6	1.2
Trade balance (% GDP)	-8.1	-9.9	-11.6	-11.2	-10.8
Net FDI (% GDP)	2.8	2.6	3.9	5.6	6.5
Remittances (% GDP)	3.6	3.8	4.9	5.0	4.9
Import cover of reserves (months)	8.6	6.6			
External vulnerability					
External public debt (% GDP)	36.1	37.9	32.4	30.3	25.0
Gross reserves (USD, billion)	13.6	14.8	19.3	22.9	27.1[4]
Financial sector					
Official discount rate (end-of-period, %)	10.0	10.0	10.0	9.75	
Lending rate (average, %)	13.7	13.3	13.1	12.6	
Exchange rate (LE per USD, mid FY)	5.9	6.2	5.7	5.7	
Exchange rate (LE per EUR, mid FY)	4.8	7.7	7.8		
Real effective exchange rate (%)[3]	-3.2	-21.5	1.8	-5.1	
Stock market (end-of-period, billion LE)	13.8	29.5	67.2	228.0	

Sources: Central Bank of Egypt, CAPMAS, Egyptian Ministry of Finance, IMF, EC staff calculations.

[1] Wholesale Price Index reflects the average basket of prices of goods and services more accurately than the consumer price index.

[2] General government, see www.mof.gov.eg/English/Reports/monthly/2007/jan07.

[3] An increase (a decrease) reflects an appreciation (depreciation) of the Egyptian pound. 4 April 2007, see www.cbe.org.eg.

GEORGIA

- **Economic growth remains robust, supported by improvements in the business climate, privatisation and foreign direct investment. Rehabilitation and recent reforms in the energy sector have been crucial in the face of the import price shock on Russian gas.**

- **Although the widening of the trade deficit is balanced by workers' remittances and inflows of capital, the real challenge is how to develop exports and gain access to new markets following Russia's ban on Georgian exports in 2006.**

- **As inflationary pressures are likely to persist in 2007, prudent fiscal and monetary policies need to be maintained. The central bank has developed new instruments to manage liquidity. Foreign capital inflows to the banking sector are growing rapidly.**

- **The European Neighbourhood Policy Action Plan, endorsed in November 2006, focuses inter alia on the business climate and governance issues, enhanced EU-Georgia trade relations, poverty reduction and cooperation in transport and energy.**

1. Macroeconomic developments

Real sector developments

The Georgian economy continued to perform dynamically throughout 2006, despite the gas import price shock and the trade and transport blockades imposed by Russia, as the relations between the two countries deteriorated amid the protracted internal conflicts in Georgia (South Ossetia and Abkhazia). According to preliminary estimates, real GDP has increased by about 9% (9.6% in 2005). While the already deeply negative net exports further deteriorated, domestic demand remained robust, owing to brisk public spending and rapid credit expansion by commercial banks. Construction, manufacturing and services all performed well while agricultural production was negative due to harsh weather and the avian flu threat. Tourism is a new area of growth and is starting to attract investors.

The initial impact on household spending of the increase in the import price of Russian natural gas to USD 110 per 1000 cubic metres as of January 2006 and then to USD 235 as of January 2007 was mitigated by the government through budgetary transfers to the distribution companies until the tariffs were raised at the end of the heating season. The household tariffs are progressive, increasing with the amount of consumption. During the course of 2007, Georgia will be able to import gas from Azerbaijan in more substantial amounts once the South Caucasus Pipeline from Baku to Turkey through Georgia is in full operation.

Fiscal policy

Tax revenues continued to grow in line with the legalisation of economic activities and strong enforcement measures by the authorities. The tax revenue to GDP ratio is estimated to have reached 21.5% (19.8% in 2005). The state budget was amended in May and July to increase defence and capital spending, financed by privatisation receipts. As a result, the fiscal deficit (on a commitment basis) increased to an estimated 2.9% of GDP (1.5% in 2005). On a cash basis, the deficit was slightly lower at about 2.3%. Total government expenditure reached 26% of GDP (23.4% in 2005) of which capital spending accounted for about 5.5% of GDP. Privatisation revenues peaked at about 4.5% of GDP in 2006 (3.6% in 2005). The government also received significant grant amounts, including from the EU and the US Millennium Challenge Corporation, totalling 2.5% of GDP (0.9% in 2005). The Ministry of Finance has already made good progress in developing the Medium-Term Expenditure Framework, which will become even more important for the government as a policy tool when the extraordinary sources of financing from privatisation come to an end. On the revenue side, the government does not plan to increase the tax burden any further. On the expenditure side, health and social assistance are starting to receive more attention.

Monetary and exchange rate policy

The main economic policy challenge in 2006 was to keep the consumer price inflation in single digits. The 12-month inflation peaked at 14.5% in July but decreased to 8.8% in December as oil prices declined and the monetary police stance was tightened whilst fiscal spending was still running above the target. The National Bank of Georgia (NBG) also allowed the lari to appreciate in 2006 to help reduce inflationary pressures. The NBG has developed monetary policy instruments, e.g. by introducing in 2006 certificates of deposits. The securitisation of government debt held by the NBG also provides the central bank with marketable securities for open market operations. Given that large and volatile capital inflows are projected to continue in 2007, exchange-rate flexibility and NBG market operations are both called for to control money supply and inflation. Dollarisation of the economy has decreased slightly in the past few years, as the Georgian lari has appreciated, and the banking sector is gaining public confidence but nevertheless foreign currency-denominated deposits remain high at 69% of total deposits.

External sector developments

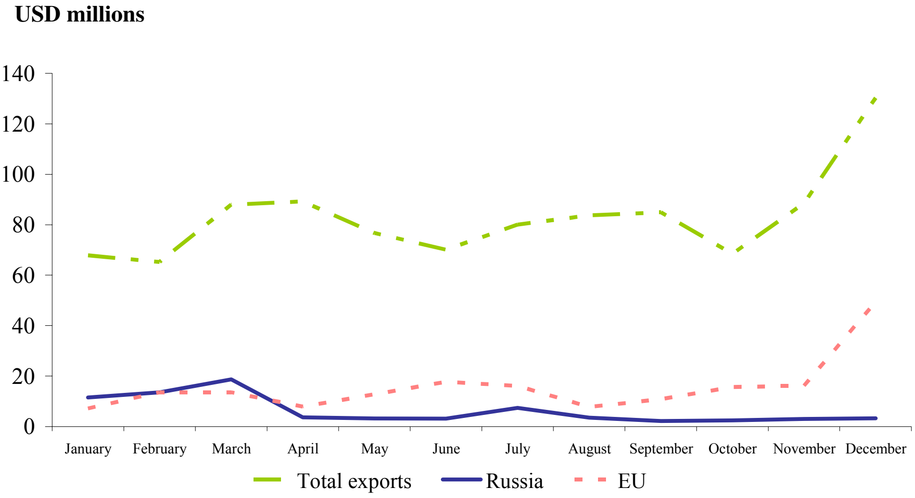
The trade deficit is estimated to have widened to around 21% of GDP in 2006 (14.5% in 2005). Despite the closure of the Russian market for Georgian goods, exports as a whole increased by over 10% in 2006 (see also chart 1). Imports from Russia other than natural gas were quickly replaced by imports from other countries and imports demand in general continued to grow rapidly (also related to strong investment activity in Georgia). The EU remained Georgia's first trade partner in 2006, while Turkey replaced Russia as its second trade partner. According to the NBG, remittances, including those from Russia, increased in 2006, reaching USD 413 million in total (about 5% of GDP). Russia was the source for nearly 70% of the remittances. The current account deficit is estimated at around 9.5% of GDP (5.4% in 2005), financed mainly by foreign direct investment (including privatisation receipts).

Gross international reserves of the NBG increased to about USD 930 million by the end of 2006, covering approximately 2.5 months of imports. Georgia's public external debt is on a sustainable path, having decreased further from 27% of GDP in 2005 to around 22% last year (USD 1.7 billion in nominal terms). According to the IMF/World Bank debt sustainability study of 2006, Georgia's debt distress risk is low. The composition of the external public debt has changed favourably over the past few years so that the share of bilateral debt has decreased from 80% to about 40%, while Georgia has had access to multilateral, more concessional loans. The grant element of the borrowing was estimated at around one third in 2005. Furthermore, Georgia recently acceded to the Council of Europe Development Bank and the Asian Development Bank. It is also expected that Georgia will have access to financing from the European Investment Bank under the Bank's new external mandate for 2007-2013.

In November 2006, Standard & Poor's revised the outlook for Georgia's sovereign credit rating (B+) from positive to stable owing to increased geopolitical risks in the region that may impair positive trends in Georgia's external liquidity, investor sentiment and economic growth. Apart from the geopolitical tensions, Georgia's rating is also constrained by relatively high inflation, a comparatively undeveloped financial sector and a narrow economic structure.

So far, private external debt has been negligible. Now the largest Georgian commercial banks have plans to access international capital markets for either equity or debt financing, following the initial public offering of Bank of Georgia shares in London last year and a first Eurobond issue in February 2007.

Chart 1 - Georgia: registered exports 2006



Source: Statistics Georgia

2. Trade liberalisation and economic opening

In September 2006, the number of tariff bands on imported goods was reduced from 16 to three (0%, 5%, and 12%). The maximum tariff of 12% is applied to those agricultural products and building materials which compete with domestic goods. The average weighted tariff is consequently low at about 1.5%. Georgia has bilateral Free Trade Agreements (FTAs) with members of the CIS (Armenia, Azerbaijan, Kazakhstan, Russia, Turkmenistan and Ukraine). Under the new EU Generalised System of Preferences (GSP) scheme, in force since the beginning of 2006, Georgia has qualified for the enhanced preferences for good governance and sustainable development (so-called GSP+). Georgia has expressed interest in concluding a Free Trade Agreement with the EU and with Turkey (which has a customs union with the EU).

3. Business climate

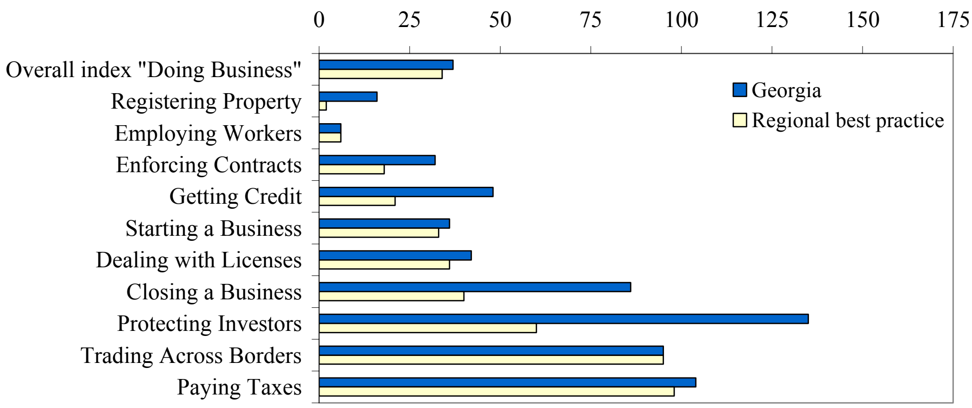
Privatisation, enterprise restructuring and business environment

The government's sweeping reform efforts over the past three years to tackle corruption and to deregulate the economy are showing tangible results in several areas. The World Bank's 2006 Doing Business Report ranks Georgia's business environment at 37th place in the world, an impressive improvement from 112th place just one year before. Despite significant progress in the fight against corruption, reported for instance by the Transparency International and in the World Bank's 2006 Anti-Corruption in Transition Report, a further improvement in the business environment will depend on sustaining the gains on anti-corruption, raising investors' protection, improving tax administration, facilitating trade and strengthening the judicial system.

After the completion of the trans-Caucasus oil and gas transit pipelines, foreign direct investment was largely driven by privatisation in 2006. The large privatisation deals from last year comprise ferroalloys and manganese production, hydropower generation, electricity and gas distribution as well as port management (Batumi) and telecommunications. Privatisation will probably come to an end by 2008 as all outstanding large state-owned assets that are not considered strategic assets for state-ownership, are expected to be sold by then. Overall, prospects for new investments are improving. A new law on electronic communication was adopted in 2006, facilitating investment in network development.

The new customs code, effective since January 2007, simplifies and harmonises customs legislation in line with EU standards. Modernisation of tax administration also continues. A restructuring of the Ministry of Finance is underway to improve the enforcement of tax and customs legislation, including the functioning of the financial police. To balance the interests of the authorities and the taxpayers, a better functioning arbitration mechanism on tax disputes should be put in place.

Chart 2 - Georgia: "Doing business" rankings



The ease of doing business index ranks economies from 1 (best) to 175. The regional best practice refers to the best ranking country in the eastern neighbourhood region.

Source: World Bank, 2007.

Financial sector reforms

The banking sector has continued to attract foreign capital with the acquisitions of major bank assets by Russia's Vneshtorgbank and Société Générale from France. Other foreign banks are in the process of establishing subsidiaries in Georgia. Foreign financing is expected to underpin continued strong credit expansion, starting from a very low level of private sector bank credit, at 15% of GDP at present. While the government has a liberal approach to developing financial services, this policy ought to be firmly complemented by appropriate supervision of the banking and non-banking financial sectors in line with international best practices. The establishment of a deposit insurance scheme has been under discussion. There are 17 operating banks (of which 10 are foreign-owned). Further consolidation is expected as the minimum capital requirement will be increased from GEL 9 million to GEL 12 million (approx. EUR 4.5 million) from July 2007. Banking supervision has been strengthened in the past few years. The areas still to be addressed include "fit and proper" criteria for bank owners and managers, identification of "true" owners, monitoring of connected lending and consolidated supervision. It also needs to be ensured that anti-money laundering measures are implemented in line with Georgia's international commitments.

Labour market reforms

A new labour code came into force in July 2006, liberalising hiring and firing to the extent that in the World Bank's 2006 Doing Business survey, Georgia's index on employing workers is in the most liberal category globally. Non-wage labour costs are at 20% of salary. The formally employed share of the labour force is on the other hand still small and the social safety nets provided by the state are minimal. Georgia's labour market is characterised by self-employment which accounted for about 65% of total employment in 2005.

4. Public institutions and public finance management

Reform in public finance management has continued with a particular focus on improving the medium-term expenditure framework and budget preparation. For example, the treasury has now taken the first steps in the implementation of the accounting reform strategy. In 2006 the government submitted to the parliament a draft law on the Chamber of Control which would reinforce the Chamber's role as a supreme auditing institution in line with international standards (INTOSAI). The adoption of the law has been delayed until 2007, pending the nomination of a new chairman for the Chamber of Control.

The new law on local self-governance entered into force in November 2006 after the local elections, consolidating a large number of small local government entities into financially more viable ones. A law on budgets of local self-governing bodies has also been enacted to strengthen the execution of local budgets. Transfers from the state budget to the local budgets are calculated according to pre-established criteria and formulas.

Legal entities of public law constitute a mixed category of public institutions, and are still evolving. It currently includes schools and cultural institutions but also government agencies. Their legal status is being clarified, defining whether the entity in question is part of the central government or falls outside it as a non-profit organisation. Reporting requirements are also being established to provide a comprehensive view of their activities and finances.

5. Social development and poverty

In autumn 2006 Georgia presented a Progress Report to the World Bank and the IMF on the Economic Development and Poverty Reduction Program. The methodology to estimate the poverty level has been changed in cooperation with the World Bank to bring it more in line with international practice. The poverty rate increased from 35.7% of the population in 2004 to 39.4% in 2005. This was largely due to the downsizing of the public sector and the restructuring of privatised firms and the increase in unemployment that followed. The data for early 2006 indicated that poverty had started to decline, however, estimated at 33.6% of the population.[1] The increase in utility tariffs may still have a negative impact, although the government has established life-line tariffs which mitigate the impact on the most vulnerable households

[1] Georgia: Poverty Reduction Strategy Paper, October 19, 2006. Available on http://www.imf.org/external/pubs/cat/longres.cfm?sk=19996.0

Following large-scale reform in the education sector, the government is currently focusing attention on the health sector where a primary healthcare reform is under way and a large hospital investment programme has been announced in cooperation with developers from the private sector. Implementation of a medical insurance scheme for the poor began in July 2006. In addition, a new poverty benefit scheme was launched in the capital Tbilisi in August 2006 and applied to the whole country in September. The government has also been paying out the last expenditure arrears (salaries, pensions and social benefits) that the previous administration had accumulated up to 2003.

Box 1 - Georgia-EU ENP Action Plan

In November 2006, the EU and Georgia endorsed a five-year Action Plan under the European Neighbourhood Policy to enhance Georgia's political, security, economic and cultural relations with the EU. The main actions are grouped under eight priority areas: (i) rule of law, (ii) business and investment climate, (iii) economic development, poverty reduction and sustainable development, (iv) cooperation in the field of justice, freedom and security, (v) regional cooperation, (vi) peaceful resolution of internal conflicts, (vii) cooperation on foreign and security policy, and (viii) transport and energy.

Under priority 1, Georgia continues to reform the judicial system in line with European standards. Public service reform and local government reform are other import areas. The fight against corruption and modernisation of the tax and customs administration are set to continue under priority 2. Maintaining macroeconomic stability and continued reforms in public finance management are important aspects of priority 3, as well as reducing poverty and continuing sectoral reforms in health and education. Progressive regulatory approximation of Georgia's legislation and practises to the EU trade related acquis, in particular in the area of food safety, technical regulation, standardisation, accreditation, metrology, conformity assessment and market surveillance and intellectual property rights protection will improve Georgia's access to the EU market. Georgia and the EU have also agreed to jointly explore options for further enhancing bilateral trade relations, including a possible establishment of a free trade agreement between them. In this context, the European Commission is currently undertaking a feasibility study on a free trade agreement between the EU and Georgia.

Border management and migration are tackled under priority 4. Regional cooperation under priority 5 is intended to enhance bilateral and multilateral cooperation in the Black Sea region and between the Black Sea, the Baltic Sea and the Caspian Sea regions. In 2007 the European Commission started to develop a Black Sea Regional Policy to enhance the ENP in this region. Enhanced efforts at confidence building are highlighted under priority 6 in the context of resolution of internal conflicts in Abkhazia and Tskinvali Region/South Ossetia. Enhanced EU-Georgia cooperation on Common Foreign and Security Policy is foreseen under priority 7. Georgia's potential as a transit country and interconnection with the transport and energy networks of the EU is fully recognised under priority 8 which foresees within energy and transport several tangible areas for closer cooperation.

The EU-Georgia ENP Action Plan is available on: http://ec.europa.eu/world/enp/documents_en.htm

GEORGIA

Main economic indicators

	2003	2004	2005	2006 prel.	2007 proj.
Real sector					
Real GDP growth (% change)	11.1	5.9	9.6	9.0	7.5
Inflation (average)	4.8	5.7	8.3	9.2	6.3
GDP nominal (USD, billion)	4.0	5.1	6.4	7.8	9.3
GDP per-capita (USD)	919	1188	1486	1810	2150
Social indicators					
Unemployment rate (ILO definition, %)	11.5	12.6	13.8		
Poverty rate[1] (% population)	54.5	35.7	39.4		
Inequality (Gini ind. consumption/income, %)	40.4				
Fiscal sector					
Total revenues (incl. grants, % GDP)	16.2	22.0	23.4	26.2	24.4
Total expenditure (% GDP)	17.5	18.9	24.9	29.1	26.8
General government balance (cash, % GDP)	-1.6	-0.2	-2.4	-2.3	-2.5
Gross public debt (% GDP)	60.8	46.4	41.1	34.3	28.9
Monetary sector					
Domestic credit to private sector (% GDP)	8.9	9.5	14.5		
Broad money (M3, % change)	22.8	42.6	26.5	39.7	27
Degree of monetisation (M3/GDP, %)	12.4	15.2	16.5	19.5	21
Dollarisation in bank deposits (%)	86.1	74.3	71.6	69.4	68
External sector					
Current account balance (% GDP)	-7.3	-8.4	-5.4	-9.5	-15.2
Trade balance (% GDP)	-16.0	-17.6	-14.5	-21.4	-24.4
FDI (net, % GDP)	8.5	9.6	8.2	11.0	12.3
Import cover of reserves (months)	1.1	1.7	1.7	2.5	2.5
External vulnerability					
External public debt (% GDP)	46.4	36.2	27.1	21.8	18.0
Debt service ratio (% exports)	11.9	11.2	7.2	6.7	5.5
Gross reserves (excl. gold, USD, million)	196	387	478	931	1100
Broad money (M3 / reserves)	2.6	2.1	2.2	1.6	
Financial sector					
Money market rate (%, average)	16.9	11.9	7.7	9.5	
Lending rate (%, average)	32.3	31.2	21.6		
Exchange rate (lari per USD, average)	2.15	1.92	1.81	1.78	
Exchange rate (lari per EUR, average)	2.43	2.38	2.25	2.23	

Sources: IMF, WB, Georgian authorities, EC staff calculations.

[1] The methodology is revised in 2004.

ISRAEL

- **Israel's GDP continued its strong growth in 2006, despite the conflict along the northern border that started in the summer with the invasion of southern Lebanon.**

- **Public debt remains high, despite a strengthened fiscal discipline. This is certainly a constraint on fiscal policy, but does not imply problems with liquidity due to the high average maturity and the warranties on the external debt.**

- **In the last four months of 2006 the fall in energy prices and the appreciation of the domestic currency against the USD foreshadowed the risk of deflation. Monetary conditions are expected to normalise in the first half of 2007.**

- **Despite a fall in overall unemployment, an increasing wealth divide and poverty continue to be among the major challenges for the country. A quarter of the population, about 1.63 million people, were living in poverty in 2006, while the number of poor children climbed to 775,000.**

1. Macroeconomic developments

Real sector developments

Israel's GDP growth continued its sharp acceleration[1] in 2006, despite the conflict along the northern border that started in the summer with the invasion of Lebanon. Real GDP growth peaked at 6% in the first semester of 2006. Relevant factors behind the resilience of the positive economic cycle include: sound macroeconomic policies, a buoyant financial situation (namely falling risk premium), improved total factor productivity; increased internal security and favourable external demand. Even though the invasion of Lebanon significantly disrupted growth (especially in the services sector) and temporarily reduced net exports, the output fell less than estimated due to unexpectedly high levels of consumption of durables and investment[2].

With the end of the hostilities, production has returned to full activity and internal demand has picked up again, together with employment and productivity. During the war demand for exports did not decrease. According to the official data, the war and the consequent slowing of economic activities in the north, had no permanent impact on unemployment (tourism, trade and service were the sectors most harmed by the war). Nonetheless the war seems to have aggravated poverty and the wealth divide, nowadays particularly widespread (chart 1). The North of Israel, heavily involved in the conflict, is one of the poorest areas of the country and the post-conflict expenditures, mostly devoted to restoring the army to full operational capacity, have removed vital resources from the provision of the social security nets, which are still severely hampered by the cuts in social spending pursued in the previous years.

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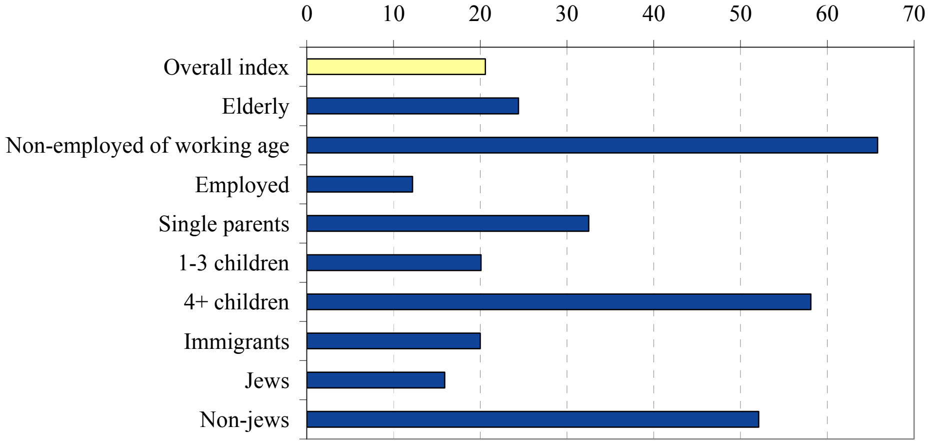
[1] This is recorded since the end of a period of prolonged recession, i.e. 2001–02.

[2] GDP data are more preliminary than usual, and thus subject to revision; because of the war. Growth is widely forecasted to average about 4.5 percent or more in 2006 and to accelerate in the first months of 2007.

Chart 1 - Israel: Percentage of households below the poverty line by family type



Source: Meyers-JDC-Brookdale Institute "Poverty update" 2006.

Fiscal policy

Prolonged growth despite the hostilities as well as the continued discipline of expenditures not related to the war lowered the budget deficit[3]. The central government cash deficit fell to 1.9% of GDP in 2005 and is expected to narrow further to around 1.5% of GDP in 2006. The general government deficit on accrual basis is allegedly close to 3% of GDP despite the government deciding that most of the war-related costs will be charged to 2007 as well as a 5% upward revision in GDP[4].

To cover the costs of the war, the 2006 budget was cut by a total of NIS 1.8 billion or 2% of each ministry's budget except for the ministries of Social Affairs and Health. These ministries were exempted, as well as the municipal authorities, including those in the north of the country where the war exacerbated existing deficits. Public debt remains high even if it is decreasing more than expected: according to estimates the public debt-to-GDP ratio would have fallen to about 90% in 2006. The high public debt is certainly a constraint on fiscal policy but does not imply a problem with liquidity as the average maturity is about 6.5 years, with a fairly smooth repayment profile.

Monetary and exchange rate policy

An overshooting of the Bank of Israel's (BoI) inflation target range (1 to 3%) occurred in the first half of 2006, mainly due to the weakness of the shekel against the USD from June 2005 to February 2006 and to the global rise in energy prices. Concurrently, wage growth accelerated, although an increase in productivity has limited the impact on unit labour costs. According to this, and considering the uncertainties in currency markets when the hostilities started, the BoI raised its policy rate to 5.5% in July 2006 (from 4%, the same level announced as of March 2007).

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[3] After years of unsatisfactory enforcing of the Deficit Reduction Law (DRL), the authorities tightened the fiscal rules in 2004, establishing a 1 percent ceiling on central government real expenditure growth during 2005−10.

[4] According to the IMF, a VAT cut in June (with an annual cost of half a percentage point of GDP) as well as conflict-related spending (which amounted to 1% of GDP) and revenue losses (0.5% of GDP) unexpectedly added to the deficit, while receipts deemed one-off and related to FDI and other activities (1% of GDP) reduced it. Previously legislated tax cuts added 0.5% of GDP to the deficit.

In the last four months of the year the sharp fall in energy prices and the appreciation of the shekel against the USD exerted a downward pressure on the prices of goods and services[5]. The result was a sharp drop in the price level at the end of 2006, which pushed year-on year inflation close to zero and foreshadowed the risk of deflation. In reaction to this unexpected development, the BoI started reducing the interest rate gradually from November (50 basis points in two steps). Inflation is currently expected to return within the inflation target range in 2007.

External sector developments

Israel's external position improved in 2006: exports have been sustained and the current account surplus, which had begun in 2003 after ten years of deficits, has been maintained at a level close to 5% of GDP. Israel has a net external liability position of nearly 20% of GDP. Nonetheless, its liabilities are mainly FDI and equity, and the country has a comparable amount of net external "debt instruments" assets as well as high net international reserves.

The high-tech industry constitutes 48.2% of Israeli exports and has enjoyed strong growth: compared to 2006, high-tech industries rose by 20.2%, medium-high technology industries rose 11.5%, medium-low technology industries rose by 10.8% and low technology industries rose by 2%. Manufacturing exports also saw a rise of 15% in 2006. The free-floating exchange rate has remained broadly level in the last two years, even if it has been constantly appreciating against the USD since March 2006.

2. Trade liberalisation and economic opening

As confirmed by the high level of trade and capital inflows, the Israeli economy is a very open one. According to the BoI, FDI inflows in 2006 exceeded by approximately 2.4 times the similarly high total of 2005: foreign investment broke all precedent records reaching an estimated USD 23.4 billion in 2006, compared to 9.9 billion in 2005 and USD 7.2 billion in 2004. In 2006, Israel ranked second in the world below only the USA for venture capital (VC) investment. A total of 1.44 billion USD was invested in Israeli companies last year, a 13% rise from 2005. VC investment in Israeli software reached a five year peak of USD 519 million USD and the Information Services Industry reached USD 52 million. In the healthcare sector VC deals reached 330 million USD.

3. Business climate

Privatisation, enterprise restructuring and business environment

The privatisation process has proceeded at a sustained pace during 2006: the Israel Oil Refineries have been split into two separate companies (in Ashdod and Haifa) and the company in Ashdod has been privatised, with the intention of privatising the second (and largest) oil refinery in Haifa during 2007. A step toward full privatisation of the post services has also been undertaken with the creation of the Israel Post Office Company. The authorities intend to sell, in the course of 2007, the government's remaining share of Bank Leumi to the private sector. In addition, the reform of the electricity and water sectors has

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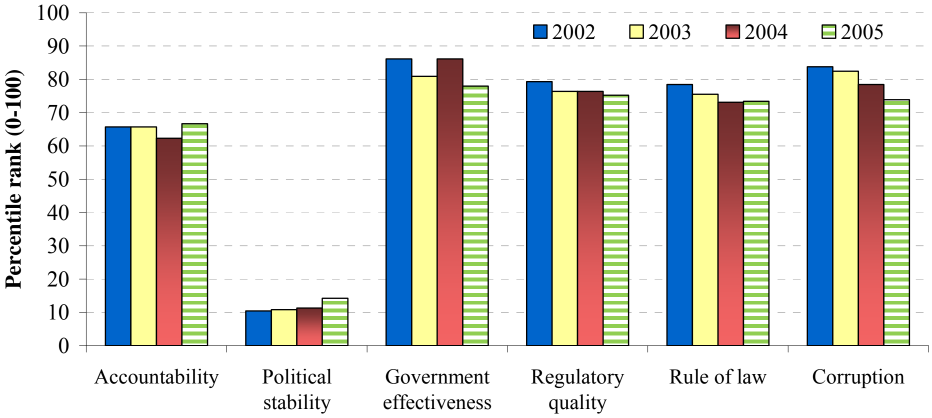
[5] The appreciation of the shekel against the dollar can be attributed to the weakness of the dollar in the international markets and to the robustness of Israel's economy, reflected in part by a large surplus in the current account of the balance of payments and by large capital inflows. The reflection of exchange rate changes in the CPI has been unexpectedly quick because nearly one quarter of the CPI basket comprises contracts that are denominated in U.S. dollars

been undertaken. Several municipalities are going to be merged and rationalised. The signature of an agreement with the European Union aimed at promoting competition in the sector of air transportation is near finalisation.

