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THE IMPACT OF THE GLOBAL FINANCIAL TURMOIL AND RECESSION ON MEDITERRANEAN COUNTRIES' ECONOMIES

by Michael Sturm
and Nicolas Sauter

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1 The paper is based on two background papers that were prepared for the ECB workshop on economic and financial developments in Mediterranean countries held in Frankfurt on 2 and 3 November 2009. It has benefited from the comments of François Gurtner, Thierry Bracke and Frank Moss and from comments made by representatives of central banks of the Eurosystem and of Mediterranean countries during the workshop. Research assistance was provided by Livia Chitu.

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ABSTRACT

This paper reviews the impact of the global financial turmoil and the subsequent recession on the economies of southern and eastern Mediterranean countries. The major effects on the economies of this region have come through transmission channels associated with the real economy, i.e. the global recession. These are, in particular, declines in exports, oil revenues, tourism receipts, remittances and foreign direct investment (FDI) inflows, with the drop in exports so far appearing to have had the strongest impact. As a result, real GDP growth has weakened in the wake of the global crisis. However, the weakening of economic activity in the Mediterranean region has been less pronounced than in advanced economies and most other emerging market regions. The main reason for this is that the direct impact of the global financial turmoil on banking sectors and financial markets in Mediterranean countries has been relatively limited. This is mainly due to (i) their lack of exposure to US mortgage-related assets that turned "toxic", a feature the region shares with other emerging markets, and (ii) the limited financial development of many countries in the region and their limited integration into global financial markets, a feature that distinguishes the region from other emerging markets and, in particular, from the euro area's neighbours to the east. Notwithstanding the relative resilience of southern and eastern Mediterranean countries in the wake of the global crisis, the region faces significant challenges. In particular, many countries need significantly higher growth rates to address the employment challenge posed as a consequence of demographic developments.

Keywords: Global economic crisis, Mediterranean countries, financial sector, international spillovers.

JEL classification: R11, E60, G21.

SUMMARY

After years of robust economic performance in the Mediterranean region, resulting from both a benign global backdrop and progress in structural reforms in many southern and eastern Mediterranean countries, the global economic environment began to pose difficulties for the region in the second half of 2008 and 2009, in the wake of the intensification of global financial turmoil and the subsequent global recession. The region has mainly been affected by the global recession rather than by the direct impact of global financial turmoil. All countries have been adversely affected by the crisis, but to varying degrees, and the Mediterranean region as a whole has been less affected than advanced economies and other emerging market regions, in particular central, eastern and south-eastern Europe.

The major effects of global developments on the economies of the Mediterranean region have come through transmission channels associated with the real economy. Declines in exports, oil revenues, tourism revenues, remittances and foreign direct investment (FDI) flows have been the major channels. As a result, real GDP growth in the region weakened significantly in 2009. However, growth has remained positive in almost all the Mediterranean countries and is also projected to be higher than that in advanced economies and many other emerging market regions in 2010.

A positive side effect of the global crisis throughout the region has been the significant fall in inflation, which had spiked in 2007 and 2008 and constituted its main macroeconomic challenge until mid-2008. As food accounts for a large proportion of many countries' consumer price index (CPI) baskets, the decline of global food prices has been a major factor in easing pressures on real incomes.

Budget balances have weakened in the region, most notably in oil-exporting countries, as a result of the sharp drop in oil prices. In non-oil-exporting Mediterranean countries fiscal deficits have increased, but not as significantly as in advanced economies. This is because of the less pronounced economic slowdown in Mediterranean non-oil-exporting countries, the relative weakness of automatic stabilisers and the decline in expenditure on oil and food subsidies after the fall in global commodity prices. The large current account surpluses of the major oil-exporting countries in the region have plummeted as a result of the drop in oil prices, while the current account balances of most non-oil-exporting countries have remained broadly stable or slightly strengthened. The decline in imports due to lower oil prices and weaker domestic demand has outweighed the drop in exports resulting from lower external demand. The large expansion of oil-exporting countries' foreign exchange reserves has come to a halt.

The main reasons for the limited direct spillover from global financial developments to financial sectors in the Mediterranean region are (i) the almost complete lack of exposure of their financial institutions to mortgage-related US securities that turned "toxic", and (ii) the generally limited integration of these countries into global financial markets.

The most direct and immediate impact has been on stock markets in the region, which since mid-2008 have been plummeting broadly in line with global markets, owing to the increase in risk aversion and the weakening in support from the regional recycling of oil revenues. However, given the limited importance of capital markets in most countries, whose financial systems are mainly bank-based, the impact of stock market fluctuations on the overall economy tends to be limited.

The sharp fall in cross-border lending of banks reporting to the Bank for International Settlements (BIS), a key feature of the "post-Lehman" global financial landscape, has been less pronounced in Mediterranean countries than at the global level, and overall dependence on financing from BIS-reporting banks is low. As in most advanced and emerging market

economies, a slowdown of credit extension to the private sector has been observed in Mediterranean countries, while bank lending to the public sector has increased. This increase in bank credit to the public sector can be attributed to the increased financing requirements of governments and, in some cases, the withdrawal of non-residents from domestic Treasury bill (T-bill) markets. Deposit growth has been stable, and some countries have even benefited from the global crisis, as the perception of risk in their domestic banking systems changed favourably in comparison with that in advanced countries' banking sectors. The global financial turmoil has, in some Mediterranean countries, slowed down the privatisation process in the banking sector.

The main economic risk for the region is a weak and uneven recovery of the global economy. Economic developments in the European Union (EU) are of particular importance to the region, given the close economic and financial links of most of its countries with the northern shore of the Mediterranean. Notwithstanding the relative resilience of southern and eastern Mediterranean countries in the wake of the global crisis, three issues could pose particular challenges if economic activity were to remain weak over a protracted period: (i) while the real GDP growth rates exhibited by Mediterranean countries in the wake of the global recession are positive, and higher than those in advanced economies and some other emerging market economies, they are still too subdued to address the significant employment challenges that many Mediterranean countries face over the medium term in view of a rapidly growing labour force and already high unemployment levels; (ii) a protracted slowdown in Mediterranean economies may cause non-performing loans to rise and add to pre-existing vulnerabilities of the banking sectors in several countries, namely an already large stock of impaired assets; and (iii) given high debt levels, most countries in the region – in particular the non-oil-exporting countries – have hardly any room for manoeuvre in further sustaining domestic demand with fiscal policy measures. Furthermore, the means by which monetary policy can respond are limited, owing to, inter alia, exchange rate regimes and still relatively high inflation in some countries.

I INTRODUCTION

This paper reviews the impact of the global financial turmoil and the subsequent recession[1] on Mediterranean countries' economies.[2] The global financial turmoil that erupted in August 2007 originated in the United States, with the sub-prime mortgage market as its epicentre. In September 2008, after the collapse of Lehman Brothers, it significantly intensified and became a global financial crisis. The turmoil has been characterised by immediate and substantial spillovers from financial developments in the United States to financial markets and banking sectors in other advanced economies, by a loss of confidence and by negative feedback loops between the financial sector and the real economy, resulting in a global recession. While at the beginning of the turmoil emerging market and developing economies appeared to have been decoupled from the economic downturn occurring in advanced economies, it became increasingly evident that such a decoupling was illusionary, owing to the intensity of the downturn, the collapse in global trade and the fall in commodity prices. Accordingly, the interconnected nature of the global economy led to a sharp and synchronised global downturn.

The direct impact of global developments on emerging market economies has, however, differed significantly between regions. In the neighbourhood of the euro area, spillovers to central and eastern Europe, and to the countries belonging to the Commonwealth of Independent States (CIS), have been particularly substantial. By contrast, the euro area's neighbours in the south have been less affected.

The major effects on the economies of the Mediterranean region have thus far come through transmission channels associated with the real economy, i.e. the *global recession*. These are, notably, declines in exports, oil revenues, tourism receipts, remittances and inflows of foreign direct investment (FDI), with the drop in exports so far appearing to have had the strongest and most direct impact. As a result, real GDP growth weakened significantly in 2009 and is projected to recover only moderately in 2010. However, the weakening of economic activity in the Mediterranean region has been less pronounced than in advanced economies and most other emerging market regions. The main reason is that, overall, the direct impact of the *global financial turmoil* on banking sectors and financial markets in Mediterranean countries has been relatively limited. This can mainly be attributed to (i) their lack of exposure to US mortgage-related assets that turned "toxic", a feature the region shares with other emerging markets, and (ii) the limited financial development of many countries in the region and their limited integration into global financial markets, a feature which distinguishes the region from other emerging markets, and in particular from the euro area's neighbours in the east. The latter largely explains the difference between the economic performance in the Mediterranean countries and that in some other emerging markets.

The remainder of this paper is structured as follows: Section 2 reviews the impact of the global financial turmoil and recession on macroeconomic developments in Mediterranean countries. Section 3 analyses the impact on the region's banking sectors and financial markets. Section 4 provides a conclusion.

1 Macroeconomic analysis is based mainly on IMF (2010a), WEO data of April 2010. Financial market data are as of 1 May 2010.

2 The economies covered are those of: Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Mauritania, Morocco, Syria, Tunisia, and the West Bank and Gaza. These are the partners, or observers, in the EU's Barcelona process, now known as the Union for the Mediterranean, which are not EU candidates or potential candidates. Albania, which joined the Barcelona Process in December 2007, alongside Mauritania, Bosnia-Herzegovina, Croatia and Montenegro, which became part of the reformed Union for the Mediterranean in July 2008, and Turkey, which has been a partner of the Barcelona process since its inception, are not covered in the paper as they are EU candidates or potential candidates. Monaco, which also joined the Union for the Mediterranean in July 2008, is also not covered as it does not have a central bank, nor a monetary and exchange rate policy of its own.

2 THE IMPACT OF THE GLOBAL FINANCIAL TURMOIL AND RECESSION ON MACROECONOMIC DEVELOPMENTS

2.1 TRANSMISSION CHANNELS THROUGH WHICH GLOBAL DEVELOPMENTS HAVE AFFECTED THE REAL ECONOMY OF MEDITERRANEAN COUNTRIES

The Mediterranean countries are largely heterogeneous in terms of their economic features, not only in terms of their natural resources but also in terms of population, size, economic structure and income level (Table 1). Economic developments are often driven by various country-specific factors and policies.

Box 1

LINKS BETWEEN THE EURO AREA AND MEDITERRANEAN COUNTRIES

The re-launch of the Euro-Mediterranean partnership as the *Union for the Mediterranean* in 2008 highlighted the significance of Mediterranean countries for Europe's economic and political environment. With more than 200 million inhabitants, the region is almost two-thirds the size of the euro area, where nationals of Mediterranean countries account for a large proportion of (non-EU27) immigrants, namely for about 14% of the immigrant (non-EU27) population in euro area countries.[1]

As regards trade ties, the Mediterranean region is one of Europe's largest energy suppliers, accounting for 16.4% of the euro area's imports of oil, gas, and mineral fuels in 2009. Its share of total euro area exports was about 5%. However, for euro area countries on the Mediterranean shore, France, Greece, Italy and Spain, Mediterranean countries are of even greater importance as regards trade: in 2009 their Mediterranean neighbours provided 26.4% of their non-euro area energy imports and received almost 10% of their total non-euro area exports.

In terms of financial links, the overall exposure of the euro area to the Mediterranean region is low when compared with neighbouring regions in central, eastern and south-eastern Europe. However, the financial exposure to Mediterranean countries matters for individual euro area countries, and for France in particular. Around 18% of France's outstanding cross-border loans to developing countries are to Mediterranean economies.

From a southern Mediterranean perspective, the euro area/EU is by far their largest partner as regards trade relations, tourism, bank lending and remittances from migrants in the euro area/EU.[2]

1 This figure excludes statistics for Cyprus, Greece, Ireland, France and Luxembourg, for which Eurostat does not provide a breakdown by citizenship). If Turkey was included, the figure would rise to 41%.
2 See ECB (2004).

Table 1 Basic economic indicators

	Population (millions) (2008)	Population growth (average annual growth rates) (2002-2008)	Nominal GDP (USD billions) (2008)	GDP per capita (USD, purchasing power parity) (2008)	Trade openness[2] (goods and services, percentage of GDP) (2008)
Algeria	34.8	1.6	159.7	6,698	69.0
Egypt	75.0	2.2	162.2	5,898	75.3
Israel	7.1	2.0	201.8	28,206	81.9
Jordan	5.9	2.3	20.0	5,314	148.8
Lebanon	3.8	0.8	28.9	13,032	182.2
Libya	6.2	2.0	100.1	14,533	94.1
Mauritania	3.0	2.4	3.2	2,052	82.0
Morocco	31.4	1.2	86.4	4,349	90.3
Syria	19.9	2.5	54.8	4,749	74.8
Tunisia	10.3	1.0	40.3	7,963	114.8
West Bank and Gaza[1]	3.8	…	6.5	1,710	83.2
Mediterranean	**201.3**	**1.8**	**863.9**	**6,932**	**…**
Memorandum items:					
euro area	322.5	0.6	13,635.2	33,081	44.6

Sources: IMF, ESA95 and ECB staff calculations.
1) 2008 data for West Bank and Gaza are estimates. GDP per capita in USD.
2) 2007 data for Egypt, Libya and Tunisia, and 2006 data for Mauritania and Syria.

In general, Mediterranean countries are small, open economies with close ties to euro area countries (see Box 1). Many of them have large tourism sectors and benefit from expatriates' remittances. Over the last few years, many have attracted significant FDI inflows, particularly when compared with previous decades. Some of them are large oil exporters. Accordingly, they are vulnerable to declines in exports, oil revenues, tourism receipts, remittances and FDI inflows (see Table 2). As a result of the global financial turmoil and recession, declines in these sources of revenue can be observed, albeit to a varying degree, depending on category and country. The drop in exports is the most substantial and direct channel through which the global crisis has affected the region, and the fall in FDI inflows also appears to be significant, while remittances, judging by past experience, tend to be a relatively stable source of revenue.

Table 2 Exposure to the main transmission channels of the global recession

(percentages)

	Exports of goods and services/GDP (2009)	Oil exports/total exports (2009)	Tourism sector/ GDP[1] (2009)	Inflows of remittances/GNI[2] (2008)	Foreign direct investment inflows/GDP (2007-2009)
Algeria	34.1	92.3	2.0	1.3	1.3
Egypt	25.0	16.8	7.4	5.4	7.0
Israel	34.6	0.0	2.7	0.7	4.2
Jordan	47.7	0.0	9.0	17.9	11.5
Lebanon	72.2	0.0	12.5	24.5	11.5
Libya	64.5	93.5	1.7	0.0	5.5
Mauritania	49.8	14.1	..	0.1	4.4
Morocco	29.0	1.1	7.7	7.8	4.3
Syria	31.7	20.9	5.1	1.5	2.5
Tunisia	49.4	9.8	9.2	4.9	5.2
West Bank and Gaza[3]	12.0	..	..	14.9	..

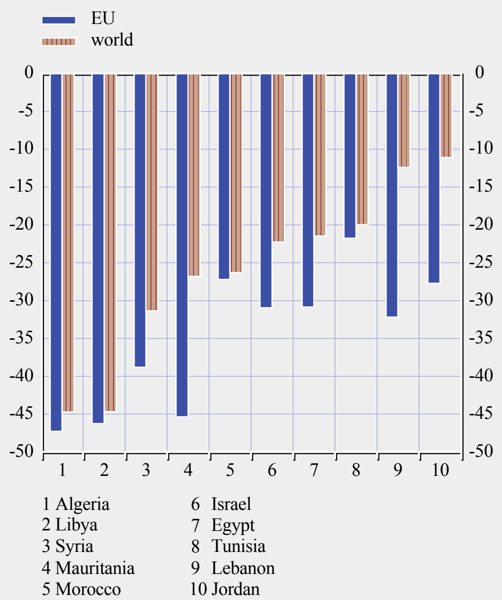
Sources: IMF and 1) World Travel and Tourism Council (WTTC), 2) World Bank, Global Development Finance Indicators (2008), 3) Economist Intelligence Unit (2009), data for 2008.

Exports from all Mediterranean countries have declined sharply since mid-2008 when the global economy entered into a synchronised downturn and global trade contracted significantly (see Chart 1). The fall in exports has been most pronounced in the oil-exporting countries of the region (Algeria, Libya and Syria). In addition to the decline in oil demand that resulted from the global recession, export (and fiscal) revenues of oil-exporting countries have been hit by the sharp and sudden fall in oil prices, which began in July 2008. However, the drop in exports has also been very pronounced for non-oil-exporting countries in the region. Figures for Morocco, Israel and Tunisia show that most of their exports are bound for regions that were very severely hit by the crisis (Morocco and Tunisia export mainly to the EU. Israel exports mainly to the EU and the United States). Between 2008 and 2009, almost all Mediterranean countries registered a more significant drop in exports to the EU than in overall exports, which highlighted the depth of the recession in Europe. The EU is the major export market for most Mediterranean countries (see Chart 2), while the role of the United States – bar its trade ties with Israel, Jordan and Algeria (oil) – is only marginal.

The tourism sectors in several Mediterranean countries have been negatively affected by the crisis, as economic strains in the countries of origin have led to a re-consideration of travel plans (and budgets). However, data on tourist arrivals in 2009 show a mixed picture (see Table 3). Reductions were observed in Israel, Algeria, Egypt and Tunisia. In other countries tourism continued to grow, although tourism receipts in some countries, such as Morocco, declined despite a higher number of tourist arrivals, as visitors reduced their spending and the length of their stay. Some Mediterranean destinations may indeed benefit from switching effects in the wake of the crisis (customers moving away from higher-cost to lower-cost destinations). The high growth figure for Lebanon is due to a base effect, as tourist arrivals were exceptionally low

Chart 1 Changes in exports, 2008-2009

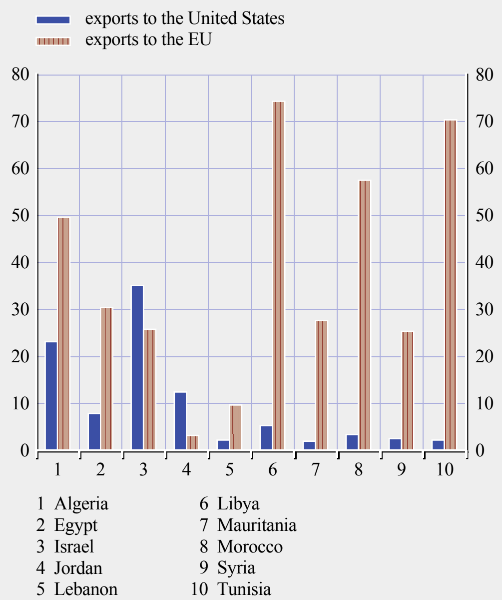
(percentages)



Sources: Haver Analytics, IMF (DOTS) and ECB staff calculations.

Chart 2 Mediterranean countries' exports to the EU and the United States

(percentage of total exports)



Sources: Haver Analytics, IMF (DOTS) and ECB staff calculations.
Note: Data refer to 2009.

Table 3 Growth in tourist arrivals in 2009

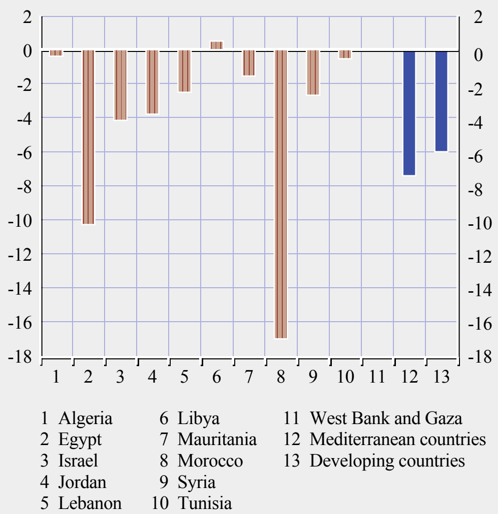
(percentages)

Algeria	-6.7	Mauritania	…
Egypt	-3.5	Morocco	5.8
Israel	-10.2	Syria	11.5
Jordan	0.6	Tunisia	-2.0
Lebanon	46.5	West Bank and Gaza	…
Libya	10.4		

Source: World Travel and Tourism Council (WTTC).

Chart 3 Growth in flows of remittances to Mediterranean countries in 2009

(percentages)



Sources: World Bank estimates and ECB staff calculations.

in the first half of 2008 as a result of the difficult domestic political situation, which started to ease with the Doha Agreement of May 2008.

