Statement by Stanley Fischer, First Deputy Managing Director
of the International Monetary Fund
at the
International Business Conference on "Opportunities for Investment
in the Mediterranean Region"
London
March 6-7, 1997

Mr. Chairman, Ladies and Gentlemen:

I am grateful to the organizers of this conference for allowing me the opportunity to address you on behalf of the IMF.

My message is a simple one: that the last few years have seen a major change in the economic environment in many countries of the southern and eastern Mediterranean--a change to a strategy that instead of trying to protect economies from the rest of the world, seeks rather to open up, to take advantage of the opportunities offered by vigorous participation in the global economy. Seen in that context, this conference has a dual importance--it is not only an important initiative for promoting investment in the Mediterranean region, but it is also a signal that the governments of the region are acutely aware of the significance of foreign investment in their countries and are seeking to encourage it.

This is a conference of business people interested in exploring business opportunities and I am sure you would like to get down to business as soon as possible. However, my remarks will

not deal with specific investment opportunities. Rather, I will talk about the important improvements that have been taking place in the overall economic climate in many countries of the region.

I do so not only because the IMF deals with economic policies and the behavior of the macro-economy rather than individual projects, but mainly because it is the economic climate in a country--which depends on its degree of macroeconomic stability, the strength of the balance of payments, openness to trade and financial flows, and its tax and regulatory environment--that is the basic determinant of the business outlook in that country and the success of specific investments.

Now let me substantiate my central message, that remarkable changes are taking place in economic attitudes and policies in many Middle Eastern and North African countries. Economic policy reform has moved to the top of the agenda of most governments, and more realistic, more forward-looking economic policies, policies that seek to take advantage of the opportunities offered by the world economy, are being put in place. This is happening because governments have increasingly come to realize that only high growth will permit them to address the challenges of achieving better living standards, lowering high levels of unemployment, and generating gainful employment opportunities for a growing number of entrants into the labor force--and that high growth is entirely possible if the right policies are put in place.

What are these changes? On the macroeconomic front, inflation rates have come down as fiscal and monetary policies have been strengthened. Reductions in domestic imbalances have translated into reduced external imbalances--as reflected in narrowed current account deficits, more sustainable debt levels, rising official reserve levels, and increased exchange rate stability. Because these improvements are widely seen as substantial and durable, and backed by the commitment of governments, they have resulted in the positive assessments that many countries have recently received from major credit agencies, and a pick-up in private capital flows to the region.

On the structural side, we are witnessing the removal of barriers to free trade and financial flows, reductions in tariff protection, reforms of banking and financial systems, as well as regulatory and judicial reforms--all of which are important to foreign private investment decisions. So too is privatization, a key efficiency measure as well as an important signal--where however progress has been uneven across countries. Other important reforms that are providing positive signals to the business community, both domestic and foreign, are the disengagement of the government from the economy through civil service reform, price decontrol, and the opening up of sectors previously reserved for the public sector.

Let me review with you briefly developments in a few of the countries in the region.

In **Egypt**, striking progress has been made toward stabilization. The fiscal deficit has been cut from as much as 20 percent of GDP in the late 1980s and early 1990s to around 1 percent

recently, with the result that inflation is now running at 5-6 percent. The external position has strengthened significantly, and large reserves have been built up. With macroeconomic stability in place, Egypt has now embarked on the next critical stage of its economic reform effort, with a program to deepen structural reforms, encompassing privatization, deregulation, trade liberalization, and financial sector restructuring. Egypt's strong overall economic performance and prospects have been recognized by the international financial community, and capital inflows are now beginning on a significant scale. These inflows--the early fruits of success--will in turn pose a new challenge to policy makers.

Israel's economy has grown by close to 6 percent annually in recent years, benefitting from and helping to absorb a major inflow of immigrants from the former Soviet Union. Inflation has been lowered almost to single digits, thanks in large measure to tight monetary policies. The peace process has improved the economy's prospects and helped attract foreign capital, especially in the thriving hi-tech sector. As the same time, structural reforms have reduced government intervention in some sectors, financial markets have been freed up, and an impressive process of trade liberalization has further subjected the economy to the discipline of international competition. Progress in other areas, including privatization, has lagged but the government has left no doubt of its decision to move ahead in these areas too.

Jordan's recent economic performance has been impressive. Growth has averaged about 6 percent annually; the underlying inflation rate is now 3-4 percent; the external current account deficit has narrowed to 3 percent of GDP; and external debt has been halved in

relation to GDP. This performance reflects the steadfast implementation of tight demand management policies and wide-ranging structural reforms. The regulatory environment has been overhauled by the new companies, competition, securities, and customs laws; the trade regime has been significantly liberalized; distortions in the price and incentive systems have been removed; significant financial sector reforms are being implemented; and privatization is being accelerated. Jordan's determined adherence to its stabilization and reform program has been increasingly recognized and supported by the international community.

After the civil war, **Lebanon** was faced with the dual task of reconstruction and stabilization. The government's ambitious reconstruction program is restoring basic infrastructure. And implementation of its stabilization program has successfully reduced inflation from triple digits to single digits--and has contributed to an accumulation of gross foreign exchange reserves equivalent to about 10 months of imports. Traditionally the economy has been open and trade-oriented with a liberal regulatory regime and a dynamic private sector. In furthering that orientation, the authorities have been pursuing reforms appropriate to the realities of the 1990s. For example, under the 1995 customs reform, a simple and transparent tariff system was put in place and virtually all quantitative restrictions were replaced with tariffs.

