



## The Political Economy of Governance in the Euro-Mediterranean Partnership

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New Challenges: Domestic Reforms

### **Economic Domestic Reforms in Mediterranean Partner Countries**

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# 1. Summary

The paper seeks to examine the progress of political and economic reforms in MEDA states bearing in mind the requirements set out to East Central European states in the following stages of their transformation:

- Creating a free trade zone with the EU;
- Joining the EU;
- Preparing for membership in the EMU.

Generally the progress of reforms in MEDA is moderate, as shown by both political and economic measures. Moreover, there is a certain divergence in progress of reforms among the group of states studied. Rankings are similar for all states in question, which indicates strong interdependence between the advancement of reforms in the political and economic spheres. Additionally, it could be assumed that progress of reforms in the political field as well as in the economy is closely linked with the level of liberalisation (internal and external) of the economy and its external relations.

The paper relies on indicators and measurements which were prepared by specialized centres. Nevertheless, some of the indicators are incomplete and do not cover all the states which are covered by the research. Limited progress of reforms creates a type of vicious circle which halts further economic development and structural changes, as investment risk is relatively high and discourages investors from wider engagement in the region. This hesitant attitude of investors halts structural changes, increase of productivity, increase of production, export growth, and finally creation of wealth of the citizens as well as their ability to self-finance (at least in part) of their reforms (structural, innovative and catching-up).

It seems that closer cooperation with the new EU member states could be conducive in fostering political and economic reforms in the region. All doubts about effectiveness of the reforms introduced with support of the EU can be dispersed by making comparisons between East Central European states and their economies with the CIS. Here the starting point was from the same level, growth and advancement was diversified, as within the MEDA Group. Analysis of the information gathered in the paper points to what seemed to be the source of differentiated advancement in reforms as well as growing interest of the investors.

When studying the pro-market reforms one cannot leave aside political issues. Talking about them one cannot run away from the role of external actors who have impact on scale of success of the reforms (states as well as such organizations as UN, WTO, EU, WB, IMF,

etc...). Institutionalization of international relations is a strong force in introducing effective democratic structures as well as creating conditions supportive for market mechanisms.

This paper shows advancement of the reforms in the political as well as economic field. It gives a ranking of states with use of criteria of progress of reforms. Finally it shows where weaknesses of the reforms lie and what should be done to bring improvements.

## **2. Introduction**

The paper was constructed in a manner enabling finding answers to following questions:

- How advanced are MEDA states in their reforms, where is advancement lagging behind, and why?
- What are the differences between MEDA states as far as progress of their reforms is concerned?
- What is the ranking of MEDA states as far as their reforms are concerned?
- What can be considered as main obstacle for the reforms to continue and advance?
- What can be considered as main stimulus of the reforms, pushing them forward?

Authors of the paper made an effort to answer all above questions, finding as much proof as possible which indicates that advancement in democratic reforms fosters economic reforms as well as the other way round. In other words, there is a close interdependence between economic (pro-market) and political (pro-democratic) reforms. The paper tries to cover a number of problems showing the advancement of the reforms but at the same time it also eliminates some the issues which could be considered important for the study. Such elimination was done on purpose, as some of the issues were studied in the research which was conducted last year. The best examples here are FDI inflows and outflows.

Despite such a selective approach the paper can be considered as relevant and well targeted to answer the questions formulated as a guideline for the study. It consists of an introduction, four parts and conclusions. The introduction gives the goal of the paper and formulates the questions which guide the conducted research. Part one covers the problem of pro-democratic reforms and political changes in MEDA. It uses special indicators, worked out by specialized centres and gives comments on the findings here. Part two deals with liberalisation of agriculture and trade. The third part talks about exchange rate regimes and exchange rate policy, while the fourth part covers the problem of privatisation. All issues are important as

far as measurement of pro-market and pro-democratic reforms is concerned. All mentioned problems were covered by reports prepared in yearly terms by the European Commission in the process of preparation of ECE states for membership. Finally a conclusion gives the overview of our findings.

Problems which the Authors of the study have decided to cover give a mixed picture of the region but at the same time they point at weak and strong factors, which can be categorised as:

- Areas requiring concentration of effort of changes;
- Areas which play a role of pulling or pushing forward changes internally;
- Areas which push as well as pull changes from outside.

The Authors of the study assume that despite certain differences in the studied group as far as economic development, pro-market reforms or pro-democratic reforms are concerned, all follow the same path of changes, which means that they can cooperate together with another on exchanging information on reforms, their obstacles as well as stimulus, and show what type of pitfalls could be met and how to surpass them. They also assume that experience of ECE states can be conducive in supporting changes and stimulating them. Finally, they assume that role of relations with the EU as well as other international organization plays an important role in changes but all listed factors have to be given a chance to play the role they are ascribed to play and this is does not happen without specific conditionality.

### **3. Liberalisation of agricultural trade**

The reforms of agriculture sectors in MPCs are pursuing within the framework of two simultaneous and interlocking processes: the implementation of commitments under the WTO and the prospects of a Euro-Mediterranean Free Trade Area. These two pending developments determine any progress in furthering reforms in agriculture. The Euro-Med Partnership assumes progressive liberalisation of agricultural trade in the region. Theoretically, a free trade agreement with the EU should give the MPCs a comparative advantage in a number of their products. However, the problem is that in the products in which the MPCs have a comparative advantage are subject to restrictions by the EU Common Agriculture Policy (CAP). At the WTO round of trade negotiations (Doha Development Round, DDA) the main focus is put on agricultural talks. Abolition of tariffs, export subsidies, and domestic support are of main interest for all participants and determine any further achievements in other fields

of the DDA agenda. This inevitable objective is indicated by the substantial share of exports in total agricultural production in most developing countries, such as MPCs.

The agricultural sector plays a major role in the creation of national wealth and rural incomes in the Maghreb countries (Morocco, Tunisia, Algeria), Turkey and Egypt. It is also a main source of employment. Agriculture plays a significant social role in creating jobs and generating income for rural people. The key feature of the agriculture sector in MPCs is its low productivity which is caused by natural handicaps (agro-climatic) and agrarian structures (small farmers predominate). Therefore, it is difficult for these countries to modernize. Additionally they are liable to be hit by the opening of national borders. The rural proportion of the population varies considerable along the MPCs countries. The rate is especially high in Egypt (56% population is rural), in Palestine (29%), Jordan (22%), Israel (8.8%). Overall, the agriculture trade in those countries is characterized by high dependence on food imports due to the scarcity water resources and dominance of fruit and vegetables in agricultural exports. Therefore, many southern Mediterranean countries remain net food importers.

The main objectives of Middle East and North Africa countries (MENA) are to ensure adequate levels of nutrition and food supplies at reasonable prices to domestic consumers, and raise production levels and yields. At the same time they are striving to reduce the vulnerability of production to adverse weather conditions, increase farm incomes, improve their stability and develop rural areas in general. A set of measures have been introduced by MENA countries in order to meet these aims. The most important activities are the following: support of producer prices, trade related measures, subsidies of farm inputs, investments in infrastructural projects.

The agricultural sector in the MPCs was built upon a system of regulation by the central administration. A range of reforms were undertaken as a consequence of a structural adjustment programme (SAP) supported by the IMF in the 1980s and 1990s. The programme included: abolition of quantitative restriction on the import of goods and services, dismantling of the administrative procedures for the allocation of foreign currencies, price liberalisation and reduction of subsidies, devaluation of local currencies, gradual transition to a flexible exchange system, liberalisation of price and subsidy system, privatisation of public domain and services for agriculture. The SAP was applied in Morocco, Tunisia (in the 80s), Algeria, Egypt and Turkey (in the 90s). The application of SAP programmes in those countries resulted in an increase of prices (effect of exchange rate policy, the abolition of subsidies and the privatisation of services), a drop in investment in agro-industrial sector and in agriculture and a decrease in income. It contributed to overall deterioration of the living conditions in the

rural areas in the MPCs in the 1990. Nevertheless the MPCs are continuing their policies of liberalising markets and reducing state intervention. Many of them are moving towards opening their borders by reducing the protection of products in most branches. This is the case in particular with Tunisia, Lebanon and Egypt. Turkey is in the process of completing the dismantling of state commodity marketing monopolies. A certain increase in export subsidies has taken place in Egypt and Lebanon, although it is generally used only to a limited extent in these countries.

Differences in the economic, geographical and social developments are major reason for political domestic pressure towards protectionism in agricultural sector. The agricultural sector is highly protected in MENA countries. Thus it is running a risk of leaving agriculture outside the liberalisation process and regional integration efforts. The main objectives of MPCs refer to: 1/ their ability to feed a growing population; and 2/ obtaining bigger access to foreign markets (EU, US) for their agricultural commodities<sup>1</sup>.

Cereals are the main group of products which has been subject to liberalisation in the MPCs. Imports of these commodities are of strategic importance for MPCs. The states of the region absorb 27% of world cereal imports. There is a significantly low rate of self-sufficiency in the production of cereal, for instance in 2004: 77% for Egypt, 53% for Tunisia and only 36% for Algeria. It is assumed that the region's dependency on foreign supplies will increase in the future. Thus the problem raises the question of how to achieve greater food security in MPCs. The first priority for these countries seems to be to take up efforts to implement appropriate national policies and to seek international and Euro-Mediterranean cooperation with a view to improving cereals supplies. The dependence on foreign cereals supplies led to the situation of considerable government support in most MPCs. Tables 1 and 2 show data on nominal and effective coefficients of protection for selected commodities in selected countries.

