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STRENGTHENING TRANSATLANTIC COOPERATION

Policy Brief

Mediterranean Policy Program—Series on the Region and the Economic Crisis

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Summary: This brief, the first in a series on the Mediterranean and the economic crisis, explores the impact of the global pressures on key countries in North Africa and the Eastern Mediterranean, including Israel and Turkey. The analysis suggests that most countries in the region are weathering the financial aspects of the crisis reasonably well, helped in some cases by a sharp recovery in energy prices.

On the trade front, the picture is more complicated. Turkey, in particular, has seen a marked increase in exports outside traditional European markets, with potentially significant implications for Mediterranean and transatlantic partners. The continued ability of the EU's southern partners to address challenges of crisis and recovery will play a key role in shaping the future of Euro-Mediterranean relations. The emergence of a more integrated Mediterranean economy could be one positive outcome of the current economic stress.

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The Economic Crisis and the Mediterranean: Mixed Effects, Longer-Term Questions

by Franco Zallio[1]

The impact of the international economic crisis on Mediterranean countries[2] has been relatively limited. With the exception of Turkey and Israel, where the first displays a deep recession (-6.5% in 2009)[3] and the latter registered zero growth, economies in the region continued to expand, even if at lower rates compared to previous years. They also exhibit noteworthy financial and macroeconomic solidity; not a single Mediterranean country needed emergency financial support.

Seen from Brussels, the rather satisfactory trends of Mediterranean economies represent both a paradox and a challenge. The paradox emerges when comparing Mediterranean countries with Central and East European ones, where economic growth rates are all negative (reaching double-digit drops in Baltic countries) except for Poland, which has managed to achieve modest growth. The picture within the European Union's (EU) eastern neighbors is similarly unfavorable. Only Azerbaijan shows evidence of a positive growth rate, while other countries are hit by recession, displaying up to double-digit drops like Armenia and Ukraine. The region receiving the highest volumes of European financial aid for the past 20 years also appears to be the one most affected by the crisis and now requires additional financial support.[4] Furthermore, the difficulties of Central and Eastern Europe have created noteworthy problems for the West European banking system, which had previously carried out important investments in that geographical area. Currently, this paradox does not seem to have affected EU policies, but it has not gone unnoticed by EU business sectors, which are increasingly interested in the Mediterranean region.

Mediterranean economies' ability to resist the international economic downturn represents a challenge for the role the EU plays in the region. The EU is the region's main economic partner, with more than 40% of overall trade exchange. But there are notable differences between Maghreb countries, where EU trade share reaches almost two thirds, and the Near East, where the United States, the Gulf and Asian countries have a considerable weight. In 2008 and 2009, the EU exported its recession to Mediterranean countries

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[2] We refer to those countries on the southern and eastern shores of the Mediterranean, from Morocco to Turkey.
[3] Where not indicated otherwise, the reported figures are drawn from the *World Economic Outlook and the Regional Economic Outlook: Middle East and Central Asia*, published by the International Monetary Fund (IMF) in October 2009.
[5] During 2008 and 2009, Armenia, Belarus, Georgia, Hungary, Latvia, Romania, and Ukraine received financial support from the EU and/or from the IMF. Furthermore, Poland obtained from the latter a precautionary flexible credit line. Among Mediterranean countries only Turkey may borrow from the IMF, with which it has been negotiating for over a year without, yet, reaching an agreement.

Table 1. Real GDP growth (annual change, percent)				
	2007	2008	2009	2010
Algeria	3.0	3.0	2.1	3.7
Egypt	7.1	7.2	4.7	4.5
Israel	5.2	4.0	-0.1	2.4
Jordan	8.9	7.9	3.0	4.0
Lebanon	7.5	8.5	7.0	4.0
Libya	7.5	3.4	1.8	5.2
Morocco	2.7	5.6	5.0	3.2
Syria	4.2	5.2	3.0	4.2
Tunisia	6.3	4.6	3.0	4.0
Turkey	4.7	0.9	-6.5	3.7

Source: IMF

through an abrupt decline in imports. The way in which Mediterranean countries—Turkey in particular, which is by far the biggest exporter in the region—coped with the strong decline in European demand, represents a challenge for both the EU's role and policies. The diversification strategy adopted for dealing with the crisis carries impacts that are not of a mere transitory nature. This is especially true for Turkey, where these strategies are coherent with a general reassessment of its regional relations. At the same time, the changes in trade flows triggered by the crisis increased economic integration among Mediterranean countries, opening new opportunities for a more intense structuring of the region, starting from Euro-Mediterranean relations.

