Deutsche Bank
DB Research

Current Issues
Emerging markets

# Two years of Arab Spring

## Where are we now? What's next?

January 25, 2013

Authors
Oliver Masetti
+49 69 910-31815
oliver.masetti@db.com

Kevin Körner
+49 69 910-31718
kevin.koerner@db.com

Magdalena Forster

Jacob Friedman

Editor
Maria Laura Lanzeni

Deutsche Bank AG
DB Research
Frankfurt am Main
Germany
E-mail: marketing.dbr@db.com
Fax: +49 69 910-31877

www.dbresearch.com

DB Research Management
Ralf Hoffmann | Bernhard Speyer

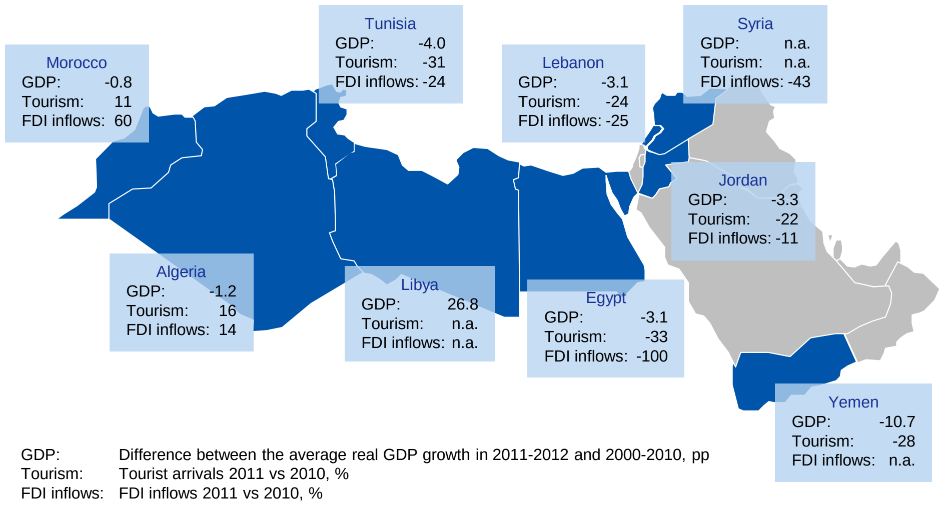
On the second anniversary of the revolutions which swept across several countries in North Africa and the Middle East and with the region in the spotlight due to war in Mali and the hostage crisis in Algeria, we analyse the changes in the political and economic landscape and assess long-term opportunities and challenges.

The Arab Spring resulted in increased political pluralism and nascent democratic institutions, but it also led to instability, setbacks in the transition towards democracy, mass protests, clashes among former revolutionary allies as well as the rise of political Islam.

Political instability has taken a toll on the region's economies. There has been a sharp slowdown in economic activity, deteriorating external and fiscal accounts and decreasing FX reserves.

The long-term challenges for the region remain as pressing as ever: high unemployment (especially among the youth), inefficient subsidy regimes and low trade diversification, among others. Expectations for rapid improvement after the Arab Spring will be disappointed, but there is a chance that less oppressive governments will be more responsive to their peoples' demands and thus at least attempt to tackle those problems.

Economic impact of the Arab Spring




Sources: UNCTAD, IMF, National Authorities, DB Research

# The Arab Spring

On December 17, 2010, vegetable vendor Mohamed Bouazizi set himself on fire in the Tunisian town of Sidi Bouzid. This act sparked a wave of dramatic political upheaval throughout North Africa and the Middle East known as the "Arab Spring" (for a chronology of events see page 5). Demands voiced by protesters and rebels were similar across the region: increased inclusion in economic and political life, better governance and strengthened civil liberties. The outcomes of the upheavals so far have varied widely, reflecting country-specific social cleavages which had been covered up by autocratic regimes in the name of political and economic stability.

In this study, we analyse some of the political and economic consequences of the Arab Spring and assess opportunities and challenges for the affected countries. We focus on the Arab countries in North Africa (Algeria, Egypt, Libya, Morocco and Tunisia) and the Levant region (Lebanon, Jordan and Syria) as well as Yemen.

## Political consequences of the Arab Spring

In Tunisia, Egypt, Libya and Yemen – in that order – undemocratic leaders were ousted and replaced by popularly elected bodies or, in the case of Yemen, a transitional government. In Libya, such a change only occurred after months of armed conflict between regime supporters and opponents and ended in the killing of the country's leader during the fight. In Syria, a civil war is still ongoing and has caused a grave humanitarian crisis with hundreds of thousands of internal and external refugees and increasing social tensions in neighbouring countries, especially Lebanon. In Morocco, Algeria and Jordan, heads of state have stayed in power but responded to social pressures through a variety of measures, including parliamentary elections, reshuffling the cabinet, changing the constitution or lifting decades-long states of emergency. In the Gulf region, major protests occurred in Kuwait and Bahrain. In the latter case, protests prompted a GCC[1] military intervention led by neighbouring Saudi Arabia.

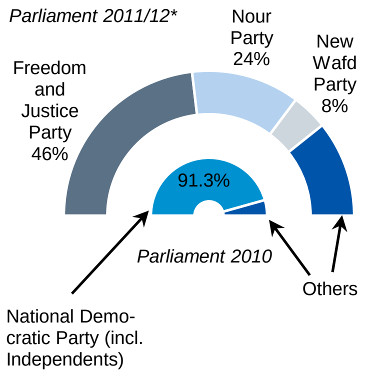
### Transition countries: Pluralism increasing, political Islam rising

After old regimes were ousted in Tunisia, Egypt and Libya, these countries saw free and fair elections with high participation rates and only minor reports of irregularities. In Yemen, a caretaker government was formed to prepare the country for competitive elections. Islamist movements, which had been suppressed under previous leaders, particularly benefitted from the new political freedom. To some extent, these forces pursue a moderate rhetoric and acknowledge the need to respect international commitments and civil rights, as well as to remain open towards the West. But a more radical strain of Islamism, namely the Salafi movement, has been on the rise as well, especially in North Africa. A conflict has thus arisen over what role Islamic precepts and practices should play in public and private lives. Human rights activists fear that, in particular, women's rights will be restricted by Islamist-dominated legislative bodies.[2]

In Egypt, the number of parties represented in the first post-Mubarak parliament increased from 9 to 15. In the parliamentary elections which took place in

[1] Gulf Cooperation Council. Members are Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.
[2] El Fegiery (2012).

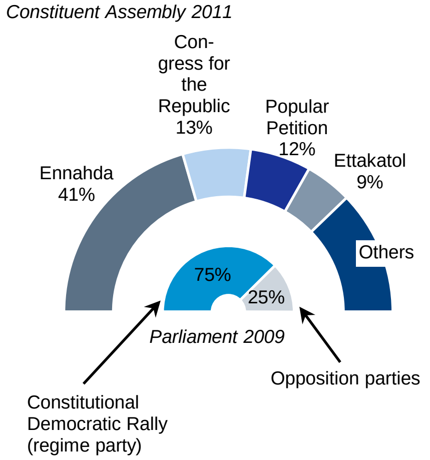
Egypt's first Islamist-led parliament 1




*The parliament was dissolved in June 2012 and has not yet been re-elected.

