

Summary: Following a cautious start, Syria has recently accelerated its economic reforms, and the politically most sensitive reforms could be launched in coming years. Economic reforms, however, remain subject to sudden interruptions, so their credibility requires a strong external anchoring through financial support as well as regulatory mechanisms. Today, however, Syria is blocking its free-trade agreement with the EU, which could strongly anchor its economic reforms. Syria seems to over-rely on regional agreements – in particular the free-trade agreement with Turkey – which, however, cannot fully replace the role of the EU and the West in general. The deepening of Syria's economic reforms and their growing social impact will increase the relevance of Western support. Western economic instruments will be a very important bargaining chip in the complex strategic game in the region. It is up to the United States and the EU to better tailor these instruments to the future evolution of Syrian economic reforms.

The Future of Syria's Economic Reforms between Regional Integration and Relations with the West

by Franco Zallio*

Syria has been the most enduring example of an economic system, strongly centralized and supported by substantial financial inflows from abroad, which has long dominated the Near East. Several features have specifically characterized Syria including the intensity of socialist economic policies that started with the 1961-65 nationalizations, coupled with the size and geographical diversification of the politically motivated financial inflows. In the 1970s and in the first half of the 1980s, foreign aid alone — coming mainly from other Arab countries¹ — reached 10 percent of GDP. This was in addition to the significant funding Syria received from the Soviet Union, other Warsaw Pact countries, and Iran. The massive financial inflows represented a true geopolitical rent, related to the Cold War, the Arab-Israeli

conflict, and the 1980-1988 Iran-Iraq war. It was these very financial inflows – funding the growing inefficiencies of its economic system – that allowed Syria to delay economic reforms.

Between Rent and Debt: The Years of Hafiz al-Asad

Syria faced its first serious difficulties in the mid-1980s when the 1986 oil price collapse drastically reduced Arab, Iranian, and Soviet financial flows. The end of the Iran-Iraq war in 1988 and the subsequent breakdown of the Soviet Union caused a further drop in grants and concessional loans. Per capita economic growth turned negative, inflation accelerated sharply, and, in 1986, Syria began to accumulate arrears on external debt. These events triggered the first economic reform measures, which were very timid and essentially limited to a partial liberalization of the agricultural sector.

In the following years, the Syrian regime succeeded in avoiding more severe reforms thanks to two favorable developments: the rapid increase in oil production, which tripled between 1986 and 1995, providing the regime

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¹ In 1978 Arab oil producers pledged to provide Syria with aid worth \$1,550 million a year for the next decade. While this sum was never achieved, Arab aid was very substantial until 1985 then abruptly falling in the latter years of the implementation of the agreement.

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with a new type of rent, and the substantial aid and concessional loans granted by GCC countries as a result of Syria's participation in the 1991 Gulf War. In the first half of the 1990s, economic growth resumed at a very substantial pace, enabling the regime to limit its reforms to some exchange rates adjustments as well as a very cautious liberalization and openness to foreign private capital. The main change was the 1991 investment law — providing incentives for private investors, both domestic and foreign — which induced a limited foreign capital inflow.² Its impact on the Syrian economy was, however, modest, and in the late 1990s – with the new oil price collapse in 1998 — per capita economic growth was again negative, while the external debt situation did not improve.

The Economic Reforms of Bashar al-Asad

In July 2000, Bashar al-Asad inherited a poorly reformed economic system from his father which, in addition to growing at very low rates, displayed unfavorable prospects. Oil production, which had touched a peak of 600,000 barrels per day (b/d) in 1995, was rapidly declining: it dropped to below 500,000 b/d in 2004 and even below 400 thousand in 2008. If in the 1990s oil allowed a delay in economic reforms, during the Bashar years, oil becomes a strong incentive to accelerate them.

Nevertheless, during the first years of his presidency, Bashar, who was hailed as an economic reformer, did not launch any major reform. On the contrary, the “Damascus Spring” (2000-2001) – crushed right after a brief flowering – deterred both political openings and deep economic reforms. Bashar continued along the lines laid down by his father and focused on limited reforms, mainly related to the financial system and foreign exchange regulations.