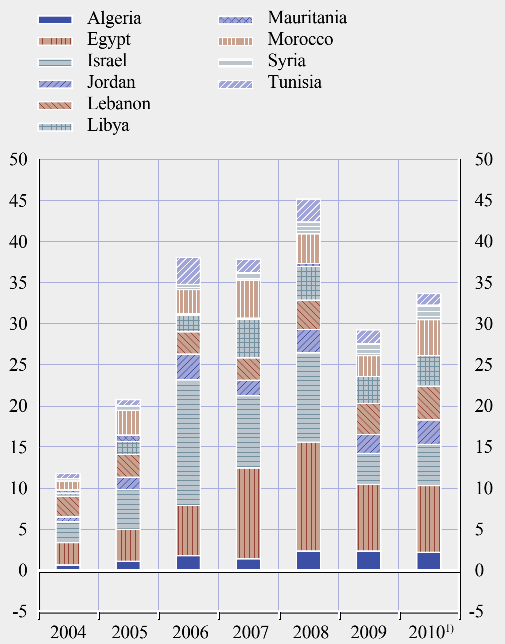
Most tourists visiting Mediterranean countries come from the EU; however, in some countries, a significant proportion of tourism revenue is also generated by visitors from Arab Gulf countries, notably in Lebanon, Jordan, Syria and Egypt. Visitors from these countries seem to have been a stabilising factor for tourism sectors. While the Gulf region has also been adversely affected by the global financial turmoil and recession, mainly through the sharp drop in oil prices, economic strains have been less severe than in advanced and most emerging market economies. As regards tourism originating from the EU, the prospects for Mediterranean countries very much depend on how the path of economic recovery pans out on the northern shore of the Mediterranean Sea.

Remittances, which are an important source of revenue for some countries in the Mediterranean region, may be adversely affected by the crisis if expatriates who send money home become unemployed or have less secure income prospects, and thus reduce their transfers. The World Bank estimates that remittances to developing countries declined by 6.0% worldwide in 2009, with the fall somewhat more significant for countries in the Mediterranean (see Chart 3). The decline is estimated to have been particularly pronounced in Morocco and Egypt, where migrant workers were hit by deteriorating labour market conditions in Europe and the United States in the wake of the global financial turmoil. Remittances are by far most important for Lebanon, Jordan and for the West Bank and Gaza. In Lebanon and Jordan, they are crucial to the covering of large current account deficits (see Sub-section 2.5). The bulk of remittances received by Mediterranean countries originate in the EU (in particular, in the case of the Maghreb countries), in the Gulf region (mainly eastern Mediterranean countries) and, in some cases, also the United States (Egypt). Key risks for remittances in the wake of the global financial turmoil are: a sluggish recovery in the countries of origin; adverse movements of exchange rates (a weakening of the exchange rates of the currencies of the countries of origin vis-à-vis those of destination countries); and more restrictive immigration/labour market policies in major countries of origin (if unemployment rises). However, compared with other sources of external revenue such as tourism receipts or FDI inflows, remittances tend to be relatively stable over time, and are less sensitive to fluctuations that reflect economic strains either in the country of origin or in the destination country.[3]

3 For further discussion, see World Bank (2010), Box 1.

Chart 4 Foreign direct investment inflows

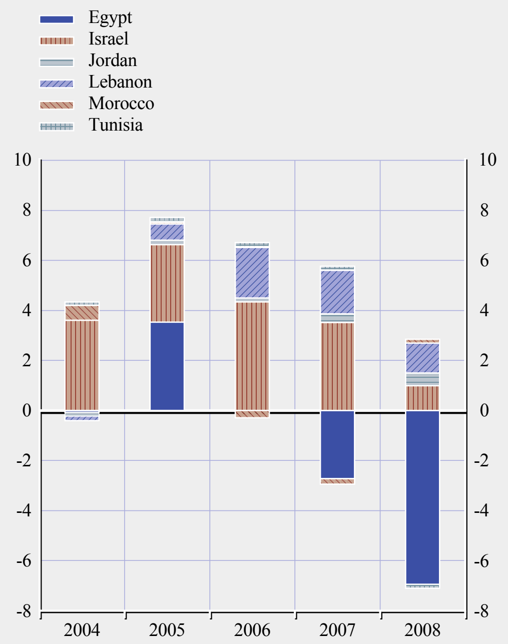
(USD billions)



Source: IMF.
Note: No data available for West Bank and Gaza.
1) Projections.

Chart 5 Portfolio investment inflows

(USD billions)



Source: IMF.

For FDI inflows, projections point to a fall of around one-third in comparison with previous years (see Chart 4). While FDI inflows are therefore likely to be lower than in the record years from 2006 to 2008, when inflows for the region as a whole reached around USD 40 billion, they are expected to be higher than the levels recorded in the first half of the decade. Furthermore, portfolio investment positions (i.e. portfolio debt and equity inflows) were subdued in 2008 (see Chart 5). However, this transmission channel has been less important in Mediterranean economies than in other emerging markets, owing to the low overall degree of global financial integration and remaining restrictions on stock ownership in some countries. In 2008, large outflows of portfolio investment could be observed in Egypt, where buoyant stock market growth had attracted speculative capital inflows prior to the crisis and foreigners withdrew from the local T-bill market (see also Sub-sections 3.2 and 3.3).

2.2 GROWTH AND EMPLOYMENT

After the robust performance of past years, real GDP growth in the Mediterranean region fell significantly as a result of the global recession in 2009. However, growth remained positive in all countries of the region bar Mauritania, and is also projected to be higher than that in advanced economies and many other emerging market regions in 2010. Stabilising factors have been the relatively limited direct impact of the global financial turmoil on their financial sectors, as well as, in some cases, close links to oil-exporting countries in the Gulf region. However, the lower growth rates experienced in the wake of the global turmoil, if protracted, would not be sufficient to address the significant employment challenges faced by many Mediterranean countries over the medium term.

GROWTH

Real GDP growth in the Mediterranean region slowed down significantly in 2009, compared with the robust growth rates of the last few years, and is projected to recover moderately in 2010 (see Table 4). However, unlike in advanced economies and many other emerging market regions, average growth in the Mediterranean in 2009 remained positive at 3.5%, with growth in the region's oil-exporting countries remaining lower than in non-oil-exporting countries. Of all emerging market regions, Mediterranean countries display the best growth performance in relative terms after emerging/developing Asia, although at a much lower level than Asia. In particular, economic activity has been more resilient than in central and eastern Europe and the CIS, i.e. other emerging market regions in the broad neighbourhood of the euro area that have been much more severely hit by the fallout of the global financial crisis and recession. This is also reflected in the fact that no country from the region has turned to the International Monetary Fund (IMF) as a result of the crisis.[4]

There are a number of possible reasons for this relative resilience: first and foremost, there has been hardly any direct spillover from the global financial market turmoil to the financial sectors of Mediterranean countries (see Section 3 for a detailed analysis). This is mainly due to the low degree of integration of many countries in the region into global financial markets. Thus, negative feedback loops between the financial sector and the real economy are not significant, although there is a risk that such loops might increase if the slowdown in economic activity is protracted.

For several non-oil-exporting countries in the region, mainly those in the eastern Mediterranean, the close economic and financial links to oil-exporting countries in the Gulf seem to have been a stabilising factor in the current situation. Large reserves accumulated in previous years allowed Gulf Cooperation Council (GCC) countries to sustain their public spending, so that tourism revenues, remittances, FDI inflows and portfolio investment inflows from this source to Mediterranean economies were less affected by the crisis than those originating in advanced economies.

The major oil-exporting countries in the Mediterranean region, Algeria and Libya, have also benefited from large reserves accumulated

4 Lebanon is the only country in the region with an IMF programme (Emergency Post-Conflict Assistance launched in May 2007 after the 2006 war, i.e. a programme not related to the global financial crisis). Mauritania's Poverty Reduction and Growth Facility, which was launched in 2006 and is due to expire in 2009, was suspended after a coup d' état in October 2008. A new programme has been requested by the government.

Table 4 Real GDP growth in emerging and developing regions

(annual percentage changes)

	Mediterranean			Sub-Saharan Africa	Central and eastern Europe	Commonwealth of Independent States	Developing Asia	Western Hemisphere
	Total	Oil[2]	Non-oil[3]					
2008	5.3	3.2	6.1	5.5	3.0	5.5	7.9	4.3
2009	3.5	2.4	3.9	2.1	-3.7	-6.6	6.6	-1.8
2010[1]	4.5	4.8	4.3	4.7	2.8	4.0	8.7	4.0
2011[1]	4.8	4.9	4.8	5.9	3.4	3.6	8.7	4.0

Sources: IMF and ECB staff calculations.
Notes: Averages weighted by GDP in purchasing power parities.
1) Projections.
2) Oil exporters: Algeria, Libya, Syria.
3) Non-oil exporters: Egypt, Israel, Jordan, Lebanon, Mauritania, Morocco, Tunisia.

during years of high oil prices. They can sustain high levels of public spending in spite of the sharp drop in oil prices (see also Sub-section 2.4).

Countries with large and long-standing fiscal and current account deficits, most notably Lebanon, Jordan, and the West Bank and Gaza (see Sub-sections 2.4 and 2.5), could be considered particularly vulnerable when the global financial turmoil intensified in autumn 2008. However, their sources of external financing proved relatively stable. This was partly attributable to the specific sources of finance themselves (Gulf countries, official donors, Lebanese diaspora), and partly to the fact that local/regional political events tend to be more important determinants of economic activity than global economic and financial developments (for example, in Lebanon and in the West Bank and Gaza).

Finally, the limited role of several countries of the region in advanced manufacturing – a sector highly affected by the global recession – and improved policies over previous years in a number of countries have contributed to the relative resilience of the Mediterranean region in the wake of the global financial turmoil and recession.[5]

The main risk for economic activity in the Mediterranean countries lies in a potentially weak and uneven recovery of the global economy. In particular, an only sluggish recovery in the EU could take a further toll on growth in the region, given the close economic and financial links of most of the countries there with the northern shore of the Mediterranean.

Another non-negligible risk is the possibility that volatile oil markets could drive oil prices either too low or too high. A sharp fall in oil prices would have an adverse effect on Mediterranean and Gulf oil-exporting countries and impede their ability to sustain public spending, with negative feedback loops to those Mediterranean countries that benefit from close links to the Gulf. A sharp increase in oil prices driven by a global economic recovery and tight global oil markets would burden non-oil exporting countries' fiscal and current accounts, would fuel inflation and would prevent a return to higher growth rates.

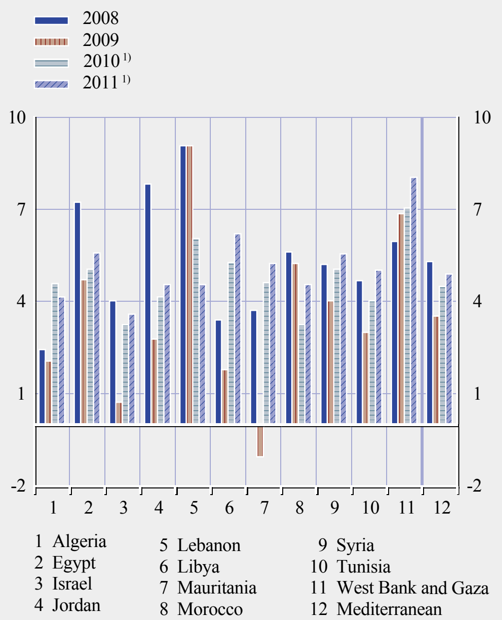
Furthermore, while the growth rates projected for Mediterranean countries for 2010-11 are positive, and higher than those for advanced economies and for some other emerging market economies, they are generally too low to address the employment challenges facing most countries in the region (see below) or to support a catch-up in income levels (see Box 2).

As regards individual countries, there are some noteworthy developments. No country except Mauritania experienced negative real GDP growth in 2009, the year of the deepest global recession in many decades (see Chart 6).

5 See IMF (2009a).

Chart 6 Mediterranean economies: real GDP growth

(percentages)



Sources: IMF and ECB staff calculations.
Notes: 1) Projections. Mediterranean average weighted by GDP in PPP terms. Owing to the lack of data comparability, West Bank and Gaza are excluded from the average, and 2009 data are estimated.

Israel exhibited a very low growth rate by regional standards in 2009. This can be attributed to Israel's close integration with advanced economies (the United States and the EU) and with global financial markets. However, compared with other advanced economies, the country has been affected by the crisis only mildly, reflecting the absence of major imbalances, a sound financial sector and the enhanced credibility of its macroeconomic management in comparison with previous decades, all of which have contributed to the relative resilience of the economy.

In the two major oil-exporting countries of the region, Algeria and Libya, oil GDP growth took a hit in 2009, on account of lower oil production in line with OPEC production cuts, whereas non-oil GDP growth remained robust (9.2% in Algeria and 6.0% in Libya), driven by the continuation of ambitious public spending programmes focused on developing the physical and social infrastructure (see Sub-section 2.4).

Egypt exhibited a pronounced slowdown, as it has been affected by the crisis via multiple channels. In addition to exports, remittances and tourism, there has also been a negative impact on oil and Suez Canal revenues (owing to the drop in oil prices and in global trade). Nevertheless, real GDP growth in 2009 turned out to be higher than was widely expected in view of these exposures. Jordan has also experienced a significant slowdown compared with its very high growth levels of previous years, owing to the multiplicity of transmission channels and, in particular, on account of the contraction in its financial services sector.

In some countries of the region, real GDP growth has been only moderately affected by global developments. In Lebanon, this can be attributed to the following: enhanced confidence, as the domestic political tensions prevailing since 2006 have largely abated; the continuing reconstruction of areas affected by the 2006 war (which also explains the high growth rates of 2007-08); and a low ratio of goods exports to GDP, which means that a drop in external demand has a relatively muted impact. In Morocco, a slowdown in non-agricultural output in response to global economic developments has been partially compensated for by exceptionally high agricultural output (which accounts for around 15% of GDP) as a result of favourable weather conditions (rain). Mauritania's output, which has been volatile over the last few years, is determined by fluctuations in the production levels of the mining sector and of the country's nascent oil industry. Real GDP growth rates in Tunisia and Syria were somewhat, but not significantly, lower in 2009 than in the previous year, also pointing to a relatively mild impact of global developments. In Tunisia, this was due partly to a major gas field coming on stream.

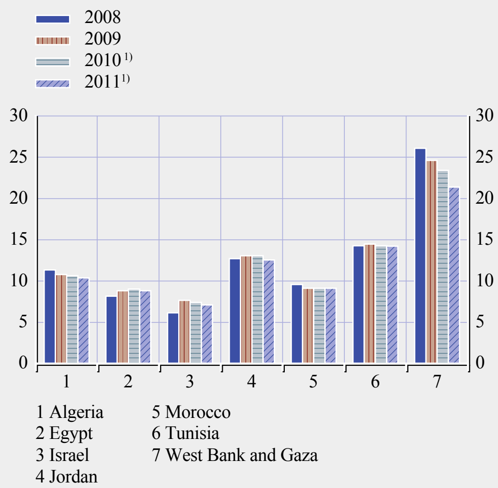
The West Bank and Gaza is a clear outlier as regards real GDP growth in 2009, as the economy there expanded by 6.8%, i.e. by the highest rate in the region and faster than in 2008. This is mainly due to the following: the area's low base after several years of decline resulting from political and security-related circumstances; the gradual lifting of restrictions on mobility and access; and the improvement of the internal security situation in the West Bank. The impact of global economic developments has been negligible, as exports account for only slightly more than 10% of GDP (and are mainly bound for Israel). There is a significant difference between the West Bank and the Gaza Strip: in the former, real GDP growth is estimated to have stood at 8.5% in 2009, compared with around 1% in the latter.

EMPLOYMENT

Unemployment rates remained stable in the Mediterranean region in 2009 and are not projected to increase significantly in 2010 (see Chart 7). This would appear to be a reflection of the following: the fact that the global economic downturn has depressed economic activity in the area to a lesser extent than it has in advanced economies and some other emerging market economies; the fact that unemployment tends to be a lagging indicator

Chart 7 Mediterranean economies: unemployment rate

(percentages)



Source: IMF.
Notes:
1) Projections. West Bank and Gaza data for 2009 are estimated. No data are available for Lebanon, Libya, Mauritania and Syria.

in the economic cycle; and the specifics and statistical issues of many Mediterranean countries' labour markets. Israel alone shows an increase in unemployment, with a pattern similar to that of advanced economies, albeit from the lowest base in the region. This reflects the fact that in 2009 real GDP growth was lower in Israel than in other countries in the region. The West Bank and Gaza exhibited a decline in unemployment as a result of the expected development of economic activity, as described above, but the level remains exceptionally high and differs significantly between the West Bank and the Gaza Strip (18% in the West Bank and 39% in the Gaza Strip in 2009).

Notwithstanding the relative stability of unemployment figures in many countries in the wake of the global crisis, unemployment remains a key economic and social challenge in view of demographic developments in most Mediterranean countries over the medium and long term. An assessment of the labour market situation in the region is complicated by two factors, which point in opposite directions. On the one hand, it would appear that in many countries unemployment figures tend to underestimate the employment challenge, owing to significant hidden unemployment or underemployment, in particular in the agricultural sector and, to a lesser extent, also in the public sector. On the other hand, many economies have a large informal sector that absorbs part of the labour force. Moreover, in some Mediterranean countries, labour market figures tend to be of low quality, and labour market participation rates are generally low by international standards.

Taking these caveats into account, a relatively simple "back-of-the-envelope" calculation shows that the growth rates projected, in the wake of the global crisis, for Mediterranean

Table 5 Economic growth and employment from a medium-term perspective

	Average annual growth (%)					Average annual growth (%)	
	GDP	Employment	Labour force	Implied employment elasticity	Unemployment rate	Growth needed to keep unemployment constant	Growth needed to reduce unemployment by 50%
	2000-2008 1)	2000-2008 1)	2009-2020	2000-2008 1)	2008	2009-2020	2009-2020
Egypt	5.0	3.3	1.9	0.7	8.8	2.9	3.5
Israel	3.8	3.0	1.6	0.8	6.0	2.1	2.4
Jordan	6.6	3.1	2.1	0.5	13.0	4.5	5.5
Morocco	4.6	1.3	1.4	0.3	9.6	5.1	6.7
Syria	4.0	1.3	2.4	0.3	8.4	7.5	8.4
Tunisia	4.5	1.8	1.5	0.4	14.2	3.8	5.5

Sources: IMF (real GDP growth, unemployment rate), ILO (employment, labour force projections), Central Bureau of Statistics Syria (employment), and ECB staff estimates.
Notes:
1) Jordan 2001-2007; Morocco, Syria 2002-2007; Tunisia 2000-2005.

countries in 2009-10 would probably not be sufficient to address the challenge in the area of employment if growth were to remain at that level for a longer period of time (see Table 5). Comparing average real GDP growth over the last few years with the growth in employment over the same period allows a rough estimate to be computed of the implied employment elasticity of real GDP growth in the respective country. Taking ILO estimates of labour force growth for the next decade as a basis, and extrapolating the implied employment elasticity of the past to the future, rough estimates can also be made of the real GDP growth needed to stabilise official (and already high) unemployment rates, as well as the growth needed to reduce them by 50%.[6]

The results indicate that, based on projected figures for 2009, real GDP growth rates will in most countries barely suffice to even stabilise high unemployment over the medium term. To significantly reduce it, considerably higher growth rates would be needed. This puts into perspective the fact that economic growth in Mediterranean countries in the wake of the crisis remained positive and higher than in advanced economies and many other emerging market economies. Unlike some emerging market economies, for example those in central Europe and the CIS, the Mediterranean countries have young populations and need to generate employment for a high number of new labour market entrants each year. Therefore, if the lower growth rates seen in the wake of the global financial crisis were to be maintained over a protracted period of time, the employment and thus social challenge in Mediterranean countries would mount significantly (see also Box 2).

6 These estimates should be interpreted with caution, as they rely heavily on the approximate calculation of employment elasticities. For some countries, errors in employment figures could cause the results to be biased. Moreover, these "back-of-the-envelope" calculations assume that the relationship between employment and GDP growth will remain constant over the next decade, and it will only remain constant if no structural changes with regard to the economy or labour market conditions occur.

Box 2

LONG-TERM GROWTH PATHS IN MEDITERRANEAN COUNTRIES

Compared with other emerging market economies, the Mediterranean region experienced only modest economic growth over the last two decades, although its growth performance was more benign over the few years preceding the global financial crisis and subsequent recession. For example, while real GDP per capita in central and eastern Europe[1] increased from USD 10,721 to USD 17,713 (constant 2005 US dollars adjusted for purchasing power parity (PPP)) between 1990 and 2007, per capita income in the Mediterranean region only increased from USD 4,276 to USD 6,067. Accordingly, the region's 2007 GDP per capita was equal to only 19% of that of the EU-15, compared with 18% in 1990 – in other words, Mediterranean countries barely kept up with the EU-15 in terms of income per capita. By contrast, in the same period, the EU-10's GDP per capita increased from an equivalent of 46% to 56% of EU-15 income per capita.

This box (i) shows that long-term growth patterns among Mediterranean countries differ from those in central and eastern Europe, i.e. unlike the situation in the EU-10 countries and contrary to what theory would suggest, Mediterranean countries with an initially lower income level do not experience faster growth than those with higher levels, and (ii) presents a decomposition

1 The ten countries that joined the EU in 2004 (EU-10), selected for statistical reasons. They and the Mediterranean countries are compared with the 15 countries that were EU members prior to the EU's enlargement (EU-15) to include countries of central and eastern Europe and Cyprus and Malta.