Sources: Ahram, DB Research

New plurality of parties in Tunisian Constituent Assembly 2




Sources: Le Point, DB Research

several rounds from November 2011 to January 2012, the Muslim Brotherhood's Freedom and Justice party enjoyed a landslide victory gaining 46.3% of the vote (see chart 1). Together with the radical Salafist Nour party they dominated parliament with over 70% of all seats. Liberal movements that were the driving forces behind the anti-Mubarak revolution performed poorly, due to their fragmentation and internal quarrelling. The newly elected parliament was dissolved after a few weeks of existence by the Supreme Court and the military in early June 2012 on a technicality. However, the result of the election still matters for Egypt's future as prior to its dissolution parliament elected the Constitutional Assembly, the body that has drafted a controversial constitution (see below). The strong showing of Islamic forces also continued in the June 2012 presidential elections, which were won by Mohamed Morsi, the candidate of the Muslim Brotherhood.

In Tunisia, the number of parties represented in the constituent assembly rose to 19 from formerly 7 in the unicameral parliament (see chart 2). Under the autocratic regime of ousted President Ben Ali, only 25% of the seats were granted to the opposition. The moderate Islamist Ennahda party came first in the elections in October 2011 with 41% of the vote and formed a coalition with two secular leftist parties. Tunisia saw several violent clashes between Salafi Islamists and secularists in 2012. The often fraught relationship between the ruling Islamist party and Salafis is sure to remain a key stress point in Tunisian politics in coming years.

In Libya, the first-ever direct elections to a General National Congress took place in July 2012. 80 representatives from 21 parties were elected by lists to the General National Congress; another 120 representatives were elected on a constituency basis. Against the regional trend, Libya elected a mildly Islamist, pro-business party with 48.8% of the vote. The Muslim Brotherhood offshoot Justice and Construction party came second with only 10.3%. Cleavages in the Libyan population follow tribal and regional lines as well as religious/secular ones, increasing the complexity of Libyan politics. Libya faces radical Islamist influence as well: some of the revolutionary brigades, which still control large parts of the country, fly the black flag often associated with radical Islamism.

In Yemen, the previous vice-president, Abdurabu Mansour Hadi, was elected as new president in February 2012. He replaced Ali Abdullah Saleh, who resigned from his 33-year presidency in a GCC-brokered plan following more than a year of protests. Hadi and the interim government that equally consists of members of the opposition Joint Meeting Parties and the previous ruling party, General People's Congress, need to lead Yemen through a difficult political and economic transition exacerbated by a high level of social unrest. The interim government still faces struggles with secessionist movements in the south and resuming insurgency by Houthi rebels in the north. The strong presence of al-Qaeda in southern parts of the country remains a severe threat to security.

## Gradual reformers: Steps towards meeting protesters' demands

King Mohamed VI in Morocco and King Abdullah II in Jordan have both stayed in power. Although both still enjoy popularity, there were also protests calling for greater political openness in both countries. In response, King Abdullah dismissed several cabinets and promised economic and social reforms. Morocco amended its constitution to grant more powers to parliament and called for fresh parliamentary elections. As these amendments require parliamentary support for the prime minister, the Moroccan king appointed a moderately Islamist PM for the first time ever. Parliamentary elections in Jordan in January 2013 were surrounded by protests against corruption and nepotism. Protests were fuelled by the government's decision to remove fuel subsidies. The main Islamist party boycotted the elections.

Of all the countries covered in this study, Algeria has remained closest to its status quo. The collective memory of the 1990s civil war and the security threat emanating from al-Qaeda in the Islamic Maghreb (which became evident in the recent hostage crisis in an Algerian gas plant) seem to have contained major political unrest. The ruling National Liberation Front party has been confirmed as the largest political force after parliamentary elections in 2012. The most visible consequence of the Arab spring was the lifting of the state of emergency which had been in place for 19 years.

### Still in violent conflict: Syria and its contagion to Lebanon

In Syria, the two-year-old civil war between forces loyal to President Assad's regime and opposition (mainly Sunni) fighters has so far cost more than 60,000 lives, according to the UN, and displaced hundreds of thousands. Although it has became increasingly unlikely that the Assad regime will be able to re-establish the previous status quo, it is highly difficult to predict the course of the Syrian conflict at the current stage. In Lebanon, the Syrian conflict has strengthened sectarian clashes between factions in support of and opposed to the Assad regime. The division between the ruling March 8 alliance, dominated by Hezbollah and its pro-Syrian allies, and the pro-Western March 14 alliance, which has so far refused to join the government, has been further deepened by the Syrian crisis.

### Drafting of constitutions remains key pending issue

The political transition in North Africa and the Middle East is not yet completed. The road to more democracy and political stability remains a long one. A milestone in the transition progress is the drafting of new constitutions replacing the existing ones, which were widely tailored to the needs of the former authoritarian governments. The process of drafting the constitution is at different stages in the transition countries.

In Egypt the drafting process was hastily completed in early December 2012 despite strong protests by the liberal opposition and the judiciary, in part due to Islamist worries that the drafting assembly would be dissolved by the courts. The draft constitution was approved by a popular referendum in mid-December with nearly 64% of total votes, with a low voter turnout of less than 33%. Opposition groups joined forces in a National Salvation Front and announced their intention to contest some provisions in the new constitution. Controversial issues are the role of Islam, the rights of religious minorities and women, as well as the separation of powers between parliament, the president and the military. Parliamentary elections are expected to take place by April, although there is no official date yet.

In Tunisia and Libya the constitution drafting process is still ongoing and also subject to public controversies, setbacks and delays. In Tunisia, the original end-October 2012 target deadline was pushed back to ensure an orderly process and a constitutional draft should only be ready by April 2013. In Libya, the composition of the Constituent Assembly is still disputed and a final draft constitution is not expected prior to mid-2013. In Yemen, the interim government that has been formed for a two-year transition period is committed to draft a new constitution and organise free elections by 2014.

## Timeline of political events

**Dec 2010**
- Anti-government protests break out after vegetable vendor Mohamed Bouazizi sets himself on fire in a provincial town in Tunisia.

**Jan 2011**
- Tunisian president Ben Ali is forced to step down and flees to Saudi Arabia.
- Anti-government riots and social demands spread to Egypt's Tahrir Square and to Jordan and Algeria.

**Feb 2011**
- Egyptian President Mubarak resigns and hands power over to the military after violent demonstrations and international pressure.
- The first day of revolt in Libya is answered quickly and brutally by Libyan security forces. In the coming days and weeks, Gaddafi employs heavy weapons against the rebels.
- Rallies calling for a new constitution and the end of corruption take place in several cities in Morocco.