Mediterranean countries and the international crisis

The impact of the crisis can be summarized by disentangling Mediterranean economies into three groups. The first one includes the two big oil-producing countries, namely Algeria and Libya. The crisis mainly affected them through the impact on oil prices, which dropped from $140/barrel (B) in July 2008 to $35/B in January 2009. To keep prices from dropping further, and push them up, they were forced to reduce oil production, triggering a strong recessive effect. Through oil revenues accumulated in previous years, they nevertheless managed to support domestic demand with a strongly expansionary public expenditure. Non-oil GDP grew considerably (by 5.7% in Algeria and 6.0% in Libya), while total GDP growth rate remained positive, even at low levels (2.1% in Algeria and 1.8% in Libya). The current recovery of oil prices, which bounced back above $70/B, will allow those countries to maintain their expansionary fiscal policies for 2010.

The second group includes Israel and Turkey, the two countries most developed and most integrated into the international economy. While their financial sectors have been affected by the international crisis to a rather limited extent, their real economies have, nevertheless, suffered considerable repercussions from the drop in external demand. Their exports declined massively (-28% in Israel in the first 10 months of 2009 and -30% in Turkey in the first nine months[5]). Drop in industrial production was a direct consequence, which spilled-over into a decrease in investments, negatively affecting private consumption. Expansionary monetary and fiscal policies, coupled with a strong devaluation, did not protect Turkey from severe recession. Israel displays a better performance, escaping recession in 2009 and heading toward recovery in 2010.

The third group includes the remaining Mediterranean countries that, notwithstanding the crisis, registered growth rates of at least 3% in 2009 (see Table 1 above), with a peak of 7% in Lebanon. These results, albeit influenced by meteorological factors (an exceptional agricultural year supported growth in Morocco, while a severe drought damaged the Syrian economy), were mainly caused by the international crisis. The crisis did not uniformly affect foreign exchange receipts across countries. Exports dropped nearly everywhere. Revenues from tourism exhibit uneven, but overall good, patterns, with particularly good results in Lebanon and Syria. Remittances dropped significantly, especially in Egypt and in Morocco. After several years of continuous growth, foreign direct investment inflows witnessed an abrupt fall, and were halved in the first semester of 2009. Other capital movement—often limited by definition because many Mediterranean countries do not allow

[5] These figures, in dollar terms, are drawn from the respective National Statistical Offices.

capital account convertibility—did not register major changes. Lebanon is the sole exception where capital inflows strongly grew, extending the economic boom triggered after the 2006 war. Good reputation and solidity of the Lebanese financial system attracted capital from abroad, especially from other Arab countries. Those movements were favored by the substantial capital losses Arab investors experienced in European and American markets.

