# 2. From Setbacks to Comebacks: Reforms to Build Resilience and Prosperity[1]

*Policy space in many countries in the Middle East and Central Asia (ME&CA) region has diminished following an extended period of shocks, particularly among the region's emerging market and middle-income countries (EM&MIs). Amid high public debt and inflation, fiscal consolidation and tight monetary policy are needed in many countries in the region. In this context, structural reforms offer a way to not only increase potential growth, but also accrue near-term growth benefits. In addition, reforms can be instrumental in accelerating economic diversification among oil exporters. In a novel analysis for the region, this chapter shows that most structural reforms help lift output, with the impact growing over time. Governance reforms—particularly, enhancing the rule of law and government effectiveness—are especially important and can also generate positive output effects during periods of weak growth or relatively limited policy space. Improving the government's ability to implement policies and regulations to promote private sector development also contributes to fostering growth through improved investment and productivity. Moreover, prioritizing governance reforms before other reforms can magnify their overall growth dividends, and the strategic packaging of reforms—for example, by combining external sector and credit market reforms—can amplify positive output effects. Importantly, the design of structural reforms will need to include political considerations and distributional impacts.*

## 2.1. Narrowing Policy Space Amplifies the Urgency of Implementing Reforms

Recent global shocks have triggered a concerning rise in debt levels and inflation in many ME&CA countries, significantly limiting policy options, especially for EM&MIs. Notably, public debt in ME&CA EM&MIs rose to an average of 83.5 percent of GDP in 2022 (from 79 percent of GDP before the pandemic), and medium-term growth is projected to remain below historical trends. Concurrently, average headline inflation in EM&MIs jumped to double digits in 2022, and monetary policy tightening in major advanced economies to bring down inflation led to tighter financial conditions in emerging market and developing economies (EMDEs) and higher borrowing costs. Amid these challenges, striking a delicate balance between implementing tighter monetary and fiscal policies to safeguard macroeconomic stability and debt sustainability while promoting economic growth has become a complex and pressing task.

Policy challenges have intensified in several economies over the last few years. Notably, many economies in the Middle East and North Africa (MENA) region (excluding Gulf Cooperation Council [GCC] countries) and Pakistan face limited policy space.[2] Meanwhile, several GCC and Caucasus and Central Asia (CCA) economies have seen some recent improvements because of higher oil prices in 2022 and financial flows to the CCA from Russia (Figure 2.1; see Chapter 1 and Online Annex 2.1 for more details).

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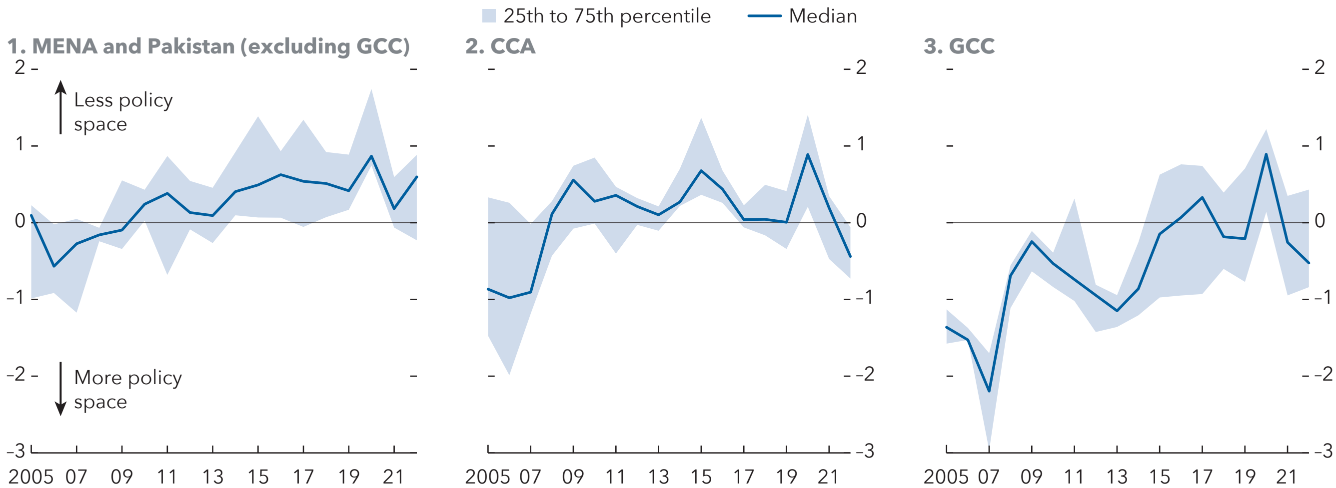
[2] Building on an IMF Staff Discussion Note (Budina and others 2023), this chapter constructs a policy tradeoff index (capturing multiple dimensions of policy constraints) (see Online Annex 2.1 for details).

**Figure 2.1. Policy Space Index in ME&CA Countries, 2005–22**




Source: IMF staff calculations.
Note: The higher the policy space index score, the more policy space is constrained. Lower values indicate more policy space. While the approach is common across countries, some country-specific aspects remain, which cautions comparisons across countries that are structurally very different (for example, oil exporters versus oil importers). CCA = Caucasus and Central Asia; GCC = Gulf Cooperation Council; MENA = Middle East and North Africa.

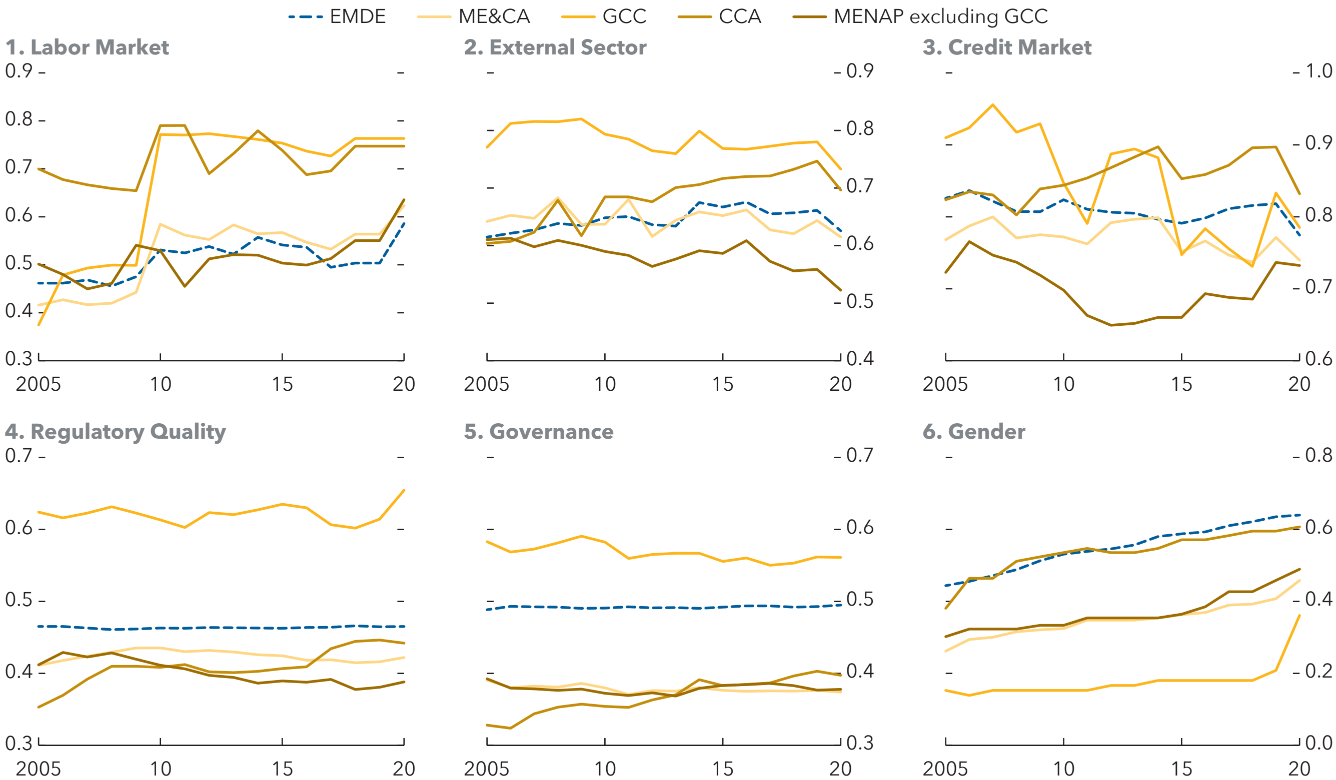
Structural reforms emerge as a promising avenue to help address current macroeconomic challenges. In this respect, the ME&CA region is politically, socially, and economically diverse, and these factors will affect the design and implementation of reforms across countries. For EM&MIs and low-income countries (LICs) in need of fiscal consolidation, structural reforms offer one of the few policy approaches that can be implemented to offset the negative impact of fiscal adjustment by generating an enabling environment for new investments and jobs.

