

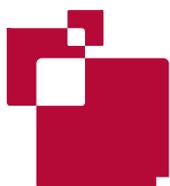
EASTERN EUROPEAN LESSONS FOR THE SOUTHERN MEDITERRANEAN

ANDRÉ SAPIR AND GEORG ZACHMANN

Highlights

- The economic profiles of southern Mediterranean countries (SMCs) bear some resemblance to those of south-eastern European countries and some former Soviet republics at the beginning of their economic transition in 1990. The SMCs resemble less the former communist countries that joined the European Union in 2004. The SMCs are more advanced in terms of market reforms, but less well equipped with human capital and infrastructure, than the former communist countries were in the early 1990s.
- The EU's willingness to underpin reforms in central and south eastern Europe and hold out the prospect of EU membership contributed to substantial growth, highlighting the long-term value of partnership with the EU.
- Long-term partnership has so far been absent for the southern Mediterranean countries. The existing Union for the Mediterranean framework is too weak to provide the necessary EU support to domestic reforms in the SMCs, and to ensure the desired stability and prosperity in the region.
- To encourage a successful transition in the SMCs, a **Euro-Mediterranean Economic Area** should be established by 2030.

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ANDRÉ SAPIR AND GEORG ZACHMANN, JULY 2011

AT THE BEGINNING OF 2011 the political establishment in the Arab world was shaken by a previously inconceivable wave of protests. The Egyptian and Tunisian regimes were ousted. Only military intervention and concessions have kept the administrations in place for now in many other Arab countries. Economic dissatisfaction, especially among the growing but under-employed young population has underpinned the uprisings.

From a European perspective, these events have some echoes of the change in the communist bloc two decades ago. The European Union responded to the communist collapse with a firm commitment to support the transition of the region's economies and the integration of ten former communist countries into the EU. The transformation of central and eastern Europe was a success for the countries involved and for Europe as a whole. Are there lessons in this for the EU's relationship with the southern Mediterranean countries (SMCs) of Algeria, Egypt, Libya, Morocco and Tunisia?

In particular, can the EU really base initiatives for the Mediterranean countries on the central and eastern European precedent? To answer this question, this Policy Contribution explores what lessons can be drawn from the economic transition of the former communist countries (FCCs) for the future development of the SMCs. The EU's past efforts to offer to its southern neighbours a framework for partnership had mixed results. The European Neighbourhood Policy (ENP) was developed to provide an economic and political framework for cooperation between the EU and its eastern and Mediterranean neighbours, in order to increase stability and prosperity. However, the ENP achieved little, partly because of domestic conditions in the neighbouring countries and partly because the EU failed to define clearly its future relationship with its neighbours. A specific policy framework aimed at the Mediterranean countries

– the Union for the Mediterranean – was launched in 2008, but suffered from the same defects as the ENP.

This Policy Contribution begins by comparing the development levels and the socio-economic framework conditions in the FCCs at the start of their transition, with the situation in the SMCs today. We include in the FCC group the eight countries of central and eastern Europe that joined the EU in 2004 (NMS-8), plus the south-eastern European countries (SEECs) and the former Soviet republics (FSRs). We examine the different development patterns of the NMS-8, FSRs and SEECs during the 20 years since the beginning of their transition, and identify success factors. We conclude that the Union for the Mediterranean framework is too weak to provide the necessary EU assistance to domestic reforms in the SMCs, and propose the creation, by 2030, of a Euro-Mediterranean Economic Area similar to the existing European Economic Area. We also outline the conditional steps that the EU and the SMCs will need to take gradually to achieve this goal.

WHERE DO THE SMCs STAND?

Despite significant differences, the five SMCs have much in common with each other (Table 1). All five have young populations and are growing, but lack employment opportunities. Only Libya stands out from the group as the least populated and the richest, with a vast natural resource endowment. The other four are relatively poor, with significant agricultural populations and out-migration.