In **Algeria** substantial progress has been made on the macroeconomic front with the budget moving into surplus, inflation declining, and official reserves being accumulated. The authorities are now moving to the more difficult tasks of privatization and labor market reform--an effort all the more impressive for taking place in a very difficult security situation.

Morocco has been pursuing a sustained fiscal consolidation effort, and as a result inflation in recent years has been contained to about 5 percent on average. The authorities have also focused on the structural reform process: privatization was initiated in 1993 and to date about 40 public entities have been sold; financial reform has been carried out to enhance market mechanisms; monetary policy is increasingly based on market-based instruments; by early 1996 nearly all interest rate controls had been eliminated; and trade liberalization has continued and will be extended through the association agreements with the EU countries.

Tunisia's recent economic performance has been strong with average annual real GDP growth exceeding 4 percent and inflation declining to about 4 percent in 1996. This has been accompanied by significant progress in structural reform aimed at liberalizing the external trade and payments system, decontrolling domestic prices, and reforming the financial sector and the public enterprises. For example, the share of the economy protected by quantitative import restrictions has been reduced from 74 percent in 1990 to 8 percent in 1995; further liberalization is under way as a consequence of the association agreements with the EU, and the privatization program is proceeding well with a total of more than 50 enterprises sold.

The changes in economic climate illustrated by these country cases are impressive. Of course, in every case, much remains to be done--paraphrasing Adam Smith we may say that there is much reform needed in every nation. But in saying that we should not ignore recent gains, and especially the underlying change in economic strategy they represent. And here I emphasize in

particular the importance of the opening up of the economies of the region to free trade and capital flows as critical conditions for accelerating real economic growth.

Why this particular emphasis on opening up? First, free trade ensures that domestic producers have access to the best technology in the world. It also places competitive pressures for greater efficiency on domestic procedures. On both counts, the resulting productivity gains should raise growth rates.

Second, and no less important, by opening up to the world economy, countries encourage the development of dynamic export sectors which can become the main engines of economic growth. This has been the secret of rapid and sustained growth not only in the southeast Asian economies but also historically for the older industrialized economies.

Third, openness to international capital flows, and particularly foreign direct investment, enables countries to tap both foreign saving and foreign technology directly, and thereby to enhance both the rate of investment and the level of technology.

The Mediterranean Basin Initiative should be central in ensuring that countries in the region derive these benefits from trade and investment liberalization. Over and above the financial assistance available through the Initiative, the association agreements with the EU countries offer the Mediterranean countries the opportunity to benefit from the opening up of their economies--by expanding export sectors, through access to the best technology, enhanced

efficiency among domestic producers, and sound choices for new investments financed from abroad.

But there are challenges associated with the Initiative. There will be substantial losses of fiscal revenue in the short run; distortions for some industries; and only limited static trade gains since most of the partner countries already have free access to the European Union market for their industrial goods. We should also recognize that the Initiative in its present form carries certain protective elements that will limit the extent of the opening up that can in fact occur and therefore the scope of the economic growth benefits that would otherwise occur. Consequently while the association agreements should be seen as stepping stones toward multilateral trade liberalization, it would be in the best interests of the Mediterranean countries if some of their protective features were removed.

At the same time as we recognize the significant progress made by countries in the region in improving their economic climate and opening their economies, we need to recognize that the process of adjustment and reform is never done, and that countries in the region need to focus not only on carrying out the policies to which they are already committed, but also to putting in place policies for the next stages of reform.

In addition to the further strengthening of policies directed at macroeconomic stability and external liberalization, there are three other areas that are critical for increasing investment and accelerating growth.

First, many economies in the region remain excessively regulated. It is hardly possible to overemphasize the importance of broad domestic deregulation for enhancing economic performance: countries need to deregulate domestically to benefit from the free market forces that drive globalization.

Second, while open and liberalizing economies will attract foreign investment, investment rates need to rise by more than the amount that can be sustainably financed from abroad. Domestic investment, financed by higher domestic saving rates--private and public--need to rise. One sure way to increase domestic saving is by reducing government budget deficits. In addition, private saving is likely to increase both if the incentives to save improve, and as growth picks up.

Third, increased resources will need to be committed to both education and health in order to upgrade the quality of the labor force. Increasingly technological change is making uneducated and unskilled labor redundant and unemployable in industrial sectors, and the structural shift of economies toward a larger and more rapidly growing service sector is not feasible without a well-educated, high quality, and healthy labor force. This is another lesson we have been taught by the economies of southeast Asia and the older industrial countries.

Increased, well-targeted, spending on health and education not only contributes to growth but--supplemented by well-designed anti-poverty policies--also helps ensure that the benefits

of growth are widely shared among the population. And growth that is not widely shared is neither socially just nor politically sustainable.

We have all no doubt sometimes despaired at the possibility of transforming the economies of developing countries experiencing high population growth rates. But such despair ignores the extraordinary powers of compound interest. If the Mediterranean region countries were to sustain a 5 percent rate of economic growth, per capita income would double in 30 years. At 7 percent, the size of the economy would double in 10 years, and given projected population growth rates, per capita income would double in 17 years.

Such growth rates are entirely feasible. But will this change happen? It can--and the beginnings of the change are visible. Whether it continues depends on the decisions and actions of governments. And the good news is that while much still remains to be done, many governments in the region are moving rapidly and in the right direction.