The most significant measure implemented is the 2001 authorization of private banks; a very important decision in a country with limited banking activity and very inefficient allocation of savings. Through significant investment coming from regional banks — first Lebanese and Jordanian banks and subsequently from Gulf Arab countries — the banking system has been expanded and today includes

² According to UNCTAD's figures, in the decade between 1991 and 2000, the stock of foreign direct investments in Syria grew by only \$1 billion: from \$208 million to \$1.244 billion.

14 private banks, of both a traditional and Islamic nature. While success has been significant, there is still plenty of room for improvement. Consequently, in January 2010, the government raised the ceiling from 49 to 60 percent for foreign ownership stakes in local banks, thus stimulating new investment in the sector. Additionally, in July 2010, the establishment of investment banks was approved, although setting a very high minimum capital requirement, which is discouraging many potential foreign investors. While carrying a far more symbolic than concrete impact, the reopening in 2009 of the Damascus Stock Exchange after 40 years of closure is also worth mentioning.

The other key area of this reform phase is the foreign exchange regime: reforms started with the repeal in 2003 of the law criminalizing possession of foreign currency by individuals, followed by a cautious liberalization of foreign exchange regulations.³

The turning point came in the middle of the decade (2000s), favored by the growing international isolation facing Syria, together with the economic difficulties created by the decline in oil production.

While this phase witnessed the deepening of measures launched back in the 1990s, the real sector, international trade, and price subsidies remained largely untouched. These measures alone, however, were insufficient to achieve

³ In 2005, the list of private sector imports that could be financed through the official banking system was expanded. Since 2006, foreign exchange bureaus have been licensed, and since 2009, citizens are allowed to purchase up to \$10,000 per month from a local bank and to transfer them abroad in payment for current transactions. Moreover, in 2007, the Syrian pound's peg was switched from the U.S. dollar to the SDR (special drawing rights), even if de facto the pound seems pegged to a basket in which the dollar has a larger weight than its weight in the SDR basket.

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a true transformation of the economic system, highlighting the need for deeper reforms.

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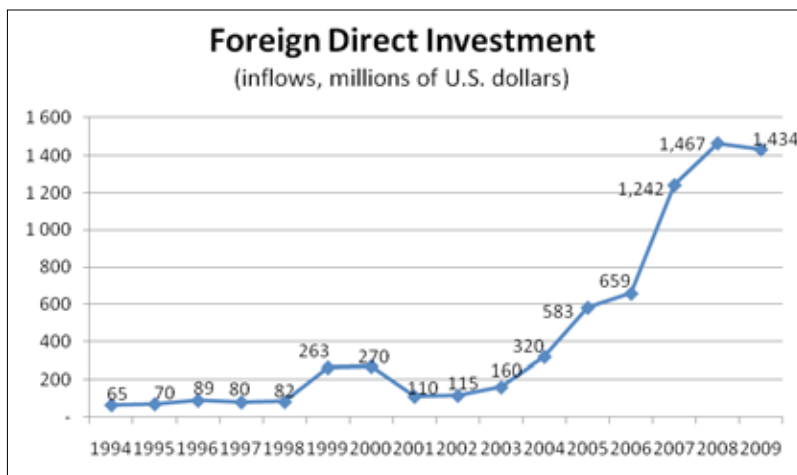
After Syria took a stand against the 2003 invasion of Iraq, relations with the United States deteriorated rapidly and in December 2003, President George W. Bush signed the Syria Accountability and Lebanese Sovereignty Restoration Act. The act came into force in May 2004, affecting trade relations (with the exception of food and medicine, all U.S. exports are prohibited), while other sanctions are affecting the financial relations. Likewise, the EU blocked the signing of the Association Agreement, which was initiated in 2004, aimed at dismantling tariffs and achieving industrial free trade.

