

**Summary:** As revolts spread throughout Mediterranean countries, the EU Mediterranean policy is experiencing a phase of great uncertainty. However, the ongoing transformation in Mediterranean countries will have deep political and economic consequences to which EU policies must adapt. While political modernization will overshadow economic issues, the latter will play a central role in ensuring the sustainability of the transformation process. Moreover, Europe's evolving cooperation with Mediterranean countries will be built upon the EU's existing economic instruments of cooperation. Currently, Egypt is turning against the economic reforms of the last decade. This could trigger the adoption of new populist economic policies, with possible long-term negative consequences. The EU could implement new tools for financial assistance helping Egypt and Tunisia to "reform their economic reforms." While preserving past economic reforms, these new tools should be modified to align their objectives more closely to the new political situation.

## Reforming Economic Reforms: Europe and the Ongoing Transformation in Mediterranean Countries

by *Franco Zallio\**

As revolts spread throughout Mediterranean countries, the EU Mediterranean policy is experiencing a phase of great uncertainty. The new instrument launched in 2008 – the Union for the Mediterranean (UfM) – has sunk into irrelevance. This became apparent last November when the Summit of the Heads of States was again postponed and on January 26, 2011 when the Jordanian Ahmad Masa'deh, its Secretary General, resigned. This was finally confirmed by the fall of former Egyptian President Hosni Mubarak, who co-chaired the UfM.

Uncertainty over political regional developments and concerns over energy supply and migration flows – accentuated by the ongoing crisis in Libya – lead to a widespread caution, coupled with policy statements backed by few concrete commitments. However, it is clear that the ongoing transformation in Mediterranean countries, whilst showing great differences from country to country, will have deep political and economic

consequences to which the EU policies must adapt.

The political transition that started in Egypt and Tunisia is promising, but it will face great challenges and undergo fluctuations and uncertainties, as already shown by the resignations of post-revolt prime ministers in both Egypt and Tunisia. Constitutional and political changes will be in the spotlight, overshadowing economic issues, and European cooperation must support the formal and material configuration of political modernization in Mediterranean countries. However, it should be noted that economic issues will play a central role in ensuring the sustainability of the transformation process. Moreover, Europe's evolving cooperation with Mediterranean countries will be built upon EU's current main instruments of cooperation, which are economic in nature. Actually, in the last decades, the EU has oriented its cooperation with Mediterranean countries toward economic reforms. This was

# Policy Brief

achieved through the use of financial instruments as well as supporting the modernization of production systems and economic regulations.

## A Sharp Deterioration in the Economic Performance

This year, the economic performance of Egypt and Tunisia will deteriorate significantly. On a macroeconomic level, this will result in a sharp slowdown in real GDP growth, a rise in consumer prices, large currency devaluation, and a sharp increase in both budget and balance of payments deficits.

This deterioration is explained by a number of factors that affected production, consumption, and capital flows. Frequent interruptions of production activities have damaged almost all sectors; tourism has also severely suffered from the drastic decline in foreign tourists' inflows, which had strong repercussions on employment levels in the sector. Consumption was badly affected by repeated interruptions in the distribution of goods and the disappearance of essential goods from the market, hoarded for precautionary and speculative purposes. The freezing of direct foreign investments occurred together with a sudden outflow of foreign portfolio investments, as well as a substantial capital flight.

The balance of payments has been adversely affected by a decline in exports, a sharp decrease in tourism receipts, and a substantial capital outflow. The resulting deficit will be mainly financed by reducing the substantial foreign assets accumulated over the previous years. This year, the budgets of Egypt and Tunisia will also record a clear expansion of the deficit, due to the increases in subsidies to basic consumer goods and in public wages devised to curb the protests.

In recent years, the economies of Egypt and Tunisia, as most Mediterranean economies, had recorded high growth rates and favorable balances of payments, which had allowed them to significantly reduce the external debt and to increase the holdings of foreign assets. This implies that they should be able to cope with the negative trends of 2011 without incurring a financial or debt crisis. Exceptional financial assistance from the EU and the United States may still be necessary, given medium- to long-term prospects, as we shall see in later sections.

