HUMBOLDT-UNIVERSITÄT ZU BERLIN

# Perspectives on Economic Integration between the EU and North Africa: Investments, Reforms, Partnership

# Wirtschaftliche Integrationsperspektiven von EU und Nordafrika: Investitionen, Reformen, Partnerschaft

Im Auftrag des Bundesministeriums für wirtschaftliche Zusammenarbeit und Entwicklung (BMZ)

Forschungsstudie des Instituts für Wirtschaftsgeschichte der Humboldt-Universität zu Berlin

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## Acronyms and Abbreviations

| | |
|---|---|
| AMU | Arab Maghreb Union |
| ASEAN | Association of South East Asian Nations |
| BFTA | Baltic Free Trade Agreement |
| BIT | Bilateral Investment Treaty |
| BMZ | Ministry for Economic Cooperation and Development |
| CAP | Common Agriculture Policy |
| CEEC | Central and Eastern European Countries |
| CEFTA | Central European Free Trade Agreement |
| COMESA | Common Market for Eastern and Southern Africa |
| DCFTA | Deep Comprehensive Free Trade Agreement |
| ECJ | European Court of Justice |
| EEAS | European External Action Service |
| EMU | European Monetary Union |
| ENP | European Neighborhood Policy |
| ESCAP | Economic and Social Commission for Asia and the Pacific |
| EU | European Union |
| FDI | Foreign Direct Investment |
| GAFTA | Greater Arab Free Trade Agreement |
| GCC | Gulf Cooperation Council |
| GCI | Global Competitiveness Index |
| GDP | Gross Domestic Product |
| GIMAS | Moroccan Aerospace Industries Association |
| GNI | Gross National Income |
| GTAI | Germany Trade and Invest Agency |
| GTMO | Group of Ministers of Transport of the Western Mediterranean |
| GVC | Global Value Chains |
| ICRG | International Country Risk Guide |
| IMF | International Monetary Fund |
| LPI | Logistics Performance Index |
| LSC | Liner Shipping Connectivity Index |
| MENA | Middle East and North Africa |
| MNE | Multinational Enterprise |
| NOC | National Oil Corporation |
| NTB | Non-Tariff Barriers |

| | |
|---|---|
| ODA | Official Development Assistance |
| OECD | Organisation for Economic Co-operation and Development |
| OEMs | Original Equipment Manufacturers |
| OPEC | Organization of Petroleum Exporting Countries |
| PAI | Industrial Acceleration Plan |
| PNEI | National Pact for Industrial Emergence |
| PTA | Preferential Trade Agreement |
| R&D | Research and Development |
| SEZ | Special Economic Zones |
| SME | Small and Medium-Sized Enterprises |
| TI | Transparency International |
| UAE | United Arab Emirates |
| UGTT | Union Générale Tunisienne du Travail |
| VAT | Value-Added Tax |

**Overview**

Six years after the Arab Spring, North Africa has again become a region of intense interest for Europe. To avoid future political uprisings and to find a long-term solution to the migration crisis requires an end to the continuous political and economic turmoil in the Maghreb countries and neighboring Egypt. Economically, the region's high youth unemployment and failure to achieve sustainable and inclusive economic growth are the foremost obstacles, since the old economic model prevalent in the region has not been able to generate the needed high number of quality jobs. This study therefore analyzes the barriers and prospects of the region's economic potential. The key ingredient to develop this potential is extensive and intensive economic integration with the world economy through trade and foreign direct investments (FDI) to enhance productivity and thereby attain inclusive export-led growth. Previous reliance on petroleum exports, public sector employment, and food and energy subsidies should make way for export diversification, open markets, and equal competition in the private sector.

The integration of the Central and Eastern European countries into the European Union serves as a guideline and role model for the future development in North Africa. Aware of the considerable differences between the two regions, the remarkable success of CEEC's integration into the EU's Single Market nonetheless presents a useful upper bound benchmark for comparison. Due to a systematic and progressive integration process, these economies transformed from central planned economies into market economies within 15 years. Starting with bilateral and intra-regional free trade agreements focusing on industrial goods, the integration process continued with a free trade zone, which encompassed trade in services, capital, and labor, and concluded with accession to the European Single Market that removed all remaining (non-tariff) trade barriers. The sequential trade liberalization followed an asymmetrical approach, which provided the new member states with market access to the EU while allowing their firms a transition phase to gain the necessary competiveness. Supported by considerable infrastructure investments and a massive inflow of FDI and EU funds, the region emerged with an export-led growth model that achieved an exceptional growth performance. The interaction between the three drivers of integration - trade, FDI, and infrastructure- created substantial employment effects, which occurred with a time delay caused by the comprehensive transformation of the economies. In addition, the objective of joining the European Union has functioned as a strong motivation for domestic

reforms and structural adjustments, which raised the quality of institutions and thereby the growth performance.

The largest difference to the European integration and obstacle to an economic awakening of North Africa is the political instability and security challenges in the region. With a fragile democracy in Tunisia, a political stalemate and no central government in Libya, and tense political situations in the other countries, the primary task is political stabilization in a difficult regional environment. Only with this precondition can the countries effectively implement reforms and realize their full economic potential.

The demographic challenges in the regions are also immense, since the migratory pressure from Sub-Sahara Africa and other developing countries towards North Africa is increasing and has turned Libya into a migration hub to Europe. The other countries in the region are also primarily destination and transit countries, although with much lower numbers. Yet, these numbers will most likely grow due to the mobility transition, a relationship between migration and development that causes an additional out-migration until the country achieves an advanced level of development. Any development and migration policy therefore needs to integrate the phenomenon of mobility transition.

With high youth unemployment as the most urgent social-economic issue in the region, a closer look shows specifics problems. First off, the high youth unemployment rate of above 20% conceals a gender gap, with female unemployment double or triple the rate of male youth. Similarly, a structural mismatch exists between the training or education offered and the skills in demand, resulting in highly educated graduates being disproportionately unemployed. Partially responsible is the inflated public sector, whose job benefits incentivize graduates to wait voluntarily for job openings instead of seeking employment in the private sector. Moreover, a large informal labor market exist due to the lack of quality jobs in the formal sector.

Certainly, the weak job creation of the private sector is also a result of the overall disappointing economic growth performance of the last years. The two shocks of the Great Recession and the Arab Spring have significantly lowered the GDP per capita growth rates in most countries, with only Morocco managing to stay above 2% annual growth while Libya's economy collapsed amid its civil war. Yet, the outlook for 2017 is cautiously optimistic, since the gradual economic recovery in Europe, its main trading partner, will drive export growth

from North Africa. Also as its main source of investments, tourists, and remittances as well, Europe's economic path will affect North Africa's development crucially. Besides political unrest and trade relations to Europe, country specific factors merit consideration as well. Especially the oil price has a diametrically opposite effect on the respective economies, determining much of the future economic path for both petroleum-exporting and -importing countries. The important tourism sector has suffered from increased geopolitical risks and terrorism since the Arab Spring, reducing export earnings and the number of visitors in Egypt and Tunisia significantly. While the tourism industry offers mostly low-skilled jobs, their share of overall employment is large and the industry generates much-needed hard currency from Western tourists.

With an economic outlook that is confounded with high uncertainty, the urgency to realize the growth potential of North Africa through integration with the global economy only grows. A key issue here are the high trade costs both between Maghreb countries and their main trading partners in the EU as well as within the Maghreb. Especially the intra-regional lack of integration stands out, with trade costs within the Maghreb often twice the costs of trading with Europe. Besides geographical distance, a country's performance in the logistics sector and its connection to global shipping networks are the main determinants of trade costs. For both indicators, the North African countries lag far behind developed economies in Europe, reflecting their shortcomings in transport infrastructure.

The transition from "shallow" to "deeper" trade integration requires preferential trade agreements on a regional and interregional basis, yet the institutionalization of trade integration in North Africa is progressing slowly. Previous bilateral agreements between the EU and North African countries have often resulted in increased trade deficits for the smaller economies, which together with other negotiations hurdles - such as judicial disputes with Morocco - prolong the implementation of deep trade agreements with the EU. Furthermore, regional agreements have only had modest success in boosting trade integration and have not yet ventured beyond liberalizing manufactures. The lack of export diversification and similar export structures constrain the trade potential and trade gains based on trade complementarities and intra-industry trade. By broadening their narrow export base and lowering high trade barriers, improved regional integration would also directly benefit the integration of North African countries in the world economy. Firms could become part of

regional and global value chains by employing economies of scale, improving competitiveness, and increasing product specialization.

The need for improvement in competitiveness and for attracting foreign firms and their investments becomes evident when comparing the region globally. According to two global indicators, which measure an economy's competitiveness and ease of doing business, only Morocco achieves a mid-table position due to improving its scores since 2010, while all the other countries have deteriorated and now rank in the lower half. Since those rankings have proven to directly reflect the respective investment climate and therefore affect the inflow of FDI, the depressed development of those inflows to North Africa comes as no surprise. With the sole exception of Morocco, all other countries witnessed a sharp decline in inflows from a temporary peak in 2007 due to the double impact of the global financial crisis and the Arab Spring. To attract more inflows again, the region has to improve openness to trade, access to natural resources, and its institutional quality. Since North Africa has a rather low governance performance, foreign investors rely on bilateral investment treaties to protect their investments. Given the enhancing effect of those treaties on FDI, their incomplete coverage in the region displays serious shortcomings, especially for Algeria, Libya and Tunisia.

Equally problematic is the inadequate transport and energy infrastructure in large parts of North Africa, which hinders trade flows and deters investments from abroad. Developing their networks of transport infrastructure, energy, and telecommunications is necessary both to connect to foreign markets and to integrate their own hinterland. The trucking as well as the railroad sector is often overregulated and state-owned, with no competition and insufficient investment. In contrast, the dynamic development of the port system, at least in Morocco and Egypt, which established deep-sea ports with hinterland connections and surrounding industrial zones, shows the virtuous growth cycle that reform policies, FDI, and trade can generate.

By employing a case study to analyze Morocco's exceptional development in the last decade, this virtuous cycle and its drivers offer a detailed insight into the factors that need to come together to transform an economy and create export-led growth and jobs. Two industries emerged that pushed the transition of Morocco – the aerospace and automotive industry. Both industries have exhibited remarkable growth rates due to FDI and in turn generated many quality jobs in the export sector. For instance, the automotive industry has prospered

due to Renault's large investments of a new assembly plant in Tangier and the whole industry has become the second largest in Africa. It now leads Morocco's exports with 30% of total exports, thereby overtaking the country's traditional export sectors of phosphates and agriculture, and the aerospace industry has become the fourth largest exporter. Foreign companies were attracted to the country because the Moroccan government invested heavily in the country's infrastructure, by upgrading existing port facilities and extending highways as well as railway-networks to connect the nascent industry clusters to airports and ports. One outstanding project, the Tanger-Med port – an important hub for trans-shipment in the Mediterranean and the Atlantic – was launched in the early 2000s and is scheduled to become one of the 20 busiest ports globally by 2018.

These positive developments resulted from an effective investment promotion, special economic zones, and structural reforms, which boosted the country's competitiveness and attractiveness beyond its natural competitive advantage of low wages and beneficial geographical location. The received FDI fostered large-scale job growth as well as an upgrading of the economy's exports, thereby increasing manufacturing activities and supporting a transition away from the reliance on natural resources. The creation of special economic zones drives this process significantly, since they provide investors with fiscal incentives and an attractive investment climate, locally concentrate economic activity and allow domestic firms to take advantage of agglomeration facilities. The promotion of industry clusters with the decisive support of a few anchor tenant multinationals attracted foreign high technology suppliers to locate in Morocco, turning it into a role model for the region.

With its strategic favorable position between the EU, the largest common market in the world, and Sub-Sahara Africa, the fastest growing region in the world, North Africa's economic potential is enormous. Detailing the exceptional development in Morocco and considering the successful European integration offer valuable lessons on how to realize this potential. The predominant imperative is the economic integration of the region in the global economy through enhanced trade and FDI supported by massive infrastructure upgrading. In doing so, North Africa will be able to set its old economic model aside and transition into a new economic model that supplies inclusive economic growth and substantial job creation.

An essential precondition is security and political stability in the region, which would provide the framework to start a reform process whose main priorities we consider to be:

- Establishing the common goal of an integrated Maghreb market. North Africa's main trading partner, the EU, needs to re-vitalize its negotiations with the Maghreb region on deep trade agreements and seek an effective and swift implementation. The region itself has to push for intra-regional liberalization that includes services, labor, and agriculture. It also needs to remove remaining non-tariff trade barriers such as custom's red tape, which impedes trade and discourages investments.
- Establishing the long-term goal of a common market with the EU. Similar to the EU enlargement, a positive narrative in North Africa based on a mutual goal for both sides of the Mediterranean could serve as a driving force for integration that pushes aside political hurdles to economic reforms.
- Improving the investment climate to attract more inflows from multinationals. Key steps are removing legal barriers to FDI, expanding the coverage of bilateral investment treaties, supporting investment promotion agencies, updating of investment charters, and improving governance performance.
- Attracting more foreign investments from the diaspora by improving communication with potential diaspora investors in the main destination countries but also in smaller communities to diversify funds and access additional capital. Remove barriers to investment similar to other foreign companies, yet offer also more structured support, especially regarding access to bank and financial networks.
- Modernizing the transport and energy infrastructure, by extending seaport facilities and decentralizing their administrations, privatizing and deregulating the other transport sectors, and promoting large-scale solar energy projects. To insure secure, reliable electricity supply 24 hours a day, investments in the power grids are also necessary.
- Integrating export-processing free zones with these transportation hubs that foster clustering of labor-intensive industries. Connecting these zones with the Hinterland and domestic industries to enable economy-wide growth effects. Incorporating of specific training centers to guarantee sufficiently educated labor forces.
- Leveraging the large flow of remittances and diaspora savings to finance these reforms and development policies. For instance, issuing regional diaspora bonds,

which invest in regional infrastructure projects and receive support from a regional central bank or the European Bank for Reconstruction and Development.

If the process of economic liberalization in trade and investments is accompanied by domestic policy reforms, the economies of North Africa will benefit from regional and global integration, increased competition, and open markets. Trade, FDI and infrastructure investments will drive the structural transformation and industrialization towards an export-led growth model, thereby generating employment and fulfilling the potential of North Africa. In the short run, the most promising ventures to accelerate job growth are the steps that would improve the investment climate such as signing and enforcing BITs, removing legal barriers to FDI, and providing the promotion agencies with the necessary tools to attract investments from abroad. The resulting increased inflows could provide a form of pressure to remove remaining investment hurdles and modernize the transport and energy infrastructure. In the case of the non-oil exporters, enhanced security measures to signal trustworthiness towards the tourism industry in developed countries would also raise the potential for a recovery in the local tourism industries. The expected signing of an Open Skies agreement between Tunisia and Europe in 2017 should also stimulate the depressed tourism sector in the country. Yet, as the example of the CEEC and the case of study of Morocco show, transforming an economy takes years of focused reform efforts, massive financial funds, and dedicated support by the government. The other suggested reform proposals of trade integration and infrastructure upgrading require therefore a longer commitment, yet the dormant economic potential of the region justifies a renewed determination towards a North African awakening.

## 1. Introduction

North Africa is the binding link between the continents of Africa and Europe. Over the last years, this link has come under severe strain and pressure. From a European perspective, the growing migration crisis across the Mediterranean has shifted considerable attention towards the region. With the European Union (EU) realizing that migration flows will only recede once the region's current dismal economic and political situation improves significantly, it has acknowledged North Africa's important role for a long-term solution of the crisis. From an African perspective, the region has been stricken twice; not only did North Africa suffer the external shock of the European Debt Crisis in the form of faltering demand by its most important trading partner, the EU; it also experienced the internal shock of the Arab Spring revolts which originated in its midst in Tunisia in 2010. Six years later, the region is still in need of higher political stability and stronger economic growth. Both of these objectives are achievable with a deeper economic integration across the Mediterranean, which would be beneficial for both, North Africa and the EU.

More integration could awaken the significant potential for economic growth and job creation in North Africa, a region that suffers from limited integration in the world economy, in turn causing low growth rates and high unemployment. Yet, North Africa's economic perspective is crucially dependent on the political stability of the region in the present and near future. The events of the Arab spring caused a revolution in Tunisia, an overthrow of the Gaddafi regime in Libya, and multiple regime changes in Egypt, with the civil war in Libya still unresolved and together with the Syrian civil war continuing to destabilize the whole region. Given a reduction in these geopolitical risks, an EU initiative to reach the next level of economic integration with North Africa together with a continuous effort by the North African countries for intra-regional integration could bring about an economic growth spurt in North Africa.

A surge in North Africa's economic growth and employment performance could stabilize the region economically and politically, which would not only benefit the region itself. It most likely would also ease the flow of migrants entering the EU since North Africa now serves as the main entry gate into Europe, with Libya as the security loophole. Out of 76 000 immigrants registered by Frontex between September and November 2016 (Frontex 2016), three quarters entered the EU by crossing the Mediterranean Sea from North Africa into Italy.

Most of these migrants originated from Sub-Saharan Africa, emphasizing the rather new role of North Africa as a transit region for migrant workers.

Overall migration pressure from Africa will remain high due to continuing high birth rates in many African countries that will lead to a doubling of the continent's population by 2050. The North African region is already in a later stage of the demographic transition, but nonetheless will experience a 50% increase of its population by 2050 - not counting Sudan, which will double its population over that period (United Nations 2015). While Germany has not been and still is not among the top European migration destinations from North and Sub-Sahara Africa, the pull factors of Germany's continuing strong economy and increasing network effects of migrants living here might change this. The income gap between the EU countries and North Africa will remain large and therefore serve as a powerful migration pull for the near future. Only political stability and a dynamic economy in the Maghreb states could change this. The fight against unemployment is widely regarded as the key socio-economic challenge for the region and the prerequisite to keep the North African youth as well as migrant workers from Sub-Sahara Africa from risking the highly dangerous passage across the Mediterranean Sea. That is why the recent "Marshall Plan with Africa" of the German Ministry for Economic Cooperation and Development (BMZ) singles out the task to create 20 million new jobs in Africa annually as its core objective.

This study shows that a significant potential for economic growth and job creation in North Africa exists and how a deepened integration between North Africa with the regional, European, and global economy could unlock that potential. The EU has already managed to integrate a peripheral and underdeveloped region before, namely the Central and Eastern European Countries (CEEC). Full EU members since 2007, these countries have undergone a remarkable economic transformation and bear witness to the positive forces of economic integration. Based on these experiences of EU enlargement and the status of Mediterranean integration so far, this study discusses the problems and potentials of further integration in North Africa via trade and investment, notably in infrastructure.

It summarizes the current political and economic status quo in the region at the beginning of 2017 and finds that despite the current political turmoil and crisis, some of the North African countries have accomplished creditable reforms in their economies, which created the preconditions to expand trade, increase investment, boost economic growth, and create

employment in the future. Case in point is Morocco, which economically outperformed its neighboring Maghreb countries in the last decade. An in-depth case study sheds light on some of the reasons behind its exceptional development. Nevertheless, the study also analyses the common shortcomings of the North African economies that are still limiting their integration in the world economy, such as trade barriers, insufficient infrastructure, reformable investment climate, low competitiveness and closely related to that an oversized public sector and dwarfed private sector. Especially the deficiencies in the North African infrastructure, which are particularly substantial in transport and energy, hinder potential economic growth.

We draw on empirical Gravity Model to analyze how a scenario of deepened economic integration between the EU and North Africa would affect trade flows between the regions and countries, demonstrating that a reduction of trade costs through further trade liberalization and facilitation would provide a decisive boost to the economies of North Africa.

Finally, the study discusses possible institutional changes, trade agreements, investment initiatives, infrastructure projects, and reform activities that could generate more exports and investments, pushing North Africa on the next level of economic integration with the world economy to realize its economic growth potential. In turn, consistent high growth rates could bring about the much-needed strong employment effects, which would remedy the most pressing challenge of high unemployment in the Maghreb region.

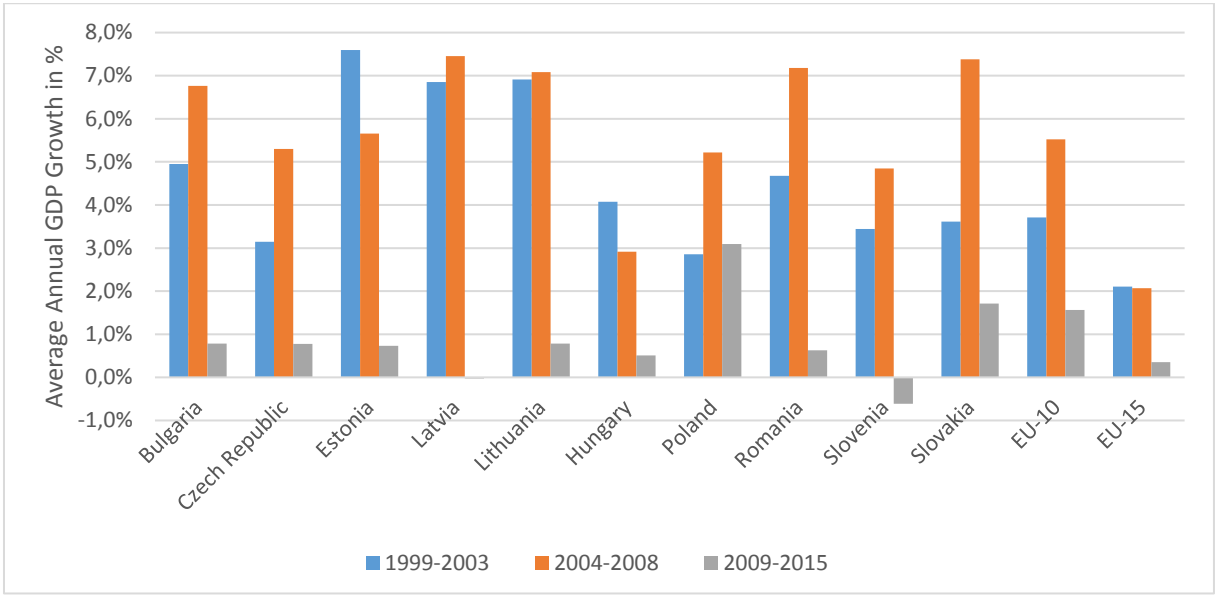
## 2. The EU Eastward Enlargement – an Object Lesson in Economic Integration

### 2.1. Trade Liberalization and Integration

In less than two decades, the formerly centrally planned CEEC became functioning market economies and full members of the EU. Their success story rests on a progressive integration process that started years before actual EU membership and culminated in accession to the EU in 2004 (and 2007 for Bulgaria and Romania). The integration process began with the creation of two free trade zones within the CEEC, seen as a first stepping-stone towards integration with the EU Single Market. In 1993, the Central European Free Trade Agreement (CEFTA) came into effect with the (former) Czechoslovakia, Hungary and Poland, followed by the Baltic Free Trade Agreement (BFTA) consisting of Estonia, Latvia, and Lithuania one

year later. The establishment of both FTAs liberalized trade on an intra-regional level and was initially limited to industrial goods. Parallel, the EU signed bilateral trade agreements ("Association Agreements)" with each respective CEEC, providing them with facilitated access to the Single Market through tariff reductions. However, the EU-15 deliberately kept tariffs and other protections in place for "sensitive" industries such as textiles, steel, and coal, fearing the sudden import competition of the CEEC. Similarly, trade in services and agricultural products liberalized only gradually until full EU membership. In addition, non-tariff barriers (NTB) acted as a brake on trade between the EU-15 and CEEC, among them sanitary and phytosanitary standards, quality standards, import licensing, and differing regulatory policies. Notably, trade liberalization followed an asymmetric approach, where imports into the EU became duty-free long before imports into the CEEC, and the EU granted larger tariff reductions as well as higher quotas. The intent of the EU was to improve the competitiveness of products from CEEC prior to full liberalization and allow them time to adjust to EU standards. The gradual integration through the Association Agreements resulted then in a FTA between the EU and the CEEC by 2001, further liberalizing trade in manufactured goods but also services, capital and labor – the latter with strong restrictions. Finally, the EU accessions in 2004 and 2007 marked the complete trade liberalization in all sectors for the new member states.

*Figure 1 Real GDP Growth in EU-10 vs. EU-15*



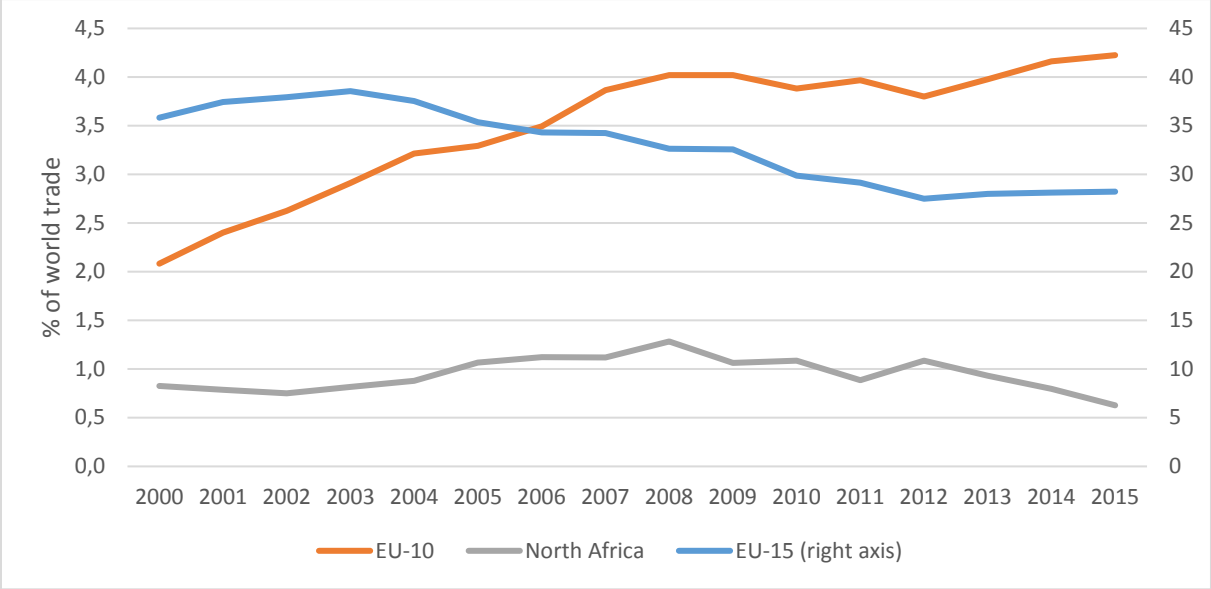

Source: Eurostat
Notes: EU-10 encompasses all CEEC that joined the EU in 2004 and 2007: Estonia, Latvia, Lithuania, Czech Republic, Hungary, Poland, Slovenia, Slovakia, Bulgaria, and Romania.

*Figure 2 Total Trade Growth of New Member States*


Source: Eurostat

The result of the gradual market integration into the EU were unprecedented growth rates before and after EU accession during the "boom" period of the CEEC between 1999 and 2008, which profited greatly from access to the EU Single Market (Jacoby 2014). While the CEEC grew by 3.5% on average in the years immediately before accession (1999-2003), growth increased to 5.5% for 2004-08 (European Commision 2009). Those years of catching-up led to a remarkable income convergence that is reflected in the increase of the gross domestic product (GDP) per capita of the new member states from 40% of the EU-15 average in 1999 to 52% by 2008. This economic expansion was driven by an enormous growth of exports from the CEEC, with exports trade creation of 171% between 1993 and 2000 and only minor effects of trade diversion to other countries (Wilhelmsson 2006). Except for the crisis year 2009, export growth continued for the region without ceasing, resulting in a trade share of 4.2 % of world trade in 2015. While the trade share of the EU-15 has decreased by 10% between 2003 and 2015 (from 38% to 28%), the share of the EU-10 has doubled since the year 2000.

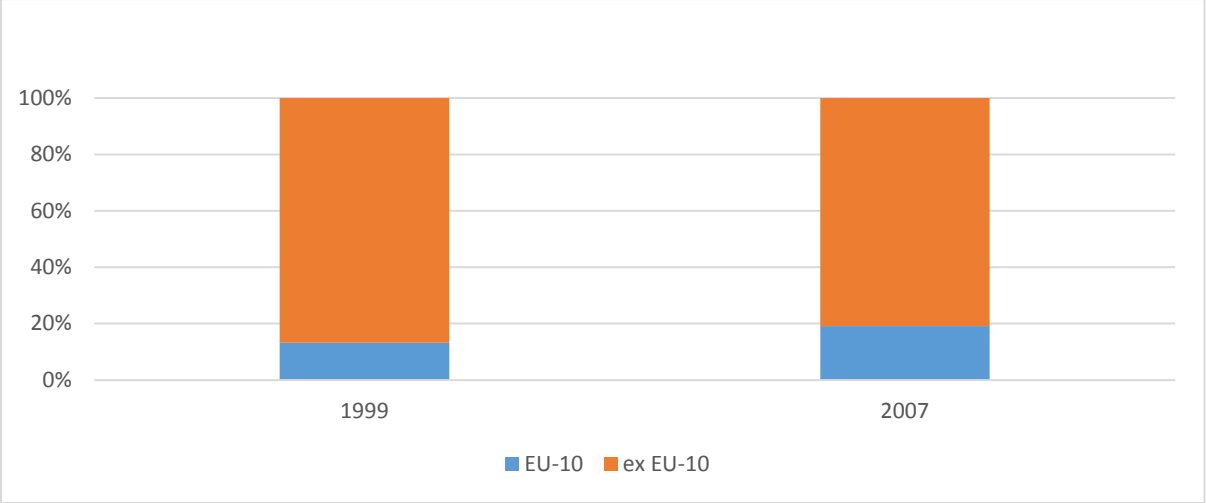
*Figure 3 Trade Share of World Trade*




Source: UNCTAD

The trade openness of both new and old member states increased as well from 47% to 56% and from 34% to 38% respectively (European Commision 2009). As an example of the catching up of the CEEC compared to the stagnation of North African countries, Hungary started out in 2000 which approximately the same trade share as Algeria but has now reached a share in world trade of 0.6%, which equals the combined trade share of the North African countries (UNCTADstat 2016). Most of the dramatic increases of trade occurred between EU-15 and the new member states with especially strong trade linkages between neighboring countries. For the boom period 2000-2008, the exports towards the EU-15 at least doubled for the new member states and even more than tripled in some cases. However, export growth *within* the CEEC has been almost equally impressive, since the intra-regional trade share increased by almost 50% - from 13% to 19% between 1999 and 2007. These numbers represent a strong case of regional integration that took place parallel to the larger integration with the EU.

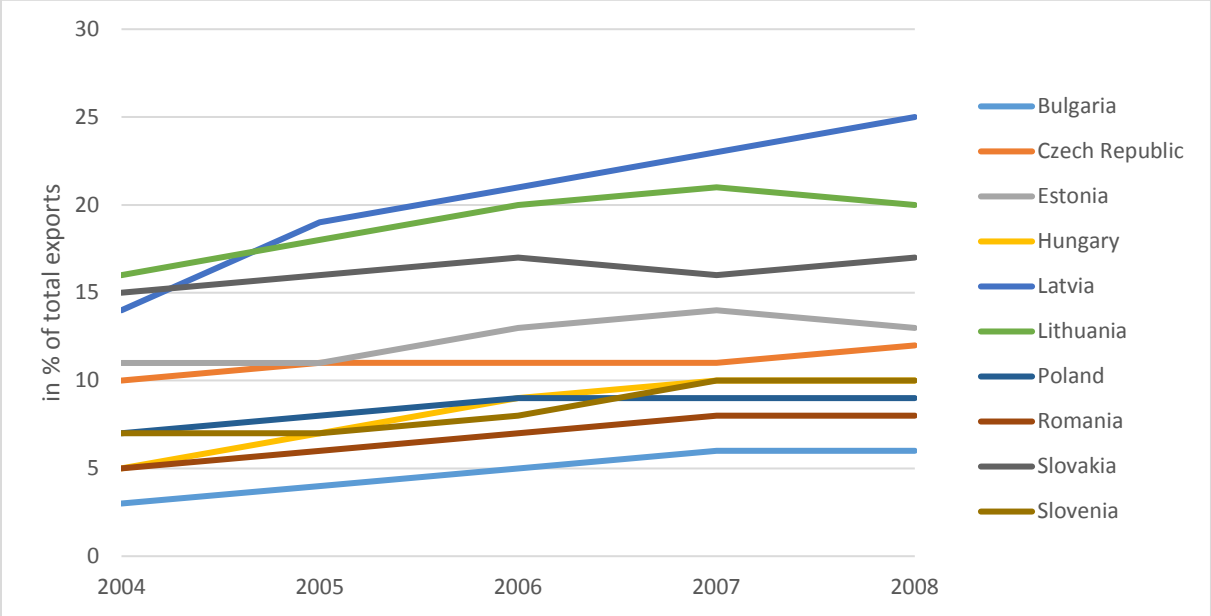
*Figure 4 EU-10 Intra-regional Exports*




Source: UNCTAD

From the start, the FTAs of the CEEC contributed largely to the substantial trade creation; estimates for the years 1994-2002 show the membership in either regional free trade agreement (CEFTA or BFTA) resulted in an additional increase of 16% in annual intra-regional trade. The FTAs therefore counteracted to some extent a further manifestation of the "hub and spokes" system between the EU-15 and EU-10 based on the bilateral EU agreements (Benedictis et al. 2005).