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<sup>1</sup> J. M. Garcia Alvarez-Coque, *Mediterranean countries and international trade issues. WTO and the Euro-Mediterranean relations*, International Center for Advanced Mediterranean Agronomic Studies (CIHEAM) Annual Report 1998, CIHEAM 1998, p. 38.

**Table 1: Nominal Protection Coefficients\* (6 year average 1995-2000)**

	Turkey	Egypt**	Morocco	Tunisia
<b>Wheat</b>	1,18	1,42	1,44	1,28
<b>Milk</b>	1,24		1,19	1,32
<b>Sugar Beets</b>	1,78	1,08	1,67	
<b>Oranges</b>		0,84	0,91	1,58
<b>Tomatoes</b>	1,1	0,74	0,91	1,89

\* The nominal protection coefficient is the ratio between the domestic price and the world price expressed in national currencies

\*\* For 98/99 only ; this figure may be an overestimate and is dependent on hypotheses regarding the actual physical flows of imports.

Source : Jacquet 2004, after Allaya, Petit, 2004

**Table 2: Effective Protection Coefficients\* (6 year average 1995-2000)**

	Turkey	Egypt**	Morocco	Tunisia
<b>Wheat</b>	<b>1,38</b>	<b>1,62</b>	<b>1,54</b>	<b>1,73</b>
<b>Milk</b>	<b>1,46</b>		<b>1,73</b>	<b>1,72</b>
<b>Sugar Beets</b>	<b>2,93</b>	<b>1,17</b>	<b>2,05</b>	
<b>Oranges</b>		<b>0,81</b>	<b>0,9</b>	<b>1,82</b>
<b>Tomatoes</b>	<b>1,11</b>	<b>0,71</b>	<b>0,9</b>	<b>1,94</b>

The effective protection coefficient measures the ratio between the unit added value computed at domestic prices and the same value computed at world priced expressed in domestic currencies

\*\* for the 98/99 year only

Source : Jacquet 2004, after Allaya, Petit, 2004

The next group of agricultural commodities of great importance for the MPCs are fruits and vegetables. In order to improve exports of those products to the EU there is a need for bigger market access for MPCs exports. However for some products the possibilities for the MPCs to improve their market share in total EU imports are limited by the significant degree of import substitution by intra-EU trade in those commodities. The export of the fruits and vegetables to the EU depends on the relationship between the volume of exports of specific products by a given country and the extent of the trade preference granted to that country for the product considered. For instance: Morocco which has high preference for citrus and tomatoes, and exports large amounts of these products to the EU, for the same reason - Turkey exports large amounts of paprika and Egypt large volumes of potatoes.

The most challenging problem for agricultural trade in MPCs refers to the evaluation of the potential impacts of trade liberalisation in the Euro-Mediterranean region. Some sectoral

models indicate that producers of cereals and livestock products in Mediterranean countries could suffer significant losses from trade liberalisation.<sup>2</sup> Much of the liberalisation efforts that have been taken by the MPCs were introduced through expansion of tariff rate quotas. In Morocco, for example, wheat has been highly protected with a tariff system, which contributed to domestic price stability. The expansion of import quotas has been used as a bargaining chip in bilateral negotiations with the European Union and with the USA.

### **Specific data covering respective MPCs**

Rural development in the MPCs countries is the central component of any strategy leading to improved living conditions and well-being of their societies. The significance of agriculture reform for MENA countries stems not only from the need for reducing rural poverty (in MENA, an estimated 70% of poverty is in rural areas; those areas cover only about 43% of the population)<sup>3</sup>, but also for making rural regions more attractive places to live and thus reducing rural-urban migration pressure.

#### **Morocco**

Substantial progress on market liberalisation issues was achieved as far as the Morocco – US Free Trade Agreement (M-USFTA) is concerned. However, the most sensitive local commodities remained highly protected. The agreement was signed in June 2004 and it was to enter into force on 1 January 2005. This is the second FTA that the US signed with an Arab country, the first was an FTA with Jordan, signed in October 2000. The M-USFTA covers market access of agricultural commodities.

#### **Tunisia**

Tunisia has undertaken several commitments to reform its agriculture sector, which refer to internal support, market access and competition (reduction of export subsidies). Under the WTO Tunisia has committed to reform its agriculture sector according to the guidelines within the agricultural structural adjustment programme (ASAP). The programme focuses mainly on internal support and market access<sup>4</sup>. With regard to internal support Tunisia has

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<sup>2</sup> *ibid.*

<sup>3</sup> World Bank, Sector overview: Rural development, <<http://lnweb18.worldbank.org/mna/mena.nsf/>>.

<sup>4</sup> Annual Report of CIHEAM 2006, s. 175. <<http://www.medobs.org/panorama/defrapp.htm>>

committed to reduce the Aggregate Support Measure (ASM) by 1.33% per year for 10 years in the period 1995-2004. In the field of market access, customs duties in Tunisia have been consolidated at levels ranging from 75% to 100%. The rate that was applied - below 40% - varies substantially from those quoted by official sources. On the basis of these commitments suspension of common customs tariffs were registered in Tunisia in 2003 for agricultural commodities and agri-foodstuffs as well as for certain machinery, raw materials, and energy products. However, agriculture and fisheries are still the most protected branches. The reduction of protection is directed mainly towards the EU than it is towards the rest of the world. In the internal market in Tunisia, there was maintained a price stabilisation mechanism. It means that for some essential commodities prices were fixed in advance by proper administrative bodies.

## **Turkey**

Following the advice of international organisations such as the World Bank and International Monetary Fund, Turkey launched in 2000 reforms to improve its agriculture support system. The objective was to improve allocation of resources and fiscal stability. Turkey committed to phase out the subsidies for fertiliser and credits and price support for production. As a form of compensation there was introduced a system of a direct decoupled income payment. In 2002 this system covered 75% of farmers and came to half of the annual budgetary subsidies. It was expected that in 2003 the rate could have reached 90%. Another part of the agriculture reform is the governmental agency level. This kind of reforms aim at reducing Turkish direct control over agricultural production and processing. Therefore restructuring of Agricultural Sales Cooperative Unions was introduced as well as privatisation of semi-public enterprises, such as sugar, alcohol and tobacco companies or tea. The reform of agriculture sector in 2003 brought agriculture prices down by about 12% (in Lira currency) and the volume of agriculture production fell about 4%. It differed substantially from one product to another.

As far as external trade in agriculture products is concerned, tariffs remained high on livestock, meat and milk products; however reduction of tariffs were carried out for cereals. Improvement of import procedures were based on sanitary and phytosanitary conditions. Export subsidies were limited to 10% and 20% of export values and between 29% and 100% of the quantities exported.

## **Lebanon**

The agricultural sector in Lebanon is of utmost importance from a socio-economic point of view. It is related to the problem of reduction of urban-rural migration and illicit crops. Government continues to regulate the wheat and sugar sectors. It resulted in purchasing all wheat production from local farmers at a subsidised rate. Additionally, the Ministry of Agriculture granted input subsidies for farmers on a yearly basis. As part of a reform package, the Export Plus Programme was introduced in 2001 to support the Lebanese agriculture exports. However, the programme is criticised for benefiting traders much more than farmers. According to this Programme the direct payments are granted to farmers under strict conditions.

## **Egypt**

Egypt keeps continuing its efforts towards further integration into the world economy. Its major goal is to boost exports in agriculture products with the framework of multilateral and bilateral trade agreements. In order to force agricultural sector modernization Egypt has carried out a range of technical, legislative and administrative improvements. The most important are the following: legislation for facilitation trade, reduction of bureaucratic constrains, improvement of institutional environment. Also introduced were procedures of exemption from fees, customs duties and sales taxes as well as financial incentives for exporters and insurance systems.

The government continued to reduce its intervention in agricultural commodities, market inputs and the agricultural equipment market. However substantial government intervention still remains. It is based on fixed prices to encourage farmers to expand production on the basis of local resources. The government subsidizes the prices of some production inputs as well as the cost of performing several production services (improved seeds, organic fertilisers, sugarcane irrigation, and measure to combat cotton epidemics). Government bodies distribute the system of inputs through the channels such as the Principal Bank for Development and Agricultural Credit.

Some progress had been achieved in the field of aid to food consumption. The government kept on reducing that aid but at the same time it was carrying on subsidising the prices of basic products (i.e. wheat, wheat flour, sugar and food oils). The poorer consumer can buy these products thorough a system of “ration cards”. The government subsidy system was even

forced after the increase of foodstuff prices which was a consequence of liberalisation of national currency<sup>5</sup>.

### **Summary – policy advice**

The poor record of EuroMed Association Agreements (EMAAs) referring to agriculture trade reforms lead to conclusions that the liberalisation in the EMAAs has a very limited scope and the composition of the regional trade agreements is based on the hub-and-spoke structure with a centre (hub) and regional partners. This resulted in the existing contradictory EU policies toward the MPCs, especially in agriculture<sup>6</sup>.