Libya apart, the SMCs' level of per capita output measured in purchasing power parity (PPP) is well below that of the average of the FCCs at the beginning of their transition in 1990. In 2009, per capita GDP in Algeria, Egypt, Morocco and Tunisia was between 15-28 percent of the corresponding EU27 figure. By contrast, the per capita GDP of the

Table 1: Selected indicators for the latest available year

	Algeria	Egypt	Libya	Morocco	Tunisia	SMCs
Population in millions	34.9	83	6.4	32	10.4	166.7
GDP (current US\$ billions)	141	188	62	91	40	522
GDP per capita (current US\$)	4029	2270	9714	2811	3792	3131
GDP growth (average % 2005-2009)	2.9	6	5.5	4.8	4.8	5.1
Public debt (in percent of GDP)	14	76	-	48	43	43
Agricultural employment (% total employment)	20.7	31.2	-	40.9	-	31
Agricultural added value (in % of total added value)	8.3	15.3	2.3	14	11	11.3
Manufacturing added value (in % of total added value)	4.7	15.5	4.7	15.1	16.6	11.1
Mining, utilities added value (in % of total added value)	47	14.2	58.8	4.7	6.9	26.1
Current account balance (% of GDP)	0.3	-1.8	15	-5.4	-3.1	0.1
Merchandise trade (% of GDP)	60	36	73	51	85	53
Share of population aged 15-24 in %	20.5	20.2	17.3	19.7	19.3	20
Unemployment in %	13.8	8.7	-	9.6	14.2	10.3
Net migration per 1000 inhabitants	-0.82	-0.84	0.64	-2.7	-0.4	-1.11
Human Development Index (2010 value)	0.67	0.62	0.76	0.57	0.68	0.63

Source: World Bank, World Development Indicators; International Monetary Fund, Historical Public Debt database and World Economic Outlook (October 2010); UNDP, Human Development Report (2010); Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat, World Population Prospects (2008 Revision).

FCCs (simple average) in 1993¹ was about 40 percent of the per capita GDP of the countries that now form the EU27. Per capita GDP was even higher in the NMS-8 countries.

THE INITIAL ECONOMIC FRAMEWORK CONDITIONS

There is a rich literature on the key elements of economic transition in the SMCs². In the following, we compare the initial economic framework conditions of the SMCs with those of the FCCs. For this

purpose we compare Algeria, Egypt, Libya, Morocco and Tunisia with four FSRs (Armenia, Kazakhstan, Russia and Ukraine) three of the NMS-8 (Hungary, Poland, and Slovenia) and four SEECs (Albania, Bulgaria, Croatia and Romania)³.

MARKET

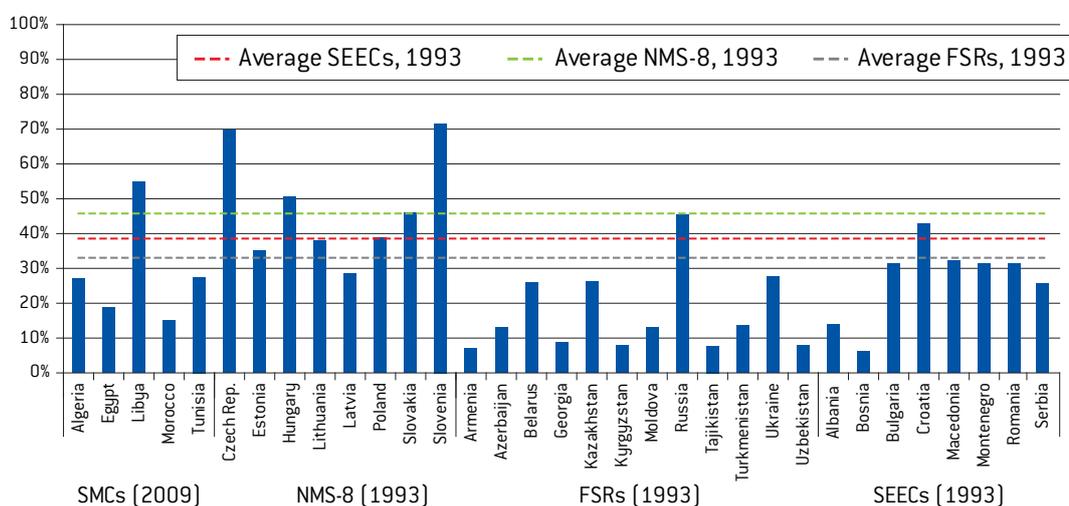
The move from a command-and-control economy towards a market economy was at the heart of the transition, resulting in a huge jump in GDP per

1. Caution should be applied when interpreting the pre-transition GDP of FCCs. The transition crisis, which lasted until the mid-1990s and implied a massive decrease in GDP in all the countries, revealed that much of the 1990 GDP was due to the biased price system in the command-and-control economies. Consequently we use 1993 as our base year.