While the business environment situation did not significantly change in 2006 with respect to the previous year, the public governance situation (as depicted by the World Bank indicators) has shown a negative trend in the last five years, which gives a picture of progressive deterioration (chart 2).

The level of the indicator of political stability is understandable as the indicator also reflects the internal security situation: it shows a sharp decrease coinciding with the increase in attacks of the *Al-Aqsa Intifada* at the end of 2000, and subsequently records a progressive improvement.

Chart 2 - Israel: Governance indicators



Percentile ranks indicate the percentage of countries worldwide rating below the selected country. Higher ranks represent improvement.

Source: World Bank Governance indicators, 2007.

Concerning other dimensions of governance, the progressive deterioration cannot, on the contrary, easily be explained by external shocks and might pose a problem in the future, if not corrected, for the economic and political situation of the country.

Financial sector reforms

The soundness of the financial sector has improved: stock and bond markets performed well in early 2006 and afterwards, especially during the conflict, and the financial markets proved to be tick. Foreign capital inflows continued during 2006, even during the hostilities, attracted by the good macro fundamentals. Nevertheless some weaknesses, mainly inherited from the previous years, remain: bank profitability and capitalisation, although benefiting from growth and relative stability, have generally been relatively low and non-performing loans remain relatively high in some sectors (e.g. construction) when compared with banks' risk capital and provisions against loan losses

The preparatory steps to the implementation of the Basel II framework have generally improved risk management even if new forms of financial risk, related to the introduction of innovative financial instruments and products, are emerging. This process has also been strengthened by the ending of the practice of requiring institutions to buy guaranteed non-tradable government bonds, by the pension reforms, by the removal of barriers to invest abroad and by the elimination of limits on insurance companies and pension funds concessions of credit to the private sector. Investors (including households) nowadays enjoy a wider range of opportunities both in terms of new operators and new products, but might not always perceive the effective financial risk associated with each of them. Moreover, supervisory authorities continue to suffer from staff and skills shortages, especially regarding the demanding new tasks.

Labour market reforms

Since August 2005, the level of unemployment has remained stable at about 8.7% - 8.9% after dropping from its peak of about 11% at the end of 2003. In absolute terms, today nearly a quarter of a million workers are unable to find a job. In recent years, the authorities have addressed the unemployment, as well as the social equity issues (with mixed results), mainly by introducing various measures designed at stimulating labour force participation through negative incentives such as cutting transfer payments and tightening subsidies' eligibility criteria. These have been the main factors behind the rise in the participation rate.

Active Labour Market Policies such as vocational training, aimed at enhancing the skills of the unemployed in order to integrate them in the job market, were also introduced, though with very limited success. The possibility of introducing an Earned Income Tax Credit, which should help working families on low income, is being examined as a possible option.

4. Public institutions and public finance management

In response to the costs of the war, the original 2% deficit target was raised and the defence budget was increased to a projected NIS 47.8 billion, including a NIS 3.5 billion supplement (spread over three years – 2007-2009) to cover war-related expenditures. The 2007 budget estimate was set at NIS 283.1 billion (in 2006 prices). A new feature of the 2007 budget is the requirement of transparency and full disclosure of the civilian part of the security budget (expenses that do not relate to the military proper).

Among the means adopted to absorb the expenses of the war, National Insurance benefits have been frozen at their current level (which already reflects a 4% cutback – the rates have not been adjusted since the 2002 Economic Recovery Plan). Likewise, the planned rise in the minimum wage has been postponed for six months (until December 2007).

The National Insurance budget was increased by only one percent – not enough to keep up with population growth – and includes, among other things, stricter eligibility rules for unemployment compensation (including a reduction in benefits for discharged soldiers in preferred jobs and raising the age of eligibility for young people). This measure will almost certainly impact negatively on the well-being of young people. A continuation of these policy measures in regard to National Insurance budgets will no doubt have a negative impact on poverty levels in Israel.

5. Social development and poverty

In the aftermath of the war the government decided to immediately implement two wide-scale programs: restoring the army's operational capacity and rehabilitating the North. The need to help the northern localities, which suffer from the same problems as most of Israel's peripheral localities – mainly unemployment and poverty – became much more urgent as a result of the war. Due to the Rehabilitation Program for the North, the countrywide war-on-poverty programs due to be implemented have been deferred. As a consequence of the fact that the scale of the poverty reduction programs has been severely reduced in the most recent years, the wealth divide will increase further and the needs of weak population groups in areas outside the North will remain largely unmet, also due to the delay in providing assistance as a result of priority being given to other war-related programs.

A recent National Insurance “Poverty Report” shows that a quarter of the population, namely 1.63 million people, were living under the poverty line in 2006, an increase of 100,000 compared to 2006. The number of poor children in 2006 climbed to 775,000, 35% of children countrywide, compared to 33% in 2004. According to these figures, while the number of children classified as “impoverished” rose only slightly in 2006 as compared to 2005, Israel’s share of impoverished children is the highest in the world. Poverty is particularly high amongst the Arab component of the population (chart 1).

Poverty has risen mainly among households with four or more children, households headed by a single working person, and Arab households. The deep cuts in child allowances, the continued failure to adjust benefit levels (except for old-age and survivors’ pensions) caused the real level of these benefits to erode. Among elderly households, however, the incidence of poverty declined to 24.4% from 25.1% one year before, mainly due to an increase in benefits for elderly people on low-income. There is an on-going public debate in Israel about priorities in resource allocation: in general the public opinion has not modified its stance on the social front despite the steep expenditures of the war: nearly 90% of the public favours an increase in social budgets while more than three quarters oppose cutting social budgets in order to cover war expenditures. Overall, the general public consider the need to fight poverty and allocate more resources to social issues a much higher concern than the defence situation.

Box 1 - Israel: Economic costs of the war on Lebanon

Even if the war on Lebanon seems not to have disrupted the strong positive trend of the business cycle, the Israeli population was probably not prepared to cope with protracted missile attacks against a third of its territory and a fifth of its population, and it paid a high price in the lives and health of civilians and soldiers, property damage, and other destruction. The social distress that surfaced during the war, especially poverty among large population groups, showed clearly that social cohesion should be strengthened as a key to Israel's ability not only to recover from damage caused by war but also in order to position itself for a better future.

Apart from the human costs and the negative impact the war had on the image of Israel, overall (preliminary) war costs amount to NIS 13-14.5 billion. This preliminary estimate includes:

• Damages to property and loss of salaries, estimated by the Property Tax Authorities at NIS 3.5 billion;
• Direct and indirect damages, estimated at NIS 6 billion;
• In the tourism industry, losses were about NIS 150 million due to the reduced foreign and domestic movements (there was a fear that the tourism industry in the North would suffer a general collapse);
• Direct damage to buildings and agricultural infrastructure amounted to nearly NIS 15 million
• Indirect damage related to the loss of export revenues, delays in crop spraying, etc. are estimated in NIS 300 million

The damage to manufacturing in Haifa and the North is estimated at NIS 4.6 billion. This is composed of direct damage (lost production and damage to buildings caused by physical attacks) and indirect damage (loss of future orders, increases in transport costs, employee transportation costs, housing problems of employees and families who temporarily relocated to the centre of the country, etc.). The overall estimate also includes defence procurements and expenses related to the restoration of the army's operational fitness.

The government decided a program of compensation for damage to businesses that were obliged to suspend operations during the war: large businesses will be compensated at 145 percent of payroll cost in August and 132.5 percent of cost in July. Small businesses will be given alternative compensation commensurate with the decline in their sales turnover, with the corresponding period in 2005 as the baseline (the lower the turnover, the higher the percent of compensation). The Ministry of Finance also established a loan fund to help small businesses recover from war-induced damage.

In the construction industry direct damage, including physical damage caused by the suspension of activity at construction sites, was rather small. Declines in property values in the affected areas will probably be more prolonged and severe.

Half of the inhabitants of the "high-risk" region (areas where inhabitants were advised to spend lengthy periods in bomb shelters) and 28% of inhabitants who lived in "lower risk" areas in the North reported that the war had caused them severe economic hardship.

The war exposed the inhabitants of the North to many needs and hardships (obtaining food and medicines, lengthy stays in poorly equipped shelters, rocket hits on residential buildings, and economic and other distress). The ways of coping with these difficulties underscored Israel's social disparities: a rather large proportion of inhabitants of the North who belonged to weak population groups (lone elderly and disabled who were left without nursing care, low-income persons, and single-parent families) had to remain in areas that suffered rocket attacks and use the services of various non-governmental relief agencies. In contrast, the more well-to-do maintained a reasonable standard of living during combats and some even temporarily relocated to safer areas. The war also illustrated the need for local welfare services and their weakness in actually dealing with the problems that came up during and after the hostilities. Some of the hardships that came to light during the war are related to the long-term trend of cuts in social service programs.

ISRAEL

Main economic indicators

	2003	2004	2005	2006 prel.	2007 proj.
Real sector					
Real GDP growth (% change)	1.5	4.8	5.2	4.8	4.4
Inflation (average)	0.7	-0.4	1.3	2.4	0.4
GDP nominal (USD, million)	0.1	122.5	129.8	137.1	142.1
GDP per-capita (USD)	17802	18560	19248	19878	19150
Social indicators					
Unemployment (officially registered, %)	10.7	10.4	9.0	8.7	8.5
Poverty rate (% households)				20.6	
Fiscal sector					
Central government revenues (% GDP)	35.5	35.3	35.7	36.0	34.2
Defense expenditure (% GDP)	10.4	9.2	8.9	9.2	7.9
Central govt. balance (incl. grants, % GDP)	-5.4	-3.7	-1.9	-1.4	-2.3
General govt. balance (incl. grants, % GDP)	-6.4	-5.4	-4.6	-2.8	-4.0
Total public debt (% GDP)	102.3	100.9	97.0	89.9	88.7
Monetary sector					
Domestic credit to private sector (% GDP)	-3.1	3.9	7.1	5.3	
Broad money (M3, % change)	2.2	4.6	7.9	5.5	
Narrow money (M1, % change)	0.5	18.0	17.5	12.2	
External sector					
Current account balance (% GDP)	1.6	2.6	2.9	4.8	4.2
Trade balance (% GDP)	-2.6	-2.3	-2.9	-2.6	-1.7
FDI (net, % GDP)	3.4	1.4	4.3	6.6	2.1
Foreign reserves (USD, billion)	26.5	27.2	28.2	27.5	
External vulnerability					
Gross reserves (excl. gold, USD, billion)	24.2	26.5	27.2	28.2	27.5
Reserves (% M2)	4.3	4.4	4.7		
External debt (% GDP)	63.3	61.0	61.3	57.6	58.7
Financial sector					
Bank of Israel policy rate (%, end of period)	7.5	4.2	3.7	5.0	
Nominal effective exchange rate (average,%)	-3.7	-3.3	-0.8	2.7	
Real effective exchange rate (average, %)	-5.3	-6.0	-2.1	2.0	
Terms of trade (2000=100, index)	97.8	95.9	96.5	95.9	

Sources: IMF, EBRD, WB.

JORDAN

- **The robust economic performance experienced in recent years continued in 2006. Real growth remained strong at 6.4%, public debt decreased by more than 10 percentage points to 72.5% of GDP and core inflation remained low. However, the twin deficits remained high with the current account balance at -13.6% of GDP (2005: -17.8%) and the budget balance (excluding grants) at -7.1% of GDP (2005: -10%).**

- **Medium-term economic adjustment remains essential to ensure the reduction of the twin deficits: on the fiscal side by continuing the fiscal consolidation efforts, and on the structural side by supporting increases in exports and FDI to finance the current account deficit. Nevertheless, the implementation of the National Agenda slowed down.**

- **The main macro-economic policy objectives for the coming years are: (i) maintaining robust growth and improving resilience to shocks, (ii) ensuring a credible medium-term fiscal stance and preserving competitiveness, and (iii) pursuing a sound management of capital inflows in order to sterilise pressure on domestic interest rates and inflation and to avoid short-term speculative inflows.**

- **Poverty reduction and job creation through sustained and broadly shared growth remain Jordan’s most important challenges. Despite a strong, sustained economic performance, high unemployment persists, and the distribution of gains from high growth remains uneven across population groups and regions.**

1. Macroeconomic developments

Real sector developments

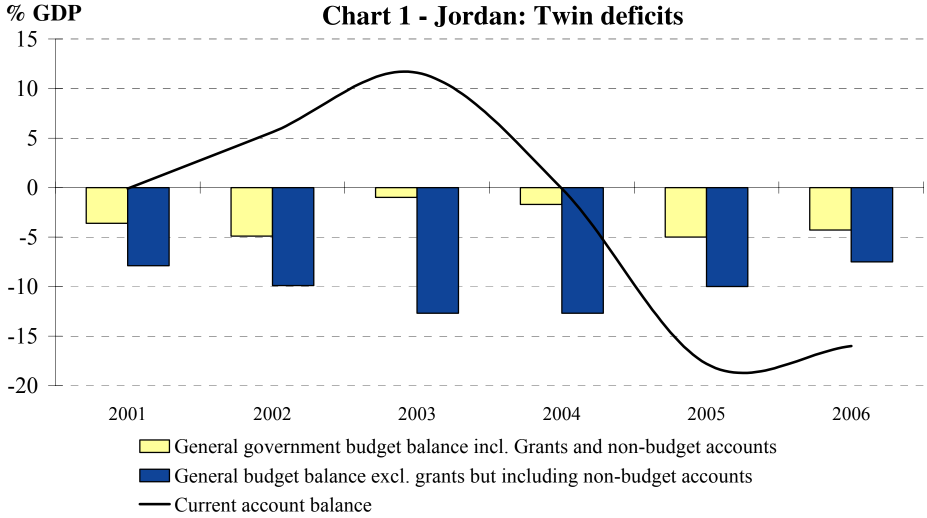
Growing in real terms at 6.4% in 2006, the Jordanian economy maintained the average high level of expansion which characterised the period 2001-2005. This sustained strong economic performance was broad-based and reflected buoyant domestic demand financed in part by large private capital inflows. Private consumption and investment continued to take advantage of high liquidity in the region. The Amman Stock Exchange index declined sharply in the first half of 2006, but has since stabilised. The contribution of net exports to GDP growth became nil, having been negative over the last few years. Unemployment declined to 14% (2005: 15%). Total factor productivity in the Jordanian economy rose by a remarkable 2.5% a year during the period 2001-2006, reflecting strong labour productivity increases in manufacturing, and in the textile sector in particular.

The economic outlook for 2007 remains unchanged compared to 2006 thanks to large investment projects. Downside risks from the recent equity market downturn, declining profits and higher interest rates, but also instability in the region are not to be neglected.

Fiscal policy

With a fixed exchange rate and an open capital account, the burden of adjustment needed to maintain macroeconomic stability, reduce the current account deficit and lower further the debt-to-GDP ratio falls on fiscal policy. To respond to this challenge, Jordan continued its efforts to reduce the budget deficit and address its dependency on external grants. The budget balance (including grants) improved to -3.8% in 2006 (-7.5% excluding grants) compared to -5% in 2005 (-10% excluding grants). Higher-than-projected revenues (income tax and general sales tax) and larger-than-expected grants (from Saudi Arabia) largely offset higher primary spending on fuel subsidies and transfers (social safety net to compensate for the large increase in domestic fuel prices), security outlays and wage bonuses[1]. In 2006 the government continued the gradual elimination of oil subsidies, which should be entirely removed in 2007. The fuel subsidy decreased to 2.7% of GDP in 2006 (2005: 5.9%).[2]

Chart 1 - Jordan: Twin deficits



Source: IMF and Jordanian Ministry of Finance.

The 2007 budget targets a deficit of 2.7% of GDP including grants (7.8% if grants are excluded). Current expenditures are planned to increase by 5.9% over 2006 reflecting high-priority one-off defence and security spending that is expected to be unwound in 2008. A new monthly price adjustment for a number of oil products was put in place but is not yet fully automatic.

In the medium term, the authorities intend to keep non-priority current spending constant in real terms. In addition, they are considering introducing, in 2008 at the earliest, specific inflation-indexed excise and full general sales tax (GST) on selected petroleum products that could generate at least 1% of GDP a year. In the meantime, the Jordanian cabinet has approved a salary hike for civil servants, as well as for both active and retired military personnel.[3]

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[1] The supplementary budget law approved by Parliament at the end of August 2006 set a target for the deficit of 6.9% of GDP.

[2] At the same time, the targeted social safety net programme related to fuel price increases was introduced successfully.

[3] It also announced that it will be revising the local and civil service salary scale as part of an ongoing public sector restructuring plan. The situation of 40 000 class four employees is currently under review: this includes drivers, office messengers, guards and technicians who do not hold a secondary school leaving certificate.

An improved fiscal balance, the partial privatisation of Jordan Telecom and strong growth all contributed to a further reduction of the public-debt-to-GDP ratio to 72.5% of GDP by the end of 2006 from 83% in 2005. The authorities are considering revising the Public Debt Law, which has been effective in securing past adjustment, and reduce the current limit on the debt-to-GDP ratio from 80%, towards a ceiling of 60%.[4]

Monetary and exchange rate policy

Monetary policy continues to aim at maintaining the exchange rate peg and keeping interest rates in line with US rates. The dollarisation ratio has been stable at about 27% of deposits, reflecting a continued confidence in the Jordanian dinar. The Central Bank's policy appears increasingly restrictive with a view to controlling inflation. However, due to fuel and imported price increases and excess liquidity which boosts domestic credit growth[5], consumption and imports, inflation increased in 2006 to 6.3% compared to an average of 2.4% over 2001-2005. On the other hand, core inflation, excluding food and energy, seems to be well contained. The Central Bank continues to remove excess liquidity through the issuance of certificates of deposit to slow domestic credit growth, and contain consumption and imports. Broad money supply (M3) increased by 14.1% (2005: 17%) in line with nominal domestic economic activity.

Following four years of modest depreciation, the real effective exchange rate appreciated by 6% during 2006, a return to the levels prevailing in the early parts of the decade. Despite the large trade account deficit (see below), there are no signs of foreign exchange shortages, given record remittances and inflows of foreign direct investment (both near 20% of GDP).

External sector developments

The current account deficit, although still very large, narrowed to 13.6% in 2006 from 17.8% in 2005. Exports continued to increase at an annual pace of 21%, a comparable rate to the period 2001-2005.[6] Imports slowed down growing at nearly 10% compared to 28% in 2005 and 43% in 2004. A still large current account deficit reflected a sizeable increase in private investment.

The financing of the current account deficit continues to rely largely on (long-term) capital inflows, which rose to record levels on the back of foreign investments in banking, mining, telecommunications and real estate[7]. It is expected that FDI inflows will fall following the exceptional flows in 2006 related to privatisation (bank and telecom) but will remain at around 10% of GDP over the medium term[8]. The

[4] According to the IMF, meeting the new target should require to keep the overall budget deficit within the limit of 3.5% of GDP over the medium term.

[5] Credit to the private sector increased by 24.4% compared to 2005 and to an annual average of 13.2% over 2001-2005 in line with buoyant demand and the rise in the Central Bank's resources. This strong growth was offset, among other things, by reductions in acquisitions of T-bills from the government, which was able to cover its financing needs with privatisation receipts.

[6] The clothing industries located in the Qualified Industrial Zones (QIZs) remain major exporters of manufactured goods though they are no longer the leading export sector. Their share remained stable at about 23% of total exports whereas exports of chemicals and manufactured goods other than clothing, which have a higher value added, have risen to 31.5% of total exports.

[7] The net private capital inflows represented 30% of GDP in 2006 compared to 19.7% in 2005 and 6.5% in 2004.

[8] The sustained foreign direct investment inflow reflects: i) the registration of new investor commitments; ii) privatisation plans; iii) inflows into Special Economic Zones (SEZ), and iv) announced projects in real estate, retail and tourism.

dramatic increase in FDI suggests confidence in the economy's ability to generate sufficiently high rates of return in the future, and indicates that investors have a favourable view of prevailing competitiveness conditions.

As a result, despite the high current account deficit, the balance of payments reached a surplus estimated at USD 1.7 billion (12% of GDP). Gross usable reserves reached USD 6.1 billion at the end of 2006, which represents a more than 25% increase (by USD 1.25 billion) compared to 2005.

The current account deficit is expected to narrow further, also on account of the free trade agreement with the US and sustained strong regional demand. Import growth is expected to stabilise in line with overall economic activity and on account of falling import prices. Revenues from tourism and net remittances should continue to finance the deficit in merchandise trade.

2. Trade liberalisation and economic opening

Jordan's efforts to build a strong and liberalised economy are reinforced by the EU-Jordan Association Agreement and the Free Trade Agreement (FTA) signed with the US. Jordan and the EU successfully concluded negotiations on the liberalisation of trade in agricultural and processed agricultural products. The agreement entered into force in January 2006. Jordan has adopted the Pan Euro-Mediterranean Protocol on Cumulation of Origin which has been in force since July 2006.[9] Jordan has made good progress and has confirmed its commitment to negotiating an Agreement on Conformity Assessment and Acceptance of Industrial Products (ACAA), and has selected the priority sectors to be included in it. Since 2006, Jordan and the EU are engaged in negotiations on services and establishment. Negotiations are also under way on the setting up of a mechanism for trade disputes' settlement. One of the main challenges in bilateral trade relations is to raise Jordanian exports to the EU and thus redress the considerable trade deficit.

According to the Industry and Trade Ministry, the value of bilateral trade with the United States trebled between 2000 and 2005. Additionally, the Qualifying Industrial Zones (QIZ) attracted USD 720 million in investments and provided 54 000 job opportunities to both Jordanians and foreigners. The authorities intend setting up more special economic zones in the future, after the successes achieved by the five-year-old Aqaba Special Economic Zone (ASEZ). They would focus on attracting light industries, medical care institutions and IT operations.

UNCTAD's World Investment Report 2006 ranked Jordan among the top 20 countries out of 141 in terms of the flow of foreign direct investment. According to the report, the country attracted around USD 1.5 billion FDI in 2005 compared to USD 651 million in 2004. The total FDI stock at the end of 2005 stood at USD 5.1 billion (about 40% of GDP), up from USD 2.3 billion in 2000 (27% of GDP). According to the Jordan Investment Board, most of the FDI coming into the country was from the Arab Gulf countries and Iraqi investors.

[9] Since that date, diagonal accumulation is also applicable with Israel, which should facilitate Jordan's exports to Europe.

Box 1 – Jordan: ENP progress report on Jordan

The European Commission published its first ENP Progress Report on Jordan on 4 December 2006. The document assesses progress in the implementation of the priorities addressed in the first year of the implementation of the EU-Jordan Action Plan.

The EU-Jordan Action Plan was adopted on 11 January 2005 for a period of five years. It aims to stimulate political dialogue and reform, facilitate Jordan's sustainable economic development and social cohesion, and progressively increase its economic integration with the EU. It is also used as a background for a dialogue that has allowed the EU to make sure that its priorities go hand in hand with Jordan's priorities, as laid down in its National Agenda, and to better target EC assistance.

The dialogue has been used to translate the Action Plan into detailed actions and to agree upon specific deliverables in the field of economic reforms. Four EU-Jordan economic dialogues have taken place, two of them even before the ENP Action Plan was adopted. The budgetary vulnerability of the country has led to agreement on measures to ensure macroeconomic stability, in particular strategies for fiscal reform and public finance management. The EU has supported this process through several structural reform programmes focused on budgetary reforms and improvement of the business environment.

The EC report conveys the message that, overall, Jordan has shown a real commitment to realising the measures of the Action Plan and has made a start with implementation. It is clear, however, that more needs to be done in the next four years. Jordan has shown in this first year that it remains strongly committed to a number of economic reforms, but it is important that these commitments continue to be translated into concrete progress.

Source: *European Commission (2006), ENP Progress Report – Jordan, Commission Staff Working Document Accompanying the Communication from the Commission to the Council and the European Parliament on Strengthening the European Neighbourhood Policy, COM (2006) 726 final, 4 December.*

In 2006, the Jordanian authorities concluded an agreement with Iraq on crude oil supply at preferential prices of USD 10 per barrel.[10] Under the terms of the contract, Iraq began to supply between 30% and 60% of Jordan's daily oil needs, estimated at 100 0000 barrels per day. Both countries agreed to lay a new pipeline for the oil supplies. For the time being the oil will be supplied by oil tankers, using road transport. The contract is expected to ease the oil subsidy burden on Jordan's budget. A Jordan-Iraq FTA is also under negotiation.

Also in 2006, Jordan has negotiated a free trade agreement with the Gulf Cooperation Council (GCC) countries reflecting the increasing trade flows between it and them. The agreement covers all commercial services, construction, insurance and banking sectors, agricultural products and movements of individuals.

In an effort to improve Jordan's data on trade and investment and in light of the pressing need for accurate, timely, and comparable statistics for effective policy-making, a single on-line Trade and Investment Information System (TIIS) was established, designed to automatically compile, standardise

[10] Before the war in Iraq, Jordan used to buy Iraqi oil at subsidised rates. The crude oil is refined in Jordanian refineries.

and publish some of the most updated national statistics on trade and investment according to internationally and nationally recognised standards.[11]
Jordan participated in a concerted international effort to support Lebanon during and after the July 2006 military conflict. The government exempted Lebanese trucks entering Jordan from entry fees and the Lebanese national carrier, Middle East Airlines, from landing fees at Queen Alia International Airport for three months. The authorities also extended help to the Lebanese by facilitating the entry of their vehicles into the country, as well as exempting them from visa and departure fees for three months.

3. Business climate

Privatisation, enterprise restructuring and business environment

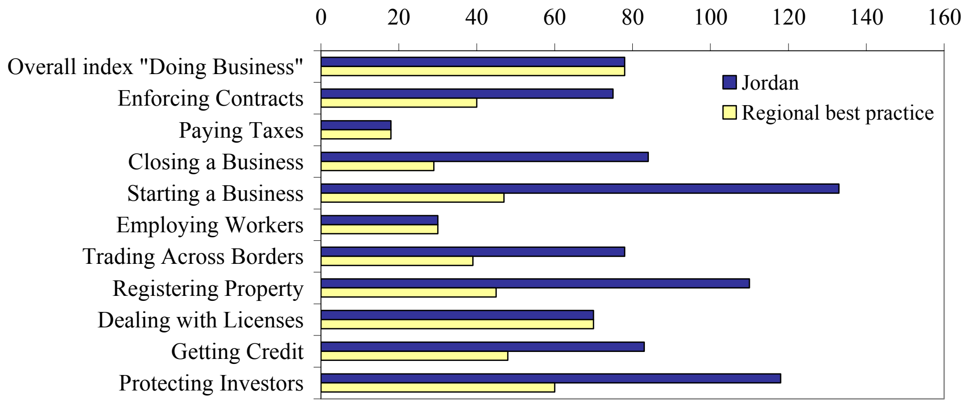
Jordan continued to make progress with structural reforms, in particular with the privatisation programme and measures to improve the investment climate. The establishment of a one-stop shop has eased the registration process for businesses. A new institutional framework for investment and export promotion has been developed and includes the creation of a Jordan Authority for Enterprise Development (JAED). This body is intended to ensure better coordination of private sector development policies and closer involvement of the private sector in the design and implementation of those policies. However, although agreement was reached on its structure, effective implementation of this scheme has been considerably delayed. A new investment bill has also been presented to Parliament, with a view to simplifying the regulatory framework and streamlining investment incentives. As a result, the Prime Minister’s office will have the right to grant any privileges, incentives or financial exemptions to any project that meets development requirements, help increase exports and provide more job opportunities. As regards enterprise policy, the authorities adopted the Euro-Mediterranean Charter for Enterprise as institutional framework for SMEs development.[12] Progress on developing a Jordanian strategy for industrial modernization and competitiveness accelerated.

The privatisation process is advancing according to plan. The authorities identified some 17 privatisation projects for 2006 including in the real estate sector. The sale of five big companies yielded receipts of USD 0.6 billion (4.2% of GDP). In addition to the sale of 37% of the state-owned phosphates company, a 40 percent stake in Jordan Telecom[13] and the core business of Royal Jordanian Airlines, the authorities plan to privatise the electricity generation company. The privatisation of Royal Jordanian Airlines is expected to be completed by the end of 2007. It is expected that privatisation will be accompanied by regulations to protect against monopoly pricing. In 2007 part of the revenue from privatisation (USD 70.6 million or 0.4% of GDP) is to be spent on a housing project for vulnerable groups of the population, the Employees Housing Fund Programme. The programme extends soft loans to underprivileged families at 3.5% interest. The Housing and Urban Development Corporation (HUDCO) will supervise the programme.

[11] The government entities which periodically furnish and update primary data on trade and investment are: the Department of Statistics, the Ministry of Industry and Trade, the Companies' Controller Department, the Aqaba Special Economic Zone Authority, the Central Bank of Jordan, the Jordan Industrial Estates Corporation, the Amman Chamber of Industry, and the Jordan Investment Board.
[12] The first Charter's stakeholders' meeting took place in February 2007.
[13] This is the most important transaction, which brought the state USD 0.4 billion (more than 3% of GDP).

Jordan was ranked 78th in the World Bank's 2006 "Doing Business" report, well ahead of other Arab countries in the Euro-Med region but after Israel (26th). It represented the best regional practice in the field of "paying taxes", "employing workers" and "dealing with licences". Compared to 2005, however, its overall relative position among all the 175 countries deteriorated in most of the indicators, except in trading across borders. As other countries in the world made more progress in improving their business environment. Further improvements in the business environment are, therefore, required if Jordan is to build on its strong record of attracting regional investors.

Chart 2 - Jordan: "Doing business" rankings



The ease of doing business index ranks economies from 1 (best) to 175. The regional best practice refers to the best ranking Arab country among the Mediterranean ENP countries.

Source: World Bank, 2007.

Financial sector reforms

Improvements in banking supervision and regulation have continued. Efforts to develop capital markets are ongoing. Bank indicators remain sound despite the major correction in the equity market. Banks are well capitalised, non-performing loans have declined and profits of the sector as a whole have increased and remain comfortable. However, rapid private sector credit expansion calls for continued vigilance and strict bank supervision.

The authorities continued the implementation of recommendations from the Financial Sector Assessment Programme (FSAP) including introducing a prompt corrective action framework and corporate governance/risk management guidelines, and improved off-site surveillance. Parliament is expected to ratify the Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) legislation.