Syria reacted by exploiting alternative relations both in the region and beyond. Western isolation pushed the regime towards an economic reform program centered around attracting investment from non-Western countries. The strong oil price increase, which has accompanied the growing regional instability following the invasion of Iraq, created ample availability of capital suitable for investment in the Gulf countries and pushed China and other Asian countries to invest in primary energy resources. These trends have benefited Syria, which has received huge investments from those countries.⁴

As outlined in the following section, Syrian relations with China and its relations within the region – while effective in helping the country to cope with Western isolation – cannot be a long-term alternative to Syrian-Western relations as the key driver of economic transformation. The sheer size of the necessary socio-economic changes calls for a strong financial support and a robust external anchoring, which non-Western partners seem unable or unwilling to provide.

⁴ Regional instability has also benefited Syrian economy through the massive influx of Iraqi refugees, estimated in 2007 to be 1.2-1.5 million people. The influx, which in the initial phase involved wealthy families with large savings, created a boom in the real estate sector and inflated private consumption, with favorable effects on GDP growth. Clearly this is a temporary factor, incapable of fixing the structural problems facing the Syrian economy.

Graph 1



The effort to deepen or re-launch relations with non-Western partners also implied the need to resolve old controversies: in 2005, Syria has agreed with Russia on the restructuring of its huge debt dating back to Soviet times. The amount outstanding was valued at \$13.4 billion, of which \$9.8 billion was cancelled, \$1.5 billion has been rescheduled over 10 years, and the remaining \$2.1 billion was used to finance Russian import of Syrian goods and Russian investments in Syria.⁵ External debt was thus reduced to \$7-8 billion, a very low figure compared to Syria's international reserves, which amounted to \$16-17 billion.⁶

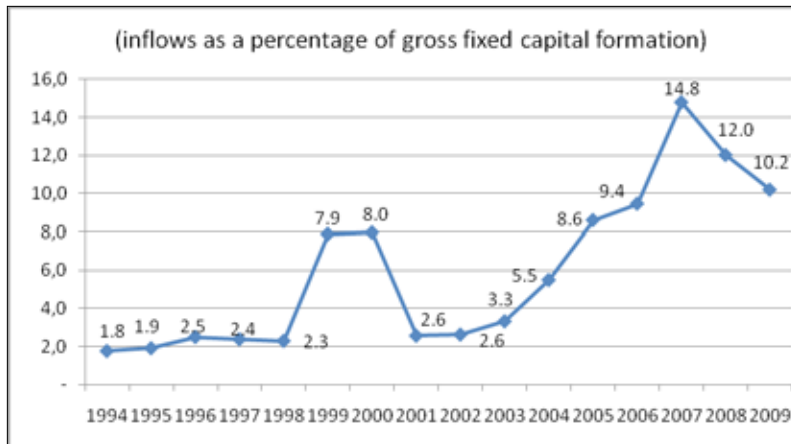
This went together with a new phase of economic reforms. The turning point occurred during the 10th congress of the Baath party in 2005, and was confirmed the following year with the approval of the five-year economic plan for 2006-2010. The plan aimed at transforming the Syrian economy into a "social market economy," switching to indirect methods of control ("indicative planning") and promoting private investment. The first step of this new phase of reform is the investment law of 2007, which offers tax

⁵ In the following years, agreements related to the Communist-era debt were reached also with Poland (2006), Romania (2007), the Czech Republic and Slovakia (2008), and Bulgaria (2010).

⁶ The increased financial strength of the country is beginning to attract the attention of international financial operators, to the extent that in September 2010, Capital Intelligence, a credit rating agency based in Cyprus, has for the first time assigned to Syria a sovereign rating: "BB-" for long-term foreign currency debt. This evaluation puts Syria among speculative investments, at a level worse than Egypt but better than Lebanon, whose rating is weakened by its high foreign debt.

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Graph 2



incentives, eliminates customs duties on imported capital goods, authorizes the acquisition of land and real estate, allows to fully transfer abroad annual profits and introduces the possibility to recourse to arbitration.