2. Development of infrastructure (Bhattacharya and Wolde, 2010), better education, improvement in the labour markets (Pissarides and Véganonès-Varoudakis, 2007), development in the allocation of financial resources especially to SMEs (Ersel and Kandil, 2007) and progress in the system of governance and institutions (Page and Van Gelder, 2001) are some of the factors for promoting growth in the region.

3. The restriction in the number of countries taken into account for the comparison groups, even if discretionary, allows individual indicators for each country to be taken into account, and better evaluation of similarities and differences.

Figure 1: GDP per capita relative to EU27 before transition



Source: Bruegel, World Bank. In PPP (constant 2005 US dollars).

capita in most FCCs. In terms of the role of markets, the SMCs are already more advanced than the FCCs were at the beginning of their transition. The European Bank for Reconstruction and Development's (EBRD) transition indicators clearly show that the degree of privatisation and liberalisation in the SMCs in 2004 (the last year for which comparable data is available) surpassed the comparable values for the FCCs at the beginning of their transition.

In addition, by 2009, the SMCs were able to attract a significant stock of foreign direct investment, while in 1990, the FCCs were not (Figure 2). This illustrates how far the FCCs were from being market economies at that time.

Although economic development in SMCs is constrained by a high degree of public intervention⁴ and insufficient market reforms⁵, these countries are much closer to being market economies than the FCCs were at the beginning of their transition.

REGULATION

The quality of political/administrative institutions is a key determinant of economic performance⁶. The systems in the SMCs today and the FCCs at the beginning of their transition, are structurally different. The FCCs typically featured a large, centralised, well educated, almost omnipotent, but still inefficient bureaucracy. The SMCs by contrast have much more decentralised, less well-educated

but also inefficient bureaucracies.

In 1996 – the earliest date for which corresponding data from the World Bank is available – the quality of institutions in the NMS-8 was significantly higher than in the SMCs today (Figure 3). This most likely reflects both a better starting point and a quicker transition in these countries compared to the FSRs and the SEECs. The situation in the SMCs today is more comparable to that in the FSRs and the SEECs in the 1990s.

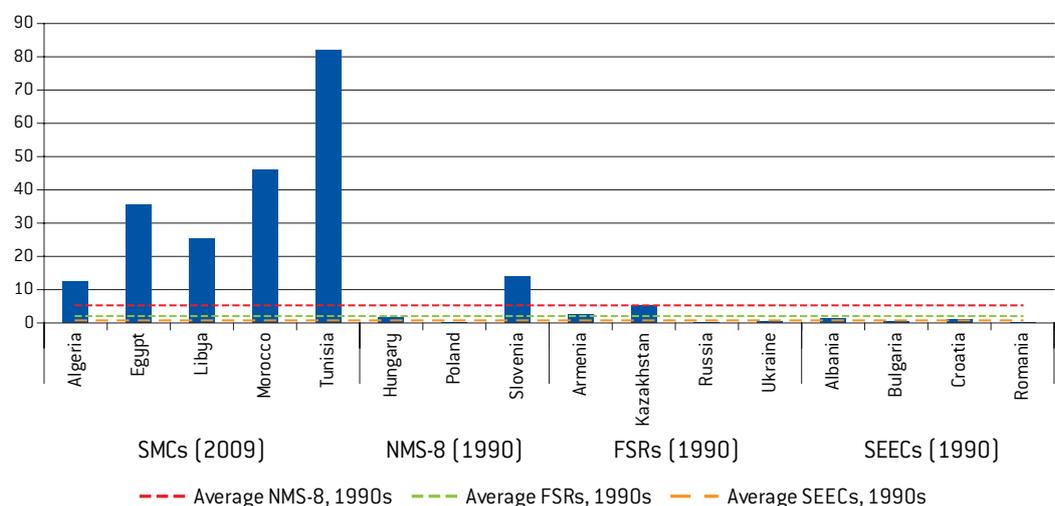
Furthermore, social institutions and cultural factors have been shown to affect development patterns. Various studies show that the pre-communist institutions mattered for both the economic and political transition in the FCCs. The NMS-8 in particular benefited from their pre-communist episode of relative economic and personal freedom, as well as the presence of functional institutions⁷.

HUMAN CAPITAL

The availability of a well-educated workforce was seen as one of the big assets of the FCCs twenty years ago. Illiteracy rates were negligible and the level of schooling was comparable to that in western Europe. Shrinking populations and brain-drains were the main human capital concerns for the FCCs during the transition.