## A Populist Trend Holding Back a Positive Economic Potential

Over the longer term, Egypt and Tunisia show positive economic prospects. This is favored by the availability of a relatively skilled labor force and the possible emergence of a stronger entrepreneurial spirit in the new economic context following the expected greater political openness. However, the realization of this positive scenario requires appropriate economic policies. It is in this respect that European cooperation could be of great importance.

Indeed, significant risks are to be found along the way. The new governments of Egypt and Tunisia, in their search for popular legitimacy, are strongly tempted to adopt populist economic measures focused on short-term effects, even at the cost of worse long-term prospects. The new authorities' priority, when setting the economic agenda, will understandably consist of measures to boost employment — of young people in particular — and moderate the prices of basic goods. This will likely lead to the interruption of privatizations and to an increase in employment in the public and semi-public sectors; subsidies for basic goods will be maintained if not augmented. These measures will likely be accompanied by protectionist measures to promote locally produced goods over imported foreign products. Based on the past experiences of Mediterranean countries, these economic policies could bring positive results in the short term but would not be sustainable in the longer term, as they would lay the grounds for a crisis in government debt and/or foreign debt. Furthermore, these measures would discourage direct foreign investment. All in all, this would reduce the integration of Mediterranean countries into the international economy, reversing the progress made by the economic reforms of the last decade. All this would have long-term adverse consequences on the economies of the region, but can still be avoided.

Populist tendencies are currently expressed mostly in Egypt. The military, and the opponents to the regime, are particularly critical of the economic reforms that were adopted in the last decade. From 2004 to 2011, the economic reforms in Egypt have been developed and managed by a team of technocrats and businessmen closely linked to Gamal Mubarak, the President's son, at the time seen as a potential successor to his father. These reforms have been highly effective in terms of accelerating economic growth and

# Policy Brief

improving macroeconomic balances. In addition, the international perception of the economic opportunities offered by the country has grown favorably and generated a very significant inflow of foreign direct investment and other deals with foreign partners. For instance, in the report on “Offshoring Opportunities Amid Economic Turbulence” published by A.T. Kearney last January (which did not take into account the recent political changes), Egypt occupied the fourth place in the world ranking of the best locations for global services outsourcing, a strong improvement on the twelfth place which it gained in 2005.

Despite the positive macroeconomic impact of economic reforms, unemployment has remained high, especially for young people, and growing inflation (in part linked to the global food crisis) has eroded the income of the poorest share of the population. Some economic reforms have mainly benefited a small elite of businessmen and politicians. Furthermore, the economic development has created a class of young people who are educated and technologically skilled, and whose frustration toward decades of a blocked policy framework has been growing. All this laid the grounds for the revolts of last months.

Paradoxically, economic reforms are now being criticized as much by the opposition, which only sees them as a factor that enabled a massive enrichment of the Mubarak family and the elites close to it, as they are by the military, who blame the economic reforms for the loss of government control over the country’s political and social situation.<sup>1</sup> Business people and technocrats who drove the economic reforms in recent years have been excluded from the new Egyptian government. Some of them are now under investigation for corruption and prevented from leaving the country, and their financial assets have been frozen. Taking into account the still large role of the army in the economy, and the vaguely socialist, or nostalgically Nasserite, vision put forward by top leaders of the armed forces, it is possible that economic reforms will be stopped, or even reversed.

<sup>1</sup> According to a 2008 U.S. embassy cable published by Wikileaks, the commander-in-chief of the Egyptian army and Defense Minister Tantawi, who is now heading the military council that took power after the fall of Mubarak, opposed economic reforms because they erode the government’s power and foster social instability by lessening the government’s control over prices and production (“U.S. embassy cables: Tantawi resistant to change in Egypt,” <http://www.wikileaks.la/us-embassy-cables-tantawi-resistant-to-change-in-egypt/>).

## Reforming Economic Reforms: A New Area of Cooperation for the European Union?

With this risk in mind, the EU could implement new mechanisms of financial assistance for Mediterranean countries to support the basic objectives of past economic reforms, reformulated in a way that pays much more attention to their social impact and ensures their transparency. In fact, the main economic challenge arising during the political transformation in Mediterranean countries is to review the economic reform process by encouraging transparency and avoiding negative social effects, without relinquishing the progress achieved over the past decade.