More broadly, reinvigorating structural reforms and supply-side policies can be instrumental in building much-needed, stronger foundations for growth. For oil exporters, reforms can help lift growth in the non-oil sector, thus contributing to economic diversification. In addition, structural reforms can play a crucial role in unlocking and enhancing a country's potential growth and productivity. For example, strong institutions (including secure property rights, the rule of law, and accountable governments) contribute to stability, predictability, and investor confidence, ultimately attracting investments and supporting sustainable development (Budina and others 2023; Gigineishvili and others 2023; Rodrik 2000; October 2019 *World Economic Outlook*). As such, implementing reforms would not only help accelerate income convergence toward advanced economies but also facilitate an improvement in human development, social outcomes, and medium-term growth (Cardarelli, Vera-Martín, and Lall 2022).

## Sizable Reform Gaps Persist in the ME&CA Region

Progress in implementing structural reforms has been limited, and many countries in the ME&CA region fall well behind the frontier (leading emerging market economies) across several indicators. Although GCC countries score relatively well on labor market, external sector, and credit market flexibility indicators compared with other EMDEs, they lag on gender-related regulations (Figure 2.2). Governance reforms are trailing in a number of ME&CA countries, with relatively poor performance across several dimensions (including voice and accountability, political stability, government effectiveness, the rule of law, and control of corruption; see Online Annex 2.2 for details). Weakness is particularly prevalent for indicators on the rule of law, corruption, and political stability in the region's LICs and fragile and conflict-affected states (FCS) such as Afghanistan, Libya, Sudan, and Yemen. Governance shortcomings in voice and accountability are also evident in Algeria, the Islamic Republic of Iran, and Turkmenistan, and in several GCC countries (for example, Qatar and Saudi Arabia).

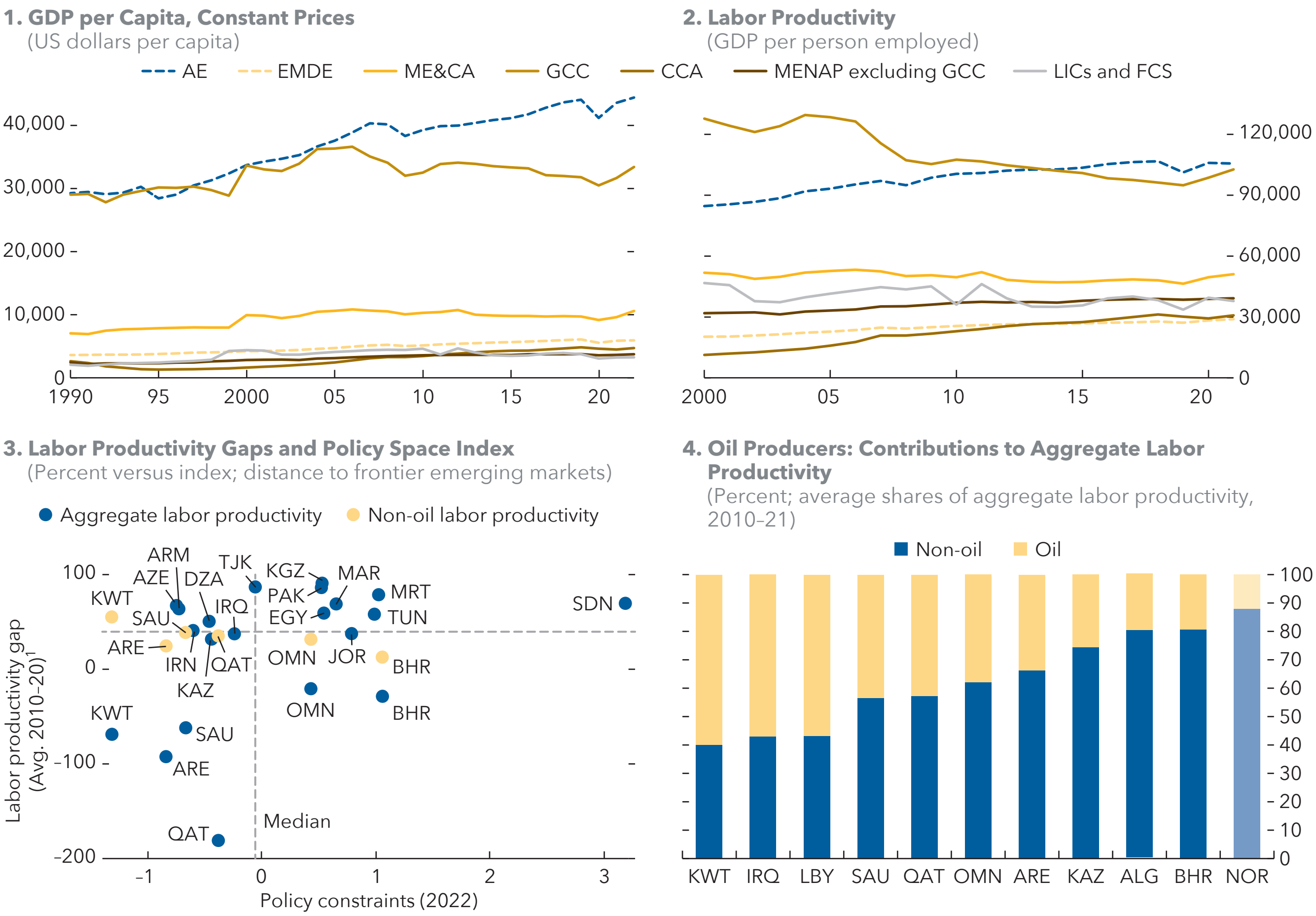
**Figure 2.2. Evolution of Structural Reforms**
*(Index, 0–1)*