Currently, SMCs face an almost inverse challenge.

Figure 2: Foreign direct investment stock (% of GDP)



Source: UNCTAD.

4. See Sala-i-Martin and v. Artadi (2002).

5. See Nabli and Végañón-Varoudakis (2007).

6. Méon and Sekkat (2004).

7. Darden and Grzymala-Busse (2006) show how pre-communist levels of education translate into voting behaviour after the end of communism. Iliev and Putterman (2007) find pre-communist statehood to be a predictor for post-communist growth.

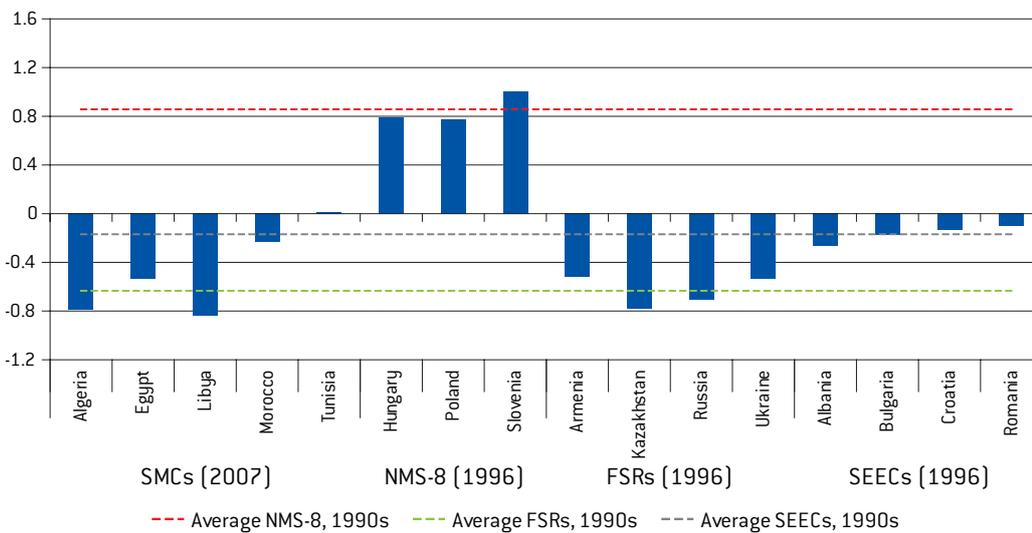
In terms of quantity and quality of education, they significantly lag behind the FCCs (Figure 4). The current average years of total schooling in the best SMCs (Libya 7.2 years) is below the corresponding values for the worst-performing FCCs in 1990 (Kazakhstan 7.7 years). Moreover, education in the SMCs does not seem to be well targeted at the local labour market. University graduates in Algeria and Morocco constitute a small proportion of the total unemployed, but have the highest unemployment rate, indicating that these countries suffer from a low return on education, which eventually translates to a low propensity to stay in school/university.

In the five countries unemployment is between 9 percent (Egypt) and 30 percent (Libya). Youth unemployment in Algeria, Egypt and Tunisia is above 30 percent. This inability of the economies to employ their present human capital leads to high migration pressure and keeps the countries at the brink of social unrest.

INFRASTRUCTURE

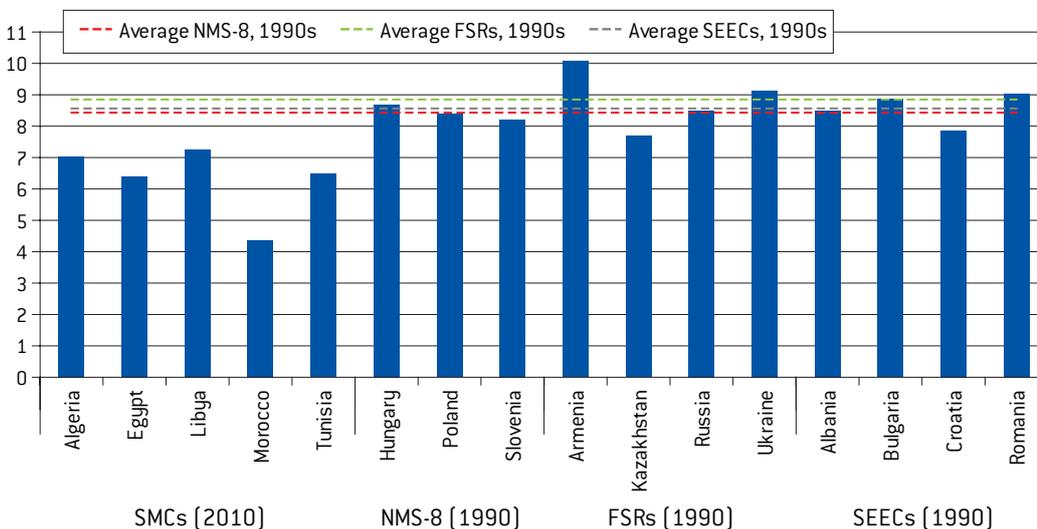
Growth is positively affected by the stock of infrastructure assets⁸. But physical infrastructure in the SMCs today is on average inferior to that in the FCCs at the beginning of their transition.

