THE BARCELONA PARTNER COUNTRIES AND THEIR RELATIONS WITH THE EURO AREA

On 15 January 2004 the Eurosystem held its first high-level seminar with the central banks of the 12 partner countries of the 'Barcelona Process'. The Barcelona Process seeks to establish a free-trade area between the European Union and a number of Mediterranean countries by 2010.[1] *The high-level seminar between the central banks of the two regions inaugurated a multilateral dialogue on issues of common interest, in parallel with –but distinct from –the Barcelona Process.*

Participants in the seminar agreed to monitor a set of indicators measuring the progress made in developing links between the euro area and the Barcelona partner countries. Against this background, this article reviews the economies of the Barcelona partner countries and highlights macroeconomic and structural features that are of potential relevance to the development of relations between these countries and the euro area.

1 INTRODUCTION

In recent years the Eurosystem has established bilateral contacts with several central banks of the Barcelona partner countries. These contacts range from policy discussions on macroeconomic issues to technical assistance on specific central banking issues. The high-level seminar, which took place in Naples in January 2004 and was organised jointly by the ECB and the Banca d'Italia, embedded these contacts in a multilateral framework to discuss issues of common interest between the Eurosystem and the Barcelona partner countries' central banks. The Eurosystem initiative for a multilateral dialogue sought to create a permanent forum for central bankers spanning the Mediterranean in order to promote a better understanding of the common issues and help participants learn from each other's experiences. The initiative helps to build a central banking dialogue that runs in parallel to the Barcelona Process while remaining distinct from the process itself.

The Eurosystem and the central banks of the Barcelona partners will regularly review the financial and economic links between the two regions. To this end, participants in the Naples seminar agreed to monitor the closeness of economic relations between the euro area and the Barcelona partner countries using a set of indicators covering the four dimensions of movement of people, goods, finance and services. Against this background, this article examines the macroeconomic setting and financial structures of the Barcelona partner countries and reviews economic and financial links with the euro area.

2 MACROECONOMIC CONTEXT OF THE BARCELONA PARTNER COUNTRIES

The Barcelona partner countries are highly heterogeneous from the point of view of both population and economic conditions. In terms of population, with almost 250 million inhabitants the region is almost as large as the euro area; but more than half of those people live in Egypt and Turkey (see Table 1). In 2002 total GDP was €610 billion, or 8% of that of the euro area; but some two-thirds of this was generated in Egypt, Israel and Turkey alone. Finally, in 2002 GDP per capita averaged over €4,800 in terms of purchasing power parity; but the actual figures varied widely, from only €440 per head in West Bank and Gaza, to almost €17,500 in Cyprus, more than three-quarters of the euro area's GDP per capita figure.

1 In 1995 the Conference of EU and Mediterranean Foreign Ministers in Barcelona marked the start of a new phase of the Euro-Mediterranean partnership, including bilateral and multilateral cooperation, subsequently known as the Barcelona Process. The Barcelona partner countries are Algeria, Cyprus, Egypt, Israel, Jordan, Lebanon, Malta, Morocco, Syria, Tunisia, Turkey and West Bank and Gaza (represented by the Palestinian National Authority). Libya has observer status. The Barcelona Process was given fresh impetus in June 2003 when the European Council in Thessaloniki endorsed the European Commission's communication on a Wider Europe, according to which the Barcelona partner countries are to be economically more closely integrated with the EU.

Table 1 General economic indicators

	Population (millions)	GDP, nominal (EUR billions)	Per capita GDP at PPP (EUR)	Unemployment (percentage)	Average annual real GDP growth (1993-2002)	Average annual population growth (1993-2002)	Average annual inflation (1997-2002)
memorandum							
euro area	307.8	7,447.9	22,331	8.4	2.0	0.3	1.8
Algeria	31.3	62.4	4,828	26.8	2.5	1.6	2.7
Cyprus	0.8	11.3	17,491	3.2	3.8	1.0	2.6
Egypt	70.5	95.5	3,446	9.0	4.1	1.7	3.2
Israel	6.3	114.7	16,348	10.3	3.4	2.3	3.7
Jordan	5.3	10.4	3,515	14.3	3.6	3.3	1.6
Lebanon	3.6	19.3	7,305	-	3.0	2.0	1.1
Malta	0.4	4.3	14,295	5.2	3.4	0.6	2.4
Morocco	30.1	40.3	3,665	12.8	3.0	1.5	1.8
Syria	17.4	24.7	3,156	-	3.9	2.3	-0.2
Tunisia	9.7	23.5	5,996	14.9	4.0	1.2	2.7
Turkey	70.3	199.0	5,967	8.5	2.1	1.4	60.2
West Bank and Gaza	3.5	79.5	439	26.0	-	-	1.8
Total	249.2	610.1	4,834	11.9	2.9	1.7	21.4