Sources: Cardarelli, Vera-Martín, and Lall (2022); Fraser Institute, Economic Freedom database; UN Educational, Scientific, and Cultural Organization Institute for Statistics; World Bank, Women, Business, and the Law database; World Bank, World Governance Indicators database; and IMF staff calculations.
Note: Each indicator is a simple average of normalized index values of subindicators. The labor market regulations indicator is a simple average of two components: hiring and firing regulations and centralized collective bargaining. The external sector reforms index is computed as the simple average of four subindicators: (1) tariffs, which aim to measure to what extent tariffs can be a barrier to trade freely internationally (tariff revenues, tariff rate, and volatility of tariffs); (2) nontariff trade barriers; (3) black market exchange rate, which aims to capture the disparity between the official and the parallel (black market) exchange rate; and (4) control of the movement of capital and people, which encompasses a country's degree of financial openness, restrictions to visitors, and whether capital controls are in place. The credit market indicator consists of ownership of banks, private sector credit, and interest rate controls. The governance indicator consists of voice and accountability, political stability and absence of violence and terrorism, government effectiveness, the rule of law, and control of corruption. The indicator for regulatory quality from the World Bank Governance Indicators is used as a proxy for business regulations. The gender regulation index covers legislation that restricts women's mobility (including the right to travel outside their home and country, choose where to live, and obtain a passport) and their position within the household (including whether a woman can legally be the head of her household and legislation on domestic violence, divorce, and the right to remarry). CCA = Caucasus and Central Asia; EMDE = emerging market and developing economy; GCC = Gulf Cooperation Council; ME&CA = Middle East and Central Asia; MENAP = Middle East, North Africa, Afghanistan, Pakistan.

Slow progress in implementing structural reforms has been accompanied by less-than-favorable outcomes in income convergence and productivity. Convergence toward advanced economy per capita income levels remains stalled overall, particularly in subregions such as the MENA (excluding the GCC) and Pakistan (Figure 2.3, panel 1). Moreover, during the past two decades, labor productivity in ME&CA has stagnated, in contrast to the upward trend observed in advanced economies and other emerging market economies (Figure 2.3, panel 2). Countries in the GCC (and partially LICs and FCS), where non-oil labor productivity has declined, have mainly driven these developments (Figure 2.3, panel 2; Online Annex 2.4), because of the overreliance on the public sector, underdevelopment of the private sector, and lack of economic diversification (Callen and others 2014). Notably, even though GCC countries have substantial policy space, they continue to exhibit labor productivity

**Figure 2.3. Real GDP per Capita and Average Labor Productivity**



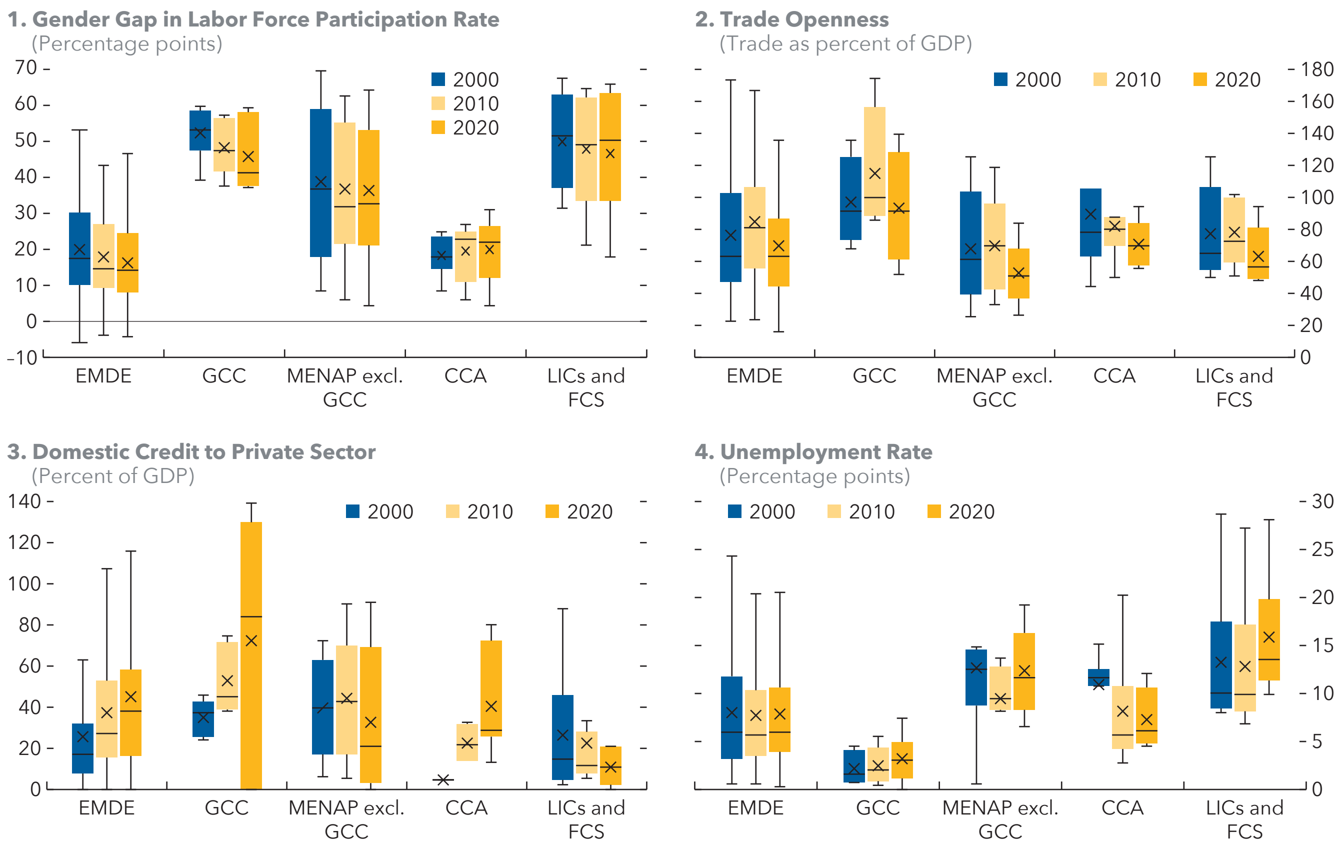

Sources: ILOSTAT database; International Labour Organization; IMF, World Economic Outlook database; World Bank, World Development Indicators; and IMF staff calculations.
Note: Country abbreviations are International Organization for Standardization (ISO) country codes. AE = advanced economy; CCA = Caucasus and Central Asia; EMDE = emerging market and developing economy; FCS = fragile and conflict-affected state; GCC = Gulf Cooperation Council; LIC = low-income country; ME&CA = Middle East and Central Asia; MENAP = Middle East, North Africa, Afghanistan, Pakistan.
[1]Gap is defined as the distance to the most productive emerging market economies outside the ME&CA regions (top quartile) each year.

gaps in the non-oil sector relative to frontier emerging markets (Figure 2.3, panel 3).[3] Furthermore, the non-oil sector contributes less to aggregate labor productivity than in other oil-exporting countries such as Norway (Figure 2.3, panel 4).

Moreover, the region faces labor market challenges and persistently high unemployment rates, particularly for women and youth (Figure 2.4). Despite improvements in education levels, gender disparities in the labor market are alarming (October 2021 *Regional Economic Outlook: Middle East and Central Asia*; Cardarelli, Vera-Martin, and Lall 2022). Gender gaps in the CCA are on par with those in other EMDEs, supported by relatively low disparities in gender legislation, but female labor force participation rates in the MENA region are among the lowest globally (at 44.5 percent in the GCC and 18.2 percent in the MENA region—excluding the GCC—and Pakistan in 2022). By contrast, the region appears to align with the EMDE average in terms of the size of the financial sector and trade openness.

[3] In Figure 2.3, panel 3, comparing aggregate labor productivity (blue markers) to non-oil labor productivity (yellow markers) for six GCC countries shows that non-oil labor productivity lags frontier emerging markets.