The debate on trade liberalisation in agriculture is dominated by regional trade negotiations between the European Union and the MPCs within the Barcelona process. Other bilateral agreements have been signed by Mediterranean countries among themselves and with countries from outside the region, notably the USA. However most of the intra-regional trade agreements entail slow and gradual trade liberalisation which is additionally reflected in numerous lists of exceptions, of which one of the most important was the exclusion of agriculture and the service sector from the liberalisation agenda. The impact of these regional and bilateral negotiations will depend on their individual and collective content but also on the future of the WTO multilateral process as almost all Mediterranean countries are directly or indirectly involved in the multilateral trade negotiation process, either as members of WTO or as candidates to become members.

The opening of the EU markets to imports from Mediterranean countries depends on a number of factors, which are not totally influenced by the Euro-Mediterranean process. First it is a result of the WTO Doha round that can lead to further market access to EU markets. The second is the EU enlargement including 12 countries from Central and Eastern Europe and Malta. The third factor refers to EU's participation in other free trade agreements (FTAs), which covers the FTA with Chile, Mexico, South Africa and the potential FTA with the Mercosur. These three components brought significant pressure for reform of the CAP towards the reduction of export subsidies and domestic agriculture support and the implementation of further EU budgetary constraints.

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<sup>5</sup> *ibid*, s. 190.

<sup>6</sup> M. Petit, *Agricultural Trade Liberalisation in the Mediterranean Region: A Complex and Uneven Process*, May 2006,

It is common wisdom that the process of trade liberalisation in MPCs could bring them significant over-all welfare gains in the long run. However until now trade liberalisation has been slow and very uneven, particularly in the case of agriculture. The constraints to further trade liberalisation in agriculture impede substantially the overall trade liberalisation process. The main constraint is the limited effort taken by the EU to open more its markets for fruit and vegetables. There is continuing worry in MPCs over the future of large segments of their agricultural sectors if they would further open their markets for grains and livestock products. There is also a significant social concern for rural poverty in MPCs. This is a main reason for maintaining high trade protection in agriculture. Therefore it is hard to imagine launching a new strategy policy of the MPCs, in which markets would progressively be more open, while public investments in rural infrastructure, as well as rural development programmes would be boosted.

#### **4. Exchange Rate Regimes in MENA Countries**

An exchange rate regime reflects progress of a given country in the process of opening of its economy, and at the same time it is an indicator of stabilisation of the economy. With progress of the reforms and departure from a fixed exchange rate regime the flows of FDI and flows of capital to the given country rise.<sup>7</sup> Empirical studies show that the probability for fixed exchange rates to become overvalued is substantially higher than for floating regimes, and the probability for exchange rates under fixed regimes to become seriously overvalued (in excess of 25%) is almost twice as high as for flexible arrangements.<sup>8</sup>

Until recently, researchers often suggested that developing countries with pegged exchange rates enjoyed relatively lower and more stable rates of inflation. In recent years, however, many developing countries have moved toward a flexible exchange rate arrangement, and – at the same time – inflation has come down generally across the developing world.<sup>9</sup>

As far as MENA countries are concerned, they have not followed the general worldwide trend in their choice of exchange rate regime. Although, over the past decades, countries have

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<sup>7</sup> Choice of peg, composition of the currency basket and the type of exchange rate policy adjustments are important in the policy mix applied in this field.

<sup>8</sup> M. Nabli, J. Keller, M.A. Veganzones, *Exchange Rate Management within the Middle East and North Africa Region: The Cost to Manufacturing Competitiveness*, American University of Beirut, Lecture and Working Paper Series, No.01, 2004.

<sup>9</sup> F. Caramazza, J. Aziz, *Fixed or Flexible? Getting the Exchange Rate Right in the 1990s*, <http://www.imf.org/external/pubs/ft/issues13/>

gradually adopted more flexible exchange rate regimes, the majority of the MENA economies continue to maintain *de facto* fixed exchange rate regimes (see Table 1).<sup>10</sup>

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<sup>10</sup> M. Benbouziane, A. Benamar, *The Impact of Exchange Rate Regime on the Real Sector in MENA Countries*, paper submitted to the Twenty-Seventh Annual Meeting of The Middle East Economic Association, Chicago, January 4-7, 2007, p. 4.

**Table 3: Exchange Rate Regimes**

	<i>De facto classification</i>		
	Bubula and Otker-Robe* 1990-2001	Levy-Yeyati and Strutzenegger** 1974-2000 <sup>(a)</sup>	IMF classification*** Data as of July 31, 2006
Algeria	<ul style="list-style-type: none"> <li>• 1990-1993 Fixed vis-à-vis a basket</li> <li>• 1990-2001 Managed float</li> </ul>	<ul style="list-style-type: none"> <li>• 1994-1997 D.F.</li> <li>• 1998-2000 Fl.</li> </ul>	Managed floating with no pre-determined path for the exchange rate
Egypt	<ul style="list-style-type: none"> <li>• Since 1960s Fixed vis-à-vis dollar</li> <li>• 1991-1996 Horizontal bands</li> <li>• 1997-1998 Fixed pegs</li> <li>• 1999-2000 Floating regime</li> </ul>	<ul style="list-style-type: none"> <li>• 1974-1988 Fx.</li> <li>• 1989-1991 D.F.</li> <li>• 1992-1999 I.</li> <li>• 2000 Fl.</li> </ul>	Conventional fixed peg arrangement <sup>(b)</sup>
Jordan	-	-	Conventional fixed peg arrangement <sup>(b)</sup>
Lebanon	-	-	Conventional fixed peg arrangement <sup>(b)</sup>
Morocco	<ul style="list-style-type: none"> <li>• Early 1970s Fixed vis-à-vis French franc</li> <li>• 1973-2001 Fixed vis-à-vis a basket</li> </ul>	Alternatively D.F. and Fl. during the period	Conventional fixed peg arrangement
Tunisia	<ul style="list-style-type: none"> <li>• Early 1970s Fixed vis-à-vis French Franc</li> <li>• 1978 Fixed vis-à-vis a basket</li> <li>• 1990-1999 Crawling bands</li> <li>• 2000-2001 Managed float</li> </ul>	Alternatively D.F. and Fl. during the period	Managed floating with no pre-determined path for the exchange rate
Turkey	<ul style="list-style-type: none"> <li>• 1990-1997 Crawling bands</li> <li>• 1998-2000 Crawling pegs</li> <li>• 2001 Independent floating</li> </ul>	<ul style="list-style-type: none"> <li>• 1974- 1980 D.F.</li> <li>• 1981- 2000 Fl.</li> </ul>	Independently floating

\* A. Bubula, I. Ötker-Robe (2002), “The Evolution of Exchange Rate Regimes since 1990: Evidence from De Facto Policies”, *IMF Working Paper*, 02/155.

\*\* E. Levy-Yeyati, F. Strutzenegger (2002), “A de Facto Classification of Exchange Rate Regimes: A Methodological Note”, *Working paper*, Business School, Universidad Torcuato Di Tella, Argentina.

\*\*\* *De Facto Classification of Exchange Rate Regimes and Monetary Policy Framework*, International Monetary Fund, <http://www.imf.org/external/np/mfd/er/2006/eng/0706.htm>.

<sup>(a)</sup> Levy-Yeyati and Strutzenegger distinguish five regimes: Inconclusive ( $\sigma_e$  low;  $\sigma_{\Delta e}$  low;  $\sigma_r$  low), noted I.; Flexible ( $\sigma_e$  high;  $\sigma_{\Delta e}$  high;  $\sigma_r$  low), noted Fl.; Dirty Float ( $\sigma_e$  high;  $\sigma_{\Delta e}$  high;  $\sigma_r$  high), noted D.F.; Crawling Peg ( $\sigma_e$  high;  $\sigma_{\Delta e}$  low;  $\sigma_r$  high), noted C.P.; Fixed ( $\sigma_e$  low;  $\sigma_{\Delta e}$  low;  $\sigma_r$  high), noted Fx., with  $\sigma_e$  the exchange rate volatility (as the average of absolute monthly percentage changes in nominal exchange rate);  $\sigma_{\Delta e}$  the volatility of

exchange rate changes (standard deviation of the monthly percentage changes in the exchange rate), and  $\sigma_r$  the volatility of international reserves.

<sup>(b)</sup> The regime operating *de facto* in the country is different from its *de jure* regime.

Source: Serge Rey (2006), “Effective Exchange Rate Volatility and MENA Countries’ Exports to the EU”, *Journal of Economic Development*, Vol. 31, No 2, p. 28; *De Facto Classification of Exchange Rate Regimes and Monetary Policy Framework*, International Monetary Fund, <http://www.imf.org/external/np/mfd/er/2006/eng/0706.htm>.