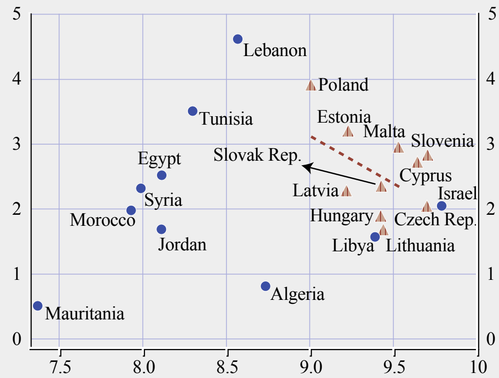
of the differences in output per capita across Mediterranean countries, showing the differences in inputs and productivity. There is strong evidence that low multi-factor productivity in Mediterranean countries is the main reason why they are struggling to keep up with other countries within the region and with the EU-15.

The chart plots the average growth rate of real GDP per capita (in PPP terms) for the EU-10 and the Mediterranean countries between 1990 and 2007 against the logarithm of the initial level of GDP per capita. The EU-10 countries show a pattern of growth convergence, i.e. poorer countries such as Poland and Estonia experienced higher growth rates than initially richer countries such as the Czech Republic or Slovenia. A linear regression confirms that growth rates in the EU-10 are negatively correlated with the initial wealth level. No such relationship can be identified among Mediterranean countries. In the natural resource-rich countries Algeria, Libya and Mauritania the average per capita growth rate was lowest, but their initial income levels differed significantly. There is no clear pattern similar to that in the EU-10 among non-oil exporting countries either.

In order to better understand why Mediterranean countries do not keep up with European GDP-per-capita levels, the table reports the contribution of capital and production technology to

GDP per capita growth, 1990-2007

x-axis: logarithm of purchasing power parity-adjusted GDP per capita in 1990
y-axis: average GDP per capita growth, percentages



Sources: World Bank, World Development Indicators (2008) and ECB staff calculations.
Notes: The growth rate is calculated as the average annual geometric growth rate of GDP per capita in PPP-adjusted constant 2005 USD. Data: 1990-2007; Libya: 1999-2007. No data available for West Bank and Gaza.

Growth accounting

(ratios relative to multi-factor productivity in the EU-15)

	1990			2007		
		Contribution from			Contribution from	
	Y/L	$(K/Y)^{\alpha/(1-\alpha)}$	A	Y/L	$(K/Y)^{\alpha/(1-\alpha)}$	A
EU-15	1.00	1.00	1.00	1.00	1.00	1.00
EU-10	0.46	1.01	0.45	0.56	0.95	0.59
Mediterranean countries						
Average	0.18	1.04	0.17	0.19	1.01	0.19
Algeria	0.26	1.08	0.24	0.23	1.11	0.21
Egypt	0.14	1.08	0.13	0.16	0.98	0.16
Israel	0.75	0.93	0.80	0.78	0.96	0.81
Jordan	0.14	1.07	0.13	0.15	1.06	0.14
Lebanon	0.22	0.91	0.25	0.30	0.98	0.31
Libya	0.43	0.63	0.69	0.42	0.67	0.63
Mauritania	0.07	0.95	0.07	0.06	1.02	0.06
Morocco	0.12	1.03	0.11	0.12	1.04	0.12
Syria	0.12	0.88	0.14	0.13	0.98	0.14
Tunisia	0.17	1.04	0.16	0.22	0.98	0.23

Sources: World Bank, World Development Indicators (2008) and ECB staff calculations.
Data: 1990-2007; Cyprus: 1990-1999; Libya: 1999-2002. No data available for West Bank and Gaza.

GDP per capita in 1990 and 2007, relative to the EU-15 level.[2] Multiplying both contributions yields the relative output-to-labour ratios. The relative contribution of capital to total output in the EU-10 and most Mediterranean countries is fairly similar to that in the EU-15. However, multi-factor productivity in Mediterranean countries in 2007 reached, on average, the equivalent of only 19% of the EU-15 level, compared with 59% in the EU-10. An exception is Israel, which exhibits the productivity level closest to that of the EU-15, which largely explains its relatively high GDP per capita.

Moreover, multi-factor productivity estimates for 1990 and 2007 indicate that productivity levels among the 10 EU Member States that joined in 2004 converges on the productivity levels of the EU-15. By contrast, the relative contribution of multi-factor productivity remained fairly constant in most Mediterranean countries.

The reasons for this feeble performance are manifold, and probably include relatively low governance levels, weaknesses in institutions and in the business environment, political instability (in some cases) and underdeveloped education systems. In order to accommodate the needs of their fast-growing populations, to create employment opportunities and to embark on a catching-up process similar to that observable in other emerging market economies, economic growth will be essential for the prosperity of Mediterranean countries in the long term. Their low multi-factor productivity calls for an increased focus on productivity-enhancing policies. Governments in the region need to concentrate on implementing further structural reforms that will foster competition, improve educational standards and the business environment, and strengthen governance.

Looking both at long-term growth and productivity trends and at catch-up patterns of Mediterranean countries also puts into perspective their relatively benign performance in the wake of the recent global financial crisis and recession. While their growth rates for 2009 and 2010 have indeed remained positive and are above those in advanced economies and most other emerging market regions, they are low in view of the growth needed to address the employment challenge and to embark on a process of catching up (see also the main text).

2 The methodology developed by Hall and Jones (1999) and Acemoglu (2009) is used to calculate measures of relative total factor productivity. Given the inputs capital K_i, technology A_i and labour L_i, country i's output Y_i is assumed to follow a labour-augmenting Cobb-Douglas production function that can be written as $\frac{Y_i}{L_i} = \left(\frac{K_i}{Y_i}\right)^{\frac{\alpha}{1-\alpha}} A_i$.

The factor share of capital in total production is assumed to be $\alpha = 1/3$. The perpetual inventory equation $K_{i,t+1} = I_{i,t} (1 - \delta) K_{i,t}$ is used to calculate the capital stock, where $I_{i,t}$ is the gross fixed capital formation in year t. The depreciation rate is 0.06. The initial capital stock is approximated by its steady state value $K_{i,0} = I_{i,0} / (g + \delta)$ with steady state growth rate. While alternative parameterisations may yield slightly different quantitative outcomes, the qualitative results presented in this box are robust to alternative approximations of the initial capital stock and the choice of , and g. Country i's total factor productivity relative to the EU-15 is then calculated as the residual:

$$\frac{A_{i,t}}{A_{i,t}} = \left(\frac{Y_{i,t}/L_{i,t}}{Y_{EU15,t}/L_{EU15,t}}\right)\left(\frac{K_{EU15,t}/Y_{EU15,t}}{K_{i,t}/Y_{i,t}}\right)^{\frac{\alpha}{1-\alpha}}$$

2.3 INFLATION, EXCHANGE RATES AND INTEREST RATES

Inflation rates, which spiked in 2007 and 2008, and thus became the Mediterranean's main macroeconomic challenge, have fallen significantly throughout the region in the wake of the global financial turmoil and recession, with the decline of global food prices being a major factor. In response to the declining inflationary pressure, most central banks have lowered interest rates and/or reserve requirements.

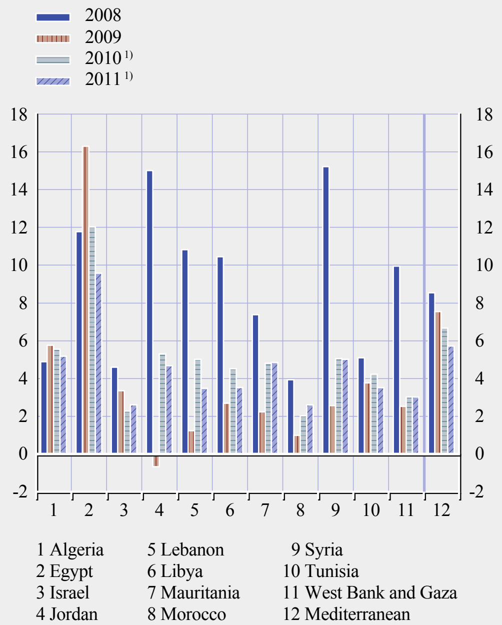
The extent of each response has been determined by country-specific circumstances, including the level of intensity of the economic slowdown and the decline in inflationary pressure, considerations concerning capital inflows and current account positions, and the exchange rate regime. No modifications of exchange rate regimes or severe downward pressure on currencies have been observed.

INFLATION

Inflationary pressure, which had been the main macroeconomic challenge in most Mediterranean countries in 2007 and 2008, has reduced significantly throughout the region in the wake of the global financial turmoil and recession (see Chart 8). This has been the result of lower economic activity and the sharp fall in commodity prices. In particular, the reduction in global food prices, which were the main reason for the spike in inflation observable in the Mediterranean until mid-2008, has alleviated inflationary pressure in the region, as food has a very high weight in the consumption basket of most of its countries.[7]

Chart 8 Mediterranean economies: inflation

(percentages)



Sources: IMF and ECB staff calculations.
Notes: 1) Projections. Mediterranean average weighted by GDP in PPP terms. Owing to the lack of data comparability, West Bank and Gaza are excluded from the average, and 2009 data are estimated.

Accordingly, in the second half of 2008 and 2009 inflation declined in many Mediterranean countries, and the dispersion of inflation rates was lower than in 2007. This fall in inflation, which was mainly due to declining food prices, eased pressures on real incomes in Mediterranean countries, an effect which presumably mitigated the impact of the global recession on the region's economy by sustaining private consumption. Nevertheless, inflation rates in some Mediterranean countries remain high, limiting the decline of the regional average from 8.5% in 2008 to 7.5% in 2009.

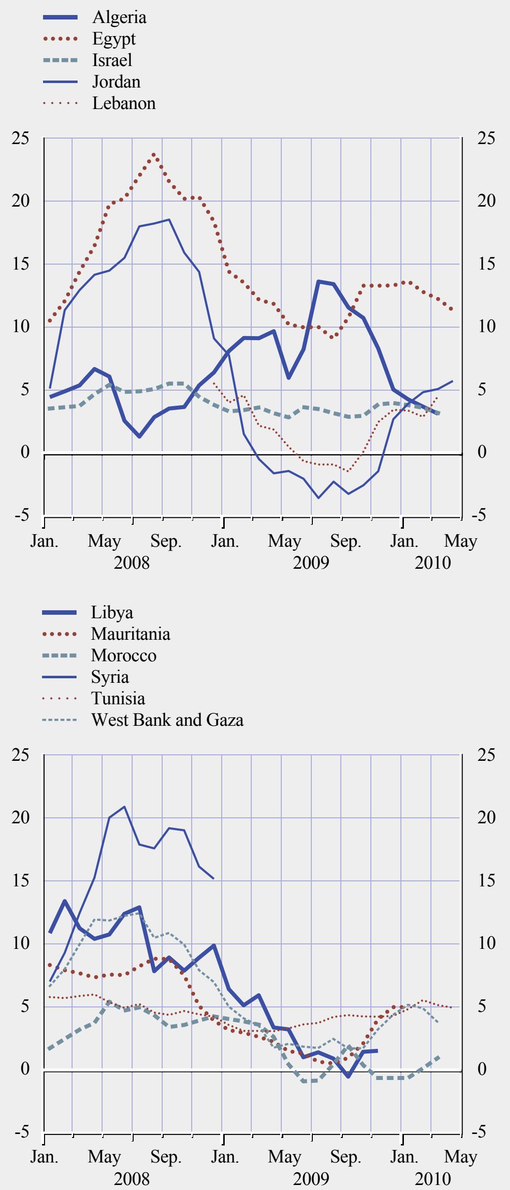
Egypt continues to be the country with the highest inflation rate in the region (with a projected average inflation rate of 12% in 2010), even though price increases have almost halved from more than 20% in the second half of 2008 to 11% in spring 2010 (see Chart 9 on monthly inflation rates). This is mainly because food prices, which have fallen globally, have proven to be sticky in Egypt. Food prices – and robust domestic demand – are also behind the rising inflation, against the regional trend, in Algeria, which points to monopolistic structures in some market segments.

In some countries, inflation moved into negative territory in the course of 2009. This primarily reflected statistical base effects, as the price index, year on year, was compared against its peak in mid-2008 (which also explains the particularly sharp fall in inflation rates in Jordan, where inflation also spiked in 2008, owing to the phasing-out of oil subsidies). In no country does there appear to be any risk of deflation.

7 In most Mediterranean countries, the weight of food items in the CPI basket amounts to between 36% and 44%. Notable exceptions are Israel and Lebanon, where food accounts for less than 20% of the national CPI baskets, and Mauritania, where the weight of food exceeds 50%. In the euro area, processed and non-processed food components make up 19.5% of the basket of goods and services included in the Harmonised Index of Consumer Prices (HICP).

Chart 9 Recent monthly inflation rates (year-on-year)

(annual percentage changes)



Sources: IMF and Haver Analytics.

Table 6 De-facto exchange rate arrangements

	Exchange rate arrangement	Reference currency
Algeria	Managed float	USD
Egypt	Managed float	USD
Israel	Independent float	
Jordan	Conventional peg	USD
Lebanon	Conventional peg	USD
Libya	Conventional peg	SDR
Mauritania	Managed float	USD
Morocco	Conventional peg	basket (EUR 80%/ USD 20%)
Syria	Peg within horizontal bands	SDR
Tunisia	Conventional peg	EUR/USD composite

Source: IMF – Annual Report on Exchange Arrangements and Exchange Restrictions 2008.
Note: Reference currency: partially ECB staff assessment.

EXCHANGE RATE DEVELOPMENTS

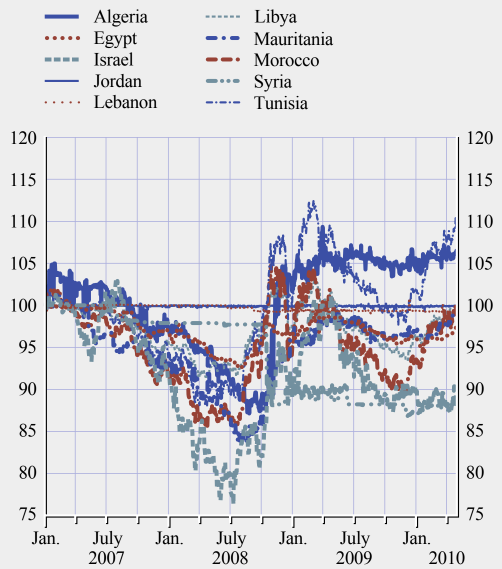
In the Mediterranean region, fixed pegs or tightly managed floats, mainly against the US dollar, prevail. Two countries, Libya and Syria, peg their currencies to Special Drawing Rights (SDRs). Morocco and Tunisia are the only countries with an orientation of their exchange rate policy to the euro. Israel is the only country with an independently floating currency and a fully fledged inflation targeting framework (see Table 6). Some countries in the region, such as Tunisia, seem to pay close attention to developments in their real effective exchange rate.

Exchange rate developments in the Mediterranean region reflect the respective exchange rate regimes of each country and the exchange rate movements of major currencies. Unlike in several other emerging market economies, particularly in emerging Europe and the CIS, no significant exchange rate fluctuations triggered by the global financial turmoil have been observable. While foreign exchange reserves have declined in some countries, downward pressure on national currencies as a result of actual or perceived economic and financial vulnerabilities has been limited.

In view of the general depreciation of the US dollar against major currencies between August 2007 – when the sub-prime crisis broke out – and August/September 2008, all Mediterranean currencies, with the exception of those with a fixed peg to the US currency, appreciated against the US dollar (see Chart 10). This trend was sharply reversed in the aftermath of the intensification of the global financial

Chart 10 Exchange rates against the US dollar

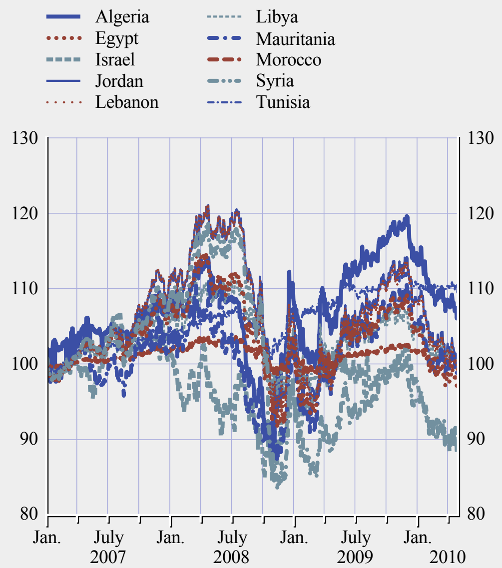
(1 January 2007 = 100; upward movement = depreciation of the national currency)



Sources: Bloomberg and ECB staff calculations.

Chart 11 Exchange rates against the euro

(1 January 2007 = 100; upward movement = depreciation of the national currency)



Sources: Bloomberg and ECB staff calculations.

turmoil in autumn 2008. With the stabilisation of global financial markets in spring 2009, the US dollar again started to depreciate against major currencies and against those in the Mediterranean that were not pegged to the US currency. As a result of the US dollar's rise vis-à-vis the euro since late 2009, Mediterranean currencies with a euro orientation, i.e. the Moroccan dirham and the Tunisian dinar, depreciated against the dollar.

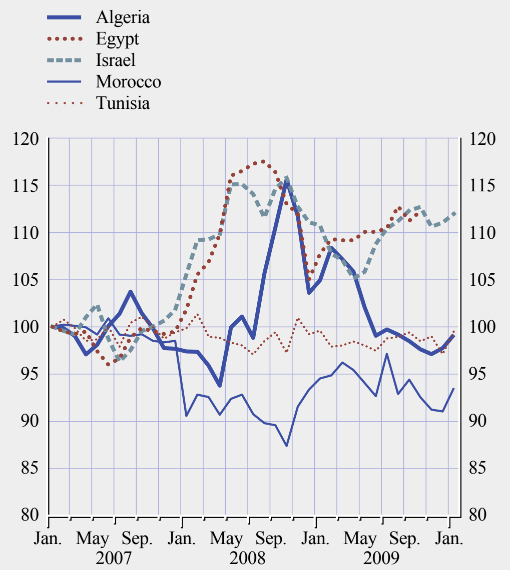
Of the Mediterranean countries' currencies, the Israeli shekel has exhibited the strongest appreciation against the US dollar, both before September 2008 and since spring 2009. This is in line with Israel's exchange rate arrangement of a free float and was triggered by strong capital inflows, which were partially attributable to a repatriation, in the wake of the global financial turmoil, of funds held abroad by Israelis, at a time when the risk of holding funds in advanced economies' financial systems was re-assessed against the risk of holding funds domestically. The Syrian pound appreciated against the US dollar in November 2008. While the Syrian currency has been pegged to the SDR within a horizontal band since 2007, the pound's moves against the US dollar and the euro are more akin to those of currencies pegged to the US dollar, pointing to tight currency management within the band.

Exchange rate fluctuations vis-à-vis the euro broadly mirror these developments (see Chart 11). Fluctuations were very limited for the Moroccan dirham (owing to the currency basket composition) and also relatively moderate for the Tunisian dinar (suggesting that the real effective exchange rate plays an important role in the country's exchange rate policy).

Indeed, the real effective exchange rate of Tunisia's currency is the most stable among those Mediterranean countries for which comparable data are available (see Chart 12). By contrast, Egypt and Israel, and to a lesser extent Algeria, experienced an appreciation of the real effective exchange rate of their currencies in 2007 and 2008, which has partially been reversed since autumn 2008. In the case of Israel,

Chart 12 Real effective exchange rates

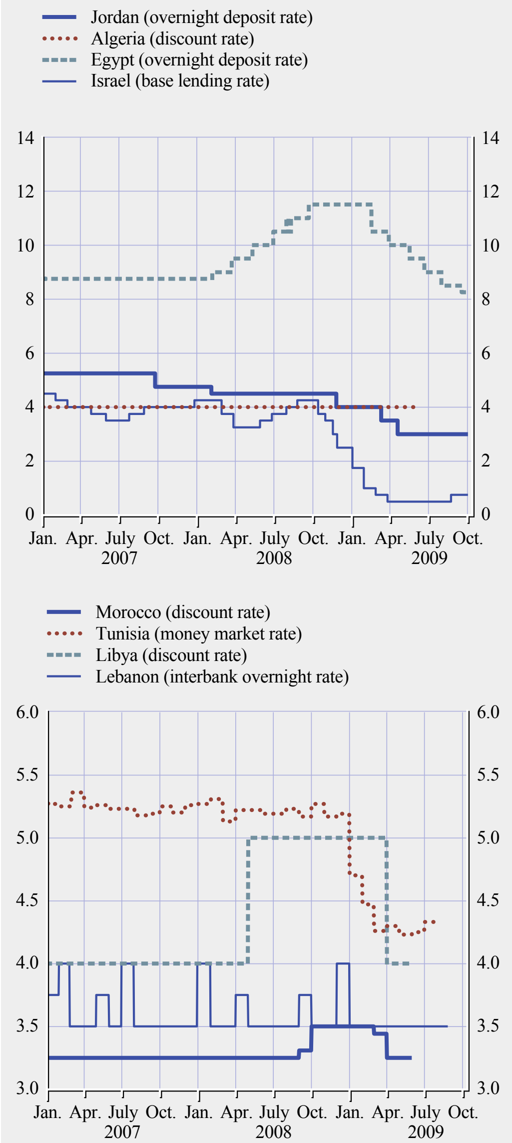
(index; January 2007 = 100)



Sources: IMF (IFS), Haver Analytics and ECB staff calculations.