Paradoxically, economic reforms are now being criticized as much by the opposition, which only sees them as a factor that enabled an enrichment of the Mubarak family, as they are by the military.

Greater transparency would limit the role of a small circle of politicians and businesspeople, and reduce clientelism, nepotism, and corruption. The adoption of more effective policies to support small and medium enterprises would encourage the multiplication of economic actors, reducing the dependency of the economic sector on the political system, while improving employment. New wage and fiscal policies more mindful of the social impact of the economic reforms would promote the redistribution of productivity gains. This should come together with a reform of the welfare system, which should no longer rely on subsidies to basic consumer goods that benefit the whole population, but ought to directly target poverty and social disadvantage. Finally, the education and health care systems should be deeply reformed.

These are issues that Europe boasts a very long experience with on both the institutional and civil society levels.

# Policy Brief

The main economic challenge arising during the political transformation is to review the economic reform process by encouraging transparency and avoiding negative social effects, without relinquishing the progress achieved over the past decade.

This experience, partly neglected in recent years, could be valuable in the current environment. This could generate new forms of Euro-Mediterranean cooperation, remodeling existing instruments of cooperation and creating new ones if necessary, to support political transformation in the region and improve its economic impact.

The exceptional financial assistance that the EU is most likely to offer Egypt and Tunisia to deal with the negative economic evolution described above should be linked to a set of structural measures promoting, so to speak, a reform of the economic reforms implemented so far. It should be noted that, whilst the army may have economic and ideological reasons to support some economic centralism, this is not the case for the opposition forces. Keeping this in mind, it is important that the objective of stability, which in the past decades has driven European policies in the region, and is today showing its limitations, does not sway Europe toward supporting populist measures. Through promoting this “reform of the reforms,” the EU could also strengthen transatlantic cooperation in the region. In fact, even the United States, who strongly supported past economic reforms, needs to now review its own policies in the region while preventing the positive results of the economic reforms of the last decade from being wasted.

## About the Partners

**G | M | F** The German Marshall Fund  
of the United States

STRENGTHENING TRANSATLANTIC COOPERATION

The German Marshall Fund of the United States (GMF) is a non-partisan American public policy and grantmaking institution dedicated to promoting better understanding and cooperation between North America and Europe on transatlantic and global issues. GMF does this by supporting individuals and institutions working in the transatlantic sphere, by convening leaders and members of the policy and business communities, by contributing research and analysis on transatlantic topics, and by providing exchange opportunities to foster renewed commitment to the transatlantic relationship. In addition, GMF supports a number of initiatives to strengthen democracies. Founded in 1972 through a gift from Germany as a permanent memorial to Marshall Plan assistance, GMF maintains a strong presence on both sides of the Atlantic. In addition to its headquarters in Washington, DC, GMF has seven offices in Europe: Berlin, Bratislava, Paris, Brussels, Belgrade, Ankara, and Bucharest.

[www.gmfus.org](http://www.gmfus.org)



Paralleli's mandate is to contribute to the creation of a Euro-Mediterranean area of freedom and of economic and social development. The institute acts at the local, national, and international level with the aim of meeting the needs of the North-West region of Italy concerning its relations with the other sides of the Mediterranean Sea. The activities of the Institute fall within the process of Euro-Mediterranean partnership initiated by the European Union with the 1995 Barcelona Process and currently undergoing a major relaunch through the “Union for the Mediterranean,” since July 2008. Paralleli intends to contribute to the reinforcement of political relations, economic cooperation, cultural exchange, and human flows between the European and the South-East Mediterranean countries. Its main objective is to promote dialogue at cultural, social, and political level between the societies of the Mediterranean countries, with the aim of encouraging and improving economic relations between them, with a particular focus on the dimension of sustainability and co-development. For this reason, the institute has decided: to involve civil society in the development of Euro-Mediterranean relations; to create and to support networking in the Mediterranean area; and to increase the value of research in order to suggest truly effective policies to local, national, and international actors.

[www.paralleli.org](http://www.paralleli.org)