**Figure 2.4. Comparing Outcomes: ME&CA versus Other EMDEs**




Sources: Fraser Institute, Economic Freedom database; International Labour Organization-modeled estimates; World Bank, Gender Statistics; World Bank, World Development Indicators; and IMF staff calculations.
Note: The gender gap is defined as the male labor force participation rate minus the corresponding rate for females. CCA = Caucasus and Central Asia; EMDE = emerging market and developing economy; FCS = fragile and conflict-affected state; GCC = Gulf Cooperation Council; LIC = low-income country; ME&CA = Middle East and Central Asia; MENAP = Middle East, North Africa, Afghanistan, Pakistan.

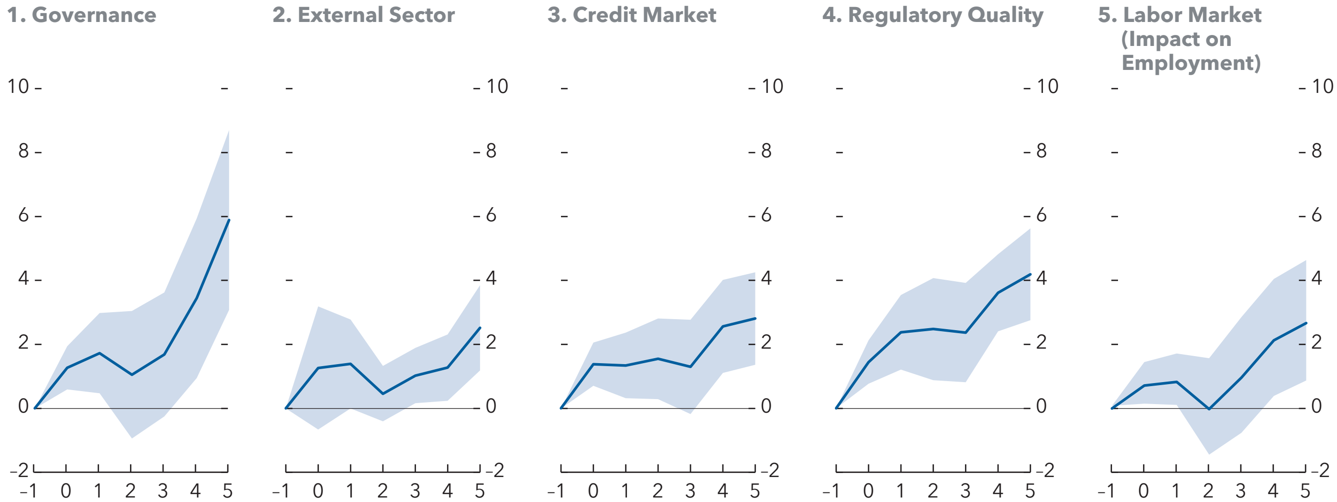
The degree of resistance to structural reforms and prospects for success across countries will vary depending on their nature and scope. In this respect, political economy considerations and ownership among policymakers are often important factors impacting the reform impetus. That said, some countries have showcased the feasibility of successful and comprehensive structural reforms (Box 2.1 and Online Annex 2.5). For example, some CCA economies have shown that rapid improvements in governance—particularly anticorruption efforts—can support economic growth (Armenia, Georgia) and protect against external shocks (Kazakhstan). Additionally, as Jordan has shown, trade liberalization and privatization efforts can effectively spur private sector participation in economic activity.

## 2.2. Implementing Structural Reforms Can Lift Growth Significantly

This section presents the analysis of the output gains from structural reforms, building on previous IMF work (October 2019 *World Economic Outlook*; Budina and others 2023) adapted to the ME&CA region.[4] The impact of major structural reforms on key macroeconomic outcomes—output, investment, employment, and labor

[4] The sample consists of 27 countries in the ME&CA regions and spans the period from 2000 to 2021 at annual frequency. In addition, Budina and others (2023) has been adapted to tailor the analysis to ME&CA. Specifically, oil prices as a regressor (as a percent change) are included and examine the impact on non-oil GDP growth and average labor productivity of the non-oil sector for oil exporters are examined.

**Figure 2.5. Average Effects of Reforms under the Baseline**
*(Percent; effect on output unless otherwise specified)*




Sources: Fraser Institute, Economic Freedom database; IMF, World Economic Outlook database; World Bank, World Governance Indicators database; and IMF staff calculations.
Note: The scale of the *x*-axis is years, where *t* = 0 is the first year of the reform is implemented. The lines denote the response to a major historical reform—defined as two standard deviations of the annual change in the structural index—and the shaded areas denote 90 percent confidence bands.

productivity—was estimated using the local projection method developed by Jordà (2005).[5] Reform areas in the analysis include governance, external sector reforms, credit market, labor market, and regulatory quality reforms (see Online Annex 2.6). The precise impact of reforms is difficult to estimate (especially amid the broad impact across different sectors) and thus results are inevitably subject to uncertainty, but the analysis provides a meaningful assessment of the direction, relative size, and importance of reforms.[6] Moreover, although the analysis does not cover structural reforms related to gender due to a lack of variation in the reform series,[7] Budina and others (2023) suggest that adopting strategies to reduce gender disparities in other EMDEs could provide a substantial boost to GDP. Generally, structural reforms can provide a boost to output over time, but their design and implementation is complex and will require policies that are tailored carefully to country circumstances (political, social, and economic) to maximize their prospects for success.

## Governance Reforms Can Yield Significant Output Gains

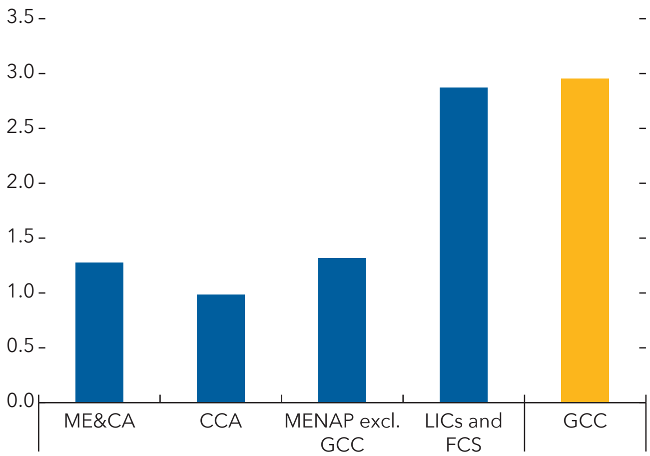
The empirical evidence shows that major reforms can have sizable output effects. Consistent with estimates from the literature (October 2019 *World Economic Outlook*; Budina and others 2023; Gigineishvili and others 2023), major reforms are associated with higher economic output, with magnitudes that increase over time (Figure 2.5). Five years after implementation, governance reforms reap the largest output gains (about 6 percent), followed by regulatory quality reforms. This result is consistent with reform gaps in both areas being relatively large in the ME&CA region, rendering the marginal return from reform relatively high compared with countries with smaller gaps (such as the global EMDEs sample in Budina and others 2023; for more detailed results, see Online Annex 2.6). This estimate implies that closing the governance gap with EMDEs could lead to an average

[5] Following the October 2019 *World Economic Outlook* and Budina and others (2023), major reforms are defined as episodes for which an annual change in the relevant indicator is at least two standard deviations of the distribution (of annual changes in the relevant indicator across the whole sample). Such major reforms would improve a country's structural quality from the median to the top 5 percent in the sample. Countries that have experienced at least two standard deviation improvements in the aggregate governance indicator include Georgia (2003), Jordan (2003), Kazakhstan (2014), and Armenia (2018). Box 2.1 and Online Annex 2.5 provide case studies of these episodes.