Labour market reforms

Official unemployment remains high (14%) but has declined compared to 2005. In their efforts to reduce unemployment, the authorities have adopted a programme that focuses on direct assistance to the neediest and on improving the system of incentives in education (e.g. by moving away from a system of subsidies to public universities to one of direct funding for selected students through a Student Support Fund) and vocational training (e.g. by restructuring vocational training institutions to enhance quality, and

supporting productive income-generating projects etc.). The Ministry of Labour has also prepared a plan to increase the work permit fees for foreign workers.[14]
A new employment and poverty reduction strategy was presented in May 2006. The government developed a comprehensive action plan for improving workers' rights, particularly in the Qualified Industrial Zones. The Labour Ministry created a so-called "Golden List" of violations of labour standards following a report issued by the US National Labour Committee in May, which accused Jordan of serious abuses of foreign workers' rights (e.g. delays in paying wages).

4. Public institutions and public finance management

Progress is being made in improving public finance management through the implementation of Jordan's financial management reform strategy, including establishing a single treasury account, modernising the budget classification, implementing the government financial information management system (GFMIS), and strengthening budget processes. In addition, the authorities have taken a significant step towards effective integration of planning and budgeting by prioritising and costing the National Agenda within a three-year resource envelope. That exercise resulted in the Cabinet's establishment of indicative budget ceilings for 2007-2009 for each line ministry to guide the preparation of annual budgets. These changes in budgeting procedures are preparing the ground for the introduction of a medium-term expenditure framework. Last but not least, tax reform remains central to the government's economic policy, to improve efficiency and transparency and to increase tax revenue collection. The government intends to reform the income tax system by rationalising exemptions, adjusting tax brackets, and eliminating some exemptions presently available for real estate. Amendments to the general sales tax law were passed by Parliament in October 2006. Draft legislation to simplify personal and corporate income tax and to streamline the fiscal incentives framework for businesses has been submitted to Parliament. The reform of the tax administration has been taken forward by merging the direct tax and general sales tax departments and setting up a large Taxpayer's Office.

Despite a decade of progress in establishing anti-corruption laws and regulations, the level of corruption in Jordan is perceived to have significantly worsened over the last year, according to Transparency International.[15]

5. Social development and poverty

Poverty reduction and job creation through sustained and broadly shared growth remain Jordan's most important challenges and are the main objectives of the National Agenda. Despite a strong, sustained economic performance, high unemployment persists, which aggravates poverty. The distribution of gains from high growth is uneven across population groups and regions.

Jordan's demographic growth is among the highest in the region and nearly 70% of the population is under the age of 30. Looking forward, about 60 000 new jobs and continued strong growth of around 7% will be needed each year to avoid higher levels of unemployment and poverty. This situation on the labour market is exacerbated by large-scale emigration of highly skilled Jordanians to the Gulf countries and immigration of low-skilled foreign labour.

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[14] The Labour Ministry puts the number of legal foreign workers at 261 000 and estimates that another 115 000 are working in the country illegally.
[15] Jordan ranked 40th, with a score of 5.3, a drop of three places on last year's ranking when the country scored an index of 5.7. The index score relates to perceptions of the degree of corruption, which ranges between zero (very corrupt) and ten (clean).

A survey by the Department of Statistics (September 2006) revealed that the highest rate of unemployment by age group was found amongst 20 to 24-year-olds (28.8%, compared to national average of 14% in 2006) followed by the 25-29 age group (18.2%). The survey also revealed that 46.2% of the unemployed had not completed their school education; yet 51.2% of the unemployed had a university degree.

Jordan ranked second among Arab countries in achieving education goals for all, according to the UNESCO 2007 Education for All Global Monitoring Report, and 49th among the 125 countries.[16]

[16] The report is published annually to encourage countries to implement programmes directed towards achieving 'education for all' goals, which include expanding pre-school educational programmes, making elementary education more widely available and reducing the gender gap.

JORDAN

Main economic indicators

	2003	2004	2005	2006 prel.	2007 proj.
Real sector					
Real GDP growth (% change)	4.2	8.4	7.2	6.4	6.0
Inflation CPI (average)	1.6	3.4	3.5	6.3	5.7
GDP nominal, (USD, billion)	10.2	11.4	12.7	14.3	16.0
GDP per-capita (USD)	1961	2131	2317	2544	2778
Social indicators					
Unemployment (%)	14.5	12.5	14.8	13.9	
Life expectancy (years)	72	72			
Literacy total (% ages 15 and above)		90			
Literacy female (% ages 15 and above)	84.7	85			
Fiscal sector[1]					
Total revenues (excl. grants, % GDP)	23.0	25.7	28.0	30.9	29.9
Total expenditure (% GDP)	35.8	38.4	38.0	37.9	38.5
Budget balance (incl. grants, % GDP	-1.0	-1.7	-5.0	-3.8	-2.7
Budget balance (excl. Grants, % GDP)	-12.7	-12.7	-10.0	-7.1	-7.8
Net public debt (% GDP)	97.7	88.5	82.8	72.4	66.7
Monetary sector					
Private sector credit (% change)	3.5	17.3	30.3	24.4	
Private sector credit (% total credit)	79.5	79.2			
Broad money (M3, %)	12.4	11.7	17.0	14.1	10.3
Degree of monetisation (M3/GDP, %)	131.4	130.8	137.2	138.9	136.9
External sector					
Current account (incl. grants, % GDP)	11.6	-0.1	-17.8	-13.6	-13.4
Trade balance (% GDP)	-19.6	-38.6	-47.0	-35.0	-35.0
FDI flows (% GDP)	4.2	5.4	10.0	6.8	9.1
Import cover (months)[2]	6.5	5.1	4.7	5.6	5.2
External vulnerability					
External public debt (% GDP)[3]	74.5	66.2	56.1	49.8	44.2
Debt service ratio[4]	17.8	15.1	12.3	11.2	10.4
Foreign exchange reserves (USD, billion)	4.7	4.7	4.7	6.1	
Reserves/M3 (%)	46.4	42.8	35.4	40.1	36.4
Financial sector					
Short-term interest rate (average, %)	2.8	2.5			
Exchange rate (per USD, end of period)	0.71	0.71	0.71	0.71	0.71
Exchange rate (per EUR, end of period)	0.87	0.96			
Real effective exchange rate (eop, 2000=100)	95.8	92.1	91.9	97.2	

Source: IMF, WB.

[1] Covers the central government and budgetary agencies. Includes non-budget account net spending.
[2] International reserves in terms of months of imports of goods and non-factor services.
[3] Total government external debt incl. government guaranteed external debt.
[4] Public external debt service in % of exports of goods and non-factor services.

LEBANON

- **The Lebanese economy stagnated in real terms in 2006 as a result of the 34-day war with Israel and the mounting political tensions.**

- **The military conflict indeed constituted a serious exogenous shock for the Lebanese economy: it brought to a halt the on-going economic expansion in the first semester of 2006, put additional pressure on the already vulnerable public finances and external current account, and postponed discussions on the implementation of structural reforms.**

- **The war aggravated the country's existing acute financial situation. The severe crisis facing the public and social sectors deepened. Disparities between the regions, differently affected by the military conflict and the blockade, widened; the divergence between the real and the financial sectors was never so apparent. The political stalemate only aggravates the situation.**

- **The government adopted in January 2007 an ambitious and comprehensive medium-term programme of socio-economic reforms. The international community endorsed the programme at the International Donors' Conference on Support for Lebanon (Paris III) and pledged USD 7.6 billion, part of it being conditional upon the progress in reforms. Their implementation is, however, fraught with serious risks, including political instability and a lack of national consensus on the necessary reforms. The ENP EU-Lebanon Action plan, adopted on 19 January, and the IMF Emergency Post-Conflict Assistance programme approved on 9 April 2007 provide a potentially important anchor for the implementation of reforms.**

1. Macroeconomic developments

Real sector developments

The military conflict and the blockade in summer 2006 brought to a halt the economic expansion on-going in the first semester. Prior to the war, the Lebanese economy was expanding at an annual rate of up to 7% in 2006.[1] This favourable economic performance was driven by the booming real estate sector, expanding tourism and impressive exports growth showing limited sensitivity to the domestic political environment; but economic expansion hallmarked all sectors.

The total direct costs of recovery and reconstruction (physical damage to infrastructure) are estimated by the Lebanese authorities at around USD 2.8 billion (12% of GDP), although some other sources refer to half of this amount. The indirect economic losses due to the war (forgone revenues, economic contraction, forgone investments, non-covered fixed costs linked to a halt in economic activity), incurred as a result of the military operations and of the blockade, are assumed to be considerably higher than the direct costs, with official estimates reaching up to two to three times the direct costs.[2]

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[1] Based on the "coincident" indicator for the first half of the year compiled by the Central Bank on a monthly basis.
[2] For more information, see: EuropeAid (2006), *Lebanon 34 day war: Needs assessmen*", and World Bank (2006), *Lebanon economic and social impact assessment*.

Yet the Lebanese economy once again showed strong resilience to shocks; however, the slow recovery observed already in the fourth quarter of 2006 was halted by the political stalemate following the resignation of six ministers[3] and the assassination of Minister Gemayel. The opposition sit-in in front of the Council of Ministers and clashes in the centre of Beirut impacted negatively on the service sector (tourism in particular) and dented consumer and investor confidence.

Overall, thanks to the results from the first semester, its capacity to rebound and the low base in 2005, the economy did not contract in real terms in 2006. According to the Ministry of Labour, unemployment increased from 14% to 20% following the destruction of several manufacturing facilities.[4] Jobs in the informal economy, which represents 34% of GNP, were also heavily affected (especially in tourism and construction).

The outlook for 2007 is surrounded by uncertainty. A quick resumption of private consumption and investment was expected, also on the back of the reconstruction efforts and direct compensation payments. Economic activity in the first quarter of the year was, however, slow. The wait-and-see attitude is likely to continue in the run-up to the presidential election, which is expected to take place by autumn 2007. The recovery in the two leading sectors of the economy, tourism and construction, requires a revival of confidence. Expected delays in reform implementation because of the political stalemate would also influence the outlook for 2007.

Box 1 – Lebanon: Resilience of the financial sector

"In a country with large structural imbalances and with a hefty political divide, the historical resilience of the financial sector during crisis is not equivalent to long-term financial immunity. There is today a drastic need to align the increasingly diverging real sector and financial sector of the economy. With the current large financial sector exposure on the State, reinforcing immunity means either reducing this exposure or reaching sound political governance that would resume investor confidence at large. This necessitates a commitment on a public finance soft-lending scenario that would be based on a comprehensive basket of adjustment measures including improvement in resource mobilization, spending restraint, privatization and international assistance, in addition to the enactment of growth oriented government measures in an economy still operating at far below potential output and full capacity. The enhancement of the real economic activity is indeed a national duty that lies upon all economic agents helping to avoid the trap of a lasting divergence between the real and financial sectors creating the seeds of a growing financial bubble with time."

Source: Audi Bank, Quarterly Report, 3rd Quarter, 2006.

[3] The ministers who resigned are Labor Minister Trad Hamadeh, Agriculture Minister Talal Sahili, Foreign Minister Fawzi Salloukh, Health Minister Mohammed Jawad Khalifeh, and Energy and Water Minister Mohammed Fneish.
[4] The President of the Lebanese Industrialists Association estimates that around 4200 workers have lost their jobs in this way.

Fiscal policy

The impact of the 2006 summer conflict with Israel and the cumulative effects of past economic policies have led to a severe fiscal crisis that requires urgent action. Various estimates are used to report on the budgetary impact of the war. According to the government's report on the *"Impact of the July War on Public Finances*" published in August 2006, the loss in public finance due to the war represented USD 1.6 billion (7.1% of GDP). The Paris III document refers, in turn, to cumulative additional fiscal needs for the period 2006-2010 estimated at USD 5.9 billion, resulting from revenue loss and additional conflict-related expenditure, inclusive of the costs of recovery and reconstruction. The impact is mitigated somewhat to USD 4.5 billion by the pledged grants and loans.[5] According to the IMF, total conflict-related spending represents approximately USD 1.48 billion spread over 2006-2008, with the bulk falling on 2007.

In the absence of a budget law for 2006 (since it was approved only retroactively in November 2006), the government continued to apply the rule of "the provisional twelfth".[6] Disbursed humanitarian and recovery grants, representing 2.9% of GDP, more than covered the direct budgetary impact of the war, estimated for 2006 at 1% of GDP. The budget deficit increased nevertheless to 11.2% of GDP in 2006 from 8.5% in 2005.[7] The primary balance was positive and represented 1.7% of GDP (including grants) compared to 2.1% of GDP in 2005.

Total revenue fell by 1.5% (instead of 9% as projected immediately after the war) compared to 2005, mainly thanks to external grants. This decline is attributed to a contraction of trade volumes (custom revenues decreased by 15.3%) and the resulting fall in VAT receipts (two percent down on 2005).[8] On the other hand, total expenditure increased by 16% compared to 2005 (instead of 23% as foreseen in August 2006), mainly owing to a 29% rise in interest payments. Debt costs increased on account of the phasing out of special effects of Paris II[9] and the gradual rise in interest rates following the assassination of PM Rafik Hariri.[10] Taking into account the pre-war projections, according to which expenditures were expected to increase by 13% over 2006, the effect of the July conflict on spending should therefore be assessed rather in terms of budget reallocation. Non-interest (primary) expenditure increased by 9.8% (instead of by 18.3% as foreseen immediately after the war) with the main driver being the 41% increase

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[5] During the Conference for Lebanon's Early Recovery hosted by the Swedish government on 31 August in Stockholm, pledges represented about USD 900 million for humanitarian assistance needs and early recovery efforts, of which USD 107 million was to be provided by the EU.

[6] Most expenditure categories were effectively frozen in nominal terms. The absence of a budget law means that new expenditure commitments are not permitted, which resulted among other things in considerable compression of investment expenditures.

[7] For consistency reasons, ratios for the fiscal deficit as well as revenue and expenditures as % of GDP are taken from the IMF. The comparisons with 2005 for revenues and expenditures are based on Ministry of Finance figures, and are consistent with those reported by *Banque du Liban*.

[8] Non-tax revenues, in particular income from public institutions and government properties, fell by more than 8% compared to 2005, whereas tax revenues increased by 1.1% despite the turmoil in 2006 .

[9] Maturing of a series of special zero-interest T-bills that were part of the debt-restructuring measures following Paris II. As these matured, the government had to issue new papers at market rates and pay interest on the debt. The weighted average interest rate on outstanding Lebanese treasury securities of all categories denominated in LL increased to 8.59 percent at the end of 2006 from 7.62 percent at the end of 2005 and 6 percent at the end of 2004.

[10] Interest payments represented in 2006 13.6% of GDP and 51.6% of government revenue compared to 10.6% and 46% in 2005 respectively.

(as compared with 2005) in direct transfers to EdL, which endured significant losses because of lost oil reserves during the war.[11]

Lebanon remains one of the most indebted countries in the world. Public debt reached USD 40.4 billion, or 179% of GDP, at the end of 2006 up by 5% from USD 38.5 billion at the end of 2005.[12] This increase is attributed mainly to a 6.2% rise in foreign debt (Eurobond' issuance) from USD 19.2 billion in 2005 to USD 20.4 billion in 2006 (domestic debt increased by 3.6%).[13] The situation is aggravated by the fact that the government is facing large debt obligations in the short term.[14]

The Central Bank and the commercial banks are involved in the discussions aimed at finding a sustainable solution to the debt problem as they hold respectively 25% and 50% of the public debt.[15] Financing the government deficit has developed into one of their main sources of revenue and created the vicious circle of permanently increasing State indebtedness. Therefore, a necessary (pre) condition for addressing the debt trap is a "consensus" or burden-sharing between the three domestic players. In accordance with this rationale, commercial banks, which reported a sharp rise in profits in 2006, have been asked to place up to 10% of their customers' deposits with the Central Bank at a rate of 0% or 1%.[16]

Monetary and exchange rate policy

As in 2005, the Central Bank was able to maintain the stability of the currency and its peg to the dollar as well as the liquidity necessary to meet the government's financing needs despite the extent of the shock. Gross foreign-currency reserves (excluding gold) exceeded USD 11.3 billion, as against USD 9.6 billion in 2005.[17]

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[11] Budgetary support to EdL (because of technical and non-technical losses estimated at more than 40% of the power generated as well as higher oil prices) reached approximately USD 1 billion in 2006, which represented about 20% of fiscal revenues and 3.3% of GDP.

[12] When looking at the gross debt figures, the implicit liabilities of the government (arrears) estimated at more than USD 2 billion (10% of GDP) should also be kept in mind. On the other hand, the net public debt which excludes public sector deposits at commercial banks from overall debt figures, increased by 7.6% in 2006 to USD 37.4 billion.

[13] As a result, the share of debt denominated in foreign currency increased to 50.4% from 49% in 2005 and outweighed debt in local currency. For comparison, debt in foreign currency represented 30% of total debt in 2000. In Lebanon, the foreign currency-denominated debt is mainly held by Lebanese institutions (commercial banks and *Banque du Liban*). Only 1.15% of total debt is held by foreign governments and 3.4% by international institutions.

[14] 65% of the public debt outstanding prior to the July 2006 war is maturing over 2007-2010, which comes in addition to new borrowing during and after the July 2006 war.

[15] The share of the debt held by the Central Bank decreased from 26% in 2005 to 19% in 2006 and is expected to decrease further to 8% by the end of 2008.

[16] Lebanese banks agreed in 2002, following the Paris II conference, to help the Central Bank by buying USD 4 billion worth of bonds in Lebanese and dollar-denominated currencies with zero interest rate. Total deposits are estimated at USD 65 billion in 2006.

[17] This was possible with the assistance of Saudi Arabia and Kuwait which deposited USD 1.5 billion at the Central Bank. At the end of August, the Central Bank's foreign assets reached a historic high of USD 13 billion. Note that these are IMF figures, which differ from those publicly available from the *Banque du Liban* and the Association des *Banques du Liban*, according to which gross reserves represented USD 10.4 billion at the end of 2006.

The banking sector remains strong. Deposits continued rising after a drop in July and August,[18] also reflecting high deposits by public institutions with the commercial banks (an equivalent of USD 1.04 billion, corresponding to 21% of total budget revenues in 2005 and 15.5% of total expenditure), in the absence of a law requiring these institutions to deposit their cash on a single treasury account at the central bank. The dollarisation of deposits in commercial banks increased from 73.2% at the end of 2005 to 76.2% at the end of 2006 owing to currency conversions in favour of the US dollar in the second half of 2006 marked by the summer hostilities and political tensions.[19] The dollarisation rate of loans stood at 81.6%, slightly lower than 82.4% in 2005. A record increase of 6% in loans to the private sector was observed compared to 1.9% in 2005 (or an average of 2.6% over the last five years). Banks' assets reached USD 76.2 billion in 2006 or 337% of GDP, one of the highest ratios according to international standards. Their exposure to sovereign debt represented 53.5% of total assets compared to 55.1% in 2005. The gradual unwinding of this exposure is likely to require both consolidation within the banking sector and a strategic shift by the stronger banks towards private-sector lending.

Capital markets seem to be unaffected by short-term instabilities, which are counterbalanced by the country's favourable medium- to long-term outlook (exceptional performance of the Lebanese stock market in 2005) and high regional liquidity. However, total capitalisation remains small (20% of GDP) even by regional standards.[20]

Inflation increased to 5.6% (CPI period average) from -0.7% in 2005. The rise in prices reflects not only the impact of the military conflict and the blockade but the effect of the sharp drop in the US dollar against the euro in a situation where more than 50% of Lebanon's food imports come from Europe. Inflation is expected to decrease slightly in 2007.

External sector developments

The balance of payments surplus reached USD 2.8 billion by end 2006 (12.4% of GDP) despite the political situation in the country and compared to a surplus of USD 747 million end 2005. It is the second highest peak historically with the highest level reached in 2003 (USD 3 billion) when the Paris II funds came in. The surplus is attributed to reconstruction aid, a deposit of USD 1.5 billion by Saudi Arabia and Kuwait and high net foreign direct investment.

In 2006, the total volume of merchandise imports and exports rose by 4.1% relative to 2005, while the trade deficit declined by 4.6% from USD 7.5 billion to USD 7.2 billion (32% of GDP). It is expected to widen, however, on the back of imported inputs for reconstruction. Despite the war and the blockade, exports progressed by 21%. However, this increase reflects mainly a jump in speculative jewellery exports to Switzerland and a rise in prices of precious metals (exports of gold increased by 80%). Imports

[18] The record high growth in banking activity registered during the first half of the year, along with the progression in the total balance sheet directly following the summer hostilities, more than offset the temporary cutback in July and August. The 2006 yearly growth rate is very close to the 9.4% average growth recorded over the previous five years. Commercial banks' assets increased by 8.3% in 2006 to USD 76.2 billion compared to a growth of 3.7% in 2005. The combined profits of all banks increased by more than 28% compared to 2005. Some deposits were withdrawn from Lebanese banks during the summer 2006 war with Israel, but the money was re-deposited again after the war.

[19] The dollarisation rate reached a peak of 76% during the hostilities, albeit far below the high of 80% in the post-Hariri assassination period.

[20] Solidere, the real estate holding company which owns much of Beirut's central district, accounts for over 60% of total capitalisation, and banks for most of the rest.

increased by a marginal 0.6%. If gold exports and imports were excluded, the trade balance would increase by 2.3% compared to 2005.

Remittances flowing into Lebanon from the 9 million Lebanese living abroad, represented USD 5.6 billion in 2006 (25% of GDP). On the other hand, foreign workers sent out USD 4.2 billion (19% of GDP), resulting in net inflows of USD 1.4 billion (6% of GDP).

2. Trade liberalisation and economic opening

Lebanon is one of the most open economies in the Arab world according to the 2006 "*Economic Freedom of the Arab World Report*" by the Fraser Institute. Following ratification by all the countries concerned, the Association Agreement with the EU entered into force on 1 April 2006, replacing the Interim Agreement, which covered only trade issues and had been in place since March 2003. The ENP Action Plan (AP) with the EU, the negotiation of which was launched in April 2006, was adopted on 19 January 2007. The economic chapter of the AP emphasises Lebanon's macroeconomic stabilisation programme to put the fiscal position on a sustainable footing while reducing the debt burden and improving public finance management. With regard to structural reforms, the measures included in the AP correspond to the national reform objectives to improve business conditions so as to enhance growth, boost investment and create jobs. High priority is attached to implementing of the privatisation programme and improving the transparency of the process. The AP also draws attention to the necessary accompanying measures to address the social consequences of economic reforms.

Lebanon and the US signed in 2006 a bilateral agreement to increase trade and investment (Trade and Investment Framework Agreement – TIFA) seen as a prelude to a bilateral free-trade agreement and a stalled bid to make progress towards WTO membership. Currently holding observer status, its full membership is expected by the end of 2007.

3. Business climate

Privatisation, enterprise restructuring and business environment

The government intends to re-launch the privatisation programme with the dual aim of raising funds for debt reduction and improving the efficiency and quality of services in key sectors.[21] The privatisation efforts have stalled for couple of years, however, as a result of numerous political deadlocks, which existed already prior to the war. It is only recently that some measures have started to move forward with the appointment of the Secretary General for the Higher Council for Privatization. Two mobile licenses were prepared for tendering with the help of two investment banks. The Telecommunication Regulatory Authority (TRA) was established in February 2007 in line with the Telecom Law of July 2002, to regulate and liberalise the domestic telecommunication sector. The remaining obstacle to proceeding with the awaited privatisation of the cellular telecom network is the blocked approval of legislation in parliament, which is necessary for steering the tendering process.

[21] The stakes are distributed across the following sectors and industries: telecommunications, power production and distribution by the national company Electricité du Liban (EDL), management of national ports at Beirut and Tripoli, several refineries, Régie du Tabac, regional water authorities.

Box 2 - "Lebanon: Recovery, Reconstruction, Reform" or the Paris III programme of reforms

The Lebanese government adopted on 4 January 2007 a programme of reforms. The programme, which simultaneously embraces fiscal, structural and social measures, is based on six pillars:
(i) a growth-enhancing reform agenda encompassing a large number of steps that would improve the business climate and the competitiveness of the economy;
(ii) a social sector reform agenda to improve social indicators and strengthen (develop) social safety nets; a pension reform is also envisaged;
(iii) a strong, but back-loaded, fiscal adjustment to increase the primary surplus;
(iv) a privatisation programme directed at increasing investment, reducing the stock of public debt and spurring economic growth;
(v) prudent monetary and exchange rate policies to maintain price stability;
(vi) international financial assistance to complement the domestic efforts and help Lebanon finance the direct and indirect costs of the war.

This ambitious medium-term programme aims to increase Lebanon's growth potential and reduce the debt stock to a sustainable level. It addresses short-term threats to stability and long-term structural challenges. The authorities plan the fiscal adjustment to begin in 2008 with increases in gasoline excise taxes, the VAT rate and the tax on interest income. In addition, the government plans to introduce a global income tax that will distribute the adjustment effort more evenly. On the expenditure side, the government intends to contain the wage bill and reform the social and energy sectors to limit open-ended transfers from the budget while protecting capital and social expenditures. Privatisation of the telecom sector will also contribute to debt reduction. The comprehensiveness of the programme is necessary to allow synergies to develop between its different pillars and help ensure its success.

The programme targets a very ambitious fiscal adjustment over five years. Based on the government's "Recovery, Reconstruction, Reform" programme, the medium-term macroeconomic framework presented in the EPCA document forecasts an increase in the primary balance (including immediate recovery grants) from 1.7% of GDP in 2006 to 5.5% of GDP in 2012 under the assumption of average 3-5% real growth rates over the period. Under this scenario, the gross debt-to-GDP ratio would fall from 179% to 128% over the next five years (15-20% of this reduction would be achieved thanks to privatisation receipts).

Political instability, a lack of national consensus on the necessary reforms and a weak track record in the implementation of reform plans are the main downside risks underlying the programme. The main fiscal elements of the reform agenda – privatisation and tax reform – cannot possibly be introduced in the current political situation.

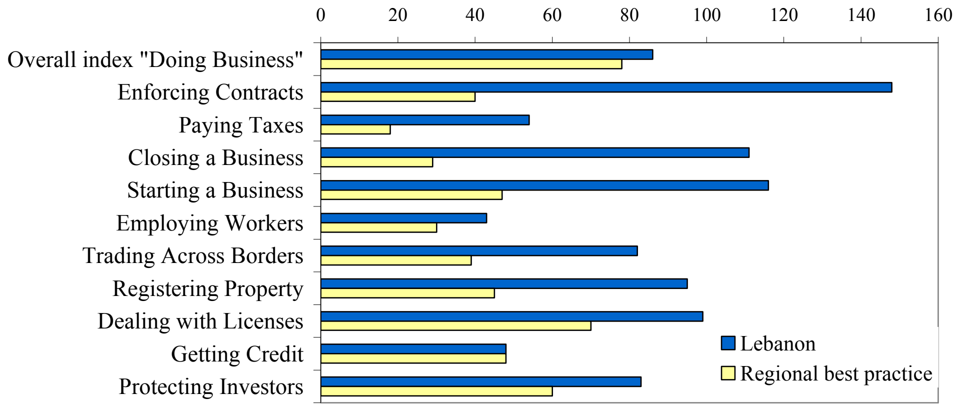
On 25 January 2007 in Paris, at the International Donors' Conference on Support for Lebanon (Paris III), the international community endorsed the programme and pledged USD 7.6 billion divided into four major types of assistance: "government support" estimated at USD 5.1 billion, "private sector support" at USD 1.5 billion, "projects underway" at USD 870 million and "funds currently being discussed" at USD 82 million. Rewards from Paris III are conditional upon progress in the reforms promised by the government.

Both the ENP EU-Lebanon Action plan, adopted on 19 January, and the IMF EPCA programme approved on 9 April 2007, provide an anchor for the implementation of reforms. The commitments made by the Lebanese authorities under EPCA are: to strengthen public finance management with a view to keeping expenditures in line with budget priorities, and to initiate reforms in the social security system and the energy sector in cooperation with the WB in order to reduce budgetary transfers.

The government has embarked on a series of structural reforms, which include growth, public finance and debt management and financial and capital market reform measures. The growth-enhancing reforms have covered competition regulation, consumer protection, SME support, intellectual property rights and trade facilitation. The restructuring of the power sector remains among the biggest reform challenges. Both technical and governance issues need to be addressed.[22]

In the "Doing business" rankings for 2006, Lebanon ranked 3rd among the Arab MED countries in terms of ease of doing business. While ranking among the regional leaders in terms of getting credit, flexibility on the labour markets, and protecting investors, it lagged behind when closing a business and enforcing contracts were concerned. According to an enterprise survey by the International Finance Corporation on the investment climate,[23] the chief obstacles faced by the surveyed firms in Lebanon were the cost of financing and corruption, followed by electricity and tax rates, tax administration, the legal system, economic/regulatory policy uncertainty and informality. These perceptions were confirmed by various indices assessing economic freedom (e.g. Fraser Institute and Heritage Foundation), which point at the need to improve the rule of law, particularly when contract enforcement and property rights are concerned.

Chart 1: Lebanon - "Doing business" rankings



The ease of doing business index ranks economies from 1 (best) to 175. The regional best practice refers to the best ranking Arab country among the Mediterranean ENP countries.

Source: World Bank, 2007.

The private sector in trade, industry and tourism was heavily affected by the military conflict, the blockade and the political instability which followed. Physical damages to infrastructure increased transaction costs in the economy and hampered economic activity while disrupting supply chains,

[22] Yearly transfers from the budget to EdL of up to 3.5% of GDP reflect a combination of various factors, among which: (i) unpaid electricity use (5% of the 32% unpaid bills are of a technical nature due to problems related to equipment and 27% are non-technical losses (theft or subscribers who are actually not billed at all – South and Bekaa Valley); (ii) a relatively low unit price per kWh, which is not indexed to international fuel prices, meaning that when prices rise, as they have in recent years, EdL ends up supplying electricity at below cost; (iii) limited production capacity, which does not meet rising demand; (iv) management deficiencies; and (v) energy generation, which is far below the installed capacity.

[23] The IFC survey is conducted in 94 countries and covers over 90,000 firms. In Lebanon, 354 firms were surveyed and the top ten investment constraints faced by those firms were identified.

production sites and distorting trade. Loss of confidence increased the costs of the war.[24] As a result, many firms are considering fleeing the country and exporting their production capacities to Gulf and other countries in the region. Agriculture is another sector that was most heavily affected by the July war.[25] A series of emergency loans was launched by the government, for example in the tourism sector, to temporarily reduce the reconstruction burden. The international donor community's response took the form of pledged soft loans earmarked for Lebanese SMEs (as much as 20% of the total pledges made during the Paris III conference).