Sources: Eurostat, ECB, IMF.
Note: Data refer to 2002, unless otherwise indicated. The real GDP growth and inflation aggregates are weighted by nominal GDP in 2002.

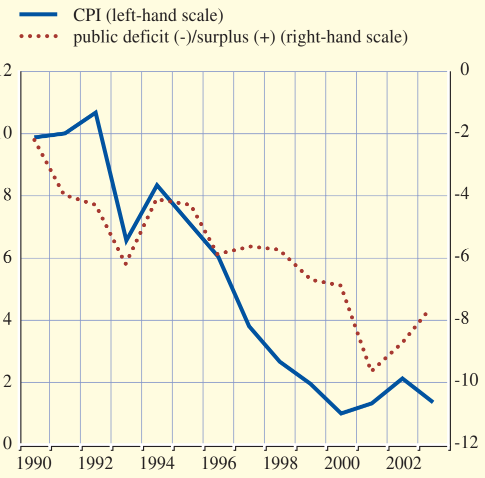
Most Barcelona partner countries are characterised by a stable monetary environment: over the last two decades, stability-oriented monetary policies have contributed to bringing down the rate of inflation in most countries. Excluding Turkey, average inflation has decreased from 20% in the early 1980s to below 2% in 2003 (see Chart 1). Inflation in Turkey has also decreased considerably over the last two years.

While these figures are encouraging, risks may arise from a lack of fiscal discipline in the region, since most governments have run a continuous, and sometimes sizeable, public deficit over the last decade.[2] The aggregate public deficit of the Barcelona partners has deteriorated considerably, from around 2% of GDP in 1990 to almost 8% of GDP in 2003. Accordingly, the debt-to-GDP ratio stood at approximately 70% for the region as a whole in 2003.

Most countries suffer from insufficient growth and structural difficulties. While real GDP growth has exceeded population growth in most of the countries over the last decade, it has not been sufficient to generate new jobs. This is particularly troubling in view of the high unemployment rates as well as the young age structure of the population in the Barcelona partner countries, which will put additional pressure on the labour market over the coming years.

Chart 1 CPI inflation and public deficit developments in the Barcelona partner countries

(annual percentage change; percentage of GDP)



Source: IMF.
Note: Average inflation excludes Turkey.