“While about 65% of economies were operating under *de facto* fixed exchange rate regimes in 1974 (within MENA, the proportion was somewhat higher, at 77%), by the end of the 1990s, only 42% of economies outside of MENA had fixed exchange rate systems. Within MENA, however, that proportion was 60%”.<sup>11</sup>

## **Exchange rate regimes overview:**

### **Algeria**

Since 1995, Algeria’s exchange rate regime has been a managed float with no pre-announced path for the exchange rate<sup>12</sup> (the regime operating *de facto* in the country is the same as its *de jure* regime – see Table 1). Algeria’s exchange rate policy aims at maintaining a stable real exchange rate against a basket of currencies weighted according to the country’s main trading partners and competitors. Through its intervention, the Bank of Algeria (BA) adjusts periodically the nominal exchange rate so as to achieve its real exchange rate target. The authorities intend to continue to manage the exchange rate in a flexible manner, taking into account the inflation objective and fundamental developments of the real effective exchange rate (REER).

The increase in real oil prices and the current economic growth suggest a tendency for the REER to appreciate. The expansionary fiscal stance also implies a real exchange rate appreciation, while the trade liberalisation envisaged under the Association Agreement with the EU points in the opposite direction. However, with the increased openness of the economy, the link between changes in the exchange rate and the inflation rate would be strengthened, which means that the country may have to choose between an appreciation of

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<sup>11</sup> Ibid.

<sup>12</sup> **Managed float with no pre-announced path for the exchange rate** – the monetary authority attempts to influence the exchange rate without having a specific exchange rate path or target. Indicators for managing the rate are broadly judgmental (e.g., balance of payments position, international reserves, parallel market developments), and adjustments may not be automatic. Intervention may be direct or indirect (source: *De Facto Classification of Exchange Rate Regimes and Monetary Policy Framework*, IMF, <http://www.imf.org/external/np/mfd/er/2006/eng/0706.htm>).

the Dinar and higher inflation. This would probably make the authorities think about implementing a more flexible exchange rate regime. Nevertheless, at this moment the situation seems to be under control. “Algeria’s full surrender requirement on hydrocarbon export proceeds makes BA the dominant seller of foreign exchange to the banks. This position has helped BA to keep the REER broadly in line with its end-2003 level that the authorities considered close to equilibrium. This policy has also resulted in a reduced variability of the Dinar/dollar exchange rate since early 2004, given the low inflation differential with Algeria’s main trading partners. The spread between the illegal parallel market and the official exchange rates reportedly disappeared in early 2006”.<sup>13</sup>

## Egypt

Since the 60s, Egypt has pegged its currency to the US dollar (fixed adjustable peg regime). With the beginning of the economic reform programme in 1991, the Egyptian government decided to reform the exchange rate system and announced the adoption of a managed floating regime.<sup>14</sup> “In fact, the exchange rate was simply devalued in 1991-1992 and then maintained fixed until June 2000. Therefore, the IMF revised its classification in 1998 and ranked Egypt as having resumed its »conventional fixed peg« arrangement.”<sup>15</sup>

In 2000, Egypt announced the beginning of the process of transition to a flexible exchange rate system. The exit from the peg went through several phases. In January 2001, the government decided to restore market stability and confidence by setting up a new central exchange rate (of EGP 3.85 per USD) and introducing a crawling peg system.<sup>16</sup> However, after the events of September 11, 2001, pressures on the pound intensified leading to a depreciation of more than 35 per cent against the dollar from mid-2000 to early 2003.<sup>17</sup> On January 2003, the Egyptian Prime Minister announced a free float of the Egyptian pound. However, the first attempt at a float was not successful. The final transition to a unified, flexible exchange rate system took place at the end of 2004. During the period 2000–2004, the Egyptian pound experienced a cumulative depreciation of 68 per cent against the US

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<sup>13</sup> *Algeria: 2006 Article IV Consultation—Staff Report*, IMF Country Report No. 07/72, February 2007, p. 8.

<sup>14</sup> B. Kamar, *De facto exchange rate policies in the MENA region: toward deeper cooperation*, paper presented for the 11<sup>th</sup> Annual Conference of the Economic Research Forum for the Arab countries, Iran and Turkey, December 16-18, 2004, Beirut, [http://www.erf.org/11conf\\_Lebanon/Macro/Bassem\\_Kamar.pdf](http://www.erf.org/11conf_Lebanon/Macro/Bassem_Kamar.pdf), p. 4.

<sup>15</sup> *ibid.*

<sup>16</sup> *ibid.*

<sup>17</sup> A. Jbili, V. Kramarenko, *Should MENA Countries Float or Peg?*, <http://www.imf.org/external/pubs/ft/fandd/2003/03/jbil.htm>

dollar. At that time, there was an active parallel market for foreign exchange, with a premium that reached as high as 15 percent over the official (banking) rate. The parallel market rate converged with the banking rate in mid-2004, prior to the establishment of a formal inter-bank market for foreign exchange.

To sum up, officially, Egypt has now a unified, flexible exchange rate regime (*de jure* regime) which is largely determined by supply and demand in the inter-bank forex market.<sup>18</sup> However, according to the IMF classification (see Table 1), the regime operating *de facto* in the country is different from its *de jure* regime which means that there is still a conventional fixed peg arrangement.<sup>19</sup>

## Jordan

The currency of Jordan was formally pegged to the US dollar on October 23, 1995 (the regime operating *the facto* in Jordan is a conventional fixed peg arrangement). The exchange rate anchor has helped the country reduce inflation and accommodate nominal shocks to money demand but made it vulnerable to terms of trade shocks.<sup>20</sup> This small open economy has remained competitive despite the significant appreciation of the dollar and the deterioration in its terms of trade in the past few years.<sup>21</sup> This was due in part to the flexibility of its labour market, structural reforms, a free trade agreement with the US and an association agreement with the EU, and the cushioning provided by oil grants from Iraq.<sup>22</sup>

The IMF agrees with the authorities of Jordan that the exchange rate peg provides a stable nominal anchor.<sup>23</sup> However, this kind of exchange rate policy requires supportive macroeconomic and structural policies, including bringing inflation into line with that in the United States. At present, the value of the Dinar seems to be appropriate. There are also no

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<sup>18</sup> *Egypt. Monetary Transparency*, Oxford Analytica, December 2006, <http://www.calpers.ca.gov/eip-docs/investments/assets/equities/international/permmissible-2007/egypt-monetary-report-2006.pdf>

<sup>19</sup> **Conventional fixed peg arrangement** – the country pegs its currency within margins of  $\pm 1$  percent or less vis-à-vis another currency or a basket of currencies, where the basket is formed from the currencies of major trading or financial partners and weights reflect the geographical distribution of trade, services, or capital flows. There is no commitment to keep the parity irrevocably. The exchange rate may fluctuate within narrow margins of less than  $\pm 1$  percent around a central rate - or the maximum and minimum value of the exchange rate may remain within a narrow margin of 2 percent - for at least three months. The monetary authority maintains the fixed parity through direct or indirect intervention (source: *De Facto Classification of Exchange Rate Regimes*, op.cit.).

<sup>20</sup> Bassem Kamar, op.cit., p. 6.

<sup>21</sup> A. Jbili, V. Kramarenko, op. cit.

<sup>22</sup> *ibid.*

<sup>23</sup> *Jordan: 2006 Article IV Consultation and Fourth Post-Programme Monitoring Discussions—Staff Report*, IMF Country Report No. 07/128, March 2007, p. 14.

signs of foreign exchange pressures, with the Central Bank of Jordan being a net buyer of foreign exchange in the past few years, and net foreign assets of the banking system increasing substantially.<sup>24</sup>

## **Lebanon**

Lebanon is a small, open and highly dollarised economy, so the Lebanese pound is pegged to the US dollar (according to the IMF, the regime operating *the facto* in Lebanon is a conventional fixed peg arrangement).

Lebanon achieved rapid deflation during the 1990s, but the economy has suffered from a loss of competitiveness and become increasingly vulnerable to the volatility of capital flows and transfers.<sup>25</sup> Lebanon's large structural fiscal deficits have led to a massive build up of public debt (170 percent of GDP by 2001), which has made the financial system more vulnerable to any significant adjustment in the nominal exchange rate.<sup>26</sup> Because of that, the exchange rate peg needs to be supported by a flexible interest rate policy and an international reserve buffer.

The Lebanese central bank conducts its monetary policy by defining two operational targets: (1) the spread between foreign-currency deposit rates and those on international markets, which attracts capital to the country to finance the current account deficit and external debt; (2) the spread between local-currency interest rates and dollar interest rates in Lebanon, to promote deposits in Lebanese pounds.

Due to the high level of dollarisation of the economy, the exchange rate peg is believed to constitute a key to the stability of the financial system. The authorities believe that the risks from exchange rate movements significantly outweigh any potential benefits (in terms of adjustment to external shocks).<sup>27</sup>

## **Morocco**

The currency of Morocco, the dirham, is officially pegged to a basket of currencies (see Table 1). The basket used to be dominated by the US dollar. In the 90s, owing to generally prudent monetary policy, the consumer price index inflation rate in Morocco has converged

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<sup>24</sup> *ibid.*

<sup>25</sup> A. Jbili, V. Kramarenko, *op.cit.*

<sup>26</sup> *ibid.*

<sup>27</sup> *Lebanon: 2006 Article IV Consultation—Staff Report*, IMF Country Report No. 06/201, June 2006, p. 18.

with those of developed countries.<sup>28</sup> “However, the dirham appreciated by about 21 percent in real effective terms during Jan 1991- Mar 2001, mainly because of the US dollar’s large weight in the basket. This, together with Morocco’s growing integration with the EU, prompted the central bank to adjust the composition of the basket in April 2001 in favour of the euro, which resulted in a relatively small depreciation of the nominal effective rate.”<sup>29</sup> At present, the basket of currencies is dominated by the euro, but also includes the US dollar and other currencies. The weights of the currencies in the basket reflect the pattern of Morocco’s trade.