*Figure 5 Intra-Regional Trade: Exports to EU-10 from EU-10*




Source: Baas & Brücker 2011

With EU accession in 2004 (and 2007), trade creation received another boost, especially within the region of the new member states. While conventional trade barriers were largely liberalized beforehand, the entry into the EU strongly reduced the still existing border effects of NTB between countries (Hornok 2010). For Poland, the accession led to an annual 18% of trade enlargement in the first five years (OCEI 2016). One downside of the export oriented growth model in the new member states was the vulnerability to external demand shocks and high dependence on the EU-15. During the EU financial crises starting in 2007/8, which sharply ended the boom period in Central and Eastern Europe, the region experienced a severe contraction of economic activity. Yet, the new member states accomplished to bounce back earlier and stronger from the crisis, avoiding the stagnation period of many Western European economies since then. Poland did not even experience a recession period at all, with only a single quarter of negative growth rates (-0.4% in Q4 of 2008), subsequently making it the country with the highest growth rate in 2009 in all of Europe.

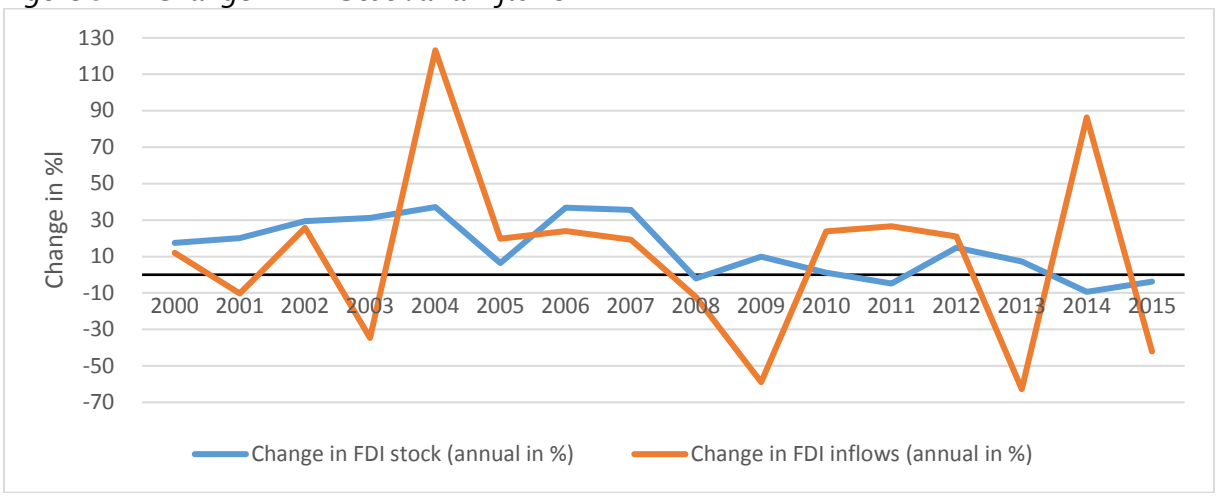
In general, the gradual integration into the Single Market of the EU led to a transformation in the trade and production structures of the new member states (Baas & Brücker 2011). By closing the technological gap between old and new member states, the economic integration process lifted the competitiveness level in the new member states, with the effect especially pronounced for high-tech sectors. Within high-tech sectors, the share of tradable goods is larger compared to low-tech sectors, thus the gain in international competitiveness implied an increase in export competitiveness and hence export flows (Antimiani & Costantini 2013).

### 2.2. FDI and Infrastructure

The other driving force of the CEEC's integration into the European and world markets has been FDI, which followed a similar development to trade. The average annual growth in FDI stock amounted to 22% between 1991 and 2015. By 2009, the level of foreign-controlled enterprises in the new member states has surpassed the equivalent level in the EU-15 for every sector of the economy. This process of FDI growth in Central and Eastern Europe was marked by two periods of especially high FDI inflows into the region. In the first post-communist years, a wave of privatization swept through the region and attracted massive investment inflows from abroad. In the years following the accession of the CEEC into the Single Market, a second wave of high FDI inflows occurred, peaking at $68 million in 2007

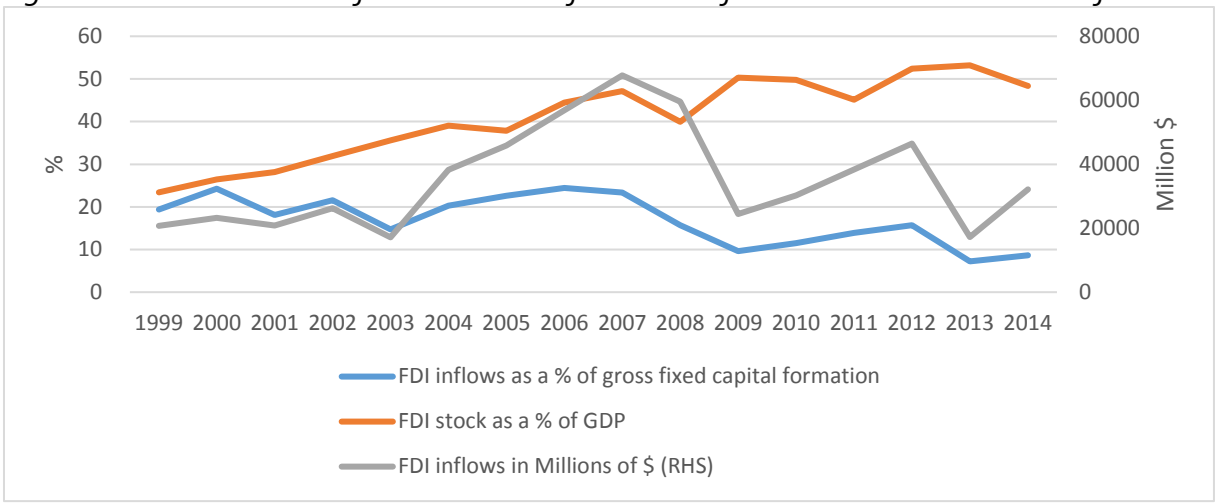
(UNCTAD 2016). However, since 2011, the stock of FDI in the new member states is stagnating due to volatile in- and outflows, reflecting to a large degree the stagnating economic recovery in most of the EU-15 (UNCTAD 2016). Even though the yearly change in FDI stock as well as inflows has not been consistent or even consistently positive, the inflows mostly surpassed the outflows in the EU-10. In terms of FDI stock in percentage of GDP, the new member states surpass with more than 50% almost every other developing region. During these years of built-up in FDI stock, the foreign investment flows -largely from the EU-15- contributed significantly to the overall investment in the emerging CEEC economies. According to official EU estimates, FDI and the corresponding technology transfer led to substantial productivity improvements in the region, which contributed more than 1% of GDP growth during the 2000-2008 period (European Commision 2009).

*Figure 6 Change in FDI Stock and Inflows*




Source: UNCTAD

*Figure 7 FDI stock in % of GDP and FDI inflows in % of investment and in millions of $*




Source: UNCTAD

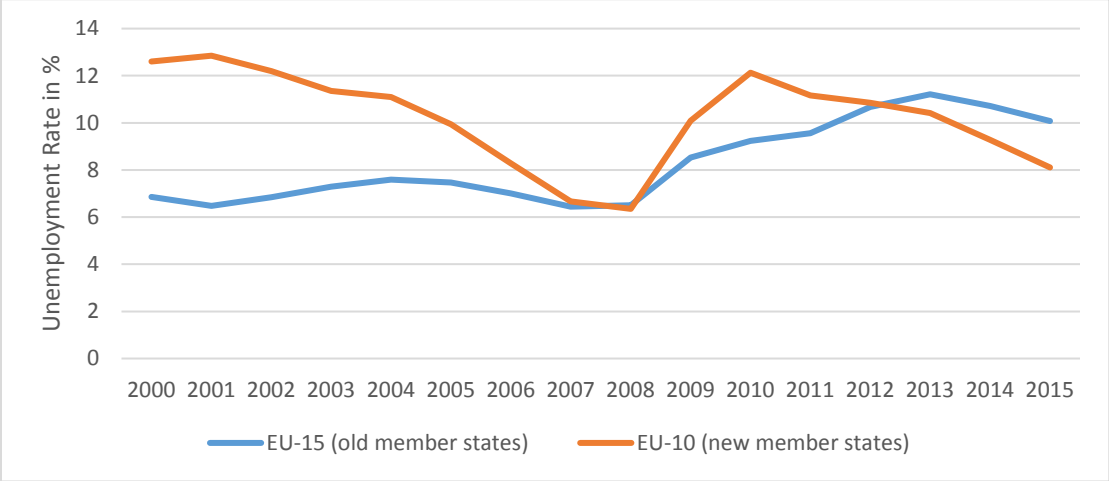
Another key ingredient in the successful market integration and income growth of the region was the extension and upgrading of the infrastructure in the CEEC. An adequate endowment of infrastructure is widely considered to be a necessary condition for the economic development and competitiveness of a region (Bom & Ligthart 2014). Focusing on the EU, the investments in energy and transport infrastructures had a positive impact on economic growth in the long term (Brons et al. 2014). This has also been empirically proven for the new member states, e.g. in the case of Poland (Rutkowski 2009). A growth-enhancing effect of improved infrastructure is also theoretically and empirically established for other developing countries (Calderón & Servén 2014). Even after the EU Eastern Enlargement, the EU allocated 30% of its structural funds purely for infrastructure investments during its 2007-2013 financial framework, acknowledging the crucial contribution of infrastructure for economic integration (Bottasso et al. 2014). Those CEEC that were relatively better equipped with regards to their infrastructure, managed to attract higher FDI inflows than their regional neighbors, emphasizing the significant role of infrastructure endowment as a FDI determinant and showing the interaction between the three drivers of integration (Bellak et al. 2009).

### 2.3. Employment

In contrast to the continuously growing trade and financial flows, the impact of the fast and deep economic integration on the labor market and employment situation in the new member states was not immediately positive. The transition period in the 1990s from communist countries to free-market economies caused a large number of job losses from public sector and state owned enterprises, which the private sector - even though it was rapidly expanding - could not immediately absorb. As a direct consequence of the restructuring process, the economic output experienced first a sharp contraction, and then a prolonged period of jobless growth in the 1990s, with the level of unemployment increasing to around 13% by the turn of the century. However, when most of the corporate restructuring had occurred, the new member states experienced a "reversal of fortune" in their labor markets (European Commision 2009). Even before accession, the CEEC saw a decline in the unemployment rate by almost 2% in 2001-2004 while the rate in the EU-15 actually increased. Starting in 2003, a period of robust growth in employment began, which has continued to the present with only an interruption during the EU financial crisis (Jude et al. 2016). Supported

by strong GDP growth rates, the emerging economies of the new member states created almost 3 million *net* new jobs in the period 2003-2007 alone (European Commision 2009). That the employment growth emerged with a delay was not unique to the region since employment does not follow in lockstep with economic growth. In general, employment starts to grow well after an economy recovered from a recession or accelerates its growth rate. By 2008, the EU-10 had succeeded in lowering their unemployment rate to 6%, even below the EU-15 average and a 50% reduction from its peak in 2000. After the EU financial crisis, unemployment numbers in the new member states increased for a few years, before it fell again below the EU-15 unemployment rate by 2012.

*Figure 8 Unemployment Rate EU-15 vs. EU-10*




Source: Eurostat

### 2.4. EU Structural and Cohesion Funds

The EU Structural and Cohesion Funds played a significant role in the economic development of the region, with the main goal of facilitating convergence of poor regions to the EU average through growth-enhancing investments in infrastructure and human capital. They financed a large part of the modernization of the national infrastructures and trans-European transport networks but also employment measures, as well as education and environmental projects (Becker et al. 2012). In the case of the new member states, empirical evidence shows that the recipient regions did indeed enjoy faster growth because of these transfers (Becker et al. 2012; Rodríguez-Pose & Garcilazo 2015). Especially during the economic downturn between 2007 and 2011, spending expenditure from structural fund transfers partially compensated the sharp drop in private demand, state revenue, and foreign investments. During the recession period alone, over 80 000 jobs have been created in the new member states based

on EU fund transfers (Jacoby 2014). Whether the size of these transfers from EU structural and cohesion funds is seen either as modest or large depends on the relative perspective. Poland, by far the largest beneficiary of EU transfers between 2007 and 2013 as the most populous new member state, had almost €68 billion allocated to it from the EU budget, not including Common Agriculture Policy (CAP) payments.[1] However, remittances from Polish migrant workers to their home country over the same period were almost as large with $60 billion (Jacoby 2014; World Bank 2017a) and FDI flows into the country surpassed both with $87 billion (UNCTAD 2016).[2] On the other hand, the impact of the EU Structural and Cohesion Funds on fostering economic growth appears to be limited for more than a third of the regions receiving transfers. An apparent threshold exits above which additional transfers lose either efficiency or their growth effect disappears completely (Becker et al. 2012), which suggests a conditional institutional capacity for transfers. Directly linked to that aspect is the importance of government quality,[3] which determines the capacity of the local governmental structures to utilize these EU Cohesion funds adequately. The quality of government affects the absorption and implementation of funds and polices, thus moderating its efficiency. Moreover, for those regions that receive the highest per capita cohesion expenditure, i.e. the poorest regions in the EU, the quality of government affects economic growth substantial more than the transferred funds themselves. Since all regions of the new member states rank negatively below the EU average for government quality, their regional institutions determine their growth performance directly, too (Rodríguez-Pose & Garcilazo 2015).

In summary, the Eastern Enlargement of the EU was an exemplarily success story owning to the extensive integration of the CEEC in the European Single Market. It demonstrates that the adopted multi-layered and sequential approach to economic integration benefitted old and new member states alike. Crucially, the EU-15 eliminated trade barriers asymmetrically, which provided the CEEC with the necessary market access to the EU while allowing them a transition phase to gain the necessary capacity to compete with EU firms and products. The

[1] To offer one perspective, Algeria with a similar population size as Poland received a total of $1.8 billion in official development assistance (ODA) during the same period.
[2] As a share of GDP, remittances amount to only 1.4% of Polish GDP in 2015, lower than for any other new member state, yet the highest in absolute terms. Relative shares for the countries range between 1.5% and 5.2% in 2015 (UNCTAD 2016).
[3] Measured by taking into account the rule of law, the control of corruption, government effectiveness, and voice and accountability.

bilateral trade agreements worked because intra-regional agreements supported the emergence of an export-led growth model in the region. In addition, the region profited from trade liberalization that encompassed NTBs as well, decreasing border effects through common standards and regulations as far as possible. Not at least, substantial investment in infrastructure helped the integration process. A beneficial investment climate developed due to privatizations, a clear cost advantages compared to the EU-15, and tax concessions. All these factors together attracted large FDI inflows from abroad, which combined with equally large financial transfers from the EU, enabled further upgrading of the infrastructure and the regional economies in general. Gradually, these foreign companies supplied their labor demand locally and created linkages with the domestic industries. An increased degree of integration led to very substantial employment effects albeit with a time delay due to the extensive transformation of the economies of the CEECs. The economic resilience of the new member states became apparent during the EU financial crisis from which the region recovered relatively quickly.

From a North African perspective, the comparison to the EU enlargement is useful as an upper bound benchmark to showcase what deep economic integration can accomplish. Since the outlook of full EU membership for the CEEC drove the reform and integration process to a large degree, the EU needs a similar strategy with North Africa to establish a long-run partnership based on a common objective. A crucial part of such a strategy has to be a massive expansion of funds by the EU to achieve similar outcomes. Taking into account an institutional capacity for transfers that limited the growth effect of EU funds, the flow of funds toward Central and Eastern Europe nonetheless surpassed capital flows towards North Africa by far and contributed strongly to the employment growth in the region. A positive narrative analogous to the full EU membership for CEEC, which motivated these states to undertake deep and often painful reforms, could mobilize the necessary political and societal support for sustainable change in North Africa. While the two regions of course differ in many aspects, they share the need for an economic transformation from a bygone economic model towards a new one.

## 3. Status Quo of North Africa

### 3.1. Political Status Quo and Outlook

Analyzing the economies of North Africa and discussing the challenges and possible actions to improve their future development remains a futile exercise if the political stability and security risks in the region are not being considered. Any analysis of the region's economic perspective or of individual countries has to take into account the current political situation and possible scenarios that might affect the economic trajectories. Following the outbreak of the Arab Spring in late 2010, three of the five countries in question experienced regime changes, while the other two saw mass protests occurring. Even today (2017), the region faces continual security threats and political stability remains fragile at best. Most of the countries in North Africa are still in a transition phase, with Morocco the most stable, Libya highly unstable and the others in between. A specific look at the problems and prospects of each North African country that have a determining influence on their future growth path is therefore in order.[4]

**Libya:** Once the wealthiest nation on the continent, Libya has turned into a de facto failed state almost six years after the fall of the Gaddafi Regime. With no central government in place, a power struggle for control continues between militias, tribes, two dueling governments, the Islamic State and Field Marshal Haftars, who commands the largest military forces in the country. As of February 2017, the political situation in post-revolutionary Libya remains unresolved with a dire outlook.

The status quo of political stalemate is therefore likely to persist in the next two years. While the Central Bank of Libya attempts to remain neutral in the civil war, focusing on paying subsidies and public salaries regardless of political affiliation, its limited reserves could force it to stop funding altogether. Both rival governments also rely on their own financial resources, needed to fund affiliated militias. Their respective ability to uphold these payments will strongly influence the durability of each government. Since different but financially powerful supporters back both factions[5], and Field Marshal Haftars has been able

[4] This section draws heavily on the country reports of the Economist Intelligence Unit and IMF's country reports (Economist Intelligence Unit 2017e; IMF 2016a).

[5] The GNA (Government of National Accord) enjoys the support of the UN, EU and other Western nations, while the HoR (House of Representatives) and their military ally Field Marshal Haftar receive support from Egypt and the United Arab Emirates (UAE).

to gain Russian backing, the conflict will probably endure into 2018 and beyond. However, if financial constraints arise, social unrest could grow and with it increased pressure on the warring parties to unify the country. The degree to which oil production can be upheld and increased will also affect the future political development; however, production will most likely not be sufficient to return to a positive economic growth path any time soon. The Trump administration could play an unknown but possibly decisive role in the Libyan quagmire, depending on its continuing support of the international recognized government in Tripoli or a possible policy change. The chance of a foreign military intervention by the US remains highly unlikely, yet given the continuing migration crisis, the EU might decide on intervention as the ultimate means to regain control of it.

Its neighboring country **Tunisia**, while being strongly affected by the economic conditions and security threats from Libya, has shown an exceptional development since the outbreak of the Arab Spring in its capital in 2010. As the only country of the Middle East and North Africa (MENA) region where the Arab Spring uprisings resulted in a transition to a constitutional democratic government, Tunisia's role in the region is unique. Since the governing coalition consists of six parties (plus independent members) and encompasses a wide array of ideologies, the chance of a break-up of the current government and new coalition building before the next election in 2019 is relatively high. Yet, any restructuring of the government will most likely take place in the constitutional framework, keeping the infant democracy intact. Its singular position as a functioning democracy in the region will continue to provide the country with political leverage to attract international support to rebuilt its economy and improve its security situation. Especially the EU must have a strong interest to prop up the country financially, thus increasing stability on its Southern border. When Tunisia hosted a large investment conference in late 2016, the EU and other donors pledged almost $ 15 billion in the next five years with the intent to foster economic growth and political stability. At the same time, its Western ties and secular orientation will keep Tunisia in imminent danger of Islamist terrorist attacks. In 2016, Tunisia experienced only one major terrorist incident, which did occur in Ben Guerdane close to the border to Libya and far away from tourism areas. However, the three major terrorist attacks and bombings in 2015 did have a lasting effect on the tourism industry, depressing the number of visiting tourists until now. Another drawback of the broad coalition government is the absence of a focused

economic ideology, which makes the agreement on and implementation of necessary economic reforms rather difficult. Despite these obstacles, the political outlook for Tunisia remains optimistic.

In comparison to its neighboring countries, **Algeria** experienced relatively limited political upheaval during the Arab Spring uprising. Major protest and riots were quickly contained but did force the government to end a 19-year old state of emergency, which ended the protests in January 2012. For now, the political situation in Africa's largest country resembles relative stability. However, the health condition of Algeria's aging President Bouteflika presents a risk to political stability throughout 2017. Re-elected in 2014, and absent a further deterioration in his health, President Bouteflika will most likely decide to stay in office until the end of his term in 2018. His exact health condition and ability to govern remain unclear as well as who might succeed him as president, both factors increasing the risk of political and social confrontations in the near future. Yet so far, the government has managed to successfully buy social peace by offering higher salaries, more housing, or lower food prices to the protesting population (Zoubir 2016). With revenues from oil and gas exports accounting for about 60% of Algeria's GDP and 97% of foreign earnings, the regime accumulated a $200 billion cash reserve in the years of high oil and gas prices. These proceeds not only bought loyalty, they also financed investment projects in infrastructure and housing, with the side effect of creating issues of corruption related to government contracts. After two years of low oil prices, public resources are diminishing and with it the government's ability to uphold the previous level of subsidies and public-sector employment. Despite increasing potential for unrest, the external threats as well as effective security forces and ineffective opposition at home will probably prevent a large-scale political uprising. The Algerian public is also quite aware of the outcomes of their revolting neighbor countries. Libya's ongoing civil war and the conflict in Northern Mail both threaten Algeria's stability externally, which in response has already deployed 75,000 soldiers to these borders, with the main objective to keep militant Islam away. Since more than 60% of its exports have a European destination, a productive relationship with the EU is in Algeria's interest. More complicated is the relation with

neighboring Morocco due to the conflicting stand on the status of Western Sahara, which provides additional geopolitical risks.[6]

**Morocco** is the most stable among the North African countries, even though the political pressure from Arab Spring protests forced King Mohammed VI to introduce political and socio-economic reforms. Nevertheless, the king enjoys extensive political support among the public, which promises a relatively high degree of political stability in the future. However, the premier minister Abdelilah Benkirane has not been able to form a coalition government after three months of talks, abandoning his efforts in January 2017. The most likely cause of the political impasse is a failing agreement between the winning party in the 2016 election – the Islamist Justice and Development Party (PJD) - and close allies of the royal palace. Such an unprecedented political deadlock in parliament could set off a political crisis and force new elections if renewed attempts of coalition forming stay unsuccessful. With twelve parties receiving at least one seat in parliament in the last election, the current crisis also reflects the extreme fragmentation of the political environment in Morocco. If this remains unresolved, it will at least hinder government efficiency and reform efforts. Like other Maghreb countries, the threat of attacks from the Islamic State or other terrorist organizations and the problems arising with returning fighters from the Libyan or Syrian civil war present a continuing security risk to Morocco. Another possible source of crisis is the contested Western Sahara territory, already straining relations with the EU since the European Court of Justice (ECJ) declared that agreements between the EU and Morocco do not apply to the territory of Western Sahara. While the first ruling from the EU General Court declared the bilateral agriculture and fisheries accord between Morocco and the EU invalid in December 2015, the ECJ changed its argumentation one year later, ruling that any EU agreements only applied to the territory of Morocco as internationally recognized. Despite the West Sahara issue, the EU remains Morocco's main trading partner and source for investments and tourists, and the kingdom a key EU partner in the region concerning efforts to stabilize the region. Together with Morocco's role in the current migration crisis as a transit and departure country, political and economic linkages will most likely endure medium-term tensions. Regardless of the

[6] Algeria has recognized Western Sahara as an independent state, while Morocco views the region as part of its territory.

geopolitical risks and domestic political gridlock, Morocco will continue to benefit from a broader degree of political and social stability than most of its North African neighbors.

After a series of regime changes, **Egypt**, for the moment, has achieved a level of political stability that allows the Arab Republic to focus on its economic problems and future development. The current president, Abdel Fattah el Sisi, is expected to run for a second presidential term and thus will face re-election in 2018. Since not only the police and the military forces support him and his government, but also a majority of other state institutions, President el Sisi will most likely win the election and stay in power for the foreseeable future. However, political tensions persist and the majority of the public remains wary of the Egyptian political system, which the parliamentary elections in 2015 reflected with an exceptionally low turnout of 10%. Just like the other North African countries, Egypt faces the insistent threat of terrorism, which has developed into a sporadic but continuous insurgency from Islamist extremist since the regime change in 2013, causing between 100 and 200 casualties every year. The Egyptian government's main adversary is the Islamic State, whose latest terrorist attack on the Christian minority in December 2016 killed 27 people. A different source for potential conflict are the political relations with Ethiopia due to its construction of the Grand Ethiopian Renaissance Dam, whose completion is projected for July 2017.[7] Fearing that the dam will affect the water and electricity supply of downstream nations, the issue of water sharing of the Nile is likely to cause tensions between the countries this year.[8] Egypt has already entered an "era of water poverty" according to its Minister of Irrigation and Water Resources, Hossam Moghazi, and is therefore concerned about any constraints to the flow of the Nile. Members of Egyptian's opposition are planning to challenge a preliminary agreement between Ethiopia, Sudan, and Egypt regarding the dam's impact and possible compensation in the Egyptian courts this year, further exacerbating the issue.

### 3.2. Demographics and Migration

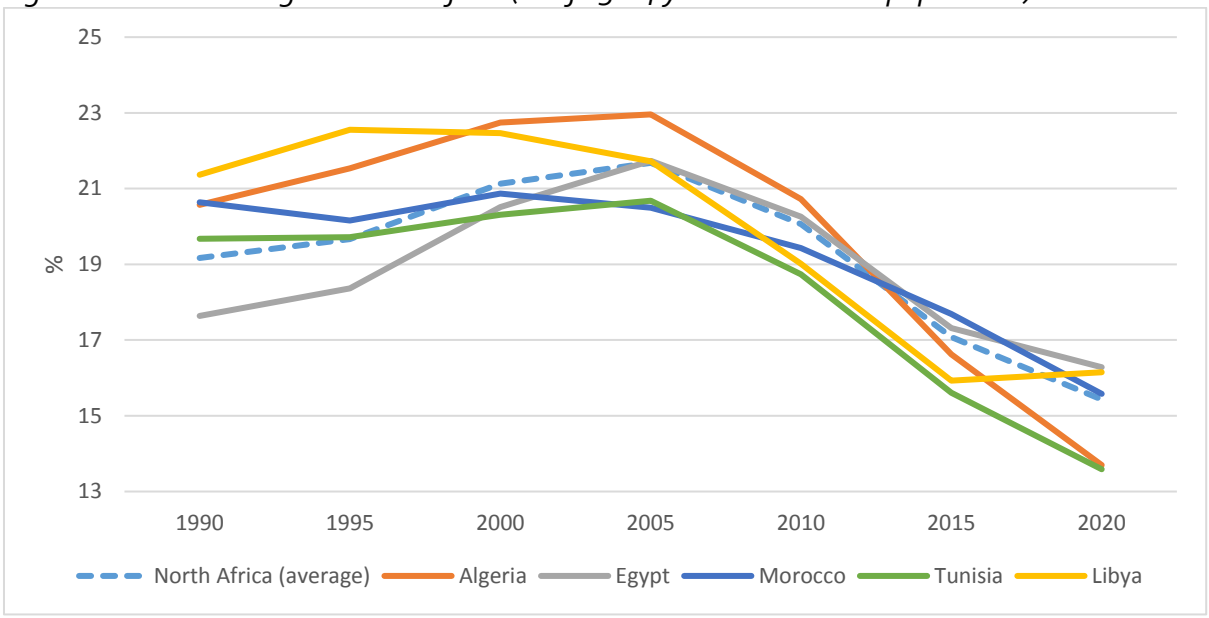
One important element in the outbreak and spread of the Arab Spring in the MENA region has been the so-called "youth bulge", i.e. the high share of young people in the overall

[7] Ethiopia is funding the dam entirely on its own through private donations and a diaspora bond that was launched in 2011.

[8] The Nile generates almost half of Egypt's electricity through the Aswan High Dam.

population. The large number of youths who were not able to find jobs or worked in informal jobs fueled the frustration and revolutionary spirit of the public. Often seen as a demographic bomb that went off in the Arab Spring, the youth bulge remains a potential source of social and political instability if the employment situation does not improve. As long as the economies of the region fail to create an environment for strong job growth, they create only a large mass of frustrated youth who either take to the streets or out-migrate. However, if the growing working-age population of the last years can find formal employment with decent wages or become entrepreneurs themselves, they would become part of an engine of job growth. This way, they would contribute to a declining dependency ratio between the working population and the total population; further boosting overall economic growth and turning the youth bulge into a demographic dividend. Mitigating this demographic pressure is the fact that the speed and suddenness of the demographic transition in all North African countries has already significantly dented the youth bulge in the region, which peaked ten years ago. Forecasts estimate that the youth bulge will shrink massively in the next ten years in relative terms, and will stagnate or even decrease in absolute numbers. Across all five countries, the youth bulge today averages around 17% and will most likely drop below 16% in the next five years from a high of 22% in 2005 (with the exception of Egypt which will see at least an absolute increase) (United Nations 2015).