Chart 13 Central bank policy rates

(percentages)



Sources: Bloomberg, IMF and national sources.

the appreciation of the real effective exchange rate was mainly the result of nominal exchange rate movements, while the inflation differential between Egypt and its major trading partners resulting from the spike in inflation in the first half of 2008 played a major role in Egypt.

INTEREST RATES

In response to declining inflationary pressure resulting from the slowdown of economic activity and falling commodity prices in the wake of global developments, most Mediterranean central banks lowered their interest rates (see Chart 13). The extent of the reductions depended on country-specific circumstances, including the exchange rate regime, the level of intensity of the economic slowdown and inflationary pressure, and considerations concerning capital inflows and current account positions. In addition to lowering interest rates, several central banks have also reduced reserve requirements in response to the slowdown in economic activity, bank lending and changing liquidity conditions. This has been a channel for easing monetary conditions, in particular in countries where the interest rate transmission channel is limited and/or where exchange rate regimes limit the scope for independent changes in interest rates. In general, central banks in the region have not been under pressure to resort to non-conventional measures to address problems in the banking sector. This can be attributed to the absence of tensions in interbank markets (see Sub-section 3.3).

Israel has exhibited the most pronounced reduction in interest rates: the Bank of Israel lowered its key policy rate by 375 basis points from 4.25% in October 2008 to 0.5% in April 2009. Consequently, interest rates in Israel were the lowest in the region, similar to rates in advanced economies. The Israeli central bank also launched a programme to purchase government bonds and intensified foreign exchange purchases in order to ease monetary conditions.[8] It was thus the only central bank in the region to adopt "non-conventional" measures similar to those taken by central banks in advanced economies. In August 2009, the Bank of Israel was the first central bank in the region (and, in fact, the world) to again raise interest rates in the aftermath of the global crisis. This move came after data on economic activity suggested that the slowdown might be less pronounced than previously expected, and as inflation – which had not fallen significantly before – again increased above the ceiling of the target band (1%-3%), triggering a rise in inflation expectations.

The Central Bank of Egypt – after a series of interest rate increases to counter rising inflationary pressure in the first nine months of 2008 – lowered interest rates by 325 basis points between February and September 2009, from 11.5% to 8.25%. Interest rates in Egypt thus remain the highest in the region, reflecting still relatively high inflation rates. Up to a level equivalent to the volume of loans extended to small and medium-sized enterprises, the central bank also exempted banks' deposits from reserve requirements.

In line with the logic of the fixed peg to the US dollar in an environment of free capital movements, the Central Bank of Jordan has continued its cautious lowering of interest rates, which started as early as September 2007, when the Federal Reserve began its monetary easing in response to the sub-prime crisis. However, it lowered its rates less aggressively, and has allowed the interest rate differential between the Jordanian dinar and the US dollar to increase, taking account of Jordan's large current account deficit and the need to generate capital inflows in a global environment characterised by increasing risk aversion.[9]

In a similar vein, Lebanon, which also pegs its currency to the US dollar, has kept interest rates stable. This implies a growing interest rate differential between the Lebanese pound and the US dollar, which reflects Lebanon's underlying vulnerabilities and, in particular, the need to attract deposit inflows from abroad into the banking system in order to finance the large twin deficit in the fiscal and current account (see also Sub-section 3.2).

Traditionally, some of the countries in the Mediterranean region do not resort to interest rate moves as a tool to manage macroeconomic developments, or only do so at the margins, partly owing to limited transmission. Of these countries, Morocco and Tunisia lowered their interest rates in the first half of 2009.

8 In 2008 and 2009 the Bank of Israel intervened in the foreign exchange market for the first time since 1997. There were two types of interventions: discretionary interventions and a programme of pre-announced purchases of foreign exchange reserves. The first discretionary intervention took place in March 2008, and they intensified in 2009 in the wake of the global financial turmoil. The interventions were aimed at curbing disorderly movements in the foreign exchange market and the appreciation of the Israeli shekel in view of its strength against the US dollar, but also vis-à-vis the euro. Also in March 2008, the Bank of Israel announced a programme to increase its foreign exchange reserves via daily purchases. In the course of 2008 and 2009, the daily amounts purchased were increased and the programme was extended beyond the initial target for foreign exchange reserves. While, at first, it was explicitly stated that the goal of the pre-announced foreign exchange purchases was only to increase reserves without influencing the exchange rate, the purchases took on multiple purposes after the intensification of global financial turmoil, when the economy significantly weakened but appreciation pressures persisted. In July 2009, the Bank of Israel announced the end of the programme of pre-announced foreign exchange purchases, but stated that it would continue to intervene on a discretionary basis in the event of unusual movements in the exchange rate which are inconsistent with underlying economic conditions, or in the event of disorderly conditions in the foreign exchange market.

9 The Central Bank of Jordan also lowered reserve requirements and stopped the issuance of certificates of deposits – the main instrument used to mop up excess liquidity in the banking sector – in anticipation of changing liquidity conditions.

Bank Al-Maghrib cut its key interest rate by 25 basis points to 3.25%, after having increased it by the same amount in view of inflationary pressure as recently as in September 2008, and the Central Bank of Tunisia reduced its key policy rate by 75 basis points to 4.5%. Both central banks also reduced their reserve requirements.

2.4 FISCAL DEVELOPMENTS

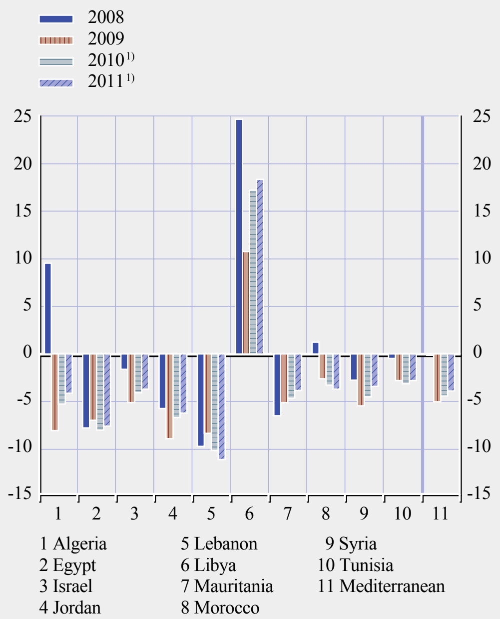
Budget balances have weakened in the wake of the global recession, most notably in oil-exporting countries, owing to the sharp drop in oil prices. In non-oil-exporting countries fiscal deficits have increased, but not as significantly as in advanced economies, as the economic slowdown has been less pronounced, automatic stabilisers are relatively weak, and expenditure on oil and food subsidies declined after the fall in global commodity prices. Some non-oil-exporting countries have launched fiscal stimulus programmes; however, fiscal space for counter-cyclical policies is very limited, or even absent altogether, in view of the high level of public debt in many countries. Only oil-exporting countries have room to support economic activity, which they have done by maintaining public spending at high levels, or by increasing it, in spite of the fall in oil revenues.

BUDGET BALANCES

Fiscal developments in 2009 were characterised by a weakening of budget balances throughout the region (see Chart 14). The fiscal deterioration was most pronounced in the major oil-exporting countries in the region, Algeria and Libya, where budget balances weakened by almost 15% of GDP. Both countries had a high budget surplus in 2008, and went from this to a deficit (Algeria) or to a far lower but still significant surplus (Libya) in 2009. This was the result of the sharp fall in oil prices, combined with the high dependency of budgets on oil revenues (79% and 87% of total budget revenues in Algeria and Libya respectively in 2008). Among the non-oil-exporting countries, Israel exhibits the greatest weakening of the budget balance as a result of the crisis.

Chart 14 Mediterranean economies: general government balances

(percentage of GDP)



Sources: IMF and ECB staff calculations.
Notes: 1) Projections. Mediterranean average weighted by GDP in PPP terms. Algeria: central government balance.

While budget deficits have been high in several countries of the Mediterranean region for many years, in particular in Lebanon, Jordan and Egypt, their increase in the wake of the global recession has been muted in comparison with most advanced economies. In addition to the fact that the economic slowdown has not been as strong in the region as in advanced economies (see Sub-section 2.2), this can be attributed to the relative weakness of automatic stabilisers in many Mediterranean countries. They are weaker than those in advanced economies on account of less developed tax and social security systems and a smaller government sector.[10] The only exception is Israel, which shares most fiscal features of advanced economies. This explains why the country has faced a more pronounced weakening of the fiscal balance.

10 See Sturm and Gurtner (2007).

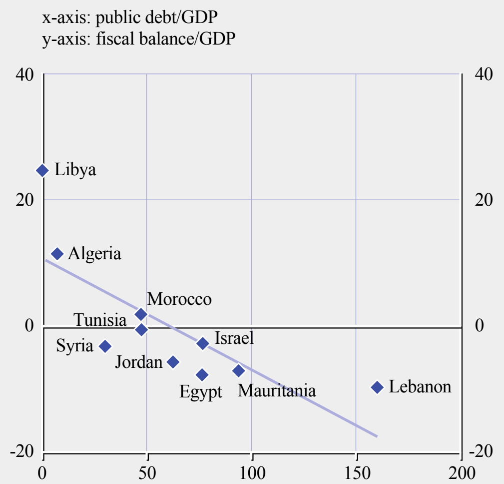
Another factor that has contributed to the relatively small increase in budget deficits in the region is that spending on oil and food subsidies has declined as a result of the drop in global commodity prices, given that several countries have comprehensive subsidy schemes for these items in place.

Some countries launched fiscal stimulus programmes in 2009 to counteract the economic slowdown caused by the global recession. For example, Egypt, Israel, Morocco and Tunisia increased their expenditure on, inter alia, infrastructure and/or supported industries that were severely affected by the global recession. The fiscal stimulus measures tended to be of limited magnitude (approximately 1.5% of GDP in Tunisia and Egypt, 1.35% of GDP in Israel and 0.5% of GDP in Morocco).[11] This was because in most cases the fiscal room for manoeuvre to adopt discretionary measures is limited or even absent – as holds true of, for example, Lebanon – as a result of the high debt levels and large deficits exhibited even before the global recession (see Chart 15). Any discretionary fiscal measures taken to sustain domestic demand had to be carefully balanced with the need to maintain confidence and long-term fiscal sustainability. Accordingly, the IMF projected fiscal tightening and the withdrawal of fiscal stimuli for most non-oil exporting countries in 2010.

Only the major oil-exporting countries of the region had significant fiscal room for manoeuvre, as they had reduced public debt and accumulated large reserves in the years of high oil prices that preceded the crisis. They also exhibited large budget surpluses, which masked considerable fiscal expansion during the period in question, when the countries launched ambitious programmes to upgrade their physical and social infrastructure, and thus significantly increased public capital, but also current expenditure.[12] Since the sharp fall in oil prices that began in mid-2008, these countries have also used this fiscal space to support domestic non-oil GDP growth, and have thus, like other major oil-exporting countries in the Gulf region,

Chart 15 Fiscal capacity for counter-cyclical policies

(percentages)



Sources: IMF and ECB staff calculations.
Notes: General government balance and gross government debt to GDP in 2008. Algeria: Central government balance and gross central government debt to GDP.

also contributed to global stabilisation efforts by sustaining import demand. They thereby also avoided the pro-cyclical pattern that has characterised fiscal policy in many oil-exporting countries in the past.

For some countries in the region, in particular in the eastern Mediterranean, budget outcomes depend significantly on continued donor support via direct budgetary support or soft loans. Deteriorating fiscal positions in key donor countries, mainly the United States, the EU (and its Member States) and Gulf countries, pose a risk for future budgetary support. For example, in Jordan, external grants fell short of expectations. Thus, in order to stave off this risk, the drive for structural fiscal reforms to reduce donor dependency has become more urgent in the wake of the global financial crisis and recession in the countries concerned.

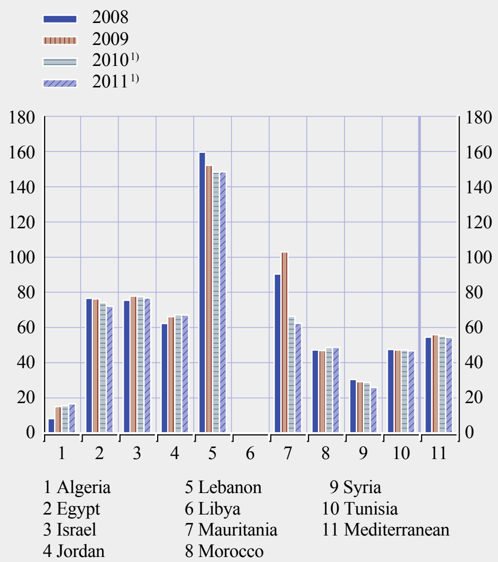
11 Data obtained from the IMF and national sources.
12 See Sturm et al. (2009). For instance, Algeria went ahead with its multi-year public investment programme of USD 155 billion (120% of 2007 GDP) and increased public spending further in 2009.

PUBLIC DEBT

Public debt in most Mediterranean countries has risen only moderately, or has remained broadly constant, since the crisis; however, it was already at high levels in many countries of the region, in particular in Lebanon, but also in Egypt, Jordan, Israel and Mauritania (see Chart 16). Lebanon's extraordinarily high level of public debt has declined somewhat, mainly as a result of robust economic activity (see Sub-section 2.2). Algeria and Libya are the only countries in the region for which public debt is no longer an issue. In all other countries, public debt levels are a severe constraint on governments with respect to taking additional fiscal measures in order to support domestic demand in the event that economic activity remains subdued. As regards the structure of public debt in the Mediterranean region, a common feature in most countries is the predominance of long-term loans with a maturity of more than five years and a relatively low dependency on external debt, with the notable exception of Lebanon.[13]

Chart 16 Mediterranean economies: general government gross debt

(percentage of GDP)



Sources: IMF and ECB staff calculations.
Notes: 1) Projections. Mediterranean average weighted by GDP in PPP terms. Algeria: central government debt.

Three of the seven Mediterranean countries that have a sovereign rating have been subject to rating changes since 2008 (see Table 7). Israel received an upgrade by Moody's and Fitch/IBCA in 2008, reflecting the steady improvement of its fiscal position prior to the intensification of the global financial turmoil. A significant improvement in Morocco's fiscal position was also the reason for Standard & Poor's decision to upgrade their rating of the country from BB+ to BBB- in March 2010. Lebanon, after having been downgraded to CCC+ by Standard & Poor's in January 2008, was upgraded again to the previous level (B-) in August of the same year. Further upgrades to

13 See Sturm and Gurtner (2007), Box 3. Based on an analysis of 2005 data, they find that the dependency on external debt is highest for Jordan, Algeria, Syria and Tunisia, where more than 50% of the debt is external. For the other countries, external debt typically accounts for less than one third of total debt. While in most countries long-term loans with a maturity of more than five years predominate, Lebanon is a notable exception to this trend. Lebanon's total domestic debt maturity is equal to (or less than) five years, posing a challenge in terms of funding costs and rollover requirements. Moreover, while Lebanon's debt is mainly domestic, it is largely denominated in foreign currency.

Table 7 Sovereign ratings

	S&P	Since	Moody's	Since	Fitch/IBCA	Since
Egypt	BB+	*22 May 2002*	Ba1	*6 July 2001*	BB+	*21 Aug. 2002*
Israel	A	*27 Nov. 2007*	A1	*17 Apr. 2008*	A	*11 Feb. 2008*
Jordan	BB	*3 July 2003*	Ba2	*21 Aug. 2003*	...	...
Lebanon	B	*22 Dec. 2009*	B1	*13 Apr. 2010*	B	*31 Mar. 2010*
Libya	A-	*18 Mar. 2009*	...	...	...	...
Morocco	BBB-	*23 Mar. 2010*	Ba1	*22 July 1999*	BBB-	*19 Apr. 2007*
Tunisia	BBB	*21 Mar. 2000*	Baa2	*17 Apr. 2003*	BBB	*24 May 2001*

Source: Bloomberg.
Note: No ratings are avilable for Algeria, Mauritania, Syria and West Bank and Gaza.

Lebanon's rating by all three rating agencies followed in the course of 2009 and in early 2010, reflecting the stabilisation of the country's domestic political situation and its resilience to various shocks. However, it currently has the lowest rating of the region, owing to its high level of public debt and fiscal deficit. Libya was rated for the first time by one of the major rating agencies in March 2009. It obtained an A- from Standard & Poor's, which is lower than that of peers with similarly strong or even weaker fiscal positions. The reasons quoted are the limited transparency of official decision-making in the country, as well as uncertainties surrounding the effectiveness of reforms in promoting private sector development.

2.5 EXTERNAL SECTOR

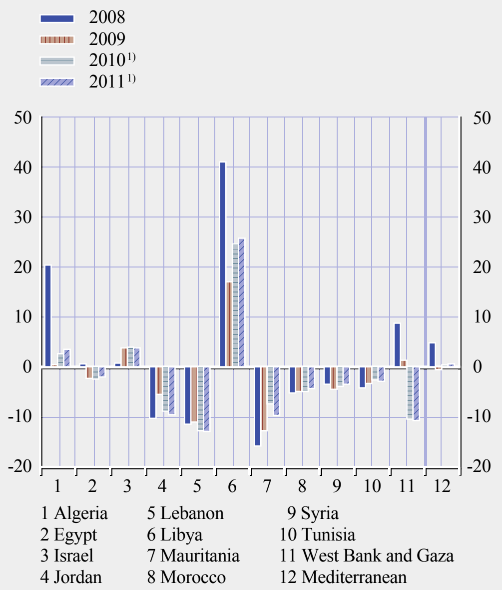
Large current account surpluses in Mediterranean oil-exporting countries have plummeted as a result of the sharp drop in oil prices, while most non-oil-exporting countries' current account balances have remained broadly stable, or are set to strengthen slightly. In most cases, the decline in imports due to lower oil prices and weakening domestic demand has outweighed the drop in exports resulting from sharply falling external demand. The large expansion in oil-exporting countries' foreign exchange reserves has come to a halt, while changes in non-oil-exporting countries' foreign exchange reserves have varied since the intensification of global financial turmoil.

CURRENT ACCOUNT BALANCES

Along with fiscal positions, current account balances are those macroeconomic variables that display the most marked differences between oil-exporting countries and non-oil-exporting countries in the Mediterranean region. As a result of lower oil prices than in previous years, oil-exporting countries' very large current account surpluses, which peaked in 2007 and 2008, plummeted by around 20% and 25% of GDP (Algeria and Libya respectively) in 2009 (see Chart 17). This suggests that oil-exporting countries' large current account surpluses of previous years were mainly cyclical, i.e. a function of high oil prices.

Chart 17 Mediterranean economies: current account balances

(percentage of GDP)



Sources: IMF and ECB staff calculations.
Notes: 1) Projections. Mediterranean average weighted by GDP in PPP terms. Owing to the lack of data comparability, West Bank and Gaza are excluded from the average, and 2009 data are estimated.

In most non-oil-exporting countries of the region, current account balances have remained broadly unchanged, or have strengthened slightly. This is the result of lower oil prices in combination with weaker economic activity. In particular, lower oil prices have led to a significant reduction of the import bill, which has outweighed the decline in exports of goods and services in many cases and has, accordingly, contributed to the strengthening of current account balances. This effect is particularly important for Lebanon and Jordan, the two countries in the region with the highest deficit in the oil trade balance over the last few years. Nevertheless, the current account deficits of Lebanon and Jordan, and that of Mauritania, remain large. In Israel, the region's only non-oil-exporting country with a current account surplus, the weakening of domestic demand has been the key driver behind a further strengthening of the current account balance, as the drop in imports has exceeded the decline in exports. Egypt (along with the West Bank and Gaza) is the only exception to this trend among the region's non-oil-exporting countries. Egypt's current account has moved into deficit after several years of surpluses, as the country's multiple sources of foreign exchange have all been affected by the global crisis: oil revenues, as well as revenues from non-oil exports, tourism and remittances, have declined, in addition to the sharp drop in Suez Canal revenues as a result of the fall in global trade.

FOREIGN EXCHANGE RESERVES

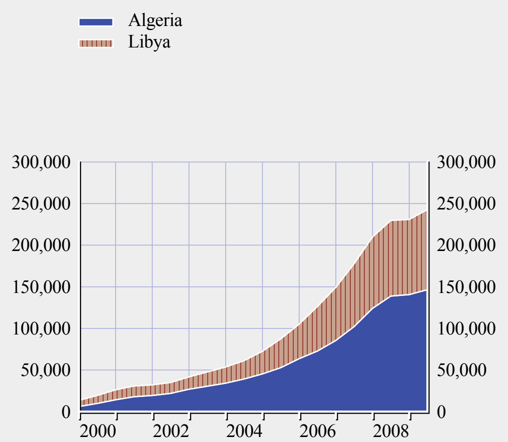
The development of Mediterranean countries' foreign exchange reserves has also been varied. The sharp rise of Algeria and Libya's foreign exchange reserves over the last few years – which now account for almost two-thirds of all foreign exchange reserves in the region – has come to an abrupt halt with the sharp drop in oil prices (see Chart 18). While, in general, non-oil-exporting countries' foreign exchange reserves were also on the increase in previous years (see Chart 19), developments since the intensification of the global financial turmoil have differed from country to country (see Chart 20).