Financial sector reforms

Under the financial and capital market reform, the government enacted a modern Securitisation Law and a Fund Management Law. Discussions on other reform measures with the relevant parliamentary committees pending their ratification have been halted due to the political stalemate. War contributed to pushing back several initial public offerings (IPOs) that were planned on the Beirut Stock Exchange.
Lebanon remains committed to implementing Basle II in 2006 and 2007 to ensure better transparency in the banking sector: reducing the risks by commercial banks through a series of measures such as increasing the paid-up capital and investing more money in training of staff to handle operational risks.[26]

Labour market reforms

It remains difficult to monitor labour markets rigorously in the absence of up-to-date economic statistics on households' living conditions, wages and unemployment. Increased labour costs in some sectors are expected after a new work permit obligation was introduced in 2005 for Syrian workers in Lebanon.

4. Public institutions and public finance management

Despite relatively high average rankings, the weak institutional environment in Lebanon, marked by overlapping powers and responsibilities, clientelism and limited accountability and transparency, hampers the implementation of economic and social reforms.

The political crisis is the major source of instability, but low wages, the lack of a clear motivation system, corruption,[27] and emigration to booming Gulf countries of employees trained by the ministries are quoted as inherent problems of the Lebanese public institutions. In addition, one of the main features of the Lebanese administration is the presence of an army of civil servants on the payroll of international organisations, which creates a double standard of services to society and in the long run weakens the country's public institutions. Frustration in the civil service is growing in a situation where up to one third of middle and senior management posts are vacant in some ministries, not to mention that six ministries have remained without political leadership since autumn 2006.

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[24] A figure of USD 200 million (incl. USD 60 million of physical destruction) has been reported by the Lebanese Chamber of Commerce and the Association of Lebanese Industrialists. Lebanon's dairy, cement, glass and prefab housing factories have been the most hit. Reported losses in the tourism sector vary between USD 1 and USD 3 billion.

[25] Southern Lebanon relies heavily on agriculture, with 45% of the working population employed in the sector.

[26] Not all Lebanese banks may be able to meet the tough conditions, which require additional investment and higher capital, as well as developing internal banking supervision.

[27] According to the annual Corruption Perception Index compiled by Transparency International, which defines corruption as the abuse of public office for private gain and focuses on corruption in the public sector, Lebanon's position improved worldwide in 2006 compared to 2005, but deteriorated in the MENA region.

The public finance institutions also suffer from significant weaknesses. According to the main findings of the 2005 World Bank Country Financial Accountability Assessment (CFAA), the budget does not cover all central government activities. Many financial activities are not transparent to the government itself. There is a dual budget system in operation. The first budget is the regular one prepared by the Ministry of Finance (MoF) and approved by parliament; it covers central government spending, executed by budget line entities. The second budget is the Foreign Financed Investments budget, prepared by the Council for Development and Reconstruction and approved by the government. The CFAA recognised that major efforts had been made by the MoF since 2001 in increasing transparency, namely by disclosing all public finance, debt and trade information. The government intends to move over time from GFS-1986 standards to a GFS-2001-compliant framework, which could also support a move (over five to ten years) to performance-based budgeting, and a phased migration from the current modified cash-based accounting system to a full accrual basis, as recommended by the IMF. Establishing and implementing modernised internal control systems remains a major challenge for the government.

A number of reforms in the tax administration are under way. A general plan to reform the tax system was formulated, the major objective of which is to implement a general income tax. The Large Taxpayer's Office was established. The government facilitated tax filing by mail and settlement through commercial banks. An Organic Budget Law is being prepared to streamline and broaden the coverage of the budget process: planning, implementation, accounting and classification, and audit and control. In addition, the government submitted more than fifty draft laws to parliament, including the Capital Market Reform Law, Tax Procedure Code, Treasury Single Account Law and Debt Management Office Law.

Efforts aiming at improving debt management are on-going. A draft law to establish a debt management office at the Ministry of Finance was reviewed by parliamentary committees in 2006. The debt office would assume responsibility for the operational aspect of the debt in both local and foreign currency. In addition, the government is working towards developing a formal debt management strategy and improving cash management. In parallel, the government is also looking into the issue of strengthening the domestic debt market and introducing a primary dealers system that would enhance liquidity in the secondary market. The draft law recommends the creation of a "Higher Council for Debt Management" under the chairmanship of the Minister of Finance and comprising representatives of BdL and of various departments dealing with debt issues at the Ministry of Finance.

5. Social development and poverty

More attention needs to be addressed to tackling the deteriorating social situation. The lack of reliable statistics on the social situation and poverty hampers the effectiveness of policy making and analysis. The differences in development between Lebanese regions remain considerable.[28] Poverty is concentrated in city suburbs and remote rural areas.

Social security, which is a two-tier system (separate schemes for civil servants and the military on the one hand, and the private sector on the other), is a source of high costs and implicit liabilities for the budget, and restricts labour mobility. In addition, only 26% of the labour force are covered by a pension scheme (including the 6% of the labour force made up of civil servants and military personnel), which is below the regional average of 30%. Informal networks and NGOs continue to be the sole complements to the existing insufficient and badly targeted state welfare schemes. Discussions on social security reform and

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

the establishment of an efficient and properly targeted social safety net are ongoing in the context of the implementation of the government programme of socio-economic reforms. The government plans to reform the National Social Security Fund (NSSF), which is facing a budgetary crisis. The government owes the NSSF up to USD 680 million in outstanding dues dating to 2001 if 2006 accounts are included.[29]

The 2004 National Survey of Household Living Conditions, released in November 2006, provides several insights into the workforce, including a comparison among gender and between regions and sectors. Nationwide, it claims, unemployment represents 8% of the labour force. Nearly half of the unemployed are from Mount Lebanon. Half of the employed work in the service sector, a quarter is involved in trade, 9% in construction and 8% in agriculture. Only 20% of women are "economically active" compared to 69% of men. Beirut has the highest rate of economic activity in the country, with an employment rate of 56.4%. In the Bekaa, only 40% of the population is economically active.

[29] The NSSF was established in 1963. It provides employees with insurance cover for sickness and maternity care. It also covers family allowance, end-of-service pensions, and work-related accidents and diseases. Any employee from any sector is eligible to enrol in the programme. According to the law, the NSSF covers the hospitalisation fees of all employees and their families under the state-run healthcare plan. Since the NSSF subscription fees were reduced in 2001 (from 37% to close to 25%), the fund has apparently failed to keep up with costs. The number of beneficiaries is not clear, with the NSSF claiming that 1.5 million people benefit from the services of the fund, while the Finance Ministry puts the number at a maximum of 800,000.

LEBANON

Main economic indicators

	2003	2004	2005	2006 prel.	2007 proj.
Real sector					
Real GDP growth (% change)	4.1	7.4	1.0	0.0	2.0
Inflation (average)	1.3	1.7	-0.7	5.6	4.0
GDP nominal (USD, billion)	19.8	21.4	21.4	22.6	23.5
GDP per-capita (USD)	5657	6114	6114	6457	6715
Social indicators					
Unemployment (officially registered, %)	n.a.	n.a.	n.a.	n.a.	
Life expectancy (years)	71				
Under 5 mortality rate (per 1000 children)	31				
Urban population	n.a.	n.a.	n.a.	n.a.	
Fiscal sector					
Total revenues (incl. grants, % GDP)	22.1	23.2	22.9	24.9	26.7
Total expenditure (% GDP)	35.4	31.9	31.4	36.0	39.1
Central government balance (% GDP)	-13.3	-8.7	-8.5	-11.2	-12.4
Gross public debt (% GDP)	169	168	180	179	176
Monetary sector					
Private sector credit (% change)	0.3	5.2	1.9	6.0	5.0
Private sector credit (% total credit)	54.3	49.9	47.2		
Broad money (M5[1], % change)	15.5	12.3	3.5	6.4	3.5
Degree of monetisation (M5/GDP, %)	255.8	266.1	274.6	276.8	274.1
External sector					
Current account balance (% GDP)	-13.3	-15.8	-11.7	-6.8	-11.0
(Merchandise) trade balance (% GDP)	-24.2	-30.2	-28.6	-25.4	-29.2
FDI (net, % GDP)	8.7	10.9	12.3	12.0	7.6
Import cover of reserves (months)	8.1	7.7	7.3	7.6	6.7
External vulnerability					
External public debt (% GDP)	79.0	86.0	89.0	90.0	89.0
Debt service ratio[2]	19.1	21.2	28.5	13.5	11.1
Gross reserves (excl. gold, USD billion)	10.3	9.6	9.6	11.3	10.4
Financial sector					
2-year L£ T-bill rate (average, %)	8.0	7.9	8.5	8.7	8.2
Exchange rate (dinar per USD, average)	1508	1508	1508	1508	1508
Exchange rate (dinar per EUR, average)	1701	1872	1875		
Real effective exchange rate (% change)	-10.7	-6.8	-4.1	2.2	

Sources: IMF, EBRD, WB.

[1] Defined as cash in circulation plus resident and non-resident deposits (or M3 + non-resident deposits).

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

MOLDOVA

- **In 2006 Moldova faced strong external shocks that resulted in a slowdown in growth. While industrial production contracted, as domestic demand, fuelled by remittances, remained strong, growth in the non-tradables sectors (e.g. construction) compensated for the drop in the industrial output and allowed GDP to grow by 4%. Both household consumption and investments increased.**

- **Trade and current account deficits widened, reflecting buoyant domestic demand, high energy prices and lower exports of food and beverages. The balance-of-payments deficit was financed by the official assistance and Paris Club debt rescheduling.**

- **Declining incomes in rural areas led to a substantial reduction of the agricultural workforce and continued fuelling migration. The Government's poverty reduction policies need to be strengthened to reverse this trend.**

- **Despite recent progress in structural reforms, the quality of Moldova's governance and market institutions is poor and the business climate is not conducive to attracting large investments. Improving the governance and the business regulations remains a key challenge for the government's policy agenda.**

1. Macroeconomic developments

Real sector developments

In 2006 Moldova's economy slowed down to no more than 4%, after five years of real GDP growth averaging 7% per annum (7.5% in 2005). This weakening of growth was the result of external shocks faced by Moldova in 2006: doubling of the price of natural gas imports from Russia and closing down of the Russian market for Moldova’s exports of wine and a number of other agricultural or food products. In view of the magnitude of the shocks, especially of the wine ban, there were fears of recession. Indeed, industrial production contracted in 2006 by almost 7% (it had *increased* by 6.4% in 2005), reflecting the contraction of the output in the food sector and sectors directly dependent on the food industry (e.g. glass and packaging). However, the decrease in industrial and agricultural production (agricultural output was reduced by 4.4% due to poor weather conditions) was more than offset by double-digit growth in the sectors producing non-tradable services such as construction, transport and telecom services. Thus, 2006 marks a further shift from tradables to non-tradables in the composition of growth in Moldova.

The performance of the construction and services sectors reflects the strength of household demand – for both consumption and residential investment – fuelled by the rising real income of the population and the increasing flow of remittances by Moldovans working abroad. Despite a substantial increase in utilities tariffs resulting from the rise of the gas import price, private consumption grew by about 7% (8.5% in 2005). Construction works increased by nearly 20%, a large part of which are residential investment. Altogether gross capital formation exceeded 21% of GDP, which is over 5 percentage points more than the corresponding figure in 2004.

Fiscal developments

In 2005, Moldova registered a fiscal surplus of 1.5% of GDP. For 2006, the PRGF programme allowed for substantial fiscal expansion, which was to translate in a moderate general government deficit of about 0.5% of GDP. In the course of the year, the policy makers feared that the fiscal impact of the external shocks would derail the fiscal programme of the government. However, the additional spending related to the need to cushion the effects of increases in utilities tariffs resulting from the gas prices could be contained and the revenue shortfall due to the wine ban was more than compensated by increasing revenue in other sectors of the economy (e.g. VAT on ever increasing imports). As a result, the State budget posted a small surplus, and the general government deficit was limited to around 0.3% of GDP.

The 2007 general government budget foresees broadly the same level of fiscal deficit in GDP terms as in 2006. One of the most difficult issues for fiscal management in 2007 will be the social expenditure in response to the increases in utilities tariffs. The government's policy since early 2006 has been to pass the increases in gas import prices through to the domestic tariffs. Domestic gas and electricity prices were already increased in 2006. In early 2007, it was the turn of the prices for heating. The government recognises that the existing income support scheme compensating for utility tariff increases needs to be reformed in order to improve its currently very low targeting efficiency. The European Commission is assisting the government in the preparation of this reform. In view of the local elections in early June, the government is also facing pressure to increase public wages, which are particularly low in Moldova.

Monetary and exchange rate developments

The gas price shock created inflationary expectations already in the very beginning of 2006. Later, with the Russian ban on Moldova's food exports, the National Bank of Moldova (NBM) was put under strong pressure to provide liquidity to a large number of food processing enterprises. The resulting monetary expansion led to a surge in inflation – to 14.5% by November 2006, against 10% in 2005 – and to a downward pressure on the exchange rate. The NBM, through its interventions on the foreign exchange market, limited the nominal depreciation of the leu against the USD to less than 4%, but fell substantially short of its target of reserve accumulation set in the agreement with the International Monetary Fund under the PRGF (Poverty Reduction and Growth Facility) approved in May 2006. Towards the end of the year, as a result of a new tightening of monetary policy – in particular, of the switch to positive interest rates on NBM instruments – and because of a surge in remittances (beyond expectations), the nominal exchange rate recovered to its level of the beginning of 2006. In addition, international reserves increased to 2.8 months of imports (close to the target of the PRGF programme) and inflation was reduced to 14.1%. Inflation continued to slow down in 2007: in the first quarter of the current year, the 12-month inflation was cut to 11.2%.

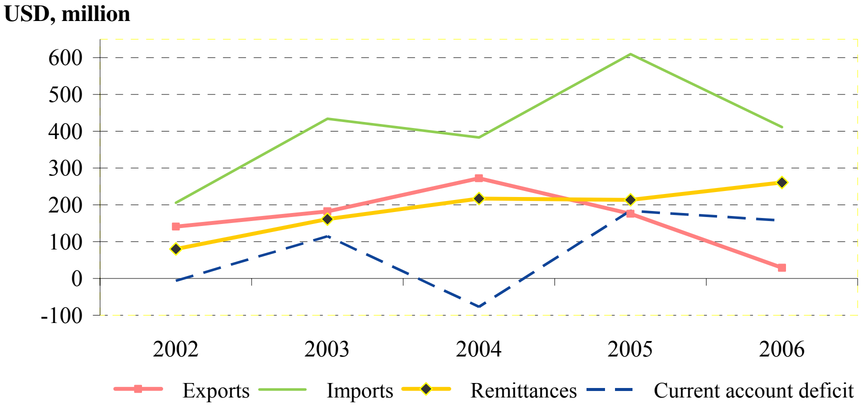
Since late last year, price stability has become by law the key objective of the NBM. The Bank aims to limit inflation in 2007 to 10%, while maintaining the floating exchange rate regime and continuing to build up reserves to approach the target of three months of import coverage.

External sector developments

Moldova's imports continued to grow in 2006, although at a slower pace than in 2005. According to preliminary estimates, imports in USD terms increased by some 15% (29% in 2005) or by USD 400 million. The import surge reflects the increase by one-third (or by nearly USD 200 million) in the value of the energy imports and sustained domestic demand. At the same time, exports remained essentially stable. In the first three quarters of the year, exports of alcoholic beverages (about one-third of Moldova's exports in 2005) were cut by half. As a result, the trade deficit (in goods and services) surged to nearly 49% of GDP, up from 41% in 2005.

As in the previous years, the bulk of the trade deficit was compensated for by workers' remittances. Remittances (remittances proper and 'compensations of employees') grew in 2006 by about 28%, to an estimated 35% of GDP (from 30.6% in 2005). However, in USD terms, they increased far less than the trade deficit. The result was a substantial widening of the current account deficit, to USD 400 million or over 12% of GDP. This is substantially more than the already high current account deficit of 8% of GDP in 2005 (USD 240 million), and more than double the deficit projected at the time of the approval of the PRGF programme (5.4% of GDP).

Chart 1 - Moldova: Changes in exports, imports, remittances and current account deficit



Source: National Bank of Moldova.

FDI increased by about 10% in nominal USD terms and reached some USD 223 million in 2006. In terms of GDP, FDI in 2006 was the same as in 2005 (6.6%). In 2006, Moldova's balance of payments needs included, in addition to the needs to finance the current account and build up international reserves, a substantial amount for clearance of arrears on Moldova's debt to official bilateral creditors (about USD 60 million). As anticipated, the financing was principally provided by the IMF and by the official creditors through the bilateral rescheduling agreements that followed the May 2006 Paris Club debt deal (all the bilateral agreement were concluded before the end of 2006).

The Paris Club deal did not provide for any debt cancellation. Yet, Moldova continued the gradual reduction of its external indebtedness through regular principal repayments, not matched by new disbursements. So, in 2006, Moldova fully repaid the loan provided by the EU under the macro-financial assistance programme in the 1990s. At the same time, part of the interest arrears owed to the

Paris Club was capitalised and thus was added to the stock of Moldova's official debt. Reflecting the capitalisation of part of the Paris Club arrears and new IMF disbursements, Moldova's public and publicly guaranteed debt increased in 2006 by some USD 100 million, and represents now about 27% of GDP. The non-publicly guaranteed external debt is substantially higher – about USD 1.6 billion. Total debt servicing was reduced from 20% of exports in 2005 to less than 15% in 2006.

For 2007, the worst-case scenario of a new big increase in gas import prices can be ruled out – Moldova concluded an agreement with *Gazprom* under which gas imports in 2007 will be priced USD 170 per thousand cubic meters, only marginally higher than their level in the second half of 2006. At the same time, as Russia is gradually lifting its restrictions on Moldova's products, exports are expected to recover somewhat. However, imports are also likely to increase further, in line with the increasing domestic demand (incomes are set to continue their growth and the flow of remittances is not expected to dry up). The size of Moldova's current account deficit will depend ultimately on the policy mix put in place by the authorities and on external financing. In December 2006, the donor community pledged over USD 1.2 billion financial support to Moldova over the next three years. Part of this is short-term balance-of-payments financing designed to cover Moldova's external financing needs. It is in this context that the EU will provide grant macro-financial assistance amounting to EUR 45 million in 2007-2008.

2. Trade liberalisation and economic opening

Moldova was one of the first former Soviet Republics to join the World Trade Organisation – it is a WTO member since July 2001. In general, Moldova has a fairly liberal trade regime, but there are still informal restrictions on exports of some key commodities. In 2006, one such restriction – the obligation of wheat exporters to pass through the Commodity exchange – was abolished. At the same time, inefficient and costly border procedures are, despite an improvement in the recent past, a significant impediment to trade.

Since the approval of the EU-Moldova ENP Action Plan, Moldova's authorities are seeking to obtain autonomous trade preferences from the EU. To qualify for these additional trade preferences, the authorities have passed reforms to improve the control of the rules of origin. Growth of Moldova's exports to the EU is also conditional to progress in compliance with EU product regulations and conformity assessment procedures. The work on rules of origin and quality control is among the key directions of the government's export promotion policy in 2007.

3. Business climate

Privatisation, enterprise restructuring and business environment

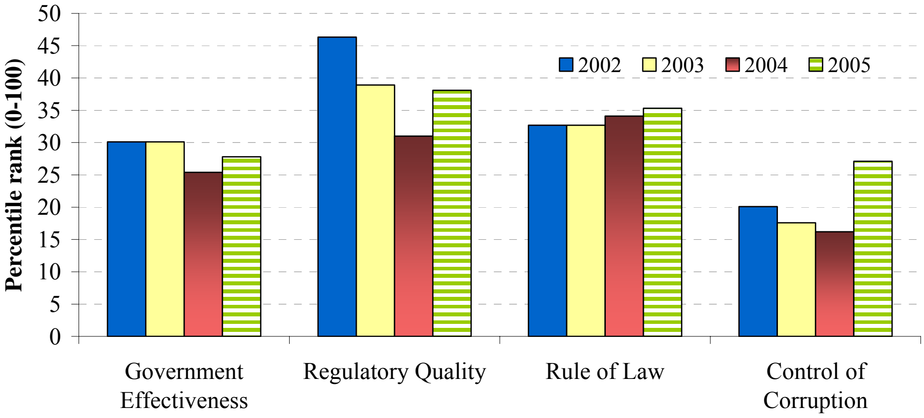
The government's economic strategy foresees several specific measures in the area of corporate governance, regulation and enterprise restructuring and privatisation. Several of these measures have already been or are being implemented. A new strategy to strengthen bankruptcy procedures is being prepared. Draft legislation on management of state property and privatisation – intended to support the new stage of the privatisation process, after the completion of the previous privatisation strategy in 2006 – is expected to be submitted to the Parliament in early 2007. The government also changed the rules regarding debt cancellation for enterprises: the Credit Council was abolished and the State Tax

Inspection was given the responsibility for monitoring tax debts. Also, in February 2007, the government established an independent agency for competition protection (this was foreseen in the EU-Moldova ENP Action Plan).

The implementation of the National Strategy of Regulatory Reform also progressed in 2006. After the completion of the comprehensive review of more than 1,000 business regulations that resulted in a substantial streamlining of licensing and business registration procedures (the first stage of the so-called “guillotine approach”), the Parliament adopted in July 2006 a law on the basic principles of regulation of entrepreneurial activity. Under this law, all regulatory authorities are required to conduct regulatory impact assessment of all existing laws and regulations.

The recent progress in governance and business regulation is already reflected in the World Bank governance indicators (chart 2). Yet, this progress is still fairly modest and it is being achieved from a very low point – due to the persistence of significant barriers related to regulation, arbitrary tax administration and heavy state interference, the business environment in Moldova is perceived as one of the worst in the region.

Chart 2 - Moldova: Governance indicators

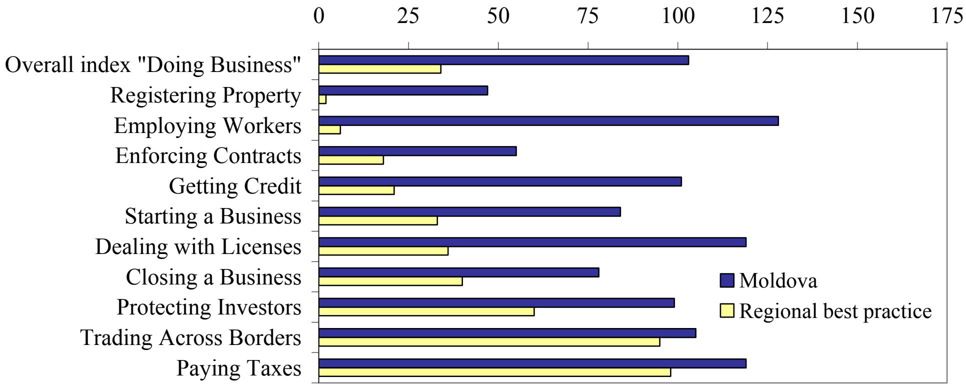


Percentile ranks indicate the percentage of countries worldwide rating below the selected country. Higher ranks represent improvement.

Source: World Bank Governance indicators, 2007.

The "Doing Business" survey conducted in 2006 confirms that Moldova lags significantly behind the best performer in the region, as is indicated on Chart 2 which compares various aspects of the business environment in Moldova (ranked 103rd out of 175 countries) with the best performer in the CIS, ranked 34th. The government itself recognises that Moldova has one of the highest regulatory compliance costs among the countries of the region.

Chart 3 - Moldova: "Doing business" rankings



The ease of doing business index ranks economies from 1 (best) to 175. The regional best practice refers to the best ranking country in the eastern neighbourhood region.

Source: World Bank, 2007.

Financial sector reforms

The weaknesses of Moldova's banking sector, identified in the Financial Sector Stability Assessment (FSAP) completed by the IMF and the World Bank in 2005, were highlighted in the second quarter of 2006 when the liquidity shortages of the food processing sector led to rumours of a possible banking crisis. There was no crisis, but since then policy makers in Moldova have been more aware of the need to strengthen domestic banks and to open up the sector to competition, including from reputable foreign banks. In 2006 and early 2007, two Moldovan banks, including one in the top five of the sector, were sold to foreign banks. One more Western European bank operates in Moldova through its Romanian subsidiary and another one has opened a representative office and is considering either an acquisition or a greenfield investment.

Yet, the most decisive step in the restructuring of the banking sector will be made after the sale to a strategic banking investor of a majority stake in Moldova's Savings Bank, the country's largest retail bank, currently controlled by the state. To prepare the sale, the government intends to complete the valuation of the bank before the end of 2007.

The financial turbulences in 2006 did not stop the credit expansion (credits to the economy increased by nearly 38%, up from 35% in 2005, and exceeded 31% as share of GDP, against 26.5% the year before) but translated into a slowdown of the monetization of the economy and in the reversal of the process of its de-dollarisation. So, the M2-to-GDP ratio was cut from 29.5 to 28.3%, and the M3-to-GDP ratio that had progressed by 5.4 percentage points in 2005 this time progressed by only 2.4 points (to 44.4%), and this, only due to a strong increase in foreign currency deposits. The part of foreign currency deposits in the total of the deposits increased to nearly 50% from less than 42% in 2005.

Concerning the non-bank financial sector, a law was adopted in March 2007 on the creation of an independent supervisory body – the National Commission on the Financial Market (NCFM). The NCFM will in principle be operational in June 2007. It will be financially and operationally independent; and when it starts operating at full capacity, it will have the right to issue and withdraw licenses for all the non-bank financial institutions. The new supervisory authority is expected to remedy a number of weaknesses in the supervision of the sector that were identified by the previous FSAP, for example, in the insurance industry.

Labour market reforms

The rigidity of Moldova's labour market is seen as one of the major obstacles to economic growth. So, while Moldova ranks 103rd (out of 175 rated countries) in the overall ranking in the World Bank's "Doing Business" survey, it is only 128th in the labour regulations ranking, the worst placed of all the Eastern ENP countries. The rigidity of the labour market is also reflected in low activity levels. According to official statistics, less than 38% of population was economically active in 2006, a decrease of 8 percentage points since 2000. Low activity in the domestic economy and massive emigration also leads to low unemployment (the number of jobless in Moldova was reduced from 7.1% of the labour force in 2005 to an estimated 5.6% in 2006) – and even to labour shortages in some sectors of the economy, such as construction.

The distribution of employment by sector is also changing, and changing fast. Agricultural employment, which still accounted for more than 50% of total employment in 2001 and 41% in 2005, decreased to less than 33% in 2006. The services sector accounted for nearly 55% of total employment, up from 47% in 2005.

4. Public institutions and public finance management

In the area of public finance management, several important results were achieved by the authorities in 2006:

- The development of the Medium-term expenditure framework (MTEF) continued, with improved coverage of government spending. The MTEF for 2007-2009 covers investment spending and public expenditures in agriculture. The MTEF for 2008-2010, currently under preparation, will also cover spending in transport and in water and sanitation. Also, the 2007 budget marked a new step in budget consolidation through integrating six extra-budgetary funds (previously covered by separate budget annexes).
- The Central Treasury made further moves towards the establishment of the Single Treasury Account (by establishing a single sub-account for the specific funds of the state budget institutions). This resulted in the improvement of the control over collection and use of the budget funds and in better cash management. Further improvements will come with the establishment of the Single Treasury Account.
- Similar changes (use of special treasury accounts) with similar results (better control over public funds and more effective cash management) were implemented for the management of the revenues of the social insurance and health insurance budgets.
- In October 2006, the government approved the new tax administration strategy, aimed in particular at strengthening the tax collection and control systems. Then in early 2007, the government established a high-level steering committee to oversee the implementation of the strategy.
- Also in October 2006, the government adopted a strategy for the development of the system of Public Financial Internal Control (PFIC). The government plans to submit new draft legislation on PIFC to the Parliament before the end of the year.

At the same time, despite an increased use of competitive procedures for the award of public procurement (PP) contracts, little progress was achieved to improve the institutional framework for PP, in particular in establishing a truly independent PP agency.

In the framework of the reform of the central public administration (launched at the end of 2005), in 2006 and early 2007 the government completed the functional review of key central public administration authorities and of the decision-making processes in the administration authorities. Based on the review's findings, the government intends to proceed in 2007 with adjustments in the task definitions and responsibilities of various public bodies. A new law on public sector remuneration was also adopted in 2006. The new law increases the basic salaries of civil servants and establishes salary grades (23 altogether). It is the first step on the way to addressing the issue of low pay in the civil service, one of the factors of corruption. Indeed, corruption remains a serious concern, although Moldova's position in Transparency International's global Corruption Perception Index improved from the 88th place in 2005 (out of 159 ranked countries) to the 79th place in 2006 (out of 163 countries). For comparison, in 2004 Moldova had only been 114th out of 146 countries. Moldova's index also improved from only 2.9 on a scale of 0 to 10 to a slightly higher level – although still very low – 3.2 in 2006.

5. Social development and poverty

Despite several years of strong growth, with a GDP per-capita of about USD 957 (estimate for 2006), Moldova remains the poorest country in Europe. The current decade has seen a sharp decrease of the poverty rate: between 1999 and 2004, it dropped from 70% of the population to 26.5%. However, in 2005, poverty rates again increased. The recent increase in poverty indicators reflects the declining incomes of populations working on farms in rural areas. The World Bank, in its "Poverty update" prepared in the first half of 2006, explains the fall in real income of Moldovan farmers by the decline in relative prices of agricultural output. This tendency has been further aggravated by the decrease in agricultural production resulting from poor weather conditions in 2005 and 2006. It is also likely that the difficulties faced by Moldova's food industry in exporting to its main food products export market (Russia) caused a further deterioration in farmers' incomes. The decline in agricultural employment, particularly visible in 2006 (see section on the labour market) is clearly a direct result of increasing rural poverty.

The decrease in inequality, rather modest, followed a pattern similar to the one in the reduction in poverty. The Gini coefficient, measuring the distribution of consumption across the population, decreased rather significantly in 2002-2003 and rose again in 2004 and 2005. Inequality in Moldova is among the highest in the region.