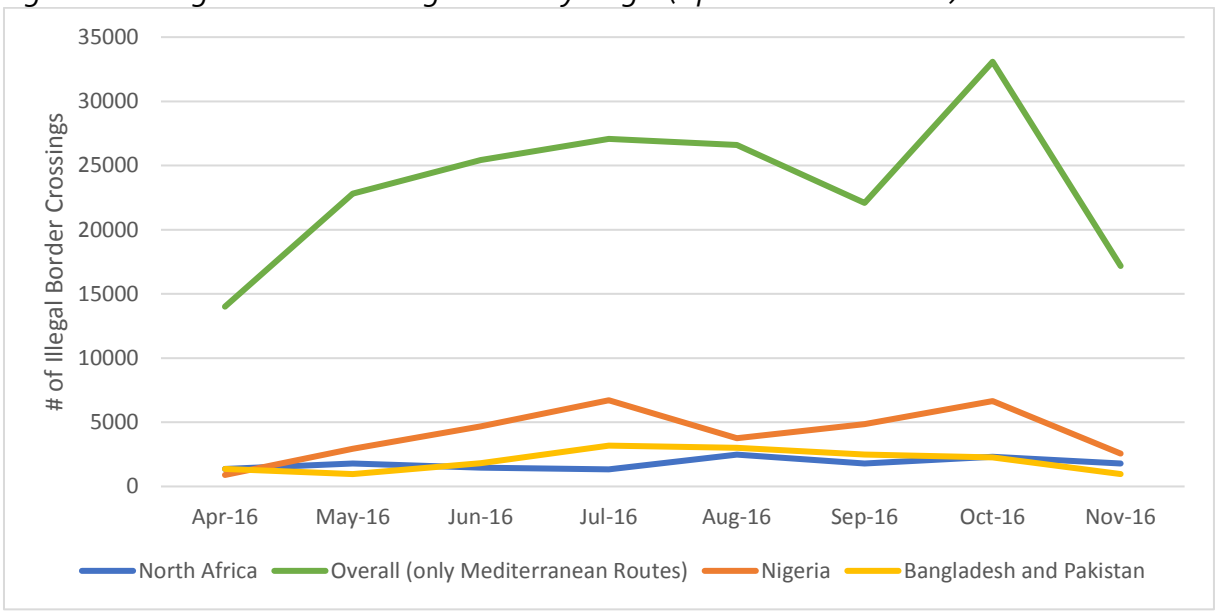
*Figure 9 Youth Bulge in North Africa (% of 15-24 year olds to total population)*




Source: UN Population Prospects

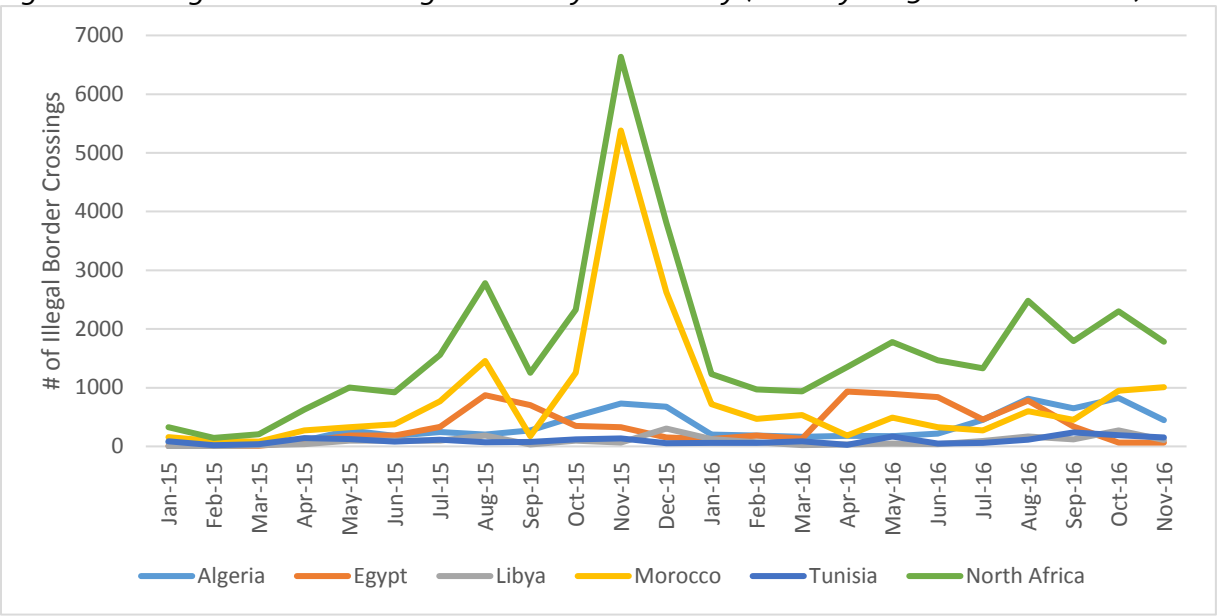
Another demographic effect of the Arab Spring uprising is the shift in the "migration systems" in North Africa (Haas 2007). Previous roles of migration or emigration countries in the region are now challenged and have changed due to the migration pressure from Sub-Sahara Africa and Asia. For decades and before the revolution in 2011, Libya as the major oil-exporting economy in the region was the destination for migrant workers, mainly from Egypt and other Maghreb countries. It used to attract a huge inflow of migrant labor looking for employment in Libya's petroleum sector. Before the revolution in 2011, almost 40% of the residing population consistent of immigrant workers (mainly from neighboring Egypt, Tunisia and Morocco). Historically, Libya also served as a stopover for migrant workers from Africa who often worked there until they could afford their onward journey to the EU (Lutterbeck 2009). In 2008 alone, 40,000 crossed the Mediterranean from Libya into Italy or Malta. As a response, Italy signed a bilateral agreement with Libya named "Treaty of Friendship, Partnership and Cooperation" in the same year that received heavy criticism on basis of human rights violations but stopped the migration flows almost completely (Bialasiewicz 2012). Following the renewed outbreak of civil war in 2014, Libya has again become the operating basis for smugglers and an illegal migration hub to Europe, with the deteriorating migration situation becoming a full-scale human rights crisis in the de facto failed state.

*Figure 10 Illegal Border Crossing into EU by Origin (April-November 2016)*




Source: Frontex

*Figure 11 Illegal Border Crossings into EU by Nationality (January 2015-November 2016)*




Source: Frontex

The political upheaval and violence of the Arab Spring itself increased the migrant numbers of North Africans in 2010 to more than 40,000, since then the monthly average had leveled off at roughly 1000 migrants until the migration crisis of 2015 pushed the numbers of migrants up again, albeit temporarily. Among the North African countries, Morocco is the main driver of the latest surge in migrants, as opposed to Tunisia, which fueled the migrant flow during the Arab Spring. Despite these numbers, the countries in the region are primarily destination and transit countries rather than origin places of migrants. Frontex figures verify that the Maghreb countries have never been the main origin countries of the European "refugee crisis" of the last years. Throughout 2016, North Africans have further decreased their share among illegal migrants entering the EU. Between January and November 2016 migrants originating directly from the Maghreb countries across the Mediterranean (including West-Sahara and Mauretania as well as Egypt) comprised 17 700 people. During the same period migrants from just Pakistan and Bangladesh entering the EU using all possible routes amounted to 23 600 (Frontex 2017). Instead, the migratory pressure from Sub-Sahara Africa and Asia has been steadily increasing, resulting in record numbers of 181,000 migrants counted on the Central Mediterranean route towards Europe.

Facing increasing migratory pressure from Sub-Sahara Africa and other developing countries due to their dire economic situation and the persistent income gap with the EU, the proposition of increasing economic growth and job creation in the origin countries is the one

and only long-term solution to the migration crisis. However, countries at an early stage of development will experience increased emigration together with economic growth. Named the mobility transition or emigration life cycle, this inverted-U relationship between migration and development causes an additional out-migration until the country achieves a certain level of development. Empirical evidence indicates a threshold of $5000-6000 income per capita; beyond that income level, migration rates tend to decrease along with further economic growth (Dao et al. 2016). Out of 54 African countries, roughly one–quarter has so far reached that development stage, depending on which income indicator is used. Suggested factors driving the migration response to development are financial constraints due to low income, demographic transitions, immigration barriers abroad, education, income inequality in origin country, transportation and communication networks, diaspora networks, and geographical constraints (Clemens 2014). When quantifying the competing explanations for the increasing part of the mobility transition, the largest drivers is the changing skill composition of the working-age population, i.e. increased education increases the share of the population with the strongest migration tendency. A significant factor is also the size of the diaspora network in the destination country and the income and inequality effect, with the latter contributing only up to 25% of the increasing segment in the emigration life cycle (Dao et al. 2016). Any development and migration policy therefore needs to integrate the phenomenon of mobility transition, forcing a sustained effort for economic growth that pushes the low-income and lower-middle income countries in Africa beyond the stated development threshold.

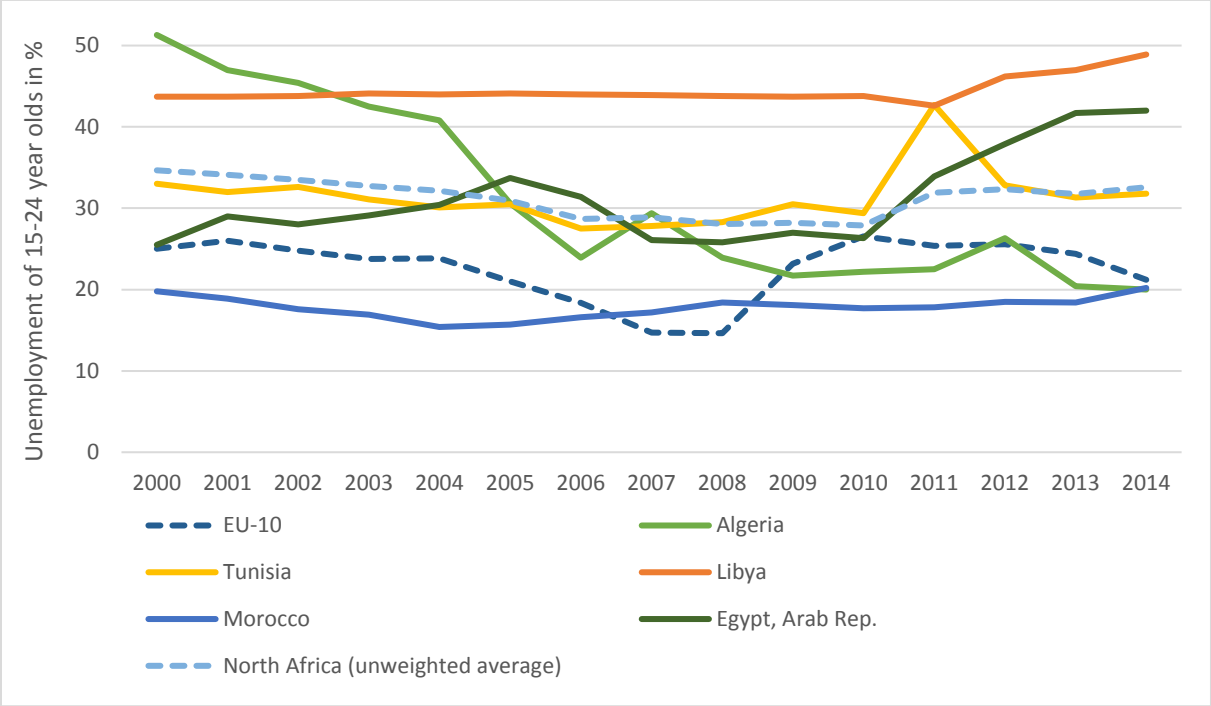
### 3.3. Economic Status Quo

Although the countries of North Africa -Algeria, Egypt, Libya, Morocco, and Tunisia- differ in their distinct economic structures, they all face the main socio-economic challenges of high youth unemployment and deficient private-sector job growth that are prevalent in the region. Of course, these two issues are closely connected, and an effective initiative for economic growth in these countries has to focus on job creation, especially for the generation born in the last 25 years. When comparing youth unemployment[9] within North Africa and with other regions, most noticeable is the exceptionally high level and stagnant development over the last 15 years. While the global average fluctuates around 13%, the North African

[9] Defined as the share of the labor force ages 15-24 without work but available for and seeking employment.

region continues to display the second highest unemployment rate in the world, only slightly below the Middle Eastern region (ILO 2016).

*Figure 12 Youth Unemployment in North Africa and EU-10*




Source: World Bank & Eurostat

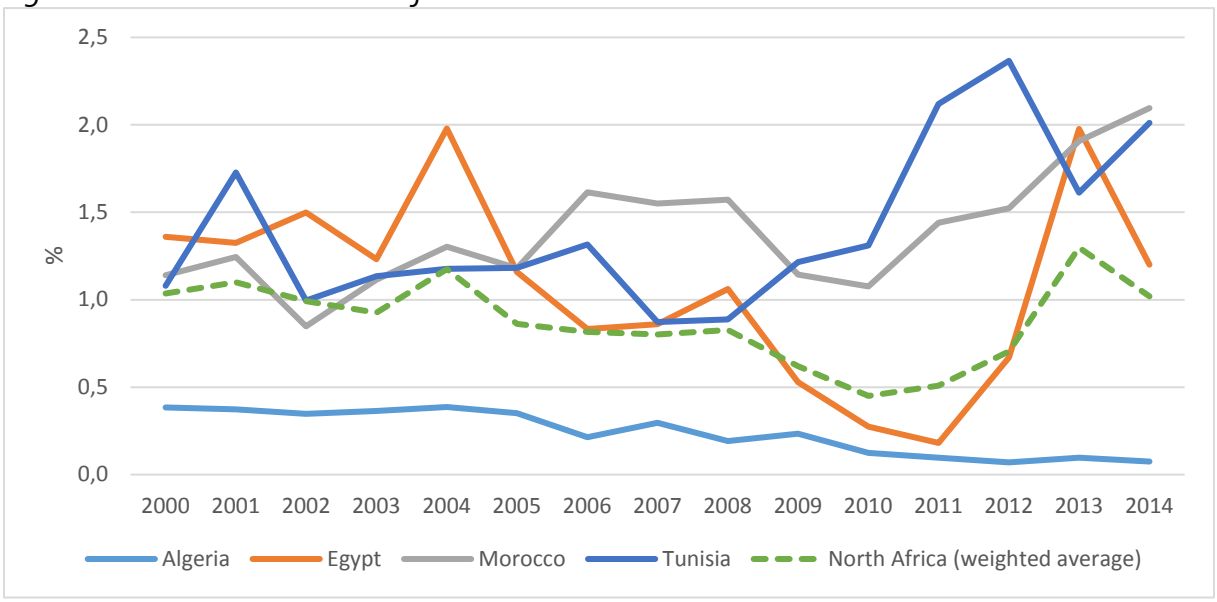
None of the countries in North Africa was able to decrease its youth unemployment below 20%, and only Algeria has successfully reduced it over the years, albeit from a very high level of 50% in the year 2000. On average, youth unemployment in North Africa has not budged below 28% and remained stubbornly high since the turn of the century. In contrast, the economic integration of the EU-10 clearly impacted the youth unemployment rate positively, lowering it during the boom years to below 15%. With the EU financial crisis and the sluggish recovery in Europe afterwards, the rate shifted upwards again and only managed to dip below 20% again in 2015. Especially striking in the Maghreb region is the gender gap in youth unemployment, with female unemployment double or triple the rate of male youth. Another exceptional feature of the North African labor market is the adverse effect of the educational attainment level, with highly educated graduates being disproportionately unemployed. While the OECD average for people with a tertiary education is around 5% in 2011, the average unemployment rate for North Africans who completed higher education or vocational training was 26% in 2011, with three main factors responsible for the discrepancy. First, a structural mismatch exists between the training or education offered and the

employability skills in demand, which raises the bar for university graduates and other first-time job seekers to find jobs. The already mentioned dearth in good quality employment in the formal labor market, especially private-sector jobs, is also partially responsible. With limited availability and low quality, the private sector in many countries is not a viable option for the unemployed youth. Related to this is an inflated public sector that represents a large share of total formal employment, offering comparatively high salaries, job security, and good benefits. The perverted but rational result is that after graduation young North Africans will voluntarily wait for public sector jobs to open up, driving up the youth unemployment rate in the process. In a 2011 survey, a mere 13% of unemployed young people in Egypt and Tunisia sought jobs in the private sector, while half of them hoped for government employment (ILO 2016). For Algeria and Morocco, the disparity was not quite as large, with 17% and 29% respectively. For many of those not obtaining a sought-after public sector job, the only option remaining is the informal sector, which has been steadily growing in the region. Due to low productivity and low skill requirements in these jobs, they constitute a dead-end route for most workers, who live close to the poverty line. Shrinking the public sector, expanding the private sector, and increasing the productivity, wages, and skill-level of jobs are therefore the needed steps towards a drastic reduction in youth unemployment.

Two potential sources for economic growth besides trade and FDI are other financial flows coming from abroad – namely ODA and remittances send home from the diaspora of migrant workers. Overall ODA flows to the region have undergone a relative decline from a long-term perspective. During the 1990s, the aid flows averaged around 2.7% of gross national income (GNI) for North Africa excluding Libya[10], while that number decreased to less than 1% in the next decade due to decent growth rates combined with almost stagnant inflows of development aid into the region (except for Morocco). Since the Arab Spring, additional inflows to stabilize the countries politically and economically coupled with falling or flatlining GNI in most countries increased its size slightly to 1.3% (World Bank 2016).

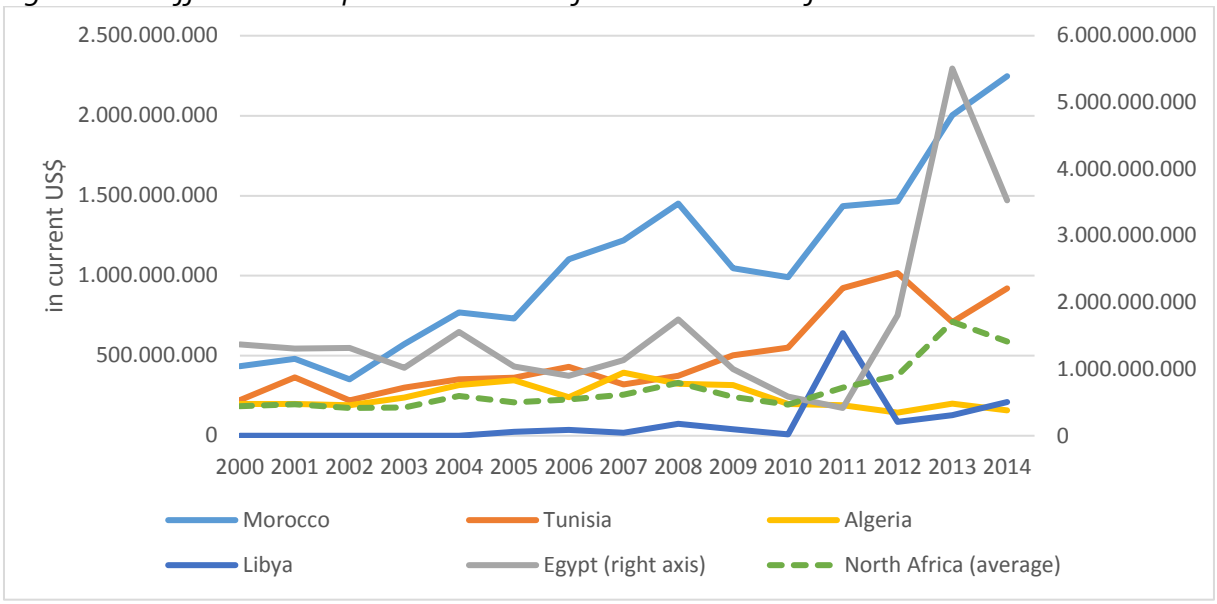
[10] Due to its pariah status under the Gaddafi regime, Libya has only started to receive significant amounts of ODA in 2011.

*Figure 13 ODA received in % of GNI*




Source: World Bank

*Figure 14 Official Development Assistance flows into North Africa*

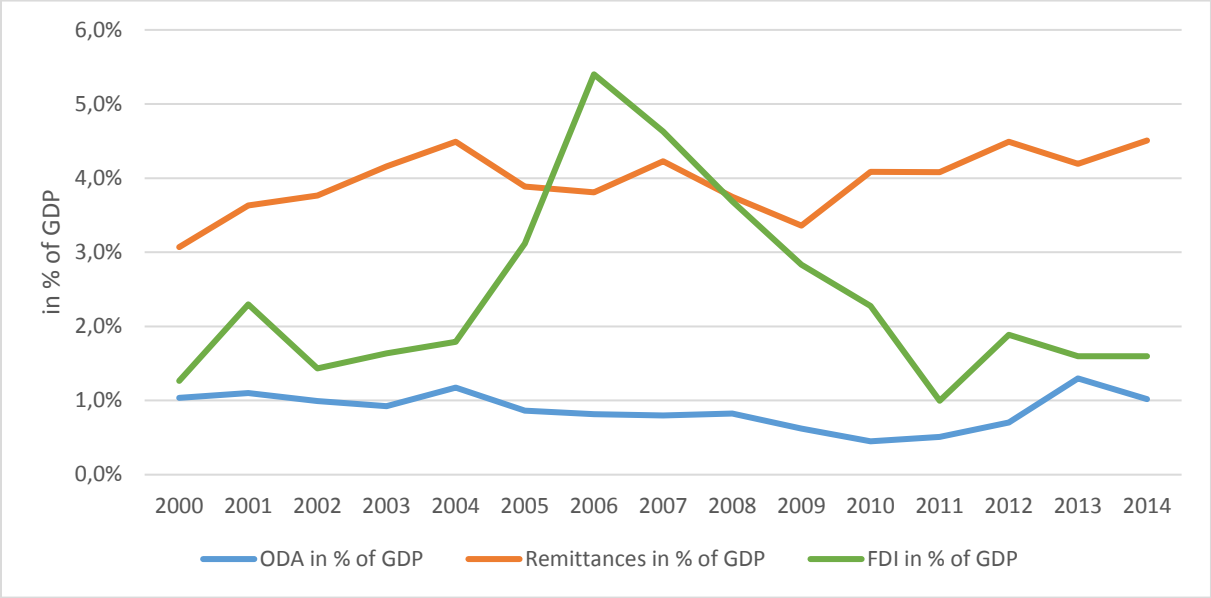



Source: World Bank

Compared to other inflows of capital, such as FDI or remittances, ODA plays only a minor role for North African countries. While FDI flows into the region experienced a period of strong growth during the early 2000s, the Great Recession of 2008 followed by the Arab Spring two years later severely stemmed these inflows. Remittances, on the other hand, have almost continually increased in absolute terms, thus offering a steady inflow into North Africa throughout the last years that is significantly less volatile than FDI flows. The official aid donors have recognized this shift, aiming to position ODA as a supporting role in which "ODA

should [...] facilitate and promote private investment" (BMZ 2017).[11] In addition, a looming change in US development policy towards Africa under the new Trump administration might indicate a severe downshift in foreign aid spending from the previous two administrations.

*Figure 15 Remittances, FDI and ODA in % of GDP (without Libya)*




Source: World Bank

The importance of remittances from migrant workers abroad for economic development in the home country has become increasingly clear not only to the governments in these countries and transnational organizations but in the field of development economics as well. It is a large and largely untapped potential source for external financing, which has garnered attention due to mainly four developments in recent years (Benmamoun & Lehnert 2013):

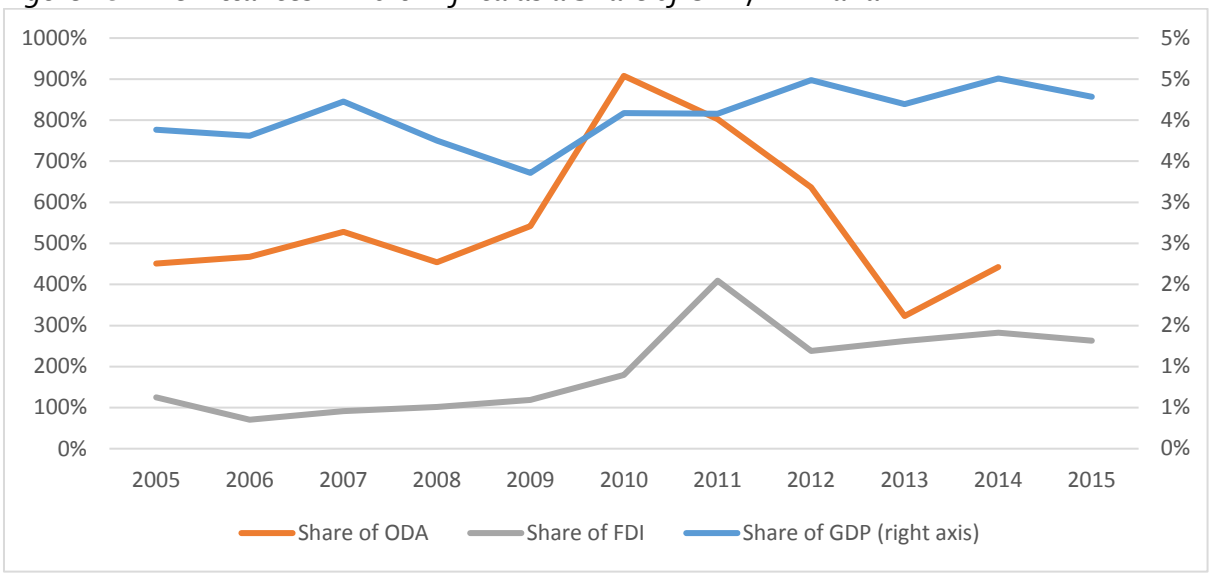
- For countries with a low savings rate at home and limited access to capital markets abroad, not only FDI but also remittances represent a potential source for domestic investment.
- The growth of global remittance flows into developing countries has grown immensely and at a higher rate than ODA. A large share of these flows has gone to lower middle income countries, since these are the countries where the income levels are low enough to push people towards high-income countries but also high enough to bear the considerable costs of emigration.

[11] See also the statement by the European External Action Service (EEAS; EU's diplomatic service):"Traditional development assistance alone cannot meet the challenge of achieving sustainable development. " (EEAS September 2016)

- Often, the size of the remittances represents a considerable share of GDP and surpasses ODA and FDI flows into the country, which often became only recently apparent to governments due to improved statistical data on international remittances.
- At the same time, in many developing countries the inflow of ODA has either decreased or stagnated during the last years, forcing governments to search for alternative means of development finance.

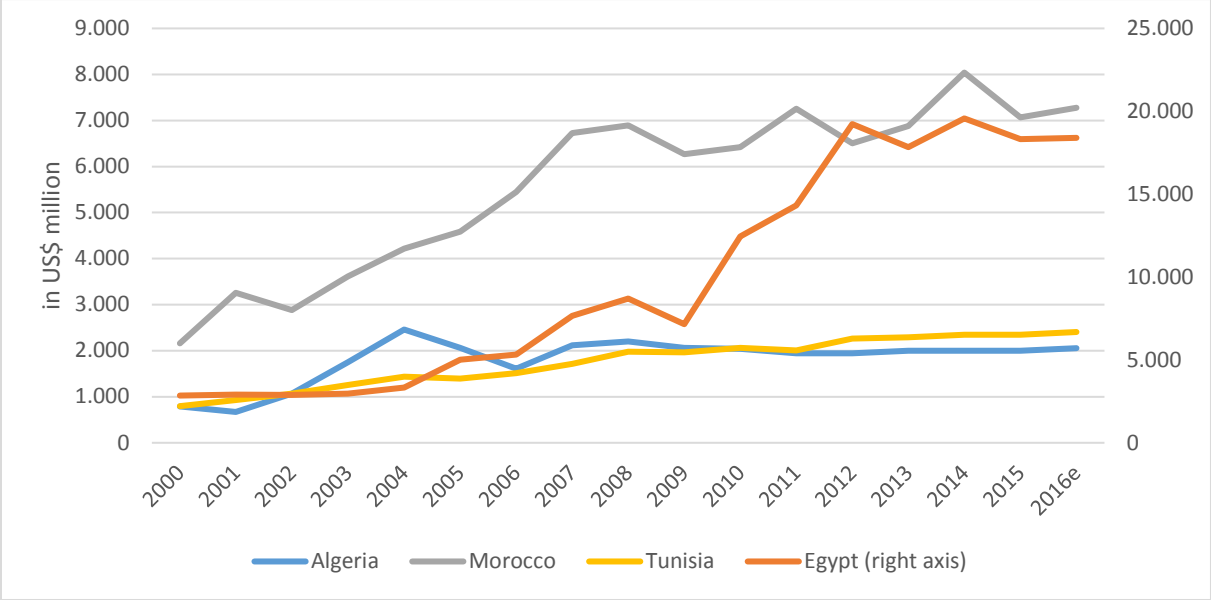
One example of the relative large role of remittances represents the official development aid of Germany that went to Africa in 2014. These aid flows to the whole of Africa equaled remittance inflows for just Tunisia and Algeria in the same year, with remittances towards Morocco and Egypt surpassing these numbers by far. For North Africa as a region, remittances were more than double the size of FDI inflows and more than four times the size of ODA in 2014.

*Figure 16 Remittances in North Africa as a Share of GDP, ODA and FDI*




Source: World Bank, UNCTAD

*Figure 17 Migrant Remittances Inflows*

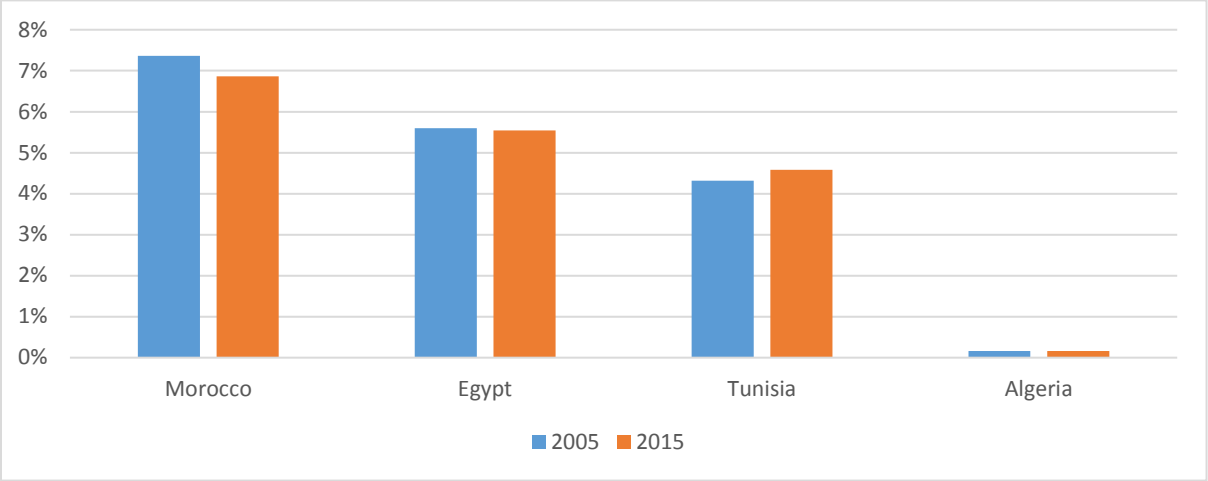



Source: World Bank

However, the question of whether these large inflows are actually growth-enhancing or poverty reducing is still debated among economists. Some argue that the additional income is purely spend on consumption, has a moral hazard effect by switching the recipients activities to from labor to leisure, or negatively affects the exchange rate reducing export competitiveness (Konte 2017). In contrast, remittances might also be spend on human and physical capital investments, thus fostering economic development (Cuecuecha & Adams Jr. 2016). Yet, the theoretical argumentation and empirical evidence of the positive economic and social impact of remittances is less ambiguous as for FDI and ODA. Research shows that while FDI and ODA both contribute positively to the economic growth rate of developing countries, the impact of remittances is significantly greater (Benmamoun & Lehnert 2013; Joshi 2016). Evidence qualifying the growth effect shows that the correlation depends crucially on the region in question (Nwaogu & Ryan 2015). Comparing these flows with ODA displays especially for Africa a growth potential of remittances and emphasizes its direct economic impact on people versus possible issues of corruption and mishandling of ODA by African governments (Bodomo 2013). In one of the latest studies, the impact of remittances depends on the so-called "growth regime" of a country. Around 60% of the 120 developing countries analyzed fall into the first category, where remittances have no significant effect on economic growth. The remaining 40% of developing countries exhibit a growth regime in which remittances influence the growth rate positively, including all North African countries with the exception of Egypt (Konte 2017). In addition, most studies find that remittances

reduce poverty, either in a cross-sectional analysis or case studies at the country level (Cuecuecha & Adams Jr. 2016).

*Figure 18 Received Remittances as Share of GDP (2005 vs. 2015)*




Source: World Bank

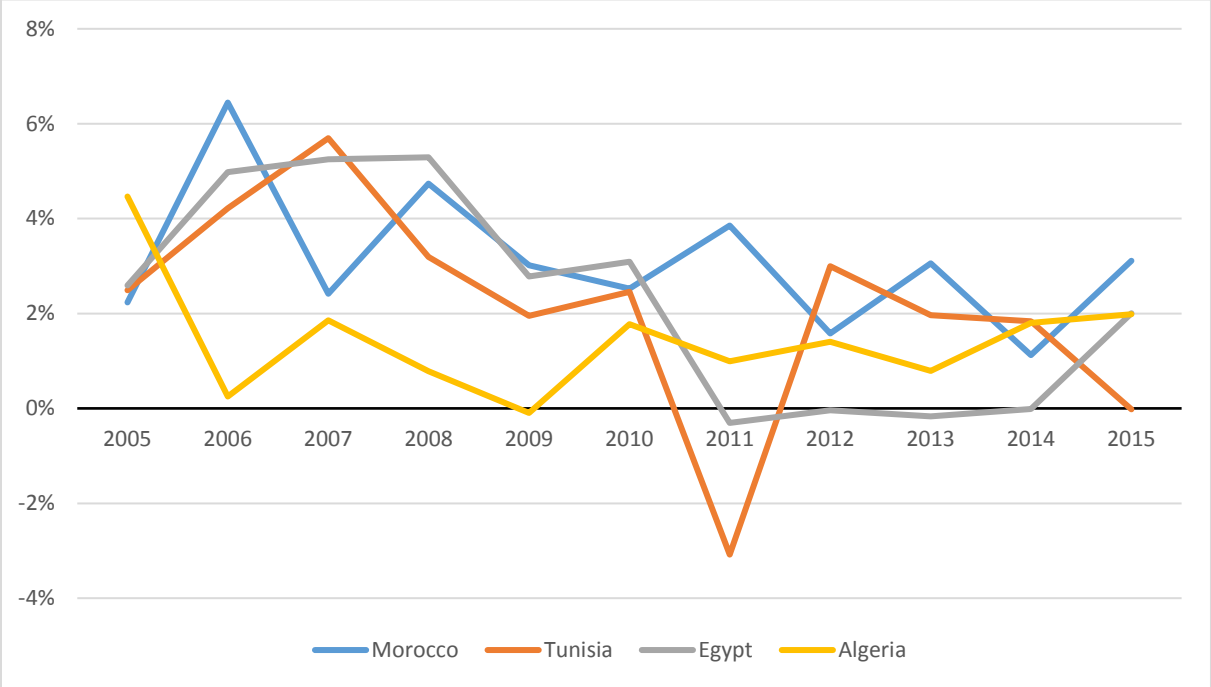
Therefore, the direct financial benefits of emigration and diasporas for North Africa are not only potentially high but also need to be considered in any discussion on migration. The obvious benefits of a stable income source for development stand in stark contrast to possible incentives for the origin countries to address and reduce outmigration. Any emigration decision by a North African migrant lowers the pressure on the home labor market while it increases the diaspora stock abroad and thus the flow of remittances. Hence, the potential of remittances remains high even though this year their impressive growth performance of the last years is expected to slow down. Continuing weak economic growth in Europe, low oil prices in the Middle East, and the change in migration policies in many remittance source countries will most likely reduce the flows towards North Africa (Ratha et al. 2016).