**Mar 2011**
- UN Security Council votes in favour of a resolution stipulating a no-fly zone over Libya resulting in a stalemate between rebel and regime forces. The no-fly zone is revoked by the end of October.
- Violence rises in Syria; Syrian security forces respond with increasing brutality to demonstrations. In the following weeks, the conflicts develop into a civil war which is still ongoing.

**Jul 2011**
- A popular referendum on constitutional amendments is held in Morocco which limit the King's influence and strengthen the parliament.

**Oct 2011**
- Gaddafi is captured and killed in Sirte, Libya. The National Transitional Council officially declares Libya liberated from Gaddafi.
- Free and peaceful elections for a constituent assembly take place in Tunisia, in which the moderate Islamist party Ennahda gains the majority of votes.

**Nov 2011**
- Parliamentary elections in Morocco are won by moderate Islamist Justice and Development Party (PJD). The King subsequently appoints Morocco's first-ever Islamist PM in January 2012 (PJD leader Benkirane).
- Elections consisting of several cycles start in Egypt after days of protest on Tahrir Square against the military council. The release of results is postponed several times with the Muslim Brotherhood scoring high.

**Feb 2012**
- President Saleh steps down in Yemen from his 33-years rule, following more than a year of protests. He is replaced by previous vice-president Hadi, who has been elected to preside an interim government in charge of leading the country through economic and political transition and of preparing elections by 2014.

**May 2012**
- Against the regional trend, parliamentary elections in Algeria confirm the leading role of ruling FLN and its ally National Democratic Rally. In September, President Bouteflika appoints a longstanding ally PM.

**Jun 2012**
- Muslim Brotherhood's Mohamed Morsi narrowly wins presidential elections in Egypt. The military council formally hands power to Morsi, but doubts about the military's role remain after it dissolves parliament and amends the constitution to grant itself greater powers. In a counter move, Morsi retires several leading military figures.

**Jul 2012**
- A General National Congress is elected in Libya which elects Magarief of the liberal National Front Party as its chairman and interim head of state. A government taking into account diverse regional interests can only be appointed in Oct 2012.

**Nov 2012**
- Egypt's President Morsi issues a decree that exempts his decisions from judicial review and bars the courts from dissolving the constitutional drafting body. He orders a reopening of investigations of crimes committed during the revolution. His move is answered with mass demonstrations.

**Dec 2012**
- In Egypt, the Islamist dominated Constitutent Assembly finishes the drafting of a new constitution. The highly controversial draft is approved in a popular referendum. The opposition wants to challenge some articles relating to the rights of religious minorities and women.

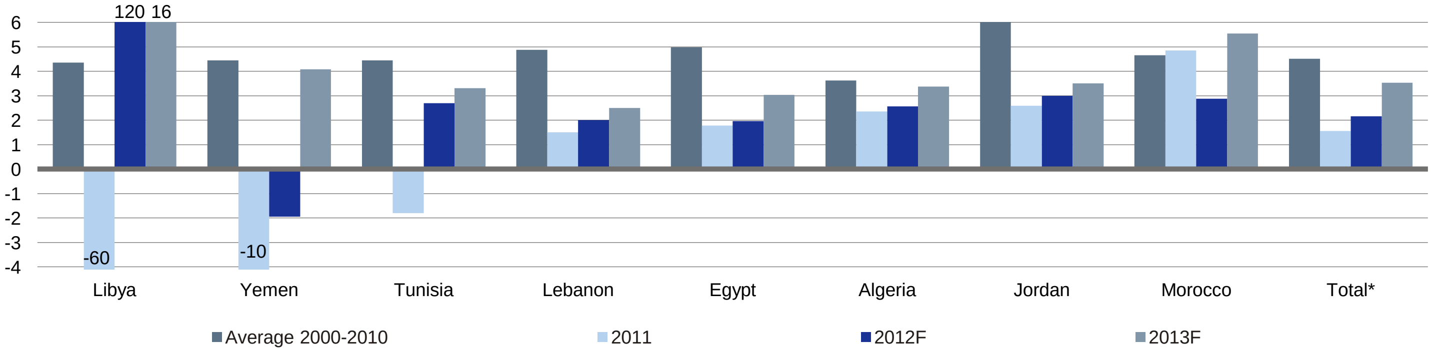
## Economic consequences of the Arab Spring

### Sharp drop in economic growth, slow recovery underway

The Arab Spring had a significant impact on economic activity in North Africa and the Levant. Average real GDP growth in the region fell from 4.2% in 2010 to 2.2% in 2011 (see chart 3),[3] its lowest level in over a decade. To make matters worse, the global economy was sluggish and the eurozone crisis hit the region hard given tight economic links (see page 11). The slowdown affected all countries, but its magnitude varied from country to country. Hardest hit initially were those countries that were at the centre of the Arab Spring, like Libya, Tunisia, Egypt, Syria and Yemen. The only country in the region where GDP growth strengthened in 2011 was Morocco. The economic recovery of the region was subdued in 2012. Average real GDP growth increased only slightly to 2.4%. We expect economic activity to pick up and GDP growth to accelerate to 3.5% in 2013, but to remain below the pre-revolutionary growth levels.

Political turmoil and external pressures take their toll on the economy 3

Real GDP, % yoy

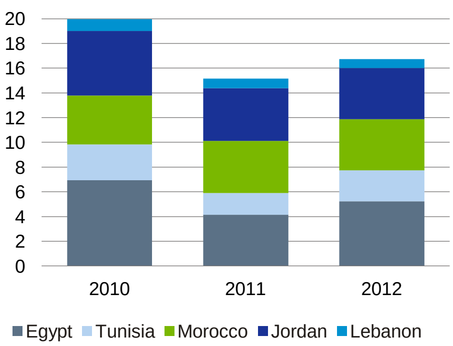



*GDP weighted average growth rate (excluding Libya and Syria)

Sources: IMF, DB Research

Tourists stayed away 4

Tourist arrivals, m, first six months




Sources: National Authorities, DB Research

Production stoppages caused by political upheaval were severe. In Libya, for example, oil production decreased due to the civil war and the international sanctions from 1.65 m barrels per day in 2010 to only 0.47 m barrels per day on average in 2011,[4] causing the economy to crash. In Egypt the widespread demonstrations and strikes in the wake of the anti-Mubarak protests paralysed the production process and deterred investments for months. In Tunisia labour unrest led to a substantial decline in the mining sector (-40% added value) and in oil and phosphate production. In Syria, oil production plummeted by 60% from the level at end-2010 to 0.16 m barrels per day in September 2012 due to international sanctions and the continuing civil war. In Yemen, economic activity was hit severely by attacks on electricity facilities and pipeline sabotage which led to painful electricity and fuel shortages.