[6] In addition to uncertainty, the literature also finds that the local projection method may yield biased estimates with small sample sizes on the time dimension (Herbst and Johannsen 2020).

[7] Ninety percent of observations are unchanged over time.

**Figure 2.6. Output Gains from Closing the Governance Gap**
*(Percent; benchmark is EMDEs except GCC for which it is advanced economies)*




Sources: Fraser Institute, Economic Freedom database; IMF, World Economic Outlook database; World Bank, World Governance Indicators database; and IMF staff calculations.
Note: The bars show the output effects after five years from closing the governance gaps in relation to EMDEs (as of 2020) and advanced economies in the case of GCC. The estimates assume linear average effects, calculated by multiplying the reform gaps by the point estimates of the output effects after five years. CCA = Caucasus and Central Asia; EMDEs = emerging market and developing economies; FCS = fragile and conflict-affected state; GCC = Gulf Cooperation Council; LIC = low-income country; ME&CA = Middle East and Central Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan.

regional output gain of about 1.3 percent in the medium term, ranging from 1 percent in the CCA to almost 3 percent for LICs and FCS (Figure 2.6).[8] Similarly, output gains in the GCC could be about 3 percent when closing governance gaps relative to advanced economies.[9] Moreover, positive effects on employment and labor productivity in the medium term suggest that governance reforms have a widespread enabling impact to strengthen potential growth.

The findings also underscore the importance of individual governance-related indicators in shaping long-term output (Figure 2.7). For example, enhancing government effectiveness has a strong positive effect in the short and medium terms. Similarly, strengthening the rule of law has the potential to increase output by about 6 percent after five years.[10] Moreover, the effects of comprehensive governance reforms are larger than those from narrower governance reforms, highlighting the enhanced effects of implementing governance reforms as a package and improving overall governance. Examples of such governance reforms include the implementation of online procurement in Georgia and Saudi Arabia (see Box 2.1) and Uzbekistan (Online Annex 2.5).

The benefits of reforms are evident beyond governance. Notably, regulatory quality reforms have a positive impact on output, contributing to a 4 percent increase after five years. This boost to activity is driven by the enabling impact on investment, as regulatory quality reforms are associated with a positive impact on investment in the same year as the reform implementation and they yield increasing returns in the subsequent year. Significant labor productivity improvements (by about 5.5 percent) are observed five years after regulatory quality reforms (for more details, see Annex Figure 2.6.1 in Online Annex 2.6). Like governance reforms, the impact of credit market and labor market reforms are larger than those estimated from the global EMDEs sample in Budina and others (2023), mainly because of the structural gaps of the ME&CA region relative to EMDEs.

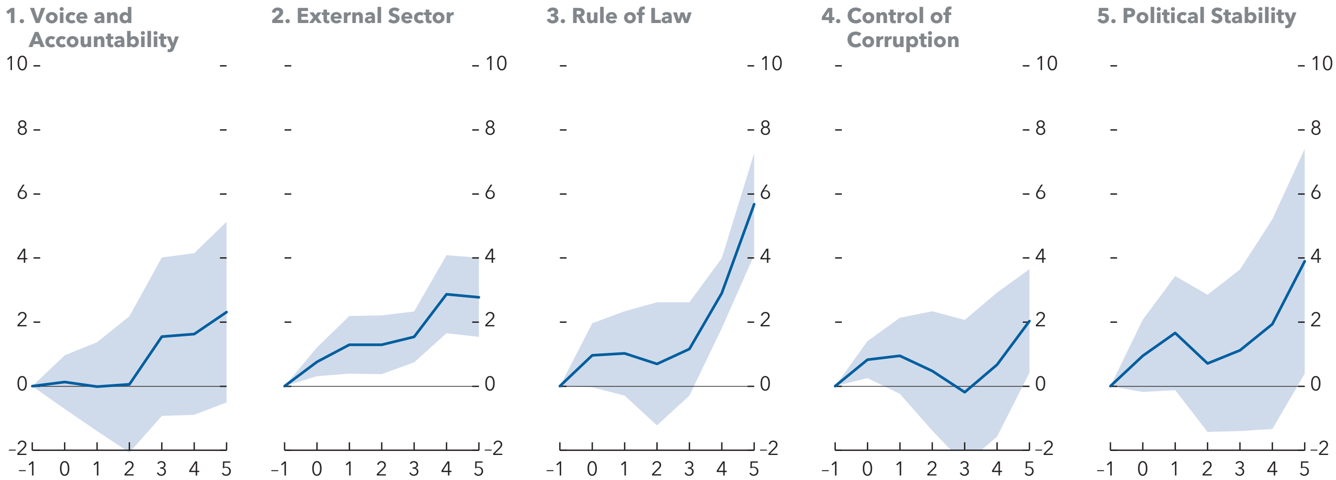
More broadly, as reforms tend to spur investment, reforms in areas where the region performs relatively well can also help boost growth. For example, external sector and credit market reforms gradually lift investment and output, contributing to about 2.5 percent output gains after five years and significant improvements in labor productivity over the medium term. Even though the short-term impact of labor market reforms may be limited, their positive effects on employment and output materialize over time.

[8] In a similar vein, lower initial governance levels amplify positive output gains more than the baseline (Annex Figure 2.6.2, Online Annex 2.6).

[9] The benchmark for the GCC are advanced economies because the GCC does well relative to the rest of the world in all governance indicators except "voice and accountability" (Online Annex 2.2).

[10] Other governance indicators are not statistically significant using a 90 percent confidence interval.

**Figure 2.7. Average Effects of Individual Governance Reforms under the Baseline**
*(Percent; effect on output unless specified)*




Sources: Fraser Institute, Economic Freedom database; IMF, World Economic Outlook database; World Bank, World Governance Indicators database; and IMF staff calculations.
Note: The scale of the *x*-axis is years, where *t* = 0 is the first year of the reform is implemented. The lines denote the response to a major historical reform—defined as two standard deviations of the annual change in the structural index—and the shaded areas denote 90 percent confidence bands.

## Some Reforms Can Have a Strong Impact during Periods of Weak Growth

Reforms can be politically costly when enacted in periods of weak economic activity. However, certain reforms can be beneficial for economic activity also during downturns, which is especially relevant during the current period of tight policies that will inevitably weigh on growth. This analysis explored this issue by considering how the baseline results differ during periods of weak economic activity.[11] As such, the findings indicate that increasing the flexibility of the domestic credit market and improving regulatory quality during weak growth can lead to significantly higher medium-term growth (1.7 percent and 1.2 percent higher, respectively, than the baseline after five years) (Figure 2.8).[12] Output effects occur as increasing credit market flexibility leads to more significant gains in investment and labor productivity (11 and 4 percentage points, respectively, in addition to the baseline effects after five years) (Annex Figure 2.6.3 in Online Annex 2.6). Kuwait and the Islamic Republic of Iran highlight the potentially significant effects of credit market reforms during periods of weak growth. In the early 2000s, both countries improved credit market flexibility.