As the graphs show, results have been very positive: foreign direct investment (FDI) increased by 88 percent in 2007 and by a further 18 percent in 2008. In 2009, when the global flow of FDI to developing countries fell by 24 percent, Syria registered only a very limited reduction (-2 percent). From 2000 to 2009, the stock of FDI in Syria witnessed a sharp increase from \$1.244 billion to \$7.334 billion. Specifically, in the 2007-2009 period alone, the stock has increased by more than \$4 billion. Moreover, according to preliminary estimates of the ANIMA Observatory, in the first half of 2010, Syria has registered the largest increase in FDI inflows among Mediterranean countries.⁷

Unlike geopolitical rents of the past decades, FDI have almost exclusively economic motivations:⁸ to attract them, it is necessary to deepen economic reforms. The second step of this new phase of reforms focused on energy subsidies:

⁷ FDI have reached EUR 2.2 billion, mainly due to two major transactions: the acquisition by China National Petroleum Corp. of 35 percent of Syria Shell Petroleum Development, and the launch of a shopping centre mega-project in Damascus by a company in the UAE. cf. Invest in Med, Bilan de l'Investissement Direct Etranger et des Partenariats. Premier semestre 2010, http://www.animaweb.org/uploads/File/AIN_BilanMIPO_S1-2010_11-8-10.pdf.

⁸ The decision to invest in Syria is dependent on the forecast rentability of the project. By discouraging Western investors and therefore reducing international competition, political factors may have increased the rentability of non-Western investments.

in 2008 the prices of key petroleum products were strongly increased, albeit from very low levels. As this was followed by compensatory public wage increases, the reduction of subsidies has had a strong repercussion on inflation, jumping to 15.2 percent from 4.5 percent in 2007. In 2009, inflation had slowed sharply (to 2.8 percent according to official figures) but there are fears of a new inflationary leap with the introduction of a value added tax (VAT), a measure postponed several times but now scheduled for 2011.

As a further step, in 2007-2008 trade liberalization slightly progressed thanks to some tariffs reduction and the thinning out of the “negative list” (the list of goods banned for import), which was reduced from more than 20,000 to less than 200 items.

Conclusion: Deepening Syrian Economic Reforms and its Relations with the European Union

Despite the severe drought that hit Syrian agriculture in recent years, the macroeconomic impact of the latest reforms has been favorable, and since 2006 GDP has grown by 5 percent a year. The international economic crisis also had a very limited impact: financial contagion was barely detectable, while the oil price decline and the international trade collapse have exerted a modest recessive effect, reducing the value of Syrian exports in 2009. In contrast to the rest of the world, Syrian remittances and foreign direct investment witnessed only a moderate fall while tourism receipts have increased. GDP growth, supported by a strong countercyclical increase in public expenditure, even accelerated at 5.9 percent, at least according to preliminary official statistics. And, despite the worsening of the drought, forecasts for the current year predict a further acceleration.

However, while the current economic scenario seems very comforting, the challenges remain very relevant. This year a modest increase in oil production is expected due to increased utilization of smaller oilfields, but long-term forecasts remain negative. Beyond oil production decline, the major challenge relates to the job market, characterized by high unemployment and a consistent influx of newcomers, a situation that could further deteriorate if public enterprises were streamlined. Furthermore, after the steep rise of

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inflation in 2008, the new pressures on prices caused by the drought, as well as those that will result from the introduction of a VAT, will increase fears of socio-political instability exacerbating the growing income inequalities produced by the economic reforms. Stemming from these concerns, Syrian authorities have focused the next five-year plan for 2011-2015 on social objectives (reduction of unemployment, poverty alleviation, and social housing), aiming at the renewal of the “social contract” to mitigate the social repercussions of economic reforms.

An agreement with an economic partner like Turkey cannot play the same role in supporting the credibility of economic reforms as much as an agreement with the EU, which remains the main trading partner of Syria.