### 3.4. Economic Outlook

The current economic performance of the Maghreb countries and Egypt suffers foremost from the political instability in the MENA region but also from a weak global growth environment. Last year saw a severe reduction in global trade and for the first time in 15 years, the expansion in trade was slower with 2.8% than global economic growth. In contrast, the average annual growth in trade since 1990 was around 5%, indicating a significant departure from the long-term trend. The World Bank and International Monetary Fund (IMF) list as possible causes a weakening global demand, China's growth slow-down, a rise in protectionism, and a shrinkage of global value chains (GVC) (IMF 2016d). Equally damaging

to the growth rates in North Africa has been the protracted economic recovery of the EU due to its direct impact as the most important export market. Since the EU debt crisis of 2009, growth on the continent was first non-existent, then became positive again in 2013, and will most likely achieve 2.0% in 2017. Due to high trade dependence on the EU, the gradual economic recovery in Europe will no longer hinder export growth from North Africa. When looking at growth in the region itself, the distinction between GDP and GDP per capita growth remains important. Even though population growth has slowed in North Africa compared to the 20th century and Sub-Sahara Africa, the region grew by 16 million in the last five years and is expected to grow by another 15 million in the next five years (United Nations, Department of Economic and Social Affairs 2015). Accordingly, growth of GDP per capita resides well below GDP growth.

*Figure 19 GDP per capita growth in %*

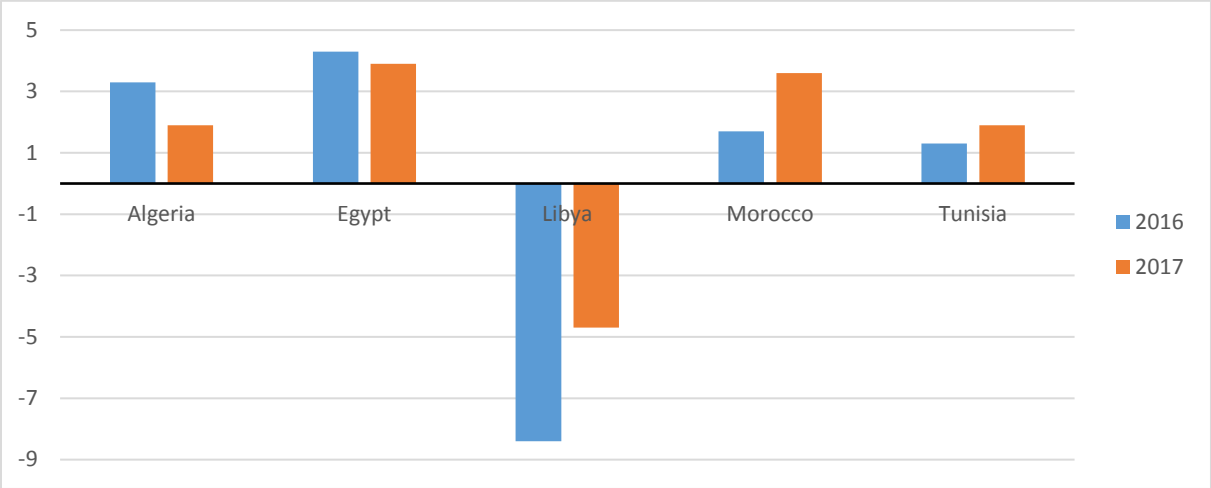



Source: World Bank

The two external shocks of the Great Recession and the Arab Spring become evident in the growth performance of the last eight years. While most countries, Algeria being the exception, managed growth of GDP per capita at around 4% in the years preceding the global recession, only Morocco -saved from regime changes- could keep the growth rates above 2%. Libya fared the worst, with a collapse of its economy in 2011 and continuous negative growth rates ever since. However, since 2015 the growth rates have partially recovered, especially in

the three largest economies of Algeria, Egypt, and Morocco, all of them with growth per capita at 2% or above. Absent a renewed outbreak of mass political protest, the economic situation in North Africa is predicted to further stabilize, with Morocco and Tunisia forecasted to increase their GDP growth rate and Libya to at least limit additional output contraction (Economist Intelligence Unit 2017c).

*Figure 20 GDP Growth in % 2016 (estimate) and 2017 (forecast)*



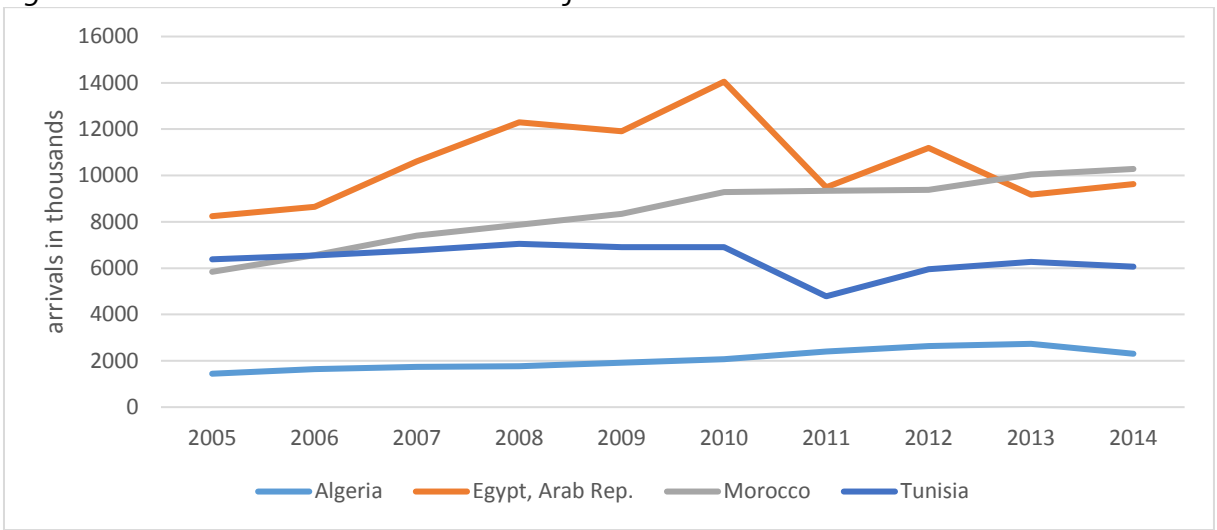

Source: EIU

These forecasts are highly dependent on the development of the political and security situation in 2017, with the current instability dampening potential economic growth. Hence, a significant improvement of the political situation would clearly affect the growth potential in the medium-term. Another unknown variable is the oil price that has a diametrically opposite effect on respective economies in the North Africa. The low oil price environment of the last two and a half years meant a boost for oil-importing countries due to reduced expenditures on oil imports and the prevalent role of energy subsidies in most of these economies. Morocco, Egypt, and Tunisia as so-called "labor abundant, resource poor" countries thus benefitted from the sharp drop of the oil price (World Bank 2013). On the other hand, Algeria and Libya, classified as "labor abundant, resource rich" countries by the World Bank, are both exporters of petroleum products whose economies and government revenue are uniquely dependent on hydrocarbon exports. For them, the low oil prices since 2014 translated into severely reduced government revenue and export earnings, as Algeria's petroleum exports account for 58% of all exports and 94% of merchandise exports (OPEC 2016). Much of the future economic path for both petroleum-exporting countries Algeria and Libya therefore depends on the oil price development. Despite the Organization of

Petroleum Exporting Countries (OPEC)'s decision in October 2016 to reduce oil production and the following small price recovery, the price of oil remains at low levels ($50-60 per barrel) compared to the high-price era of 2011-2014 with an average price of $100 per barrel. Yet, even a slight uptick in the oil price could lead to higher revenues for these two countries, which would mean fiscal stabilization in 2017 and a possible stronger growth performance, given that Libya is able to increase its oil production from currently low levels.

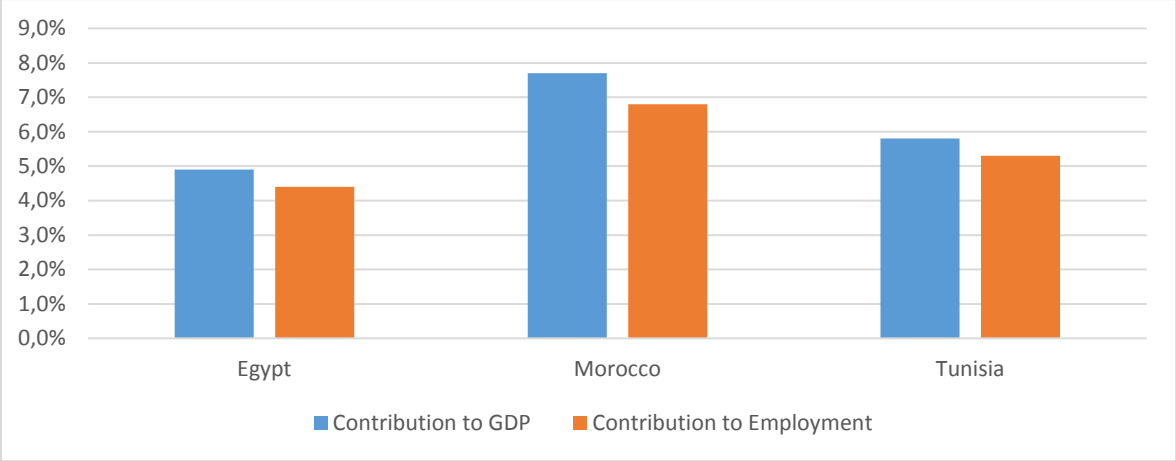
In the resource-poor countries of Egypt, Morocco, and Tunisia the tourism industry is similar important to their economies and has suffered from increased geopolitical risks and terrorism since the Arab Spring. While the direct contribution to GDP is between 5% and 8% in these countries, the indirect contribution is often twice as large and the exports earnings from tourism account for 15% to 25% of total exports (WTTC 2016). After the regime changes in Egypt and Tunisia, the number of arrivals has strongly declined and not yet recovered, since these countries experienced repeated terrorist attacks. Only Morocco, which is the lone country in North Africa ranked as a low travel-security-risk destination, was able to attract more tourists during the last decade. While the tourism industry offers mostly low-skilled jobs, their share of overall employment is large and the industry generates much-needed hard currency from Western tourists.

*Figure 21 International Tourists in North Africa*



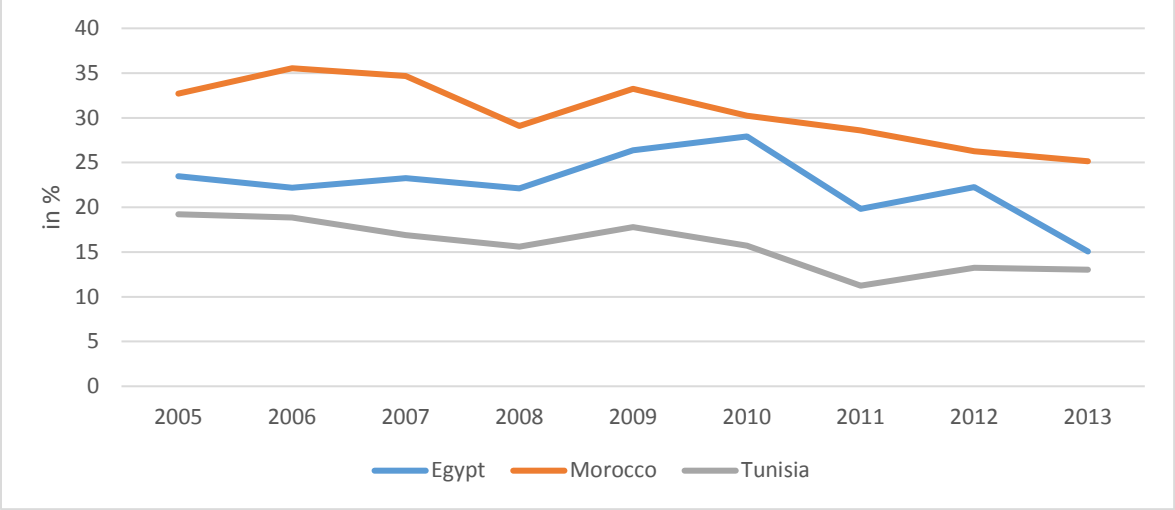

Source: World Bank

*Figure 22 Direct Contribution of Tourism Industry to GDP and Employment in 2015*




Source: World Travel and Tourism Council

*Figure 23 Tourism Receipts as % of Total Exports*




Source: World Bank

Given the critical political and security situation in the region and their effect on the tourism industry and general economic performance, the countries of North Africa are nonetheless predicted to grow this year with Libya as the exception to the trend. However, despite the positive outlook for growth in 2017, the forecasted growth rates are too low to have a significant impact on the North African economies. A sustained period with GDP growth above a 5% threshold is needed to achieve robust job growth that will not only be able to absorb the growing working population but have a lasting impact on the high unemployment rate. Past growth performances before 2008 are witness to the fact that these growth rates are achievable, yet now the region needs to accomplish higher investment and productivity growth to attain inclusive economic growth that benefits every part of society.

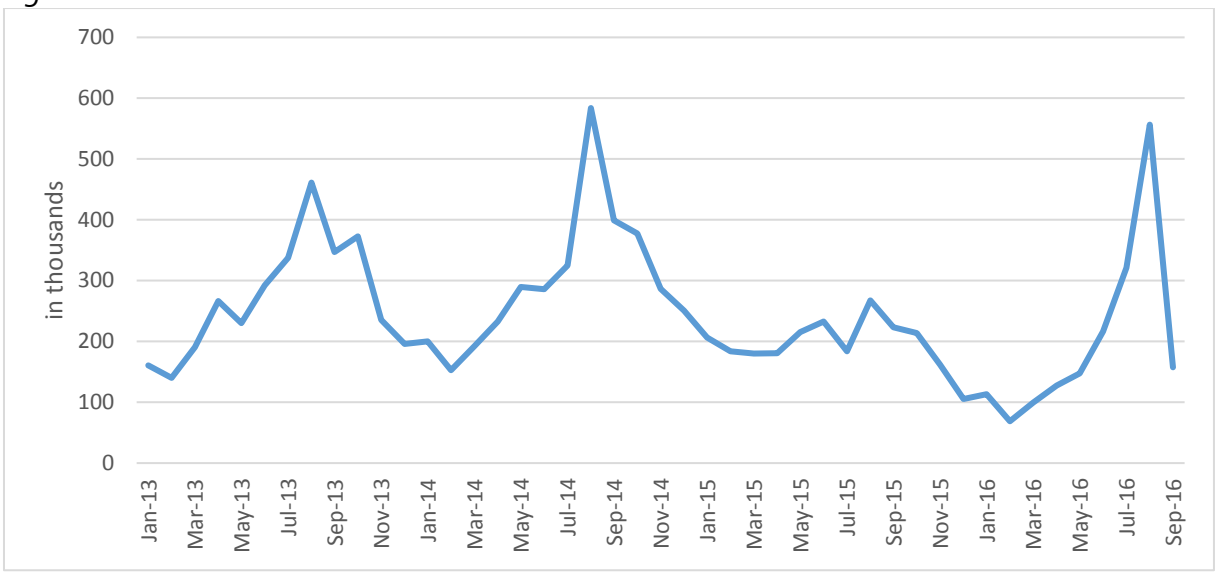
On an individual country level, the economic challenges and outlook differ starkly depending on each's country economic structure, dependencies, and institutional setting. In **Algeria**, the economy suffers from a mix of problems that characterizes a petroleum-exporting and also a North African economy. Characteristic for the region, Algeria is afflicted with widespread corruption, lack of transparency, and abundance of bureaucracy. The poor performance of the public sector is evident in the Transparency International's Corruption Perceptions Index 2015, which ranks Algeria in 88th place out of 167 countries, and the World Bank's Doing Business 2016, which puts Algeria at 163 out of 189 (Zoubir 2016). Similar to other oil exporters, the country relies on a rentier economy that is completely depended on its hydrocarbon exporters and thus the world price of oil for financing its government expenditures and acquiring hard currency from abroad. The hydrocarbon sector provides for 30% of Algeria's GDP, a number that has remained virtually unchanged in the since 2000, and accounts for 40% of its government revenue. Since Algeria's regime has been unwilling and unable to transform the economy during the last decade, the recent period of low oil prices has put the government under intense fiscal pressure. Due to a fiscal breakeven oil price[12] of more than $100 per barrel during the last years, the regime was forced to mainly finance the last two years of government spending out of Algeria's oil saving fund, a cash reserve of original $200 billion. The all-time high budget deficit of 2015 was particularly spend on fuel and other energy subsidies and a high wage bill for the large public sector (IMF 2016a). With spending on wages and salaries nearly doubled in the last decade, the ratio of employees in the public sector now exceeds 40% of total employment. Similarly, the broad subsidies covering energy, food, and housing accounted for 14% of GDP in 2015. Threatening fiscal stability, the oil fund has already decreased by more than 50%, and will most likely reach its statutory floor this year (Economist Intelligence Unit 2017a). The severe revenue contraction limits Algeria's ability to pay imports to approximately two more years and compels the government to cut budgets and investments, increase the prices of some goods, and decrease imports. Taken together, the fiscal tightening will further weaken GDP growth in 2017. The projected breakeven oil price for 2017 is around $87 per barrel, accordingly a modest upsurge in the oil price to above $80 per barrel would provide the regime with some financial breathing space (Jewell et al. 2014). With stabilized income flows, Algerian's government could attempt to diversify the economy away from petroleum and gas to

[12] The oil price at which the fiscal balance is zero.

develop new industries, thereby seeing new growth options for job creation. However, the question remains if any gain in fiscal flexibility would be used for reform efforts. A first positive indication is the adoption of a new constitution last year, which explicitly states a diversified economy and combating corruption as objectives (IMF 2016a).

For **Tunisia**, the economic outlook is equally bleak; the Tunisian government itself calculated their 2017 budget with a predicated GDP growth rate of 2.5% as does the IMF, while their central bank is even less optimistic with 2.2% and other external assessments are forecasting growth to stay below 2% (Economist Intelligence Unit 2017e). Once heralded as the "Tiger of the Mediterranean", its proclaimed growth potential after the Tunisian revolution of 2011 has so far failed to realize. Regardless of the exact growth rate that will occur, it will be significantly lower than the 5-6% of GDP growth needed to affect the high unemployment substantially. Together with an absence of improving economic opportunities, outbreaks of social unrest are still likely. Besides the continuing difficult political environment, some key factors are holding the economic performance back. The terrorist threat remains high, precluding a return of the tourism industry to previous levels, since European tour operators refuse to integrate the country in their programs. Following the devastating attacks of 2015, the arrivals numbers in 2016 stayed below the earlier ones from 2013, not to mention the tourism industries turnover before the revolution. As a key provider of GDP and employment, the tourism sector's current underperformance therefore hurts the overall economy.

*Figure 24 Tourism in Tunisia: Arrivals to the Borders*




Source: Ministry of Tourism Tunisia

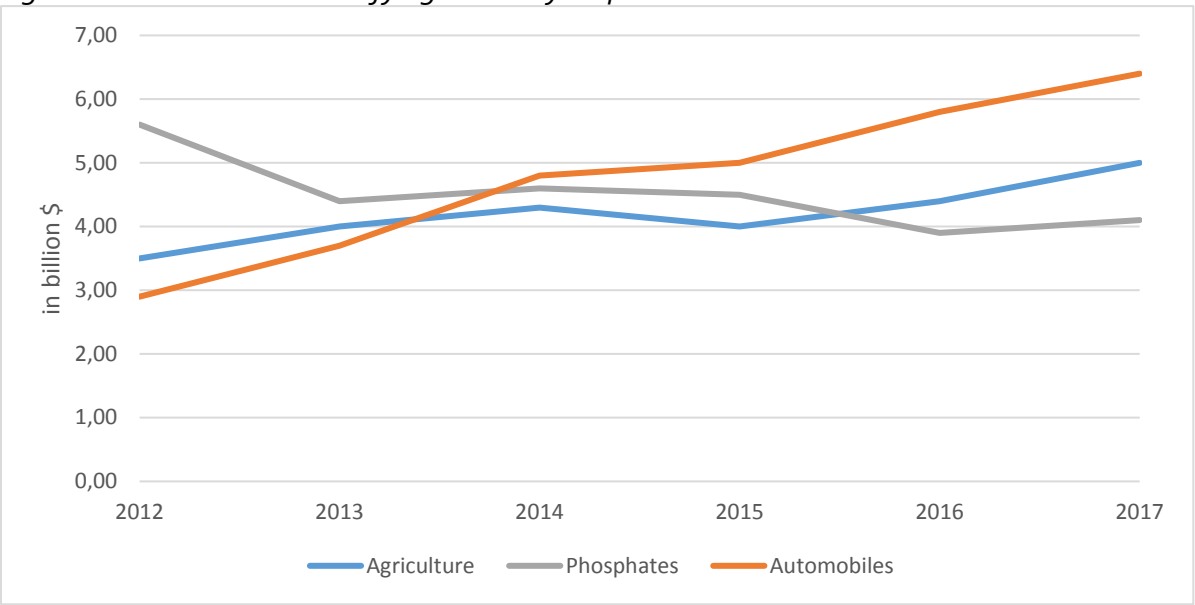
Another sector that is operating below its potential is the large agricultural business of olive oil production. Only two years ago, Tunisia made headlines as the largest olive oil exporter worldwide, surpassing Spain due to a record harvest and thus accounting for 10% of Tunisia's total exports and 40% of agricultural exports. Yet, for the 2016/17 season olive oil production is forecasted to fall again from its previous heights to the second-lowest yield in 14 years. Estimates show exports to reach only 70 000 tons in 2017, which is well below the annual quota allowed by the EU. The EU generously expanded the quota for two years to offer economic support during the current transition phase of Tunisia's political and economic reformation. As the country's second most important crop and sizable share of exports, the drop in olive oil production will have a significant effect on exports and economic growth in 2017.

As typical for the region, Tunisia's public sector wage bill is one of the highest in the world, and its draining of public expenditures is pushing the government to adapt reforms that would modernize their bloated civil service. The regime change has not ended the habit of job creation through public employment drives; quite the opposite happened during the post-revolutionary years, when the new government added 200,000 jobs to its payroll by early 2014 (Benoit-Lavelle 2016). Yet a further reliance on the public sector to solve the problem of high unemployment is unfeasible and undesired, since the wage bill already captures 63% of tax revenues and reaches 14% of GDP (IMF 2016c). Privatization of the country's state-owned enterprises must be also high on the political agenda, since these enterprises often highly inefficient and loss-generating (Economist Intelligence Unit 2017e). Yet, Tunisia's powerful labor union UGTT presents a formidable roadblock towards public sector reforms, which would entail short-term economic pain to gain the rates of economic growth that could have an impact on high unemployment. In a country with a total labor force of 4million and where less than half of the Tunisians work in the formal sector, the labor union with its 800 000 members will resist any reforms that undermine its privileged position in the Tunisian society and threaten their job security. An attempt by the government to shrink the large grey economy and update its public sector and labor laws could also provoke opposition from the union's side and results in more and wider strikes. However, promising events such as the successful "Tunisia 2020" international investment conference in November 2016 and the government's resolve to undertake reform efforts could provide a growth boost for 2017.

In addition, the enduring slump in oil prices has supported the fiscal stance of the Tunisian government, reducing outlays on its fuel and energy subsidies. Together with a proposed energy subsidy reform it could lead to a further decline of the subsidy share of government expenditure that decreased from 18% of total government expenditure in 2013 to about 1% last year (IMF 2016c).

In resource-poor **Morocco**, the economy also profited from favorable oil prices, which halved their petroleum imports from 11% to 5.7% of GDP between 2014 and 2016. It also supported the regime's efforts to reduce their energy subsidies, with the government's expenses on subsidies also declining strongly from 3.5% to 1.2% of GDP. In 2012, fuel subsidies represented 5.5% of GDP, a number that shrunk to 1.2% in 2015, when the government fully liberalized fuel prices. Similar reductions in certain food subsidies (wheat and sugar) are also planned, emphasizing the regime's intent to follow through with the modernization of the economy. The overall outlook of Morocco's economic performance is positive, with a comparatively strong 3.6% of GDP growth forecasted this year. While the industrial and service sectors will improve on their growth rates from 2016, it is mainly the recovery of agricultural production from a severe contraction in the previous year that will drive the growth rate upwards (Economist Intelligence Unit 2017d). Despite the country's transformation into an industry and service economy providing 85% of output, the agricultural sector still accounts for 40% of employment and thus volatility in agricultural output affects private consumption. A steady upward development of Morocco's tourism industry stands in stark contrast to the other countries in North Africa, and with almost a doubling of international tourists in the last decade, the country has surpassed Egypt as the most-visited nation in Africa. Given the region's security issues, the tourism success in Morocco that contributes 25% of total exports and employs 400,000 people is exceptional and underscores the achievement of the country's security forces. It also shows the vulnerability to potential external shocks, such as regional spillovers from terrorism that have reduced tourism revenue in 2015 and could do so again. Apart from regional security risks, much of Morocco's economic fortune depends on its main trading partner, the EU. A continuation of the period of slow growth in Europe could translate to a decrease in Morocco's exports and tourism earnings as well as remittance and investment inflows (IMF 2016b).

*Figure 25 Morocco's Diversifying Economy: Exports in billion $*




Source: IMF

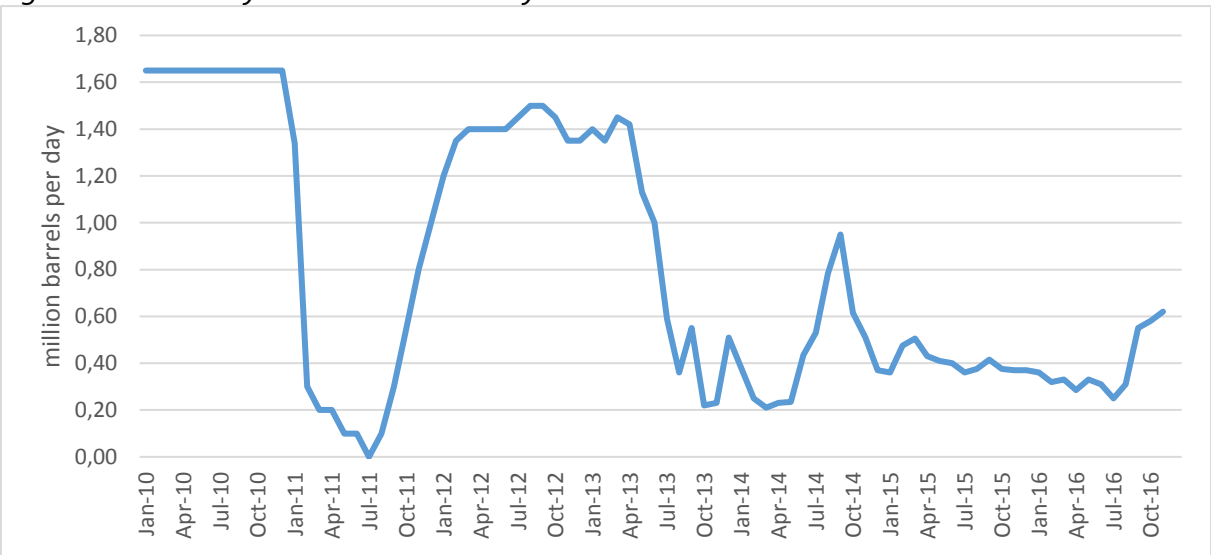
The implemented reform agenda of the Moroccan monarchy has resulted in unique economic achievements by diversifying the economy away from sole reliance on agriculture and phosphate production in the past. Developing its tourism industry and the rise of the export industry in automobile, aeronautics, and electronics, have resulted in higher and more inclusive economic growth. Yet, a few hurdles remain that could hinder future development, among them the refusal to completely open Morocco's transportation and electricity sectors to foreign equity investments. So far, full foreign ownership is not allowed in these sectors, hampering investment from abroad and infrastructure development. An inefficient bureaucracy, which accounts for 40% of government expenses and about 10.5% of GDP in 2016, not only constitutes a sizeable wage bill but also stands in the way of realizing investments projects fast and cost-efficient (IMF 2016b). Similar to its neighboring countries, a lack of skilled labor and high inequality -due to a small elite holding most of the economic power- are bound to prevent higher economic growth. Nevertheless, since becoming a hub for European manufactures which locate their production in special economic zones (SEZ), these manufacturing industries rapidly expanded their share of exports. Meanwhile, they bring in more revenues than agriculture or phosphate, emphasizing Morocco's diversifying economy. Further increasing the potential of private sector growth and quality job creation are a high investment rate in infrastructure and human capital. Combined with the government's reform effort aimed at the civil service pension system and curbing the growth

of the public sector, the Moroccan economy will thus continue to prosper and most likely maintain its position as North Africa's poster child for development.

**Libya**, as the problem child of the region, is still on the brink of economic collapse despite a few promising improvements in 2016. With the political stalemate unresolved and the complete reliance on petroleum as its sole natural resource and export product, the country's economic outlook for 2017 is highly uncertain and depressed. Driven by a rise in food prices due to an almost complete withdrawal of food subsidies, inflation in 2016 has increased to 20% Inflation (Devarajan et al. 2016) and is expected to remain at that level until 2018 (Economist Intelligence Unit 2017c). Since oil production has dropped to a quarter of pre-crisis production levels in 2016, the resulting fall in revenues prompted record high deficits in the fiscal and current account. Libya expanded its oil export potential by reopening a seaport terminal for oil exports in October 2016 but its ability to actually increase oil production continuously and sustain these production levels long-term is highly doubtful due to the political instability.

If the various political factions and the National Oil Corporation (NOC) manage to keep up oil production at the 0.7 million barrels per day level that they achieved in January 2017, it could bring a massive boost to Libya's shriveled GDP yet would still not suffice to curb the twin deficits with revenues unable to offset expenditures and imports. The latest projections by the NOC estimate an increase to 900,000 barrels per day by March 2017, which would improve the macro outlook, yet remain well below the former full capacity of 1.7 million barrels per day. However, a sudden or unexpected spike in oil production could exercise downward pressure on the world market price for oil and affect OPEC's strategic output goals, in turn negatively affecting Libya's revenue stream. Uncertainty will thus prevail for 2017, since the issue of how to manage and share the country's oil wealth between the warring factions is an open question and could prevent a political solution.

*Figure 26 Monthly Oil Production in Libya*




Source: US Energy Information Administration

So far, the central bank handles the financing of public salaries and subsidies , keeping a neutral position between the two governments, since it still holds a large foreign reserve of around $70 billion (Economist Intelligence Unit 2017c). However, urgent short-term challenges are the lack of basic services for the majority of the population, and once political stability has returned the rebuilding of the infrastructure, human capital, and housing for the vast number of displace people that amount to at least 10% of the population. If the medium-term challenges of the reconstruction of the heavily damaged oil infrastructure are also met, Libya could employ its earning potential based on Africa's largest hydrocarbon reserves to undertake the necessary economic diversification of the private sector. Moving the Libyan economy away from its hydrocarbon dependency, is the necessary path of development and an essential for job creation and inclusive growth.