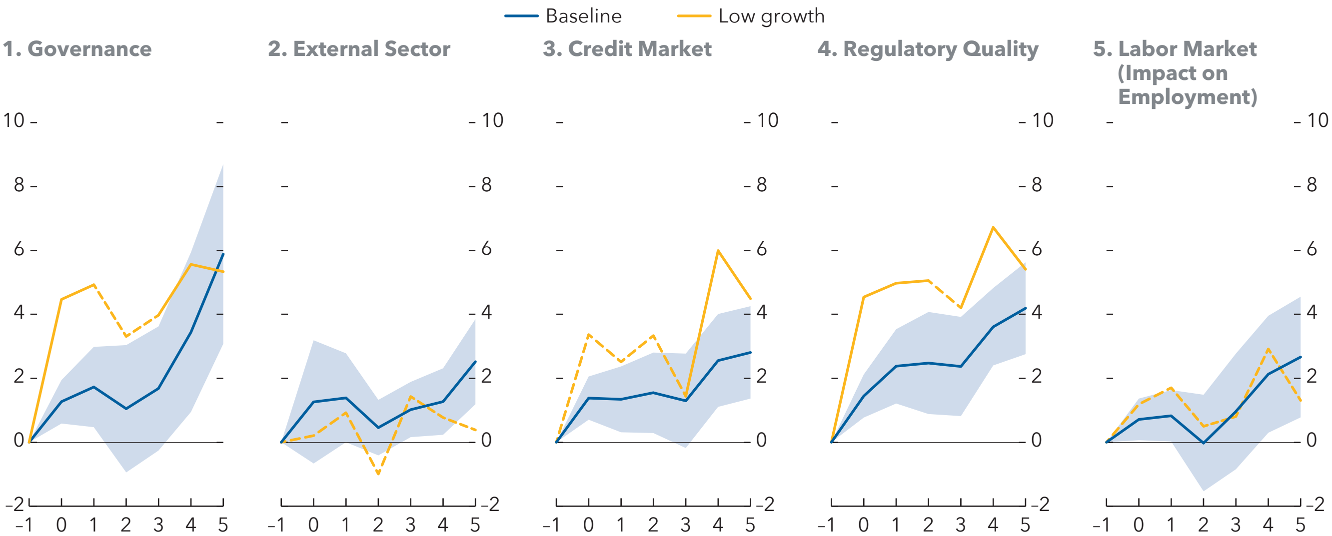
Kuwait, for example, enhanced the capital market by expanding cross-listing agreements and operationalized a credit bureau. The Islamic Republic of Iran allowed more flexibility in setting interest rates, licensing of private banks, and authorizing private insurance companies. These reforms added to strong economic growth in subsequent years (during 2004–07, Kuwait and the Islamic Republic of Iran's non-oil growth averaged above 10 and 6 percent, respectively).[13] Yet it appears that external sector reforms have a more pronounced effect on output (Figure 2.8) and investment (see Online Annex 2.6) when implemented during expansionary cycles. Though positive, the baseline effect of labor market reforms (on employment) appears to be statistically insignificant, possibly muted by the high level of informality across EMDEs (October 2021 *Regional Economic Outlook: Middle East and Central Asia*).

[11] For the empirical analysis, a country is considered to have weak economic activity or low growth for a specific year when it experiences below-median growth during that period.

[12] Although the point estimates of the output effects of credit market reform under low growth are larger than those under the baseline in the near term, they are not statistically significant.

[13] The sample includes 12 country examples with major credit market reforms, of which five countries under weak growth.

**Figure 2.8. Average Effects of Reforms: Low Growth Scenario versus the Baseline**
*(Percent; effect on output unless otherwise specified)*



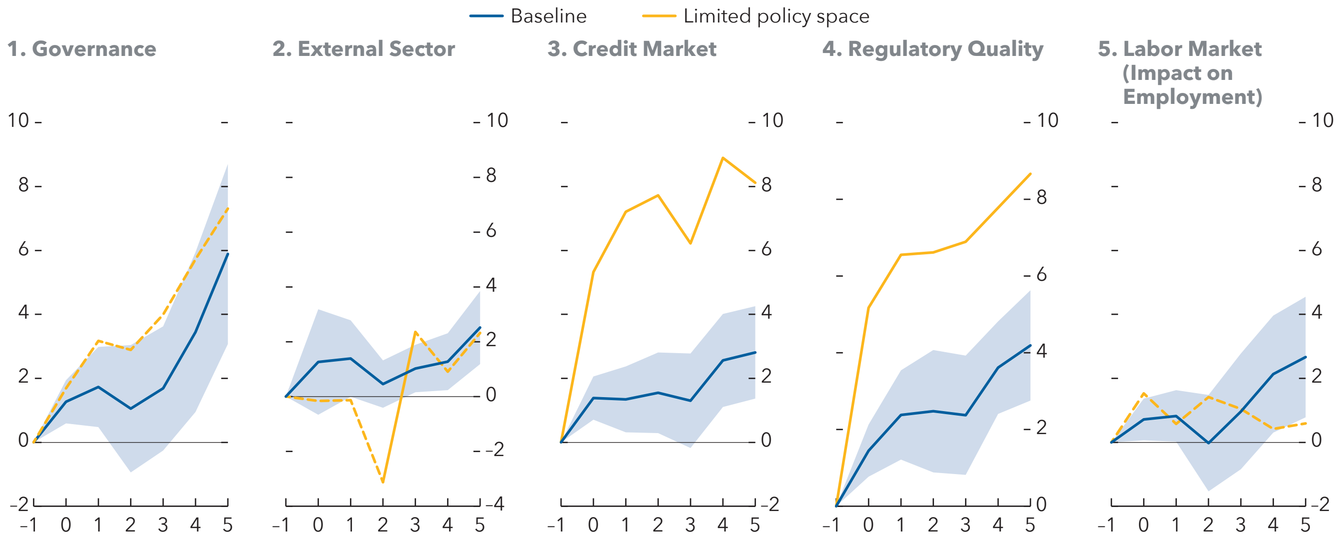

Sources: Fraser Institute, Economic Freedom database; IMF, World Economic Outlook database; World Bank, World Governance Indicators database; and IMF staff calculations.
Note: The scale of the *x*-axis is years, where *t* = 0 is the first year of the reform is implemented. The blue lines denote the baseline (that is, sample average) responses to a major historical reform—defined as two standard deviations of the annual change in the structural index—with the shaded areas denoting 90 percent confidence bands for the responses. The yellow lines denote the responses when growth is low where the solid (dashed) segments denote statistically significant (insignificant) responses at the 90 percent level.

## Sizable Reform Impact May Also Occur during Periods of More Limited Policy Space

Point estimates suggest that some reforms may have larger positive effects on economic activity when the policy space is relatively tighter.[14] Credit market and regulatory quality reforms have a significantly higher positive impact on output when policy space is relatively lower than in the baseline. For instance, increasing flexibility of credit markets when policy space is more limited is expected to raise output by 8 percent after five years, compared with just below 3 percent in the baseline (Figure 2.9). Under limited policy space, the larger positive output effects of credit market reforms are achieved primarily through significant increases in investment and substantial boosts in labor productivity (Annex Figure 2.6.4, Online Annex 2.6). These results may stem from the fact that credit market reforms enhance the private sector's access to credit, which could support private sector adjustment. Simultaneously, improving regulatory quality could lead to increased confidence and investment when growth is sluggish, or policy space is limited.

[14] Countries have limited policy space in a specific year if their policy space score is below the median across all countries in that year. More results on policy space can be found in Online Annex 2.6.

**Figure 2.9. Average Effects of Reforms under a Limited Policy Space Scenario versus under the Baseline**
*(Percent; effect on output unless otherwise specified)*




Sources: Fraser Institute, Economic Freedom database; IMF, World Economic Outlook database; World Bank, World Governance Indicators database; and IMF staff calculations.
Note: The scale of the *x*-axis is years, where *t* = 0 is the first year of the reform is implemented. The blue lines denote the baseline (that is, sample average) responses to a major historical reform—defined as two standard deviations of the annual change in the structural index—with the shaded areas denoting 90 percent confidence bands for the responses. The yellow lines denote the responses when growth is low where the solid (dashed) segments denote statistically significant (insignificant) responses at the 90 percent level.