MOLDOVA

Main economic indicators

	2003	2004	2005	2006 prel.	2007 proj.
Real sector					
Real GDP growth (% change)	6.6	7.4	7.5	4.0	4.5
Inflation (average, %)	11.6	12.4	11.9	12.7	11.4
GDP nominal (USD, billion)	2.0	2.6	3.0	3.2	3.6
GDP per-capita (USD)	548	721	883	957	1055
Social indicators					
Unemployment (ILO-definition, %)	7.9	8.1	7.1	5.6	
Rate of activity (%)	40.8	39.7	39.5	37.5	
Poverty rate (% population)	29.0	26.5	29.0		
Inequality (Gini-index consumption/ income, %)	35.6	36.1	37.8		
Fiscal sector					
Total revenues (% GDP)	34.0	35.4	38.6	40.5	42.4
Total expenditure (% GDP)	33.3	34.6	37.0	40.8	42.9
General government balance (% GDP)	0.7	0.8	1.5	-0.3	-0.5
Gross public debt (% GDP)	61.5	45.5	36.0	35.6	
Monetary sector					
Credit to economy (% change)	44.4	22.2	35.0	37.8	13.5
Credit to the economy (% GDP)	21.9	23.1	26.5	31.2	30.6
Broad money (M2, % change)	24.4	44.7	36.7	12.2	12.0
Degree of monetisation (M2/GDP, %)	20.4	25.4	29.5	28.3	28.2
Broad money (M3, % change)	30.7	37.7	35.0	23.6	14.7
Degree of monetisation (M3/GDP, %)	30.8	36.6	42.0	44.4	46.5
Dollarisation in bank deposits (%)	50.1	44.7	41.8	49.1	
External sector					
Current account balance (% GDP)	-6.8	-2.2	-8.1	-12.3	-6.2
Trade balance (% GDP)	-33.8	-30.0	-40.6	-49.3	
Remittances (% GDP)	24.4	27.0	30.6	36.3	40.0
FDI (net, % GDP)	3.7	5.7	6.6	6.9	
International reserves (USD, million)	302	470	597	770	
External vulnerability					
External public/publicly guaranteed debt (% GDP)	50.9	33.9	25.9	27.0	
External public and private debt (% GDP)	97.7	73.0	69.6	76.6	
External debt service/exports goods and services (%)	19.8	21.3	20.2	14.5	
Reserves (% M2)	71.1	72.0	68.9	79.6	
Import cover of reserves (months)	1.9	2.3	2.4	2.8	
Financial sector					
NBM base rate (end-of-year)	14.00	14.50	12.50	14.50	
Exchange rate (lei per USD, average)	13.94	12.33	12.60	13.13	
Exchange rate (lei per EUR, average)	15.74	15.31	15.67	16.47	
Real effective exchange rate (% change)	-5.4	12.8	-1.3	-1.4	

Sources: IMF, EBRD, WB, NBM, EC staff calculations.

MOROCCO

- **The Moroccan economy has shown good resilience to rising international oil prices, as well as to the steady implementation of an ambitious programme of economic reforms. Good levels of rainfall, an exceptional harvest and the dynamic behaviour of all economic sectors have led to a rebound in real GDP growth to 8.1% in 2006.**

- **Notable progress has been made in fiscal consolidation. The public deficit, at 2.1% of GDP in 2006, has sharply contracted from the 2005 level of 5.3%. However, further action in needed to curb high food and petroleum subsidies, and contain the wage bill to increase fiscal space for priority infrastructure and social expenditures.**

- **Poverty, unemployment, illiteracy and social exclusion still remain key challenges. Growth-stimulating reforms need to be adequately complemented with social interventions aimed at improving access to basic social services for vulnerable populations**.

1. Macroeconomic developments

Real sector developments

The Moroccan economy performed extraordinarily well in 2006. A bumper crop resulting from favourable weather conditions for agriculture, a steady growth of the non-agricultural sector (+5.2% end-2006), and rising international demand (+9.1%) explain the acceleration of the real GDP growth rate at 8.1% (2005: 2.4%). The tourism, construction, and telecommunications sectors, all with growth rates above 6.5%, continue to be the main driving forces behind non–agricultural output. Rapid growth in labour-intensive sectors has brought unemployment under the bar of 10% for the first time in more than three decades (2006: 9.7%); however, urban unemployment remains high (15.5%), particularly among the young (31%), the educated (20.8%) and women (20.9%).

Fiscal policy

Morocco is the path of fiscal consolidation and a number of important budget and fiscal reforms have shown encouraging results during 2006. The overall fiscal deficit (excluding privatisation receipts) is expected to reach 2.1% of GDP in 2006, down from 5.3% in 2005. Buoyant revenue performance stemming from an overall improvement of the fiscal revenues (up by 15.7% compared with 2005) has been largely offset by continued expenditure pressures related to high oil and food subsidies (2.5% of GDP), restructuring of the two public banks, transfers to the civil servant pension fund as a result of the voluntary retirement exercise, and new wage concessions, mostly in the education and health sectors. The public debt-to-GDP ratio stood at 57.0% of GDP end-2006, showing a clear improvement from 2005 (62.7%). The authorities have adopted a gradual approach to a medium term consolidation strategy aimed at bringing the fiscal deficit to 3% of GDP and the public debt to GDP ratio to 60%.

During 2006, total revenues, excluding privatisations, amounted to MAD 147 billion or 25.3% of GDP, up from MAD 127 billion in 2005. Total expenditures in 2006 amounted to MAD 156 billion (27% of GDP), a slight increase from 2005 levels. Although the government has made efforts to curb expenditures as, for instance, by implementing the voluntary retirement programme, the sharp growth of food and petroleum subsidies continues to be a heavy toll on the budget. Subsidies increased again during 2006 in line with rising international oil prices, and are expected to have reached 2.5% of GDP by end-2006.

In 2006 the government embarked on a comprehensive fiscal reform process aimed at stabilizing the flows of fiscal revenues. A central focus was placed on indirect taxation[1], and parallel actions on income tax and custom tariffs simplification and modernisation of the fiscal administration.

Monetary and exchange rate policy

Inflation remained contained but strong economic growth and high oil prices have pushed inflation in 2006 to 3.3%, above the target of 2%. Abundant liquidity continues to be one of the main features of the Moroccan economy. Money supply (M3) grew over 17% in 2006 (2005: 14%). Monetary growth was fuelled in 2006 by worker's remittances, a substantial amount of domestic debt reimbursement, and the impact of privatisation proceeds. This has prompted a tightening in monetary policy by the Bank Al-Maghrib (BAM) which has moderately raised interest rates. The BAM has also sterilised significant amounts of money in order to keep money supply growth at manageable levels (4.8% growth since end-December 2005). In 2006, new Central Bank statutes were passed by Parliament institutionalising Bank Al-Maghrib (BAM) independence in the conduct of monetary and exchange rate policies, enshrining price stability as its core mandate, and diversifying its policy instruments to ensure a good functioning of the money market. The new statutes prohibit BAM from giving facilities to the Government and to state-owned institutions.

The Moroccan dirham is pegged to a basket of currencies which is dominated by the euro. While the current fixed peg exchange rate has so far accommodated market movements and avoided any major misalignment of the dirham, the Moroccan monetary authorities are considering a move towards a more flexible exchange rate regime by 2009.

External sector developments

Morocco's export performance improved in 2006 as the free trade agreements (FTAs) with the United States and Turkey came into effect, and tariff dismantling with the EU continued satisfactorily. Preliminary figures for 2006 show exports progressing by 11.2%, led primarily by increases in exports of 13% in clothing, 22% in fish and 12% in electronic components. However, imports also progressed by 11% in 2006 as a result of the booming economy – mainly semi-finished goods (+17.5%), and imports related to the energy bill (+12%). The trade deficit is expected to have reached 16.3% of GDP by end-2006. However, despite this trade deficit, the current account balance is running a surplus for the sixth consecutive year (end-2006: 3.9% of GDP). Workers' remittances (estimated at over USD 5 billion in 2006, or about 9% of GDP) and tourism receipts were at record highs and were the main

[1] Indirect taxation reforms include the simplification of the VAT law and procedure, the reestablishment of its economic neutrality via the reduction of exemptions and the streamlining of its rate structure.

determinants of the surplus. The reserves position reached over 9 months' worth of imports. The country's external debt was brought down to 19.7% of GDP compared with 22.2% of GDP end-2005.

Morocco is still an attractive place for foreign investors. Net FDI inflows reached USD 3 billion in 2006, roughly the same amount than in 2005, which shows the positive perception of Morocco in the eyes of foreign investors.

2. Trade liberalisation and economic opening

Morocco has an important role to play in the deepening of South-South regional integration. Its recent ratification of the Agadir agreement pursuing the establishment of an FTA between Morocco, Tunisia, Jordan and Egypt should help boost intra-regional trade. While the agreement is now fully implemented following enforcement instructions by the four customs authorities, a few aspects still require further clarification, such as the exclusion of some agricultural and processed agricultural products, and the modalities to address non-tariff barriers. The Agadir agreement allows member countries to fully benefit from the pan-Euro-Mediterranean protocol of origin established in 2006, which allows for diagonal cumulation of origin. Morocco, Algeria and Tunisia have also agreed to improve bilateral relations and economic integration amongst the Maghreb countries. Major trade and welfare gains in the region could be achieved by opening the border between Morocco and Algeria. There are also renewed efforts to revive the Maghreb Arab Union (UMA), which also includes Libya and Mauritania.

The year 2006 also opened new prospects for further trade liberalization, with Morocco among the first wave of Mediterranean countries to open negotiations with the EU on services and investment liberalization. Negotiations at regional level started on July 5, 2006 in Brussels on standard provisions for a future services and investment Protocol which will be the basis for each bilateral negotiation. During 2006, Morocco has also started negotiations with the EU towards progressive liberalisation of trade in agricultural, processed agricultural and fisheries products with a possible selected number of exceptions. The tariff dismantlement for trade in industrial goods with the EU continued on schedule in 2006 with the objective of full liberalization in 2012.

3. Business climate

Privatisation, enterprise restructuring and business environment

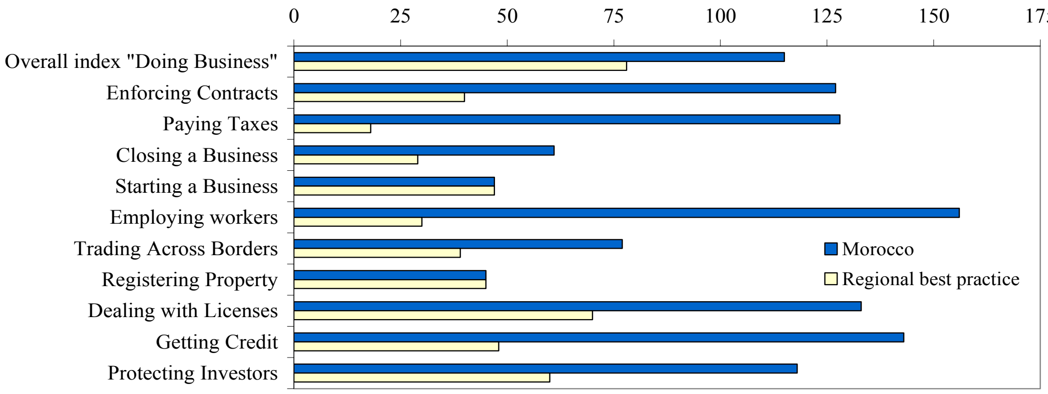
The privatisation process continued during 2006.[2] Privatisation receipts generated from the sale of SOMATHES, a small share of Maroc Telecom and the remaining 20% of Régie des Tabacs are expected to have generated MAD5 billion by end-2006 (3% of GDP). COMANAV (Compagnie Marocaine de Navigation) was privatized early 2007. Other projected privatisations for 2007 include the postal service, another share of Maroc Telecom and the *Banque Centrale Populaire*, and DRAPOR (Société Marocaine de dragage des ports), which could generate some MAD 2 billion (0.5% of GDP).

[2] In 2005, the state sold 16% of Maroc Telecom to Vivendi Universal, four state sugar companies to the Moroccan holding, ONA for MAD 1.367 billion (USD150 million) and 12% of SOMACA to Renault.

Morocco ranks 10th in a list of 17 MENA countries in the World Bank index measuring the ease of doing business in 2007.[3] It does best in ease of starting a business[4] (ranked 2nd), closing a business (5th), and registering property (6th). However, it comes last out of the 17 for employing workers, and is in 15th place for dealing with licences.[5] In spite of these modest rankings, the 2007 Doing Business report shows that Morocco was the top reformer in the MENA region in 2005-06. Progress was accomplished in three of the ten areas studied in the report: (i) reducing the minimum capital required to start a business (from 100 000 to 10 000 dirham), which has led to a sharp increase in new business starts; (ii) halving (from 5% to 2.5%) the property transfer tax, thereby easing the transfer of property; and (iii) simplifying tax rules by combining multiple tax regulations into one source, which has made compliance easier.

However, Moroccan employers continue to experience problems when hiring and firing workers. Morocco has the world's top score in the WB index measuring the difficulty of hiring. The high rigidity of employment is a factor that contributes greatly to Morocco’s high unemployment rate and may explain the significant size of its informal sector.

Chart 1- Morocco: "Doing business" rankings



The ease of doing business index ranks economies from 1 (best) to 175. The regional best practice refers to the best ranking Arab country among the Mediterranean ENP countries.

Source: World Bank, 2007.

Simplifying the legislative framework of investment, improving corporate governance and the functioning of the judicial system are also key priorities for the business environment.

Financial sector reforms

Morocco has made considerable efforts to put in place the main components of the ongoing financial sector reform. State participation is gradually decreasing in Morocco's banking system, while foreign shareholders, in particular French banks, have increased their participation in the country's banking sector. The restructuring of the two troubled state-owned banks —Crédit Immobilier et Hôtelier (CIH) and Crédit Agricole du Maroc (CAM)—is almost complete. Restructuring efforts have led to the

[3] The Doing Business 2007 Report ranks 175 economies on the ease of doing business.

[4] In Morocco, it takes 11 days to start a business compared to 106 days in the Occupied Palestinian Territory and 46 days on average in the region.

[5] Morocco has the most rigid labour market in the region and licences cost three times the average in the region.

participation in the CIH of two leading financial institutions, the Moroccan "Caisse de Dépôt et de Gestion" and the French "Caisse Nationale des Caisses d'Epargne." Restructuring has transformed the CAM into a universal bank with specialisation in the agricultural sector and improved its financial stance. CAM has benefited from two recapitalisation programmes, one from the state with MAD1 billion, and another from other major institutions. It is expected that CAM's financial situation will be in regulatory compliance during 2007.
Morocco's regulatory and supervisory framework is evolving fast. The latest regulatory developments occurred with the introduction in February 2006 of a new banking law that reinforced BAM's role granting it greater autonomy and broader supervisory and regulatory authority. However, information disclosure continues to fall short of international norms, with banks currently reporting according to local accounting standards. Enhancing banks' credit risk assessment capacity, particularly in the case of retail and SME lending, remains a challenge.

Labour market reforms

In 2006, the Moroccan national economy created some 300,000 net jobs, bringing the national unemployment rate down to 9.7% (2005: 11.1%). However, the working population keeps growing steadily (2006: +1.5%), and now stands at almost 11 million people, which makes it necessary to broaden efforts to maintain the declining trend of unemployment rates. Urban unemployment still remains very high at 15.5% in 2006 compared with rural unemployment at 3.7%, partly explained by migration flows from rural to urban areas. Yet urban unemployment in 2006 shows a significant contraction (down from 18.4% in 2005). Unemployment, especially among young people, is still a major challenge in Morocco,[6] and affects well-qualified people most, with a 19% unemployment rate among young graduates in 2006 (2005: 22.7%).

Public action has focused on measures aimed at increasing flexibility in the labour market where the private sector would play a central role as the main provider of employment. The voluntary retirement programme introduced by the government in 2005 aims to encourage public officials to move to the private sector thus mitigating pressure on the public sector. Other measures boosting the dynamism of the labour market are, for instance, the Moukawalati programme aiming the creation of 30,000 SME by 2008, the reorganisation of the Agency for Employment Promotion (ANAPEC), and efforts to effectively implement the 2004 labour code.

4. Public institutions and public finance management

Morocco signed the UN Convention against corruption in December 2003 but has not yet ratified it. A proposal of law on money laundering was adopted early 2007, and the transparency in the process of awarding government contracts was reinforced. Morocco ranks 79th (out of 163 countries) in an index measuring corruption in the public sector in 2006; its relative position has slightly improved compared with the 2005 and 2004 Corruption Perception Index.

The ongoing process of public finance management modernisation set in motion since the late 1990s has produced tangible results like the increased transparency of budget laws, the implementation of programme budgeting and the reduction of delays in the presentation of budget review acts to Parliament. The Ministry of Finance has recently established a medium-term fiscal framework and

[6] Unemployment figures do not take into account non declared unemployment in the informal sector or underemployment in several areas of the economy.

intends to promote the generalisation of medium-term expenditure framework (MTEF) practice in the public administration through the launching of sectoral MTEFs in several pilot ministries. The 2006 and 2007 Budget Laws include for the first time a study estimating the budget impact of current tax expenditures and the government has launched a project to consolidate the account of local governments, which should lead to the presentation of projected budgetary activities of local government.

5. Social development and poverty[7]

Although over the last 35 years GDP growth in Morocco has averaged an annual 3.8%, poverty is still a major challenge. Erratic, weather-dependent growth rates have been insufficient to curb high poverty rates. At present, about 15% of the population are considered poor (with income of under USD2 a day) and an additional 25% as economically vulnerable.[8] Some 19% of Moroccans live below the national poverty line. Adult illiteracy affects almost half of the population aged 15 and older (2004: 47.7%), compared to 10% for all Low Middle Income Countries; around 29% of the population have no access to electricity; almost one in five Moroccans do not have access to an improved water source (2004: 19%); almost 10% of children aged 0-5 are underweight; and more than 8% of the population are not expected to survive past the age of 40 (2004: 8.6%). These indicators explain why Morocco ranks low in the 2006 United Nations Development Programme (UNDP) Human Development Index (123rd out of 177 countries).

Poverty is pronounced in both rural and urban areas, although it is predominantly a rural phenomenon, with nearly two thirds of Morocco's poor living in rural areas. In urban areas, poverty is around 8% and is largely determined by high levels of unemployment (90% of unemployment is urban), limited economic opportunities, and poor living conditions in slum areas (which are home to 1.2 million citizens).

The government's approach to deal with poverty and exclusion has been mostly centrally-driven with little coordination among ministries and inadequate population targeting.[9] Although the Government dedicated 55% of public expenditures to social sectors in 2005 (2002: 47%), results have been below expectations. Education absorbs 6% of GDP but the quality and coverage remain weak. The Government spent 5.01% GDP on health in 2005, less than in 2004 (5.2% of GDP) and 2003 (5.1% or USD 218 per-capita),[10] which is insufficient to meet the needs of the population. The government intends to allocate a budget of MAD 6.08 billion to healthcare in 2006. Currently only 16% of the population have health insurance, and most of them live in urban areas and work for the public sector.

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[7] Human Development Indicators for Morocco can be found in the Human Development Report 2006, UNDP.

[8] Vulnerable people are those living at or below an income level 50% above the poverty line.

[9] The 2004 Morocco Poverty Report by the World Bank indicated that there had been few signs of pro-poor targeting of funding allocations of social programmes at the provincial level.

[10] Data for 2005 reveal that there is one doctor for every 1 845 Moroccans, and one basic healthcare institution for every 12 033 citizens. Currently, the country has 126 public hospitals and 2 484 basic healthcare institutions. There are 16 307 doctors in the country, 57% operating in the public sector. There are also 15 400 qualified nurses. Average life expectancy is 71, the birth rate has declined to 20.4 per thousand from 22.4 per thousand in 2000, and the mortality rate was 5.5 per thousand in 2004 compared with 6.1 per thousand in 2000.

Recent attempts by the Government to redress this situation include the launch in May 2005 of the National Human Development Initiative (INDH) aimed at closing the social gaps present in the national fabric. With a total cost of USD1.2 billion over five years (2006-2010), the program is quickly attracting international funding (a five-year loan amounting to USD100 million from the IBRD at the end of 2006 and a €60 million grant from the EU in 2007.

MOROCCO

Main economic indicators

	2003	2004	2005 prel.	2006 proj.
Real sector				
Real GDP growth (% change)	6.1	5.2	2.4	8.1
Non-agriculture real GDP growth (% change)	3.5	4.6	5.4	5.2
Inflation CPI (period average, change)	1.2	1.5	1.0	3.3
GDP nominal (USD, billion)	49.8	56.4	58.9	65.9
GDP per-capita (USD)	1656	1887	1944	2145
Unemployment rate (in %)	11.9	10.8	11.0	9.7
Fiscal sector				
Total revenues (including grants[1], MAD, billion)	103.6	113.6	127.1	147.1
Total expenditure (excl. Hassan II Fund, MAD, billion)	124.1	132.6	152.9	156.8
Central government wages and salaries (% GDP)	11.16	11.31	11.84	10.93
Central government balance (% GDP)	-4.3	-3.8	-4.0	-1.7
Central govt. balance[2] (% GDP)	-4.6	-4.0	-5.3	-2.1
Central government balance[3] (% GDP)	-3.3	-2.9	-4.0	-1.7
Total government debt (% GDP)	60.9	58.8	62.7	57.0
Monetary sector				
Broad money (M3, %)	8.7	7.8	14.0	17.1
Degree of monetisation (M3/GDP, %)	81.0	83.3	90.8	95.9
External sector				
Current account balance (% GDP)	3.6	1.9	2.3	3.9
Trade balance (% GDP)	-12.4	-15.8	-16.3	-16.3
FDI (USD, million)	2440	1689	3077	3080
Gross reserves (USD, billion)	14.0	16.5	16.2	19.6
Gross reserves (months of imports)	9.6	9.2	8.8	9.2
External vulnerability				
Total external debt (% GDP)	26.4	23.1	22.2	19.7
Debt service ratio[4]	16.5	11.6	9.3	6.8
Reserves/M3 (%)	34.6	35.1	30.3	31.0
Financial sector				
Short-term interest rate (money market, average, %)	3.22	2.39	2.78	2.58
Exchange rate (MAD per USD, average)	9.573	8.866	8.869	8.790
Exchange rate (MAD per EUR, average)	10.814	11.021	11.042	11.043

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

[1] Includes tariffs earmarked for food subsidies and revenues of the road fund.
[2] Including Hassan II Fund.
[3] Including Hassan II Fund, grants and privatisation revenues.
[4] Percentage of exports of goods, non-factor services and MRE (public and publicly guaranteed debt, excluding early amortization on account of debt swaps.

OCCUPIED PALESTINIAN TERRITORY

"We might like to think of the Arab-Israeli conflict as just one regional conflict among many. But it is not. No other conflict carries such a powerful symbolic and emotional charge among people far removed from the battlefield. As long as the Palestinians live under occupation, exposed to daily frustration and humiliation; and as long as Israelis are blown up in buses or in dance-halls: so long will passions everywhere be inflamed." Kofi Annan

- **Heavy aid flows amounting to USD 1.2 billion in 2006 (about USD 300 per-capita) have not prevented the OPT economy from crumbling (an estimated 8% real GDP contraction in 2006). Donors have circumvented the Palestinian Authority, channelling aid directly to individuals.**

- **The fiscal deficit in 2006 will approach USD 1 billion (over 21% of GDP) mainly as a result of the freezing of transfers of clearance revenues by Israel (estimated at USD 730 million), the suspension of direct budget support by major international donors and the tighter closure policy leading to declining tax revenues.**

- **Living standards have substantially deteriorated. In June 2006 2.7 million people (roughly two thirds of the population – 76% in Gaza and 59% in the West Bank) were below the income poverty line, up 50% from the end-2005 level. Over a fifth of the population (22%) are unemployed.**

- **Commitments included in the 2005 Agreement on Movement and Access have not been met. The uninterrupted construction of the separation barrier has impoverished Palestinians at an estimated rate of 2-3% of GDP per year whilst increasing numbers of internal and external closures continues to have a dramatic effect on prospects for recovery.**

1. Macroeconomic developments

Real sector developments

Economic developments in the OPT in 2006 have been mainly influenced by political events. The victory of Islamic Hamas in the January 2006 Parliamentary elections and the subsequent political diplomatic and financial isolation of the PA have resulted in a lost year for the Palestinian economy. Israel's decision to stop transferring clearance revenues, the suspension of direct budgetary support by major international donors as well as Israel’s tighter closure policy provoked the collapse of the economy in 2006.

Real GDP dropped by 8% in 2006,[11] poverty rose by 30% and the unemployment rate reached 23.6%. Real GDP per-capita has dropped 40% since 1999. Unprecedented levels of aid have somewhat cushioned the economic consequences of the PA government's isolation but prospects for recovery remain severely hampered by the political impasse resulting from the Hamas refusal to comply with the principles established by the Quartet of Middle East Peace brokers.

Fiscal policy

The worrying fiscal trends already present in the OPT economy in 2005 have escalated to unsustainable levels in 2006. The estimated budget deficit in 2006 reached USD 957 million (over 21% of GDP), up from an average budget deficit of 17.7% of GDP during 2000-05. This huge deficit reflects the fiscal consequences of the international reaction that followed the coming to power of the Islamic movement Hamas in March 2006. Israel thereafter withheld most of the USD 730 million of clearance revenues it collected in 2006 on behalf of the Palestinian Authority (PA) and tightened its closure policy; international donors suspended direct budget support and banks refused to engage in financial transactions with the PA for fear of possible legal repercussions, particularly in the US, if seen to be financing the PA government.

Resources to fund recurring government expenditure collapsed in 2006. Total domestic revenue dropped from around USD 40 million to USD 15 million per month from 2005 to 2006. As a result, public sector salaries have not been not fully paid during 2006. Crumbling domestic revenues have been compensated by large amounts of assistance mostly outside of the budget and individual allowance payments by donors to people who would otherwise be dependent on the PA or other sources for salaries or social benefits. Total aid flows amounting to USD 1.2 billion in 2006 (some USD 300 per-capita) have played a major role in sustaining the economy and helping to alleviate the consequences of falls in household incomes. This aid may have prevented a further fall in GDP of around 12%. The EU alone provided an unprecedented €692 million to the Palestinians.

The return to a more sustainable fiscal situation remains contingent on two factors: progress on the political front and government efforts to curb expenditures. Through the former, the OPT would regain access to a regular flow of fiscal revenues, including clearance revenue transfers and international donors' budget support; in addition, parallel action is needed on the expenditure front, in particular to curb the high wage bill[12] (21% of GDP in 2005 at almost USD 99 million per month). Other urgent

[11] The quality of data generated by domestic sources (Palestinian Central Bureau of Statistics- PCBS) is difficult to assess; therefore the figures reported should be interpreted with caution. There are important divergences in macroeconomic estimates according to the source of information. Most figures used in this article have been reported by the World Bank and the IMF, although references to national sources are consistently made when divergences are substantial, as it is the case with real GDP growth estimates. The PCBS has reported a real GDP contraction of 6.6%.

12 The PA's wage bill is the single largest item of government expenditure and has been growing at a 9% rate per annum since 2000. In 2006 public employees totalled 158,000 (81,000 for the civil service and 77,000 for the security forces). Over 8,000 persons were recruited just in the first quarter of 2006, out of which four fifths in the security services. Massive salary arrears reaching nearly USD 600 million are the result of partial payments during 2006.

fiscal reforms would include improving the collection of utility bills, eliminating the subsidization of petroleum products, streamlining social transfers, and reforming the public sector pension system.[13]

Monetary and exchange rate policy

Inflation has remained low in 2006 at 3.6%, unchanged from 2005. It was slightly higher in Gaza, where some food items saw an increase in their prices as a result of the destruction of agricultural land by Israel and Gaza's isolation. In general, price increases in food and transport, which make up over 50% of the CPI basket in the OPT, were the main contributors to the overall increase in prices.

External sector developments

EU's trade with the OPT remains marginal; the OPT ranks 173rd among the EU's trading partners worldwide, with total trade standing at some USD 52 million in 2006, almost a 10% contraction from 2005. Agricultural products (e.g. cut flowers. grapes. strawberries) still account in 2006 for 50% of EU's imports from the OPT[14] although regressing steadily from previous years (2004: 78.5%; 2002: 67.7%); in contrast, imports of textiles and clothing have boomed, rising from 0.1% of imports in 2004 to 24.2% in 2006.

Total trade flows estimates for 2006 point to sharp declines in both imports and exports; the relatively sharper decline in imports (-35% as against -25% for exports) has brought about a small improvement in the trade balance (2006:-52.7% of GDP; 2005:-54.5%), but the overall fall-off in trade reflects also the PA's near-bankruptcy and strong disruptions in production and distribution channels. The huge trade deficit, estimated at USD 1.6 billion in 2006, has been only partly financed through increasing amounts of foreign aid. The estimated current account deficit of 20% of GDP has worsened 13% compared with 2005 levels of around 18%.

2. Trade liberalisation and economic opening

The revival of the Palestinian economy will depend largely on the relaxation of internal and external controls and greater openness to trade. However, during 2006 movement and access within the OPT and between the OPT and Israel, its largest market, has been greatly restrained due to mounting political tensions with neighbouring Israel. The commitments included in the 2005 Agreement on Movement and Access (AMA) have not been implemented (see Box 1).

Internal movement within the West Bank has been impaired by a 40% increase in the number of fixed impediments since August 2005 (575 checkpoints as of end-2006), which has resulted in a socio-economic fragmentation of the West Bank; transportation costs have increased six- to sevenfold along some routes and access to education and health care has been severely disrupted. Continued construction of the separation barrier has further complicated the movement of goods and people and

[13] PA pension schemes are among the most generous in the world. Implicit debt accumulated from the current civil service schemes stands at around USD 200 million, nearly 180% of 2005 GDP. World Bank, West Bank and Gaza Public Expenditure Review, February 2007.

[14] The West Bank exports very little agricultural products to countries other than Israel. On the other hand, Gaza heavily depends on exports to the EU, with nearly 40% of its exports geared towards the European market.

the access of farmers to their land,[15] affecting the Palestinian economy to a great extent, estimated at 2-3 percentage points of GDP per year.[16] Outflows from the Gaza Strip to Israel have been dependent on an unpredictable closure regime affecting the only gate for goods, the Karni crossing point, which has limited the ability of Palestinian traders to export and greatly affected export revenues.[17] In the light of mounting problems facing Palestinian exports via Israel, consideration is being given to exporting directly to third countries via Egypt using the Rafah crossing point, as already agreed in the Agreement on Movement and Access, but not implemented. So far Rafah has been used exclusively for the movement of people. The opening of this route continues to be delayed by uncertainties related to the transit agreements with Egypt and Israeli restrictions on the movement of Palestinian trucks.