Over the past decade, Morocco has achieved stable macroeconomic and financial conditions. It has made considerable progress in trade liberalisation; next steps include tackling remaining obstacles to trade and increasing trade in services. The sectoral reforms taken to prepare the economy to the challenges of globalization are producing results. Both the existing currency-basket peg of the dirham and the current level of the exchange rate for the dirham seem to be appropriate. Nevertheless, the authorities have the intention to prepare for the eventual transition to a more flexible exchange rate regime. This idea is supported by the IMF, as a gradual move toward a flexible exchange rate is likely to allow Morocco to derive greater benefit from its growing integration into the world economy.<sup>30</sup>

## **Tunisia**

The exchange rate policy in Tunisia is closely related to the economic performance of the country. Since the mid-1990s Tunisia has enjoyed low inflation and, on average, 5 percent real GDP growth (during 1996–2001). Tourism has become increasingly important, and dependence on agriculture has declined. Tunisia’s exchange rate policy has been facilitated by the absence of major terms of trade shocks and by capital controls for non-residents.<sup>31</sup>

Until 2000, Tunisia targeted the REER of the Dinar. The country avoided the potential risks associated with REER targeting thanks to appropriate monetary and fiscal policies.<sup>32</sup> Since 2000, the Central Bank of Tunisia has reduced its intervention in the foreign exchange market

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<sup>28</sup> A. Jbili, V. Kramarenko, op.cit.

<sup>29</sup> Ibid.

<sup>30</sup> *Morocco: 2006 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Morocco*, IMF Country Report No. 06/413, November 2006.

<sup>31</sup> A. Jbili, V. Kramarenko, op.cit.

<sup>32</sup> *Tunisia: 2006 Article IV Consultation—Staff Report; Staff Statement*, IMF Country Report No. 06/207, June 2006, p. 5.

and allowed for more flexibility in the exchange rate, in effect leading to a trend towards real depreciation. Gradual structural reforms combined with a trend towards depreciation of the REER since 2000 have supported competitiveness and export growth. At present, the *de facto* exchange rate regime is a managed float with no pre-determined path for the exchange rate (see Table 1). It is expected to be an intermediate step toward a floating exchange rate regime.<sup>33</sup> However, according to the IMF experts, substantial progress toward a floating exchange rate needs to be underpinned by banking sector reform, debt reduction, full implementation of the new broad money targeting framework, and deeper money and exchange markets.<sup>34</sup> Furthermore, it is important to provide more scope for market forces to determine the exchange rate and allow increased flexibility in both directions. In this regard, the REER continued to depreciate in 2005 (by 4½ percent on average). Although there are no obvious signs of an exchange rate misalignment and the depreciation has not created inflationary pressures so far, the Central Bank of Tunisia will continue to closely monitor developments in this area.<sup>35</sup>

## Turkey

Since February 22, 2001, the exchange rate regime in Turkey has changed over from a crawling peg regime<sup>36</sup> to an independent floating regime<sup>37</sup>. The change took place following the financial crisis suffered by the country at this time (huge depreciation of the Turkish lira against the euro<sup>38</sup>), which obliged the monetary authorities to allow the Turkish currency to float. The transformation of the exchange rate regime appeared to be a good solution and the floating exchange rate regime is performing its shock-absorbing function pretty well. However, the process of transition to the floating regime was not a smooth one. After the

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<sup>33</sup> Tunisia is in the process of gradually opening up the external capital account and moving to a floating exchange rate.

<sup>34</sup> *Tunisia: 2006 Article IV Consultation...*, op.cit.

<sup>35</sup> *ibid.*

<sup>36</sup> **Crawling peg regime** – the currency is adjusted periodically in small amounts at a fixed rate or in response to changes in selective quantitative indicators, such as past inflation differentials vis-à-vis major trading partners, differentials between the inflation target and expected inflation in major trading partners. The rate of crawl can be set to adjust for measured inflation or other indicators (backward looking), or set at a pre-announced fixed rate and/or below the projected inflation differentials (forward looking). Maintaining a crawling peg imposes constraints on monetary policy in a manner similar to a fixed peg system (source: *De Facto Classification of Exchange Rate Regimes...*, op.cit).

<sup>37</sup> **Independently floating regime** – the exchange rate is market-determined, with any official foreign exchange market intervention aimed at moderating the rate of change and preventing undue fluctuations in the exchange rate, rather than at establishing a level for it (source: *ibid.*).

<sup>38</sup> In 2000 and 2001, the Turkish lira saw its value fall by 12.8% and 50.8% respectively against the euro.

floatation of the lira, there was a strong upward pressure on the Turkish currency. This made the CBT intervene a number of times in the market. As the CBT adhered to its monetary programme and exercised restraint and transparency in the conduct of foreign exchange intervention, it gradually regained credibility.<sup>39</sup> However, research done by the IMF experts did not prove that market interventions in Turkey were a useful tool to smooth volatility. According to the results of the research, neither foreign exchange sales nor purchases were significant for the economic stability of Turkey during that period of time.<sup>40</sup>

In June 2006, while reaffirming their commitment to the floating exchange rate regime, the CBT again argued that the use of reserves on a one-off basis would help prevent a disorderly market adjustment (by facilitating the unwinding of speculative trades) and that reserves had been built up during good times for precisely this purpose. In the opinion of IMF experts, taking into account previous Turkish experiences, sizeable foreign exchange sales in a one-sided market were largely ineffective and carried costs.<sup>41</sup> Therefore, in the event of renewed market pressure, the exchange rate should be allowed to adjust and any foreign exchange sales, which may be required to counteract unusual lira volatility in illiquid markets, would need to be accompanied by a tightening of monetary policy.

## Conclusions

Over the past decade, a growing number of IMF member countries have adopted more flexible exchange rate regimes (most under market pressure). The trend towards exchange rate flexibility is likely to continue for a number of reasons. Rigid exchange rate regimes appear to be more crisis prone than flexible ones. Hence, countries that do not implement sound macroeconomic policies will be forced to adopt more flexible regimes. Other countries will increase exchange rate flexibility to minimize the risks associated with economic and financial integration with the rest of the world.<sup>42</sup>

With regard to how much flexibility is desirable and the appropriate timing of transition, there is no one-size-fits-all approach. The speed and sequencing of improvements in financial systems and progress in fiscal adjustment should be major factors, and the scope for

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<sup>39</sup> R. F. Guimarães, C. Karacadag, *The Empirics of Foreign Exchange Intervention in Emerging Market Countries: The Cases of Mexico and Turkey*, IMF, July 2004, p. 11.

<sup>40</sup> *ibid.*

<sup>41</sup> *Turkey: Third and Fourth Reviews Under the Stand-By Arrangement and Request for Waiver of Performance Criteria—Staff Report*, IMF Country Report No. 06/402, November 2006.

<sup>42</sup> R. Duttagupta, G. Fernandez, C. Karacadag, *From Fixed to Float: Operational Aspects of Moving Toward Exchange Rate Flexibility*, IMF, July 2004, p. 3.

flexibility may range from loosely managed floats to intermediate regimes.<sup>43</sup> In general, when economies mature, the advantages of exchange rate flexibility appear to increase. Developing countries – particularly those with less exposure to short-term capital flows – may benefit from pegging their exchange rates to gain credibility and discipline fiscal and monetary policies. However, relatively developed emerging market economies with open capital accounts appear to gain from exchange rate flexibility.<sup>44</sup>

Most MENA countries have pegged their currencies more or less continuously to the US dollar, although more of their trade is typically with the EU countries than with the US. The Euro-Med agreements which have been signed in recent years between the EU and MENA countries are likely, over the next decade, to have a considerable positive influence on the flows of trade and investments between the EU and the MENA countries. In addition, the emergence of the euro and the Euro zone mean that there is now, for the first time, a substantial and viable alternative anchor currency for these countries.<sup>45</sup> On the other hand, according to the IMF experts, many countries from MENA region should focus on the process of transformation to more flexible exchange rate regimes. Hence, it is important for the authorities in these countries to consider not only the desirability of a peg to the euro, but also that of other alternative possible exchange rate regimes, such as regional currency unions, on the one hand, and genuine floats, on the other.<sup>46</sup> A strong argument for introducing free floating regimes in this region is that the pegging regimes can be quite unstable in MENA countries, because of the relative volatility of MENA countries currencies against the US dollar and against the euro.<sup>47</sup> While, for example, Egypt tend to exhibit long-lasting lower volatility against the US dollar than against the euro, the same is not true for Morocco, Algeria and Tunisia, as these countries exhibit much more volatile apparent pegging (and a more euro-oriented pegging in the case of Morocco).

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<sup>43</sup> A. Jbili, V. Kramarenko, op.cit.