In the **Arab Republic of Egypt**, the growth outlook after years of political turmoil has substantially improved. For the next few years, annual GDP growth of close to 5% is forecasted (Economist Intelligence Unit 2017b) mainly thanks to an ambitious reform plan that is supported by a large IMF loan. Over the next three years, Egypt will receive $12 billion from the IMF to meet the three challenges of fixed exchange rates, high levels of deficit and debt, and poor growth performance in the past. In November 2016, the central bank of Egypt consequently floated the Egyptian pound, resulting in a strong depreciation, which closed the

gap between the official and the parallel market exchange rates. The flexible currency functions as a confidence-building move by the authorities and is set to affect the external competiveness and current account positively. While boosting the competitiveness of exports, the weaker pound will push up import prices, in turn increasing food costs since Egypt is a large net food importer. Moreover, the exchange rate liberalization will most likely keep inflation high at around 20% together with the newly introduced value-added tax (VAT) of 13%, which will exert further pressure on the consumer price level. Monetary policy will therefore focus on keeping inflation expectations in check to avoid exacerbating the food problem, since alleviated prices for food imports increase poverty directly. Sensitive to the issue of feeding the poor in Egypt, the new VAT contains exemptions for food items and the government plans to utilize parts of the additional revenue for higher food subsidies. This balancing act of lowering the fiscal deficit while supporting the poor through higher spending becomes more difficult due to a decline in other income streams. Tourism receipts fell sharply following the bombing of a Russian tourist aircraft in October 2015, further aggravating the shortage of foreign exchange, which affect the import-dependent industries (Devarajan et al. 2016). With lower demand for Egyptian migrant workers in the oil-producing countries of the Gulf, the flow of remittances has also dwindled by $2 billion between 2014 and 2016 (IMF 2017).

An energy subsidy reform to shrink government expenditures by bring down fuel subsidies, which accounted for 3% of GDP in 2016, was part of the reform agenda in November since they mainly benefitted the non-poor population. The energy subsidies also resulted in skewed incentives by supporting energy-intensive industries at the expense of labor- or capital-intensive industries. Nonetheless, the energy sector remains one of Egypt's major growth engines and is likely to expand its role. Natural gas fields have been detected that could bring about major investment from foreign energy companies and with production to start in a few years will curtail the need for energy imports and boost growth rates. Yet, even the projected growth of 5% could nonetheless remain too low to cut significantly into unemployment with the number of people entering the labor market in the next five years forecasted at 5 million (United Nations, Department of Economic and Social Affairs 2015). If Egypt fully implements the economic reform program that also includes structural reforms to foster inclusive growth and job creation, e.g. improved financial access for small and

medium-sized enterprises (SME), it could tap into its large economic potential. Absent political reform delays or social unrest, the Arab Republic with a dynamic and young population, a large domestic market, and favorable geographical position with beneficial access to important foreign markets could embark on a path of long-term growth. The next section highlights how the future economic development of Egypt and the Maghreb countries crucially depends on a significant reduction of their trade costs.

## 4. Trade Costs as Factors for Economic Integration – Gravity Model Analysis

The degree of integration between markets is widely considered an essential prerequisite for growth in terms of value added output and employment. Especially for low income countries, which have limited domestic demand and typically a shortage of both capital and skilled labor, good access to foreign markets is key for long-term development. For one, even developing countries with good market access can develop a comparative advantage in the production of labor-intensive manufacturing goods (such as textiles, consumer electronics) or tradable services and attract FDI to become part of GVCs. Second, a deep integration between local and foreign markets is needed to ensure that domestic producers can actually benefit from FDI through knowledge spillovers and as local input suppliers and in the long-run become internationally competitive. Evidence from Eastern enlargement of the EU strongly suggests that countries can indeed "climb-up" the global value chain in this way.

To shed light on the degree of economic integration between countries and their dynamic effects, integration needs to be measured in a way that is both encompassing – including tariffs but also the wide range of NTB to trade – and comparable over time and across countries. Yet, it is near impossible to directly measure all factors that can affect the flows of goods or production factors between countries, ranging from exchange rate risks over informal trade networks to tariffs and geographical distance. The standard approach to measure economic integration capturing all possible barriers is therefore to use a gravity model of trade based on the comparison between intra-national and international trade flows (Anderson & Wincoop 2003; Novy 2013).

**Box 1: Measuring Trade Costs with the Gravity Model of Trade**

The key idea in gravity frameworks is to back-out trade frictions associated with crossing a state border by relating trade flows between any two countries to trade within these countries and economic fundamentals that drive trade. A typical relationship that can be derived from basic demand and supply relationships and can be estimated with data is shown in equation (1):

$$t_{ij} = t_{ji} = \left(\frac{\tau_{ij}\tau_{ji}}{\tau_{ii}\tau_{jj}}\right)^{1/2} - 1 = \left(\frac{X_{ij}X_{ji}}{X_{ii}X_{jj}}\right)^{1/2(\sigma-1)} - 1\,, \qquad (1)$$

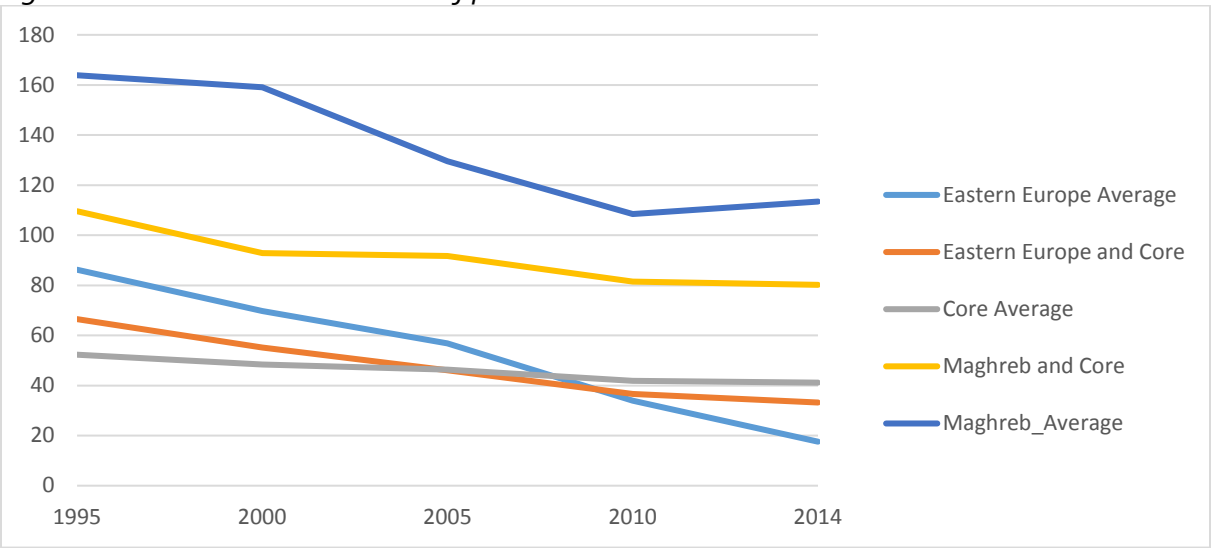
where $t_{ij}$ trade costs between two countries i and j is the geometric average of international trade costs relative to domestic trade costs. International and domestic trade costs in turn are derived from observed trade flows $X_{ij}$ and their relationship to supply and demand in a model with monopolistic competition. The extent of competition between firms is captured by the elasticity of substitution $\sigma > 1$. (In most empirical applications $\sigma$ is calibrated to be in the range of 5-8. The World Bank ESCAP database works with $\sigma = 8$.)

In the following, we will use the latest version of the United Nations Economic and Social Commission for Asia and the Pacific (ESCAP) World Bank Trade Cost database to show the evolution of trade costs between core countries of the EU, countries in Northern Africa and countries in Eastern Europe since 1995. The trade costs have been derived as explained in Box 1., they measure the ad valorem equivalent of trade costs in percentage of the value of production.

The first thing to note in figure 27 is that trade costs are systematically lower for the richer countries in the European core (Arics et al. 2016). Given that the decision to invest abroad will typically depend on cost differences between alternative locations, this increases the risk of poor countries to fall further behind, notably a further marginalization of African countries in global trade (Iwanow & Kirkpatrick 2009). In contrast, average trade costs between Germany, France and Italy have evolved from 52% of production value in 1995 to 41% in 2014. The achievement in Eastern Europe is very remarkable: for example, trade costs between Poland and Germany have declined from 66.5% of production value in 1995 to 55% in 2000 and further 46% in 2005 down to 33% in 2014. Even more impressive is the integration within Eastern Europe, such as between Czech Republic and Poland, where trade costs have declined from 86% in 1995 to below 20% in 2014, a reduction by nearly 80%. Compared to this, trade costs between European core countries (here France and Italy) and North African states (Algeria, Morocco, Egypt and Tunisia) have shown much less dynamics and changed from an average of 110% in 1995 to 80% in 2014. In this perspective, the lack of integration

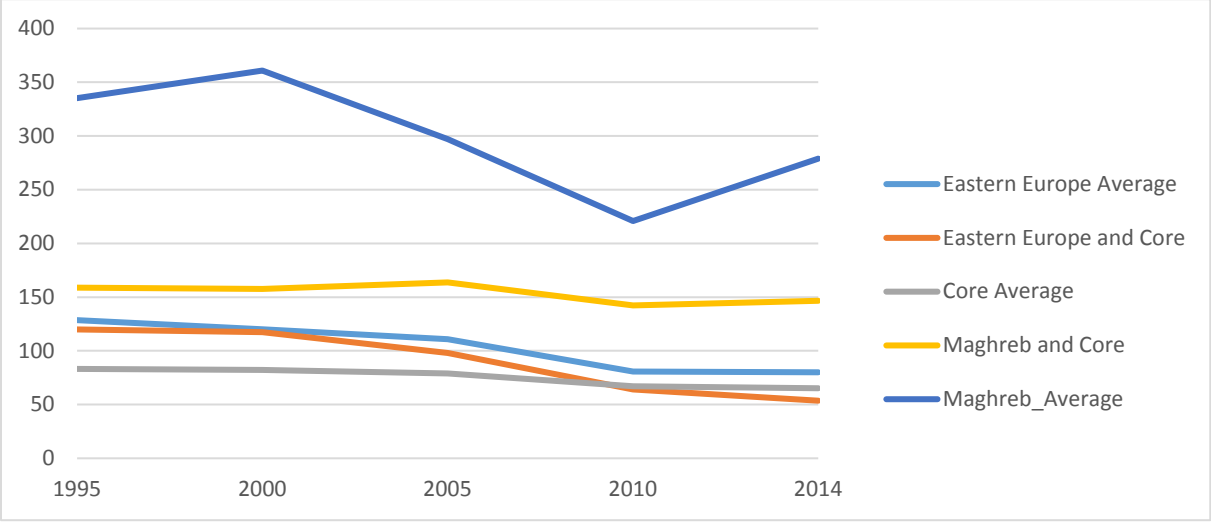
between Maghreb states stands out. While trade costs have fallen from around 160% in 1995 to around 110% in 2010, they did not recently decline any further and have recently even shown a tendency to increase again.

*Figure 27 Total trade costs as % of production value*




Source: own calculations based on ESCAP World Bank Trade Costs

*Figure 28 Agricultural trade costs as % of production value*




Source: own calculations based on ESCAP World Bank Trade Costs

Figure 28 shows that trade costs for agricultural goods behaved differently. Overall, trade costs are higher, which is in part due to the lower tradability due to characteristics of the goods (fragility, perishability), but it also reflects higher tariff and NTB to trade in these goods. We see that trade costs between Eastern Europe and the European core have converged to those within the core – notably after 2004 -, while trade costs between Europe and Maghreb countries have stayed high over the last 20 years, in spite of many efforts to

bring them down. Trade costs between Maghreb countries reflect the key problem of failed integration in the region: these costs ranged from 335% of production value in 1995 to 278% in 2014, hence about twice as high as trade costs with European states.

What can explain this huge variation between country groups and over time? Clearly, to some extent, simple geographical distance can account for differences in the levels of trade costs, but not much for their changes over time. The impressive success in terms of economic integration between the European core and Eastern Europe, but also within Eastern Europe itself, needs to be seen as a result of deep trade integration, involving a removal of tariffs, extensive investment in physical infrastructure and trade facilitation and a reduction of NTB to trade.

**Box 2: Logistics Performance Index**

The international Logistics Performance Index (LPI) is a summary indicator of performance in the logistics sector, which combines data on six key components into one general index. The six components are

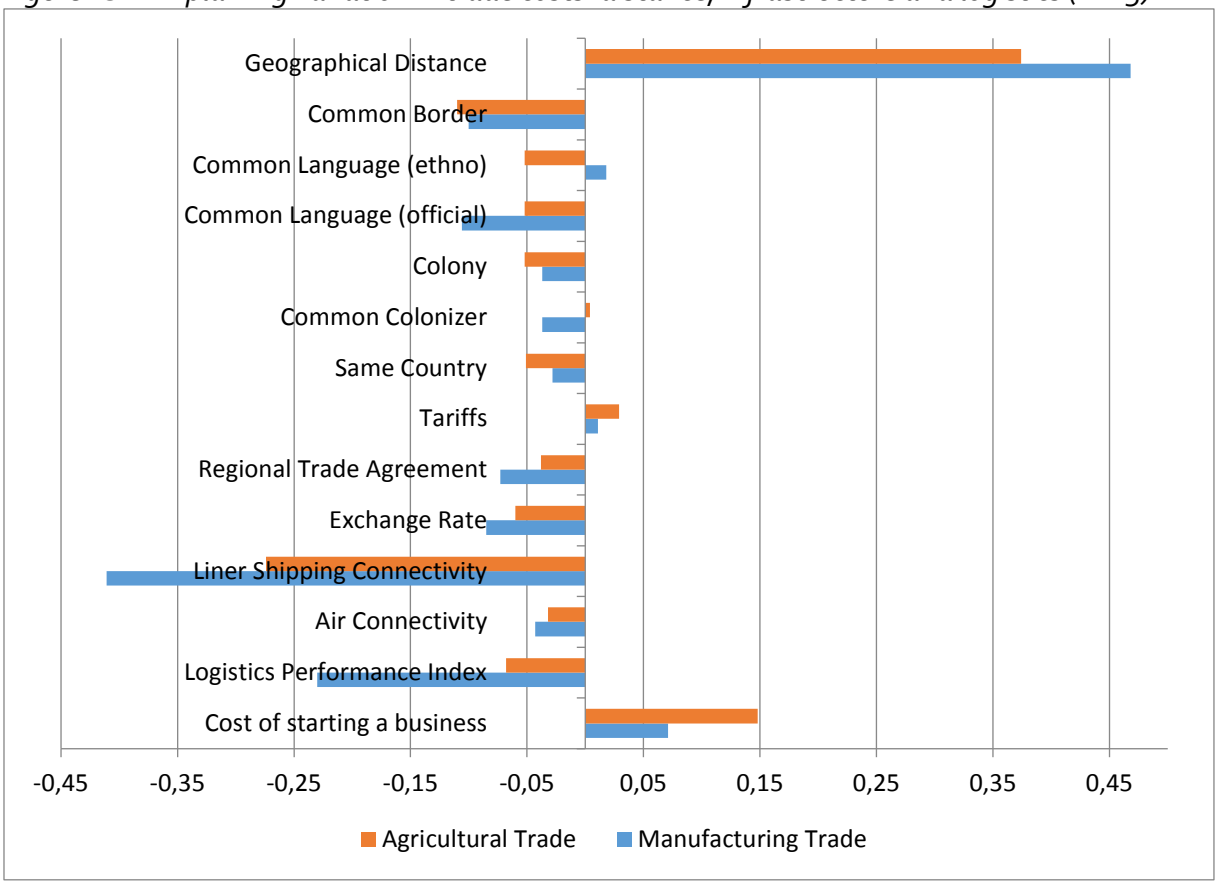
1. the efficiency of customs and border clearance, rated from very low (1) to very high (5),
2. the quality of trade and transport infrastructure, rated from very low (1) to very high (5)
3. the ease of arranging competitively priced shipments, rated from very difficult (1) to very easy (5)
4. the competence and quality of logistics services, rated from very low (1) to very high (5)
5. the ability to track and trace consignments, rated from very low (1) to very high (5) and
6. the frequency with which shipments reach consignees within scheduled or expected delivery times, rated from hardly ever (1) to nearly always (5)

Source: World Bank.

While this was under way before 2004, accession to the EU has deepened economic integration much further. Moreover, given the fact that water transport is generally much cheaper than transport over land, the high trade costs between Maghreb states and Europe reflect an enormous potential for further integration. Several recent studies have shown that trade costs in developing countries are very sensitive to NTB, such as the quality of physical infrastructure and indicators of logistics performance (Iwanow & Kirkpatrick 2009). In a recent contribution, Arvis et al. (2013) show based on the ESCAP World Bank Trade Cost database that besides geographical distance, a country's score on the Logistics Performance Index (LPI) and its index of liner shipping connectivity (LSC) are the main determinants of

trade costs. In contrast, tariffs or regional tariff agreements matter much less. Figure 3 replicates their findings for a global sample of countries.

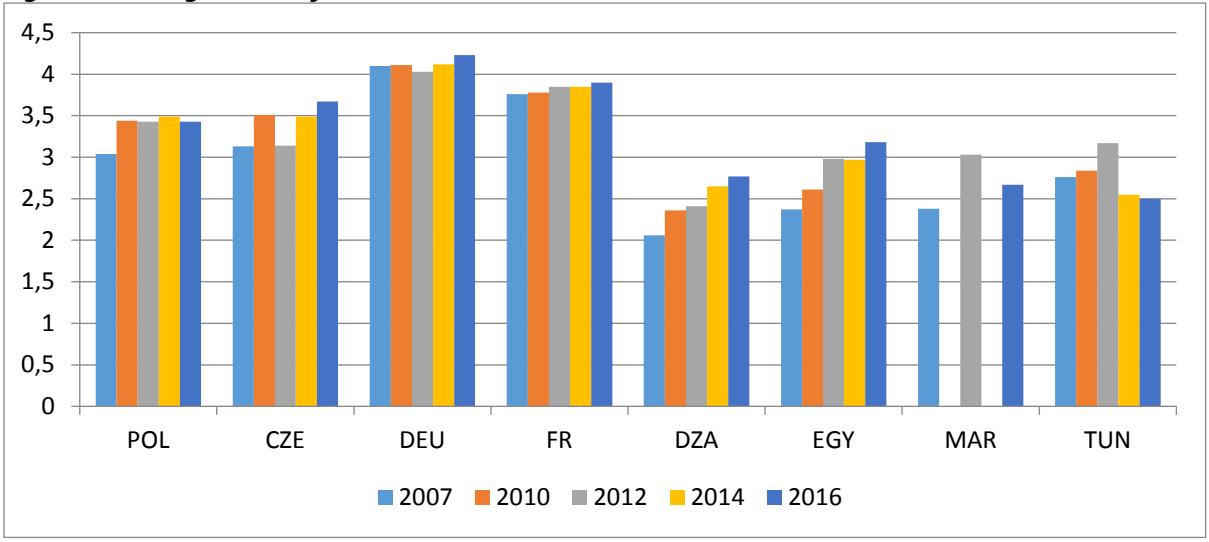
*Figure 29 Explaining variation in trade costs: distance, infrastructure and logistics (2005)*




Source: based on Arvis et al (2013)

Not surprisingly, Germany and France are most advanced in terms of their logistics performance. Poland and Czech Republic have managed to close the gap in recent years, with improvements along all six dimensions of the index. The four Maghreb countries in the sample also show some improvements, although they vary. Algeria and notably Egypt have improved their logistics performance considerably, while both Morocco and Tunisia continue to lag behind. The evidence is different if we look at the evolution of Liner Shipping Connectivity. While here again, Germany and France are most advanced, Poland has improved its position. Among the Maghreb countries, it is now Egypt alongside with Morocco, which have closed the gap to the European core, reflecting these countries' enormous investments in port infrastructure. In contrast, Algeria and Tunisia have fallen behind.

*Figure 30 Logistics Performance Index*



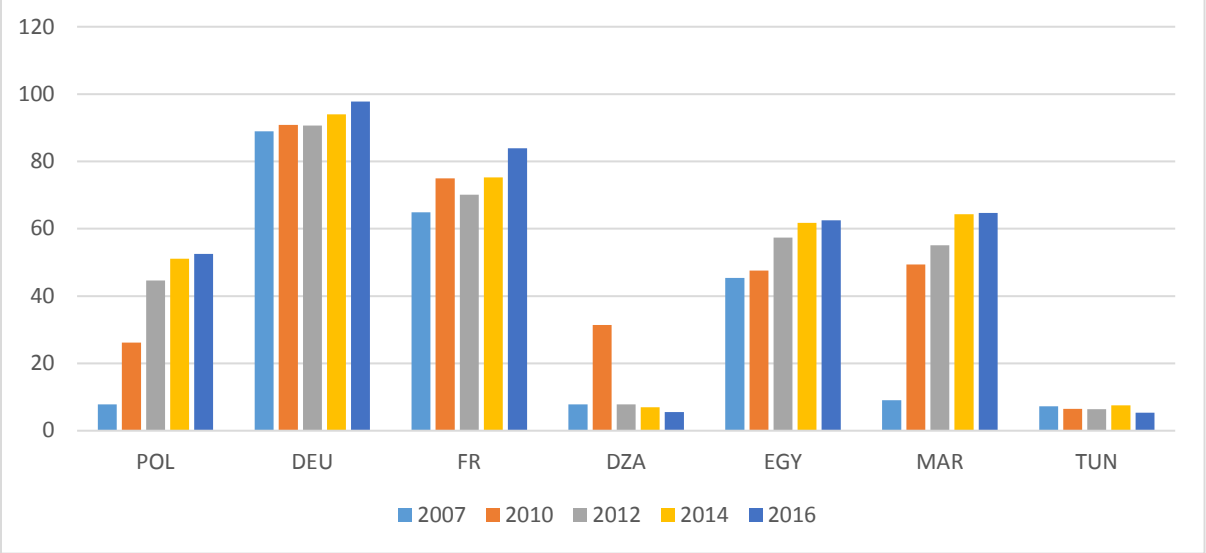

Source: World Bank.

**Box 3: Liner Shipping Connectivity Index**

The Liner Shipping Connectivity Index (LSC) shows how well countries are connected to global shipping networks. It is computed by the United Nations Conference on Trade and Development (UNCTAD) based on five components of the maritime transport sector: number of ships, their container-carrying capacity, maximum vessel size, number of services, and number of companies that deploy container ships in a country's ports. For each component a country's value is divided by the maximum value of each component in 2004, the five components are averaged for each country, and the average is divided by the maximum average for 2004 and multiplied by 100. The index generates a value of 100 for the country with the highest average index in 2004. . The underlying data come from Containerisation International Online.

Source: United Nations Conference on Trade and Development, Review of Maritime Transport 2010.

*Figure 31 Liner Shipping Connectivity Index*




Source: UNCTAD.

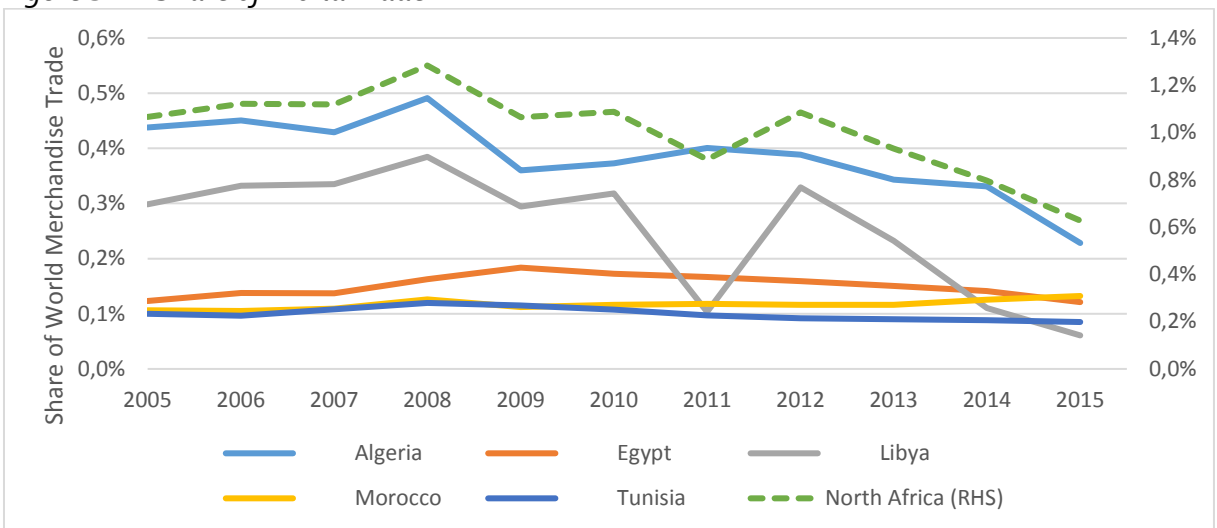
## 5. Challenges and Potential of Economic Integration

### 5.1. Trade Integration – Constraints and Prospects

The key to generate inclusive growth and create quality employment in North Africa is economic integration. Deepening economic integration within the region and globally will make the economies more competitive, enhance their productivity, and benefit consumers due to lower costs. Most importantly, improved economic integration means the chance for greater economic growth and diversification, and thus the potential for job creation. The means to integrate the countries of North Africa deeper into the global economy are enhanced trade and FDI. Therefore, this chapter will summarize the constraints and barriers that trade and FDI face in the region, and the potential and opportunities that could arise if these constraints were removed.

In principle, the Maghreb countries ought to be well integrated into the world economy and strong exporters. Countries with a small domestic market have higher trade openness especially in the geographic vicinity of high-income regions such as the EU. In addition, low wages and incomes should foster convergence and the geographical location amid global trade routes should further boost trade. Instead, North Africa displays an extremely low level of economic integration and currently accounts for 2.5% of the world population, yet contributes less than 1% to world trade. Its trade share has decreased by half during the last years, standing at 0.6% in 2015, which is just above the trade share of Hungary, a country with less than 6% of North Africa's population.

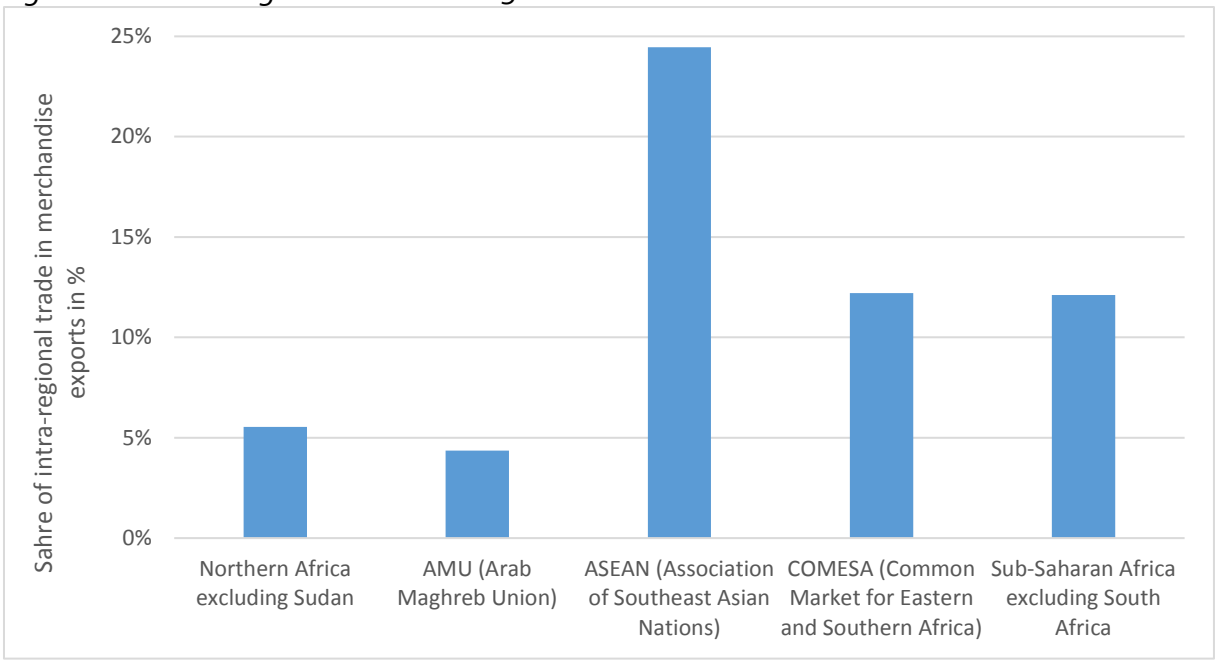
*Figure 32 Share of World Trade*




Source: UNCTAD

The trade performance even worsens when shifting from a global to a regional perspective. Here, North Africa is one of the least integrated region in the world, trading only 5.5% of its exports among themselves, and even less among members of the Maghreb Union. With intra-regional trade almost non-existent in the region, the drought of trade is emphasized when compared with other developing regions, such as the Association of South East Asian Nations (ASEAN) or the Common Market for Eastern and Southern Africa (COMESA).

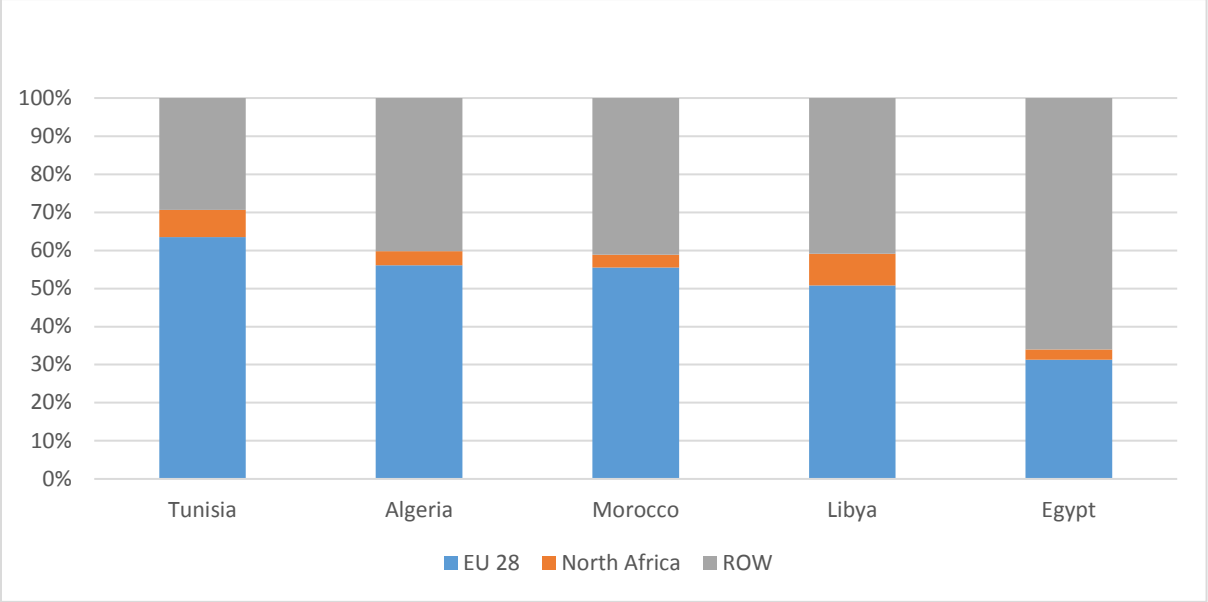
*Figure 33 Intra-Regional Trade in 2015*




Source: UNCTAD

In the last years, the trade dependence on Europe has declined due to weak demand growth in the EU and to faster trade liberalization elsewhere. Yet, Europe remains the most important export and import market by far for the Maghreb countries, since they trade more than 50% of their goods with their largest trading partner. Only Egypt displays a more geographically diverse trade orientation, nonetheless a third of its trade takes place with Europe. Simultaneously the economic rise of China and India has been a blessing and curse for the countries in North Africa. Higher demand from these countries has reduced the dependency on the EU market, yet competition increased for domestic producers and exporters, especially in the textile and electronics industries. The upside are lower prices for the region's consumers (Ali & Sami 2016).