Figure 3: Governance indicator



Source: World Bank world governance indicators.

Figure 4: Average years of schooling



Source: Barro-Lee (2010).

8. Calderón and Servén (2004).

According to a composite index on physical infrastructure based on the methodology of Kumar and De (2008), only Albania in 1990 performed worse than Algeria, Egypt, Morocco and Tunisia today (Figure 5).

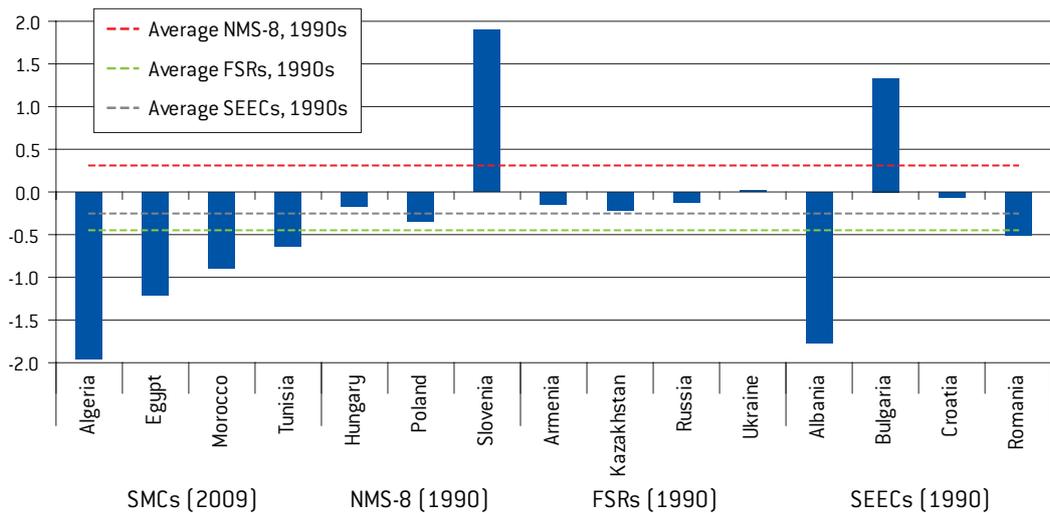
In terms of infrastructure management, the SMCs perform worse than the FCCs at the beginning of their transition. As indicated by the EBRD infrastructure reform indicator, the management of infrastructure in Algeria and Tunisia is at the level the NMS-8 achieved in 1995. Only Morocco is more advanced, with the infrastructure management level reached by the NMS-8 in 1999⁹.

GROWTH PERFORMANCE

The previous sections examined how the current socio-economic conditions in the SMCs compare with those in the FCCs at the start of their transition period. In this section we examine what has the growth performance of the FCCs has been during the last 20 years, and reflect on the lessons for the SMCs.