Its success is however far from granted and the socio-political risk may therefore slow down economic reforms, or even stop them altogether. Therefore, a sustainable reform process requires both strong financial external support and an external anchoring through agreements that “lock-in” economic reforms, thus increasing their credibility. In this latter regard, the new regional relations have been favorable to the Syrian regime, with some developments that may play an important role. An example is last June’s agreement by Jordan, Lebanon, Syria, and Turkey to set up a free-trade area, together with a visa-free travel regime for their nationals. This preliminary agreement develops earlier bilateral deals on free movement of goods and people. In the case of Syria, the agreement is based on two earlier deals: Syrian participation in the GAFTA (Greater Arab Free Trade Area), which entered into force in 2005, liberalizing trade exchanges between Syria and other Arab member

states, and the free-trade deal between Syria and Turkey, which came into force in 2007.

This latter agreement is particularly significant for Syrian economic reforms because it brings Syria closer to the EU trade regime. In fact, Turkey has a customs union agreement in force with the EU and has already achieved considerable progress in normative approximation with the EU. Furthermore, the free trade agreement between Syria and Turkey adopts the Pan-Euro-Mediterranean cumulation of origin system, promoted by the EU. Therefore, at first glance, the agreement with Turkey, as well as its future extension to Jordan and Lebanon, seem to represent a good external anchoring for Syrian economic reforms. As opposed to a free trade agreement with the EU these agreements do not provide financial support to Syria, thus lacking a key tool necessary to mitigate the socially negative impact of reforms. Furthermore, an agreement with an economic partner like Turkey – of growing importance for Syria but still with limited relevance – cannot play the same role in supporting the credibility of economic reforms as much as an agreement with the EU, which remains the main trading partner of Syria.

Therefore, it seems that Syria’s regional relations cannot be a long-term alternative to its economic relations with the West, which reopens the case of economic relations with the West. The United States has regularly renewed the Syria Accountability Act, most recently in May 2010. However, in February 2009, they granted a temporary exemption, approving an export license for Boeing 747 spare parts and, more importantly, this year removed the veto that had hitherto blocked the membership application to the World Trade Organization (WTO) that Syria presented in 2001. Consequently, in May 2010, the WTO has set up a working group to examine the application, and granted observer status to Syria. While this is certainly a significant step towards the integration of Syria into the world economic system, engaging in free trade with the EU under the Association Agreement would have more effect in promoting economic reforms.

However, the Association Agreement has gone through ups and downs: it was negotiated in 1998 and initialed for the first time in October 2004, but the signing was blocked by the European Union due to deterioration of bilateral

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political relations. Following the improvement of relations between the two, a new and updated agreement, accounting for EU enlargement as well as economic reforms in Syria, was initiated in 2008. In October 2009, while the EU expressed its readiness to sign the agreement, Syrians decided to block it, considering the signing of the Association Agreement less urgent given the recent growth of its regional economic relations.

However, this does not come without a price, foremost in terms of reduced financial assistance. Syria in fact receives very limited European support: the recently agreed National Indicative Program for 2011-2013 allocated Syria EUR 128 million. In comparison, the National Indicative Program 2011-2013 for Tunisia provides for EUR 240 million worth of aid, four times the aid received by Syria in per capita terms. Moreover, in 2009, funding received by Tunisia from the European Investment Bank (EIB) was more than five times that obtained by Syria, again in per capita terms. Delaying the Association Agreement, and the related refusal to sign an action plan in the context of the European Neighborhood Policy, have repercussions for Syrian economic reforms that go beyond financial support: the anchoring role the EU can play, in terms of both regulatory model and provision of technical assistance, is greater than that which could be played by Turkey or other regional countries.

The deepening of Syria's economic reforms and their growing social impact will increase the relevance of Western support, even in the eyes of the Syrian regime. Western economic instruments (mainly sanctions removal from the United States and aid and normative anchoring from the EU) will be a very important bargaining chip in the complex strategic game in the region. It is up to the United States and the EU to better tailor these instruments to the future evolution of Syrian economic reforms.

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