3. Business climate

Privatisation, enterprise restructuring and business environment

The poor business environment in the OPT is the result of two main factors: mounting Israeli restrictions on the movement of both labour and goods and excessive administrative hurdles. The former have affected the regular flow of Palestinian exports and imports, resulting in massive distortions in the economy, including the loss of external markets, shrinkage and fragmentation of internal markets between major cities, and increased transaction costs, risk and uncertainties.

Administrative barriers persist, as reported by the World Bank's 2007 Doing Business index. Out of 17 MENA countries, the OPT ranks 13th for ease of doing business, 16th for closing a business, and last for starting a business. Nor do the OPT's rankings get any better when the sample is expanded. Worldwide, the OPT ranks 127th out of 175 countries, in stark contrast with neighbouring Israel, which comes 26th. The OPT is almost the worse place in the world to start a business, in 173rd place, with only Chad and Guinea-Bissau ranking lower, and also ranks very low in terms of ease of closing a business (151st position).

The crisis affecting the PA government during 2006 has not favoured progress with reforms conducive to a better business environment. A weak and complex legal framework persists in key areas relating to private sector activities, making it difficult to attract sufficient domestic and international investment.[18]

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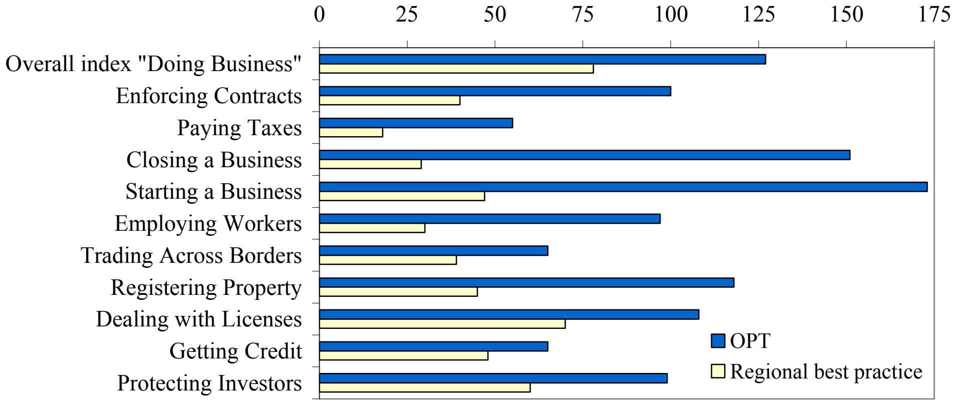
[15] In November 2006, the United Nations Office for the Coordination of Humanitarian Affairs (OCHA) stated that the separation barrier had denied 60% of land-owning families access to their land because they had been refused a permit to cross. With gates open 64% of the official time and only 40% of total gates available for Palestinian use, Palestinian access to land has been further restricted even when permits are available. Protracted lack of access has resulted in land confiscation and loss of agricultural livelihoods.

[16] Word Bank Technical Team Report, August 15, 2006. An Update on Palestinian Movement, Access and Trade in the West Bank and Gaza

[17] The Palestine Trade Centre (PalTrade) estimates daily export losses for the first quarter of 2006 at some USD 600,000. Exports of goods and services from the OPT to Israel fell by almost 7% in nominal terms in 2006, and over 10% in real terms.

[18] The legal system affecting the OPT is very complex as a result of past foreign occupations, each of which has established its own set of regulations. A great deal of Jordanian law and some Ottoman laws remain in application in the West Bank, while in Gaza Egyptian laws are common.

Chart 1 - OPT: "Doing business" rankings



The ease of doing business index ranks economies from 1 (best) to 175. The regional best practice refers to the best ranking Arab country among the Mediterranean ENP countries.

Source: World Bank, 2007.

Financial sector reforms

The Palestinian financial sector has continued to demonstrate its resilience to the crisis. The Palestinian banking system has remained liquid in 2006; private sector deposits continued to grow by about 7% in 2006, up from 2% in 2005. Banks report increased inflows from Palestinians abroad seeking to help family members in the territory. Although banks in the OPT have somewhat cushioned the impact of dramatic revenue cuts by increasing loans to non-government clients (a rise of about 7.5% compared with the situation at end-2005), bad loans are growing rapidly (some 20% at end-2006 up from 15.5% in January 2006) limiting the ability of the banks to maintain this effort in the future. Debt service obligations due by PA employees have been relatively small, in part because loans were rescheduled. These loans will become a concern if normal payment of PA salaries does not resume in the near future.[19]

Labour market reforms

Movement of Palestinians within the OPT and between the OPT and Israel continues to be restrained by an intricate regime of internal and external closures, including a reduction in the number of permits granted by Israel to Palestinian labourers. During 2006, employment in Israel and Israeli settlements decreased by 6% in the West Bank and collapsed in Gaza due to lack of access of Gaza's workers to Israel. As a result, Palestinians have been prevented from accessing land and markets, which has contributed to raise unemployment rates, although at a more moderate pace than expected (23.6% in 2006 up from 23.5% in 2005).[20]

[19] According to the Palestinian Economists Association, the indebtedness of the PA public employees to Palestinian banks has risen sharply to USD 315 million, equivalent to USD 2 000 per public sector employee.

[20] Unemployment rates estimates provided by national sources point to a decline rather than an increase. According to the latest PCBS Labour Survey, the unemployment rate dropped year-on-year from 23.8% end-2006 to 22.0% end-2005 due to a jump in agricultural employment in the last quarter of 2006 deriving from an especially abundant olive harvest. However, the sharp increase in the percentage of unpaid family members in the period end-2005/end-2006 (from 10.4% to 17.4% in the West Bank and from 6.5% to 9.9% in Gaza) points to unemployment rates higher than the official PCBS estimates.

The concentration of agriculture-related job generation in the West Bank has widened the disparity between unemployment rates in the West Bank (16.2% end-2006 down from 21.8% end-2005) and Gaza (34.8% up from 28.2% during the same period). Young people in the age group 20-24 are hardest hit by unemployment at 34.8% (West Bank: 25.9%, Gaza: 51.5%). The public sector is still the largest employer in the OPT, accounting for over 21% of total employment (14.5% in the West Bank and 40.8% in Gaza).

4. Public institutions and public finance management

Corruption is still an issue in the OPT. So far the PA has not adopted a national anti-corruption strategy and anti-corruption measures have been intermittent rather than part of a comprehensive approach to combat corruption. Measuring corruption in the public sector using the 2005 Corruption Perception Index (CPI) by Transparency International places the OPT in the 107th position among 158 countries and 13th among 14 countries in the MENA region.

Governance indicators deteriorated in the OPT from 2004 to 2005, according to a study published by the World Bank in September 2006.[21] Four out of six governance indicators showed negative trends, the control of corruption having deteriorated the most, and only the rule of law having experienced a substantial positive change. During 2006, the paralysis in the political process inflicted further damage on governance standards in Palestine; violence and political instability were rife, and much-needed reforms in the public administration were postponed.

Significant damage has been inflicted in 2006 to the OPT's public finance management system. Past reforms have been reversed, including the creation of a single treasury account (STA), and the introduction of modern internal audit and control techniques within the Ministry of Finance (MoF). During 2006, requirement by foreign donors to operate outside the PA government structures and restrictions imposed by the U.S. Office of Foreign Assets Control (OFAC) gave the Office of the President control over some government revenues, de facto duplicating the functions of the MoF and suppressing the STA. Fiscal transparency has also been affected; sizable amounts of cash have been channelled to the OPT during 2006 and their exact amounts and uses have been unrecorded; and reporting on fiscal operations has weakened as no expenditure and revenue data have been made publicly available since Hamas took power in March 2006.

5. Social development and poverty

Human development in the OPT is declining as a result of the socio-economic developments that took place in 2006. Mounting levels of poverty and high unemployment are putting at risk past achievements which used to place the OPT at the forefront of human development in the region.[22]

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[21] Source: "Governance Matters V: Governance Indicators for 1996-2005," World Bank Policy Research Working Paper, September 2006.

[22] According to the United Nations Development Programme (UNDP), Human Development Report 2005, the OPT used to perform impressively in indicators used to measure human development. In 2004 (latest available figures), the adult literacy rate was very high at 92.4% and almost universal for young people between 15-24 years old; 92% of Palestinians had access to an improved water source; and 95% of the population were expected to survive age 40.

Protracted adversity has consistently eroded the effectiveness of existing safety nets, which has resulted in raising levels of poverty. In 2005 there were an estimated 1.3 million people living below the official poverty line (over 27% of the population), nearly double the number in 1998.[23] Most of the poor lived in deep poverty. Using income as the main criterion to measure poverty produces much higher estimates, roughly 2.7 million people in 2006, up 50% from the end-2005 levels.[24] Widespread poverty is unevenly distributed in the OPT. In Gaza poverty is endemic, with 76% of households below the poverty line end-2006; in the West Bank, estimates give a figure of 59% of households.

Differences between rural and urban poverty are negligible. However, from March to December 2006 poverty progressed much faster in urban areas (from 44% to 63%), largely determined by rising unemployment linked to increased restrictions of movement and the difficulties the PA faces in paying public workers. On average, public employees received only 50-55% of their normal incomes in 2006, which has pushed families to cut back consumption dramatically and postpone indefinitely most household payments such as water, electricity, phone bills and rents. Around 71% of government employees now fall below the income poverty line (USD 460 per month) compared to 35% in June 2005. Some 13% of public employees had to look for a second job to access an alternative source of income.

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[23] In 2004, the PCBS estimated the official poverty line for the representative household at NIS 1,934 (some USD 430) in monthly consumption expenditures. In per-capita terms this amounted to USD 71.8 monthly (USD 2.4 per day). Estimations for deep poverty line were NIS 1,622 in monthly consumption expenditures (some USD 362). UNRWA. *Prolonged Crisis in the Occupied Palestinian Territory: Recent Socio-Economic Analysis*. November 2006.

[24] Poverty estimates based on income need to be carefully considered because they are generally less accurate than poverty measures based on household expenditures and consumption. Stated poverty figures for 2006 are constructed according to the household income. A household is below the poverty line when income is under NIS 2,000 per month. Household income under NIS 1,000 means deep poverty. Near East Consulting, Palestine Poverty Monitor, March-December 2006.

Box 1 – OPT: The Agreement on Movement and Access (AMA): unmet commitments[25]

The AMA was signed between the Government of Israel (GoI) and the Palestinian Authority on 15 November 2005. One year later, the United Nations Office for the Coordination of Humanitarian Affairs (OCHA) reported that progress with implementation was insignificant. Movement and access controls have increased and earlier relaxations have been reversed.

Overall, AMA's provisions have not been respected:

1. The reopening of the Rafah border crossing with Egypt was maintained until 25 June 2006 under the auspices of the European Border Assistance Mission (EU BAM). On that day Palestinians attacked an Israeli military post at Kerem Shalom and captured an Israeli soldier and the crossing was closed. Since then, Rafah has remained closed on 86% of days, ostensibly due to Israeli security concerns.

2. The situation in Karni, the primary commercial crossing, remains well below expectations. 400 export trucks per day were expected by the end of 2006. However, since June 15 Karni has operated erratically, the number of exports trucks averaging 12 per day in 2006.

3. The movement of goods and persons between Gaza and the West Bank has not been permitted by the Israeli authorities. Bus and truck convoys between the two areas have not been established. The movement of people remains virtually impossible and expensive. The movement of goods depends on Israeli freight companies and requires off- and on-loading at Karni commercial crossing (for the Gaza Strip) or other crossings between the West Bank and Israel.

4. The number of physical obstacles to movement has increased from 385 in August 2005 to 575 end-2006 (+49%) in the West Bank contributing to the fragmentation of the socio-economic space into a northern, a central, and a southern economic zone. Further restrictions to movement have been imposed on individuals through the extension of the permit system. Passage through a checkpoint requires a permit and the eligibility for permits varies between checkpoints. Different types of permits are issued for individuals, private vehicles, public vehicles, commercial trucks and commercial goods. Workers' flows have been greatly affected de facto preventing workers from accessing employment.

5. The Gaza seaport construction has not started. The GoI has not assured donors that it will not interfere with the construction of the seaport.

6. Discussion on the issues of security arrangements for the re-construction and operation of an airport in the Gaza Strip ceased.

[25] See OCHA. *The Agreement on Movement and Access One Year On*, November 2006.

OCCUPIED PALESTINIAN TERRITORY

Main economic indicators

	2003	2004	2005 prel.	2006 proj.
Real sector				
Real GDP (USD, million)	3998	4655	4929	4100
Real GDP growth (% change)	5.8	6.0	6.0	-8.0
GDP per-capita (USD)	1221	1372	1398	1271
Real GDP per-capita (% change)	2.1	2.5	2.5	-11
Real GNI (% change)	6.6	4.3	6.8	-7.6
Inflation CPI % (average)	1.1	3.0	3.6	3.6
Unemployment rate (%)[1]	25.6	26.8	23.5	23.6
Fiscal sector				
Revenue (% GDP)	19.1	20.5	21.9	23.2
Expenditure (% GDP)	32.3	32.8	34.3	37.2
Public sector wage bill (% GDP)	21	23	21	27
Overall fiscal balance (% GDP)	-13.2	-12.3	-13.3	-21.7
External budget support (USD, million)		353	349	747
External sector				
Exports (goods and services, USD, million)	433	482	665	500
Imports (goods and services, USD, million)	2404	2751	3352	2183
Trade balance (% GDP)	-49.3	-48.7	-54.5	-52.7
Trade balance with Israel (% GDP)	-34.3	-34.9	-39.4	
Current account balance (% GDP)	-14.0	-17.5	-17.8	-20.2
Financial sector				
Israeli shekel per USD (end-of-period, average)	4.37	4.30	4.60	4.22
Israeli shekel per EUR (end-of-period, average)	4.93	5.34	5.72	5.29
Jordanian dinar (per USD (end-of-period, average)	0.71	0.71	0.71	0.71
Jordanian dinar (per Euro, end-of-period, average)	0.80	0.88	0.88	0.89

Sources: PCBS, World Bank and IMF reports, UNCTAD (figures for the fiscal sector, excluding 2006).

RUSSIA

- **The softening of energy prices during the second half of 2006 is starting to cause a reduction in the external surplus, which has potentially wide-ranging implications for growth in Russia.**

- **After several years of robust growth, investment was the most dynamic demand-side component of GDP in 2006. The investment share of GDP is now at roughly the OECD average of 22%.**

- **Russia has experienced a strong reversal of its traditional capital outflows. FDI yearly inflows have now reached a 3.2% share of GDP, which is a similar value to other major emerging economies.**

- **In spite of Russia's robust performance and positive outlook, significant reforms are still necessary to assure growth sustainability: the creation of a stable and non-discriminatory legal framework for private investors, both domestic and foreign, the deregulation and opening up of important sectors of the economy (notably, the gas industry) and last but not least, the reform of the state.**

1. Macroeconomic developments

Real sector developments

Solid economic growth in Russia continued, and even accelerated slightly in 2006, on the back of further increases in oil prices in the 1st half of the year. In 2006 real GDP growth was 6.7%, up from 6.4% in 2005: nominal Russian GDP is now close to the USD 1 trillion benchmark. For 2007, growth is forecast to remain above 6%. On the demand side, the most notable development in 2006 was the surge in investment (gross capital formation soared by 13.7%, compared with 8.3% in 2005). Government spending also accelerated, from 2.2% in 2005 to 4.6% in 2006. On the other hand, overall consumption growth decelerated (it increased by 9%, as opposed to 9.7% in 2005), while net exports amplified their negative contribution to growth (from -12.8% in 2005 to -14.3% in 2006). Industrial production growth in 2006 was 3.9%, at roughly the same level as 2005 (4%), while agriculture accelerated from 2% towards 2.8%. The strongest performance was observed in construction (14% in 2006, as opposed to 10.6% in 2005) and in some services sectors (financial services, for instance, increased by 11% in 2006, from 6.9%). This continued robust growth performance led to a significant fall in unemployment, which declined to 6.9% at end-2006 (ILO methodology), compared with 7.7% in 2005. Major metropolitan areas (Moscow, St. Petersburg) effectively face labour shortages in some sectors. Correspondingly, real wages increased by 15.4% y-o-y in December 2006, compared with 14.9% in 2005.

Fiscal policy

Russia's *headline* fiscal position continues to be strong. The federal budget posted a surplus in 2006 7.4% of GDP. This is roughly the same level as 2005, and far above the Government's projected forecast in the 2006 budget of 3.2% (this forecast was based on a conservative oil price assumption –

USD 40 per barrel – in the 2006 budget). Nevertheless, Russia continues its strong fiscal expansion, linked to the 2007-2008 election cycle (elections to the Duma -parliament- in December 2007, presidential elections in March 2008). Non-interest expenditures in the 2007 budget are expected to increase by around 1% of GDP at the federal level. This increase comes on the top of an earlier one during 2006. Most of this increase (around 0.7% of GDP) is linked to the pre-electoral National Priority Programmes (NPP), in the areas of agriculture, education, health and housing. As a result, the budget surplus is forecast to fall to around 4.6% of GDP in 2007 (and, unusually, the government's oil price assumptions in the 2007 budget now look somewhat optimistic, at USD 61 per barrel).[1]

The share of central government revenue in GDP at end-2006 was a little more than 23% (closer to 42%, if the regional authorities are included), and expenditure just below 16% (33%).

Russia's twin surpluses (in the fiscal and external accounts) have also enabled the country to massively reduce its gross public debt (i.e., including both external and domestic debt), which was halved between 2005 and 2006 (from 16.4% of GDP to 8.6%).

The robust headline figures above hide a considerably more worrying picture, when one looks at *non-oil* fiscal balances. The non-oil general government fiscal balance reached a deficit of -6.9% of GDP in 2006, up from -5.9% in 2005.

Monetary and exchange rate policy

The Central Bank of Russia (CBR) follows a managed exchange rate regime, with parallel and sometimes incompatible inflation and exchange rate targets. The rouble is pegged to a USD-EUR basket. In February 2005 the CBR started targeting a currency basket of initially 0.9 USD and 0.1 EUR, with the CBR progressively increasing the EUR share to reflect its share in Russia's foreign trade. In late 2006, the euro share was around 45%. The medium-term aim of the CBR is to introduce a floating exchange rate *cum* inflation targeting regime. Full liberalisation of the capital account was introduced in 1 July 2006, six months ahead of schedule. CPI inflation in 2006 finally dropped bellow two digits, to 9% (from 10.9% in 2005). Also for the first time, the CBR fulfilled its own inflation target set at the beginning of 2006 (the 2007 target of 8% also looks achievable), and undershot its REER appreciation target, which reached 7.7% in 2006 (against a target of 9%, and compared with the 10% appreciation observed in 2005).

Monetary policy continues to be relatively accommodative, as the – until recently – high and increasing oil prices keep boosting the current account surplus. The recent reduction in the current account surplus (which fell from 11.2% of GDP in 2005 to 9.8% of GDP in 2006), which is expected to continue in 2007, may imply a reduction of the structural excess liquidity, making monetary policy tools (including the CBR refinancing interest rates) more effective.

The main tool for sterilization of the current account surplus remains the accumulation of part of the oil exports revenue at the Stabilisation Fund (StabFund), which reached close to USD 90 billion by end-2006, and around USD 93 billion by the end of Q1/07 (compared with around USD 44 billion in

[1] At its 26 April 2007 (and presumably last) Annual Address to the Duma – The Russian Parliament- President Putin unveiled a package of additional pre-electoral spending estimated at RUR 650 billion (around USD 25 billion), implying (*if* fully executed) a further fiscal impulse of around 2% of GDP.

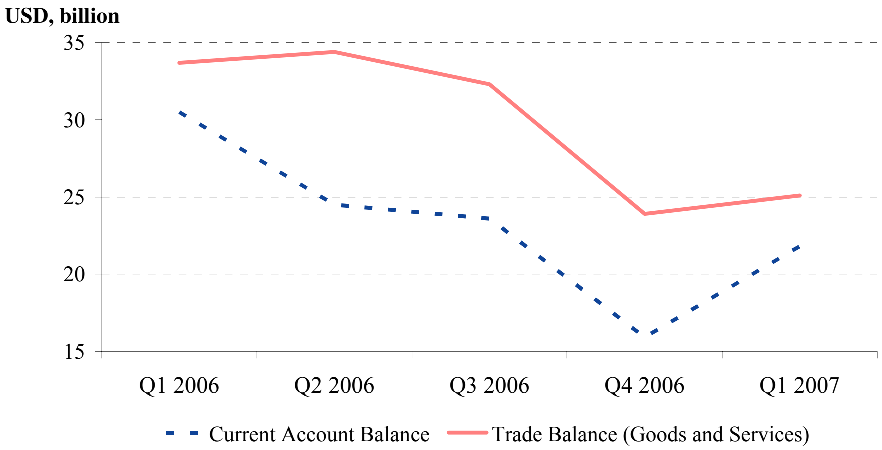
2005).[2] Total hard currency reserves at the CBR, which include the StabFund, reached almost USD 300 billion by end-2006, and approximately USD 340 billion by the end of Q1/07 (from around USD 182 billion in 2005), or almost 18 months of imports. This makes Russia the world's 3rd largest holder of hard currency reserves (after China and Japan).

The money market interest rate in 2006 was 3.4% (i.e., negative in real terms, reflecting the excess liquidity originating from the current account surpluses), compared with 2.7% in 2005. The – little used – CBR refinancing rate stood at 11% at end-2006, a similar level to 2005.

External sector developments

The trade surplus reached over 14% of GDP in 2006, a similar level to 2005 (14%). The total *value* of exports increased by 24% (32% in 2005), on the back of further increases in oil and gas prices during the first half of 2006, while the value of total imports increased by almost 27% (26% in 2005). Russia's total exports by volume of crude oil– the most important Russian export - increased by a mere 1.9% in 2006 (with a 2.4% growth in exports to non-CIS markets and a 1.2% fall in oil supplies to CIS markets). As a comparison, the growth rate of total export volumes in 2005 was 5%. The fall in oil price, and the increase in imports started to reduce the trade balance during the second half of 2006. The current account surplus for Q1/07 fell by almost 30% y-o-y, while the 2007 forecast is for a surplus of 7.9% of GDP, a almost 2% of GDP fall from the 2006 level (chart 1).

Chart 1: Russia - Current account and trade balance



Source: Central Bank of Russia.

[2]The StabFund underwent significant changes during 2006: its assets were converted from roubles into hard currencies (as of end 2006, they were composed of USD 39.4 billion, EUR 30.8 billion and GBP 4.6 billion). Additionally, in April 2007, it was decided that, from 2008 onwards, the Fund will be divided into a fiscal stabilization and a generational (i.e., investment) components, and that the taxation of the gas sector will be added to its revenue sources.

Foreign direct investment more than doubled between 2005 and 2006, from USD 14.6 to 31 billion. FDI yearly inflow as a share of GDP is now over 3.2%, a level very similar to other major emerging markets. Total net private sector capital inflows reached USD 41.6 billion, up from USD 1.1 billion in 2005 (and after persistent net outflows since 1994). Total gross capital inflows reached almost USD 100 billion in 2006, a six-fold increase compared with 2005.

The official external debt-to-GDP ratio decreased further in 2006, from around 12% in 2005 to 4.7%. A new round of debt pre-payment to the Paris Club, this time worth USD 22 billion (using StabFund assets) followed the 2005 debt redemptions with the IMF and the Paris Club. At the same time, corporate and private sector external debt continues to grow (of the net capital inflow figure above, USD 25.1 billion was borrowed by banks). Total accumulated private debt was USD 126 billion by end-2005 (or around 17% of GDP).

2. Trade liberalisation and economic opening

Trade liberalisation and trade reform

Negotiations on WTO membership – started in 1993 – now appear to be close to completion, with some expecting accession before end-2007. An initial breakthrough was reached with the EU in May 2004, and an agreement with the US was finally reached in November 2006 (initially foreseen to be signed at the July St. Petersburg G8 Summit, but delayed mostly due to disagreements concerning the opening up of financial services). After signing a bilateral deal with Moldova about the removal of Russian restrictions on its agricultural exports (mainly wine), the only major remaining obstacle seemed to be a – presumably similar – deal with Georgia,[3] which is also suffering from similar import restrictions.

In late January 2007, an additional potential hurdle appeared, in the form a new draft law. The Russian government approved the draft law "On the rules of foreign investments in enterprises having strategic importance for national security of the Russian Federation". This legislation has been in preparation for almost two years. It comprises the "Law on strategic enterprises" and also the "Amendments to the Law on Subsoil" (the latter first submitted to the Duma in the summer of 2005, and still waiting a reading there). The "Law on strategic enterprises" substantially increased the number of activities deemed strategic (from 7 to 39), now including sectors that might contradict WTO commitments (namely, "natural monopolies", infrastructure). The – traditionally more liberal – Ministry of Economic Development and Trade (MEDT) has indicated that it will try to change those components of the draft law.

Upon Russia's accession to the WTO, the EU is expected to launch talks on a deep Free Trade Area (FTA) between the EU and Russia. 2007 will also see the start of EU-Russia talks concerning the successor agreement to the Partnership and Cooperation Agreement (PCA), the legal cornerstone of EU-Russia relations. Russia has also indicated it may formally apply to OECD membership after WTO accession.

[3]WTO Accession needs the agreement of the majority of WTO members, which increases the danger of last minute "hold-ups" in search of further concessions.

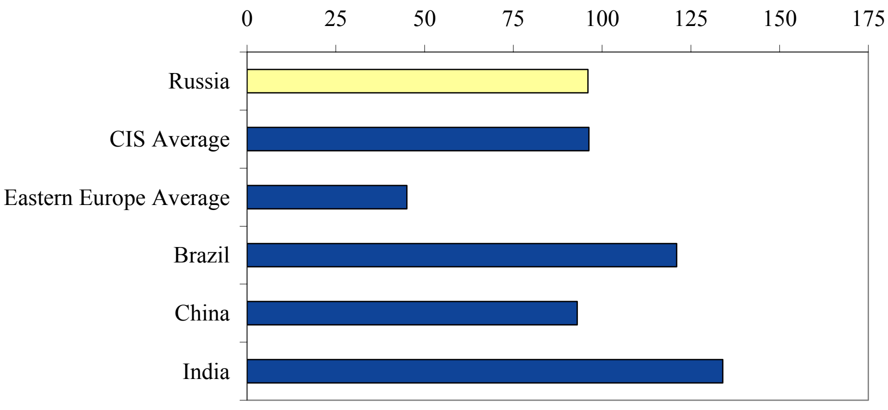
3. Business climate

Privatisation, enterprise restructuring and business environment

Large additional privatisations have virtually stopped in Russia, as an apparent drive to extend the government's role in the economy continues.[4] The private sector share in GDP has declined to 60%, compared to 65% in 2004. Some recent indications of this drive are the merger of Russia’s eight major aircraft manufacturers into a single entity (the “United Aircraft Building Corporation”), which is expected be at least 75 % state owned, the granting of a monopoly on foreign military sales to Rosoboronexport (the Russian state-owned defence export agency), and the notorious acquisition by *Gazprom* of 50% plus one share of the capital of the Sakhalin-II gas exploration and LNG (liquefied natural gas) facilities from Shell, Mitsui and Mitsubishi. The reform of *Gazprom* – the domestic gas quasi-monopoly – continues to be delayed, but wider reform in the energy sector has somewhat advanced, with the privatisation of parts of “RAO-UES” (the electricity holding) proceeding, and with the announcement of a timetable for the gradual liberalisation of domestic energy (electricity and gas) prices by 2010.

Regarding the business environment, the World Bank report “Doing Business 2007” ranking Russia 96th out of 175 countries, *above* countries like Brazil and India and roughly at the same level as China (although this is a relative worsening compared to its 2005 ranking of 79th out of 155 countries). Russia also ranks exactly average among the CIS countries, and above countries like Ukraine. The areas where Russia performs worst are still licensing requirements (“dealing with licences”) and financing (“getting credit”). On the other hand, it ranks surprisingly high on items like “enforcing contracts” (25th, significantly *above* the OECD average of 31), “registering property” (44th) and “protecting investors” (60th) (chart 2).

Chart 2 - Russia: "Doing business" rankings



The ease of doing business index ranks economies from 1 (best) to 175.

Source: World Bank, 2007.

[4]This does not exclude the increase in the *minority* participation of private capital in state-owned Russian companies, as shown by the liberalization of *Gazprom* shares, and the IPOs of Rosneft (the state-owned oil giant) and Sberbank (the state-owned, market leader commercial bank).

Financial sector reforms

The banking sector in Russia continues to develop very fast, on the back of strong economic growth, an improving external position and improving public finances, which have resulted in very rapid credit growth. In 2006 demand deposits grew by 31% compared to 2005, while domestic credit increased by 28% (to around 22% of GDP). The total Russian banking sector assets amounted to roughly 53% of GDP by end 2006 (up from 44% of GDP in mid-2005). The banking sector is still characterised by structural weaknesses, notably the large number of under-capitalised 'pocket' banks, the dominant position of state-owned banks, notably Sberbank (which has the CBR as a majority shareholder) and a small share of foreign banks (which nevertheless increased to 12% of the domestic banking capital in 2006, a almost doubling compared to 2004). The previously mentioned substantial increase in banking-intermediated foreign liabilities of firms may also be a matter for concern.

Russia currently has 1183 institutions authorised to perform banking operations (1093 of which are banks -67 are foreign owned or with foreign participation). 924 banks, or approximately 84% of their total (accounting for nearly 99% of all household deposits) were accepted into the deposit insurance scheme introduced in 2003, which was used to eliminate some of the undercapitalised banks that previously plagued the Russian banking system.

The *equity market* in Russia grew in value from USD 325 billion in early 2005 to over USD 1 trillion by the end of 2006, or from 53% to over 100% of GDP (far above the EU average). During 2006, Russia was one of the best performing stock exchange markets in the world.

Labour market reforms

Russia's official resident population continues to shrink, falling from 143.5 million in 2005 to 142.8 million in 2006. On the other hand, life expectancy seems to have started to increase again. The population figure above does not include the estimated 10 to 14 *million* migrants that live in Russia, most of them illegally. Estimations are very imprecise, as Russia has no visa requirements for citizens of CIS countries, bar Georgia, and for Belarusian citizens there is even not passport control at the borders. One indirect way to assess the scale of the phenomenon is to look at the items "compensation of employees" and "remittances" in the Russian current account. The former item jumped from USD 1.2 billion to USD 4.3 billion between 2005 and 2006. On the other hand, "remittances" surpassed over USD 3 billion in 2005, but fell to USD 1.6 billion during the first 9 months of 2006 (the share of remittances towards CIS countries is 85%).