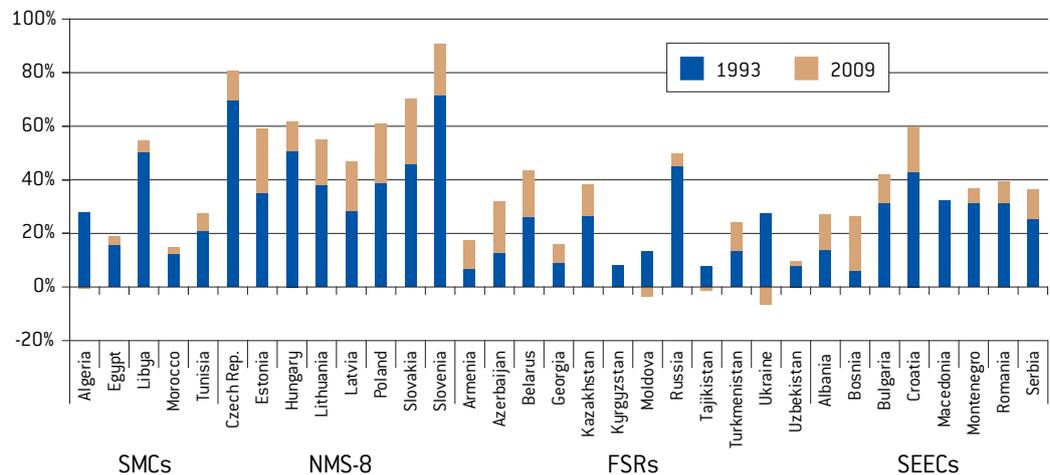
In the past decade, the FCCs grew at an annual rate of 5.3 percent (Figure 6). This shows that after an initial slump, the transition unlocked significant economic growth potential. This potential was founded on a favourable factor endowment (eg skilled labour and infrastructure) and on the

Figure 5: Composite infrastructure indicator



Source: Bruegel based on World Bank data.

Figure 6: Development of GDP per capita relative to EU27 average between 1993 and 2009



9. See World Bank (2006).

Source: Bruegel based on World Bank data. In PPP (constant 2005 US dollars).

presence of advantageous informal institutions. These favourable conditions were under-exploited in the pre-transition economic system and their subsequent awakening underpinned a rapid catching-up. Furthermore, the political transition allowed the FCCs to reduce expenditure on internal and external security.

Apart of these characteristics, shared to some degree by all FCCs, significant regional differences in terms of the initial level of economic development, the presence of institutions and the European response to the transition, translated into different regional development patterns.

From the beginning of their transition, the NMS-8 achieved a higher level of economic development. Some of the NMS-8 inherited valuable social capital from their pre-communist past, and European action towards these countries was very bold. The success of the NMS-8 indicates that the combination of their favorable initial conditions, the policy decisions taken and the European response created a virtuous cycle. Based on their relatively good initial conditions, the EU established strong trade relations, granted (initially limited) labour mobility, offered substantial transition funds and, even in 1993, held out the prospect of EU membership. These measures were conditional on the implementation of economic and political reforms by the NMS-8. The offer of EU accession, the visible effects of European funds and the transition-induced improvements in quality of life, meant that much of the NMS-8 population was willing to abandon legacy privileges, such as food and fuel subsidies. Furthermore, the flat distribution of assets at the beginning of the transition limited the power of vested interests. Consequently, bold economic reforms were politically sustainable. In the mid-term, economic reforms led to substantial and inclusive growth. Consequently, further reforms were politically feasible, and equipped the countries for ultimate EU membership.

The FSRs started with a lower level of economic development as well as the absence of a pre-

communist episode of economic and personal freedom. For this and other reasons, their institutions started from a significantly weaker position, and many of the FSRs still endure fights for property rights that prevent investment and distract from economic development. Meanwhile, levels of corruption are higher and there is less trust in markets. The EU's response to transition in the FSRs was cautious and was unable to break the vicious cycle of: (i) reluctance to reform because of fear of instability and (ii) limited growth. The EU did not offer the possibility of EU membership, free trade or labour mobility. The technical and financial assistance (TACIS¹⁰: about €2 per capita per year) certainly helped to improve institutional capacity in these countries, but a lack of clear conditionality aligned to a long-term strategy meant the transition was hampered.

Interestingly, the EU strategy towards the (comparatively small) SEECs has switched from the second (FSR-type) to the first (NMS-8 type) of these models in the last decade. The willingness of the EU to provide an anchor for reforms in these countries has contributed to substantial progress in some of them, highlighting the value of a long-term EU perspective.

From 2005-09, GDP growth in the SMCs was significant (5.1 percent per year), but was clearly socially unsustainable, as indicated by the high youth unemployment, and as demonstrated by recent events. The economic growth potential that could be unleashed by transition in the SMCs is probably lower than that in the FCCs at the beginning of their transition. First, in terms of factor endowment the SMCs have a less well educated labour force and an inferior infrastructure. Second, some of the potential gains from transition present in the NMS-8 in 1990 have already been reaped in the economic systems of the SMCs: the allocation of goods and production factors is already markets-based to a great extent, and the countries are part of international value chains.

However, there is significant room for

'The economic growth potential that could be unleashed by transition in the southern Mediterranean countries is probably less than that in former communist countries at the beginning of their transition.'