## 2.3 Attention to Sequencing and Packaging Reforms Is Valuable

### Strategically Sequencing and Packaging Reforms Can Amplify Their Impact

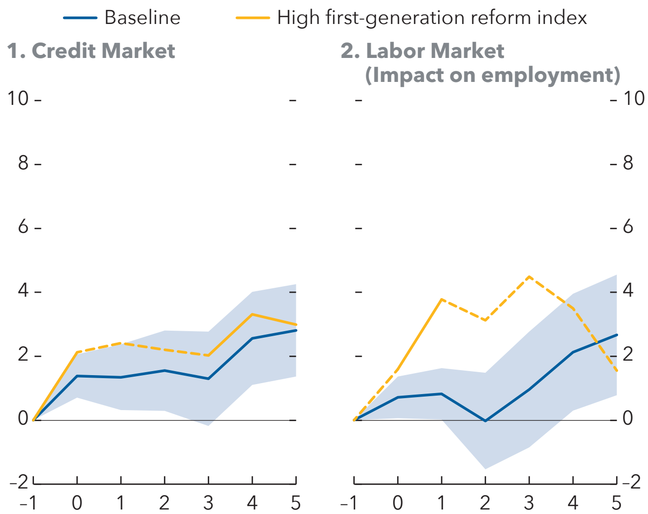
The specific sequence in which reforms are implemented can play a crucial role in affecting macroeconomic outcomes.

- First, reforms in areas of relative weakness, such as governance, would yield the largest gains. Reform efforts in Georgia and Kazakhstan demonstrate how prioritizing governance reforms and bolstering the rule of law can be pivotal for implementing other reforms (Box 2.1; see also Online Annex 2.5). Improved governance generally plays a crucial role in driving other reforms by fostering trust and confidence in public institutions and creating a favorable business climate.
- Second, a "first-generation" reform package—governance, regulatory quality, and external sector reforms—has a positive impact on the returns from subsequent reforms. For example, Jordan's large-scale trade liberalization and privatization in the early 2000s led to a jump in private sector participation. The share of credit to the private sector increased from 72 percent in 2000 to 88 percent in 2005 (Online Annex 2.6). Moreover, the results indicate that credit market reforms would have a substantial effect on output once countries implement first-generation reforms. The estimated increase in output is about 2 percent when credit market reform is implemented after first-generation reforms, surpassing the baseline of 1.4 percent, and the gains persist for several years after the reform (Figure 2.10). These results are consistent with earlier findings drawn from a global sample of emerging market economies and low-income countries (October 2019 *World Economic Outlook*; Budina and others 2023). Similarly, labor market reforms after first-generation reforms also produce positive outcomes, though with a more pronounced impact in the near term.

In addition, when certain reforms are implemented together, they can amplify each other's positive effects, resulting in more substantial gains than when the reforms are implemented separately. The empirical evidence shows that the gross effect of the first-generation reform package is larger than the sum of the effects of its

**Figure 2.10. Average Effects of Reforms under High First-Generation Reform Index versus the Baseline**

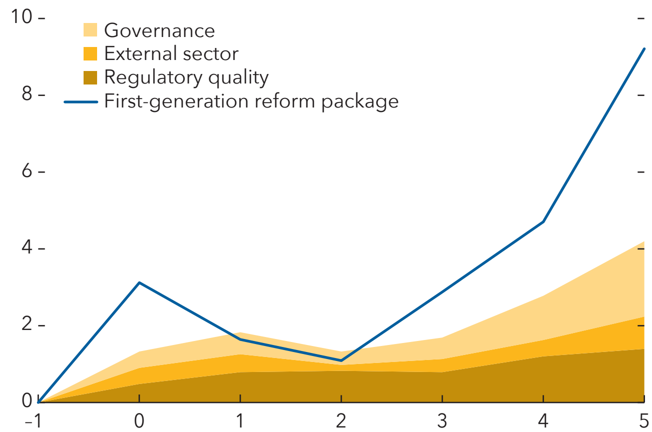
*(Percent; effect on output unless otherwise specified)*




Sources: Fraser Institute, Economic Freedom database; IMF, World Economic Outlook database; World Bank, World Governance Indicators database; and IMF staff calculations.
Note: The blue lines denote the baseline (that is, sample average) responses to a major historical reform, defined as two standard deviations of the annual change in the structural index, and the shaded areas denote 90 percent confidence bands for the responses. The yellow lines denote the responses when first-generation reform index is high, that is, above the sample median, where the solid (dashed) segments denote statistically significant (insignificant) responses at the 90 percent level.

**Figure 2.11. Output Effects of First-Generation Reform Package**

*(Percent)*




Sources: Fraser Institute, Economic Freedom database; IMF, World Economic Outlook database; World Bank, World Governance Indicators database; and IMF staff calculations.
Note: The scale of the *x*-axis is years, where *t* = 0 is the first year of the reforms are implemented. The blue line denote the response to a major historical first-generation reform package—defined as the sum of one-third of a major historical reform (two standard deviations) on its three components. The stacked areas denote the responses to one-third of a major historical reform (two standard deviations) on the three components of the first-generation reform package, namely governance, external sector, and regulatory quality, when implemented individually.

components when they are implemented individually (Figure 2.11). The first-generation reform package could raise output by about 3 percent in the year of its implementation, accumulating to more than 9 percent after five years, more than doubling the total output gains compared with implementing its components individually.

Several country examples highlight the benefits of comprehensive reforms. For example, Morocco implemented a package of multiple reforms—including trade liberalization and the monetary policy framework—to improve social and economic outcomes. Saudi Arabia also stands out as an example of a successful bundled reform approach. Through its ambitious Vision 2030 plan launched in 2016, the country achieved greater government efficiency, upgraded trade infrastructure, and better labor market outcomes (including raising the female labor force participation rate from 23 percent in 2016 to 28 percent in 2022, nearing the 2025 target of 30 percent). Moreover, access to credit improved for small and medium enterprises, with bank loans increasing almost fourfold, from 2 percent to 7.7 percent (see Box 2.1).

## 2.4. Where Macro Policies Need to Tighten, Reforms Provide Growth-Enhancing Options

Overcoming the political economy challenges of implementing reforms can be a complex and delicate task because reforms often face resistance from stakeholders with vested interests. The extent of resistance can also vary depending on the nature and scope of the reforms. A multifaceted approach is therefore required (see Box 2.1 for insights on Georgia, Morocco, and Saudi Arabia). Strong leadership and effective communication are essential to build support and trust in the reform agenda. Building coalitions and seeking consensus among diverse stakeholders can help navigate political resistance, and transparency in the reform process helps build trust and attract support. Involving the public in the reform process through consultations and participatory mechanisms can help legitimize the reforms and ensure that they align with the population's needs and aspirations. Studying successful reform experiences in other countries and benchmarking against best practices can provide valuable insights and improve the design and implementation of reforms. For countries with capacity constraints to implementing reforms and limited fiscal space, external actors (international organizations and donor countries) can provide technical assistance and financial support. Overall, persistence in the face of obstacles and a commitment to the reform agenda are essential.