In order to control this large and mostly unregulated migrant population, and on the back of several ethnic and xenophobic incidents, Russia introduced a new migration law in late 2006. Under it, a quota of six million foreign workers was set for 2007. The new legislation also relaxes the rather stringent procedures for CIS and other foreign citizens to obtain legal work permits. At the same time, it also increases fines for businesses that employ illegal migrants. Additionally, a government decree restricts the number of non-Russians working in the retail trade.

4. Public institutions and public finance management

Russia is a federal state, albeit one with an unusually centralised federal government.[5] Russia so far has no Medium-Term Expenditure Framework (MTEF), but rather a three-year fiscal indicative plan. The first fiscal financial plan covers the period 2006-2008. In April 2007, it was decided that a formal three-year budgetary framework with separate oil and non-oil budgetary systems will be introduced from 2008 onwards, capping the transfers from the former to the latter (at 3.7% of GDP by 2011) and setting a limit for the non-oil deficit (4.7% by 2011).

The effectiveness of public spending is still a concern, as some budget items persistently fail to use all their budgeted allocations (in 2006, the worst performers were the "social policy" and "state security" –24%- items, which were underspent by 19.2% and 24%, respectively).

5. Social development and poverty

Russia has experienced a substantial poverty reduction since the 1990s. The share of households whose income is below USD 2 a day fell to 5% in 2004, and the official estimates of the level of poverty were almost halved between 1999 and 2004, reaching around 17%. Nevertheless, regional income disparity is very wide, and income inequalities among population groups may be on the increase, even as poverty falls.

EU-Russia relations are based on the Partnership and Cooperation Agreement (PCA) that came into force in December 1997 for an initial period of ten years. Preparations for a new strategic cooperation agreement that will replace it are on the way. The EU was a key provider of technical assistance to Russia through the TACIS programme: more than EUR 2.6 billion has been allocated to Russia since 1991. EU financial support programmes are now being considerably scaled back, given the country's much improved financial situation. Presently Russia's ENPI (European Neighbourhood and Partnership Instrument, which replaced TACIS in 2007) allocation is EUR 30 million per year for the period 2007-2010. In addition to this amount there are other smaller EU programs (for instance, Cross-Border Cooperation, Nuclear Safety).

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[5] And with a growing state bureaucracy: the number of civil servants in Russia increased from 0.6 million in 1992 to 1.2 million in 2002.

RUSSIA

Main economic indicators

	2003	2004	2005	2006 prel.	2007 proj.
Real sector					
Real GDP growth (% change)	7.3	7.1	6.4	6.7	6.8
Inflation CPI (average, %)	13.7	10.9	12.7	9.7	8.1
GDP (nominal, USD, billion)	431.2	591.9	763.8	979.0	1193.3
GDP per-capita (USD)	3007	4116	5322	6856	8469
GNI per-capita (PPP, current prices, USD)	8760	9680	10640		
Social indicators					
Unemployment (%)	8.9	7.6	7.7	6.9	6.4
Life expectancy (years)	64.9	65.3	65.8		
Under 5 mortality rate (%)	21	21			
Literacy (total, %)	99	99			
Fiscal sector					
Total revenue (% GDP)	19.5	20.6	23.7	23.2	
Total expenditure (% GDP)	17.1	15.7	16.2	15.8	
Central government balance (% GDP)	1.7	4.2	7.5	7.4	4.6
Gross public debt, (% GDP)	27.8	20.9	13.2	8.5	
General gov non-oil balance (% GDP)	-4.6	-4.3	-5.9	-6.9	
Monetary sector					
Private sector credit (% change)	44.7	48.2	35.2	48.3	
Private sector credit (% total credit)	75.8	94.6	124.6	144	
Broad money (% M2)	38.5	33.7	36.3	40.5	30.8
Degree of monetization (M2/GDP, %)	29.9	31.1	33.4	38.1	
External sector					
Current account balance (% GDP)	8.2	9.9	11.0	9.8	7.9
Trade balance (% GDP)	13.9	14.5	15.4	14.3	10.0
FDI (% GDP)	1.8	2.5	2.0	3.2	2.7
Import cover (months)	12.1	15.5	17.5	17.4	16
External vulnerability					
External public debt (% GDP)	22.8	16.4	9.3	4.6	
Debt service/exports (%)	12.0	10.0	7.4	7.9	
Gross reserves (excl. gold, USD, billion)	77	125	182	296	378
Reserves/M2 (%)	1.7	1.5	1.5	0.8	0.8
Financial sector					
Short term interest rate (average, %)	3.8	3.3	2.7	3.4	
Exchange rate (rouble per EUR, end of period)	36.8	37.8	33.9	34.7	32.4
Exchange rate (rouble per USD, end of period)	29.5	27.7	28.8	26.3	25.7
Real effective exchange rate (1992=100)	127.3	137.3	149.2	167[1]	177.2

Sources: Rosstat, Ministry of Finance of Russia, CBR, WDI, IMF, Troika Dialog, DB Research and EC staff calculations.

[1] *Jan-Oct 2006.*

SYRIA

- **The Syrian economy proved to be quite resilient in 2006: economic activity, supported by private investment and by the oil boom, continued its growth.**

- **The economic recovery has been accompanied by a rise in inflation since the 4th quarter of 2006, due to the expansionary monetary stance, the international crisis of confidence in 2005 (which triggered the depreciation of the exchange rate), repeated public sector wage increases and higher prices of imported commodities.**

- **The fiscal policy stance in 2006 has been rather disciplined, which led to a reduction of the yearly deficit, but it is expected to be more expansive in 2007.**

- **Improvements in the business climate are expected with the implementation of a new law on investment and the preparation of several business simplification laws and programs. Nevertheless some provisions of the law, especially the elimination of the tax exemption, are controversial and may bring mixed results.**

- **The current Five Year Plan outlines a comprehensive strategy to address the challenges stemming from the progressive depletion of oil reserves.**

1. Macroeconomic developments

Real sector developments

The Syrian economy proved to be quite resilient in 2006: economic activity, supported by private investment and by the oil boom, continued its growth. However, this growth was accompanied by a rise in inflation, due in part to an expansionary monetary policy since the 4th quarter of 2006. Moreover, US economic sanctions and international pressure in the context of UN Security Council resolutions put Syria in a not very comfortable economic position.

Growth in the non-oil sector continued to be sustained by investment expansion and good export performance, reflecting greater access to regional Arab markets. This, together with the windfall from higher oil prices and an increase in FDI, will ensure the maintenance of a comfortable balance of payments position.

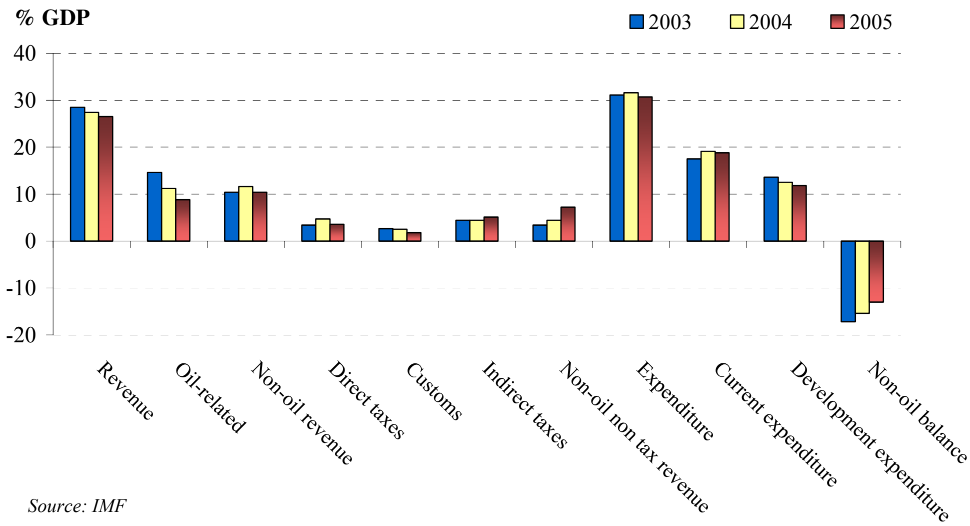
The Central Bureau of Statistics announced that the unemployment rate in Syria was 8.5 % in June 2006 (a rate equivalent to the 2010 objective in the 10th Five Years Plan). However, these new official figures are largely contradicted by the unofficial rates of 20-25%[1].

[1] The difference can partly be explained by a consideration of the definitions: the CBS uses the ILO standards (considering that a person is unemployed in case s/he has not worked more than one hour in a week); on the contrary, unofficial figures consider a person to be unemployed in case s/he has worked less than 2 days in a week.

It is estimated that the war in Iraq and the subsequent civil unrest has cost the Syrian economy as much as two billion USD annually through lost trade and, more recently, the necessity of supporting over one million refugees that have flooded into the country. With Syria receiving little international aid to support people from Iraq, almost all of the cost of providing at least basic services to the refugees, whose numbers have swelled the Syrian population by more than 7%, is substantial. This inflow of Iraqi refugees positively influences the demand side of the Syrian economy.

For 2007, the main challenge is the decrease of subsidies of diesel prices which needs to be accompanied by an income policy that smoothes the impact for the most vulnerable people.

Chart 1- Syria: Budget developments



Source: IMF

Fiscal policy

Non-oil revenues decreased slightly, whilst oil-related income has increased by 1.2% of GDP to 10%. The level of expenditure has remained fairly steady, resulting in an improvement in the deficit of nearly 1% of GDP (to -3.2%).

The fiscal stance for 2007 is expected to be slightly more expansive: the No.52/2006 ratifies the 2007 state budget. Total allocations are SP 588 billion with an increase of 18.8% on 2006. Current expenditures in the 2007 budget amount to SP 330 billion (10% with respect to 2006). Investment expenditures in 2007 amount to SP 258 billion (32.3% from 2006 allocation). Oil-related revenues are supposed to reach SP 246 billion or 49% of local revenues. Total budget deficit is expected to reach 4.2% of GDP, while the deficit excluding oil related revenues will reach 16.6% of GDP.

Syria’s gross public debt, estimated at 60% of GDP in 2006 is barely sustainable, but steady. Nevertheless, the non-oil fiscal balance has improved compared to 2004, mainly due to increasing non-oil revenues. Current public expenditures remain generally high while development expenditures are low.

Monetary and exchange rate policy

The recent economic recovery has been accompanied by a steady rise in inflation since the 4th quarter of 2006 due to several factors, including: i) the expansionary monetary stance (with credit to the private sector growing on average by more than 20% in recent years ii) the depreciation of the exchange rate as a result of international confidence crises and iii) increased price of imported commodities.

Due to successful interventions to alleviate pressure on the exchange rate, the Syrian pound has recently appreciated. The central bank took a number of measures including raising interest rates, relaxing some foreign exchange restrictions, and intervening in the parallel market, to deal with the pressures on the exchange rate triggered by the politically-driven confidence crisis.

The free market exchange rate recently appreciated, mainly reflecting the underlying strengthening of the balance of payments. In 2007, the switch from a USD peg to a trade-weighted basket of currencies (including the euro), as announced by the central bank, should reduce the inflationary impact of a weakening US dollar.

External sector developments

In general, available data on Syrian external trade are not fully reliable due to a number of factors: i) widespread incorrect custom declarations to elude taxation; ii) incomplete accountability of commercial exchanges with Iraq; iii) ongoing custom reform resulting in delays in data collection and iv) occasionally, the application of different exchange rates. That said, a common noticeable feature of Syrian trade patterns is that commerce with the EU, which remains Syria's main trading partner, is decreasing mainly to the advantage of Turkey[2], but also of Saudi Arabia, Iraq and Eastern countries. This, apparently, is particularly the case for exports, more so than imports. For the near future, Syrian imports (including EU imports) are expected to increase in line with the high growth rates of the developing Syrian economy, the massive inflow of Iraqi refugees and the elimination, foreseen for the end of 2007, of the “black list” for imported products. Furthermore, the completion of the customs reform will result in greater reliability of trade data.

Oil-related products currently represent the largest part of the Syrian balance related to EU trade. The non-oil current account balance improved, contributing to maintaining external balance despite the sharp fall in net oil exports. Public and external debts remained moderate; and official reserves covered close to two years of imports. Similarly, the non-oil budget balance improved further, although mainly due to the increase in transfers from public enterprises.

[2] Starting January 2007, the coming into force of a new Free Trade Agreement between Syria and Turkey is likely to further contribute to the increase of trade and exchanges between the two countries.

2. Trade liberalisation and economic opening

The country has contributed to regional integration, particularly with Iran. Agreements involve cooperation in the fields of energy, information technology, medicine, housing and urban development, and agriculture. The establishment of a committee for joint investment has also been agreed. Syria aims to have its rail network connected to that of Iraq and Iran, which would lead to more efficient shipment and would contribute to the integration of the economies of the three countries. According to some estimates, Syrian-Iraqi bilateral trade amounts to almost USD 3 billion, though more than half of this is believed to be unregulated activity across the border by private citizens. Syria, along with Iran, may be being singled out by the US as enemies to the peace process in Iraq but Damascus is working hard to get a piece of the Iraqi market.

Encouraging private and foreign investment in Syria is one of the most prominent objectives of the 10th Five Years Plan. Despite a recent increase in the foreign direct investment inflows to Syria, the business environment is still considered weak (ranked as 130 out of 175 countries according to the World Bank). The government is now taking measures to encourage more investors to operate in the country. The latest step in this direction has been the enactment of two new laws on private investments: i) Decree N° 8/2007 represents a substantial shift toward increasing the role of the private sector and encouraging foreign investments[3] and ii) Decree N° 9/2007, which establishes the Syrian Investment Commission as the successor of the Investment Bureau, widening and strengthening its authority.

3. Business climate

Privatisation, enterprise restructuring and business environment

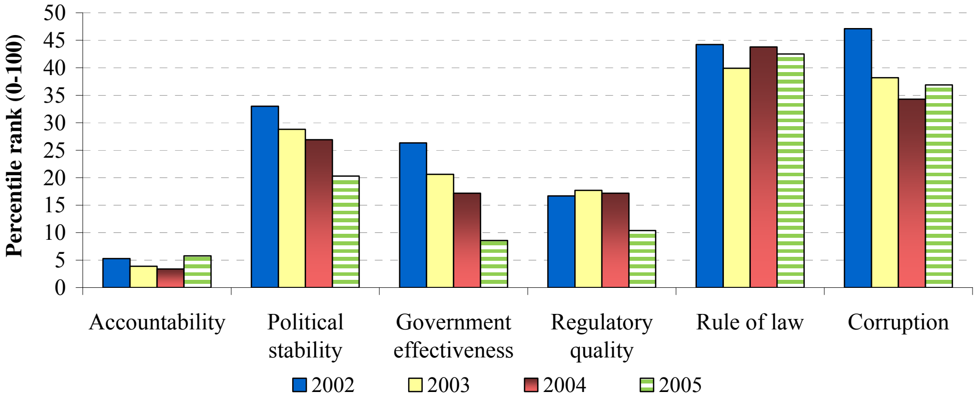
In 2007 Syria ranked as the 142nd (out of 161 countries) freest economy in the world according to the index calculated by the Heritage Foundation. On a regional basis, Syria is ranked as 15th out of 17 countries in the Middle East and North Africa Region. Syria ranks well in the fiscal and monetary fields where it is in the 88th percentile and 68th percentile, respectively. However, it ranks very low in financial and investment freedom, property rights and corruption. In 2006 Syria improved its business environment: the world ranking of the country according to the World Bank indicators has increased by five places to 130th. The most prominent advance has been recorded in the field of facility of employment of workers (14 positions, to the 89th place). Administrative simplifications in starting a business and dealing with licences have also improved the general doing business picture. However, investor protections seem, relatively, to have regressed.

Further improvements in the business climate are expected with the implementation of the new investment law (see Box). It is worth considering what the impact of the new investment rules on the Syrian economy will be. With regard to this, the most important and controversial change introduced by the law is the elimination of the tax exemption[4].

[3] The main change of the new law is the elimination of the tax exemption.

[4] This could be seen by investors as a negative signal, and is feared to decrease domestic and foreign investment in the country. However, in 1991, when the previous regime was introduced, the income tax on the highest income bracket reached 63%. Nowadays, income tax can be as little as 14%, according to the dynamic tax

Chart 2 - Syria: Governance indicators



Percentile ranks indicate the percentage of countries worldwide rating below the selected country.
Higher ranks represent improvement.

Source: World Bank Governance indicators, 2007.

Financial sector reforms

In 2006 the Syrian government approved amendments to the banking law; according to the new amendments, the minimum capital requirement for a private bank has been increased from USD 30 million to USD 100 million. In addition, the minimum capital requirement for an Islamic Bank has been increased to USD 200 million instead of USD 100 million.

Despite the fact that some initial steps at reforming the banking and financial sectors have recently been taken, the Syrian financial system is still dominated by state-owned banks and remains largely undeveloped. Financial sector reforms appeared however to regain some momentum in 2006 and are likely to proceed further in the near future. A stock market is expected to open in 2007.

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reduction system adopted in the income tax law (which allows companies to reduce their income tax if they meet certain criteria). As a consequence, according to the government, the tax exemption was no longer justifiable. Furthermore, the authorization of repatriation of profits without any restriction is expected counterbalance the negative effects and to contribute to increasing FDI in the country.

Box 1 – Syria: The new investment law

The sectors covered by the new investment law are broad: industry, oil and gas, energy, agriculture, environment, transport and IT services. However, the new law does not impose any regulations on tourism, real estate or the financial sectors (tourism and the financial sector are already governed by specific laws and institutions, while investment in the real estate sector should be regulated by a new law expected for the near future).

The most substantial changes introduced by the new law are as follows.

1. End of tax exemptions - Investment will be subject to income tax law N° 51/2006. In real terms, this is an elimination of the tax exemptions granted by the previous investment law of 1991 which offered tax holidays for investors up to 7 years. This is one of the main issues of the new law. However, the Higher Council for Investments has the right to adopt a different tax treatment for projects of "higher importance to the national economy".

2. Dispute settlement process - Any dispute between an investor and the Syrian public entities should be resolved in a "friendly manner". If this is not possible, four other ways are possible: i) arbitration; ii) the Syrian judiciary; iii) the Arabic Investment Court established by the 1980 agreement concerning investments between Arabic countries; iv) the Investment Protection Agreement signed between the Syrian Arab Republic and the investor country. The law also states that the Syrian courts should deem all investment-related disputes as "urgent".

3. Right to repatriate funds - Investors now have the right to repatriate the annual profits achieved by the invested funds in a convertible currency after paying the relevant taxes while law N° 10 restricted repatriation of profit to income derived from exports. They are also allowed to repatriate their share in the project upon the liquidation of the project in a convertible currency, and are authorized to repatriate the invested funds if unforeseeable forces prevented the establishment of the project. Furthermore, any foreign employees in the project can repatriate 50 % of their income and 100 % of their end-of-service compensation.

4. Exemption on customs duties – Exemptions will continue to apply: any project licensed under this new law is authorised to import all that is necessary to the completion of the project itself, without being subject to import duties (all fixed assets and means of production are exempted). Means of transportation are also concerned, as long as they are used only for the purpose of the investment.

5. Right to buy land and buildings - According to Decree No.8, the investor has the right to buy the land and the buildings needed for his project. He is also allowed to exceed the ownership ceiling for land if this land is used for the purpose of the project.

6. Set up of the Investment Commission - The Decree N° 9 establishes the Syrian Investment Commission which replaces the Investment Bureau. While the latter was operated as a "mailbox" to transmit investment requests from inventors to the Higher Council for Investment, chaired by the Prime Minister, the new Commission will license projects directly. The main responsibility of the Higher Council will be, from now on, to draw up national investment strategies and policies. The new Commission will come under the responsibility of the Prime Minister's office and is entitled to set up offices within and outside Syria to help promote the investment climate. It will also act as a "one-stop shop" for investors where they can carry out all that is necessary without having to consult other Ministries or Government institutions. It will also be in charge of preparing an investment map, simplifying investment procedures and providing data to investors.

Labour market reforms

The labour market in Syria faces strong supply pressure, with both current and prospective high unemployment. The labour force is expected to grow at a sustained pace (4% yearly average over the next 20 years) and the long-awaited reform of the public sector is likely to result in an additional influx of civil servants made redundant. Some 30% of the Syrian workforce is employed by the state, and under Syria's very rigid labour laws, only the Prime Minister can fire them.

On the other hand, the education system, including vocational and technical training, should be significantly upgraded to better match the needs of the national labour market: Syria's free and universal education system places little emphasis on professional skills. The recent decision to allow private universities has been welcomed by the private sector as a step in the right direction. A major obstacle to creating a competitive market economy in Syria is the low level of technical training.

The government has cautiously taken steps to develop active labour market policies, including a labour market observatory, apprenticeship training schemes and upgrading the national system of technical and vocational education and training. In September 2006 the Agency for Combating Unemployment, created in 2002 to provide entrepreneurship training, micro-credits and a guaranteed employment programme, has been replaced by the Public Commission for Employment and Projects Development. However, in the absence of real and comprehensive employment and education strategies, including a strategy for life-long learning, and a labour market liberalisation that should reduce the costs of hiring and firing workers, these initiatives are not sufficient to address the country's daunting employment challenge.

4. Public institutions and public finance management

Official and reliable data on public institutions, public finance and, more generally, the fiscal stance are usually not readily available in Syria. However, recently, the government seems to be more aware of the adverse medium-term prospects for the public finances, mainly due to the progressive depletion of oil reserves. The Five Year Plan addresses this substantial challenge. The plan outlines a comprehensive stabilisation and structural reform strategy. Moreover, an action plan specifying tangible policy measures for the next two years has just been finalised.

5. Social development and poverty

According to the UNDP in 2005, 2 million Syrians out of a population of around 17 million could not afford to meet their basic needs, whilst general poverty affected nearly a third of Syrians. This situation has recently being aggravated by the inflow of refugees coming mainly from Iraq. The increasing numbers of Iraqi people resettling in Syria as a consequence of instability in their own country is now causing growing financial strain[5]. The huge numbers of extra residents in Damascus are also severely straining already inadequate services and infrastructure, and damaging Syria's weak,

[5] In 2006, Iraqis were given six months to get visas to stay in Syria from the time of crossing the border. Since January 2007, families must apply for residency permits within 15 days of being in Syria; these permits must then be renewed every three months by leaving Syria and returning (it used to be every six months).

centrally planned economy, causing soaring food prices and inflation of rents[6]. Nearly 75.000 Iraqi students have enrolled in Syrian schools causing over-stretching of the education sector and overcrowding in schools (in some schools, about 60 students are cramped into each classroom). Syria's healthcare system is similarly overburdened.

Using some of the oil revenues to create a fund to cushion the transition process, pay unemployment benefits (currently non-existent in Syria) and retrain workers could be considered a temporary solution (also taking into consideration that Syria is expected to become a net importer of oil in the next years).

[6] According to a study by the National Organisation for Human Rights in Syria on the effect of Iraqi refugees on inflation, an average two-bedroom apartment in a suburb of Damascus two years ago could be rented monthly for 8000 Syrian pounds (USD 160). Now it costs 20000 Syrian pounds (USD 400), that is a 250% increase.

SYRIA

Main economic indicators

	2003	2004	2005	2006 prel.	2007 proj.
Real sector					
Real GDP growth (% change)	1.0	3.1	2.9	3.2	3.7
Real non-oil GDP growth (% change)	3.9	5.0	5.5	5.5	
Inflation (average, %)	5.8	4.4	7.2	5.6	14.4
GDP nominal, (USD, billion)	22.7	24.7	27.3	29.4	30.3
GDP per-capita (USD)	1285	1360	1464	1534	1542
GDP (nominal, USD, million)	22719	24691	27297	29384	30317
Social indicators					
Unemployment (officially registered, %)	10.8	12.3	8.0	8.5	
Fiscal sector					
Total revenues (% GDP)	28.5	27.4	26.5	27.5	
Oil-related revenues (% GDP)	14.6	11.2	8.8	10.0	
Non-oil revenues (% GDP)	13.9	16.1	17.7	17.6	
Total expenditure (% GDP)	31.1	31.6	30.7	30.7	
Current expenditures (% GDP)	17.5	19.1	18.8	18.9	
Development expenditures (% GDP)	13.6	12.5	11.8	11.8	
Central govt. balance (% GDP)	-2.6	-4.2	-4.2	-3.2	
Non-oil budget balance (% GDP)	-17.2	-15.4	-13.0	-13.1	
Gross public debt (% GDP)	60.1	61.9	57.0	60.2	55.2
Monetary sector					
Credit to private sector (% change)	30.3	35.0	45.9	21.9	
Broad money (M2, % change)	7.8	15.3			
Degree of monetisation (M2/GDP, %)	77.8	76.5			
External sector					
Current account balance (% GDP)	1.1	1.9	-0.6	-0.6	-1.8
Balance of goods and services (% GDP)	12.1	13.8	13.5	14.9	
Non-oil export of goods and services (% GDP)	3.5	5.0	5.2	5.6	
Non-oil import of goods and services (% GDP)	-6.1	-7.5	-7.6	-8.4	
Oil balance (% GDP)	2.4	1.3	0.7	1.0	
FDI (% GDP)	0.7	1.1	2.0	2.5	
External vulnerability					
External public debt (% GDP)	18.1	19.7	25.0	22.6	
Debt service ratio (%)	4.2	3.5			
Financial sector					
Lending rate (%, average)	8.0	7.5	8.0		
Exchange rate (Syrian pound per USD, average)	11.2	11.2	11.2	11.2	
Exchange rate (Syrian pound per EUR, average)	12.7	13.9	14.0		

Sources: Syrian authorities, IMF estimates.

TUNISIA

- **In 2006, as in 2005, the Tunisian economy has proved to be resilient, despite the difficult external context (namely the price increase of basic commodities, especially oil, resulting in a negative macroeconomic impact). Growth has remained strong (real GDP growth is expected to rise from 4.2% in 2005 to about 5.8%), in a context of macroeconomic stability.**

- **Inflation accelerated in 2006, leading the central bank to raise its key interest rate by 25 basis points, the first adjustment in three years. Consumer price inflation accelerated from 2% in 2005 to 4.7% for the first 10 months of 2006. This acceleration reflects mainly the increase in international prices for oil and some basic commodities (core inflation, excluding energy and food products, stood at 3%. Annually, inflation stabilised at 3.9% in 2006.**

- **Rising oil prices also adversely affected the external accounts situation. Despite the partial coverage of oil consumption by domestic production and robust growth in exports of non-textile manufactures and services, the external current account deficit widened in 2006 but is expected to narrow down in 2007.**

- **Despite the positive outlook for the country, the major challenges remain the reduction of the high unemployment rates particularly for young and skilled workers, the improvement of the quality of credit and policies geared at stimulating private investment.**

1. Macroeconomic developments

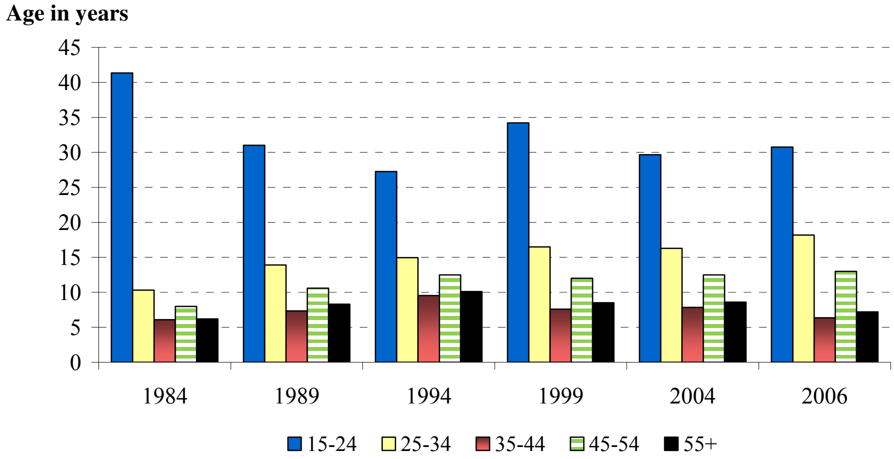
Real sector developments

In 2006, as in 2005, the Tunisian economy has proved to be resilient, despite the difficult external context (namely the price increase of basic commodities, especially oil, resulting in a negative macroeconomic impact). Growth has remained strong (real GDP growth is expected to rise from 4.2% in 2005 to about 5.8%) in a context of macroeconomic stability.

For 2007, growth expectations remain favourable. Real GDP growth in 2007 might accelerate to 6.0%, assuming that agricultural production continues to increase towards its potential in the non-textile sector and that the particularly favourable outlook for the services sector, especially communications, continues at its present pace (annual growth rate of nearly 10%). The buoyant growth performance, are also driven by the sustained expansion of domestic demand, particularly household consumption investment since 2005.

Despite the positive outlook for the country, its major challenges (high unemployment rates, especially for young and skilled workers, access to credit, poor quality of credit and lack of private investments) remain. In particular growth, though sustained, has not contributed to reducing unemployment amongst the most highly skilled people between 20 and 34 years old. Instead, the sustained economic activity generally seems to have favoured unskilled, very young (19 years old and below) and elderly (over 35) workers (chart 1). This may be related to the possible excess of high skilled workers produced by substantial public expenditure in the area of education (see Box 1). Such a situation should be properly managed to avoid the risk of causing structural unemployment amongst the younger cohorts of the population, a situation which might lead to a non-negligible social cost. As a whole, the official unemployment rate has decreased slightly, from 13.9% to 13.4%

Chart 1 - Tunisia: Unemployment by age group



Source: 2006 IMF Article IV consultation.

In addition, significant medium term risks, relating to the global economy, remain: global economic growth could be substantially weaker if the slowdown recently observed in the United States deepens and/or if petroleum prices return to their record levels.

Fiscal policy

The higher oil prices have had a negative impact on the budget in terms of additional fuel subsidies (additional expense of 0.7% of GDP) as compared to the 2006 budget. Despite this, the fiscal deficit, at 3.2% of GDP, remains virtually unchanged compared to 2005. That has been possible due to the improved income stemming from non-tax revenues.

According to the government plans, further efforts to consolidate debt, as well as the use of a portion of privatisation receipts for anticipated debt reimbursement, should reduce public debt from 58.4% of GDP in 2005 to 54.5% in 2007. In particular, medium and long term external debt is expected to decline sharply from 54.6% of GDP in 2005 to about 45% in 2007.