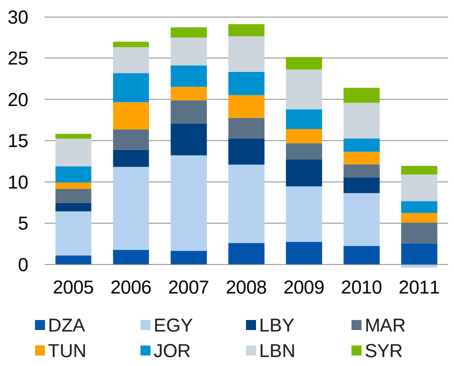
One of the most immediate effects of the Arab Spring was a sharp decline in tourism (see chart 4). The number of tourist arrivals in the five main tourist

[3] The average growth rate excludes Libya and Syria. Syria is largely excluded from the economic analysis as the availability of reliable data is severely hampered by the ongoing civil war. In general, the Syrian economy is suffering strongly from the impact of the war and international sanctions, with a deep recession caused by a collapse of oil revenues, tourism and FDI, a widening current account, the depletion of FX reserves and strong depreciation of the currency.

[4] US Energy Information Administration.

FDI inflows slowed down 5

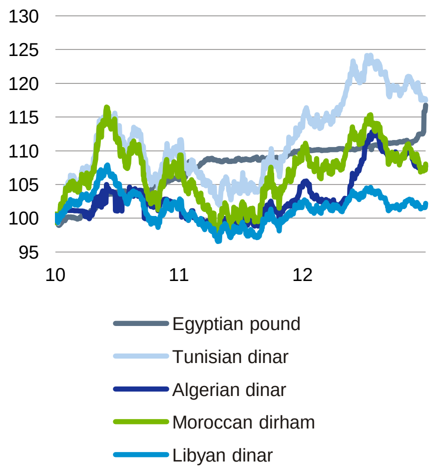
FDI inflows, USD bn




Sources: UNCTAD, DB Research

Weakening currencies 6

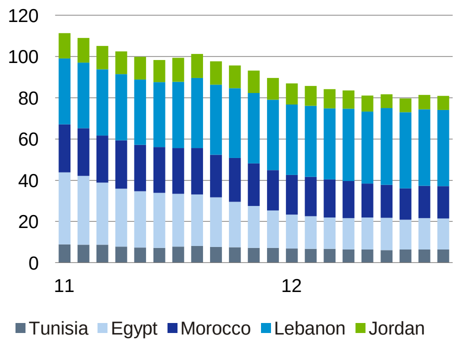
Index 01.01.2010 = 100




Sources: Bloomberg, DB Research

Oil-importing countries experienced a sharp decline in FX reserves 7

FX reserves, USD bn (ends Sep 2012)




Sources: IMF, National Central Banks, DB Research

destinations in the region − Egypt, Tunisia, Morocco, Jordan and Lebanon − fell by a quarter, from 20 million in H1 2010 to 15 million in H1 2011. The decline was most severe in Egypt and Tunisia, at about 40% each. In 2012, tourist arrivals to the region recovered, but remained way below pre-revolution levels. Given that tourism receipts account for over 20% of GDP in Lebanon, 12% in Jordan and between 5% and 8% of GDP in Morocco, Tunisia and Egypt,[5] the decline had a significant effect on economic growth.

Foreign direct investment (FDI) inflows also diminished sharply, accelerating the trend that started with the financial crisis in 2008-09. Between 2010 and 2011 FDI inflows fell by 46% to USD 11.4 bn, their lowest level since 2004. The regional decline was mainly driven by a sharp reduction in FDI inflows in Egypt, Tunisia and Lebanon (see chart 5).

In 2012, a slowdown in exports kept economic activity in North Africa and the Levant depressed. A major reason for this slowdown was the recession in Europe, the region's most important trading partner (see page 11). Especially affected were Egypt and Tunisia, which saw their exports decrease by more than 5% yoy in H1 2012. Export growth also turned negative in Jordan and stagnated in Morocco. Against this trend exports in Libya and Algeria increased, thanks to high oil prices.[6]

## Widening external deficits and diminishing FX reserves, but international aid chipping in

For the oil-importing countries lower tourism revenues, weak exports and an elevated import bill caused by high international oil and food prices resulted in a sharp widening of current account deficits. Between 2010 and 2012 deficits nearly doubled in Egypt, Morocco, Lebanon and Jordan. On the other hand, oil exporters like Libya and Algeria have reported solid current-account surpluses all along.

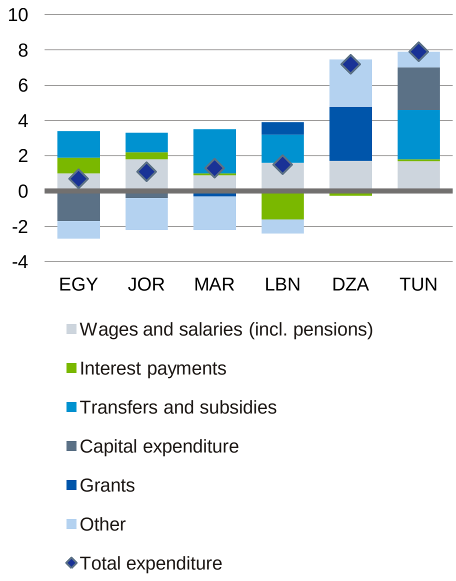
The Arab Spring events led to a weakening of the region's currencies. The strongest depreciation was experienced by the Tunisian dinar (see chart 6). In many cases, stronger depreciation could only be averted by substantial interventions of the national central banks, which sold FX and bought the local currency to prop up the exchange rate. These interventions, however, came at the cost of depleting FX reserves (see chart 7). Overall FX reserves of the oil-importing countries decreased by a quarter between early 2011 and mid-2012. The fall was most dramatic in Egypt, where FX reserves dropped from USD 35 bn in January 2011 to USD 15 bn in December 2012. In Jordan, reserves declined from USD 12 bn at the beginning of 2011 to USD 7 bn in December 2012. Only in Lebanon did FX reserves remain relatively stable and even increase over the last two years to a sizeable USD 37 bn, supporting the currency peg against the US dollar. In Yemen, a stronger depreciation was only prevented by intervention from the IMF and Saudi Arabia.

To avoid a full-blown balance-of-payments crisis the international community stepped in to support the region. The G8 and the international financial organisations founded the "Deauville Partnership" in May 2011 to coordinate international aid for affected countries. Members pledged up to USD 70 bn. However, to date only a fraction of the promised aid has actually been disbursed. One of the actions already taken was to extend the mandate of the European Bank for Reconstruction and Development (EBRD) to include Jordan, Tunisia, Morocco and Egypt. This should make available up to USD 2.5 bn a year for these countries. The IMF has also committed to provide loans to

5 As of 2010; International Monetary Fund (2011).
6 IFS.

Increase in government expenditure driven by higher subsidies and wages 8

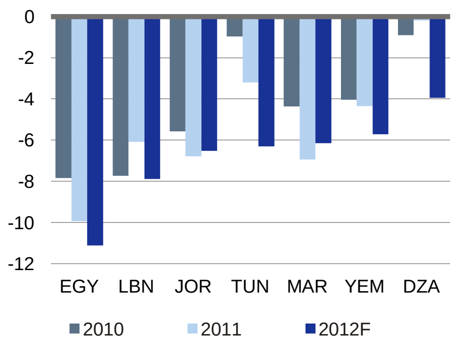
% of GDP, 2012 versus 2010, pp.