2 The notable exception is Algeria, although only central government data are available for that country.

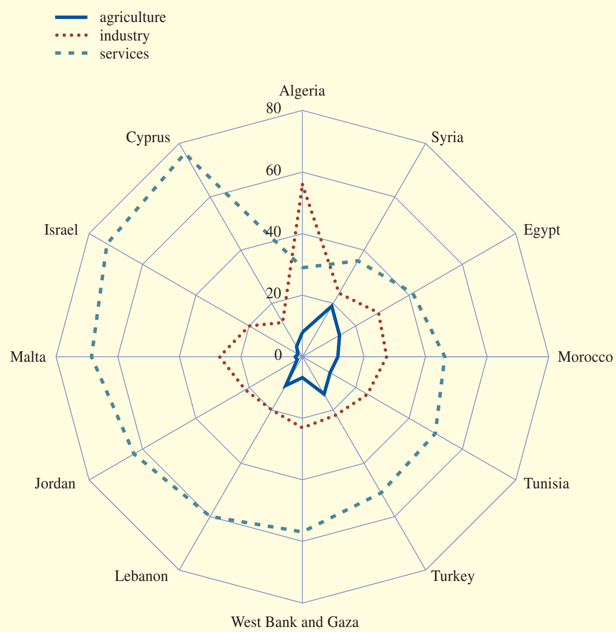
Box

STRUCTURE OF THE BARCELONA PARTNERS' ECONOMIES

The structure of the Barcelona partners' economies differs widely, as shown in the chart below. Services are important in several economies, contributing more than half of total value added in all but four countries. The large share of services is primarily a result of tourism, which is an important source of income for the region. In addition, banking services rank high for the acceding countries, Cyprus and Malta, and for Lebanon. By contrast, Algeria and Syria are net oil exporters, while Israel has emerged as a high-tech producer. Agriculture contributes almost 20% to the gross value added in Syria.

Sector contributions to gross value added

(percentage)



Sources: World Bank, Eurostat.
Note: Data refer to 2000.

Possible tools for increasing the growth potential of these Mediterranean countries while preserving stable macroeconomic conditions include consolidating their legal frameworks, improving their education systems and strengthening intra-regional links. Authorities in the region have acknowledged the challenge of enhancing their growth potential, and several of the Barcelona partner countries have embarked upon processes of structural reform in recent years. This has included the liberalisation of international trade and foreign direct investment (FDI), more flexible exchange rates, and fiscal and institutional reforms.

One area of institutional reform has been monetary policy, several countries having taken steps to modernise the operational framework and improve the efficiency of their money markets. To this end, interest rates, which had been regulated in many countries, have been

Table 2 IMF exchange rate regime classification

Country	Exchange rate regime	Pegging to	Target of monetary policy	Capital controls	
				Portfolio and credit operations	FDI and real estate transactions
Algeria	Managed floating	–	No explicit anchor; monitoring various indicators	Yes	Yes
Cyprus	Peg within a horizontal band	EUR	Exchange rate anchor	Yes	Yes
Egypt	Peg within a horizontal band[2)]	USD	Exchange rate anchor	Capital market securities and commercial credits only	FDI and real estate transactions
Israel	Crawling band	Basket	More than one anchor: exchange rate and inflation targeting	No	FDI
Jordan	Peg to a single currency[1)]	SDR	Exchange rate anchor	No	FDI and real estate transactions
Lebanon	Peg to a single currency	USD	Exchange rate anchor	Yes	Real estate transactions
Malta	Peg to a basket	Basket	Exchange rate anchor	Yes	Yes
Morocco	Peg to a basket	Basket	Exchange rate anchor	Yes	Yes, except liquidation of FDI
Syria	Peg to a single currency[2)]	USD	Exchange rate anchor	Yes	Yes
Tunisia	Crawling peg	–	Monetary aggregate	Yes	Yes, except liquidation of FDI
Turkey	Independently floating	–	Inflation targeting	Yes	Yes, except liquidation of FDI

Source: IMF.
Note: Data refer to December 2002.
1) The currency is de jure pegged to the special drawing right (SDR), but has de facto been pegged to the US dollar since late 1995.
2) The regime shown is that maintained in the major market. Other markets use different regimes.

liberalised. This development has been accompanied by a gradual liberalisation of capital accounts.

In most countries, monetary policy has remained oriented towards stabilising the exchange rate vis-à-vis either the euro or the US dollar, or against a basket of currencies (see Table 2). Most exchange rate arrangements can be classified as intermediate, as only the Turkish lira floats independently and no country in the region has established a hard peg. To ensure consistency between the features of the exchange rate arrangements and the external trade and financial flow patterns, regimes have at times been modified. Aligning the exchange rate system with trade structures continues to represent a particular challenge for those countries in the region in which currency mismatches exist between import payments and export receipts. Over recent years the Mediterranean region has witnessed some movement towards more flexible exchange rates as the authorities have progressively reduced their involvement in the daily determination of exchange rates.