The sizable macroeconomic impact of structural reforms calls for increased attention to their swift implementation, especially where fiscal and monetary policies need to remain tight:

- Governance reforms (among all the outcomes) demonstrate a robust and substantial positive effect on economic growth and other macroeconomic indicators and should be prioritized. Government effectiveness and the rule of law are shown to be particularly influential. By reducing both political and economic uncertainty, governance reforms can create an environment that fosters increased investment, leading to higher economic growth (Acemoglu and others 2019; Afzali, Çolak, and Fu 2021). Moreover, these reforms can play a pivotal role during downturns or periods with limited monetary or fiscal policy options.
- Targeting regulatory quality and credit market reforms also affect output positively by stimulating investment. This underscores the significance of reducing the state's intervention in nonessential sectors, streamlining bureaucratic processes, and fostering an environment where younger and more innovative firms can thrive (Rigo and others 2021). This principle applies equally to oil-exporting countries, where non-oil productivity growth has been declining in recent years, and economic diversification away from overreliance on oil and gas exports is essential.
- Policymakers can amplify the impact on output by strategically sequencing and packaging reforms. First-generation reforms such as governance, external sector liberalization, and regulatory quality reforms can yield significant upfront gains. When these first-generation reforms are implemented together, their combined gross effect tends to be larger than when they are implemented individually. Therefore, policymakers should concurrently focus on improving governance, enhancing regulatory quality, and reducing external sector barriers.

Addressing the distributional effects of reforms and ensuring the protection of vulnerable groups is crucial and especially pertinent in the context of external sector liberalization as empirical evidence has demonstrated its negative effect on employment (Autor, Dorn, and Hanson 2013; Engel and others 2021). In this respect, some reforms, undertaken simultaneously, could have an offsetting distributional effect. For example, implementing active labor market policies (such as training and reskilling possibilities) along with external sector liberalization can help address potential distributional consequences and facilitate the smooth reallocation of labor (Engel and others 2021). Enhancing social safety nets for the vulnerable will also be important. By balancing these aspects carefully, policymakers can create a more inclusive and effective reform strategy that leads to sustainable economic growth and development.

A number of other actions can help support growth and render it more resilient. Enhancing labor market flexibility in good times can elevate workforce productivity and open more employment opportunities, but efficiency considerations need to be balanced against the need to protect workers and their income (October 2019 *World Economic Outlook*). Engaging in regional and international trade allows countries to access larger markets, tap into new technologies and knowledge, and benefit from economies of scale. Ensuring access to finance for all segments of society is crucial for stimulating investment and driving economic growth. Finally, investing in gender-specific reforms (such as promoting equal access to education and vocational training for women, implementing policies that support work-life balance and parental leave, and encouraging women's participation in entrepreneurship and leadership roles) can significantly contribute to economic progress and better social outcomes.

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## Box 2.1. Transformative Tales: Structural Reforms in Georgia, Morocco, and Saudi Arabia

**Georgia: Anticorruption efforts as a gateway for structural transformation.**[1] Following the Rose Revolution of 2003, the Georgian government enacted a zero-tolerance policy toward corruption. Political commitment at the highest level, coupled with strict compliance, was crucial. In this respect, increased credibility following high-profile corruption cases and arrests aided the shift in attitude about corruption. Institutional reforms ensued in key public institutions: judiciary, tax, customs, electricity distribution, land and property rights registration, and higher education. Public sector salaries increased in the reformed institutions, and graduates who succeeded in those institutions' qualification exams filled new vacancies. Standardized university tests were administered in a unified manner that addressed widespread problems in the university entrance process. The strategy also prompted a reduction in red tape that helped improve the business environment. In 2005, Georgia enacted a new tax code that streamlined the system, lowered tax rates, and significantly broadened the tax base by rescinding most tax benefits. In addition, a comprehensive customs reform in 2006 eliminated the 16 customs bands, replacing them with a zero rate for 86 percent of imports. The expanded tax base, enhanced compliance, and rigorous enforcement offset the revenue loss caused by lowered tax rates. The result was meaningful: indicators on corruption, government effectiveness, and regulatory quality jumped from lower worldwide ranks to the top 30th percentiles over five years. Moreover, early successes fostered the population's buy-in and increased trust in public institutions, and structural reform efforts continued unabated for several years. That said, governance reforms have been partially reversed in more recent years, demonstrating the importance of sustained, strong political will.

**Morocco: Multiple reform packages and the New Model of Development.**[2] Morocco launched a new wave of structural reforms in the wake of the pandemic to address lower growth since the mid-2000s, still-high informality, elevated youth unemployment, and low female labor market participation. The country's New Model of Development aims to boost private sector investment, strengthen human capital accumulation, enhance women's participation in economic life, improve the social protection system, and reinforce the governance of public institutions (Cardarelli, Koranchelian, and Queyranne 2023). Reforms are being made to the health care system by expanding health insurance to all Moroccans and conducting a comprehensive overhaul. Social protection system reform targets support better by gradually reducing existing subsidies and extending conditional cash transfers based on the new Unified Social Registry. Education system reform aims to reduce the primary school dropout rate, increase primary school students' skills acquisition, and expand access to extracurricular activities. Morocco is also implementing a series of reforms to support private sector development by reforming state-owned enterprises, introducing a new charter of investment, establishing the new Mohammed VI Fund to finance large infrastructure projects and provide firms with equity or quasi-equity, and strengthening competition.

**Saudi Arabia: Vision 2030 is underway.**[3] Saudi Arabia's economic transformation is progressing swiftly. Even with the slowdown caused by the COVID-19 pandemic, Saudi Arabia has made strides on several fronts since the 2016 launch of Vision 2030, notably by diversifying across the external and real sectors, boosting female workforce participation, and enhancing digitalization. Improvements to the regulatory and business environment (along with a new set of laws to promote entrepreneurship, reduce the cost of

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[1] IMF (2003, 2004, 2006, 2007, 2008); Torosyan and Filer (2012); World Bank (2012).

[2] Cardarelli, Koranchelian, and Queyranne (2023).

[3] World Bank, World Development Indicators; IMF (2023).

## Box 2.1. *(continued)*

doing business, and streamline numerous fees for small and medium enterprises) have contributed to higher private sector investment and boosted the non-oil sector's economic contribution. The authorities are also enhancing the non-oil industrial base by attracting investment, boosting competitiveness, facilitating trade, and supporting climate policies under the Saudi Green Initiative. Efforts to enhance competitiveness and develop a robust logistics infrastructure to support trade have resulted in a substantial increase in the number of licenses issued in strategic industries and improved Saudi Arabia's score on the World Bank Logistics Performance Index. Labor market and human capital reforms have yielded positive outcomes, including an improved World Bank Human Capital Index rank since 2016. In 2022, female workforce participation was already close to meeting the Vision 2030 target of 30 percent because of transformative legal and labor market reforms, which gender budgeting will support further. Additionally, the share of Saudis in high-skilled jobs increased markedly (from 32 percent in 2016 to 42 percent in 2022, surpassing the 40 percent midterm target for 2025). Since the launch of the information and communication technology sector strategy in 2019, Saudi Arabia's digital economy has outperformed the primary targets set for 2023. Saudi Arabia's improvement in the World Bank's government effectiveness rankings and the United Nations E-Government Development Index since 2016, along with the expansion of cashless operations from 18 percent in 2016 to 62 percent in 2022, underscore the country's high global ranking for digital infrastructure and the maturity of digital government transformation. Robust digital development in Saudi Arabia has bolstered financial inclusion, strengthened the financial sector's resilience, and enhanced government efficacy. Overall, Saudi Arabia's non-oil growth has accelerated since 2021, averaging 5.3 percent in 2022 spurred by strong domestic demand. Non-oil growth is expected to remain robust and above 4 percent in the medium term, supported by Saudi Arabia's sound macroeconomics policies and strong reform momentum.