Sources: IMF, IIF, DB Research

Ballooning fiscal deficits 9

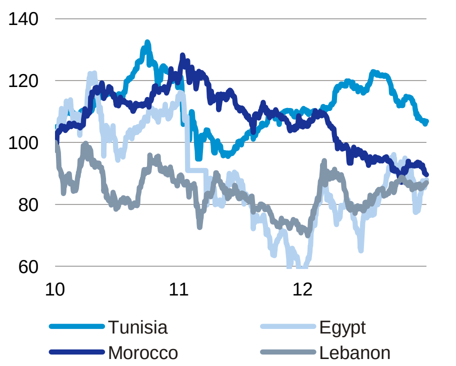
Fiscal balance, % of GDP




Sources: IMF, DB Research

Equity markets hit 10

Index 01.01.2010 = 100




Sources: WEFA, DB Research

Morocco, Jordan, Yemen and most recently to Egypt,[7] valued at USD 6.2 bn, USD 2 bn, USD 93 m and USD 4.8 bn, respectively. Additional bilateral financing support is coming mainly from the wealthy Gulf countries. Qatar, for instance, supports Egypt with loans and grants of USD 5 bn.

## Large fiscal costs, rising public debt

The governments in North Africa and the Levant responded to the political unrest and weakening economic performance by increasing public spending. The highest increases in government expenses relative to GDP occurred in Tunisia and Algeria, with 7.9 pp and 7.2 pp, respectively, between 2010 and 2012. Most fiscal measures taken were aimed at sustaining social cohesion and mitigating the effects of the high international food and fuel prices on domestic consumers. Popular steps taken in most countries were to increase subsidies on energy and food (see page 10), to raise public-sector wages and pensions, and to expand unemployment benefits (see chart 8). Over the same period government revenues increased only marginally relative to GDP or, as in Egypt, even declined due to the subdued economic activity, lower tax collection, and new tax exemptions and breaks.

As a result, fiscal deficits widened sharply (see chart 9). The situation was worst in Egypt, where the fiscal deficit reached 11% of GDP in FY 2011/12, and in Tunisia, where the fiscal deficit more than sextupled from about 1% of GDP in 2010 to 6.3% of GDP in 2012. In Algeria, the deficit jumped to 4% of GDP despite solid oil revenues, highlighting the effect of the sharp spending increase. The deterioration of the budget balance was less pronounced in Morocco, Lebanon, Jordan and Yemen, but nevertheless all four countries exhibited high deficits of close to 6% of GDP in 2012.

The consequences of the fiscal expansion are also reflected in increasing public debt levels. Most worrying is the situation for the countries that already entered the crisis with high debt-to-GDP ratios, like Egypt and Jordan. In both countries the public debt level has risen by more than 6 pp over the last two years and stands now at close to 80% of GDP. In Morocco and Tunisia debt levels were lower initially but also increased sharply to 58% of GDP and 46% of GDP, respectively, in 2012. In contrast, public debt in Lebanon slightly decreased over the last two years, but at a staggering 135% of GDP in 2012 – the highest level in the region – it remains a constant source of concern. In Libya and Algeria, thanks to oil wealth, indebtedness is only in the single digits as a percentage of GDP.

## Stock markets hit by uncertainty

In 2011, the region's four biggest stock markets in terms of market capitalisation − Egypt, Tunisia, Morocco and Lebanon − recorded major losses (see chart 10). Heaviest affected was Egypt, where the Cairo Stock Exchange Index (CASE30) was closed for nearly eight weeks in early 2011 and lost about 50% throughout the year. Stock prices in Lebanon, Tunisia and Egypt have recovered but remain very volatile. The Cairo Stock Exchange Index was the world's third-best performing index in 2012, gaining 50.8%.

[7] At the time of writing Egypt had reached IMF staff-level agreement, with IMF board approval still pending.

## Chances and challenges ahead

The Arab Spring threw into sharp relief some deep structural problems that have hampered development in the region for decades. The current political changes offer an opportunity to tackle these issues and pave the way for a better future in North Africa and the Levant.

### Youth unemployment, skills mismatch

The MENA region faces a structural employment gap, especially with its swelling youth population. Regional unemployment rates are around 10%, but youth unemployment is closer to 30% (see chart 11).[8] Demographics, market rigidities, and bloated public sectors are key hurdles.

The region has one of the fastest-growing workforces in the world. With a 2.7% annual workforce growth rate, the IMF has estimated that the region will see 10.7 million new labour market entrants by 2020.[9] Egypt alone must create nearly 700,000 jobs a year for its unemployment rate to remain unchanged.[10]

Labour market inefficiencies remain a key problem in the region. In the World Economic Forum's Global Competitiveness Index, the MENA region had the lowest labour-market efficiency ranking in the world. The highest-ranked country is Jordan, at 101 out of 142 countries. In addition, the region faces widespread skill mismatches, as inefficient education systems produce unprepared market entrants. Firms operating in the region regularly list insufficient labour skills as a major constraint.

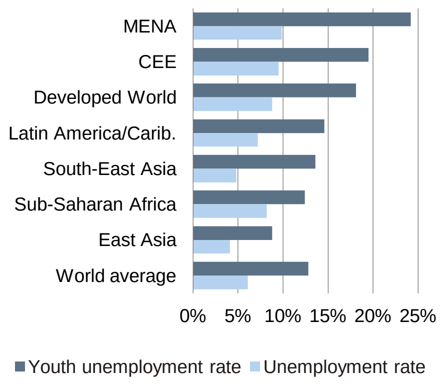
Perhaps more importantly, the public sector accounts for an outsized portion of employment in the Middle East, 9.8% of GDP compared with the global average of 5.4% (see chart 12).[11] Taking only non-agricultural employment, in 2010 public employment constituted 42% of total employment in Jordan and 70% in Egypt.[12] On average, public-sector salaries accounted for 35.5% of government expenses in 2009 for regional governments.[13]

In addition to crowding out the private sector, this system has created an environment in which young job-seekers find working in the public sector more desirable. The 2003 Syrian Unemployment Survey indicated that 80% of young unemployed persons found a public-sector job preferable to a private-sector position.[14]

The large public sector has also bred a lack of economic dynamism in the region, further setting back employment gains. A World Bank study from 2010 found that the MENA region has some of the lowest firm entry density rates in the world, suggesting a lack of entrepreneurship, with a rate almost four times lower than that of Europe and Central Asia (see chart 13).[15] According to the World Bank's 2013 Doing Business report, investors in the MENA region have to deal with insufficient protection of investor and property rights. The survey also finds that business managers are particulary concerned about corruption, anticompetitiveness and uncertainty regarding regulation. With an average "Ease of Doing Business ranking" of 98 (see chart 14),[16] the MENA region as a