10. TACIS: Technical Assistance to the Commonwealth of Independent States. According to the EU, "the Community's TACIS programme encourages democratisation, the strengthening of the rule of law and the transition to a market economy".

improvement. The quality of regulation in SMCs is poor. Liberalisation remains incomplete in many sectors and the state interferes pervasively with the pricing mechanism. International trade is constrained by trade barriers. And certain sectors are cut off from foreign investment. These factors constrain market-based development. Overcoming this through economic reform could give a significant boost to growth. However, serious reforms would produce highly visible losers, such as employees in protected sectors, recipients of subsidised food and owners of economic rents. The scale of the necessary structural adjustment (eg high agricultural employment) would make such political reforms unsustainable if the economic gains do not accrue rapidly and cannot be quickly redistributed to the losers. The alternative would be conditional outside assistance and a credible political project that encourages the population and politicians to tolerate a limited period of social hardship.

A EUROPEAN RESPONSE

The EU has – at least since the start of the Euro-Mediterranean Partnership in 1995¹¹ – accepted that it plays an important role in the southern Mediterranean region. For the last fifteen years, EU policy towards the SMCs has been structured around trade, migration and assistance.

In terms of trade, EU liberalisation so far has mainly covered industrial goods, while agricultural products, which are vital for the SMCs, are largely excluded. Negotiations to open up agricultural trade and to liberalise trade in services and investment started in 2008 but are not yet concluded.

Migration is considered to be one of the priority areas of the Euro-Mediterranean Partnership, but little progress has been achieved because of conflicting interests.

Assistance to the SMCs, meanwhile, has been substantial. EU support to the Mediterranean countries¹² has been the second largest European programme for external assistance, allocating almost €9 billion between 1995-2006. Yet, because of lack of conviction and ownership on both sides, this support is not seen as having been very effective¹³. In 2007-2010 the new European

Neighbourhood and Partnership Instrument (ENPI) spent respectively €7.20 and €5.20 per capita per year for Tunisia and Morocco (by comparison Ukraine receives €2.70 per capita per year from the ENPI). Bilateral aid from individual EU governments, and EIB financing for the region, are also substantial.

But the main problem with the EU approach so far is that it has been piecemeal, with no real effort to bundle together its trade, migration and assistance policies into an overall strategy to support development in the SMCs. The responsibility lies, however, not only with the EU but also with the Mediterranean partners, which have not shown determination to implement the necessary social, political and economic reforms.

The events in Egypt and Tunisia open up the tantalising prospect of a transition towards a new social, political and economic era in the SMCs and in the Mediterranean region as whole. Whether or not these countries will be able to transform their societies and follow a path towards sustainable development will be determined first and foremost by their own efforts. But there is much that Europe can and must do to ensure a favourable outcome which is in its own interest. Europe must provide short- and medium-term financial assistance to help the SMCs, and should mobilise its development banks to help foster transformation. But above all, the EU should define a new strategy towards these countries that spells out the credible and comprehensive approach to the Euro-Mediterranean relationship that has so far been lacking. The approach must include short- and medium-term concrete and measurable steps designed to foster the transition process.

The EU should offer the SMCs full accession to the EU single market by 2030, provided the countries meet the necessary conditions in terms of meeting the relevant *acquis communautaire*. This would entail the progressive elimination of all barriers to the free circulation of goods, services, capital and labour as well as the adoption by the SMCs of all the rules and policies linked to the single market. It would also include access to specific transfer mechanisms designed to foster economic, social and environmental convergence and to offset the costs. For example, the SMCs would

11. The Euro-Mediterranean Partnership (aka Barcelona Process) was launched by 15 EU members and 14 Mediterranean partners, as the framework to manage both bilateral and regional relations. It seeks to create a Mediterranean region of peace, security and shared prosperity. Its main pillars are a political and security dialogue, the gradual establishment of a free-trade area and promoting inter-cultural dialogue.
12. Algeria, Egypt, Lebanon, Libya, Jordan, Syria, Tunisia, Occupied Palestinian authority, Morocco, Israel.
13. The Nair Report (2001) on the Barcelona Process to the European Parliament highlighted the lack of strategic vision as one of the reasons for the failure of the policy. According to Natorski (2008) the low level of intra-European coherence, the limited and slowly disbursed funds as well as the lack of a sense of co-ownership and cooperation between the partners made MEDA ineffective.

get access to specific structural funds and be allowed to issue emission permits usable in the EU's emission trading system (ETS).