3 THE BANKING AND FINANCIAL SECTORS OF THE BARCELONA PARTNER COUNTRIES

The structure of the banking and financial sectors across the Barcelona partners varies widely (see Table 3). Bank assets as a share of GDP are as low as 40% in Algeria, while Lebanon and the two EU acceding countries, Cyprus and Malta, display ratios comparable to the euro area average. Nonetheless, an analysis of the data over time shows that the role of banks is generally expanding. Over the last

Table 3 Selected indicators of financial development in the Barcelona partner countries

(percentage)

	Bank assets/GDP	Claims on public sector/total claims	Stock market capitalisation/GDP[1]
memorandum			
euro area	235	20	68
Algeria[1]	39	80	-
Cyprus	228	15	67
Egypt	112	37	25
Israel	132	9	53
Jordan	201	18	72
Lebanon	290	54	7
Malta	394	21	37
Morocco	92	23	27
Syria	98	77	-
Tunisia	72	8	12
Turkey	56	67	32
West Bank and Gaza	143	18	19

Sources: IMF and World Bank.
Note: Data refer to 2002, unless otherwise indicated.
1) Data refer to 2001.

decade both the level of bank penetration in the economy, as measured by bank assets to GDP, and the level of bank intermediation, as measured by the ratio of domestic credit to GDP, have been on an upward trend. Other quantitative indicators confirm a rising level of financial development and a growing role for the banking sector in many Barcelona partner countries. Specifically, the ratio of currency in circulation to GDP has declined over the last decade, showing a reduced use of cash for transactions, while the ratio of bank deposits to GDP has increased, which may reflect increasing confidence in the banking sector.

The financial systems in all the Barcelona partner countries appear to be bank-focused, since the assets of other financial intermediaries are small compared with those held by the banks. Similarly, the capital markets are less developed than the banking systems (see Table 3). Financial deepening, in conjunction with the structural reform of the banking sector, is one potential avenue for diversification and appears necessary as a basis for sustained growth. The development of capital markets would also assist in improving the scope and quality of price information for financial services.

Banking sectors tend to be relatively concentrated, although the largest banks are small by European standards. In the Barcelona partner countries only seven banks show a balance sheet of more than €20 billion, with substantial off-balance sheet activities in some cases. While overall bank profitability is relatively low, this varies widely across countries. Similarly, interest rate and commission income are of varying importance for banks in the different countries.

In many Barcelona partner countries, banking is still closely linked with the public sector. Indeed, in four countries the public sector absorbs more than half of total bank lending (see Table 3). This focus on public sector lending may imply the crowding-out of private sector investment. While state ownership of banks was reduced in many countries in the 1990s, most of the biggest banks in the region are still publicly controlled. In addition, the banking system in most of the North African countries is largely part of the public sector, as is the entire Syrian banking system.

Recently, authorities have opened financial markets up to the private sector and to foreign operators. Foreign bank entry may enhance the efficiency of the domestic system by transferring know-how, technology and capital. A growing awareness that banking thrives more easily if deposit and lending rates are determined by the market has led to the abolition of interest rate regulations in most countries. In the same spirit, banks have expanded their range of activities and introduced new financial instruments.

Adequate supervisory standards are necessary if international capital flows are not to become a potential threat to financial stability. In some Barcelona partner countries the quality of supervision has been improved to the point where it is now almost – if not fully – compliant with international standards. However, the close links between the public sector and the banks do raise concerns about potential conflicts of interest. Moreover, further improvements with regard to cooperation with international fora are particularly desirable. In this regard, it is worth noting that Egypt, Israel and Lebanon were recently recognised as cooperating jurisdictions by the Financial Action Task Force on Money Laundering, leaving none of the Barcelona partner countries listed as non-cooperative.

4 ECONOMIC AND FINANCIAL LINKS WITH THE EURO AREA

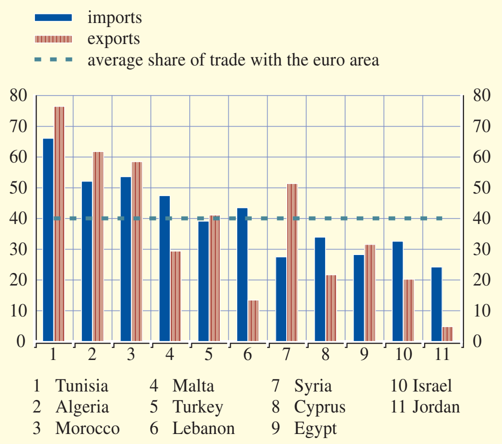
The EU and the Barcelona partner countries intend to use the Euro-Mediterranean partnership as an instrument for enhancing growth and entrenching reforms in the region by strengthening economic and financial links. This section takes stock of the current state of integration.