Some countries have not seen any significant changes in their foreign exchange reserves. Other countries, most notably Israel, Lebanon and Jordan, have exhibited an increase in reserves since mid-2008. In Israel, this is the result of the programme of pre-announced purchases of foreign exchange reserves, in combination with large discretionary interventions to stem the appreciation pressure on the Israeli shekel (see Sub-section 2.3). In Lebanon, reserves have increased as a result of greater confidence in the economy in view of the political stabilisation and a steady inflow into bank deposits from abroad. Jordan also managed to increase its reserves further, implying that the two most vulnerable countries in the region have so far weathered the global financial turmoil relatively well, without downward pressure on the exchange rate, as they were able to maintain capital inflows. Morocco and Egypt have seen a drop in foreign exchange reserves since mid-2008, reflecting pressure on the balance of payments. In Egypt, the authorities have mainly drawn down foreign currency deposits held with commercial banks, in view of large portfolio outflows in 2008,[14] and have thus limited sharp movements in the

14 See Sub-sections 3.2 and 3.3 on the withdrawal of non-residents from the Egyptian T-bill market and movements in stock markets.

Chart 18 Foreign exchange reserves of oil exporters

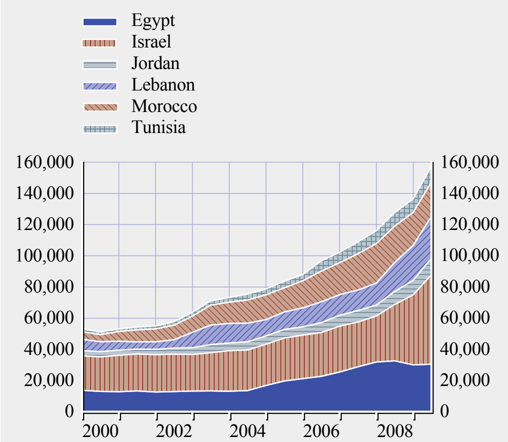
(USD millions)



Source: IMF.

Chart 19 Foreign exchange reserves of non-oil exporters

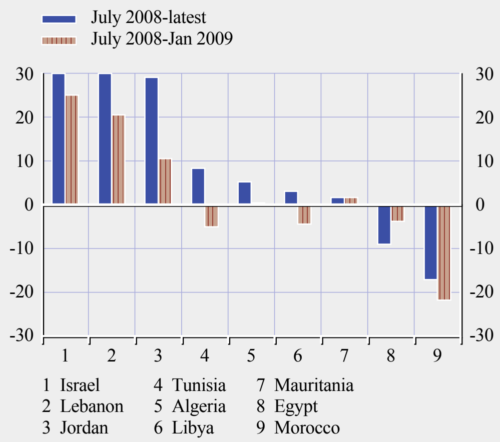
(USD millions)



Source: IMF.

Chart 20 Changes in foreign exchange reserves since July 2008

(percentages)



Sources: IMF and ECB staff calculations.
Note: Latest available data refer to August 2009, except for Mauritania (October 2008).

exchange rate. In Morocco, Bank Al-Maghrib accommodated a spike in demand for foreign currency by the country's commercial banks in the wake of the intensification of global financial turmoil in the fourth quarter of 2008.

In August 2009, the IMF's general allocation of special drawing rights (SDRs) to member countries became effective, which was part of the global policy response to the financial crisis – it provided liquidity to the global economic system by supplementing member countries' foreign exchange reserves. In September 2009, a special SDR allocation was made under the IMF's Fourth Amendment to the Articles of Agreement. These SDR allocations led to an increase in Mediterranean countries' foreign exchange reserves (see Table 8). Reserves rose between 1% and 5% in most countries. Mauritania's foreign exchange reserves, by contrast, rose by 42% as a result of the SDR allocation, reflecting the country's previously very low level of reserves (in terms of GDP). Overall, the region's reserve levels have appeared to be adequate enough to avert potential shocks and speculative attacks, also in comparison with other emerging markets. In 2009, reserve levels in most Mediterranean countries surpassed the average reserve level (relative to GDP) of central, eastern, and south-eastern European countries (22.7%), as well as the average reserve level of other emerging markets (15.9%).[15]

15 The level of reserves given for other emerging markets is based on IMF reporting countries for which data on reserves are available and which are neither Mediterranean nor central, eastern and south-eastern European emerging market economies.

Table 8 Allocation of special drawing rights (SDR)

Country	General SDR allocation	Special SDR allocation	Total allocation			
	SDR millions	SDR millions	SDR millions	USD millions (as of September 6, 2009)	Percentage of FX reserves (August 2009)	*Memorandum item:* FX reserves/GDP
Algeria	930.1	139.4	1069.5	1683.5	1.2	104.5
Egypt	699.6	63.0	762.5	1200.3	4.0	16.5
Israel	688.1	88.9	777.0	1223.1	2.2	30.3
Jordan	126.4	18.8	145.2	228.6	2.2	47.4
Lebanon	150.5	38.4	188.9	297.4	1.2	85.6
Libya	833.0	180.9	1013.9	1596.0	1.7	158.9
Mauritania	47.7	4.2	51.9	81.7	41.7	5.5
Morocco	436.0	39.7	475.7	748.8	3.4	24.1
Syria	217.6	25.0	242.6	381.9	…	…
Tunisia	212.4	26.1	238.5	375.4	3.9	26.5

Source: IMF.
Note: Data for Mauritania is for October 2008.

3 THE IMPACT OF THE GLOBAL FINANCIAL TURMOIL AND RECESSION ON BANKING SECTORS AND FINANCIAL MARKETS

3.1 MEDITERRANEAN COUNTRIES' FINANCIAL SECTORS – A RECAP OF KEY FEATURES AND ISSUES

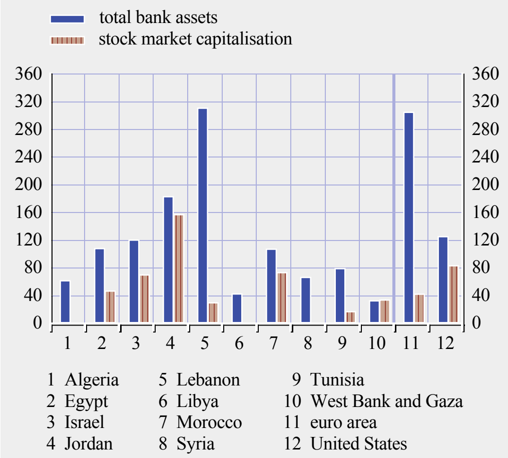
This sub-section briefly recaps the key structural features and issues of Mediterranean countries' financial sectors. Reviewing these features, along with standard banking sector indicators, provides the background to, and sets the stage for, analysing the impact of the global financial turmoil.

BANK-BASED FINANCIAL SYSTEMS

Most Mediterranean countries' financial sectors are bank-based, with capital markets tending to be underdeveloped and generally playing a subordinate role in financial intermediation (see Chart 21). Corporate bond markets are in a nascent stage of development, with a few exceptions such as those in Algeria, Israel (see also Sub-section 3.3), Morocco and Tunisia. Some Mediterranean countries have miniscule or only recently established stock markets, as in the case of Algeria, Libya and Syria (the Libyan and Syrian stock markets were established in 2008 and 2009 respectively). In most countries, stock market development, as measured against GDP, was buoyant until the global financial turmoil erupted (see also Sub-section 3.3) and, in some cases, stock market capitalisation exceeded total bank assets prior to the turmoil. This relatively recent development should not, however, serve to overstate the role of stock markets as a source of finance for the corporate sector. The growth of stock market capitalisation over the last decade – until the point when Mediterranean countries' markets also took a dive in the wake of the global financial turmoil – resulted predominantly from price increases, rather than from the issuance of new shares or the listing of new companies. Accordingly, the role of markets in financing new investment was more limited than stock market capitalisation might suggest. Moreover, market liquidity tended to be low, with trading activity often concentrated on a few stocks.

Chart 21 Total bank assets versus stock market capitalisation (2008)

(percentage of GDP)



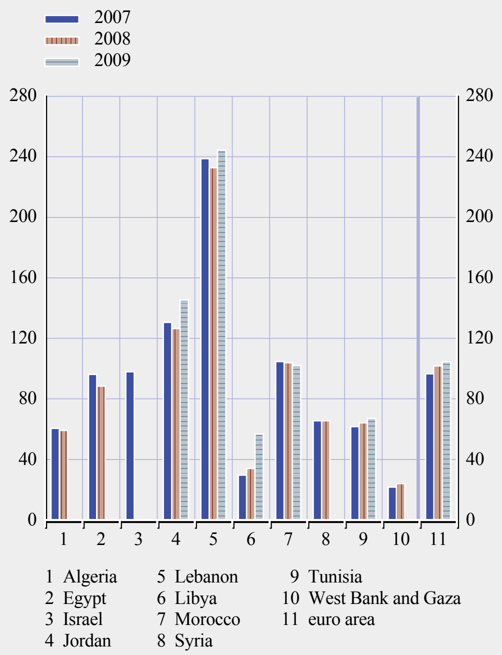
Sources: IMF, S&P Global Stock Markets Factbook 2009 and ECB staff calculations.

SIGNIFICANT DIFFERENCES BETWEEN COUNTRIES

Mediterranean countries exhibit considerable differences as regards the degree of financial deepening and the size of the banking sector. In terms of both broad money and bank assets, measured against GDP in both cases, Lebanon has by far the most developed banking sector (see Charts 22 and 23). This is a reflection of (i) the country's traditional role as a regional financial centre with relatively sophisticated banks that are active in and around Lebanon, (ii) the arrival of strong deposit inflows from the Lebanese diaspora (see also Sub-section 3.2) and (iii) the country's very high level of public debt, which is to a large extent funded by domestic banks. Other countries with a sizable banking sector and a high degree of financial deepening are Jordan, Israel, Egypt and Morocco. The banking sectors are small and underdeveloped in those oil-exporting countries that also have a tradition of heavy state intervention in the economy, i.e. Algeria, Libya and Syria. They lag behind in terms of economic and financial liberalisation, as many other countries in the region have started to implement banking sector reforms over the last few years, including privatisation and foreign bank entry, and reforms of their legislative and regulatory frameworks.

Chart 22 Broad money

(percentage of GDP)



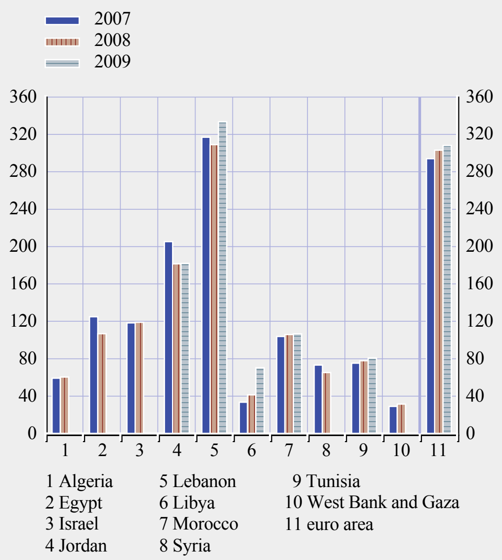
Sources: IMF and ECB staff calculations.

PRIVATE SECTOR ACCESS TO FINANCING – A KEY CHALLENGE

Notwithstanding banking sector reforms, private sector access to credit is a challenge in many Mediterranean countries and tends to constrain investment – this can be gauged by banks' claims on the private sector (see Chart 24). Credit to the private sector, measured in terms of GDP, is relatively high in Israel and Jordan and is at an elevated level in both Lebanon (despite claims on the private sector accounting for less than one-quarter of total bank assets, owing to the high exposure to the public sector) and Morocco, which has shown a significant increase in private sector lending in recent years. The extent of lending to the private sector is particularly small in Algeria, Libya and Syria, in line with their generally underdeveloped financial sectors (see above), and in the West Bank and Gaza, where it mainly reflects a lack of bankable projects, given political and thus economic uncertainty. Reasons for the low level of private sector credit in Mediterranean countries include the privileged access of public sector companies to credit, an underdeveloped

Chart 23 Total bank assets

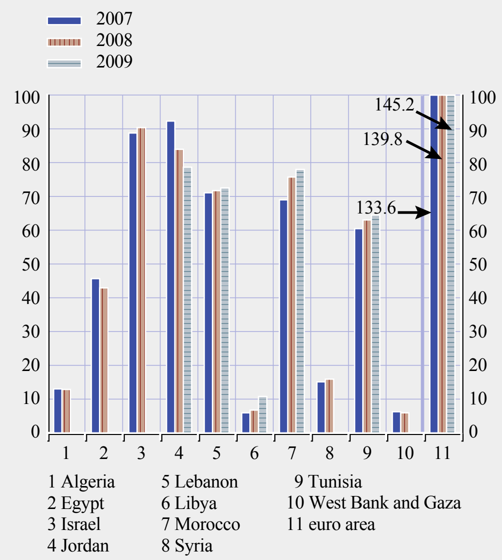
(percentage of GDP)



Sources: IMF and ECB staff calculations.

Chart 24 Bank claims on the private sector

(percentage of GDP)



Sources: IMF and ECB staff calculations.

credit culture and risk management capacity, low competitive pressures and a still high stock of non-performing loans in some countries. Accordingly, for many private sector companies, retained earnings are the main source of funding for investment, impeding the exploitation of business opportunities and ultimately economic growth.

LIMITED INTEGRATION INTO GLOBAL FINANCIAL MARKETS

Mediterranean countries' integration into global financial markets is relatively limited, as evidenced, for example, by the low amount of foreign bank lending to the region (see Chart 25). In the third quarter of 2009, the region as a whole accounted for less than 1% of the total cross-border claims of BIS-reporting banks and only for 3.5% of the cross-border claims of BIS-reporting banks on emerging and developing countries. Relative to their GDP, foreign bank lending is lower than in other emerging market regions. The limited financial integration reflects the region's general state of economic reform, liberalisation and financial development, set against the background of the traditional state domination of the economy in many countries. Moreover, while real GDP growth in the years prior to the crisis was higher than in the previous decade, it did not match the growth rates of many other emerging market regions, meaning that investment and lending opportunities might have been less pronounced than in other parts of the world.

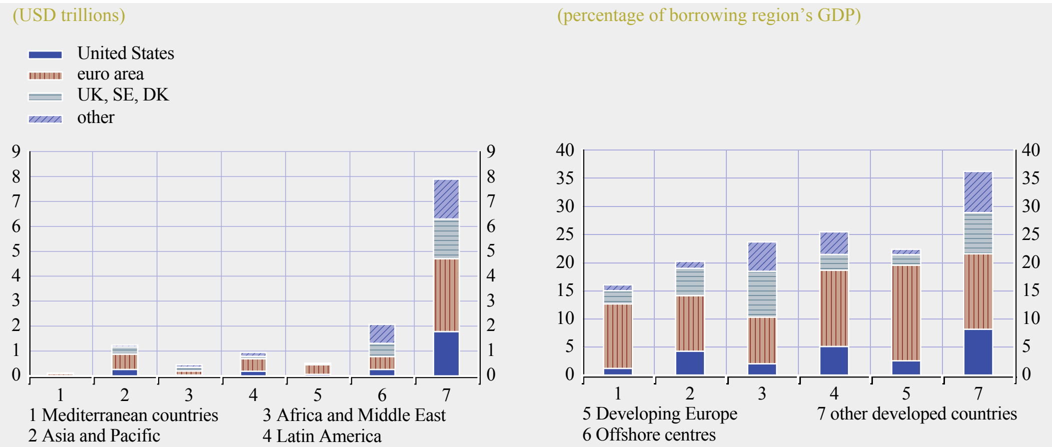
A REVIEW OF STANDARD BANKING SECTOR INDICATORS

Standard banking sector indicators for Mediterranean countries, based on data from the IMF Global Financial Stability Report (GFSR) of April 2010 and, for some countries, on IMF Article IV reports,[16] provide a picture of where banking sectors stood in the course of 2009. Depending on availability, the latest data refer to different quarters in 2009, so that the full impact of the crisis on banks' balance sheets may not yet be discernible from these indicators.

Standard indicators capturing bank capitalisation, bank profitability and non-performing loans point to generally sound capital positions and reasonable profitability in the region. Asset quality is revealed as being the Achilles

16 While using IMF (2010b) GFSR data ensures that data are broadly comparable across countries, the drawback is that they are only available for six countries for the years preceding 2009. Data for Algeria, Libya and Syria are taken from the latest IMF Article IV reports published in the second half of 2009, or the first half of 2010, i.e. they may not be fully comparable.

Chart 25 Total bilateral claims of BIS reporting banks by region



Sources: BIS (Consolidated Banking Statistics) and ECB staff calculations.
Notes: UK (United Kingdom), SE (Sweden), DK (Denmark); data for the third quarter of 2009.

heel of some countries' banking sectors, as non-performing loan (NPL) ratios are still very high, notwithstanding some progress in dealing with NPLs and increasing provisions over the last few years. Accordingly, some countries, notably Algeria, Egypt, Libya and Tunisia, entered the global financial crisis with an already high stock of problematic assets on their banks' balance sheets.

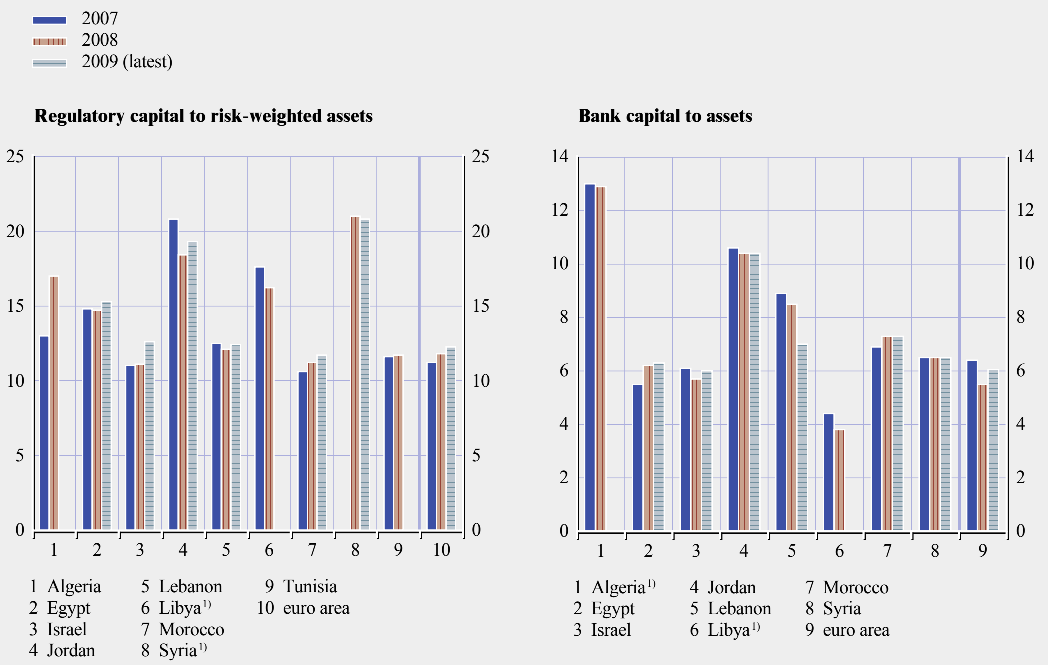
Mediterranean countries' banks are, in general, sufficiently capitalised, with a capital adequacy ratio of more than 10% (see Chart 26). Jordanian banks have the highest level of capitalisation, as also indicated by the ratio of bank capital to unweighted assets, which gauges the overall leverage of banking sectors.

Bank profitability in Mediterranean countries can generally be assessed as satisfactory, despite significant differences between countries and the fact that profitability is higher in many other emerging market economies (see Chart 27). An increase in profitability is obstructed, in several countries, by a narrow product range with a focus on traditional lending and a high number of non-performing loans.

Several Mediterranean countries' banking sectors entered the global financial turmoil with an already high stock of non-performing loans, and in some cases also with relatively low levels of provisioning (see Chart 28). Progress has been made in reducing NPLs and increasing provisions over the last few years: for example, the NPL ratio in Jordan declined from 17% in 2002 to less than 5% in 2008. Nevertheless, NPL levels remain high, in particular in Algeria, Egypt, Libya and Tunisia, where NPLs account for 15% or more of total loans. While provisions in Egypt have now reached 90% of total NPLs, they account for less than 60% in Tunisia and less than 20% in Syria.

Chart 26 Bank capitalisation

(percentages)



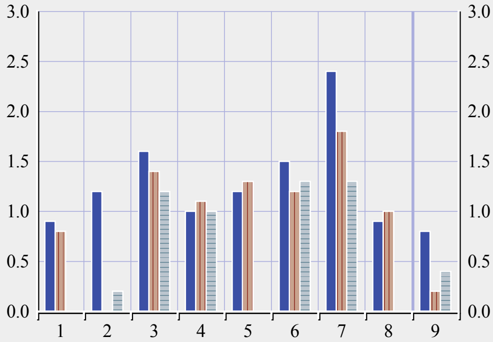
Source: IMF.
Notes: 1) Data from latest IMF Article IV report. Euro area: median.