<sup>44</sup> R. Duttagupta, G. Fernandez, C. Karacadaga, op.cit.

<sup>45</sup> D. Cobham, G. Dibeh (eds.), *Monetary Policy and Central Banking in the Middle East and North Africa*, European University Institute, March 2007.

<sup>46</sup> *ibid.*

<sup>47</sup> A. Lahrèche-Révil, J. Milgram, *Exchange-rate policies and trade in the MENA countries*, Universidad de Granada, August 2006, p. 2.

## **5. Privatisation reform in MPC countries – overview, obstacles and achievements**

*A successful market economy depends on well-structured partnerships between the private sector and the government.* Privatisation is an instrument of economic policy and was one of the main objectives of liberalisation process in CEECs. As stated by Bassem Kamar and Damyana Bakardznieva<sup>48</sup> it is one of the key determinants of the direct investment level and has a crucial influence on investment liberalisation. This is why we have decided to deal with this issue, and assess the level and progress of privatisation processes in MPC countries traditionally known as authoritarian, or having a relatively high number of state-owned companies. However after a decade of state domination of economic activity the role of governments is undergoing change and MPC countries are also following this trend. MPC governments are more and more aware of the fact that in order to cope with the new global economy they have to reduce the size of the public sector. More room must be made and a greater role must be given to the private sector which is more efficient and more dynamic. Furthermore, the larger the private sector, the bigger private-sector investments and capital inflows are – and this is crucial for an effective market economy to develop and grow. For these reasons in the 1990's and in the late 1980's privatisation processes started in the region – with different solutions, programmes and results.

Despite the general opinion that MPC countries as a whole lag behind other regions it cannot be said that they have not made an effort to reform. In most countries economic reforms are on the agenda. Privatisation tends to be an important one, especially in the context of liberalisation. The state-dominated economies that prevailed in the MPC countries have gained momentum. Liberalisation in the MPC countries will never be fulfilled as long as main economic activities are overwhelmingly carried out by the state. Thus in most MPC countries privatisation was included in economic reform packages. The exception is Syria which actually so far has not tried the process of privatisation. However still some thought is being devoted to the prospect. Due to this fact Syria will not be included in the paper.

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<sup>48</sup> B. Kamar, D. Bakardznieva, The Reforms needed to attract more FDI in Egypt, Lessons from CEECs experience,

## Characteristics of privatisation reform

In most cases first privatisation laws were introduced at the end of the eighties and the beginning of the nineties. Despite the entrance of special laws the process began with a considerable delay. In Morocco for example the privatisation law was accepted by the Parliament in 1989 but it took 4 years to carry out its first operation. In Egypt, which accepted law on privatisation in 1991 and launched the process in the same year, the pace of privatisation was extremely slow. Due to this fact the date of 1996 is taken for the actual begin of the privatisation process. The first part of the privatisation process brought very modest effects as well as benefits. The process was re-energized first by Morocco in 1999 than followed by Jordan and Egypt in 2000. At that time also Lebanon and Algeria joined the ranks of the declared privateers, still there wasn't much progress in the matter.<sup>49</sup> Lebanon recorded probably the poorest results in the transfer from public to private ownership. There were approximately only 2 transfers carried out in the period 1988<sup>50</sup>-2005. Lebanon introduced one of its first privatisation laws in 1999 but despite this fact it still had to implement special formulas delivering transparency and fairness in the process. Algeria on the other hand gathered the most modest proceeds from its 3 first privatisation operations until 2000.<sup>51</sup> In 2006 Lebanon started its privatisation push. The objective of this push was to attract foreign funds. Optimistic plans for 2006 privatisation (the sale of telecommunications, companies and flagship carrier Middle East Airlines was planned for 2006<sup>52</sup>) were disturbed by the 2006 war with Israel. Despite this, telecommunication privatisation is still on track as it is supposed to ease considerably the public debt and bring additional revenues to the budget. This is also how the IMF sees it, and the body suggested in 1007 that Lebanon's privatisation programme was the best way to cut debt and a core element of the overall strategy to raise growth.<sup>53</sup>

Laws accepted by the governments established the legal basis for selling off state assets. In Lebanon, for example, the law was based on internationally approved principles. Laws draw up lists of state owned enterprises (SOEs) chosen in the first place to be transferred. The number of entities given over to the process differed between countries. Due to their slow

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<sup>49</sup> Kamal S. Shehadi, *Lessons In Privatisations. Considerations for Arab States*, United Nations Development Programme, January 2002.

<sup>50</sup> In 1998 privatisation of Banque du Liban et d'Outre Mer (Blom) was proceeded. Foreign investor bought 22% of shares for sale amount of 122 million USD.

<sup>51</sup> First privatisation transactions In Algeria 1 in 1996 and 2 in 1999 gathered only 55,1 million USD of revenues.

<sup>52</sup> <http://www.ameinfo.com/69364.html>

<sup>53</sup> International Monetary Found, *Lebanon – 2007 Article IV Consultation Mission Concluding Statement*, May 28, 2007, <http://www.imf.org/external/np/ms/2007/052807.htm>

pace, and despite the early introduction of the privatisation laws, most of the MPC countries did not accomplish the full privatisation plan. Most of the early laws under which countries introduced privatisation lacked transparency, proper regulations and effective administration – as was the case in Algeria. They were far from ideal. Algerian law of 1995 created certain procedural difficulties for evaluating state-owned firms and the modalities of privatisation.<sup>54</sup> The main objective in introducing this reform was to modernize and open economies to international exchanges. Privatisation brings well-known positive effects such as creation of new jobs; attraction of private foreign and local investments; and reduction of the burden on the State's budget (less public entities mean less subsidies to the state business). It also gathers additional revenue for the government's budget.

Moroccan authorities, for example, expect that due to the privatisation process the competitiveness and productivity of private companies will be enhanced and local development will be supported. The Algerian government decided in 2003 to accelerate economic reforms and pressed for further changes. It was liberalisation and privatisation reform which were about to boost economic growth and influence new job creation within the country. However, it must be stressed that internal drivers for the reform launch were not devoid of an external pressure. International donors paid much attention to the overall lessening of state control over the economy. Privatisation was one of the main points included in the reform programmes supported by international organizations. Some even made the beginning of a privatisation process a pre-condition for their financial support. This was the case, for example in Egypt, which introduced an economic reform and structural adjustment programme established together with IMF.<sup>55</sup>

Sectors that prevailed in the process were infrastructure, manufacture and services.<sup>56</sup> In the 1990s the main activity was concentrated in the manufacturing and services sector and the countries that took the lead were Egypt and Morocco (Egypt started privatisation with considerable delay but in the end speeded up). Later on transactions selling off shares in the telecommunications industry made this sector the region's leading revenue generator. The first telecommunication shares were sold by the Moroccan government in the year 2000 (Maroc Telecom for 2,110 million US dollars). It was followed by Jordan (Jordan

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<sup>54</sup> The US Department of State, Algeria 2005 Investment Statement; [www.state.gov/e/eeb/ifd/2005/51356.htm](http://www.state.gov/e/eeb/ifd/2005/51356.htm)

<sup>55</sup> Programme included also privatisation of banks.

<sup>56</sup> 15 transactions between 2000-2005 within infrastructure and 19 in the same period within manufacture and services.

Telecommunications Company, transaction value 508 million USD). Transactions connected with telecom accounted for nearly 67% of its proceeds in the period 2000-2005.

There were different ways of privatisation applied in MPCs. Some like Algeria made available most modes of privatisation, from a straight sale of assets, to the sale of shares through a competitive bidding process, the stock exchange or private deals.<sup>57</sup> In the case of Egypt it can be stated that this country in the period 1991-2004 applied mostly majority type privatisation. There were 135 transactions where one of the majority methods was used compared to 70 operations with application of partial privatisation. Tunisia on the other hand between 1987 and 2006 preceded 49% of all transaction with application of the total privatisation technique. Partial privatisation took up only 19% of all transactions.<sup>58</sup> The most widespread privatisation technique in Tunisia was asset sales followed by the block sales method (which by far is the most revenue-generating method).<sup>59</sup>

Taking into consideration the biggest proceeds from privatisation in the developing countries one will notice that although the process started in the early 90s none of the MENA countries was placed among the biggest revenue-generating countries. This simply proves the fact that the pace of MENA privatisation in its early stages was extremely slow and insignificant. The process was started belatedly and with reluctance. Statistics show that the MENA region lagged behind Latin America and Caribbean. Between 1990 and 2003 LAC received 47% of world's privatisation proceeds and MENA only 5%.<sup>60</sup> This relation changed in years 2004-2005 when MENA took 8% and the LAC only 3%.<sup>61</sup> A result of 8% is still not satisfying but shows a degree of progress. Also the number of transfer transactions improved. In the World Bank Top 10 revenue-generating countries statistics for the period 2000-2003 Morocco was included as the only representative of the MENA region.<sup>62</sup>

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<sup>57</sup> Arslan Chikhaoui, *Integration Challenge of North Africa Region*, Tokyo Conference on Investment to Africa, February 26, 2003, [www.mofa.jp/region/africa/conf0302/north.pdf](http://www.mofa.jp/region/africa/conf0302/north.pdf)

<sup>58</sup> Boyan Belev, Fondazione Eni Enrico Mattei (FEEM), *Report on privatisation and regulatory reform in the MEDA region*, Project title: "Understanding Privatisation Policy: Political Economy and Welfare Effects", Project no. CIT5-CT-2005-028647. Project co-funded within 6<sup>th</sup> Framework Programme of the EU.