For most Barcelona partner countries, trade with the euro area is significant, reflecting their geographic proximity and their complementary production structures. By contrast, the degree of integration with the rest of the world and each other is low.[3]

Financial links include euro area bank lending to the Barcelona partner countries, FDI, and

Chart 2 Barcelona partner countries' trade with the euro area

(percentage of total trade)



Source: IMF Direction of Trade Statistics.
Note: Data are for 2002.

financial flows related to the movement of people, i.e. workers' remittances and income from tourism. With the exception of an increase in bank lending from the euro area, links between the two areas appear to have stagnated over recent years.

Trade relations are close, especially from a Mediterranean perspective. On average, trade with the euro area accounts for some 40% of total trade (see Chart 2). However, while Malta, Turkey and the Maghreb countries are very open with regard to the euro area, the Mashrek countries are more oriented towards the United States or the Gulf states.[4] Overall, the euro area has constantly registered a trade surplus with the Barcelona partner countries. Imports from the euro area consist mostly of machinery, manufactured goods and chemicals, while exports are agricultural products, textiles and fuels.

3 In 2002 the Barcelona partners' openness (the average ratio of exports and imports to GDP) was 34%, compared with 57% for the Asean-4 countries, 50% for the acceding countries, 29% for Russia and 21% for the Andean countries.

4 The Maghreb, as used here, refers to Algeria, Morocco and Tunisia, while Mashrek refers to Egypt, Israel, Jordan, Lebanon, Syria, and West Bank and Gaza.

By contrast, trade among the Barcelona partners accounts for only about 5% of total trade, since several countries produce similar goods and because inadequate infrastructure, together with tariff and non-tariff barriers, prevents greater intra-regional trade. Even though Jordan, Lebanon and Syria are relatively more open to the region than the other countries, their trade share with the other Barcelona partners never exceeds 15% of their total trade. Authorities in the region, recognising the obstacles to trade, have launched initiatives for regional integration, with financial support from the European Union and the European Investment Bank.

From a euro area perspective, trade with the Barcelona partners accounts for some 3% of total external trade. Trade with this region is higher for Spain, Italy and, in particular, Greece than for the central and northern European countries.

Using the development of trade as an indicator for integration between the euro area and the Barcelona partners, it appears that the full effect of the Barcelona agreement has yet to materialise. It is true that overall trade has increased substantially since the conclusion of the Barcelona agreement in 1995, and more than doubled over the last decade. However, seen in relation to global trends, the euro area's share in the total trade of the Barcelona partners has stagnated in the last decade.

Bank lending from the euro area is important from a Mediterranean perspective, and has gained in importance over the last decade. Bank claims from the euro area account for more than half of total foreign bank claims in the region, while representing less than 2% of the total claims of euro area banks abroad. However, almost half of the total claims on the Barcelona partners are on Turkey alone. The euro area provides two-thirds of all foreign bank lending to the Maghreb countries and Lebanon, but this share is considerably lower in the other countries. With regard to exposure, Germany and France account for more than two-thirds of euro area banks' total claims. As an indicator of strengthened ties, bank lending to the Barcelona partners has increased over the last decade by over two-thirds. Viewed from a global perspective, it is notable that euro area banks' cross-border lending to the Barcelona partners increased as a share of their lending to developing countries from 15% in 1993 to 24% in 2002.

While bank lending from the euro area is relatively important for the Barcelona partners, the picture is more mixed with regard to FDI. Since 1995, FDI inflows from the euro area have on average been around 20% of total FDI, with large variations from country to country. In addition, the sector allocation of FDI varies widely across the region. While in Algeria, Egypt and Syria the fuel sector attracts most FDI, in Cyprus the largest share goes to offshore banking and in Jordan it goes to business in the free-trade zone. Meanwhile, the privatisation of public sector companies has been prominent in moving investment into Morocco and Tunisia. FDI from the euro area has stagnated as a percentage of the total FDI allocated in the Barcelona partner countries, reflecting a lack of dynamism in economic integration between the two areas. However, as FDI is subject to large variations over time, this has to be treated with caution.