Chart 27 Bank profitability

(percentages)

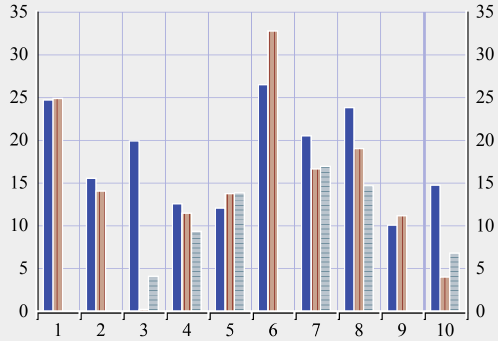
2007
2008
2009 (latest)

Return on assets



1 Egypt
2 Israel
3 Jordan
4 Lebanon
5 Libya[1]
6 Morocco
7 Syria[1]
8 Tunisia
9 euro area

Return on equity



1 Algeria[1]
2 Egypt
3 Israel
4 Jordan
5 Lebanon
6 Libya[1]
7 Morocco
8 Syria[1]
9 Tunisia
10 euro area

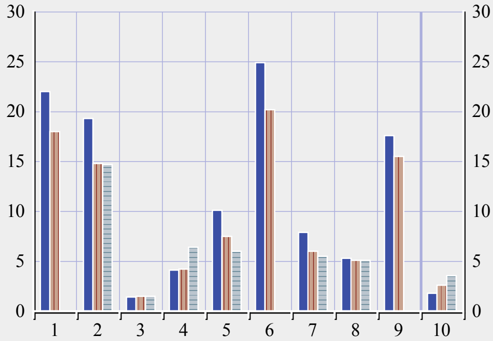
Source: IMF.
Notes: 1) Data from latest IMF Article IV report. Euro area: median.

Chart 28 Non-performing loans (NPLs)

(percentages)

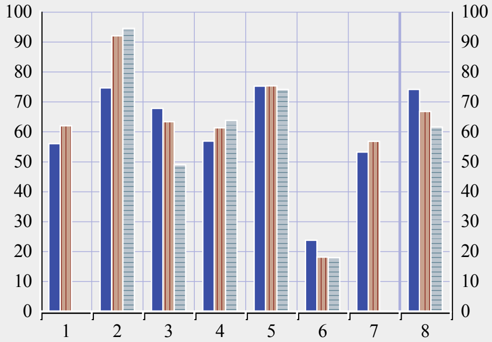
2007
2008
2009 (latest)

NPLs to total loans



1 Algeria[1]
2 Egypt
3 Israel
4 Jordan
5 Lebanon
6 Libya[1]
7 Morocco
8 Syria[1]
9 Tunisia
10 euro area

Provisions to NPLs



1 Algeria[1]
2 Egypt
3 Jordan
4 Lebanon
5 Morocco
6 Syria[1]
7 Tunisia
8 euro area

Source: IMF.
Notes: 1) Data from latest IMF Article IV report. Euro area: median.

3.2 THE IMPACT OF GLOBAL DEVELOPMENTS ON BANKING SECTORS

This sub-section identifies a number of areas in which the effects of global financial developments on banking systems in Mediterranean countries are discernible (based on data available so far), and examines issues that are relevant to advanced and/or other emerging market economies, but do not necessarily constitute risks to, or have the same relevance in, the Mediterranean region. First, an analysis of the exposure to "toxic" assets originating in the United States and the interconnectedness between Mediterranean countries and foreign banks and international credit flows is presented. This is followed by an examination of the liability side of banks' balance sheets, namely deposit growth and deposit dollarisation in the wake of the crisis, as well as by a close look at the asset side, i.e. trends in credit growth, asset quality and the extension of credit to the private sector in comparison with that extended to the public sector. Finally, a topic relevant to the Mediterranean region is discussed, namely the impact of the crisis on privatisation in the banking sector.

EXPOSURE TO "TOXIC" ASSETS

The epicentre of the global financial turmoil that started in August 2007 was the US sub-prime mortgage market. The first transmission channel of the crisis to financial sectors outside the United States was via securitised US mortgages of various types, which were purchased by banks around the globe, notably in an environment of low interest rates that was conducive to a "search for yield". These US asset-backed securities – often highly complex – turned "toxic" as default rates on housing loans in the United States increased and the underlying assets lost value.

The exposure of financial institutions in Mediterranean countries to long-term US asset-backed securities was only minor, and this can be used as a proxy to gauge to what extent mortgage-related securities found their way into banks' assets in the different countries of the region (see Table 9). In all countries, with the exception of Israel, exposure was either non-existent or negligible, indicating that the bulk of these assets were purchased by financial institutions in advanced economies, and not by those in emerging market and developing economies. The following factors explain this lack of exposure of Mediterranean banks: (i) the risk aversion of banks in the region; (ii) a lack of sophistication that has prevented the banks from investing in complex products; and (iii) tight regulation.[17] In Israel, only one large bank had significant exposures to US asset-backed assets, resulting in losses equal to 25% of capital. This was not, however, "life-threatening". Moreover, most US asset-backed securities held by Israeli banks comprised senior debt of government-sponsored enterprises (Freddie Mac and Fannie Mae).

Table 9 Foreign holdings of US long-term asset-backed securities

(USD millions)

	2007	2008
Mediterranean countries		
Egypt	76	75
Israel	1,432	1,725
Jordan	1	<0.5
Lebanon	2	3
Mauritania	0	0
Morocco	<0.5	<0.5
Syria	0	0
Tunisia	54	1
West Bank and Gaza	0	0
Algeria, Libya, Gabon, Nigeria [1]	3	6
Memorandum		
Total Africa	404	304
Total Asia	454,017	676,088
Total Caribbean	295,690	295,318
Total Europe	670,408	515,494
Total Latin America	6,538	7,005

Source: US Treasury International Capital System (TICS).
Note: as of 30 June of the respective year.
1) The US TICS groups these countries together.

RELIANCE ON FOREIGN BANKS AND CROSS-BORDER CREDIT FLOWS

Another channel through which Mediterranean countries' banks could have been affected by the crisis is their reliance on foreign banks

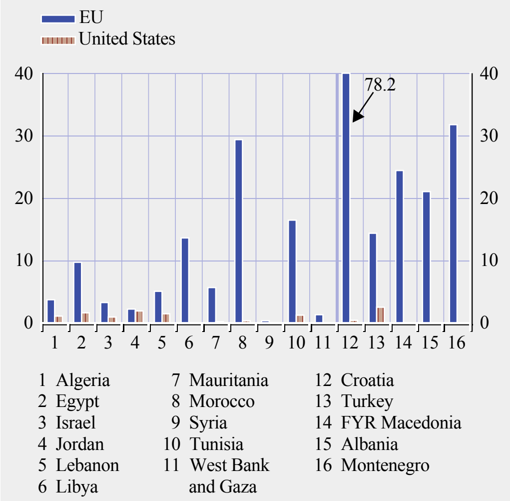
17 For instance, the Central Bank of Lebanon had banned investment in mortgage-backed securities in 2005.

and the reduction of cross-border credit flows that resulted from the global financial turmoil. The effects emanating from this transmission channel, however, appear to have been limited so far. This is probably a result of the relatively low degree of integration into international financial markets of most countries in the region, also in terms of foreign ownership of banks.

The overall reliance of Mediterranean countries on banks from the EU and the United States – which have been severely affected by the crisis and where the process of deleveraging has been intense – is low (see Chart 29). While US banks are hardly active in the region, European banks have a greater presence, with significant claims on Egypt, Morocco and Tunisia, in particular. However, in comparison with south-eastern Europe, for example, Mediterranean countries' dependence on bank financing from the EU is much more limited. The risk that deleveraging and heightened risk aversion in advanced economies in the wake of the global financial crisis will lead to financial disruption, e.g. via the cutting of banks' credit lines, has thus been less relevant to Mediterranean economies than to countries in emerging Europe.

Chart 29 Claims of EU and US banks on Mediterranean economies

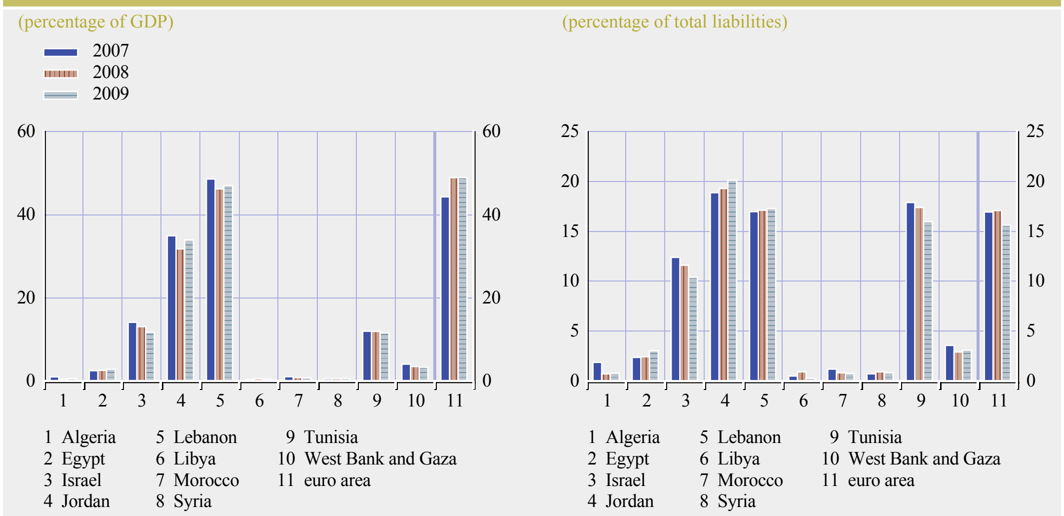
(percentage of respective country's GDP)



Sources: BIS (Consolidated Banking Statistics), IMF and ECB staff calculations.
Note: Banks' claims as of the fourth quarter of 2009, and GDP data for 2009.

Mediterranean banks also have relatively low foreign liabilities, except in the case of Lebanon and Jordan, and – to some extent – Israel and Tunisia (see Chart 30). A significant share of

Chart 30 Foreign liabilities of Mediterranean banks



Sources: IMF and ECB staff calculations.

Table 10 Bank ownership structure

(2005)

	Algeria	Egypt	Israel	Jordan	Lebanon	Morocco
Number of commercial banks:	18	43	15	23	64	16
of which government-owned	7	15	0	0	0	5
of which foreign-owned	10	20	1	8	25	5
Fraction of assets owned by foreign banks (%)	9.0	20.9	n/a	9.5	n/a	21.9

Source: World Bank, Database on Bank Regulation and Supervision (June 2008).

Lebanese banks' foreign liabilities are deposits held by the Lebanese diaspora, which have been a relatively stable source of funding, and those of Jordanian banks are to a large extent regional, thus tending to be relatively stable. Nevertheless, maintaining confidence in the banking system and the overall macroeconomic environment is particularly important in these countries.

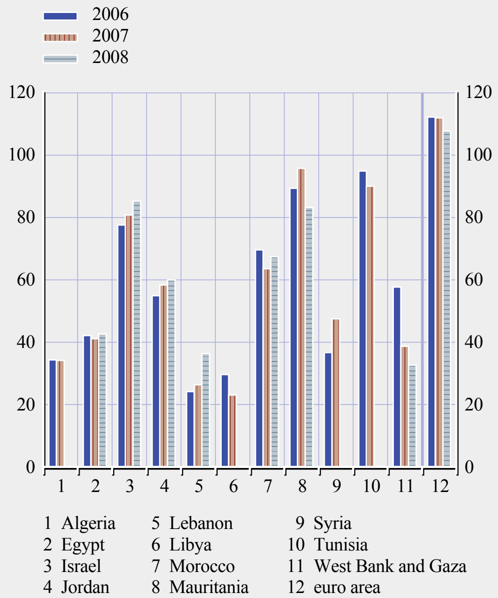
The role of foreign banks in Mediterranean countries is also limited (see Table 10), although some progress has been made as a result of privatisation over the last few years (this is not yet fully reflected in the table). While the number of foreign banks active in some countries is sizable, the share of assets owned by them is generally low. This contrasts sharply with the situation in many central, eastern and south-eastern European countries.

The relatively low degree of international financial integration of Mediterranean banks, as reflected in limited funding from foreign sources, is also mirrored in generally low loan-to-deposit ratios (see Chart 31). Loan-to-deposit ratios have consistently remained below 100% in all the region's countries. Accordingly, banks rely mainly on domestic sources to fund lending. The relatively low loan-to-deposit ratios may reflect (i) limited bank lending on account of, for example, underdeveloped banking sectors (as in the case of Libya) or a lack of bankable projects (as in the case of the West Bank and Gaza), and (ii) a stable inflow into the domestic banking system from savings (in Lebanon, for instance). Low loan-to-deposit ratios tend to reduce vulnerability to external shocks, for example, that global deleveraging translates into a disruption of financial intermediation in Mediterranean countries.

A key development in the wake of the global financial crisis has been the sharp reduction of cross-border lending by BIS-reporting banks. This began in the second quarter of 2008 and became more pronounced after the collapse of Lehman Brothers. While total cross-border claims of BIS-reporting banks fell by an average compound quarterly growth rate of 1.8% over the period from the third quarter of 2008 to the third quarter of 2009, total credit flows

Chart 31 Loan-to-deposit ratios in Mediterranean countries

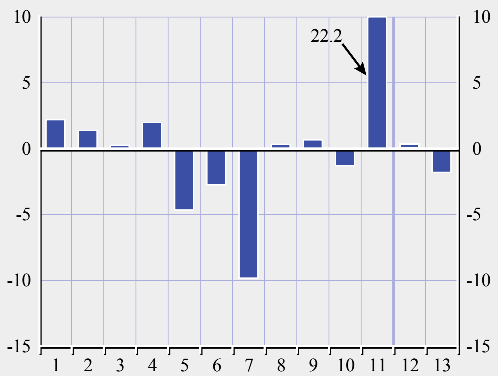
(percentages)



Sources: Bankscope and ECB staff calculations.
Note: Euro area: ECB statistics.

Chart 32 Changes in cross-border claims on Mediterranean countries in the period from the third quarter of 2008 to the third quarter of 2009

(percentage changes)



1 Algeria
2 Egypt
3 Israel
4 Jordan
5 Lebanon
6 Libya
7 Mauritania
8 Morocco
9 Syria
10 Tunisia
11 West Bank and Gaza
12 Mediterranean
13 world

Sources: BIS (Consolidated Banking Statistics) and ECB staff calculations.

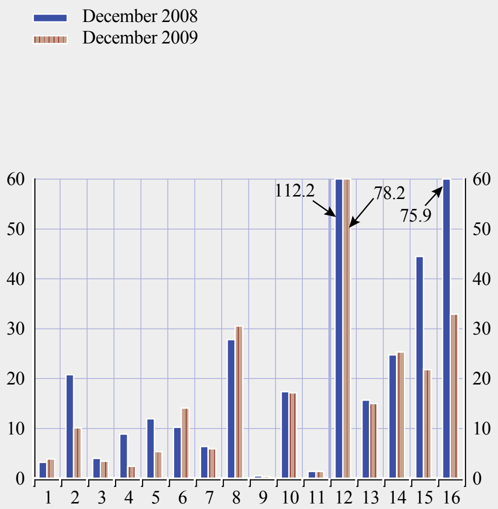
to Mediterranean countries exhibited slightly positive growth with an increase of 0.2% (see Chart 32). Notwithstanding this relatively benign average figure, there have been some noticeable reductions in certain countries, in particular in Lebanon, Libya, and Mauritania.

As regards claims of EU banks on Mediterranean countries, only a marginal reduction was recorded over the course of 2009 (as a percentage of Mediterranean countries' GDP), except in the case of Egypt, Jordan, and Lebanon (see Chart 33). This contrasts with developments in some south-eastern European countries, where exposure has been reduced more significantly – however, the initial claim levels were much higher.

Most funding of Mediterranean countries by BIS-reporting banks originates in the EU (see Chart 34), although the overall amount of

Chart 33 Change in EU banks' claims on Mediterranean countries

(percentage of GDP)

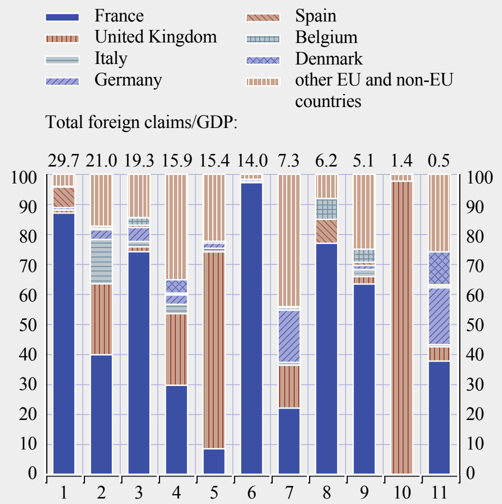


1 Algeria
2 Egypt
3 Israel
4 Jordan
5 Lebanon
6 Libya
7 Mauritania
8 Morocco
9 Syria
10 Tunisia
11 WBG
12 Croatia
13 Turkey
14 FYROM
15 Albania
16 Montenegro

Sources: BIS (Consolidated Banking Statistics), IMF and ECB staff calculations.
Notes: Banks' claims as of the fourth quarter of 2008 and 2009, and GDP data for 2008 and 2009. WBG stands for West Bank and Gaza, and FYROM for FYR Macedonia.

Chart 34 EU banks' shares in total foreign claims on Mediterranean countries

(percentage of total foreign claims)



1 Morocco
2 Egypt
3 Tunisia
4 Lebanon
5 Jordan
6 Libya
7 Israel
8 Mauritania
9 Algeria
10 WBG
11 Syria

Sources: BIS (Consolidated Banking Statistics), IMF and ECB staff calculations.
Notes: Banks' claims as of the third quarter of 2009. WBG stands for West Bank and Gaza.

total claims in terms of GDP differs significantly from country to country. With the exception of Israel, EU banks account for more than 70% of total foreign claims in all Mediterranean countries. Among EU banks, French banks provide the highest share of funding for most Mediterranean countries.

DEPOSIT GROWTH AND DOLLARISATION

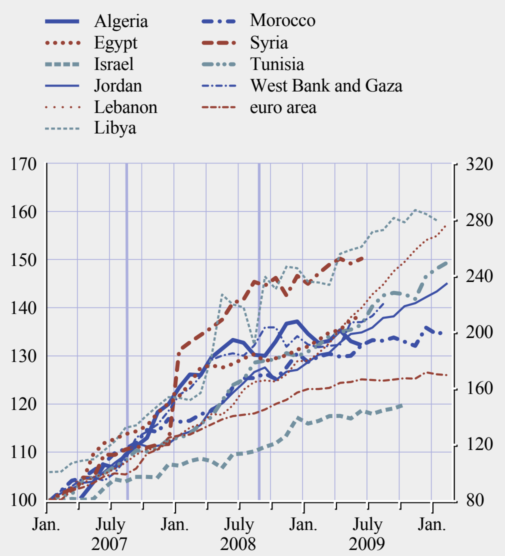
Mediterranean countries' banking sectors have exhibited a sound development of their deposit base in the wake of the global financial turmoil (see Chart 35). This can be seen as a sign of confidence in the banking sectors, and is crucial, as domestic deposits are the main source of funding for the region's banks (see above). In some countries, the growth rate of bank deposits slowed down in the course of 2008 and 2009 in comparison with previous years. Some countries also appeared to have benefited from the crisis in terms of inflows from abroad – Israel and Lebanon, for example – as the perception of the risks in their banking systems relative to those in some advanced economies changed as a result of the crisis.

Another indicator of continued confidence is the decline in deposit dollarisation in countries that traditionally have a relatively high share of foreign currency deposits. In the Mediterranean region, this is the case for Lebanon and, to a lesser extent, Jordan, as a result of past economic shocks and crises. In both countries the share of US dollar deposits has continued to decrease, to the benefit of local currency deposits, since the intensification of the global financial turmoil in September 2008 (see Chart 36). This is an indication that depositors do not perceive any increased risk of a devaluation vis-à-vis the US dollar, to which local currencies are pegged (see Sub-section 2.3).

Rather than being driven by global developments, deposit dollarisation in Lebanon is strongly influenced by domestic political and geopolitical events, as evidenced by the spike in dollarisation following the assassination of Prime Minister Hariri in 2005, and that following the armed conflict in 2006 and the ensuing domestic political stalemate. A decline in dollarisation was exhibited in the wake of the

Chart 35 Bank deposit growth

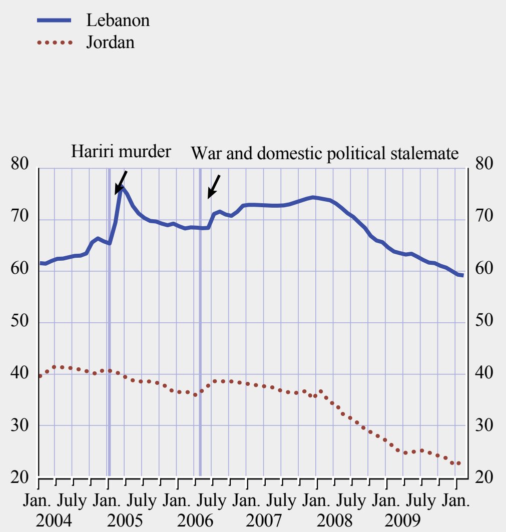
(index 2007 M1 = 100)



Sources: IMF and ECB staff calculations.
Note: Libya: right-hand scale.