Monetary and exchange rate policy

Inflation accelerated in 2006, leading the central bank of Tunisia (CBT) to raise its key interest rate by 25 basis points in September, the first adjustment in three years.. In particular, consumer price inflation accelerated from 2% in 2005 to 4.7% in 2006. This acceleration mainly reflected the increase in international prices for oil and some basic commodities (core inflation, excluding energy and food products, stood at 3% for the first 10 months of 2006, a level comparable with the 2.5% recorded in 2005). Inflation also reflected the lagged effect of oil prices increases in 2005, as a result of the delayed transport price adjustments implemented at end-2005.

Strong domestic demand and the gradual depreciation of the nominal effective exchange rate may also have contributed to inflationary pressures. In light of these developments, the Central Bank of Tunisia has reduced liquidity in the financial system. Further progress in view of increased exchange rate flexibility might also prove to be useful to contain imported inflation.

Inflation has now slowed down since August 2006: if this trend continues, as is expected, the annual consumer price level should decrease in 2007 by 3.5%.

External sector developments

The surge in oil prices has also adversely affected the external accounts position: the external current account deficit has widened in 2006 (and eventually to narrow down in 2007) despite the partial coverage of oil consumption by domestic production and the strong growth in exports of non-textile manufacturing and services.

Nevertheless, the external position remains sustainable. In fact, the current account balance, excluding energy products, was in surplus in both 2005 and 2006. The international reserves also continue to rise, partly thanks to the partial privatisation of *Tunisie Télécom*, which yielded USD 2.2 billion. In October 2006, reserves amounted to nearly USD 6.5 billion, the equivalent of almost five months of imports of goods and services.

2. Trade liberalisation and economic opening

Tunisia is actively seeking regional and global cooperation: a number of agreements were introduced or came into effect in 2006, among which the adoption of the system of pan-European cumulation of rules of origin and the entry into force of the free trade agreement with Turkey deserve to be mentioned. Tunisia has initiated preparatory work for the negotiations on including agricultural products in the free trade area with the European Union. The country is also actively involved in the integration of the Maghreb countries: in this context, Tunisia took part in the conference on financial sector reform and prospects for regional integration in the Maghreb held in December 2006 in Rabat, and will host the third conference on the development of the private sector in late 2007.

The gradual liberalisation of the capital account is continuing: non-residents could subscribe to Treasury bills for up to 10% of each emission in 2006 (this ceiling was raised to 20% from January 1, 2007 and is likely to be further raised to 30% on January 1, 2009). Further measures have been announced by the authorities and it is hoped that they will be implemented in the near future, namely: (i) the liberalisation of medium and long term external borrowing for companies listed on the stock exchange; (ii) the raising of the ceilings on allowances and transfer rights of foreign currency in connection with business travel, tourism, and certain personal expenses; (iii) greater opportunities to open foreign currency accounts; (iv) enactment of an exchange amnesty; (v) amendment of the exchange legislation so as to make the requirement of prior authorisation the exception rather than the rule; and (vi) a closer alignment of onshore/offshore regimes in view of the total elimination of barriers by 2010.

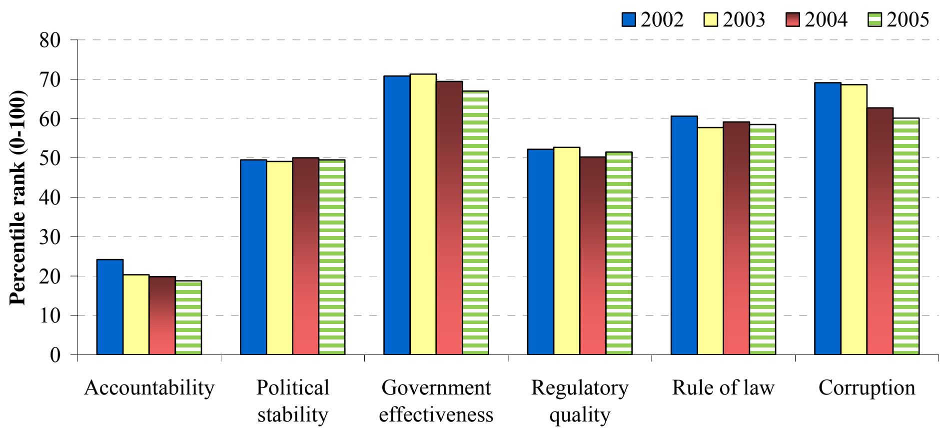
3. Business climate

Privatisation, enterprise restructuring and business environment

The Tunisian business environment worsened slightly in 2006 in relative terms: the world ranking, according to the 'doing business' indicators, fell 3 positions to 80th. The worsening situation concerns in particular the procedures for starting a business, the possibility of getting credit and, to a minor extent, ease of trading across borders.

As regards governance, Tunisia is also subject to the recent trend of deteriorating situation that is common to the whole region: all the components of the World bank governance indicators, apart from regulatory quality, recently recorded a downturn.

Chart 2 - Tunisia: Governance indicators



Percentile ranks indicate the percentage of countries worldwide rating below the selected country. Higher ranks represent improvement.

Source: World Bank Governance indicators, 2007.

Financial sector reforms

The authorities have continued to introduce reforms aimed at strengthening the financial sector and thus stimulating growth and minimizing the risks associated with the liberalization of international capital flows. These reforms have required the amendment of the Banking Law and the issuing of the relative implementing regulations, providing a legal framework for the consolidation of the banking sector The amendment of the CBT Law establishes the legal framework required for the transition to an inflation targeting regime.

A recent Financial Sector Assessment Program (FSAP) update has been carried out by the IMF: the findings underscored the need for credit institutions to continue efforts to strengthen their capital base, particularly by proactively reducing their portfolio of nonperforming loans and improving their risk coverage ratio through provisioning, as well as seeking to increase their profitability. Capital adequacy ratios are at adequate levels and provisioning rates continue to rise (48.4% in 2006 with the ambitious objective of reaching 70% in 2009).

Nonetheless, the Tunisian banking sector is still characterized by a large share of nonperforming loans (NPLs) as a share of loans outstanding. The problems affecting the tourism industry since 2001 have contributed to this increase in the NPL ratio. While a sharp decline took place in 2005, the ratio today remains close to 20%.

Several measures have been adopted in recent years to deal with the NPLs problem. These include a change in the procedures for obtaining real estate collateral, more favourable tax deductibility rules for NPL provisions and write-offs, and the establishment of asset recovery companies. Specifically, procedures for sale of real estate under judicial supervisions have been simplified, the tax-deductible portion of provisions against NPLs has been raised to 85% in 2004 and 100% in 2005, and the conditions for writing off fully provisioned bad debt have been clarified, although they remain rather strict.

Most banks have established asset recovery companies, to which they have transferred their old NPLs, which, in most cases, were fully provisioned. Up to now the amount recovered on the loans transferred (1.3 billion Tunisian *dinar*) has been modest.

Labour market reforms

Labour market reforms are generally stalling, despite repeated declarations of commitment by the authorities. The government has attached great importance to education reforms, aimed at making education widely accessible in the hope of reducing unemployment, but it can be argued that this might not resolve entirely the problem.

Flexibility in the labour market remains relatively low, non-salary costs remain at a comparatively high level (less so as regards the costs for dismissing surplus workers), and the weight of the public sector in the economy is still excessive. Greater flexibility and interventions aimed at increasing the allocation efficiency of the labour market are key to creating favourable conditions for higher growth and lower unemployment.

4. Public institutions and public finance management

Some progress has been made in the area of tax reforms, namely: i) the reduction in the corporate income tax rate from 35% to 30%, ii) the elimination of the 29% VAT rate, iii) the easing of VAT credit refund procedures, iv) the reduction in customs duties and in the number of tariff lines at the multilateral level, and v) the simplification of customs procedures through the establishment of advanced IT systems to boost enterprise competitiveness.

A substantial proportion of the privatisation receipts has been devoted to early repayment of the external debt; however, the fiscal consolidation effort should continue by adopting long-term measures to increase revenue and control expenditure so as to maintain long-term fiscal sustainability, beyond the scope of short-term measures.

Structural fiscal reform should be supported by the gradual elimination of costly subsidies on retail prices for petroleum products: despite the authorities decision to charge a portion of the oil price increase to customers, and in order to limit subsidies and encourage energy saving, retail prices in Tunisia remain lower than those in its trading partners (domestic oil prices increased by about 15% in 2005, similar to what happened in 2005).

5. Social development and poverty

In the medium term, the authorities express the very ambitious objective of bringing per-capita income to the level attained in the lower-tier OECD countries and to reduce the unemployment rate to below 10%. According to the 11th Plan the strategy to achieve this objective is threefold: i) stimulate private investment, particularly in high-value-added sectors, ii) reform the education and training system to improve its efficiency, and iii) continue to gradually open up the Tunisian economy. The plan emphasises the need to continue with the reform effort in order to make productivity the main factor of growth, targeting a productivity gain of approximately half the projected GDP growth rate.

The substantial public resources allocated to education might have contributed to the sharp increase in the unemployment rate amongst people with superior education, which has nearly tripled in the past 15 years and is now officially close to 15%. The unemployment rate is particularly high for young people aged between 25 and 34 years old. In particular, the unemployment rate of people between 25 and 29 years old, which includes recent university graduates, has reached 23.4% of the total and has almost doubled in the past 20 years.

TUNISIA

Main economic indicators

	2003	2004	2005	2006 prel.	2007 proj.
Real sector					
Real GDP growth (% change)	5.6	6.0	4.2	5.8	6.0
Inflation (average)	2.7	3.6	2.0	3.9	2.0
GDP nominal (USD, billion)	25.0	28.1	28.7	29.2	29.5
GDP per-capita (USD)	2531	2811	2829	2924	3180
Social indicators					
Unemployment (officially registered, %)	14.5	14.2	14.2	13.9	13.8
Poverty rate (% population)			73.1		
Literacy (total, %)			77.1		
Fiscal sector					
Total revenues (% GDP)	29.5	29.7	28.9	29.6	
Total expenditure (% GDP)	32.8	32.2	31.7	34.1	
Central govt. balance (% GDP)	-3.4	-2.5	-3.1	-3.2	-3.1
Gross public debt, (% GDP)	63.0	60.9	57.3	55.6	54.5
Monetary sector					
Credit to private sector (%)	4.6	5.3	6.3	8.4	7.0
Broad money (M3, % change)	6.3	10.3	9.2	8.3	
Degree of monetisation (M2/GDP, %)	61.7	61.3	64.0	63.7	
Dollarisation in bank deposits (%)	706.2	755.3	939.4	976.3	
External sector					
Current account balance (% GDP)	-2.9	-2.0	-1.3	-1.6	-1.4
Trade balance (% GDP)	-9.1	-8.6	-6.9		
FDI (net, % GDP)	2.2	2.1	2.5	9.5	
Import cover of reserves (months)	2.7	3.0	3.5	3.7	4.7
External vulnerability					
External public debt (% GDP)	64.8	63.8	57.2	56.8	55.7
Debt service ratio[1]	13.0	13.7	13.2	12.9	12.4
Gross reserves (excl. gold, USD, million)	2945.4	3935.7	4372.2	4563.1	
Financial sector					
Short term interest rate (average, %)	5.0	5.0	5.0	5.0	
Exchange rate (dinar per USD, average)	1.3	1.2	1.3	1.3	
Exchange rate (dinar per euro, average)	1.2	1.4	1.6	1.5	
Real effective exchange rate (1992=100)	90.5	87.0	84.2	86.7	

Sources: IMF, EBRD, WB.

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

UKRAINE

- **Economic growth exceeded expectations in 2006, despite the negative energy price shock. Structural reforms have not progressed, however, owing to the political turmoil after the March 2006 parliamentary elections.**

- **After the adoption of pending WTO-compliant legislation in late 2006, Ukraine's accession to the WTO reached the final stage. Preparations are also under way to start negotiations on an EU-Ukraine Free Trade Area (FTA) after WTO accession.**

- **Inflation accelerated again in late 2006 due to hikes in energy and utility tariffs. An understanding on moving toward inflation targeting is emerging but the authorities are still cautious with respect to the nominal exchange rate anchor of the hryvnia.**

- **Regulatory and administrative reforms, including in taxation, need to be pursued to improve the business environment. Financial market development and better regulation are crucial for Ukraine to become a notable emerging market.**

1. Macroeconomic developments

Real sector developments

Real GDP growth rebounded to 7.1% in 2006 (2.7% in 2005) despite the soaring import prices on natural gas and the uncertain political situation, which put reform efforts on hold. The energy price shock accelerates restructuring and energy-saving efforts, particularly in steel and chemical industries. As described in the energy chapter in this Occasional Paper, Ukraine is one of the most energy-intensive economies in the region[1].

Private consumption was fuelled by high real income growth and rapid credit expansion, while investments in fixed capital also picked up after a slowdown in 2005. Net exports were more negative than the year before, although the external demand and prices for Ukraine's steel exports rebounded during the year. Wholesale/retail trade and transport/communications performed particularly strongly, growing by 17.7% and 6.6%, respectively. Industrial output increased by 6.2%, ranging from 8.9% in metallurgy to 3.2% in chemicals. The latter faced more difficulties in adjusting to the gas price increase. Agricultural output increased only marginally by 0.4%.

Inflation moderated to single digits in mid-2006 (partly explained by supply conditions of food products) but increased again to 11.6% year-on-year in December as a result of (delayed) pass-through of higher gas import prices to consumers. Salaries continued to grow rapidly, although somewhat slower than in 2005, 18.3% against 20.3% in real terms (or 29.2% against 36.7% in nominal terms). The government continued to boost social transfers, pensions in particular.

[1] International Energy Agency (2006*) Ukraine, Energy Policy Review*.

Fiscal policy

Buoyant income growth and private consumption supported strong growth in personal income tax and VAT collection, so that the fiscal deficit for 2006 is likely to have been curbed at around 1¼ % of GDP on a cash basis. Little progress was made in privatisation in 2006 after the previous year's landmark steel sector deal, and privatisation proceeds reached only 0.1% of GDP against 5.1% of GDP in 2005. Instead, the government tapped the Eurobond market for its financing needs. Looking forward, the need to develop the domestic hryvnia bond market will become more important.

Despite the overall fiscal conservatism of the authorities, the quality of public finances has not improved and the sustainability of the pension system is a particular concern given the demographic trends. The level of public expenditure has increased rapidly, from 36.8% of GDP in 2003 to an estimated 45.4% last year, as revenue collection has been strengthened, firstly, to finance higher spending on public wages and social transfers and secondly, more recently, to focus on other areas such as sectoral subsidies and public investment. The 2007 budget was vetoed by President Yushchenko in the midst of a prolonged confrontation over constitutional division of powers. The budget was finally adopted with the understanding that the government would find a way to increase the minimum wage and pensions in a supplementary budget. This is expected to increase the projected fiscal deficit from the original target of 2.4% of GDP to a revised government estimate of 2.7%, which is based on the official real GDP growth forecast of 6.5% for 2007.

Ukraine has maintained its BB- sovereign credit rating largely thanks to significant reduction in public debt, estimated at 15% of GDP compared to 61% of GDP in 1999. In the aftermath of the 1998 financial crisis, Ukraine established a fiscal rule which imposes a ceiling on outstanding debt stock at 60% of GDP.

Monetary and exchange rate policy

The National Bank of Ukraine (NBU) has undertaken preparations on moving towards inflation targeting, continuing discussions with the government on a Memorandum of Understanding. At present, Ukraine's monetary policy regime is linked to a peg of the hryvnia (UAH) to the USD at an official rate of 5.05 UAH per USD. The NBU's 2007 Monetary Policy Guidelines allow fluctuations within a narrow corridor of 4.95-5.25 UAH but so far the NBU has been very cautious given the perceived public sensitivity of the exchange rate issue. Short-term interest rates have little significance in the monetary policy framework and real rates have in fact remained clearly negative. Persisting financial dollarisation is another feature which reduces the effectiveness of monetary policy.

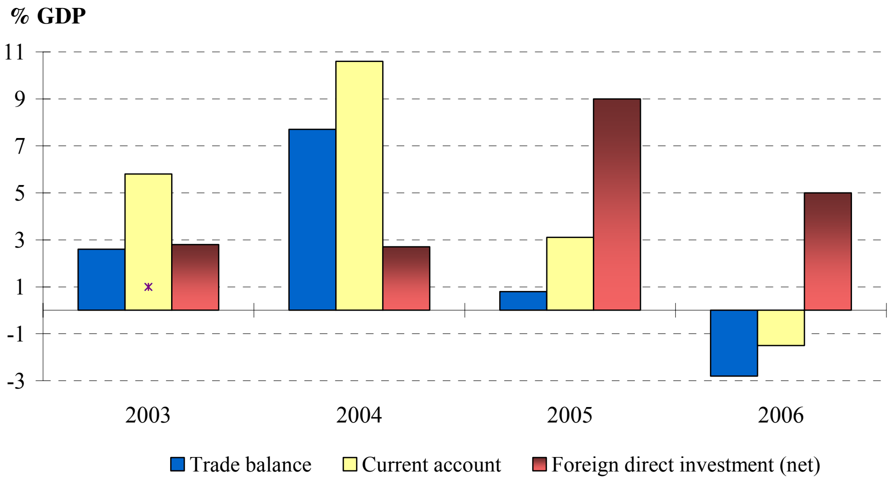
Gross international reserves of the NBU continued to increase in 2006, reaching USD 22 billion at end-2006, equivalent to about 5 months of projected imports. Base money growth is driven largely by the NBU's interventions in the foreign-exchange market and changes in the government deposits held at the NBU. In 2006, the monetary stance tightened until the last quarter of the year when reserve accumulation by the NBU picked up again. Monetisation of the economy (annual average M3/GDP) leapt to 44.4% in 2006.

External sector developments

Ukraine's external vulnerability continues to be high as metal products account for about 40% of exports and steel prices have been extremely volatile over 2004-2006. The current account has switched into a deficit of 1.6% of GDP in 2006 against a surplus of 2.9% in 2005. Ukraine recorded a trade deficit of about 2.9% of GDP, as a surplus in services (2% of GDP) mitigated a growing merchandise trade deficit (4.9% of GDP). Net energy imports soared as the import price for natural gas increased by some 60% in January 2006 to USD 95 per 1000 cubic metres. A further increase to USD 135 is effective as of January 2007. The increase in net energy imports is coupled with strong imports demand for private consumption and investment overall.

Capital inflows, including FDI, have picked up and the banking sector in particular has started to attract foreign capital. The sustainability of the recent rapid credit expansion, fuelled by access to external funding, is becoming a concern in the light of the weaknesses in banking supervision. While public external debt was reduced to 12.2% of GDP, commercial banks and other private enterprises borrowed heavily abroad in the past few years, bringing the total gross external debt of Ukraine to 48% of GDP. These trends are set to continue in 2007.

Chart 1- Ukraine: Balance of payments



Source: National Bank of Ukraine.

2. Trade liberalisation and economic opening

Ukraine's parliament (Verhhovna Rada) approved in December 2006 a final package of legislation required for WTO accession, which included measures on contested issues such as the sugar market, scrap metal exports, imports of used cars as well as access to Ukraine's services markets. The multilateral process to review those and other aspects with a view to finalising the accession process is ongoing. The European Commission and Ukraine started on 5 March 2007 negotiations on a new Enhanced Agreement to replace the present Partnership and Cooperation Agreement. Once Ukraine's accession process to the WTO is finalised, negotiations on a deep and comprehensive Free Trade Area can also start. In 2005, Ukraine lowered several import tariffs and upon WTO accession weighted average tariffs for agricultural and food products will also be lowered to an estimated 10.7% (from an estimated 19% before accession). For all goods combined, the weighted average tariffs will be about

5%. Ukraine benefits from the EU's preferential imports under the GSP, the utilisation rate of the GSP having reached 67% in 2005.

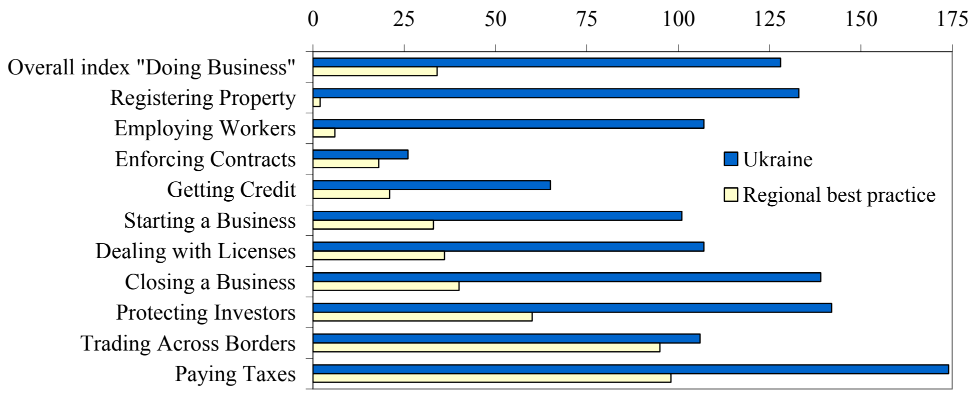
In 2006, the Commission and the Ukrainian Government agreed on a new agreement on trade in steel products, which foresees an increase in the EC import quota to 1.32 billion tonnes in 2007. The Commission has also been authorised to sign a renewal of the textiles agreement. Both agreements should be become obsolete upon Ukraine's accession to the WTO.

3. Business climate

Privatisation, enterprise restructuring and business environment

Ukraine's governance system is still in transition towards a fully functioning market-oriented economy. The European Commission's first progress report on the implementation of the European Neighbourhood Policy Action Plan[2] concurred with the findings of comprehensive cross-country surveys on the business climate. For instance, according to the Doing Business Database[3] the overall situation remained unchanged from 2005 to 2006, Ukraine ranking in 128th place among 175 countries in terms of ease of doing business. The main obstacles to businesses remain uncertain investor protection, tax pressure, excessive red tape and a dysfunctional judicial system.

Chart 2 - Ukraine: "Doing business" rankings



The ease of doing business index ranks economies from 1 (best) to 175. The regional best practice refers to the best ranking country in the eastern neighbourhood region.

Source: World Bank, 2007.

The 2006 privatisation target was missed as no large enterprises were sold due to legal disputes or otherwise unclear privatisation plans. Privatisation proceeds were at 26% of the target of 559 million hryvnia. The 2007 budget foresees privatisation proceeds of 10.6 billion, including possibly Ukrtelecom, Odessa Portside Plant and some minority stakes in energy sector assets such as regional distribution companies. The private sector accounts for some 65% of GDP.

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[2] See the Commission of the European Communities (2006) *ENP Progress Report -Ukraine*, COM (2006) 726 final of 4 December 2006. Available on http://ec.europa.eu/world/enp.
[3] See http://doingbusiness.org for the latest results for 2006.

Financial sector reforms

Ukraine's financial markets are dominated by commercial banks, while the non-bank financial market is in the early stages of development. Over 2006, bank loans to consumers more than doubled and loans to businesses increased by some 50%. Credit expansion outpaced deposit growth as banks had access to external funding. The market entry of several foreign banks has brought upon modern management and business practices, which is a defining feature of future competition for market shares. A rising portion of bank lending is in USD (64% in case of consumer loans) as the perceived fixed rate of exchange vis-à-vis the USD increases the attractiveness of the interest rate differential. The National Bank of Ukraine is considering several ways to curb excessive lending in foreign currencies and to inform the public of the exchange rate risks. Dollarisation and other financial market trends are further described in the box below.

Labour market reforms

Unemployment has continued to decline from 7.2% in 2005 to 6.4% in January-September 2006 (based on ILO definitions). The average monthly wage is 1041 hryvnias (158 euros). The grey economy's share of GDP is declining gradually but still exceeds 30% according to various estimates. Non-wage labour costs are relatively high at 38.8% of the salary and therefore not conducive to further formalisation of the informal economy.

The government has set the minimum wage with a view to gradual convergence with the so-called minimum living standard (cost of living for a working individual) that is indexed to the changes in consumer prices. In the public sector the entire wage scale moves in line with the increases in the minimum wage. In the private sector, wages are mostly set through sector-wide collective bargaining. Underreporting of wages is common for tax evasion purposes, which calls for reforms in addressing the high non-wage labour costs. As the adoption of a new Labour Code is pending in the parliament, it is still hard to assess the scope and direction of labour market reforms in Ukraine. Ukraine's labour force participation rate has been quite stable in recent years at 62%, and the proportion of women in the labour force is fairly high at 49%. Net migration has turned positive over 2005/2006. Total population continued to decline, however, reaching about 46.6 million in 2006.

4. Public institutions and public finance management

Ukraine's governance system as a whole is in need of a systemic reform, starting from the definition of clear constitutional responsibilities. Complicated, ambiguous and even contradictory legal acts are common, also as a result of vested interests.[4] The budget system is tightly defined in legislation but lacks transparency and accountability in revenue and expenditure planning and execution.

[4] The main challenges facing Ukraine's public administration and public finances are well documented in recent comprehensive assessments by the OECD and the World Bank. OECD (2006) *Ukraine Governance Assessment.* Available on http://www.oecd.org. World Bank (2006) *Ukraine Creating Fiscal Space for Growth: A Public Finance Review*. Available on http://www.worldbank.org.

Box 1 – Ukraine: Financial market trends in Ukraine

2006 was marked by continued entry of foreign capital to Ukraine's banking sector. The share of foreign capital increased to 27.6% of the statutory capital of banks (19.5% in 2005). The number of operating banks increased to 170 (January 2007) of which 13 are fully foreign owned. The top ten banks account for about 55% of all bank assets. The average capital adequacy ratio has declined somewhat to about 14% at present. The National Bank of Ukraine continues to push for higher capitalisation in the sector.

Deposit growth of 39% for 2006 shows that confidence in the banking sector continues to improve. Deposits in foreign currency, however, grew more than hryvnia deposits, increasing the rate of dollarisation from 34% to 38%. Credit expansion has been rapid, starting from a low level in 2000 when domestic credit to the private sector was equivalent to only 11% of GDP. As of 2006, this ratio had increased to about 45% of GDP. In the past two years the lending has really taken off, credits granted to households growing by 135% in 2006. The fastest growing segment included mortgages and consumer loans, most of which are denominated in foreign currencies. Strong growth in mortgage lending is expected to continue as outstanding mortgage loans are estimated to total no more than 3% of GDP. A similar tendency has been pronounced in other transition countries in 2006 (Croatia, Romania, Bulgaria and the Baltics). With increased competition, interest spreads have declined to around 5%.

Although banks dominate Ukraine's financial market, the securities market has also recently started to develop, in conjunction with privatisation. Stock market capitalisation has rebounded following the May 2006 turmoil in the world's emerging markets so that by the end of the year market capitalisation at about USD 44 billion was equivalent to about 42% of GDP (31% at end-2005) which is above the regional average. Stock prices continued to rise briskly in early 2007 but Ukraine's stock market is also subject to any turbulence in the world's emerging markets.

See also EBRD (2006) *Transition report 2006 - Finance in transition.*

The circumstances of the past year, with the protracted political turmoil and constitutional confrontations in the aftermath of the 2006 parliamentary elections, have not been conducive to strengthening the governance system. In some areas, such as public procurement, there has been even further backtracking. There are, however, some reform processes under way (e.g. tax administration, treasury management, internal audit and control) which could contribute to more effective and accountable public spending. An overall strategy for the public finance management reforms is needed to support the reform efforts under a common vision.

5. Social development and poverty

Poverty incidence[5] declined rapidly from 30% of population (2000) to below 20% (2003). Although more recent data is not available, the average rate of economic growth (7.2% in 2004-2006) and increases in social transfers would lend support to efforts to further reduce poverty. As economic growth and employment generation have been mainly confined to the big cities and other urban areas, pockets of poverty persist in mostly rural areas with a more elderly population depending on subsistence agriculture. Pensions have been the government's main instrument of social protection although this has proven costly as pension outlays have increased rapidly from 12% of GDP (2004) to an estimated 17 % (2005/2006).

[5] This is a national headcount figure based on the cost of a food basket of 2500 calories and an allowance for non-food goods and services.

UKRAINE

Main economic indicators

	2003	2004	2005	2006 prel.	2007 proj.
Real sector					
Real GDP growth (% change)	9.6	12.1	2.6	7.1	5.5
Inflation (average, %)	5.2	9.0	13.5	9.1	13.0
GDP nominal, (USD, billion)	50.1	64.9	82.9	106.1	115.0
GDP per-capita (USD)	1053	1372	1766	2041	2160
Social indicators					
Unemployment (ILO definition, %)	9.1	8.6	7.2	6.9	6.5
Poverty rate (% population)	19.5				
Inequality (Gini-index consumption/ income, %)	28.1				
Fiscal sector					
Total revenues (% GDP)	35.9	35.0	41.3	43.0	43.2
Total expenditure (% GDP)	36.8	39.5	43.6	45.4	47.3
General government balance (% GDP)	-0.9	-4.4	-2.4	-1.3	-3.0
Gross public debt (% GDP)	30.6	25.5	19.4	15	15
Monetary sector					
Domestic credit to private sector (% GDP)	26.7	27.1	35.6	47.0	
Broad money (M2, % change)	46.5	32.3	54.4	34.7	
Degree of monetisation (M2/GDP, %)	29.9	32.0	37.7	44.4	
Dollarisation in bank deposits (%)	32.2	36.5	34.2	38.0	
External sector					
Current account balance (% GDP)	5.8	10.6	3.1	-1.6	-3.8
Trade balance (% GDP)	2.6	7.7	0.8	-2.9	
FDI (net, % GDP)	2.8	2.7	9.0	5.0	5.0
Import cover of reserves (months)	2.9	3.1	5.1	5.0	
External vulnerability					
Total external debt (% GDP)	47.6	47.3	46.6	48.3	49.5
Of which: public external debt (% GDP)	21.6	19.2	14.7	12.2	11.0
Debt service ratio (% exports)	6.2	4.6	4.9	5.1	4.5
Gross reserves (excl. gold, USD, million)	6731	9302	19115	21899	
Broad money (M2 to reserves, %)	2.6	2.5	2.0	2.3	
Financial sector					
NBU discount rate (%)	7.0	9.0	9.5	8.5	
Lending rate (%)	17.9	17.4	16.2	13.2	
Exchange rate (hryvnia per USD, average)	5.33	5.30	5.13	5.05	
Exchange rate (hryvnia per EUR, average)	6.0	6.6	6.4	6.3	
Real effective exchange rate (% change)	-5.7	2.7	17.0	8.0	

Sources: IMF, World Bank, Ukrainian authorities, EC staff calculations.