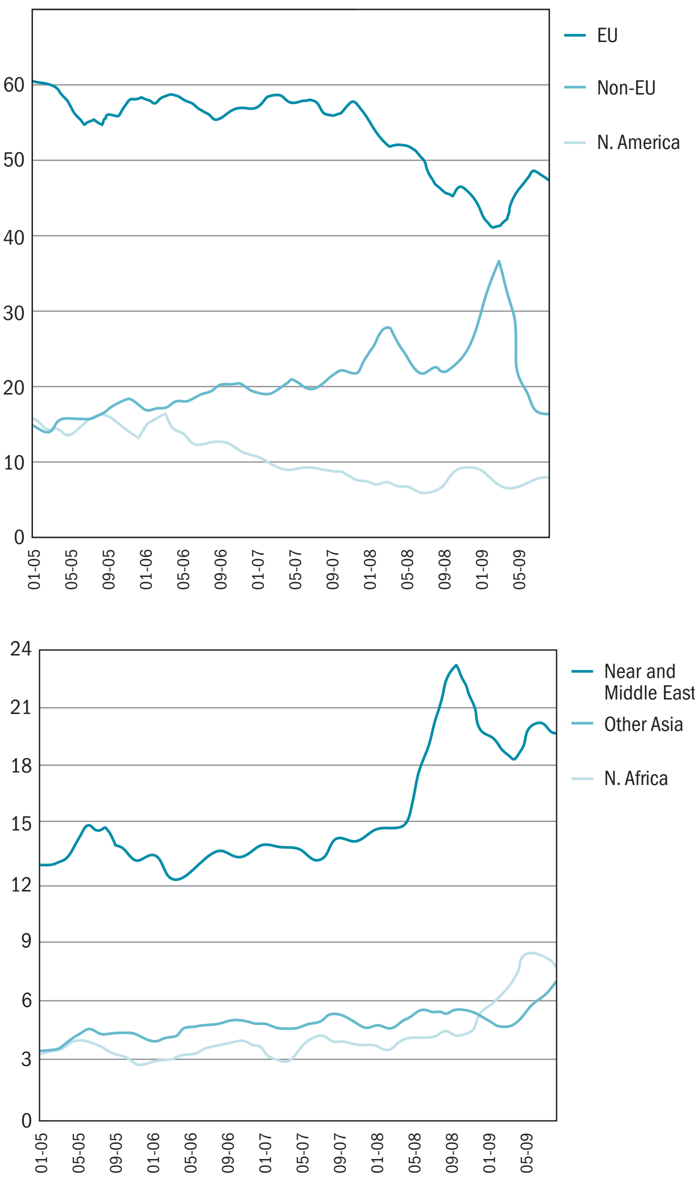
According to IMF forecasts, in 2010 all Mediterranean economies will register positive growth rates. Turkey, among them, should witness a substantial recovery, even though—as in the United States and the EU—employment remains in a precarious state. Unemployment (which showed a steep increase in 2009, reaching 17% for non-agricultural labour force, and 28% for the 15-24 age group, in July-September) is likely to remain elevated for the full year. It could, therefore, be inferred that the impact of the crisis on Mediterranean countries was mainly temporary, without causing structural changes. While it is too soon to draw firm conclusions about structural effects of the crisis, lessons from Turkey, examined in the next section, lead us to think that Mediterranean economies will come out from the crisis significantly changed.

Turkey, between the EU and the Mediterranean region

The impact of the crisis on the productive structure and geographical orientation of the Turkish economy is noteworthy. In 2008 and 2009, the decline of EU demand considerably affected a country that back in 2007 had exported to that market a remarkable 56% of its total exports. This decline caused a net drop of its industrial production (-13% in the fourth quarter of 2008, -21% and -15% in the first two quarters of 2009). This has highlighted the weakness of an industrial development model heavily dependent on products destined to be exported to the EU. Consequently, the crisis has accelerated a diversification of export markets. A process that was timidly launched in previous years stimulated by the quick economic growth registered since 2003 in countries close to Turkey (Russia, Mediterranean countries, and Gulf countries).

As shown in Figure 1, the decline in Turkish exports to the EU[6] is matched by an increase in exports toward non-EU European countries (mainly Russia), North Africa, and the Near and Middle East. Nowadays, exports to the latter are close to 20% of total Turkish exports. Data from the first nine months of 2009 are impressive. Total Turkish exports declined, in dollar terms, by 30%. This fall is not specific to a single region but is general.[7]

Figure 1. Turkey's Selected Exports Markets
(Jan. 2005-Aug. 2009 percentage share)



Source: TURKSTAT, CBT

[6] On a smaller scale, a similar phenomenon occurred for exports toward the United States, which witnessed a sensible drop.

[7] The only exception is North Africa, due to growing exports to Algeria, Egypt, and Libya.

Nevertheless, Turkish exports have more than doubled to Egypt, increased by 53% to Libya, by 24% to Syria, and by 18% to Algeria. Outside the Mediterranean basin, exports toward Iraq increased by 41%, thus turning it into Turkey's fifth-best customer, outranking the United States, Russia, and the United Arab Emirates, and coming very close to Italy and the United Kingdom.[8]

These increments, which are taking place during a period of world crisis, are of particular significance. They, in fact, demonstrate that the increase of the Mediterranean share in Turkish exports is not the mere statistical counterpart of the decline in EU share. Instead, it results from a policy focused on diversifying export markets, which, given the positive economic perspectives of the Mediterranean region, should witness further strengthening.