Chart 36 Foreign currency deposits in Lebanon and Jordan

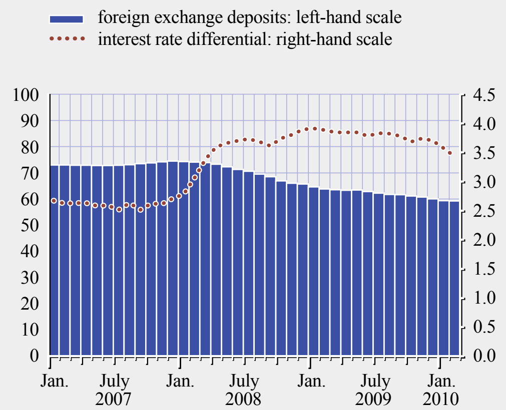
(percentage of total deposits)



Sources: Haver Analytics and ECB staff calculations.

Chart 37 Interest rate differential and de-dollarisation in Lebanon

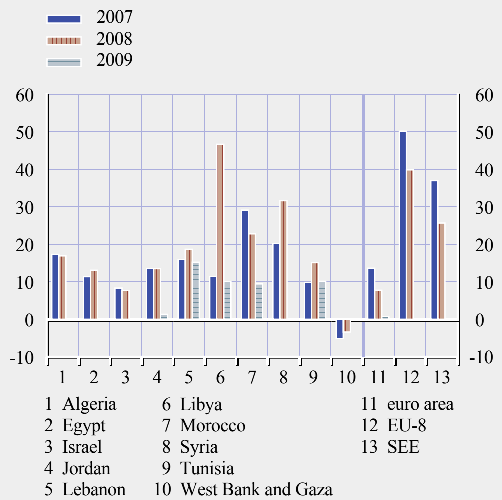
(left-hand scale: percentage; right-hand scale: percentage points)



Sources: Haver Analytics and ECB staff calculations.

Chart 38 Growth in credit to the private sector

(annual percentage changes)



Sources: IMF and ECB staff calculations.
Notes: EU-8 comprises central European non-euro area EU members. SEE stands for south-eastern European countries.

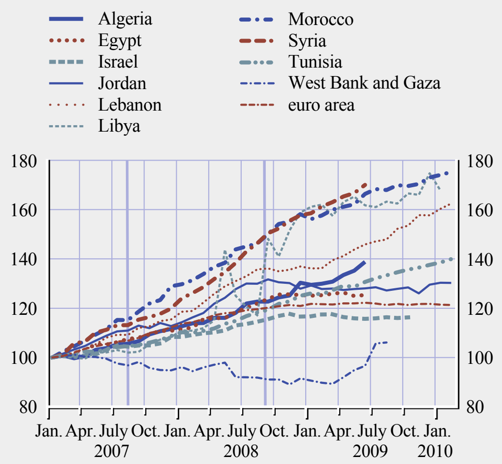
stabilisation of the domestic political situation in 2008 and 2009. Given Lebanon's high exposure to domestic political and geopolitical risks, these appear to be more important determinants of confidence in the currency and the domestic banking sector than global financial developments. Nevertheless, the persistently high degree of deposit dollarisation is a sign of vulnerability. Moreover, the recent increase in the share of local currency deposits is also related to a growing interest rate differential in favour of deposits denominated in Lebanese pound, generated by the Central Bank of Lebanon in order to promote the use of the local currency (see Chart 37).

CREDIT GROWTH AND NON-PERFORMING LOANS

Most Mediterranean countries have experienced relatively high rates of growth in credit to the private sector over the last few years, although this growth was generally not as buoyant as that in central, eastern and south-eastern European countries (see Chart 38). Credit growth in the region continued unabated after the global financial turmoil erupted in August 2007. However, since the intensification of the turmoil in autumn 2008, a slowdown has been observed in several countries, for example in Egypt, Israel and Jordan, while the pace of credit extension in other countries appears to have remained unchanged (see Chart 39).

Chart 39 Claims on the private sector in the wake of the global financial turmoil

(index 2007 M1 = 100)



Sources: IMF and ECB staff calculations.

The slowdown in credit growth recorded since late 2008 is a reflection of the global economic downturn, which has since then also spilled over to emerging market economies, including those in the Mediterranean region. Demand for credit has probably decreased in view of dampened economic prospects, and there are currently no signs of a credit crunch that is driven by the supply side (in addition to the general problems of the private sector in many countries of the region in obtaining credit – see Sub-section 3.1).

Unlike the situation in central and south-eastern Europe, foreign currency credit to the private sector is not a major financial stability concern in the Mediterranean region. Lebanon is the only country with a very high share of credit extended in foreign currency (mainly in US dollars), which has declined somewhat since autumn last year (see Chart 40). To avoid a currency mismatch in banks' balance sheets, Lebanon limits the ratio of private sector loans to deposits in foreign currencies to 70% (see above on deposit dollarisation in Lebanon). Some other countries, such as Egypt, Israel and Jordan, also have a non-negligible, albeit moderate, level of foreign currency credit.

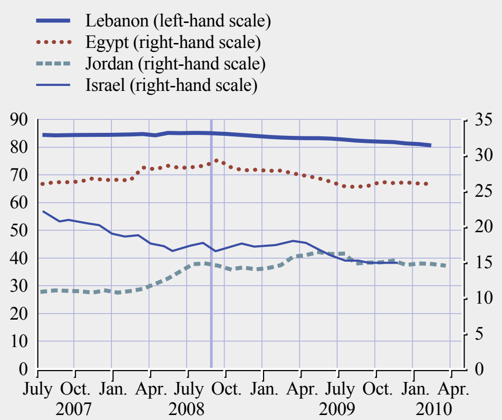
Looking at individual financial institutions, banks in the region appear to be in the "comfort zone" as regards a combination of NPL ratios and capitalisation, in comparison with cases of past bank defaults in the Mediterranean countries (see Chart 41).[18]

Looking ahead, the prospects for asset quality could potentially be an issue of concern in Mediterranean banking sectors in the wake of the global financial turmoil and recession, given (i) that many banks in the region entered the economic downturn with an already high stock of non-performing loans (see Section 3.1, Chart 28) and (ii) that the strong credit growth of previous years has contributed to the decline in NPL ratios (as have specific policies addressing the issue) and that the quality of this newly generated credit portfolio still needs to be tested in a more challenging economic environment.

18 It should be noted, however, that this chart only covers those banks that reported non-performing loans.

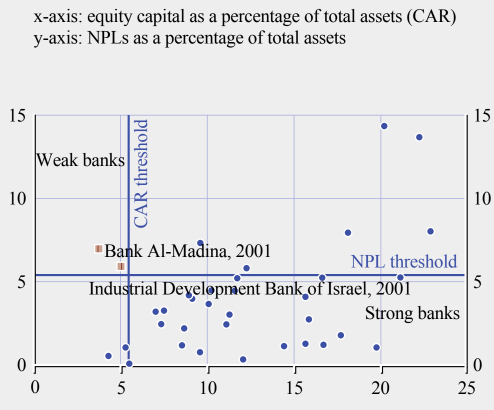
Chart 40 Foreign currency-denominated credit to the private sector

(percentage of total private sector credit)



Sources: Haver Analytics, Central Bureau of Statistics Israel, Central Bank of Jordan and ECB staff calculations.

Chart 41 Non-performing loans and capitalisation in past defaults



Sources: Bankscope and ECB staff calculations.
Notes: Only for banks reporting non-performing loans (NPLs). The thresholds for NPLs and the capital adequacy ratios (CARs) are derived from past experience and reflect the minimum NPL and CAR levels of past defaulting banks (Bank Al-Madina (Lebanon) and Industrial Development Bank of Israel) one year before their insolvency.

While an increase in defaults, and thus in non-performing loans, is normal in an economic downturn, the combination of an entrenched problem in several countries' banking sectors with the potentially detrimental nature of the global economic cycle is a specific risk for the region. In the Mediterranean region, an increase in NPL ratios as a result of the crisis would be added to an already high share of low-quality assets in some countries and would thus further impair banks' balance sheets. At the same time, the economic slowdown may be protracted and not be followed by a dynamic recovery. In this case, apart from an increase in NPLs, the outlook for growth in banks' core earnings would also be dampened by weak prospects for lending activity.

The exposure of some banks in the Mediterranean to specific sectors, for example the property sector, construction and tourism, which boomed in the years prior to the crisis but suffered in its aftermath, might need particular attention. Property market developments are particularly important for Egypt, Jordan, Lebanon and Morocco, which have experienced a rapid expansion of credit to this sector over the last few years. Anecdotal evidence suggests that property sales in these countries have dropped since the beginning of 2009. In particular, demand for secondary homes in popular tourist spots has moderated considerably in Egypt and Morocco. Prudential regulation has prevented an excessive exposure of individual banks to the property sector in Egypt, Jordan and Lebanon. The Moroccan authorities are strengthening their surveillance practices with regard to, inter alia, mortgages and the property sector, particularly as a result of the contraction in demand for high-end property (which often comes from Europe).

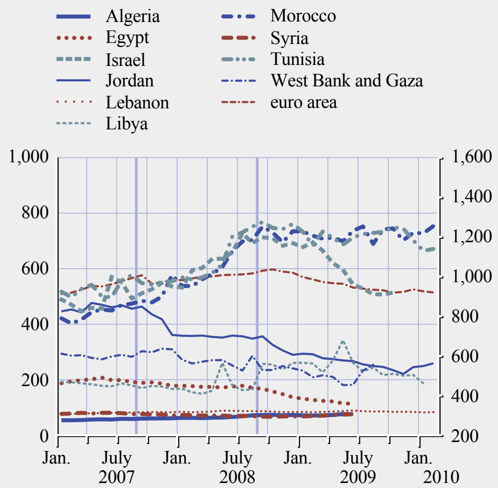
To what extent banks' asset quality is a matter of concern depends not only on NPL ratios, but also on whether governments are in a fiscal position to step in and support the banking system. Mediterranean countries differ significantly in terms of their fiscal room for manoeuvre. Among the four countries with the highest NPL ratios – Algeria, Egypt, Libya and Tunisia – two countries, Algeria and Libya, have ample fiscal space (see Sub-section 2.4). Furthermore, in these two countries, most NPLs are owed by state companies to public banks. To resolve the issue of NPLs, the governments can therefore either inject capital into state companies to enable them to repay loans, or support the state banks. Thus, the issue ultimately boils down to the solvency of the government, which, owing to buoyant oil revenues of previous years, low public debt and large reserves, is not in jeopardy in either of the two countries. By contrast, Egypt and Tunisia have only limited fiscal room for manoeuvre.

PRIVATE VERSUS PUBLIC SECTOR CREDIT

Since autumn 2008, there has been a clear trend in most Mediterranean countries (and beyond) towards a slowdown in bank lending to the private sector (see above), and an increase in credit extended to the public sector. This is reflected in the ratio of outstanding credit to the private sector to credit to the public sector, which has recently been either declining slightly or stagnating in most countries where it had been rising before (see Chart 42). The growth

Chart 42 Credit to the private sector versus credit to the public sector

(credit to the private sector as a percentage of credit to the public sector)



Sources: IMF and ECB staff calculations.
Note: Israel and Tunisia: right-hand scale.

in bank credit to the public sector has been most pronounced in Israel, Egypt and Jordan, whereas the phenomenon is non-existent in oil-exporting countries of the region, as they can draw on assets accumulated over previous years to finance budget deficits (see Chart 43).

This trend has been driven by the following developments:

- Fiscal deficits have increased as a result of the economic downturn, so that the financing requirements of the public sector have been on the rise.

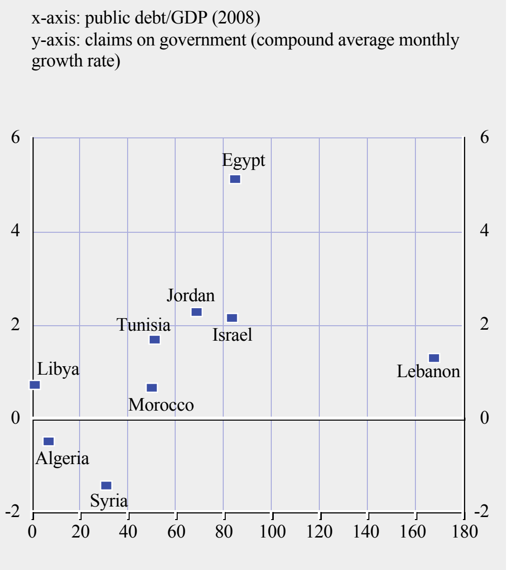
- Foreign investors have largely withdrawn from local Treasury bill markets in the wake of the intensification of the global financial turmoil. Accordingly, in countries where such markets are relevant, governments have had to rely increasingly on domestic banks to absorb T-bills issued to finance rising deficits. A case in point has been Egypt where increased issuance has driven up the share of government securities in total domestic credit, from around 46% in mid-2008 to 57% in early-2010 (see Chart 44). At the same time, the share of outstanding T-bills held by non-residents, as well as the share of foreign currency-denominated government securities, has decreased.

- The economic slowdown has reduced demand for credit from the private sector in view of dampened economic prospects and lower capacity utilisation, which has led to a reconsideration of investment plans.

For banks, the opportunity to increase lending to the public sector may not be unwelcome. As lending to the government is usually less risky than lending to the private sector (as long as public finances are sufficiently sound), it improves their risk profile, in particular as lending to the private sector involves more risks related to the economic slowdown and as some already hold a relatively high stock of non-performing loans.

Chart 43 Expansion of public sector credit since September 2008

(percentages)



Sources: Haver Analytics and ECB staff calculations.

Chart 44 Government securities issuance in Egypt

(percentages)

Sources: Haver Analytics and ECB staff calculations.

For the economy as a whole, however, this development may become problematic if the additional resources channelled to the public sector are anything other than resources freed as a result of lower private sector demand for funding. In other words, if the decrease in private sector credit is anything other than demand-driven, re-directing credit to the public sector in view of higher financing requirements and foreign investor withdrawal constitutes a case of crowding-out, with potentially adverse effects on private investment and economic growth. This would take place against the background of long-standing difficulties with private sector access to credit in several countries, and would thus exacerbate this problem (see Sub-section 3.1).

In the case of emerging market economies, the potential for crowding-out has two dimensions: (i) in view of rising budget deficits, the public sector increasingly relies on domestic bank financing, i.e. private credit is crowded out by public credit (domestic dimension); and (ii) increased public financing requirements in advanced economies, given sharply rising budget deficits in combination with the increased risk aversion of foreign investors in the wake of the financial crisis, may lead to a crowding-out of credit to some emerging market economies by credit to advanced economies (external dimension).

PRIVATISATION

The global financial turmoil appears to have slowed down the process of bank privatisation in some Mediterranean countries, which had gained momentum in previous years (see Table 11). This holds true of Algeria and Egypt. In Algeria, the sale of the country's third largest bank, Credit Populaire d'Algérie (CPA), has been postponed indefinitely by the government, which initially intended to sell 51%. The sale was officially launched in October 2006, and had reached its final stage, but was cancelled in late November 2007. In Egypt, the privatisation of the third largest public bank, Banque du Caire, was postponed in June 2008. By contrast, bank privatisation has continued in Libya where two banks were partially privatised in 2007 and 2008 and where tenders for two banking licences to establish subsidiaries have been announced by the Libyan central bank, and in Tunisia where Banque Tuniso-Koweitienne was privatised in 2008.

Table 11 Privatisation of banks in Mediterranean countries

Country	Year	Number of banks privatised	Amount (USD millions)
Egypt	2004	1	52
Egypt	2005	2	65
Egypt	2006	5	4,117
Egypt	2007	2	170
Lebanon	2005	1	236
Libya	2007	1	205
Libya	2008	1	308
Morocco	2004	1	86
Tunisia	2005	1	42
Tunisia	2008	1	340

Sources: World Bank, Privatization Database and ECB staff calculations.

There are three potential causes behind the adverse impact of the global financial turmoil on bank privatisation in Mediterranean countries (and possibly beyond):

- As potential bidders have come under stress owing to the global financial crisis, they may lose their appetite (or ability) for foreign acquisitions. For example, Citigroup, which was one of the six finalists (together with five EU banks) in the bid for Algeria's Credit Populaire d'Algérie, withdrew from the process as a consequence of the sub-prime crisis. For Egypt's Banque du Caire, bidders failed to meet the government's target price, which may also be related to the impact of financial stress on bidding banks.

- For governments in the process of bank privatisation, the global financial turmoil may have increased the uncertainty about the soundness of bidding banks, in particular those from advanced economies. The financial position of potential bidders may be opaque, making it more difficult for governments to assess their ability to successfully run privatised banks and to contribute to the overall development of the financial sector. This factor seems also to have played a role in the Algerian case.

- The global financial turmoil, along with developments in advanced economies' banking sectors, may have increased political opposition in emerging market economies to bank privatisation in general, and to foreign ownership in particular. Nationalisations and other problems experienced by banks in the United States and the EU, as well as issues associated with a strong foreign bank presence in central, eastern and south-eastern Europe, could lead to a backlash against bank privatisation, foreign bank entry and financial liberalisation in general, making it harder for reform-oriented forces to argue their case.

BANKING SECTOR POLICIES IN RESPONSE TO THE CRISIS

Given the thus far limited overall impact of global financial and economic developments on financial sectors of Mediterranean countries, the policy response has also been muted, in particular in comparison with the measures taken by advanced economies. In many advanced economies, far-reaching and comprehensive steps had to be taken by governments and central banks after the collapse of Lehman Brothers, in order to stabilise the financial system. Government measures there focused on guaranteeing deposits and interbank lending, on capital injections into banks and on relief programmes for impaired assets, while central banks resorted to non-conventional measures to ensure sufficient liquidity provision.[19]

In Mediterranean countries, financial sector policies in response to the crisis have been mainly precautionary in character. There has been no need to recapitalise banks or to address impaired assets (apart from the long-standing NPL problem in some countries). The precautionary measures that have been taken are manifold. They include, for example, (the announcement or reiteration of) deposit guarantees (Egypt, Israel, Jordan), the requirement to retain dividends instead of distributing them in order to strengthen the capital base of banks (Jordan), an increase in the capital adequacy ratio (Morocco) and increased provisioning for NPLs (Tunisia). Several countries have enhanced the monitoring of banks' exposure to sectors potentially affected most by the crisis, such as the property sector, construction, tourism and exports. Moreover, some countries are considering a strengthening of their banking supervisory structures.[20]

3.3 THE IMPACT OF GLOBAL DEVELOPMENTS ON FINANCIAL MARKETS

This sub-section tracks the impact of the global financial turmoil on different segments of Mediterranean countries' financial markets, looking at stock markets, corporate bond markets, sovereign bond and credit default swap (CDS) spreads and interbank markets. Stock markets have been the most severely affected by global developments, while other markets have been affected only at the margins, partly owing to the extent of their development in many countries of the region.

19 In the euro area, government support of the banking sector is estimated to have led to a direct increase in public debt of 3.3% of (2009) euro area GDP. Contingent liabilities as a result of guarantees already provided amount to 7.5% of GDP, which may rise to up to 19.9% of GDP if banks take recourse to all the support measures offered thus far. See ECB (2009a). See ECB (2009b) on the ECB's response to the financial crisis as regards the implementation of monetary policy and non-standard measures, and ECB (2009c) on recent developments in the balance sheets of the Eurosystem, the Federal Reserve System and the Bank of Japan.

20 For example, in July 2009 Egypt merged the separate agencies in charge of securities markets and insurance into one supervisory body, the General Authority for Financial Supervision. In the West Bank and Gaza, oversight of the securities markets was transferred from the Palestine Monetary Authority to a newly established Capital Market Authority. In Israel, a reform is under discussion that will adjust supervisory structures in line with the changes that have taken place in the financial sector in the wake of the banking sector and capital market reforms of the last few years, which led to an increased role of non-bank financial institutions, in particular insurance companies and mutual and provident funds.