*Figure 34 Trade Dependence on EU in 2015*




Source: UNCTAD

Similar to the Eastern European enlargement, the EU undertook a step-wise approach of trade integration with the non-EU Mediterranean countries. Its original plan entailed at first bilateral agreements, then regional free trade agreements and by 2010 a free trade area including the EU and the Mediterranean. However, in stark contrast to the integration of the CEEC, the original process has so far only be implemented partially and with a long time delay. While the EU signed bilateral Association agreements with Tunisia, Morocco, Algeria, and Egypt that came into force in 1998, 2000, 2005, and 2004, respectively, the institutionalization of trade integration in North Africa is processing at very slow speed. Currently, the EU is in negotiations with Egypt, Morocco, and Tunisia regarding Deep Comprehensive Free Trade Agreements (DCFTAs), which go beyond trade in manufactures and encompass also the areas of agriculture, services, intellectual property, and investment protection. A conclusion of the negotiations anytime soon is however unlikely, since further meetings with Egypt are not scheduled at the moment and negotiations with Tunisia only started in 2015. In the case of Morocco, the court hearing in front of the European Court of Justice regarding the opposing viewpoints on West Sahara's political affiliation have made the situation worse. In December 2016, the court ruled that the previous two trade agreements between the EU and Morocco do not apply to the controversial territory of West Sahara, resetting all trade negotiations. Due to the uncertainty surrounding the DCFTAs, the creation of a Euro-Med FTA in the near future remains highly doubtful.

An important reason for the delay in liberalizing trade with the EU beyond the current state is the gained experience regarding the trade creation effect of the Association Agreements. Looking at the whole MENA region, the result was a significant increase of exports from the EU into the MENA region, while the effect on exports to the EU was rather limited (Cieslik & Hagemejer 2009). Focusing on individual countries, the existence of these preferential trade agreements (PTAs) has not increased exports from North African countries, instead in the case of Morocco boosted imports much more than exports, increasing the trade deficit with the EU and the USA by more than five times respectively four times in the immediate years following the agreements (1999-2009 and 2005-2009). Egypt's PTAs have not decreased trade, however, trade between the Arab Republic and Asian countries grew much more rapid in comparison. The gap in import versus export growth shows partially an unpreparedness to compete in foreign markets, especially in Europe, and competition from third markets such as India and China (Rouis & Tabor 2013). In addition, the hub-and-spoke approach of the bilateral agreements between EU and North Africa runs contrary to regional integration efforts and manifests the trade dependency of the region on Europe's import demand.

Past efforts of regional trade integration via PTAs have been undertaken by all five countries in Northern Africa; they have signed various agreements and joined a multitude of PTAs, yet not one of these agreements encompasses all five of them, except for the established Arab League. The smallest and latest is the Agadir Agreement signed by Egypt, Jordan, Morocco, and Tunisia, which entered into force in 2007. It has liberalized trade in agriculture and industrial products between its members with the intention to boost regional integration. However, these countries are all members of the much larger Greater Arab Free Trade Agreement (GAFTA) as well, which already established a FTA for agricultural and industrials goods in 2005 and simplified custom clearance procedures between its 18 member countries. Therefore, the additional trade creation effect of the Agadir Agreement has only been modest. While intra-regional trade increases slightly and exports out of the region as well, trade diversion occurred as well, indicating that trade potential among the member states is still way below potential (Kahouli & Maktouf 2015). Trade liberalization under GAFTA has also resulted in only a modest trade response, increasing intra-regional exports and imports but remaining below the integration level of other FTAs. In order to shift from "shallow" integration to "deeper" integration, the members of GAFTA have also negotiated the

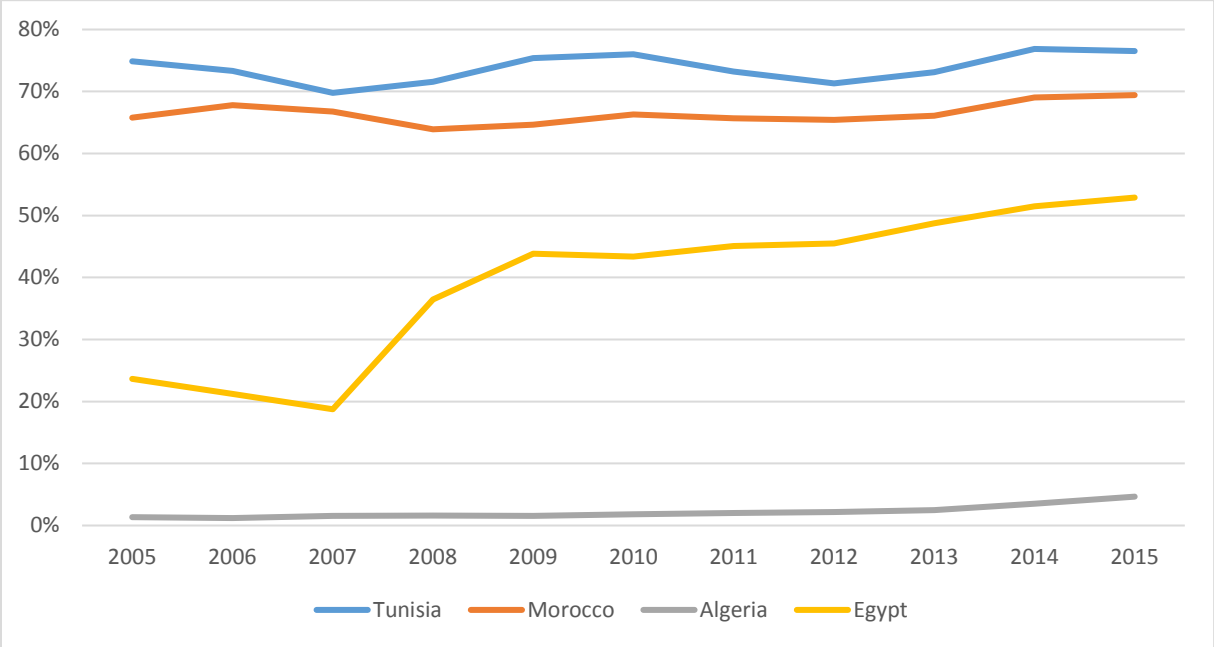
liberalization of trade in services, agreeing on a schedule of commitment in February 2017. However, only the founding nine members, among them Morocco and Egypt, are participating in this next step of liberalization, indicating a two-speed regional integration in the future. The Arab Maghreb Union (AMU), established in 1989, is the region's most central agreement, encompassing all five Maghreb countries and Egypt as an observer. Due to long-lasting political tensions between its members, however, progress towards trade liberalization between neighboring countries has been almost non-existent. The overlap of membership in various PTAs often works against the intent of trade integration in the region. With each agreement entailing a different regime of rules and regulations, complying with all of them without conflict requires time as well as capacity, and is costly for firms, especially for SMEs. One key problem are the diverse Rule of Origin systems, which impede trade harmonization, and creation of integrated supply chains in the region.

However, overlapping membership in various PTAs is not among the top constraints towards regional integration. At the institutional level, the slow progression of trade integration has kept protectionist trade policies at the national level in place, impeding firms from benefitting of a more integrated and thereby larger market in North Africa.

Limiting the potential for regional integration is also the lack of export diversification with the two almost exclusive hydrocarbon exporters Algeria and Libya, industrial minerals in Morocco and Tunisia, and comparatively developed manufacturing sector in Morocco, Tunisia, and Egypt. Among the non-oil exporters in the region, the resource endowments, export structures, and production capabilities are similar, constraining the trade potential based on trade complementarities. Given these structures, the North African countries therefore do not yet constitute natural trading partners, since the regional export structures are too similar and the imports from the region deviate significantly from out of region imports. However, similar to the development in East Asia, countries with similar export structures could nonetheless gain by developing intra-industry trade based on industrial specialization and competition. It would thus foster trade integration in North Africa and offer the chance of upgrading their respective export quality (Ali & Sami 2016). A broadening of their export base is especially necessary for the hydrocarbon producers Algeria and Libya, whose past economic model based on oil exports becomes increasingly inept in a low-oil-

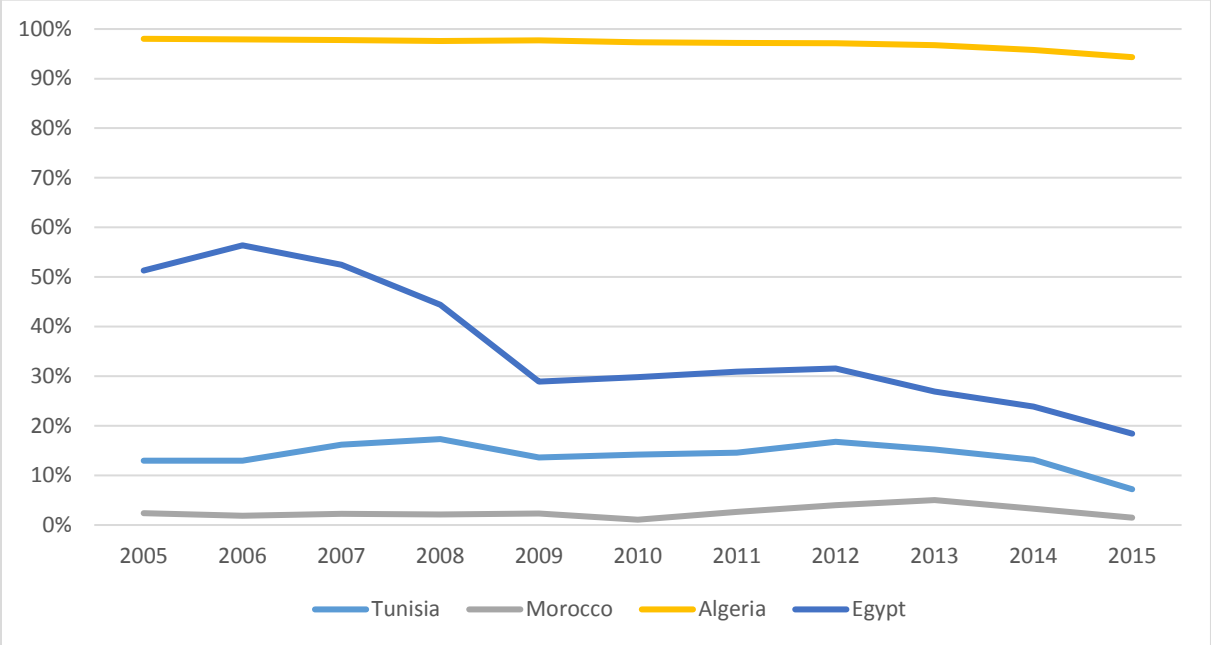
price environment, offering no opportunity for inclusive growth and job creation. In comparison, Tunisia and Morocco display higher trade volumes and export diversification of non-petroleum products and Egypt has achieved a remarkable growth of manufacturing during the last decade (Rouis & Tabor 2013).

*Figure 35 Share of Manufactures in % of Total Exports*




Source: World Development Indicators

*Figure 36 Fuel Exports as % of Total Exports*




Source: World Development Indicators

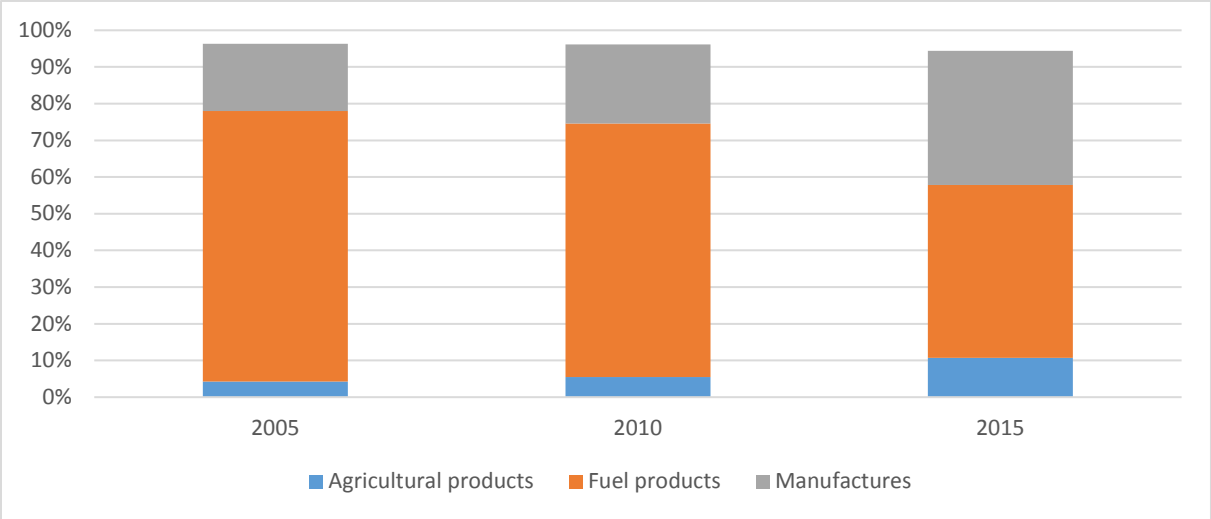
Trade policy also bears responsibility for the very low intra-regional exchange of goods, since these countries also share the characteristic of large public sectors, impeding private sector development and thus trade growth. While tariff protection in the region is still comparatively high, protection of agriculture by high tariffs accounts for it mainly. More important are the restrictive NTB and inefficient cross-border measures, which prevent any meaningful "deep" regional integration. That tariff and NTB between the North African countries are still widely applied is partially explained by the cost of tariff reductions in the form of revenue losses. The respective governments feel these costs therefore immediately and directly, while the benefits of regional integration on the other hand manifest itself in the long-term, and only indirectly. However, in all North African countries, revenue from trade taxes were below 6% of total government revenue. Therefore, a reduction of these revenue streams through trade liberalization is financially manageable, even in these fiscally challenging times. Moreover, experience shows that the losses might only be short-term, since increases in overall trade volumes raise trade tax revenue in the long term despite tariff reductions or are compensated by other domestic tax revenue (Baunsgaard & Keen 2010).

Political tensions, trust issues, and cooperation failure between the North African countries pose another relevant hurdle for regional integration. The probably largest literal barrier to more economic integration in the region is the closed border between Algeria and Morocco, which for the last 23 years has severely restricted the flow of goods and people between the two nations. Yet, the political changes in the region, the renewed urgency to improve the economic performance, and the common external security challenges of migration and terrorism create the opportunity to restart the integration process. Improved regional integration would also directly benefit the integration of North African countries in the world economy. By employing economies of scale, improving competitiveness and increasing product specialization, firms in the region become part of regional value chains. In turn, their potential to compete on the world market and integrate within global manufacturing chains grows as well.

In summary, the North African countries experienced a decade of arrested development, with a trade performance that cost them half their share in world trade. With the notable exception of Morocco, they have failed to join GVCs, liberalize the region beyond trade in

manufactures, lower high NTB, and diversify their narrow export base. The result is a stunted private sector and stalled employment growth. Instead, they mostly stuck to their old economic model that relied on exports of primary commodities such as oil and public sector employment. Yet that economic model is becoming obsolete and has not been able to generate the necessary inclusive growth and job creation for the increasing working age population of the last years. Due to growing fiscal deficits and low oil price, the old model is no longer viable and non-sustainable. Necessary is a new economic model that instead fosters a private sector, which in turn is able to seize the opportunities of economic integration. By producing in regional (and global) value chains and for a larger market with economies of scale, a growing private sector would create productive employment that benefits the large numbers of unemployed or informal workers (Ben Ali 2016). Egypt and also Morocco have had some success in this regard, and as a result the share of manufactures exports has doubled since 2005.[13] Nevertheless, the hydrocarbon producers Algeria and Libya need to abandon their reliance on oil and gas exports and instead aim for export diversification.

*Figure 37 Share of Export Groups in Total Exports from North Africa*



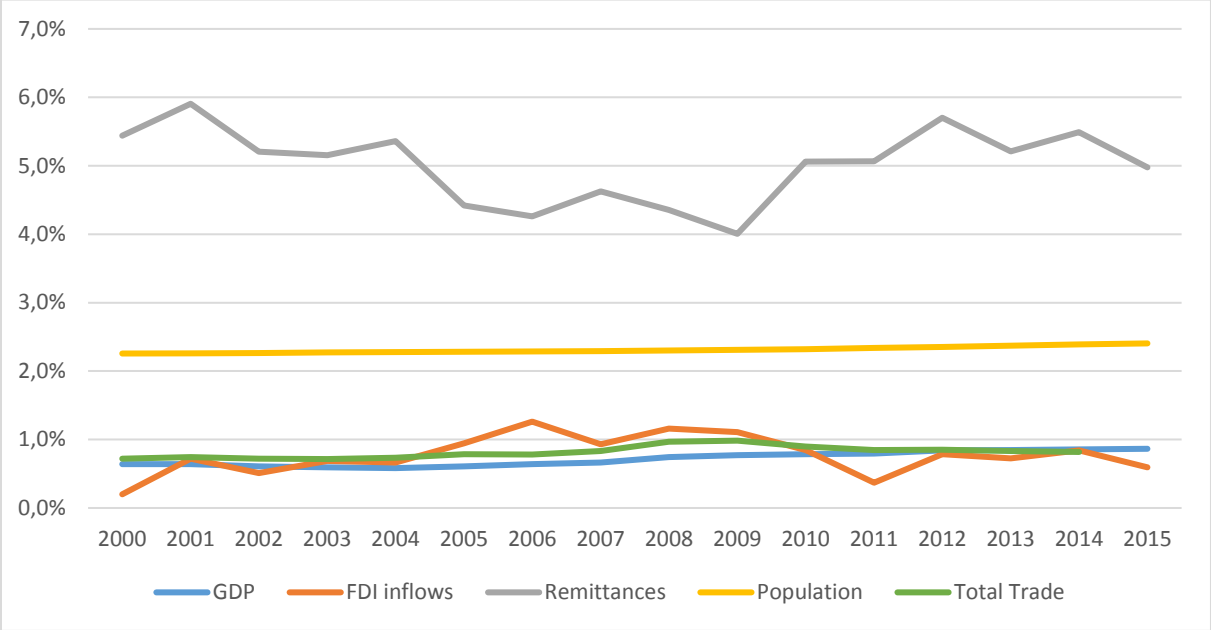

Source: UNCTAD

With its strategic favorable position between the EU, the largest common market in the world, and Sub-Sahara Africa, the fastest growing region in the world, North Africa's trade potential is huge. Yet, the North African countries need to master four challenges to realize

[13] The share of fuel exports, however, has largely declined because of lower petroleum prices, which halved the value of Algeria's merchandise exports between 2011 and 2015 and Libya's severe drop in oil production.

the prospect of robust growth that would boost their GDP and trade share in the world to equal their population share. Without enough political will, the process of trade liberalization on the institutional level will linger. Any effort to advance from shallow to deep regional integration also requires the political courage to abolish protectionist trade policies. The resources to finance the economic transformation and provide the jobs, skills, and technology for expanding the private sector will have to come from abroad, requiring a strong uptake in FDI inflows into the region. Finally, neither trade liberalization nor integration will prove successful if trade facilitation and trade infrastructure in the region do not significantly improve as the next chapters emphasize.

*Figure 38 North Africa's Share in Selected World Indicators*




Source: World Development Indicators

### 5.2. North Africa's Competitiveness and Business Climate – Ranking the Region

The lackluster economic performance of the Maghreb region and Egypt stems directly from their shortcomings in supporting the private sector and its competiveness. Two indices have measured and ranked almost all countries in these areas, permitting a comparison of the North African countries with their competitors on the world market. Drawing on two different editions of these indices -2010 and 2017- also allows an evaluation of the improvement or failure over time.

The Global Competitiveness Index (GCI) aims at evaluating and ranking countries' competitiveness, which is defined by the efficiency of their institutions and policies, as well as their productivity. For this, it assesses annually the factors driving productivity and, consequently, prosperity in 138 countries (World Economic Forum 2016). The GCI combines 114 indicators, which are grouped into 12 pillars. These are organized into three sub-indexes, which are given different weights in the calculation of the overall Index, depending on each economy's stage of development. The index is based on statistical data from internationally recognized agencies as well as on perceptions collected by the World Economic Forum's annual Executive Opinion Survey.

*Table 1: Global Competitiveness Index*

| | Algeria | | Egypt | | Morocco | | Tunisia | |
|---|---|---|---|---|---|---|---|---|
| | 2010 | **2017** | 2010 | **2017** | 2010 | **2017** | 2010 | **2017** |
| **Overall Rank (out of 133/138)** | 83 | **87** | 70 | **115** | 73 | **70** | 40 | **95** |
| A: Basic Requirements | | | | | | | | |
| Institutions | 115 | **99** | 56 | **87** | 64 | **50** | 23 | **78** |
| Infrastructure | 99 | **100** | 55 | **96** | 70 | **58** | 37 | **83** |
| Macroeconomic Environment | 2 | **63** | 120 | **134** | 32 | **49** | 55 | **99** |
| Health and Primary Education | 77 | **73** | 84 | **89** | 87 | **77** | 30 | **59** |
| B: Efficiency Enhancers | | | | | | | | |
| Higher Education and Training | 102 | **96** | 88 | **112** | 99 | **104** | 32 | **93** |
| Goods Market Efficiency | 126 | **133** | 87 | **112** | 68 | **64** | 39 | **113** |
| Labor Market Efficiency | 127 | **132** | 126 | **135** | 129 | **124** | 98 | **133** |
| Financial Market Development | 132 | **132** | 84 | **111** | 96 | **83** | 87 | **119** |
| Technological Readiness | 123 | **108** | 82 | **99** | 76 | **81** | 55 | **80** |
| Market Size | 51 | **36** | 26 | **25** | 56 | **55** | 66 | **69** |
| C: Innovation and Sophistication Factors | | | | | | | | |
| Business Sophistication | 128 | **121** | 72 | **85** | 78 | **76** | 54 | **101** |
| Innovation | 114 | **112** | 74 | **122** | 96 | **96** | 38 | **104** |

Note: The number of covered countries rose from 133 in 2010 to 138 in 2017.

Source: Global Competitive Report, various issues.

Among the four included North African countries[14], Morocco shows the highest overall competitiveness in 2017, while Egypt marks the regional bottom. Morocco performs comparatively well in the pillars of institutions, macroeconomic environment, and market size. However, globally this still implies a medium performance. Compared to their overall ranking, institutions are less of a problem for the other countries in the region as well. Only Algeria struggles with a highly inefficient accountability of private institutions and a lack of adequate property rights protection. Moreover, high gross national savings and an extremely low government debt thanks to their oil revenues drive Algeria's comparatively stable macroeconomic environment. Its large negative budget balance and comparatively high inflation are more problematic, resulting from the latest period of low oil prices. In contrast, Egypt's and Tunisia's competitiveness is significantly impaired by an unstable macroeconomic environment. Further improvements in the region's economies are possible by increasing their export share, which is well below the global average. Additionally, innovation activity as well as labor market efficiency – concerning flexibility as well as the efficient use of talent – in the region lag far behind global standards. Plus the efficiency of goods markets as well as the development of financial markets in all four countries except Morocco need to improve significantly in order to keep pace with competing global economies. More investment in higher education and training facilities is also highly recommendable, while the region's level regarding health and primary education is in line with the global average. Between 2010 and 2017, the performance of Egypt and Tunisia significantly deteriorated, while Morocco and Algeria kept their robust position in the global middle. Due to the increased geopolitical tensions and regime changes since the Arab Spring, in Tunisia and Egypt the competitiveness declined across almost all included pillars.

The World Bank's Ease of Doing Business Index captures how difficult it is for a local entrepreneur to open and run a small to medium-size business when complying with relevant regulations (World Bank 2017b). For 190 countries, it measures and tracks changes in regulations affecting 10 areas in the life cycle of a business. However, since it does not directly take into account more general conditions such as macroeconomic stability, the quality of institutions or infrastructure, corruption, or crime, it cannot be seen as a comprehensive measure of a country's business environment. More specifically, the Doing Business data

[14] Libya is left out due to lack of data.

relates to domestic laws, regulations as well as administrative requirements. Additionally, some indicators are based on actual practice, for which legal practitioners and professionals are surveyed. Moreover, it draws on small to medium-size firms, meaning their experience with laws, regulations, and practices might be different or irrelevant to larger and often foreign-owned companies. For the construction of the index, economies are ranked on their ease of doing business, with a high rank implying that the regulatory environment is more conducive to starting and operating of a local firm. The rankings are determined by sorting the aggregate distance to frontier scores on the 10 topics, each consisting of several indicators, giving equal weight to each topic.

*Table 2: Ease of Doing Business Index*

| | Algeria | | Egypt | | Libya | | Morocco | | Tunisia | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2010 | **2017** | 2010 | **2017** | 2010 | **2017** | 2010 | **2017** | 2010 | **2017** |
| **Overall Rank (out of 183/190)** | 136 | **156** | 106 | **122** | | **188** | 128 | **68** | 69 | **77** |
| Starting a Business | 148 | **142** | 24 | **39** | | **163** | 76 | **40** | 47 | **103** |
| Dealing with Construction Permits | 110 | **77** | 156 | **64** | | **187** | 99 | **18** | 107 | **59** |
| Getting Electricity | | **118** | | **88** | | **128** | | **57** | | **40** |
| Registering Property | 160 | **162** | 87 | **109** | | **187** | 123 | **87** | 59 | **92** |
| Getting Credit | 135 | **175** | 71 | **82** | | **185** | 87 | **101** | 87 | **101** |
| Protecting Minority Investors | (73) | **173** | (73) | **114** | | **185** | (165) | **87** | (73) | **118** |
| Paying Taxes | 168 | **155** | 140 | **162** | | **121** | 125 | **41** | 118 | **106** |
| Trading across Borders | 122 | **78** | 29 | **168** | | **114** | 72 | **63** | 40 | **92** |
| Enforcing Contracts | 123 | **102** | 148 | **162** | | **143** | 108 | **57** | 77 | **76** |
| Resolving Insolvency | (51) | **74** | (132) | **109** | | **169** | (67) | **131** | (34) | **58** |

Note: The methodology of some subindexes changed slightly over time. I.e. in 2010, the subindex "protecting minority investors" was defined as "protecting investors"; and the subindex "resolving insolvency" was defined as "closing a business". Libya as well as the sub-index "getting electricity" were not included in the 2010 survey. Moreover, the number of included countries rose from 183 in 2010 to 190 in 2017.

Source: Doing Business Report, various issues.

In the most recent index, Morocco and Tunisia are the best performers among the North African countries, while Algeria and Libya lag far behind. As the region's leader, Morocco performs comparatively strong in the areas of dealing with construction permits, starting a

business and paying taxes. The former seems to be less problematic across all countries in the region except for Libya, whereas in the area of paying taxes Morocco completely outperforms its neighboring countries. Tunisia, Algeria, and Libya still need to improve their regulations for starting a business as well as enforcing contracts, in order to compete with Morocco and Egypt. In contrast, regarding resolving insolvency Morocco can still learn from its regional peers. In particular, Algeria surprises with a strong performance in resolving insolvency as well as trading across borders. Whereas Egypt's trade performance is evaluated to lag behind the other countries in the region, driven by its high cost and long time to import, its regulations concerning exports meet the regional average. Notable deficiencies across all North African countries are a limited access to credit as well as an inadequate protection of minority investors. Since 2010, Morocco achieved a large improvement in regulations and Tunisia remained in the global middle, while Algeria and Egypt fell behind.

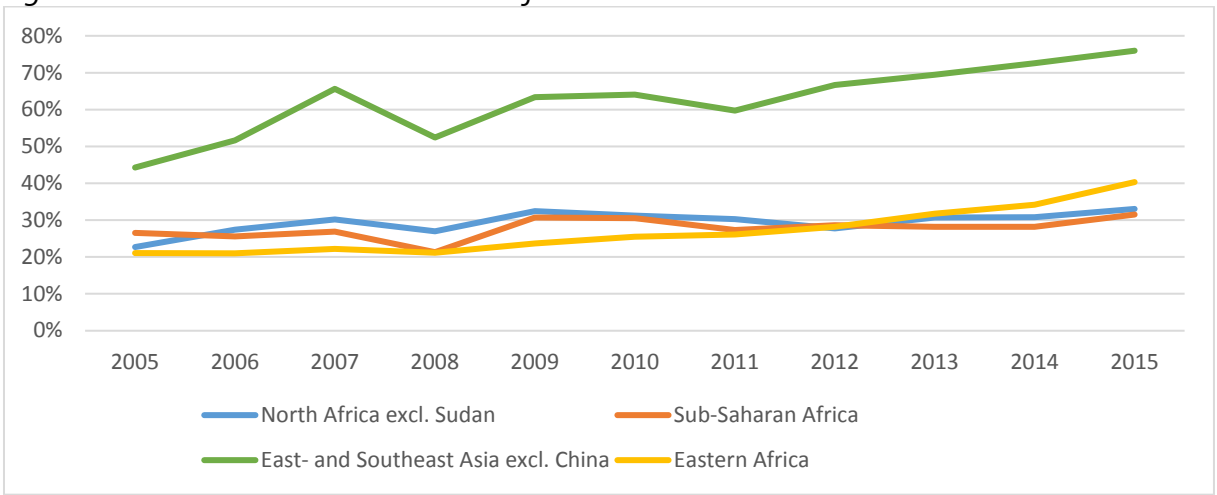
Doing Business indicators and rankings are considered to be directly related with higher or lower inflows of FDI, since a higher ranking suggests a more favorable investment climate. Yet, whether Doing Business scores actually indicate a better quality of the investment climate in general and hence a correlation between the rank and FDI inflows requires empirical evidence. Cross-country evidence that is available so far shows that indeed countries with a better ranking attract larger FDI inflows (Jayasuriya 2011; Corcoran & Gillanders 2015; The World Bank 2013). The relationship, however, is only significant for middle-income countries (and not for Sub-Sahara Africa or the OECD) and seems to be driven by the indicator "Ease of Trading Across Borders" (Corcoran & Gillanders 2015). It also carries a regional component, where a regional level of trade regulation increases or decreases individual countries' attractiveness to FDI. In all empirical studies, the economic effect on FDI flows is strong and the relationship between the overall regulatory environment and FDI inflows provides clear policy implications. For example, a one-percentage point increase in the Doing Business score would increase annual inflows of FDI by a striking 21% (The World Bank 2013). If that correlation also signifies causation, the results imply that even a modest regulatory reform (and hence improvement of the Doing Business indicators) could potentially cause a substantial enlargement of FDI.

### 5.3. Foreign Direct Investments – Constraints and Prospects

An inflow of FDI is able to support the structural transformation and industrialization of a developing economy, thereby generating employment in the short- and long-term. Investments from abroad are also capable of enhancing a country's capacity for upgrading of its export structure, whose quality in turn has direct effects on economic growth. The presence of multinational enterprises (MNEs) in the country not only improves the export portfolio it also enables local producers to climb up the value chain due to transfers of knowledge and technology (Harding & Javorcik 2012). These advantages of FDI, however, do not occur automatically, instead investment and industrial policies have to facilitate the spillover effects and backward linkages to domestic producers. Otherwise, the impact on growth and structural transformation are limited (Sutton, J. et al. 2016). The case study of Morocco in this report and another case study of Tunisia have confirmed these restrictions, qualifying the positive impact of FDI on economic growth. To increase the returns to foreign investments, an environment inductive to spillover effects is necessary, requiring responsive educational and financial systems and a developed infrastructure (Belloumi 2014).

Equivalent to the flow of exports and imports, the North African countries were outpaced regarding the inflow of FDI compared with other developing regions in the last decade. While the region managed to increase their FDI stock by about 50%, Eastern Africa doubled their stock and East- and Southeast Asia grew equally impressive from an already high level in 2005. Only when considering Sub-Sahara Africa as a whole, does this region perform slightly worse than North Africa.