It may be tempting to consider this data as further evidence of the "we are losing Turkey" argument and treat Turkey as a challenge to the European role in the region. Nonetheless, some more reassuring, if not positive, conclusions can be drawn. To begin with, one must underline the positive value a country acquires by diversifying toward emerging markets during a crisis that mainly stemmed from developed countries. Diversification diminishes Turkey's vulnerability toward its export markets. Second, one must consider the benefits its expanding economic role can bring to the Euro-Mediterranean region.

New challenges, new opportunities

A more ambitious role for Turkey in the region, both economically and politically, is on the agenda. The international economic crisis has accelerated its progress. This could offer the EU the opportunity to overcome one of the major weaknesses characterizing Euro-Mediterranean relations.

The Euro-Mediterranean region, in fact, suffers from a weak economic integration among Mediterranean countries, whose negative effects have been emphasized by the downturn. The serious challenges raised by the international crisis, and the difficulties achieving a true global economic governance, may lead to a growing economic regionalism that would aggravate the weaknesses of poorly structured areas. European interest in strengthening integration within the Euro-Mediterranean area is, thus, increasing. A more active role for Turkey as catalyst for deeper South-South integration could represent an important opportunity. In fact, EU countries dominate economic relations of Mediterranean countries, while South-South relations remain limited. Trade among Mediterranean countries represents only 5% of their total exchanges. This is a very low level, and the Euro-Mediterranean free trade area's slow entry into force has not succeeded yet in expanding it.

Nevertheless, if appropriately implemented, Euro-Mediterranean free trade agreements could offer considerable opportunities to deepen South-South integration. These agreements, in fact, allow for the so called "diagonal" cumulation of rules of origin. This permits the sum of local value contents from different countries within the Euro-Mediterranean free trade area to benefit from duty-free access to the European market, which promotes industrial integration across Mediterranean countries.

To date, such opportunity has not been fully exploited. As it has been recently noted, "It seems that the cumulation of the rules of origin has not been fully utilized. The main reason … are high costs of EU inputs."[9] If the high costs of input produced in the EU stand as the major obstacle against the integration of productive processes within the Euro-Mediterranean area, it results that Turkey—thanks to the low prices and good quality of its products—could become an important supplier of input and of intermediate goods to Mediterranean countries producing duty-free industrial goods bound for the EU. This could upgrade the status of Mediterranean countries inside the international division of labor, where the EU continues to be the final destination market and the anchor for trade policies. In this scenario, an increasing role for Turkey in regional economic relations would not damage the regional role of the EU, but it could improve the outcome of such role.

The crisis appears to have strengthened the regional role played by Turkey. This represents a significant opportunity for the EU and its Mediterranean ambitions. Taking advantage of such

[8] While there is no room here to expand on this matter, Iraq's growth potential cannot be disregarded when evaluating the growing role of Turkey in the Euro-Mediterranean area, particularly on the medium-long run. Iraq has already signed agreements with international oil companies and is currently negotiating others which will lead to a massive increase in productive capacity. This could allow Iraq to become the second OPEC producer, immediately after Saudi Arabia. This is not the first time that Iraq seems on the verge of making huge progress exploiting its oil reserves. A project of this size—which impinges upon key economic interests of other oil producing countries in the region—could end up increasing local and regional instability rather than economic development. Nevertheless, with a note of caution, it could be argued that the development of Iraqi oil industry will have a strong positive impact on the Turkish economy, and consequently on its Mediterranean partners.

[9] CASE-CEPS. "Economic Integration in the Euro-Mediterranean Region." Final Report. September 2009, p. 14. Available at: http://trade.ec.europa.eu/doclib/html/145214.htm

opportunity would mean succeeding in exploiting the international economic crisis for a better structuring of the Euro-Mediterranean region. Rather than protecting its role *vis-à-vis* the emergence (or, rather, the re-emergence) of another regional player, the true challenge for the EU appears to be that of valuing and appreciating the regional evolution of Turkey by encouraging its cooperative potential, thus promoting further integration within the Euro-Mediterranean area. What remains to be seen is the extent to which the EU, weakened by the stalls of negotiations on Turkey's membership in the Union, will be able to stand up to the challenge. An early test may be the EU Strategy for the Mediterranean region, which the new European Commission will design after the already-approved EU Strategy for the Baltic Region and the currently-under-preparation EU Strategy for the Danube Area.