Investment among the Barcelona partner countries is rather limited, since few local banks focus on investing in the Mediterranean region, and information on investment opportunities in other countries in the region is not readily available. Many economies are dominated by small family-run enterprises that do not adhere to internationally recognised accounting standards and are consequently unattractive to investment from abroad.

Although migration to the euro area is economically and socially important given the geographic proximity and average income differentials between the two regions, this appears to have reached a plateau. Some 4.7 million people from the Barcelona partner countries now live permanently in the euro area; almost half of them came from Turkey and live in Germany, and another 30% came from the Maghreb countries and live in France.[5] A major obstacle to raising human capital in the region is the low return rate of students studying in Europe.

Workers' remittances account for a considerable share of several Barcelona partner countries' current account receipts. In 2001 workers' remittances accounted for 2% of the Barcelona partners' aggregate GDP and totalled €12.5 billion. In particular, receipts in the Maghreb countries and Turkey stem primarily from the euro area, while most of the other countries receive remittances predominantly from the United States and the Gulf states.

Also as a result of geographic proximity and income differentials, tourism from the euro area contributes 2% to the GDP of the Barcelona partner countries. They receive more than 18 million tourists a year from the European Union, including a considerable number from the euro area. An increasing share of these tourists are migrant workers returning home for the summer, especially to Turkey and Morocco.

In sum, the Barcelona partners' economies have been – and will continue to be – quite closely linked to economic developments in Europe. While these links are more important for these countries than for the euro area as a whole, a closer inspection of the data shows that the importance of these relations varies from country to country. Turkey and the Maghreb countries, as well as the two acceding countries, Cyprus and Malta, have especially tight links with the euro area, while links are less intense for the Mashrek countries. On the euro area side, France, Germany, Italy and Greece have the closest links with the Barcelona partner countries. With regard to developments over time, the evidence so far appears to indicate stagnation in most areas of economic and financial integration between the two areas over the last few years. While the creation of a free-trade area by 2010 between the EU and the Barcelona partner countries is expected to increase trade and financial integration, this needs to be supported by the appropriate policies.

5 CONCLUSION

While monetary developments in most Barcelona partner countries have been stable in recent years, growth has not been strong enough to generate jobs. Fiscal discipline has also been a problem in several countries.

One way of entrenching reforms and increasing growth potential is to proceed towards regional integration, both among the Barcelona partners themselves and with the euro area. Further economic and financial integration between the euro area and the Barcelona partner countries should prove beneficial by increasing competition in the latter region, thereby increasing its growth potential. However, this result will only be possible if the economies in the region make headway on structural progress and both sides intensify efforts to integrate the two regions economically and financially.

The individual Barcelona partner countries vary considerably in terms of both economic structures and the intensity of their economic links with the euro area. Links are especially close for Turkey and the Maghreb countries, but less so for the Mashrek countries. In view of insufficient growth and structural difficulties, the authorities have initiated reforms in some fields. However, there appears to be considerable scope for further improvement, in particular by consolidating legal frameworks, enhancing education systems, strengthening intra-regional links and improving fiscal discipline.

While the structure of the financial sector varies widely across those countries, all of their financial systems appear to be bank-centred,

5 However, these figures must be treated with caution, as they depend on the nationality laws of the respective countries.

relatively concentrated and closely linked with the public sector. Recently, authorities have opened up the financial markets to the private sector and to foreign operators. Adequate supervisory standards are necessary if international capital flows are not to become a potential threat to financial stability. In this regard, choosing an adequate exchange rate system represents a particular challenge.

With regard to trade, most Barcelona partner countries are very open towards the euro area. However, while trade relations between the two areas are close, especially from a Mediterranean perspective, trade does not appear to be intensifying over time.

Moreover, while bank lending from the euro area is quite important for the Barcelona partners and has gained importance over the last decade, the picture is more mixed with regard to FDI. Migration to and tourism from the euro area are other economically and socially important mechanisms that forge links across the Mediterranean.