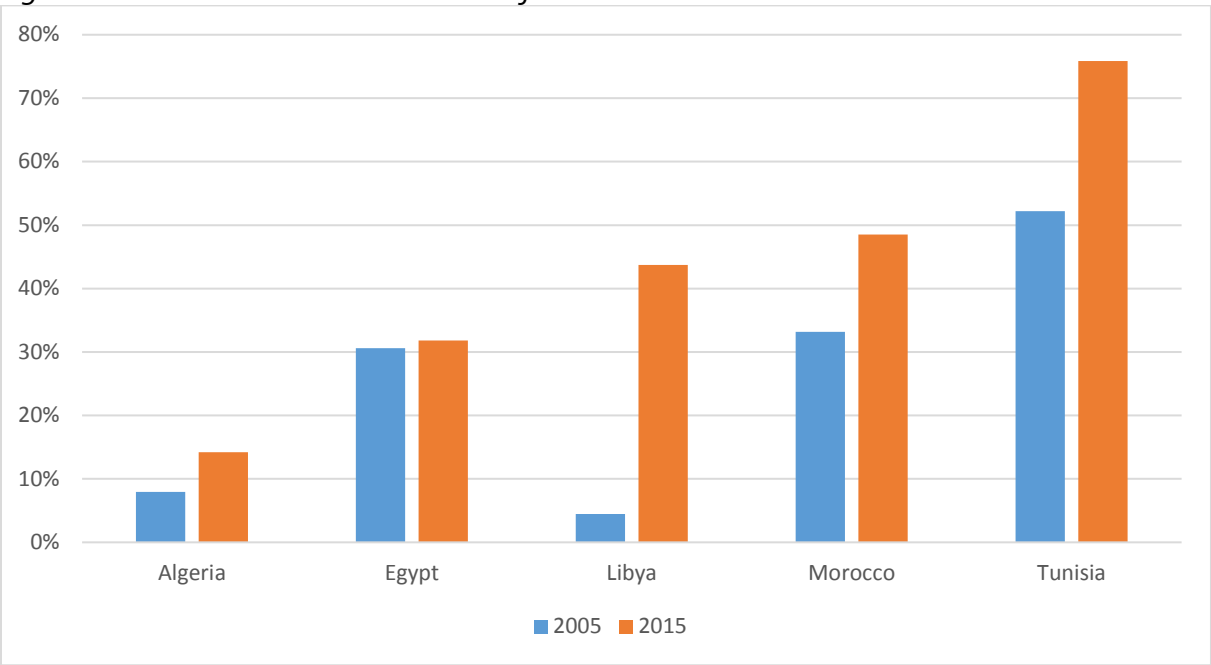
*Figure 39 FDI Inward Stocks as Share of GDP*




Source: UNCTAD

Comparing Egypt and the Maghreb countries individually presents an inconsistent picture. Leaving Libya aside, whose rise is largely a side effect of its collapsing GDP, Morocco and Tunisia have positively enlarged their FDI stock compared to GDP. In contrast, Egypt affected by political instability experienced a stagnating share, while Algeria doubled its stock, albeit from a very low starting position in 2005.

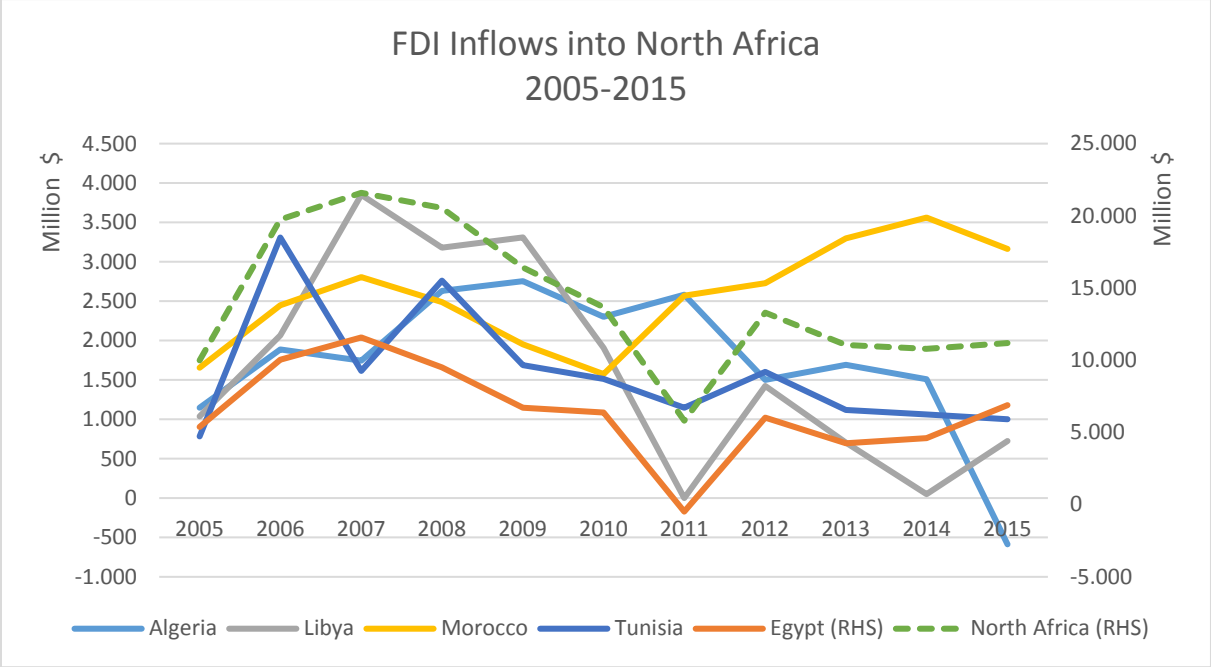
*Figure 40 FDI Inward Stocks as Share of GDP*




Source: UNCTAD

A closer look at the actual annual inflows reveals a more depressed development in North Africa. With the sole exception of Morocco, all other countries witnessed a sharp decline in inflows from a temporary peak in 2007. The double impact of the global financial crisis in 2008 and the Arab Spring becomes more than apparent, a shock from which the overall FDI inflows into North Africa have not yet completely recovered. Morocco, the least affected country by the Arab Spring, successfully bucked the regional trend of shrinking inflows, apparently offering the right factors to attract investments from abroad. Inflows into Egypt, traditionally the largest receiver of FDI in the region, have also gained a new dynamic recently, increasing again since the accession of power by President el-Sisi in 2013. With the latest estimates for 2016 suggesting a 9% rise on the previous year, the Arab Republic is likely to continue the FDI growth trend in 2017.

*Figure 41 FDI Inflows into North Africa*




Source: UNCTAD

The poor performance of North African and Middle Eastern countries in attracting FDI compared to other regions of the world has generated a number of empirical analyses in the last decade. With the main aim to seek out the determinants of FDI in the MENA region, these studies have established a consensus view on the factors attracting and discouraging investment flows from abroad. First, MNEs consider a combination of economic and political factors when deciding to invest in a country, among others: Access to large markets, natural resources, low costs of labor and other inputs, skills and knowhow, proximity and access to leading firms or markets that could serve as suppliers or buyers of products, and macroeconomic and political stability. Specific analyses that evaluated the determinants of FDI inflows to the Maghreb region or individual North African countries, however, are scarce. Nevertheless, a consensus emerges that local market size, proxied by a host country's GDP per capita, as well as a host country's trade openness, proxied by the sum of exports and imports as a percentage of GDP, have a strong positive impact on FDI inward flows to the MENA region (Aziz & Mishra 2016; Helmy 2013; Bannaga et al. 2013). While a positive relation between local market size, representing market demand in the host country, and inward FDI suggests that most FDI to the MENA countries is market-seeking, trade openness should mainly matter for investors who are interested in using the host country as an export-platform. Indeed, empirical evidence supports the notion that MNEs investing in the region

are predominantly interested in accessing new markets. In this context, new markets refer at the same time to the host country's domestic market itself as well as to the regional economy as a whole (Hisarciklilar et al. 2007). However, to a lesser extent, the availability of natural resources in the MENA countries has also been identified to attract foreign investors (Mohamed & Sidiropoulos 2010), which suggests that a share of FDI to the region is resource-seeking. This result appears to be predominantly driven by the Gulf Cooperation Council (GCC) countries who command large natural resources and receive around 35% of FDI inflows to the region (UNCTAD 2016).

Moreover, the empirical evidence shows that MENA countries with relatively strong institutions and low political risk tend to attract a larger amount of FDI than less stable countries (Gammoudi & Cherif 2016; Bannaga et al. 2013). Especially FDI inflows to the manufacturing sector tend to suffer from adverse political shocks, while investments in natural resource sectors and non-tradable activities are less sensitive to those shocks (Burger et al 2013). This suggests that the extent to which heightened political instability affects aggregate FDI is critically contingent on the initial sector composition of these flows. Interestingly, corruption seems to play only a minor role (Méon & Sekkat 2002; Helmy 2013). Rather a government's effectiveness, regulatory quality, and accountability have an impact on investors' country selection in the region (Bannaga et al. 2013). While identified as a direct determinant itself, political as well as institutional stability indirectly affects also the importance of other determinants (Gammoudi & Cherif 2016). More specifically, institutions determine the feasibility and profitability of engaging in economic activity by providing physical and organizational infrastructure, enforcing contracts, reducing uncertainty or protecting property rights. Still, the Arab region has one of the lowest governance performances in the world (Bannaga et al. 2013). Therefore, foreign investors rely on bilateral investment treaties (BITs), which establish clear, simple, enforceable, and reciprocal rules for foreign investment protection from government expropriation, to secure their investment activities. Empirical evidence shows that BITs have a positive and complementary effect on FDI inflows to the MENA region (Mina 2012), serving as a second-best approach to property right protection, a function normally provided by domestic institutions. From the reverse direction, BITs also have a positive impact on the FDI outflows of the EU, the largest source of foreign investment in the world (Guerin 2010). Given the potential FDI enhancing effect of

BITs, the coverage of BITs in the region displays serious shortcomings, especially for Algeria, Libya and Tunisia. While Egypt and Morocco have signed BITs with almost every major economy and as a result have 73 respectively 49 BITs in force, the numbers for the other Maghreb countries is considerable lower. Libya, for example, has not signed treaties with the United States, the second largest provider of FDI after the EU. Moreover, its BITS with China, South Africa, Qatar, and the United Kingdom are not yet in force[15]. Similar gaps exist for Algeria, which has no BITs in place with either the United States or the United Kingdom; and both, Algeria and Tunisia, have no BITs in force with Qatar and South Africa. As a manifestation of the political tension among the Maghreb countries, the intra-regional coverage of BITs between Algeria, Libya and Tunisia is non-existent (UNCTAD 2016).

*Table 3: Bilateral Investment treaties of North Africa*

| Country/BITs | Algeria | Egypt | Libya | Morocco | Tunisia |
|---|---|---|---|---|---|
| BITs signed | 48 | 100 | 37 | 68 | 54 |
| BITs in force | 28 | 73 | 24 | 49 | 34 |

Source: UNCTAD

In summary, the key determinants of FDI to MENA countries are the size of the economy, its trade openness, natural resources, and institutional quality. Other relevant determinants include bilateral trade agreements, already existing agglomerations of foreign investments in the host country, research and development (R&D) expenditures, and the difference in relative factor endowments. When comparing the determinants of FDI flows to the MENA region with those to developing countries in general, two factors with further FDI potential become apparent. The quality of infrastructure as well as the host country's financial development level have proven effective in attracting FDI to developing countries (Mohamed & Sidiropoulos 2010), thus improving the MENA countries' overall weak performance in these fields could increase FDI inflows to the region additionally.

[15] Qatar is the second-largest FDI provider from the MENA region after United Arab Emirates and South Africa the most important one from Africa.

*Table 4: FDI Determinants*

| FDI determinants | Measured as | Impact on FDI inflows |
|---|---|---|
| Market Size | GDP per capita | positive |
| Trade Openness | (Exports+Imports)/GDP | positive |
| Bilateral Trade Agreements | Dummy for WTO-membership/EMU membership/regional trade agreements | positive |
| Institutional Quality | World Bank Governance Indicators | positive |
| Institutional Property Rights Protection | Political risk index | positive |
| Bilateral Investment Treaties | Number of BITs entered into force | positive |
| R&D Expenditures | Share of R&D expenditures in GNI | positive |
| Quality of Infrastructure | number of telephone mainlines and mobile phone subscribers per 1000 people | positive |
| Financial Development | Weighted average of liquid liabilities, credit to private sector and credit by banks to the private sector | positive |
| Political instability | Political risk index | negative |
| Corruption | Corruption Perception Index (TI) | negative |
| FDI Agglomerations | Lagged dependent variable | positive |
| Relative Difference of Factor Endowments | Unit labor costs in host country divided by unit labor costs in source country | positive |
| Natural Resources | Total oil supply, fuel exports as a share of merchandise exports | positive |

The potential for higher FDI in North Africa is foremost given by the fact that FDI inflows into the region have already been twice as large ten years ago as they are now. An improvement of the political and security situation in the region would automatically enhance the investment climate, triggering additional inflows. Further reforms that directly upgrade the crucial determinants of FDI would increase inflows as well, and investment promotion agencies reduce the often prevalent bureaucracy and information costs. The existence of a virtuous cycle, in which FDI and economic growth affect each other positively, adds to the prospect of strong FDI development in North Africa (Iamsiraroj 2016). A similar dynamic

relationship has been demonstrated between trade and foreign investments, as the case study on Morocco in this report demonstrates. In the long run, higher trade openness together with economic growth fostered FDI inflows in Tunisia even under the previous autocratic regime (Belloumi 2014). These mechanisms emphasize the existing linkages between trade, FDI, and growth, suggesting a comprehensive reform approach that considers these factors not in isolation. Besides the crucial role of determinants for FDI inflows, the pooling of FDI into SEZs warrants a closer look at the interplay between them and the transformational role these zones can have in developing countries.

### 5.4. Potential for FDI: The Role of Special Economic Zones

FDI inflows can have a significant impact on economic growth in developing countries due to their potential to accelerate economic transformation through capital stock accumulation and technological spillover. Foreign investments also often drive improvements of employment conditions and infrastructure. The increase in cross-border activities will open up new opportunities for the private sector in developing economies, i.e. tap into new markets, access new technologies and resources, spread risk, reduce costs, and increase competitiveness (Agosin 2008). Moreover, the economic gains to domestic consumers can be significant, when foreign competition erases local monopolies and brings lower prices and broader access to quality products and services.

Developing countries have been increasingly relying on special economic zones (SEZ) in order to attract foreign capital and create new jobs. This form of industrial policy provides special policy incentives and infrastructure in a delimited geographic location to firms that can attract further FDI, create jobs, develop and diversify exports, even when economy-wide problems of business environment and protective barriers are not yet resolved. Common SEZ features include streamlined processing of goods ready for export, lower export fees, as well as reductions in taxes and import tariffs of intermediates, all of which aim to make firms located in the SEZ more competitive on the world market (Zeng 2015). The pull of geographical clustering and networking of related value-added activities is argued to have an increasing effect on the choice of location by multinational enterprises (MNEs) (Dunning 2009). The establishment of affiliates abroad increases the demand for labor and drives up investments as well as exports in the host economy. In order to benefit the most from inward

FDI, developing countries should design SEZs and industrial clusters in such a way that they support the upgrading and diversification into new industries (Monga 2011). Optimally, it starts with labor-intensive, assembly-oriented activities while focusing on the creation of manufacturing jobs and absorbing large segments of the low-skill labor force. At the same time, promoting the upgrading of skills, industry activity, and technology improves the economy's endowment structure and moves it towards higher-value activities at a realistic pace. For this, it is important to encourage linkages between SEZ-based firms and local firms such that the zones provide demonstration effects for success and serve as catalysts to broader reforms.

This is based on the idea that firms located within zones are assumed to have a productivity and technology advantage over domestic firms; not least because of their likely foreign ownership. Foreign-owned firms, which are especially in developing countries the predominant type of SEZ investments, receive product, process, and distribution technologies or management and marketing skills from their headquarters (Crespo & Fontoura 2007). Identified channels through which this advanced knowledge is expected to translate into private sector development and productivity increases of the host economy are production linkages, worker mobility, and imitation (Smeets 2008). Empirical evidence shows that backward linkages with domestic companies in upward industries are the primary channel for knowledge and technology spillovers. Along the supply chains, higher positive externalities and a lower intensity of negative competition effects are expected, since MNEs might have an incentive to transfer some knowledge to their local suppliers in contrast to minimizing information leakages to competitors (Castellani & Zanfei 2006). Moreover, the presence of foreign exporters eases local firms' access to the international market and reduce their export costs by providing them with relevant information about markets, technology and distribution services (Aitken et al. 1997). At the same time, export-oriented firms tend to impose stringent cost and quality requirements on inputs, which should induce domestic suppliers to increase their productivity. Supporting local firms in meeting those requirements is particularly crucial for domestic authorities of developing countries, where the majority of SEZs preferably target export-oriented firms in order to promote a country's industrial and commercial exports.

For developing countries, it is especially important to employ "soft industrial policies" which deal directly with the coordination failures of existing industries and clusters that limit their productivity and expansion. More particularly, complementary to tariffs, export subsidies, and tax breaks for foreign corporations, governments should engage in programs to help industrial clusters by increasing the supply of skilled workers, encouraging technology adoption, and improving regulation and infrastructure (Harrison & Rodríguez-Clare 2010). The rationale behind this is the risk that MNE-led exports are likely to remain technologically stagnant, leaving developing countries unable to progress beyond the assembly of imported components if host-country policies do not develop adequate local capabilities (Chandra 2006). Indeed, there is a broad consensus that the size of spillover effects is positively affected by a firm's absorptive capacity, which is assumed to depend on its level of R&D spending as well as its human capital endowment (Griffith et al. 2004). Therefore, investing in training and research facilities specific to the targeted sectors' needs and linking them to the private sector is crucial for increasing the spillover potential of SEZs. Moreover, encouraging joint ventures between foreign and domestic companies can also be a beneficial strategy to boost the host economy's performance. Shared ownership presents a higher potential for the diffusion of important technology, as well as a higher probability of inter-sectoral linkages with the local economy (Smeets 2008). However, a larger share of domestic ownership could also reduce the incentive for the parent firm to transfer technology that is more advanced to its affiliate, due to its limited control over the management, thereby decreasing the spillover potential.

The investment climate within the zone crucially contributes to a SEZ's success – besides the traditional sources of competitiveness (such as low wages, trade preferences and fiscal incentives) and the geographical location as well as the domestic market size (Farole 2011). In this context, the investment climate refers to the risks, transaction costs and opportunities involved in investing in and operating a business. Especially, a well-developed infrastructure network as well as a reliable connection to the domestic transportation hubs are essential. In this light, a wider trend has emerged defined by the development of multi-layered hubs at strategic locations, which aim at creating a beneficial and attractive business environment for firms operating in several industries. For this, the hub provides a combination of preferential services and incentives regarding logistics, transportation, infrastructure, and

business operation. Among others, this includes the creation of a new type of port city, which geographically clusters the traditional port business, industrial production sites, and service suppliers in several SEZs, at the same time linking them to extensive infrastructure and transportation networks (Ducruet et al. 2011). Consequently, in order to support SEZ performance, it is crucial to integrate them into broader trade and industrialization strategies. Moreover, while a not negligible degree of government coordination is required, the involvement of the private sector in this process is indispensable. Ideally, the state and the private sector establish a strategic collaboration and coordination between them with the task to uncover where the most significant bottlenecks are, design the most effective interventions, periodically evaluate the outcomes and learn from the mistakes made in the process (Rodrik 2008). How Morocco rather successfully applied that approach to its SEZs shows the case study in the next chapter, while the next section details the role of infrastructure in constraining development.

### 5.5. Infrastructure – Constraints and Prospects

High trade costs within North Africa and between the region and Europe are to a considerable extent due to an infrastructure gap. In order to foster employment growth in agro-industry, industry and tradable services and break into the new global industrial economy, North African countries need to develop their networks of transport infrastructure, energy, and telecommunications both to connect to foreign markets and to integrate their own hinterland.

The countries of North Africa have already extensive road networks, as well as some railway lines and several ports, including regional hubs. However, in many parts the transport infrastructure remains underdeveloped and poorly integrated. As in most countries, road traffic is the main mode of land transportation for goods trade excluding liquid bulk. As all other infrastructure, the road networks in the region are most densely developed in the north, connecting the main cities along the coast. Extensive works to complete the Trans-Maghreb Highway to connect all countries of the Arab Maghreb Union (Mauretania, Morocco, Algeria, Tunisia, Libya and Egypt) have been pushed by the Algerian government, which nearly completed the East-West Motorway (1216 km). Morocco and Tunisia are in the process of completing highways on their sides of the border, compatible with the Algerian motorway.

However, while there is cooperation at the technical level (supported by the Group of Ministers of Transport of the Western Mediterranean (GTMO 5+5 initiative)[16], political tensions between Algeria and Morocco since 1994 have led to a closure of the border between the two countries and impeded any further integration. Another key issue is the fragmentation of the trucking sector in the region. Often many small providers would wait for cargo at a port, which leads to congestion and inefficiencies. More generally, the trucking sector in the region is in need of restructuring to create a modern industry, with capable trucking operators that are free to charge market rates and government involvement that is limited to regulation on safety and licensing. Related to this is the implementation of the TIR system of transit guarantees, which is incomplete in the region. While Morocco, Algeria and Tunisia are contracting parties to the TIR convention, Libya and Egypt are not, and Morocco and Algeria do not use the benefits of the system for cross-border traffic.

The railway network is relatively less developed in the region. Railways are state owned and operated and typically not profitable, with the exception of Morocco. However, recently, railways have become another priority for investment in several countries, also due to new initiatives by GTMO 5+5 to develop a trans-Maghreb railway axis as agreed in Lisbon 2014. Morocco has invested in a freight railway connection between the port of Tanger MED and Tanger automotive city in operation since 2012 and started to construct a high-speed railway connecting Tangier and Casablanca. Tunisia suffers from the fact that most of its railways are narrow gauge (1 meter) and hence not directly compatible with the standard gauge tracks of her neighbors. Attempts to construct a railway network in Libya with Chinese, Russian and German contractors have stalled since 2010, as well as discussions to build a railway connection between Tunisia and Libya. Egypt's railway network is concentrated in the Nile delta, connecting major cities and ports as well the Libyan border at Sallum. After years of neglect, the government has very recently started to invest in the railway infrastructure and taken steps towards a deregulation of the sector.

Another key element in North Africa's transport infrastructure are seaports. While trade within the region is limited, trade flows with Europe, North America and East Asia are important and have attracted major investment in port infrastructure over the last decades.

[16] The GTMO stands for "Conference of Transport Ministers of the Western Mediterranean", a group that fosters cooperation on transport in the Western Mediterranean and includes all Maghreb countries.

The seaport system has undergone fundamental changes with the spread of containerization since the 1970s. Within the region, a dynamic system of hub ports and smaller ports has emerged, now dominated by the hub ports of Tanger Med in Morocco, and Port Said and Damietta on the Suez Canal in Egypt. Table 5 shows the size of these ports compared to other main ports in the Mediterranean. The performance of Tanger Med clearly stands out. This rise is a recent phenomenon, where the port of Tanger Med gained importance compared to Casablanca and Alger due to four main factors (Mohamed-Chérif & Ducruet 2016). First, Tanger Med obviously benefits from its strategic geographical position in the Gibraltar Straits connecting the Mediterranean and the Atlantic. Second, the port developed due to a new national policy, which ended the state's monopoly in the port sector, moving to the so-called "landlord-model" of public-private partnerships. Third, from the beginning the project of Tanger Med combined a logistics-free zone with industrial zones, which created complementarities between the transport sector and industrial activities. Finally, the Tanger Med project benefitted from improvements in hinterland accessibility through highways and railways. The dynamics of other ports in the region seem to be hampered by a lack of hinterland connection, low complementarity to industrial zones and inefficient port organization. In the case of Algeria, a key challenge is improving the organizational efficiency through public private partnerships and realizing better hinterland accessibility. Egyptian ports are dynamic, but seem to suffer from relatively untransparent organization.

In Tunisia, the inadequate transport infrastructure of the port system has already proved costly. Logistic bottlenecks at the current largest port of Radès cost the economy more than €200 million annually. Strikes by the port workers against privatization plans of the government and attempts to install 24-hour operations have resulted in penalty fees of €46 million to the EU since 2011. Consequently, Tunisia plans a deep-water seaport at Enfidha accompanied by an industrial zone, to attract transshipment flows, yet realization of the project is still uncertain, with the financing costs of more than $1 billion the main challenge. Tunisia aims to start constructing on the port for 2018 and once completed, the intended transshipment hub could create 20 000 direct and indirect jobs, which would enable a traffic capacity of 2.7 million TEUs, slightly below the level at Tanger Med.

*Table 5: Major Container Ports in the Mediterranean*

| Port | Country | Container Traffic (000 TEU), 2010 | Container Traffic (000 TEU), 2014 | Growth (% per annumn) | Max quayside depth (m) | Lead terminal operator |
|---|---|---|---|---|---|---|
| Tanger Med | Morocco | 2058 | 3080 | 10.6 | 9 | APMoeller, CMA-CGM |
| Port Said | Egypt | 3475 | 3959 | 3.3 | 13.2 | APMoeller |
| Damietta | Egypt | 1096 | na | na | 14.5 | Local |
| Valencia | Spain | 4207 | 4442 | 1.4 | Na | Local |
| Giao Tauro | Italy | 2851 | 2970 | 1.0 | 16 | APMoeller |
| Marsaxlokk | Malta | 2370 | 2750 | 3.8 | 13 | APMoeller, CMA-CGM |

Source: Containerization International

As in all developing countries, another key factor for economic growth is a reliable power grid. With strong predicted growth in electricity demand, all countries in the region urgently need to improve their energy infrastructure. Table 6 shows some key statistics for the energy sector in this region. Until the enormous wind and solar energy potential becomes usable, the region is characterized by an uneven distribution of oil and gas resources. Especially Libya and Algeria are abundant in energy resources, compared to Tunisia, Morocco and Egypt, so that all countries could clearly benefit from a deep integration of energy markets similar to what coal and steel were for Europe (Ahmed & Othmani 2014). Also, increased energy trade with Europe could foster growth and development in the region. However, several obstacles stand against this. For one, only Algeria, Morocco, and Tunisia are currently synchronized with the EU grid. Next, while high-voltage interconnecting transmission lines exist, the network is still incomplete. Furthermore, electricity markets in the region remain vertically integrated, state-owned monopolies, characterized by cross-subsidization and high levels of often untransparent regulation.

*Table 6: Energy Sector Indicators*

| | Population | Electricity generation capacity (MW) | Peak electricity demand (MW) | Capacity reserve margin (%) | Average electricity tariff (US cent/ kWh) |
|---|---|---|---|---|---|
| Algeria | 34 | 11332 | 7718 | 47 | 4.7 |
| Egypt | 83 | 24504 | 22079 | 11 | 2.5 |
| Libya | 6.3 | 6006 | 5759 | 4 | 3.3 |
| Morocco | 31.3 | 5596 | 4550 | 23 | 11.2 |
| Tunisia | 10.3 | 3580 | 2793 | 28 | 9.5 |

Source: World Bank

Hence, in principle the region could benefit from its energy abundance, yet requires an update of energy grid infrastructure, a deregulation of energy markets, and coordinated moves towards a better tradability of electricity across borders. Importantly though, in some cases (such as Tunisia), projected demand for energy is going to outstrip local supply from fossil sources in the next decade. In this respect, plans to establish interconnections between North Africa and Southern Europe are highly promising, for example an interconnection between Tunisia and Sicily from a new power plant through a submarine cable. Equally important would be an increase in intra-regional energy trade and projects to develop the large alternative sources of energy from wind and solar power. A role model project is taking place near the southern town of Ouarzazate in the desert region of Morocco. Here a consortium led by a Saudi-Arabian firm has just finished constructing the first of five planned solar power stations with a 500MW output capacity. Largely financed by the European Investment Bank and the World Bank, the aim of the project is to create 2,000 megawatts of solar generation capacity by the year 2020 at an estimated cost of $9 billion, making it one of the world's biggest solar power plants. However, this energy infrastructure project is only one of many successful endeavors that Morocco has undertaken in the last decade and which have set the country apart from its North African neighbors as the case study of Morocco's SEZs in the next section demonstrate.

## 6. A Case Study of Morocco – The Successes of SEZs in Tanger and Casablanca

Analyzing Morocco's exceptional achievements in attracting FDI and establishing successful export industries, two industries stand out with remarkable growth rates in the last decade whose emergence is related to the contribution of foreign firms: the aerospace as well as the automotive industry. The former industry, the smaller one of those two, experienced yearly growth rates of 15-20% between 2008 and 2015 reaching a turnover of €900 million in 2015. Since its emergence in the late 1990s, it managed to become Morocco's fourth largest export-industry, accounting for 5% of total domestic exports in 2015, after automotive, phosphate, and agriculture (GTAI 2016). The history of the Moroccan Aerospace industry dates back to the 1950s when a French state-owned aerospace manufacturer created a subsidiary operating with Morocco. However, it was a joint venture between the public airline Royal Air Maroc and a French aircraft engine manufacturer in 1999 that laid the cornerstone for the industry's rapid development in Morocco. In the following years, several subsidiaries were created, attracting even more foreign firms into the region. One important addition to the industry's success was the joint venture between Royal Air Maroc and the American aerospace manufacturer Boeing in 2001, which operates as a supplier of cable harnesses. Thus, with Airbus, Boeing and the Safran Group investing in Morocco, the aerospace cluster became compliant with the most stringent European and American standards of quality for both civil and military operations.

This paved the way for Morocco transforming itself into a fast-growing supply and manufacturing base for the world's major original equipment manufacturers (OEMs). Comprising just 10 companies in 2000, in 2015 already more than 110 companies operating in the aerospace industry had established themselves in Morocco, employing 11,000 qualified workers (GIMAS 2015). The industry consists of eight sectors, where metalworking accounts with 35% for the largest share of it, followed by electronics and services. More than 70% of the firms are of foreign origin with an overwhelming majority of French firms (DEPS 2012). Domestic firms make up about 20% of the sector investments, mainly operating as subcontractors to aircraft and engine OEMs as well as to companies operating in the sectors of components design and manufacturing, assembly of electronic cards, cables, and aircraft structure. Foreign firms are attracted to Morocco by its low labor and operational costs; but also the geographic proximity to Europe makes Morocco interesting for foreign investment (Rchid et al. 2014). Not surprisingly, and owing to Morocco's limited market capacity, the

aerospace cluster exports more than 80% of its production (DEPS 2012). While France receives 85% of the exports, only 10% of it goes to the United States (Ahmad et al. 2013).

Similar, the substantial development of Morocco's automotive industry occurred due to foreign investors. The history of the automobile cluster in Morocco dates back to the 1960s with the installation of the Moroccan car manufacturer SOMACA as a joint venture between the Moroccan government and two European car manufacturers. However, as in the case of the aerospace industry, a French company played a major role in attracting more industry-specific business to the North African country. Renault had successively taken over the property of SOMACA by 2006. Additionally, and more crucially, Renault invested €1 billion into a new assembly plant in Tangier in 2009. Operations started in 2012 and the first 100,000 vehicles were produced in 2013 (Renault 2014). With a local production capacity of 340,000 cars per year it is by far the manufacturer's largest site in Africa, alongside production in Algeria and South Africa. Estimations show that Renault created 7000 direct jobs and about 30,000 indirect jobs with the new assembly plant, owing to the fact that around 40 suppliers have joined or are about to follow Renault's production plant (Tanger Automotive City 2016). The whole automotive industry currently employs around 100,000 workers in 150 automobile-related companies in Morocco (OBG 2016). With more than 400,000 vehicles produced in 2015, Morocco is the largest car producer in North Africa and the second largest, after South Africa, in Africa (OBG 2015). However, due to the country's limited market capacity,[17] almost everything of the sector's production is primarily exported to Europe. With an annual growth rate of over 20% during the last 5 years, the industry makes up for almost 30% of total exports, thereby overtaking the country's traditional export sectors of phosphates and agriculture, with assembled automobiles representing 60% of exports.

The two sectors' emergence goes hand in hand with the country's development and investment promotion strategies. Under the National Pact for Industrial Emergence (PNEI), launched in 2008 as a more robust successor of 2005's Emergence Plan, the Moroccan government targeted the development and modernization of six key export and high value added sectors, including aeronautics, automotive, agro-industry, offshoring, textiles and pharmaceuticals. In order to attract more foreign investors, it involved a massive

[17] In 2015, around 120,000 cars were sold in Morocco for a population of 33 million people. Sales are expected to rise to 160,000 in 2016, with Renault making up for almost 40% of the sales.

improvement of the country's infrastructure as well as the facilitation of access to land by creating integrated platforms.[18] More specifically, Moroccan authorities established export-processing free zones dedicated to specific industries where investors benefit from several privileges. These include exemption from VAT and customs duties, a specific taxation framework,[19] simplified customs procedure, no constraints on capital as well as allowed repatriation of capital and profits. Morocco's first free zone, the Tanger Free Zone,[20] was established in 1999 well before the PNEI. However, the creation of the MidParc Free Zone specific to the aeronautics industry in Casablanca and the Automotive City in Tangier, both in 2013, as well as the Atlantic Free Zone in Kenitra in 2014 can be attributed to the PNEI. Moreover, Renault's commitment to open a new production plant was awarded with its own free zone Renault Tanger-Med, adjacent to the new Tanger-Med port complex.