If successful, the process would imply that, by 2030, Europe and the Mediterranean countries would constitute a vast Euro-Med Economic Area (EMEA) similar to the present European Economic Area (EEA) that links the EU to Iceland, Norway and Liechtenstein. At that stage the Mediterranean countries would effectively share 'everything but institutions' with the EU, a concept already put forward by the European Commission back in 2002¹⁴ in the spirit of extending to Europe's neighbours the set of economic, social and political principles and standards that define the EU itself.

Achieving this long term vision requires bold but gradual steps on both shores of the Mediterranean. While the SMCs would have to gradually implement the European legislation and transform their economies, the EU will have to support the countries' efforts financially but also demonstrate its commitment to the long-term vision by gradually fulfilling its promises of opening its markets to goods, services, capital and labour. The hope is to generate the kind of virtuous circle of economic reforms and sustainable growth that helped the countries of central and eastern Europe at the beginning and throughout their transition period. Membership of the EMEA should therefore be viewed as the ultimate goal of a process involving a *quid pro quo* approach in which the benefits offered by the EU are conditional on the achievement of clearly defined transition milestones on the part of the Mediterranean countries.

On the EU side, the key offers would include: a revised trade agreement providing for the gradual elimination of all remaining barriers to the free circulation of goods, services and capital. This would include agricultural products, which should have front-loaded access to the European market. The permanent access to the European labour market for certain categories of Mediterranean

workers, especially professionals, should be organised through a 'Blue Card' system, a temporary European work permit for high skilled foreigners, as proposed by von Weizsäcker (2006). More generally, the EU should do its part to put in place circular migration schemes. Although its main contribution should be in terms of regulatory changes (mainly in the area of trade and migration), Europe should also provide substantial assistance for human capital (including institutional capacity building) and physical infrastructure development through both the EU budget and European financial institutions such as the EBRD and the EIB. An amount of €10 billion per year for a period of 10 years (equivalent of 2.5 per cent of the present GDP of the SMCs) would be sufficient in our view and would represent a good investment in the stability of Europe's southern neighbourhood¹⁵.

On the Mediterranean side, the milestones would include the gradual implementation of EU legislation in the economic field (such as competition policy, investment protection and consumer protection) and in the areas of social and environmental policies. In order to ensure the success of circular migration schemes, Mediterranean countries also need to put in place effective legal and institutional mechanisms to promote the reintegration of returning migrants, including temporary tax exemptions for entrepreneurs, portability of social rights, and retraining programmes. In general, it would be crucial for the EU to put in place a system of effective conditionality aimed at the creation of the rule of law in all areas conducive to sustainable development.

There is a significant risk that the high hopes of the local population and of the international community towards the future economic and political situation in the Mediterranean countries could turn sour in the coming months due to short-term economic difficulties. Transition is a long-term process that typically involves some painful adjustments. Transition therefore needs to be nurtured with care to ensure it survives. And

14. Speech by Romani Prodi in Louvain-la-Neuve in December 2002.

15. This order of magnitude is certainly not unrealistic. At the G8 Deauville Summit in May 2011, President Sarkozy said that "multilateral development banks could provide over €14bn, including €3.5bn from the EIB, for Egypt and Tunisia for 2011-2013 in support of suitable reform efforts". He has also announced that G8 members could increase this effort up to €28bn.

'By 2030, Europe and the Mediterranean countries would constitute a vast Euro-Med Economic Area (EMEA) similar to the present European Economic Area (EEA) that links the EU to Iceland, Norway and Liechtenstein, sharing "everything but institutions" with the EU.'

because painful structural reforms are difficult to sustain in the present climate of high expectations, there is a clear danger that unless there are short-term successes, the SMC population might quickly turn to policy makers promising populist measures, such as legacy industry protection, and food and fuel subsidies.

Europe can help overcome this dilemma by providing the long-term vision of the EMEA as a credible expectation for the future. However, such a vision needs to be accompanied by clear signs

of short-term EU action in order to get through potentially traumatic economic reforms and to demonstrate the EU's commitment to its future partnership with the region. EU finance ministers should announce bold measures, including substantial macro-financial assistance to Egypt and Tunisia, and assistance for large infrastructure projects that would increase employment. In parallel, EU employment ministers should agree on a limited guest worker programme for certain categories of workers from these two countries.

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