Youth unemployment highest in the world 11

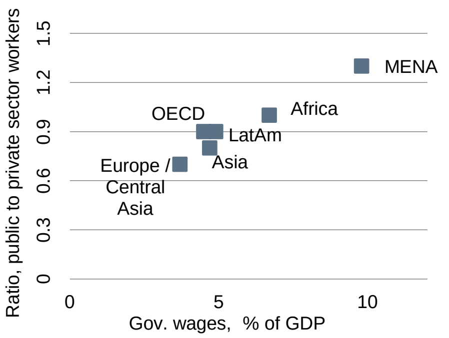
Total and youth unemployment by regions, 2010




Sources: ILO, DB Research

MENA's bloated central governments 12

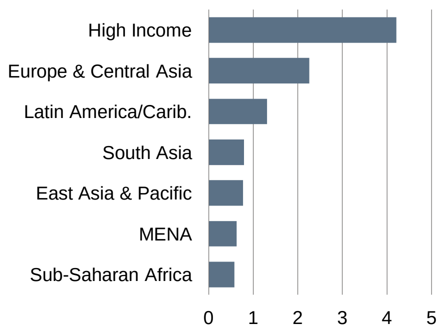
Central government wage bill by region, 1990s




Sources: World Bank, DB Research

Region lags in firm entry rates 13

Firm entry density by region, 2004-2009 avg.

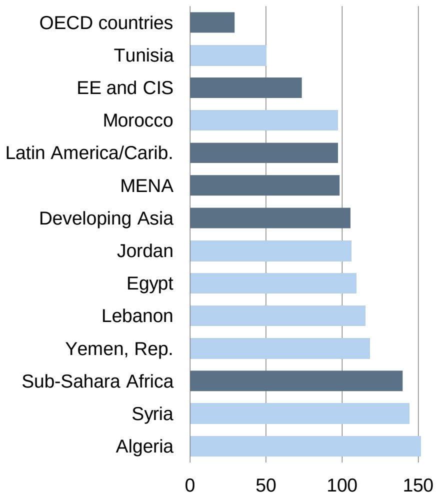



Sources: World Bank, DB Research

8 International Labour Organization (2012).
9 Ahmed et al. (2012).
10 Legatum Institute, Carnegie Endowment for International Peace and Atlantic Council (2011).
11 Bteddini and Heidenhof (2012).
12 Ahmed et al. (2012).
13 World Bank Indicator "Compensation of employees (% of expense)".
14 Kabbani and Al-Habash (2008).
15 Klapper and Love (2010).
16 The World Bank Ease of Doing Business Index ranks 185 countries, where a high ranking means the regulatory environment is more business friendly regarding start-up and operation of a local firm.

Shortcomings in the business environment 14

Ease of Doing Business Ranking (1-185)




Sources: World Bank, DB Research

whole finds itself in mid-range internationally. However, apart from Tunisia and Morocco to some extent, most of the Arab Spring countries in this study score relatively poorly. While in the past some governments have put bold efforts into reforming their countries' business environment, the report states that since the beginning of the Arab Spring in 2011 the region's reform process has lost some momentum, hampered by the problems and uncertainties that accompany the political transition processes. The combination of these factors is a formidable obstacle to boosting employment in the region.

### What needs to be done?

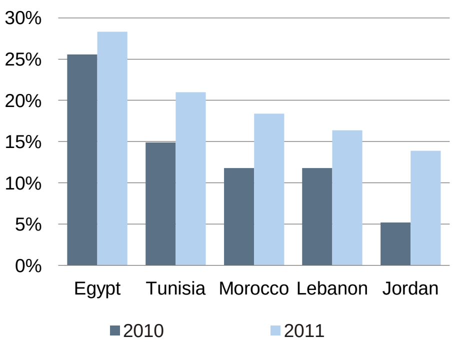
There are numerous avenues through which policy makers can address the employment problem. First, regional governments must transition from being primary employers to creating the right environment for the private sector to provide jobs. Yet in the aftermath of the Arab Spring, several countries have taken the opposite approach, using public-sector employment and expenditure as a way to prop up the economy. The Egyptian government announced a 15% increase in the base wage of all civil servants, while the transitional Tunisian government announced an employment plan that would add 20,000 new jobs in the public sector. Second, improving the business environment can stimulate private-sector growth and increase job opportunities for the population. And third, education systems must be reformed in order to better prepare graduates for the requirements of private-sector positions. Scaling up existing pilot programmes that help train the labour force can offset some of the labour mismatches holding back employment.

## Subsidies: Inefficient and unaffordable

Subsidies, particularly energy subsidies, have long been a core component of welfare regimes for most countries in the MENA region. But in the past few years the combination of rising commodity prices and political instability has pushed subsidy spending in many countries to unsustainable levels. Especially for net energy-importing countries in the region, large subsidy bills take outsized shares of government spending, a main reason for the shrinking fiscal space and growing debt-to-GDP ratios. Moreover, in many cases the main beneficiaries of subsidies are not the poorest segments of the population.

Subsidies increased across the region 15

Subsidy expenditures as % of total expenditure




Sources: National Authorities, DB Research

### Ballooning subsidy bills, uneven success

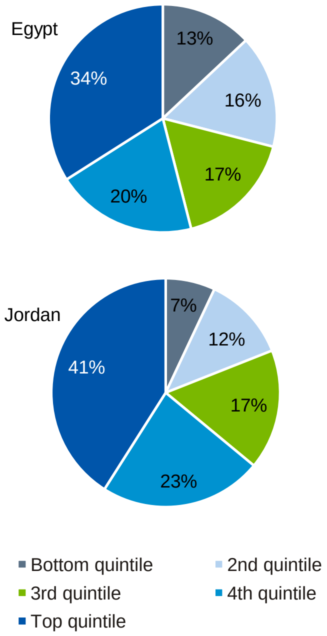
Subsidies were already at high levels before the Arab Spring: Egypt's subsidies equalled 9.3% of GDP, Algeria's 6.6%.[17] In response to the Arab Spring, subsidy bills ballooned (see chart 15): Morocco saw total subsidy expenditure increase from 3.6% to 6.1% of GDP from 2010 to 2011. Jordan saw a nearly 200% increase in subsidy expenditure in 2011, Lebanon 46% and Tunisia 68%. In Egypt, subsidies absorbed 42.8% of annual revenues in 2011, and accounted for almost 10.4% of GDP.[18]

Despite their large size, subsidies have done little to address their stated goals, and have numerous unintended consequences for affected countries. Several studies have shown that the beneficiaries of energy subsidies are overwhelmingly found in the top income quintile of the population, especially in non-rural areas. In Jordan and Morocco, the bottom quintile benefits from less than 10% of subsidies (see chart 16).[19] In addition, subsidies have led to high

[17] United Nations Development Programme (2012).
[18] National Authorities; IEA.
[19] International Monetary Fund (2012b).