Furthermore, Moroccan authorities engaged with foreign investors in setting up industry specific training centers in the respective industrial zones in order to improve the quality and sustainability of its labor pool. An Aerospace Institute was established in 2011 by the Moroccan Aerospace Industries Association (GIMAS) in partnership with the French Union of Metal Industries, the Moroccan government, and the French Development Agency. By 2015, already 1500 students had graduated from the offered training programs of 6 to 9 months in the area of composites, sheet metal work and electronic systems, with 99% of them finding an employment upon the completion of the course. Additionally, a specialized Institute for Aeronautics and Airport Logistics, offering training in maintenance, was launched in partnership with Royal Air Maroc at the end of 2013 in Casablanca (OBG 2015). For the automotive sector, a professional training center was set up, with establishments in Casablanca, Kenitra, Tangier and in the Tanger Free Zone. Companies receive training subsidies of almost €4000 per person recruited each year. Even though the launch of PNEI coincided with the onset of the European debt crisis, the government's efforts were quite successful. The Moroccan initiative created 110,000 newly industrial jobs between 2008 and

[18] Integrated industrial platforms (P2I), in general, provide real estate for businesses, related services, one-stop shop functions and transport connections.

[19] More specifically, invested companies are exempted from paying corporate taxes during the first 5 years of business; for the following 20 years, it is fixed to 8.75%, and to 17.5% thereafter.

[20] The very first free zone in Morocco was actually established in 1961 at the former port of Tangier. In 2009 it comprised 78 companies (60% trade and 30% manufacturing) employing 3550 workers. However, it was dismantled due to the new port Tanger-Med (ACTRAV 2012).

2011 reaching 445,000 jobs in the sponsored industrial sectors in 2012. Simultaneously, the industrial exports grew by 22% annually during these years of weakened European demand.

At the same time, the Moroccan government invested heavily in the development of the country's infrastructure. While the country's existing key port facilities were upgraded, and highways as well as railway-networks were extended in order to connect the nascent industry clusters to the local airports and large ports, one outstanding project, the Tanger-Med port – an important hub for trans-shipment in the Mediterranean and the Atlantic – was launched in the early 2000s. Tangier has always been a port city; however, from the early 1900s Casablanca's traffic at the Atlantic coast superseded it. For a long time, Tangier's location at the border was perceived as a barrier due to its remoteness from Morocco's core economic regions around Casablanca and Rabat, and a lack of adequate port and hinterland infrastructure. However, in the early 1990s, policies changed, and Moroccan authorities recognized its potential as a gateway to the European market as well as to catch transit traffic in addition to domestic needs. Launched in 2002, the first phase of the deep-water port was finished in 2007. At the costs of around €1 billion, two large container terminals were constructed, with an annual capacity of 3 million TEUs. The second phase, launched in 2009, aims to add two more terminals by 2018 with a capacity of 5.2 million TEUs to the port's capacity. The planned capacity of overall 8 million TEU would turn Tanger-Med into one of the 20 busiest ports globally. The estimated investment costs of €1.4 billion were partly financed by loans from the European Investment Bank and the Arab Fund for Economic and Social Development as well as by the issuance of bonds by the Tanger Med Port Authority. A unique feature of the port complex is its decentralized administration. In 2006, Morocco introduced a port reform, which eased the transfer of maritime services into the hands of private companies and allowed for decentralized decision-making.[21] A public private partnership was created to oversee the development of the Tanger-Med port complex. While the first three terminals are managed by European companies,[22] partly in partnership with Moroccan companies, the fourth terminal will be run by a local terminal operator.

[21] The law excludes the Tanger-Med port from its field of application. Thus, while the rest of Moroccan's port sector is overseen by the National Port Authority, the new port facility at the Gibraltar Strait is managed by its own port authority.

[22] Among others, the Dutch APM Terminals and EUROGATE Tanger, a consortium of firms including the French CMA-CGA and the Swiss MSC.

Among West Mediterranean ports, Marsaxlokk (on Malta) and Algeciras (Spain) account for the highest growth rates and could have serviced several Maghreb ports. However, due to congestion and high operational costs, smaller ports get the chance to develop transit functions and to compete in this rapidly evolving market. In the immediate vicinity, Algeria and Tunisia are also engaging in building their own port hubs. Compared to Tanger-Med, those projects, however, seem to remain too port-centric without offering a wide diversity of accompanying services and face constraints due to the traditional centralized port management. 85% of the Tanger-Med port's traffic is destined for trans-shipment and only 15% for domestic demand of imports and exports, suggesting that the Casablanca port will remain the main load center of the country, currently servicing about 80% of the total container traffic (Ducruet et al. 2011). Since its operational start in 2007, the port's traffic has increased continuously. During the first year of operation, container traffic at Tanger-Med was close to 1 million TEUs. In 2014, with still only two terminals operating, the port reached its capacity with a traffic of 3 million TEUs (Tanger Med 2015).[23] In 2015, 260,000 new automobiles passed through the port (where more than 80% of it came from the Melloussa Renault factory), up from 100,000 vehicles in 2012 (TSMA 2016).

Apart from its port facilities, the Tanger-Med complex comprises several commercial and industrial free zones with a well-connected road and rail network.[24] A 53km long highway connects Tanger-Med to the Tangier-Casablanca expressway and a 45km rail line provides a connection to the national railway network. Funds for the investment costs of nearly €800 million for the railway connection came primarily from a consortium of Moroccan banks, and to a lesser extent from the Islamic Development Bank as well as the French Development Agency. Furthermore, the construction of a 200km high-speed line from Tangier to Casablanca, the first phase of a joint project of the French and Moroccan national railway operators, started in 2011. More than half of the estimated total investment costs of around €4 billion were financed by loans from France, Saudi Arabia, Kuwait and the UAE (OBG 2015). The main economic development in the last decade, especially in the automotive and

[23] This put it in 49th place in the ranking of the top 50 World Container Ports in 2014. The neighboring ports of Said (Egypt) and Algeciras (Spain) were on the 41st and 31st place, respectively.

[24] Among others, a free logistical zone for merchandise storage and quality control, a duty-free commercial zone at Fnideq, Tétouan Shore for offshore services, as well as the Mellousa industrial hub, a series of free zones in the Tangier-Tétouan region targeting export industries. These zones include the Renault Tanger-Med production site as well as the Tanger Automotive City.

aeronautics sectors, was driven by companies investing in the country's free zones. Since its launch in 1999, over 500 manufacturing firms have settled in the Tanger Free Zone employing more than 45,000 workers (Tanger Med 2015). While this also comprises companies active in computer engineering, aeronautics and textiles, it is the automotive sector, with 60 active manufacturers, that contributed significantly to the zone's success. This becomes apparent in the establishment of its affiliate Tanger Automotive City in 2012, which was developed to accommodate the overflow from automotive operations and to encourage further specialization.[25] Most of the car components suppliers serve Renault in its nearby production site and the several car manufacturers in (Southern) Europe. Between 2000 and 2013, €2 billion FDI flowed into the network of zones, of which alone €1 billion was provided by Renault (OBG 2014). The rest came from companies of European (mainly French and Spanish), US, Maghreb and Middle Eastern origin.[26] For the aeronautics industry, Morocco established a special free zone next to Casablanca's international airport in 2013. The MidParc Free Zone was developed by a public Moroccan investment fund in partnership with three international companies in the aeronautics, defense and space industries.

In order to capitalize the achievements under the PNEI, particularly in the aerospace and automotive industries, the Moroccan government launched the 7-year Industrial Acceleration Plan (PAI) in 2014. It aims to bring the industry's contribution to GDP from 14% to 23% and to create 500.000 new jobs by 2020.[27] A large part of it shall be achieved via ecosystems, or productive industrial clusters, which strive to stimulate growth and enhance competition. They plan deeper business integration in order to ensure technology transfers that are expected to improve the quality and productivity of local production. The economic literature argues that spillover effects are more likely to be positive along the supply chain, based on the idea that MNEs might have an incentive to transfer some knowledge to their local suppliers in contrast to minimizing information leakages to competitors when investing horizontally (Castellani & Zanfei 2006). Therefore, Moroccan authorities aim at increasing the

[25] Note that only a part of the Tanger Automotive City was designated as a free zone. The non-free zone part is for general use comprising related services (supply, storage, delivery) and logistics.

[26] In 2009, almost 30% of the investments were of French origin, 20% Spanish and 10% Moroccan (ACTRAV 2012).

[27] More specifically, for the automotive sector, the PAI predefines sector exports of €10.8 billion as well as 50,000 new jobs by 2020 (OBG 2015). For the aeronautics sector, the respective numbers are €2 billion and 30,000 (OBG 2016).

degree of local sourcing by motivating more backward linkages within industry clusters.[28] So far, linkages among already existing companies in Morocco have been reported to be low even though many suppliers were drawn to Morocco by their customers (Rchid et al. 2014).[29] A low degree of interaction between firms as well as most R&D coming from headquarters abroad – as shown by Rchid et al. (2014) for the Moroccan aerospace industry – suggests an efficiency-seeking motivation for FDI. For vertical (efficiency-seeking) and export-platform FDI the adverse competition effect is less likely to occur. However, empirical evidence especially for developing host countries remains scarce. In order to enhance integration, Morocco focuses under the PAI on developing local operators by encouraging them to form joint ventures with foreign players, for instance, to better understand and master a given profession. Moreover, joint ventures are generally expected to have a higher potential for the diffusion of important technology, as well as a higher probability of inter-sectoral linkages with the local economy. This is empirically backed by several studies, even though a larger share of domestic ownership could also reduce the incentive for the parent firm to transfer more advanced technology to its affiliate, due to its limited control over the management, thereby decreasing the spillover potential. The PAI, therefore, also plans to extend existing training facilities and to build new ones. Moreover, the planned creation of further industrial parks and free zones is expected to attract more FDI and strengthen cooperation (Smeets 2008).

So far under the PAI 30 international investment agreements have already been signed, with a total planned investment of €690 million and 39,000 new jobs, with 21 of the 30 investment agreements being inked with companies in the automotive sector. Among these is a contract with PSA Peugeot to build a new car production plant in the Atlantic Free Zone in Kenitra, with an expected annual production capacity of 200,000 cars as well as 200,000 engines and the prospect of 1,500 new direct jobs. This third car OEM in Morocco plans to use its new production site as an export-base to African and Middle-Eastern markets, announcing an initial local content rate of 60% at the beginning of operation in 2019, which will eventually rise to 80%. Moreover, Renault committed to invest another €1 billion to build an industry ecosystem and to raise local sourcing to 65%. Similarly, UK automotive parts manufacturer

[28] More specifically, local sourcing in the automotive sector shall rise to 60% by 2020, from currently 45% (OBG 2015); in the aerospace sector, a rate of 35% is targeted (OBG 2016).

[29] For example, all Airbus-suppliers, except for one, are already present in Morocco.

Delphi signed a framework agreement for seven new facilities by 2021, creating 13,000 new jobs (MCINET 2016). In the long run, Morocco's annual production capacity is expected to surpass 600,000 cars. In the aerospace sector, several companies have also announced to increase their capacities. Among others, Bombardier, one of the first companies in MidParc, committed to investing up to €200 million by 2020, thereby, creating 850 new direct jobs and 4,400 indirect jobs (OBG 2016). Moreover, inspired by the ecosystems of Renault and PSA Peugeot for the automotive sector, Boeing plans to attract 120 suppliers of Boeing to help raise Morocco's aeronautics' exports by €1 billion and to create 8,700 jobs (Reuters, 2016).

Under the recent development and investment promotion strategies, Morocco has continuously increased the volume of FDI in recent years. While many of the North African countries have seen a decline in FDI inward flows, investments in Morocco's grew by 23% between 2011 and 2015,[30] totaling to a stock of €45.4 billion in 2015. With this, Morocco accounted for 22% of the North African FDI inward stock, and for 28% of inward flows to the region in 2015 (UNCTAD 2016). In order to further strengthen this trend and to support the realization of the country's development and investment strategy, Morocco introduced a new investment charter in July 2016, which replaces the outdated investment charter implemented in 1995. For more effective and coordinated investment promotion activities, the country's various trade and investment promotion agencies were consolidated under the newly created Moroccan Agency for Investment Development and Export. In order to allow for a more dynamic framework, the new charter distinguishes between incentives on the national, sectoral and regional level. It aims to develop at least one free zone in each of the country's 12 regions while the free zone status will also be granted to qualifying large exporting industries not located inside the zones. These include a 5-year corporate tax exemption for new industrial companies. Moreover, it also recognizes indirect exporter status for subcontractors.

While Morocco's efforts to improve its investment climate and, thereby, to attract foreign investments have proven fruitful, with much of the increase in FDI having been focused on the industrial sector, it still needs to improve its business climate in order to further benefit from the increased business activity. Among the MENA countries, Morocco is one of the few countries where political instability does not rank highly as a top business environment

[30] FDI inward flows to Tunisia decreased, for example, by 13% over the same period (UNTAD).

obstacle, according to the World Bank's Enterprise Survey (World Bank 2016). It is rather a high degree of corruption as well as an inadequately educated workforce and competition from the informal sector that impede the business environment.[31] Even though Moroccan authorities increasingly engage with large companies in setting up training institutes specific to the industry's needs (see above), local workers still fail to meet the technologically advanced companies' labor requirements. In Morocco, 26% of the firms offer formal training, compared to a regional average of 17%. However, these numbers remain well below the lower-middle-income average of 37%. In addition, the extent and quality of enrolment at the tertiary level lags far behind the regional average (World Bank 2016). This is in line with other findings for the aerospace and automotive industry in Morocco, arguing that Morocco needs to address the quality of education and skill mismatch in order to successfully accelerate the diversification of the economy and to move activities up the value chain (Ahmad et al. 2013; Maturana et al. 2015). Additionally, Morocco's innovation activities and business sophistication still perform poorly (World Economic Forum 2016). Even though the availability of scientists and engineers does not seem to be the biggest obstacle (rank 67), it is the quality of scientific research institutions and the university-industry collaboration in R&D that lag far behind (rank 112 and 100, respectively). Thus, in order to keep track with its ambitious industry targets under the PAI and to stand up to technologically more advanced clusters abroad, Morocco needs to further upgrade its training facilities and incentivize research. A key reason being that the development of human capital, besides machine availability, has been identified to be the most critical driver of the automotive industry performance (Chahid et al. 2014). However, it has to be noted that the Moroccan authorities seem to be on the right track with increasingly targeting the development of local skills,[32] but it will take some time for implementation as well as first improvements to materialize. Interestingly, many foreign firms like Bombardier refer to the availability of skilled labor as a reason to invest in Morocco (Ahmad et al. 2013). Another crucial impediment to doing business is the access to finance (World Economic Forum 2016). In a first step, this has been addressed by implementing a special fund that grants financial assistance for investment

[31] 21% of the firms identify corruption of the top obstacle, compared with the MENA average of only 8%.

[32] For example, Safran has signed an agreement over €1 million with the Ministry of Higher Education and Scientific Research to develop technological research over the next 5 years (OBG, 2015b).

projects in some industrial sectors.[33] Yet especially with respect to SMEs' access to credit, Morocco's business climate needs to improve significantly in order to ensure an adequate development of the local businesses. Concerning the labor market effects, among others, corruption, obstacles in the judiciary, administrative issues, and higher costs of financing are impediments to job creation in Moroccan firms (Schiffbauer et al. 2015). Moreover, investors continue to view labor regulations as a significant constraint; i.e. procedures regarding lay-offs remain complicated and onerous, imposing a significant financial burden on companies.

The example of Morocco shows that an effective investment promotion can contribute positively to a country's economic development. More specifically, the objective of attracting foreign investors incentivized large infrastructure projects and structural reforms in Morocco, which, in turn, boosted the country's competitiveness and attractiveness beyond its natural competitive advantage of low wages and beneficial geographical location. The received FDI during the last 15 years fostered large-scale job growth as well as an upgrading of the economy's exports, thereby increasing manufacturing activities in the country and supporting a transition away from the reliance on natural resources. The creation of SEZs drives this process significantly, since the SEZs, by providing investors with fiscal incentives and an attractive investment climate, locally concentrate economic activity and allow domestic firms to take advantage of agglomeration facilities. Moreover, an improved infrastructure network contributes to the country's attractiveness as well as to the economic integration of less developed or remote regions.

The promotion of industry clusters in Morocco, with the decisive support of a few anchor tenant MNEs, has helped to attract foreign high technology OEMs to locate in Morocco. It remains crucial to start attracting the right foreign technology that the country needs to support the transition of domestic industrial capacities. While Moroccan authorities are already paving the way towards a more sustainable economic development by integrating the zones' programs within a broader framework of growth policies and by increasing state capacities, it is still necessary to strengthen linkages between foreign and domestic firms within zones as well as across zones and outside the zone. Moreover, further policies to improve the investment and business climate outside the zones are required in order to

[33] i.e., the fund can contribute up to 30% of the costs of acquiring or building new professional buildings, up to 30% of the costs of acquiring new capital goods, and up to 15% of the purchases of new investment goods. Contributions are limited to 15% of the investment and €2.8 million (AMDI).

increase local firms' participation in the FDI-driven export and employment expansion in Morocco. So far, the efforts of Morocco investment policies and infrastructure investment have fostered economic growth zones that not only raised high-quality employment but also offered a new economic model based on export-led growth for the country and the region as a whole.

## 7. Conclusion and Reform Proposals for Economic Integration

For North Africa to have a common prospering future, the essential precondition is security and political stability in the region. Consequently, every political initiative needs to focus on solving the political stalemate in Libya, stabilizing the emerging and still fragile democracy in Tunisia, helping to ease tensions between Morocco and Algeria and preventing further spillovers from conflicts in the region. If the Maghreb and Egypt achieve a foundation of political stability, economic reforms will have the opportunity and chance to succeed. Taking the exemplary economic integration of the Central and Eastern European Countries as a role model, it serves as the upper benchmark for a possible future if integration succeeds. To do so the main thrust of a reform agenda has to target trade integration and the prerequisite trade infrastructure because we think this is key for both foreign and domestic investments. We therefore offer the following reform proposals for North Africa to increase potential growth and reduce the high levels of unemployment.

Just as the CEECs undertook an economic transformation from state-run planned economies to liberalized market economies, the old economic model of the Maghreb and Egypt has to give way to a new economic model that relies on trade and the private sector for economic development, inclusive growth, and job creation. The previous overreliance of the North African economies on remittances, oil, natural resources, and tourism displays the economic transformation that awaits them but also offers potential to achieve that transition towards a new economic model and to become an integral part of GVCs. The medium-term goal is a shift away from the overdependence on the public sector as the primary employment option, converting the economies towards a preference for the private sector. With the right set of policies, the private sector could prosper and create the high-quality jobs that the young and too often unemployed graduates in the region urgently need. We believe that improved economic integration of the region in the global economy would help North Africa through

enhanced trade and FDI supported by massive infrastructure upgrading, exemplified by the exceptional development in Morocco.

### 7.1. Enhancing Trade

A key element should be a forceful and persistent effort to increase the regional and global trade integration of North Africa. The current "shallow" integration under the GAFTA and Agadir Agreement should advance towards a deeper trade integration that includes trade in services and agricultures and a removal of the very substantial NTB. If only a few members are willing or able to push for a true common market in the region, the potential benefits warrant the two-speed approach. Even a revived AMU is achievable if political resistance is overcome by a common goal of an integrated Maghreb market. North Africa's main trading partner, the EU, needs to re-vitalize its negotiations with the Maghreb region on the DCFTAs and seek an effective and swift implementation. However, the EU should also review its current approach and the DCFTAs coverage. With growing trade opportunities to East Asia and Sub-Sahara Africa, the countries of North Africa have gained trade flexibility and lost their one-sided dependency. Based on the sobering experience of the previous PTAs, the EU needs to account for reluctance on the part of their trading partners and win their approval by emphasizing an asymmetric liberalization process. Moreover, the EU should minimize the hub-and-spoke effect of the bilateral agreements, while fostering intra-regional trade in the manner of the CEECs. Since a deep trade integration often entails a surrender of domestic sovereignty and policy flexibility, the EU will have to respect doubts in the region and work to dissuade them by keeping flexibility and policy autonomy in the DCFTAs. Including a more flexible approach to agricultural trade in the trade agreements is also essential to enhance the export potential of North Africa. Where politically feasible the EU should reduce its trade barriers to agricultural goods from the region and, as the case of olive oil from Tunisia highlights, allow for short-term adjustment of import quotas based on harvest outcomes and supply side changes.

Trade liberalization through FTAs would significantly reduce the prevalent high trade costs in the region, especially if they lower the NTBs and harmonize rules of origin, standards, and regulations. However, the individual countries should not wait for regional or bilateral agreements to increase their trade potential. Instead, the governments should also act

unilaterally to lower trade costs, thereby providing the chance for SMEs to increase their competiveness and export diversification. With lower costs and higher competiveness, the private sector can increase their intensive and extensive trade margin, producing more products and serving more markets. A broadened exports base enables these firms to join regional and GVCs, and ultimately create substantial employment.

Especially regional integration suffers from the lack of infrastructure, poor logistics, and cross-border trade facilitation; it should therefore be a priority to improve the regional business networks. Supporting business-to-business dialogue, and fostering communication between logistics and trade experts, could provide the region with a growth-enhancing business network apart from official and often tense government relations. Also crucial to further integration, both globally and regionally, are high costs associated with trade financing and insurance. Improving access to loans or lines of credit is thus a prerequisite if the firms in North Africa are to take advantage of expanded export opportunities.

### 7.2. Enhancing FDI

The second driver of integrating North Africa successfully in the global economy and generating economic growth are FDIs, which have proven to be an essential component of the European integration process and contribute significantly to East Asia's impressive growth performance as well. The downfall of FDI inflows since the financial crisis of 2008 has hampered the growth performance of the North African economies ever since, yet together with the positive development in Morocco and recently Egypt bears witness to the significant effect of political stability on FDI inflows. Taking a cue from Morocco's exceptional investment performance, the other countries in the region thus need to ensure potential investors of their macroeconomic and governmental stability. In order to attract more inflows from MNEs that foster the establishment of export platforms in the economies, governments in the region should undertake new efforts to improve their governance performance. Only then will technological spillovers from existing and future FDI occur that lead to cross-linking and fostering of domestic firms. With an improved investment climate and greater openness to trade due to lowered trade barriers, the countries would again become competitive in attracting FDI inflows.

As an additional proof to potential investors of good governance and a sound institutional framework, the Maghreb countries of Algeria and Libya as well as Egypt could aim to join the "Open Government Partnership", an international platform committed to making governments more open, accountable, and responsive to citizens. It requires concrete action plans from governments to promote transparency, empower citizens, fight corruption, and harness new technologies to strengthen governance. Tunisia has already joined the partnership and Morocco signaled official interest in participating. Moreover, investment promotion agencies in the North African countries should be supported and close relationships with their European counterparts fostered, such as the "Germany Trade and Invest" agency (GTAI), which provides German export-oriented SMEs with all relevant information for planning and conducting foreign business activities. More importantly, Algeria, Libya, and Tunisia should remedy the shortcomings in the coverage of BITs by signing and bringing into force treaties with each other and the largest FDI origin countries. Finally yet importantly, the reduction of customs red tape and better trade facilitation in general are additional means to attract foreign investments for the private sector.

### 7.3. Sustainability and Costs of Economic Integration

These benefits of integration have to be shared across people and regions, since the process of economic integration and the shift to a new economic model produces not only winners but also losers. To guarantee a sustainable trade and FDI integration, the respective governments need to develop regional policies to connect rural and remote areas with the urban growth centers. Required are also social policies to support the people who become unemployed during the transition phase and offer training and education opportunities to advance their employability in the new emerging sectors. While in general reducing subsidies is important to address revenue considerations and reduce misplaced incentives, the poor are in need of continuing support through food and energy subsidies. Policies that channel consumption subsidies away from the more affluent part of the population are therefore an integral part of the reform process.

### 7.4. Closing the Infrastructure Gap

As a precondition for trade integration and FDI, the region urgently needs a modernization of its transport and energy infrastructure, since most countries suffer from a substantial infrastructure gap. First and foremost, seaport facilities to connect foreign and domestic markets need to be improved and extended. Following the example of Morocco, Algeria and Tunisia have launched projects to build new deep-water seaports in El Hamdania west of Algier and Enfidha (or alternative locations) in Tunisia. In both cases, it is essential to ensure an integrated approach with PPP and the establishment of SEZs from the beginning. Private consortia with sufficient experience, following the "landlord model", should execute the construction and operation of these ports. Evidence from other SEZs suggest that private actors should be as far as possible involved in the operation, while government influence should be limited to regulation, technical assistance, and information. Here again, Morocco has set an example with its P2I approach of integrated platforms to support private business. Second, the already extensive road and highway network of the region needs to be modernized and completed. Related to this is an improvement of the trucking sector, which is in most parts too fragmented and inefficient. A deregulation of the sector is needed to allow trucking operators to charge market rates and limit government involvement to regulation on safety and licensing. Related to this is the implementation of the TIR system of transit guarantees, which is incomplete in the region. While Morocco, Algeria, and Tunisia are contracting parties to the TIR convention, Libya and Egypt are not, and Morocco and Algeria do not use the benefits of the system for cross-border traffic. Third, the railway system needs to further upgrading. While Morocco, Algeria and Egypt have started to do so, Tunisia and Libya lag behind. In all countries, electrification is still incomplete, which prevents the introduction of modern equipment. Here, coordinated action is even more important than elsewhere to ensure that railways actually help cross-border integration. Tunisia needs to update the existing system to make it compatible with the standard gauge railways of her neighbors. The GTMO 5+5 can be the right forum to develop coordinated action plans towards a trans-Maghreb railway axis. Beyond investment in physical infrastructure and control of technical standards, it is important to support steps towards a deregulation of the railway sector, allowing private actors into the market. Finally, all countries in the region need to modernize their energy sector. Existing electricity grids do not always conform to European standards and are not fully synchronized. While the region is abundant in fossil

energy sources, they are unequally distributed and dependent on volatile global market conditions. Investment in solar and wind energy would be beneficial in all parts of the region and should be integrated in existing electricity grids. In addition, new linkages to European neighbors such as between Algeria and Spain or Tunisia and Italy should be supported to generate higher levels of energy trade and stabilize the regional distribution of electricity.

### 7.5. Financing of Reforms – ODA, the EU, Remittances and Diaspora Bonds

Despite the positive impact that FDI inflows have on export diversification, upgrading of the technology content of exports, and economic growth, the volatility of the inflows from abroad poses problems of continuity and predictability for the receiving economies. The tremendous costs involved with infrastructure investments and the critical condition of the public finances in many North African countries also emphasize the critical issue of financing the necessary reforms and investments. As the study has shown, the resource of official development aid in its overall size is relatively small in comparison to other capital flows. Hence, it should be applied in tandem with other financial means or utilized as leverage for investments by the private sector. Developing countries could also employ ODA complementary to their own financing or rely on local philanthropy efforts. With the advent of the Arab Spring, special funding for the region has also grown, e.g. the MENA Transition Fund initiated by the G8 in 2011 to support the six Arab countries in transition since 2011 (Egypt, Morocco, Yemen, Jordan, Libya, and Tunisia) with an overall funding of around $223 million. Yet, if the EU is intent on developing an economic partnership with North African countries akin to the Eastern Enlargement it also has adapt its strategy and upscale its funding from millions to billions to achieve a similar outcome in the long-run. Together with the necessary financial support, the EU needs to create a visionary yet achievable objective for the future partnership between the two regions – the goal of a common market that includes the North African countries and thereby encourages them to undertake the required reforms to accomplish such a degree of economic integration. While such a process will take years, the efforts of such a transformation have proven worthwhile as the EU-10 can attest to, at least in the long-run.

Financial support for such an endeavor could come from the largest capital flows that North Africa receives – remittances. In 2016, the region as a whole received remittances that amounted to $30 billion, surpassing FDI inflows and ODA by far. Leveraging remittances and

diaspora savings for development finance is therefore a quintessential ingredient in North Africa's economic integration process. With the exception of Libya, the other countries with a large diaspora population could utilize the potential of remittances. A large share of the savings of migrant workers is placed in bank deposits of developed nations. Since those deposits receive interest rates that are currently close to zero, alternative investment opportunities for these savings are sought-after. The inflow of savings from abroad could help to develop the financial sectors and finance investments of interest to the diaspora in the home countries, such as housing, schools, hospitals, and infrastructure. There are various options to tap into the remittances funds. One possible method of financing is the so-called "Financial Future-Flow Pre-Financing Programme" of the African Export-Import Bank, which offers loans and uses as collateral future remittance flows (and other future non-trade sources of repayment). The North African countries could also directly offer diaspora bonds, defined as "debt instruments issued by a sovereign country to raise funds by placing them among its diaspora population" (United Nations Conference on Trade and Development. 2013). These remittance-backed bonds would encourage migrants to not only remit to but also invest in their respective home countries; successful examples of such diaspora bonds exist in Israel, India, and Sri Lanka. However, the cost of raising capital that way might be higher than capital raised from international capital markets. In order to reduce these costs, the Maghreb countries could issue regional diaspora bonds, which invest in regional infrastructure projects and receive support from a regional or European development bank.

To derive the full benefit of remittances, the Maghreb countries and Egypt need to remove a number of obstacles and improve transparency. They have to implement policies that facilitate remittances flows into the region, by decreasing the costs of or remove barriers to international transfers of remittances. These policies need to foster competition in the market of remittances transfers, which includes a privatization of the banking sector. An improved access to transparent financial services, which would direct more of the remittance flows to more effective channels, would also lower costs and corruption (Benmamoun & Lehnert 2013). Reducing remittance costs from the sending end requires sending countries to facilitate the access to bank accounts and financial services for migrants, which would make informal channels for sending money far less attractive. For example, Germany has some of the most expensive transfer channels for African remittances (especially to Nigeria

and Ghana), burdening migrant workers with unnecessary costs and decreasing the financial means in the receiving countries. Besides the financial benefits of a large diaspora network, the countries in North Africa should also leverage their extensive and potent diaspora to improve productivity in the region. The diaspora network can communicate knowledge and expertise back home. A policy initiative should thus facilitate communication networks where emigrants abroad share information with businesses at home. More importantly, the diaspora can also directly invest in their home countries with diaspora investors playing a parallel role to other foreign investors. In the case of Tunisia, diaspora investments have flown into more rural and less-developed regions compared to other FDI, thus generating growth and employment outside of special economic zones and urban centers (UNDP 2016). This beneficial impact of diaspora investments is applicable to the other countries in the region since they have equally large diaspora communities in Europe, the MENA region, and other developed countries. To increase FDI from their diasporas, the respective governments need to improve their outreach efforts of their investment promotion agencies to raise awareness of investment benefits and diversify their communication with potential diaspora investors to reach them not only in the main destination countries.

### 7.6. Impact on Sub-Saharan Africa

Given a process of economic integration, a more stable and economically prospering North Africa will most likely attract more migrant workers from across the Sahara. Yet, these flows have a long precedent, especially in regard with Libya as a magnet for migrant labor in its petroleum industry. In order to cope with these potential inflows, the North African countries need not only to exhibit strong GDP and employment growth rates for the foreseeable future but also built and maintain the institutional capacities to manage and possible limit the arrival of migrant workers from Sub-Sahara Africa. For those migrants already in North Africa, the countries have to face the enormous challenge of integrating them in their respective societies. Support on the migration issue come from the EU that initiated a Sub-Saharan Africa–EU Partnership Framework to engage locally with five prioritized countries (Niger, Nigeria, Senegal, Mali, and Ethiopia) to combat causes of migration. However, the prospective markets in Sub-Saharan Africa and its growing middle class represent an opportunity for North Africa' trade. While high tariff and NTB, transport costs, and border corruption hinder trade flows between the regions, the potential for exponential growth is

there. Even though the trade share with the rest of Africa is still on the one-digit level, Morocco has been actively intensifying its trade relationship with Sub-Sahara Africa, and has achieved a tenfold increase of its exports between 2000 and 2013 (Ali & Sami 2016).

The aim of this study was an analysis of the potential for economic integration in North Africa. In first presenting the challenges of the region regarding its political, demographic, and economic situation, the study allowed for an assessment of the potential. A thorough investigation into the barriers and prospects of more trade, investment, infrastructure, and trade costs unveiled the elements that have hindered the economic performance of North Africa in the past. It also showed where changes have to occur for an economic awakening of the region to take place. A case study on the development in Morocco offered some valuable insights into well-working policies and reforms and a role model to emulate for the other countries in the region. Under the mentioned preconditions, with a reform-minded political will, and concerted effort to attract foreign investments and integrate its economies regionally and globally, North Africa could be able to set old economic models aside. In its place, new economies that generate inclusive economic growth and substantial job creation are possible.

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