<sup>59</sup> Samir Ghazouani, *The impact of corporate governance, ownership structure, and economic and financial liberalisation on the financial and operating performance of newly privatised firms in selected MENA countries*. Faculté des Sciences Economiques et de Gestion de Tunis (FSEGT) University of Tunis El Manar, Tunisia, FEMISE Research Programme 2004-2005.

<sup>60</sup> Sunita Kikeri, Aishetu Kolo, *Privatisation: Trends and Recent Developments*, The World Bank, [http://rru.worldbank.org/Documents/Privatisation/Privatisation\\_paper.pdf](http://rru.worldbank.org/Documents/Privatisation/Privatisation_paper.pdf)

<sup>61</sup> The best result achieved in 2004-2005 Europe and Central Asia.

<sup>62</sup> Sunita Kikeri, Aishetu Kolo, *Public Policy for the Private Sector, Privatisation Trends*, The World Bank Group, Private Sector Development Vice Presidency, Note Number 303, February 2006.



**Table 4: Privatisation data 1990-2003 and 2000-2005**

Country	No of Firms Sold (1990-2003 total)*	Total proceeds (USD million 1990-2003)	Largest Single sale as % of Total Proceeds	Total proceeds (USD million; 2000-2005)
Morocco	80	6.769	31	6.424
Tunisia	70	800	29	598
Egypt	117	4.688	8	2.738
Jordan	9	937	54	930
Algeria	4	152	19	651
Lebanon	1	122,0	100	236 (in 2005 only)
<b>MENA total<sup>63</sup></b>	302	<b>18,984</b>	-	<b>18.064</b>
<b>Europe and Central Asia</b>	5 634	<b>104.1</b>		<b>85.578</b>
<b>LAC</b>	1 265	<b>195.1</b>		<b>19.286</b>

\* Source: John Nellis, Privatisation in Developing Countries, A Summary Assessment, A publication of Egyptian Centre for Economic Studies, 2005. And own calculation based on The World Bank Privatisation Database, Privatisations by Region, 2007, [rru.worldbank.org/Privatisation/Region.aspx?regionid=436&view=number](http://rru.worldbank.org/Privatisation/Region.aspx?regionid=436&view=number);

## Achievements

Although it is too early to assess the overall impacts of privatisation in MPC some trends and achievements can be distinguished. Some countries such as Morocco helped to liberalise and reinforce key sectors exposed to the process. In Jordan this reform caused investment growth as privatisation allowed foreign investors to take part in transactions as well as posing an incentive for private foreign and local investors to invest more willingly in the private sector. Morocco achieved probably the biggest, out of the MENA region countries, privatisation-related investment growth. The Moroccan privatisation programme allowed the country to stimulate FDI flows and become the biggest FDI recipient in the region. Most investments are located in the telecommunication sector, the privatisation of which seems to be one of most successful in the region and is thought to have paved the way for general regional privatisation of telecom sector. It is also a positive achievement of the Moroccan privatisation reform that 82.5% of the revenues (by 2005) came from international investors.<sup>64</sup>

In Morocco privatised entities generated around 6.3 billion USD of takings. In most countries under analysis privatisation has yielded additional financial benefits for governments. New private investments and new opportunities influenced the creation of new jobs. Some MPC

<sup>63</sup> MENA here includes also Oman, Qatar, Iran, Saudi Arabia, United Arab Emirates and Yemen.

<sup>64</sup> Samir Ghazouani, The impact of corporate governance, ownership structure, op. cit.

countries such as Jordan, Egypt and Algeria launched the restructuring of a certain amount of state owned enterprises in order to increase privatisation efficiency. A positive trend was also opening of most sectors to be subject to privatisation. Algeria kept only the oil and energy sectors closed to transformation. Jordan can be characterized by a high level of support for the process. The country engaged in aggressive moves and hastened the economic reform process. As for 2001 it was estimated that due to the privatisation progress that over 6,500 new jobs have been created mostly in telecom and related sectors. It is also indicated that Jordan managed to sell state assets with minimum lay-offs.<sup>65</sup>

### **Obstacles and problems with the privatisation process implementation**

Researchers dealing with the subject of privatisation in the MPC seem to share a common opinion when it comes to assessing the reform. All stress the fact that the process of transforming the state's role in the economy lacked of comprehensiveness. The privatisation programmes applied did not include a firm plan and were often only partially fulfilled. Especially earlier reform efforts acted mostly as responses to internal crises or were an answer to external pressures and thus were irrelevant and left a lot to be desired.<sup>66</sup> Among the most often mentioned reasons for poor effects of privatisation reform is the argument of weak governance and lack of the proper institutional environment. Strong institutions in most developing as well as developed countries proved to be those which underpin successful economic reforms. Privatisation in the MPC countries continues, however the share of the public sector remains significant. The weight of the public sector poses an impediment to growth. Public expenditures are usually high and do not constitute efficient and reasonable distribution of services. In this way governance improvement is as important as the privatisation process itself. Limiting weaknesses of governance will contribute to corruption reduction, enhance budgetary and financial management as well as improving public spending quality.<sup>67</sup> In the end of the 90s and at beginning of the new century more attention was paid to creating good governance practices, improvement of the judiciary system and some degree of adjustments in the field of institutional issues were made.

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<sup>65</sup> <http://www.jordanembassyus.org/07122001009.htm>

<sup>66</sup> Sufyan Alissa, *The Challenge of Economic Reform in the Arab World: Toward more productive economies*, Carnegie Papers, Carnegie Middle East Papers, May 2007, [www.carnegieendowment.org/files/cmec\\_1\\_econ\\_reform\\_final.pdf](http://www.carnegieendowment.org/files/cmec_1_econ_reform_final.pdf)

<sup>67</sup> World Bank, *Middle East and North Africa Region Strategy Paper*, August 2004, [lnweb18.worldbank.org/mna/mena.nsf/All/B154D5429A9154A085256C6A00662360?OpenDocument](http://lnweb18.worldbank.org/mna/mena.nsf/All/B154D5429A9154A085256C6A00662360?OpenDocument)

In fact reforms should be considered part of a multidimensional process and thus most of them require prior or subsequent change to function properly. Reform results often depend on complementary changes and reforms in other related areas. Thus privatisation should go together not only with governance improvement, but also increasing transparency, labour market reform, corporate governance, improvement of business environment for foreign investors, liberalisation, trade openness, increasing easiness of doing business, administration improvement, lessening restrictions and others.

Most difficulties have their roots in political issues. Political attitudes of governments, reluctance of elites and societal scepticism are those aspects that have traditionally hindered the pace and deepness of any reform to be named. Privatisation also suffered due to political aspects that restrained changes and growth. Some governments established cosmetic reforms in order to cushion political or economic pressures, keep privileges of dominant groups of society (so called elites) especially in the beginning of the 1990s. However the attitude has been changing and more caution was given to the real improvement of the economy. Currently governments try to do their best to eliminate obstacles that slow the pace of these indispensable reforms. Governments act in order to gain political support, and make use of instruments to calm nationalistic fears of foreign takeover. What is more, governments open the field for private competition in some of the most traditional areas such as transport, water supply, power etc. Lebanon even had the courage to experiment with supplying public services from private sources. There is a growing number of projects connected with private provisions of public services. Just to give an example there are private power projects in Egypt, Morocco and Tunisia; and projects concerning private water supply in Egypt, Lebanon, Morocco and Tunisia. Jordan plans to privatise its telecommunications network and more.<sup>68</sup>

MPC countries faced strong resistance on the side of society and elites worried of harm to their interests. Society was sceptical about state's withdrawal from the economy. Pursuit of this kind of reform poses a serious socio-political challenge. It is not only that the governments and authorities are unwilling to give up control of SOE's but also society is unwelcoming to the privatisation. This is because in the MPC countries privatisation is an euphemism for unemployment and government withdrawal from social programmes.<sup>69</sup>

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<sup>68</sup> Nemat Shafik, *Public Policy and Private Initiative: Towards New Partnership in MENA*; Article 1997; [www.erf.org/middle.php?file=nletter/Sep97-03](http://www.erf.org/middle.php?file=nletter/Sep97-03)

<sup>69</sup> Samir Ghazouani, *The Impact of corporate governance, ownership structure, and economic and financial liberalisation on the financial and operating performance of newly privatised firms in selected MENA countries*, FEMISE Research Programme 2004-2005.