Subsidies do not benefit the needy 16

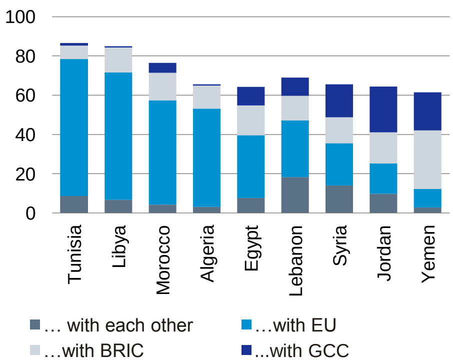
Incidence of energy subsidies per income quintile




Sources: IMF, DB Research

Trade tilted towards EU 17

% of trade (2010)




Sources: DG Trade, IMF DOTS, DB Reasearch

energy use rates, in both oil-exporting and oil-importing countries. Over the past two decades, energy intensity has declined in all regions of the world with the exception of MENA. This reflects that energy subsidies have led to a concentration of industrial activity in energy-intensive industries, as well as low rates of energy efficiency in both transportation and private consumption.[20]

### Subsidy reform: A necessary but difficult move

In late 2012, regional governments started to take some steps to address growing subsidies. Egypt cancelled subsidies of highest quality (octane) petrol and outlined further steps such as lifting subsidies on heavy industries, and a pilot programme for distributing subsidised energy products through coupons and “smart cards”. In Jordan, the government abolished fuel subsidies completely in November 2012, leading to the largest protests in the country since the start of the Arab Spring.

Indeed, the biggest obstacle regional governments face in reforming subsidy regimes is the potential for political instability as a result of such reform. International organisations have stressed the need for methodical reform, with each step clearly articulated and explained to the public in order to avoid potential unrest. Regional governments face a trust deficit vis-à-vis their populations, and this must be addressed for the effective reform of subsidy programmes.

There are numerous potential paths for regional governments looking to reform subsidy regimes. The switch from blanket subsidies to targeted regimes through coupons or direct cash transfers helps alleviate the effects on low-income segments of the population, while reducing the levels of overall subsidy spending. Incremental reductions of subsidies on heavy industries can help mitigate the potential for sectoral damage. The fiscal space made by reforming subsidies can be used to spur economic growth in more dynamic sectors.

## Strengthening economic ties within the region and with other emerging markets

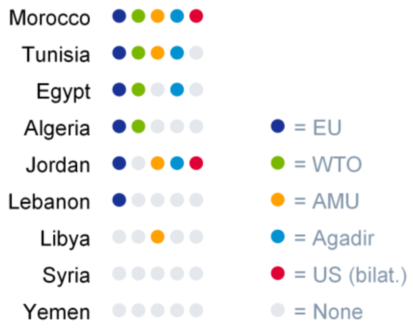
### Trade relations are heavily tilted towards the EU

Trade relations in North Africa and the Levant have historically been heavily tilted towards Europe. The EU is the most important trading partner for all countries covered in this study (see chart 17), except Jordan, which trades slightly more with Saudi Arabia, and Yemen with a great share of trade with developing Asian economies (over 56% of exports go to China and India alone). All countries except Yemen and Syria take part in the EU’s Neighbourhood Policy and are more specifically targeted by the Euro-Mediterranean Partnership through Association Agreements (except Libya). Ties to the EU range from trade to foreign direct investment, migrant remittances and tourist flows. While close links to a highly developed region are positive in general, and in this case also natural given the geographical proximity, they also expose countries to spill-overs from negative developments, such as the current crisis in the eurozone. A diversification of trade relations, including an expansion of intra-regional trade, would thus be welcome, also in light of the subdued growth prospects for Europe in the medium run.

[20] United Nations Development Programme (2012).

## Enhancing intra-regional trade

Trade agreements in the region 18



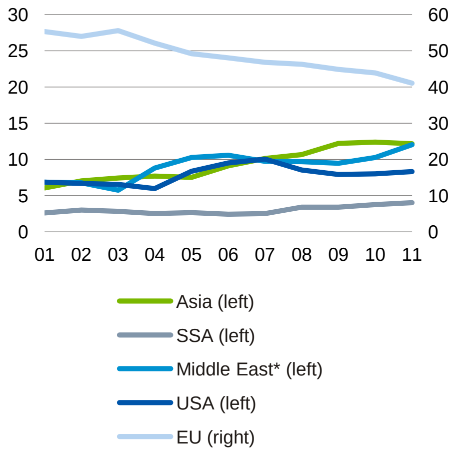

Sources: db InfoCenter, DB Research

Intra-regional trade currently makes up only around 3% of the region's total trade. Trade barriers between the countries are among the highest in the world (if only non-tariff barriers are considered, they are the highest).[21] Logistical bottlenecks such as high transport and communication costs, an underdeveloped transport infrastructure and inefficient trade procedures hamper trade in general but especially intra-regional trade.

Regional trade agreements exist (see chart 18), but most of them have had limited impact and lack political momentum. All countries have agreed to establish a Greater Arab Free Trade Area (GAFTA) under the leadership of the Arab League. Egypt, Jordan, Morocco and Tunisia went a step further and signed the so-called Agadir Agreement in 2004. Another cooperation framework, the Arab Maghreb Union (AMU) made up of Algeria, Libya, Morocco and Tunisia, has stalled since its creation due to political tensions between the members, for instance between Morocco and Algeria. The border between these two countries has been effectively closed for the last 16 years. AMU might be revived by the new political leaders, as hinted by a meeting of the members' foreign ministers in February 2012. Jordan and Morocco were invited to join the GCC in May 2011. The accession process is still open, with Jordan having finalised an Action Plan in November 2012, and both countries receive economic support packages from the GCC.

Increasing trade ties with EMs 19

Share in total trade, %




*excludes intra-regional trade

Sources: IMF DOTS, DB Research

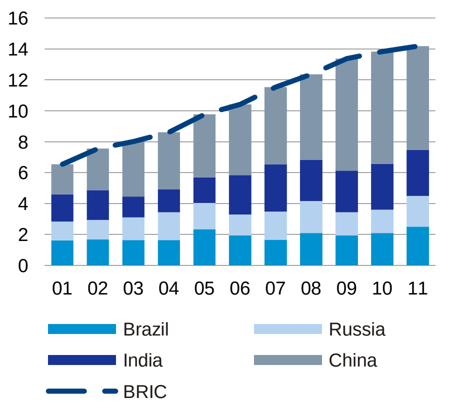
Unlocking intra-regional trade and investment can bring substantial benefits to the region. Estimates put the annual economic cost incurred by the lack of integration at around 2% to 3% of GDP.[22] Potential gains could also be had by liberalising trade in services such as finance, communication and logistics. Further benefits could come by enhancing labour mobility between labour-abundant and resource-rich countries. And finally, the greater region is in a globally competitive position to provide solar energy. Co-operating on trans-border power infrastructure might be a starting point for successful economic integration.[23]

## Establishing closer ties to other emerging markets

Exports from North Africa and the Levant could be stimulated by establishing closer ties with fast-growing emerging markets. Actually, over the last decade the importance of emerging markets for the region's exports already started to increase. The trade share with the Middle East countries increased from about 7% to 12% over the last decade and with Asia it doubled from 6% to 12% (see chart 19).