STOCK MARKETS

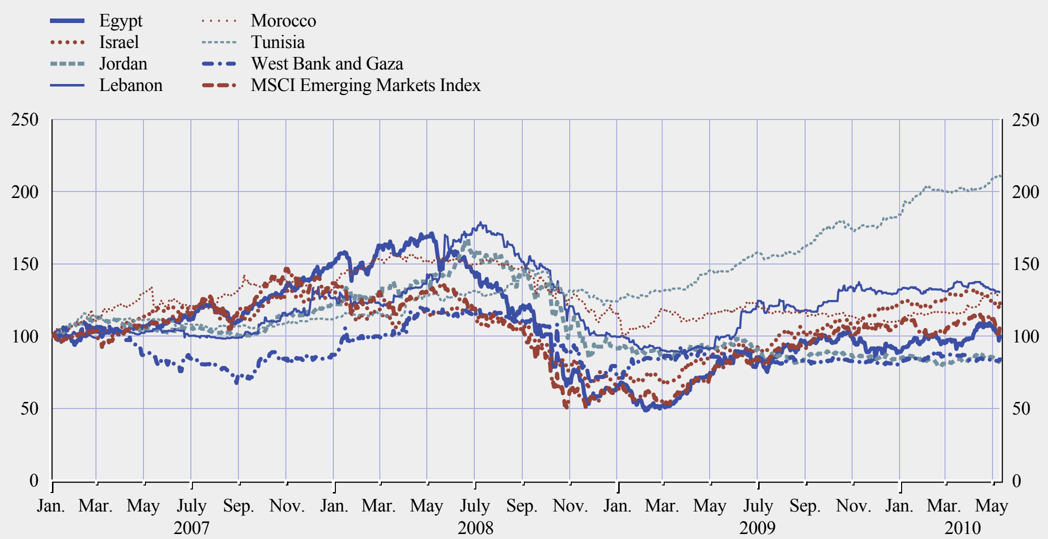
Stock markets were the area in which the impact of intensified global financial turmoil was felt most directly and most immediately in the Mediterranean region. Mediterranean countries' stock markets recorded significant losses in the second half of 2008 (see Chart 45). The losses of 2008 followed several years of very strong stock market growth fuelled by buoyant global stock market developments and a specific regional feature – the regional recycling of oil revenues from GCC countries in the wake of high oil prices, which drove up stock markets in Egypt and Jordan, for example, as well as, albeit to a lesser extent, in Morocco.

This pattern of regional oil revenue recycling also explains why in the first phase of global financial turmoil, between August 2007 and mid-2008, most Mediterranean stock markets enjoyed a brief period of decoupling from global stock markets, including the MSCI for emerging markets. While the MSCI already saw a moderate correction as a result of the global re-pricing of risks in this period, stock market indices in Egypt, Jordan and Morocco, for example, continued to rise. This short period of decoupling came to an end in mid-2008 when oil prices rapidly fell from the peak they had reached in July, and in particular after the collapse of Lehman Brothers in September. The global rise in risk aversion triggered a sharp fall in most Mediterranean stock markets, and GCC stock markets also recorded dramatic losses, exacerbated by the abrupt change in economic outlook resulting from the sharp fall in oil prices – i.e. the specific regional factor of oil revenue recycling lost force. Since March 2009, Mediterranean countries' stock markets have seen a recovery largely in line with global and emerging market developments. However, the overall impact of stock market developments on the real economy in the Mediterranean should not be overestimated, as stock markets are only playing a limited role in financing investment in most countries of the region.

A few country-specific developments are worth noting. Israel's stock market has been that which has followed the MSCI EM index most closely, indicating that portfolio investment tends to be driven by global developments (see also Box 3). This reflects the country's high degree of

Chart 45 Stock market developments

(re-indexed, 1 Jan 2007 = 100)



Sources: Bloomberg and ECB staff calculations.

international financial integration, with regional trends not playing a role. The Lebanese market, by contrast, is very much driven by domestic political and geopolitical events (see also Sub-section 3.2 on trends in dollarisation), which explains the sharp rise in May 2008 against the global market trend (in response to the reduction of domestic political tension) and the spike in June 2009 (following the parliament elections). Developments in the West Bank and Gaza also tend to be driven by political events, rather than by global economic trends. Egypt's market experienced relatively large upward and downward movements before and after the crisis, while the strongest recovery since the crisis has been that of the Tunisian stock market.

Box 3

INTEGRATION OF MEDITERRANEAN STOCK MARKETS

Based on a cointegration analysis applied to stock market indices, this box evaluates the extent of integration between financial markets in Mediterranean countries and the United States, the EU, the GCC, and emerging market stock indices. Cointegration methods have been widely used to study the integration of financial markets in both advanced economies (Taylor and Tonks (1989) and Kasa (1992)) and emerging markets, particularly in central and eastern Europe (Gilmore and McManus (2002), and Syrioupoulus (2006)). This box presents the results of tests (i) for co-movement among bilateral pairings of two stock indices based on the Engle-Granger procedure and (ii) whether an individual stock index can be dropped from a co-integrating vector of Mediterranean stock markets without affecting the overall cointegration relationship, based on an exclusion restriction test within the Johansen framework.

End-of-period stock market indices have been taken from Bloomberg for the period from the first week of 2000 to the fortieth week of 2009 (505 observations). Weekly indices reduce the problem of non-synchronous trading in Mediterranean markets and suffer less from heavy-tailed distributions and ARCH effects than daily series. All indices are in logarithms and integrated of order one.

Applying the Engle-Granger methodology (see table), bilateral cointegration is found for the stock indices of Egypt and the United States, as well as for Jordan, Saudi Arabia and Abu Dhabi. Israel's Tel Aviv 25 Index is co-integrated with the S&P500, the Dow Jones Eurostoxx and the MSCI emerging markets index.

The Johansen procedure allows for multiple cointegrating vectors among the Mediterranean stock indices. Optimal lag length is chosen by standard criteria. The maximum eigenvalue statistic is used to determine the number of relevant cointegration relations. Among the seven Mediterranean stock markets for which data are available, one cointegration relation has been identified. The exclusion test to determine that an individual index does not form part of this relationship can only be rejected for Egypt, Jordan and Lebanon. Thus, it is only between these three countries that the test finds financial integration among Mediterranean stock markets. Next, the US, EU, MSCI EM and GCC indices are sequentially added to the vector of seven Mediterranean stock market indices. The exclusion restriction is not valid for the US, EU, and some GCC stock indices, indicating that these indices influence stock market movements in the Mediterranean. The number of co-integrating relations increases to two when the Eurostoxx,

Results from a cointegration analysis of weekly stock indices from 2000 to 2009

Bilateral cointegration relations 1)		Exclusion of country *j* from joint cointegrating vector		Exclusion of country *j* from joint cointegrating vector with Mediterranean markets			
(Pairings)		Country *j*	Rejection probability 2)	Country *j*	Rejection probability 3)	Cointegration relations	Lag structure
Egypt	*S&P500 (US)*	*Egypt*	*0.002*	*S&P500 (US)*	*0.000*	*1*	*2*
Israel	*S&P500 (US)*	Israel	0.095	*Eurostoxx*	*0.000*	*2*	*2*
Israel	*Eurostoxx*	*Jordan*	*0.046*	MSCI EM	0.514	1	2
Israel	*MSCI EM*	*Lebanon*	*0.000*	Abu Dhabi	0.508	1	1
Jordan	*Saudi Arabia*	Morocco	0.729	*Dubai*	*0.014*	*2*	*1*
Jordan	*Abu Dhabi*	Tunisia	0.847	Kuwait	0.419	1	1
		West Bank and Gaza	0.340	Oman	0.514	1	1
				Qatar	*0.016*	*1*	*1*
				Saudi Arabia	*0.006*	*2*	*2*

Sources: Bloomberg and ECB staff estimates. Data: week 1, 2000 to week 40, 2009. The data series for Abu Dhabi starts in week 38, 2001 and for Dubai in week 13, 2000.
Notes: Characters in italics indicate significant cointegration relationships.
1) The null hypothesis of no cointegration could be rejected at the 5% significance level (Engle-Granger methodology).
2) Probability of rejecting the null hypothesis that cointegration restrictions are binding i.e. $\beta_{1,j} = \beta_{2,j} = 0$ (Johansen methodology). The cointegrating vector comprises seven Mediterranean economies. One cointegration relation has been identified.
3) Probability of rejecting the null hypothesis that cointegration restrictions are binding i.e. $\beta_{1,j} = \beta_{2,j} = 0$ (Johansen methodology). Country *j* has been added to the cointegrating vector with seven Mediterranean economies.

Dubai or Saudi Tadawul stock indices are added, which shows that EU and GCC markets are particularly relevant for stock market developments in the region.

As evidenced by the econometric tests presented in this box, Mediterranean markets follow market developments in the United States and the EU. Regional recycling of oil revenues from GCC countries also appears to play a prominent role in some markets, particularly in Jordan. However, overall financial integration between Mediterranean stock markets is relatively low. For Israel, price movements in advanced economies are more significant than developments in the Mediterranean and the GCC. Moreover, Israeli stock markets are affected by developments in other emerging market economies.

CORPORATE BOND MARKETS

Corporate bond markets do not play a major role in most Mediterranean countries; accordingly, they have not been a relevant transmission mechanism for the effects of the global financial turmoil to the region. One exception is Israel. Local corporate bond markets have developed quickly in Israel since the major financial sector reforms of the last few years. The reforms were aimed at developing capital markets and strengthening non-bank financing of the corporate sector, and at increasing competition and foreign entry in the banking sector. As a result of the reforms, non-bank financing via the corporate bond market has been very dynamic, as corporate bond issues have surged over the last few years, with both large and medium-sized companies tapping the market. By the end of 2007, non-bank financial institutions provided almost 50% of the business sector's outstanding credit.

Severe strains have been visible in the Israeli corporate bond market in the wake of the global financial turmoil. In 2008, after the collapse of Lehman Brothers, bond yields shot up and the market dried up; the most severe effects were recorded by property companies that had exposure to foreign property markets. Yields decreased and new issuance became possible in the course of 2009, albeit mainly by larger companies with high ratings. In response to the corporate bond market turmoil, authorities temporarily suspended mark-to-market rules for institutional investors under certain circumstances, and announced guarantees and the establishment of several public-private funds to purchase bonds. This announcement instilled confidence and contributed to an unfreezing of the market.

SOVEREIGN BOND AND CDS SPREADS

Sovereign bond spreads of Mediterranean countries increased moderately from August 2007 onwards and spiked sharply in September/October 2008, in line with developments in other emerging markets, in view of the intensification of global financial turmoil and the increase in risk aversion (see Chart 46). Since the beginning of 2009, spreads have gradually come down, again in line with global developments.

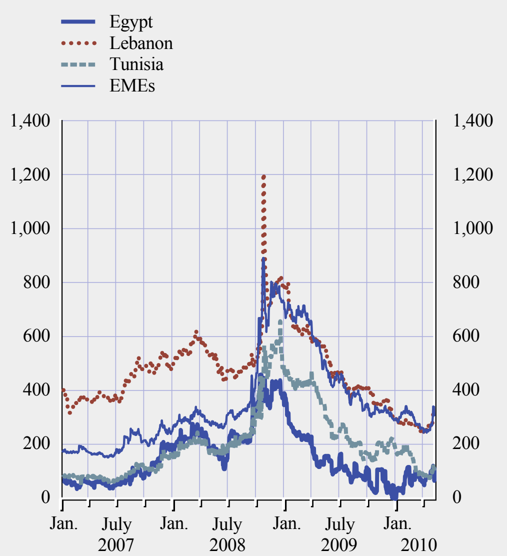
Notwithstanding this broad tracking of global patterns, country-specific developments in the Mediterranean are also worth noting. Lebanon exhibits the highest spread in the region, mirroring the country's vulnerability, but the level still appears moderate in view of the very high public debt figures. This reflects the expectation of continued donor support and financial inflows from the Lebanese diaspora.[21] While in the past, Lebanon's spread has always significantly exceeded the emerging market average as a result of the country's vulnerability, since autumn 2008 its level has been in line with the average. Accordingly, Lebanon's position has improved, not in absolute but in relative terms, which reflects the relatively heavier deterioration of the economic and fiscal situation in other emerging market economies in the wake of the crisis. Egypt and Tunisia's sovereign spreads did not increase to the same extent as the emerging market average in autumn 2008 and, in contrast to the emerging market average, in summer 2009 Egypt's spread fell back to levels similar to those before the crisis.

These developments are also mirrored by CDS levels (see Chart 47). Lebanon's CDS, while still the highest in the region, has now returned to pre-crisis levels following a spike in autumn 2008

21 See also Schimmelpfennig and Gardner (2008) on specific factors explaining why Lebanon had been able in the past to manage severe financial pressures despite significant external vulnerabilities.

Chart 46 JP Morgan EMBIG sovereign bond spreads

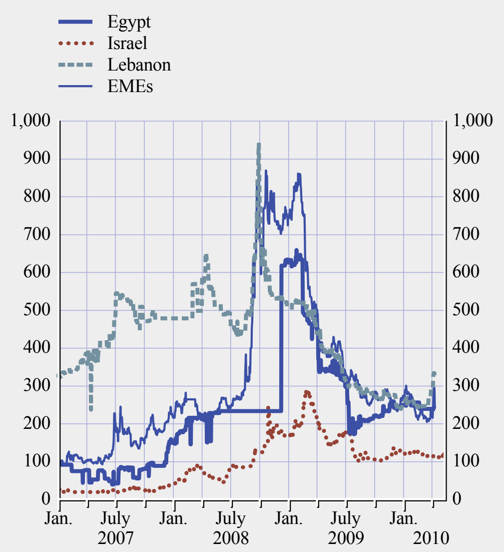
(basis points)



Source: Bloomberg.

Chart 47 CDS levels

(basis points)



Source: Bloomberg.

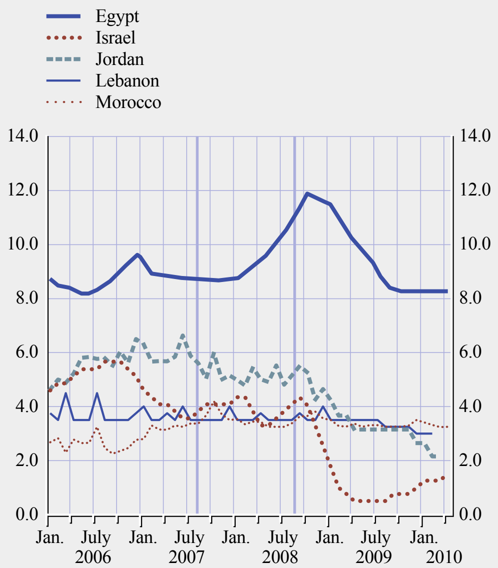
and, unlike before the crisis, is now in line with the emerging market average. Israel's CDS is relatively low and moved only moderately during the turmoil, but remains above pre-crisis levels. All in all, the development of sovereign bond and CDS levels in Mediterranean countries, while broadly following global developments, reflects the fact that within the emerging market environment, the Mediterranean region has been less affected by the global financial turmoil than other regions, for example central and eastern Europe, and the CIS countries.

INTERBANK MARKETS

While central banks in advanced economies had to intervene strongly in interbank (money) markets in the course of the global financial turmoil, no comparable tensions were observable in Mediterranean countries (see Chart 48). Interbank lending rates broadly mirrored central bank policy rates, and spreads between interbank rates and central bank policy rates remained at normal levels. The rise in interbank lending rates observed in Egypt between January and October 2008 can be attributed to increases in the central bank policy rate in response to rising inflationary pressure (see Sub-section 2.3). The absence of major money market tensions in the region, despite liquidity conditions changing in several countries, is due to the fact (i) that interbank markets are not developed in several countries, (ii) that banking sectors in the region generally exhibit structural surplus liquidity, (iii) that banks in the region did not encounter problems similar to those in advanced economies, i.e. confidence in counterparties' financial positions was not eroded, and (iv) that in small countries with a limited number of banks only a few players are active in interbank markets, and these players tend to know each other and the respective counterparty risks relatively well.

Chart 48 Interbank lending rates

(percentages)



Source: Haver Analytics.

4 CONCLUSIONS

While the direct impact of the global financial turmoil on Mediterranean economies has been limited, the region was hit by the subsequent global recession, following years of robust economic performance that resulted from both a benign global backdrop and progress in structural reforms in many countries of the region. All countries in the region have been adversely affected by the crisis, but to varying degrees, and the region as a whole has been less affected than advanced economies and other emerging market regions, in particular central, eastern and south-eastern Europe.

The major effects of global developments on the economies of the Mediterranean region have come through transmission channels associated with the real economy. Declines in exports, oil revenues, tourism revenues, remittances and FDI inflows have been the major transmission channels, of which the drop in exports has been the strongest. As a result, real GDP growth in the region weakened significantly in 2009 and is projected to recover only moderately in 2010. However, growth has remained positive in all countries of the region except Mauritania, and is also projected to be higher than in advanced economies and many other emerging market regions in 2010.

A positive side effect of the global crisis throughout the region has been the significant fall in inflation, which had spiked in 2007 and 2008 and which constituted the main macroeconomic challenge until mid-2008. The decline in global food prices has been a major factor in lowering inflationary pressures, thereby supporting real incomes and private consumption. Most central banks in the region eased interest rates, and, in economies in which the interest rate transmission channel tends to be weak, central banks also cut reserve requirements. In contrast to several other emerging market economies, no major currency depreciations have been observed.

Budget balances have weakened, most notably in oil-exporting countries as they maintained high levels of public expenditure to support economic activity amid a sharp drop in oil prices. In non-oil-exporting countries, fiscal deficits increased, but not as significantly as in advanced economies, since the economic slowdown was less pronounced, as automatic stabilisers are relatively weak and as expenditure on oil and food subsidies declined, following the fall in global commodity prices. Large current account surpluses of the region's major oil-exporting countries have plummeted as a result of the sharp drop in oil prices, while most non-oil-exporting countries' current account balances have remained broadly stable or have slightly strengthened.

A key factor explaining the relative resilience of Mediterranean economies is that the direct impact of the global financial turmoil on banking sectors and financial markets in the region has been very limited, and thus, unlike in advanced and some other emerging market economies, negative feedback loops between the financial sector and the real economy are largely absent.

The reasons for this limited spillover from global financial developments to financial sectors in the region are: (i) the almost complete lack of exposure of financial institutions to mortgage-related US securities that turned "toxic"; (ii) the generally limited integration of Mediterranean countries into global financial markets, and (iii) the reliance of Mediterranean banks on domestic sources of funding and their limited links to banks in advanced economies.

Nevertheless, some effects of the global financial turmoil on Mediterranean countries can be identified. The most direct and immediate impact has been on stock markets in the region, which have been plummeting since mid-2008, broadly in line with global markets, owing to the increase in risk aversion and the weakening in support from regional oil revenue recycling. However, given the limited role of capital markets in most countries of the region, the impact on the overall economy should be limited.

The sharp fall in cross-border lending of BIS-reporting banks – a key feature of the "post-Lehman" global financial landscape – has been less pronounced in Mediterranean countries than at the global level. In Mediterranean economies, as in most advanced and emerging market economies, a slowdown of credit extension to the private sector has been observable, which would appear to be a result of mainly the decrease in demand for credit in view of dampened economic prospects. At the same time, an increase in bank lending to the public sector has been seen in many countries.

This increase in bank credit to the public sector can be attributed to the increased financing requirements of governments – a result of the rise in fiscal deficits in the wake of the economic downturn. Moreover, in some countries foreign investors have largely withdrawn from domestic T-bill markets as a result of the general rise in risk aversion. Thus, governments have increasingly had to rely on domestic banks to fund their rising financing requirements, which, if protracted, could lead to a crowding-out of private sector investment. In some countries, the global financial turmoil has also had an adverse impact on privatisation plans in the banking sector.

Given the thus far limited overall impact of global financial and economic developments on financial sectors in the Mediterranean, the policy response has also been muted, in particular in comparison with the measures taken by advanced economies.

Looking forward, the key risk for the region lies in the potentially weak and uneven recovery of the global economy. Economic developments in the EU are of particular importance, given the close economic and financial links of most countries with the northern shore of the Mediterranean, and for some countries, developments in the GCC are also highly relevant. With regard to a scenario in which global economic activity remains weak over a protracted period, most countries in the region, in particular the non-oil-exporting countries, have hardly any room for manoeuvre in sustaining domestic demand with fiscal policy measures, owing to high debt levels. Furthermore, the means by which monetary policy can respond are limited, owing, inter alia, to the exchange rate regimes and the still relatively high inflation levels in some countries. Moreover, while real GDP growth rates were positive – and higher than those in advanced economies and some other emerging market economies – in 2009, such subdued growth rates, if protracted, would not be sufficient to address the significant employment challenges that many Mediterranean countries face as a result of a rapidly growing labour force and already high unemployment levels over the medium term. In order to return to higher growth rates, foster investment and productivity and generate employment, further structural reforms remain crucial in areas such as governance, the business environment and the role of markets.

As regards banking sectors, the indirect effects of the global recession on the real economy of Mediterranean countries may still be unfolding and result in a rise in non-performing loans. In several countries, an increase in non-performing loans would add to the legacy of an already large stock of impaired assets.

A major reason for the limited impact of the crisis on the region is the low degree of integration into global financial markets and the lack of sophistication of banking sectors in many countries – therefore, a factor which has often been identified as an impediment to economic development in the past has shielded countries from some of the spillovers of global financial turmoil. This should not be taken, however, as an argument for maintaining the status quo and limiting further financial sector reform. While the lessons of the global financial crisis need to be taken into account when reforming the financial sector, fostering financial integration into the global and regional capital markets, as well as increased foreign participation, would enhance the efficiency of financial intermediation in the region and facilitate private sector access to capital, an issue which is still impeding investment and economic growth in many Mediterranean countries.

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