Weakness of regulation and the fact that MPC governments lack the capacity not only to design, but also to implement and manage comprehensive plans for reforms stands behind the statement that the states have been unable to ease the negative side-effects of socially sensitive reforms such as privatisation. This caused the rise in resistance and lack of support for the process of public-to-private transfer.<sup>70</sup>

### **International donors' input into the MPC privatisation process**

The motivation for undertaking reforms in the MENA region differed between the countries as did the outcomes and the factors that shaped all the reforms and determined their effectiveness. Financial crises in the mid-1980s resulted in reforms across the region, but those reforms were mostly externally driven. They were designed and prescribed by the International Monetary Fund and the World Bank as a part of stabilisation and structural adjustment programmes. The main principle of these programmes was market reform together with a considerable reduction of the state's role in the economy, and thus reforms concentrated on four main areas such as government spending cuts; privatisation of SOE's; trade-barrier reduction; interest and exchange rate liberalisation. All these elements were introduced to different degrees in each country. This first part of reform efforts was full of flaws and weaknesses as these reforms did not constitute a comprehensive reform plan. They were partial and mostly were neither sustained nor fulfilled completely.<sup>71</sup> International financial institutions were strongly engaged in the process of economic changes and transformations within the MENA Region. The World Bank's strategy on MPC included strong support for the development of the private sector.<sup>72</sup>

MENA countries gained their own momentum for reform. They can no longer dismiss reforms into the background as the region already lags behind other developing regions. This is so although MENA has the potential to grow and develop. If it was not for international donors such as the World Bank, IMF or European Union, regimes in the Arab States would not feel obliged to introduce changes. International institutions pave the way for reforms in the MENA and they assist governments in shaping comprehensive reform programmes.

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<sup>70</sup> Sufyan Alissa, *The Challenge of Economic Reform in the Arab World...op. cit.*

<sup>71</sup> Sufyan Alissa, *The Challenge of Economic Reform in the Arab World: Toward more productive economies*, Carnegie Papers, Carnegie Middle East Papers, May 2007, [http://www.carnegieendowment.org/files/cmec\\_1\\_econ\\_reform\\_final.pdf](http://www.carnegieendowment.org/files/cmec_1_econ_reform_final.pdf)

<sup>72</sup> As above.

The IMF and the World Bank have been present in the Region since the very beginning, when these countries were making their first steps towards creating and introducing economic reforms. The IMF supports these countries through technical assistance, training and policy discussions as an addition to lending. It concentrates mostly on public sector reform, transparency issues, development of financial market and exchange rate regime reform, but also which reforms are about to help the region adopt such reform and which economic policies will contribute to improvement of economic performance.<sup>73</sup>

The IMF is the one that strongly supports the process of privatisation (in Egypt, Jordan, Lebanon, Morocco and Tunisia) while the World Bank is the one that prevails in advising on privatisation.<sup>74</sup> Up until June 2001 the World Bank provided the region, with which it has a long history of partnership, over US\$ 34 billion. 46 percent of lending granted between 1997 and 2001 has been allocated in traditional areas such as agriculture and infrastructure. 30 per cent of lending were accounted for in the same period by such priorities as support for public sector management, policy reform and development of the financial sector. By and large the World Bank has also expanded services within the Region that are not included in direct lending. These services consist of private investment inflow encouragement with an application of the World Bank guarantees reducing risk perception of the potential investor. Such guarantees found application in the case of support for privatisation of the telecommunication sector in Jordan and electric power in Morocco and Lebanon. The World Bank cooperates also with a number of sister institutions like the International Finance Corporation (IFC) and the Multilateral Investment Guarantee Agency (MIGA; this institution works to encourage investment in developing countries through providing guarantees). By the year 2001 the International Finance Corporation, whose main objective is to promote development through application of the private sector, invested in the Region a total sum of \$2.5 billion.<sup>75</sup> These investments have leveraged \$13 billion of additional private investment. Generally support of the World Bank directed to the MENA Region focused on several priorities, among them investment climate and private sector-led growth.<sup>76</sup> The World Bank has been assisting the Jordanian privatisation process since 1995. Now the Group of the

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<sup>73</sup> In 2003 only Jordan had an access to financial resources under IMF supported programmes.

<sup>74</sup> IMF and the Middle East and North Africa, IMF Staff, 2003, <http://www.imf.org/external/np/exr/ib/2003/081503.htm>

<sup>75</sup> The World Bank in the Middle East and North Africa, The World Bank MENA Region, Regional Brief [www.ictmedsme.com/~contentseumedis/portada/encuesta/docs/Mena+&+world+bank-01-+regional+brief.pdf](http://www.ictmedsme.com/~contentseumedis/portada/encuesta/docs/Mena+&+world+bank-01-+regional+brief.pdf)

<sup>76</sup> Other World Bank priorities are: public sector management and institution building; social protection and human development; gender and culture; rural and community development; and knowledge, partnership and outreach.

World Bank manages a trust fund for USAID with which it was collaborating since the very beginning in Jordan. This fund's role is to support the Jordan Privatisation Programme. The WB was assisting the Jordanian government also by forming a privatisation strategy, helping to design the law and institutional framework as well as by supporting the Jordan Privatisation Programme implementation. Privatisation Programmes in many MENA countries were prescribed by these international donors, who have treated privatisation as a prerequisite for structural adjustment and development loans – an example for that might be at least Egypt. In 1998 Algeria completed a long programme of economic adjustment and reform under auspices of The World Bank and the International Monetary Fund. One of the main objectives for this programme was of course privatisation and increase of private sector share in the economy<sup>77</sup>. As a part of overall help to promote development of the MENA private sector the World Bank engaged in improvement of the urban transport project in Tunisia, in Morocco it supported the process of telecom privatisation.

The European Union regulated its relations with the MENA Region through the Barcelona Process. In the economic basket of the Barcelona Declaration, financial aid for MENA economic growth support was included. Among many other principles was support for Small and Medium Enterprises development. The financial instrument of EU-MED partnership – MEDA – was set to mitigate and compensate negative effects of economic changes. Its aim was also supporting local entrepreneurship and the development of the private sector. Knowing that in developing countries the private sector is indispensable as a creator of employment growth and revenue, the EU decided to concentrate in the large part on financing this priority within MEDA. In the period 1995-2001 most MEDA resources was designed for improvement of the institutional and economic environment (1.058.6 million Euro) and private sector development (718.9 million Euro).<sup>78</sup> Institutional environment improvement was financed in the framework of the structural adjustment facility and through different technical assistance projects (mostly devoted to infrastructure projects). Within this priority (institutional and economic environment) technical assistance as well as SAF funds went for privatisation support and SOE's restructuring projects in the Region. 718,9 million Euro served for financing the private sector development in the region. These interventions included direct help to SMEs, quality improvement, human resources development, entities financing projects and other. Structural Adjustment Facilities contributed to reforms of the

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<sup>77</sup> The World Bank, Middle East and North Africa, Regional Brief 2007.

<sup>78</sup> *Evaluation of Economic Co-operation between the European Commission and Mediterranean countries, Final Report, Volume 1, November 2003, s.21.*

(source: [http://europa.eu.int/comm/europeaid/evaluation/reports/med/951645\\_vol1.pdf](http://europa.eu.int/comm/europeaid/evaluation/reports/med/951645_vol1.pdf)).

institutional and economic environment that became friendlier toward the private sector however its results were limited due to the lack of proper engagement on the beneficiaries' side. European Union financial instruments also supported private sector improvement through creation of the so called Business Centres. These Centres organized training for entrepreneurs and helped them to grow their companies' (Small and Medium ones) competitiveness.

FEMIP (Facility for Euro-Mediterranean Investment and Partnership) also played an important role – an instrument established within the European Investment Bank (EIB). FEMIP puts the strongest pressure on advancement of private sector activity in MENA countries, treating it as a way to sustain overall growth and new job creation. Financial support is contributed to projects connected with the private sector and is spent on public projects that aim at helping to create environment favourable to the improvement of private entities' functioning.<sup>79</sup> In the first year of FEMIP (2002 – 2003) the European Investment Bank designed 1.8 million Euro. Sixty percent of this sum supported private sector projects.

The European Union's offer to establish a Euro-Mediterranean Economic Area and assistance programmes of IMF and the World Bank have a chance to provide an institutional framework which will help those countries to create a credible gradual reform strategy. However much is still to be done in order to make those efforts and supports fully function.

## **6. Summary**

MPC countries driven by severe financial crises can no longer able to afford to fund their massively inefficient and debt-ridden public sectors and have realized that in order to develop and grow they must change their state-dominated economies. Undoubtedly a great role has been played here by international donors that supported the process of economic reforms in the region as well as enticed those countries to introduce changes by promising financial and technical support. Although the privatisation reform started over 20 years ago the process is still uncompleted. Some positive effects however can be seen. There were several spectacular transactions that generated additional budget revenues (like privatisation of telecommunication sectors across the region). That the pace was extremely slow and the reforms introduced partial was one of the reasons for unsatisfying MPC performance. Thus MPC countries should make a considerable push for speeding up the process and making it

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<sup>79</sup> *Evaluation of Economic Co-operation between the European Commission and Mediterranean countries, Final Report, Volume 1, November 2003.*

(source: [http://europa.eu.int/comm/europeaid/evaluation/reports/med/951645\\_vol1.pdf](http://europa.eu.int/comm/europeaid/evaluation/reports/med/951645_vol1.pdf)).

more comprehensive. Privatisation can not be introduced in isolation from other necessary economic reforms and establishing a friendlier institutional environment is necessary for the sake of reform success. Governments, in order to change the attitude of society as well as reluctant elites, should engage in active political management and governance. Privatisation, though, should be depoliticized.

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