BRICs trade with the region on the rise 20

Share in total trade, %




Note: Combined trade shares of DZA, EGY, JOR, LBN, LBY, MAR, SYR, TUN, YEM

Sources: IMF DOTS, DB Research

The BRIC countries are becoming more important trading partners (see chart 20). China and India have an interest in the natural resources of the region, which includes some of the world's top producers of oil (Algeria and Libya), gas (Algeria and Egypt) and phosphates (Morocco and Tunisia). China is also a source of some commodity imports for the region, such as water-intensive foodstuffs, while Russia is a key supplier of wheat to Egypt, covering 50% of Egypt's demand (Egypt is the world's largest wheat importer). Overall, the BRICs are key suppliers of manufactures to the region. For example, Tunisia is now the largest market for Brazilian cars in the Arab world.

Not only trade but also investment ties with the BRICs have strengthened. China has secured 80% of infrastructure contracts in Algeria in recent years. As a result, Algeria hosts today the biggest Chinese diaspora in northern Africa, of

[21] African Development Bank (2012).
[22] Santi et al. (2012).
[23] World Bank (2010).

about 35,000 people. China was also the largest foreign investor in Egypt in 2009, with investments totalling more than USD 500 m. India is active in Egypt, too, with investments in the services and assembly industry sectors. Russia and Brazil have engaged in oil extraction and upstream investment. Russia's Gazprom has signed a memorandum of understanding with Sonatrach, the state-owned Algerian oil company, and Brazil's Petrobras has invested in oil-exploration ventures in Libya. High-level official visits, business fora and technology transfer projects are likely to further enhance economic relations.[24]

North Africa and the Levant offer a bridgehead location into Europe, Africa and the Middle East as well as preferential trade agreements with third countries as competitive advantages supplementary to low labour costs. If countries embrace trade and investment liberalisation more forcefully, these advantages will translate into concrete improvements in living standards for the region's population.

Oliver Masetti (+49 69 910-31815, oliver.masetti@db.com)
Kevin Körner (+49 69 910-31718, kevin.koerner@db.com)
Magdalena Forster
Jacob Friedman

[24] Castel et al. (2011).

## References

Ahmed, Masood, Dominique Guillaume & Davide Furceri (2012). Youth Unemployment in the MENA Region: Determinants and Challenges. In: Addressing the 100 Million Youth Challenge – Perspectives on Youth Employment in the Arab World in 2012. World Economic Forum.

African Development Bank Group (2012). Jobs, Justice and the Arab Spring: Inclusive Growth in North Africa.

Bteddini, Lida and Guenter Heidenhof (2012). Governance and Public Sector Employment in the Middle East and North Africa. Voices and Views. World Bank. (http://menablog.worldbank.org/governance-and-public-sector-employment-middle-east-and-north-africa)

Castel, Vincent, Paula Ximena Mejia & Jacob Kolster (2011). The BRICs in North Africa: Changing the Name of the Game? North Africa Quarterly Analytical. First Annual Quarter 2011. African Development Bank Group.

Deutsche Welle (2012). Syria's Assad watches war chest dwindle. EIU Country Risk Service.

El Fegiery (2012). A Tyranny of the Majority? Islamists' Ambivalence about Human Rights. FRIDE Working Paper 113.

International Labour Office (2012). Global Employment Trends 2012.

International Monetary Fund (2011). Regional Economic Outlook: Middle East and Central Asia. October 2011.

International Monetary Fund (2012a). Regional Economic Outlook Update: Middle East and North Africa: Historic Transitions under Strain. April 2012.

International Monetary Fund (2012b). Regional Economic Outlook: Middle East and Central Asia. Presentation. November 2012.

Kabbani, Nader and Leen Al-Habash (2008). Raising Awareness of Alternatives to Public Sector Employment among Syrian Youth. Working Paper No. 387. Economic Research Institute.

Klapper, Leora and Inessa Love (2010). New Firm Creation: What has been the effect of the financial crisis? Viewpoint September 2010. World Bank Group.

Legatum Institute, Carnegie Endowment for International Peace and Atlantic Council (2011). Egypt's Democratic Transition: Five Important Myths about the Economy and International Assistance.

Santi, Emanuele, Saoussen Ben Romdhane and William Shaw (2012). Unlocking North Africa's Potential through Regional Integration: Challenges and Opportunities. African Development Bank Group.

United Nations Development Programme (2012). Energy Subsidies in the Arab World. Arab Human Development Report Research Paper Series.

World Bank (2010). Economic Integration in the Maghreb.

World Bank and International Finance Corporation (2012). Doing Business 2013: Smarter Regulations for Small and Medium-Size Enterprises.

# Emerging Markets publications



Our publications can be accessed, free of charge, on our website www.dbresearch.com
You can also register there to receive our publications regularly by E-mail.

Ordering address for the print version:
Deutsche Bank Research
Marketing
60262 Frankfurt am Main
Fax: +49 69 910-31877
E-Mail: marketing.dbr@db.com

Available faster by E-mail:
marketing.dbr@db.com

© Copyright 2013. Deutsche Bank AG, DB Research, 60262 Frankfurt am Main, Germany. All rights reserved. When quoting please cite "Deutsche Bank Research".
The above information does not constitute the provision of investment, legal or tax advice. Any views expressed reflect the current views of the author, which do not necessarily correspond to the opinions of Deutsche Bank AG or its affiliates. Opinions expressed may change without notice. Opinions expressed may differ from views set out in other documents, including research, published by Deutsche Bank. The above information is provided for informational purposes only and without any obligation, whether contractual or otherwise. No warranty or representation is made as to the correctness, completeness and accuracy of the information given or the assessments made.
In Germany this information is approved and/or communicated by Deutsche Bank AG Frankfurt, authorised by Bundesanstalt für Finanzdienst-leistungsaufsicht. In the United Kingdom this information is approved and/or communicated by Deutsche Bank AG London, a member of the London Stock Exchange regulated by the Financial Services Authority for the conduct of investment business in the UK. This information is distributed in Hong Kong by Deutsche Bank AG, Hong Kong Branch, in Korea by Deutsche Securities Korea Co. and in Singapore by Deutsche Bank AG, Singapore Branch. In Japan this information is approved and/or distributed by Deutsche Securities Limited, Tokyo Branch. In Australia, retail clients should obtain a copy of a Product Disclosure Statement (PDS) relating to any financial product referred to in this report and consider the PDS before making any decision about whether to acquire the product.
Printed by: HST Offsetdruck Schadt & Tetzlaff GbR, Dieburg

Print: ISSN 1612-314X / Internet/E-mail: ISSN 1612-3158