Growth and Stability in the Middle East and North Africa

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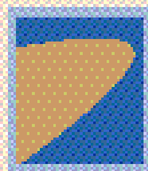

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Preface

This pamphlet was prepared in the Middle Eastern Department of the IMF by a team consisting of Mohamed A. El-Erian (Deputy Director), Sena Eken (Division Chief), Susan Fennell (Senior Economist), and Jean-Pierre Chauffour (Economist). It benefited from comments provided by colleagues in the IMF and World Bank. Special thanks to Mark Allen, Paul Chabrier, Stanley Fischer, Zubair Iqbal, Abdelali Jbili, Desmond Lachman, Saleh Nsouli, Nemat Shafik, and Inder Sud. The authors are also indebted to David Driscoll for editing the manuscript, Ilse-Marie Fayad and Peter Kunzel for research assistance, and Amber Browne and Barbara Lissenburg for secretarial assistance. The views expressed in the paper are those of the authors and do not necessarily reflect the views of the IMF.

Summary

1. The MENA region is rich in natural resources, labor, and entrepreneurial endowments with a large GDP and population. Its countries vary, in some cases considerably, in economic size, population, public/private sector balances, and financial and natural resources.

2. MENA countries have made important economic gains in recent years. The structure of most economies has been strengthened by reforms in the financial sector, exchange and payments systems, and public finances. Inflation has been lowered in a number of countries and foreign assets, while reduced, remain significant.

3. Despite important achievements, the MENA region is yet to exploit fully its considerable economic potential. This is most evident in low per capita income growth, underexploited regional trade and investment opportunities, and the low share of resident financial holdings invested within the region.

4. As is widely recognized by policymakers in the region, poor economic diversification, insufficiently responsive economic policies, and adverse external developments constrain most countries' ability to exploit more fully their economic potential. The long-standing Arab-Israeli conflict and other political uncertainties have also discouraged investment.

5. The need to progress further in addressing impediments to sustained high economic growth and financial stability is accentuated by the current outlook for the region's external environment. Prospects for the terms of trade and the demand for labor services are such that the region cannot expect major windfall gains. In contrast, the eventual achievement of a comprehensive, just, and durable Arab-Israeli peace, as well as growing economic integration with the European Union, gives promise of gains if the overall economic and financial environment is appropriate.

6. Several countries in the region have made significant progress in adjustment and reform, while others lag behind. Despite these differences, countries in the region may be thought of as confronting eight policy challenges: intensifying privatization and deregulation, reforming public finances, improving the functioning of labor markets, strengthening human resources, enhancing domestic and foreign investments, improving financial intermediation, liberalizing external trade and payments, and ensuring a supportive fiscal, monetary, and exchange rate policy mix.

7. Fulfilling this agenda is not easy and the stakes are high. The institutional framework and human capabilities must be strengthened. Certain countries also require timely disbursements of foreign assistance on appropriate terms to support their domestic policy efforts.

8. The potential for significant gains is accompanied by the possibility of short-term costs as economies adjust to more efficient structures that promise high sustained economic growth, reduce vulnerability to adverse external developments, and allow countries to benefit from the changes in the world economy. The costs may be minimized through proper planning and sequencing of policies, with the remaining elements alleviated by well-targeted social safety net provisions.

9. With appropriate policies, prospects are good for a reinvigoration of the region's economic growth and development, as individual country developments are reinforced by welfare-enhancing region-wide effects. As a result, all countries in the region would be in a better position to exploit their considerable economic potential and meet the legitimate aspirations of their growing populations.

Achieving Growth and Stability in the Middle East and North Africa

The Middle East and North Africa (MENA) region covers the enormous area extending from the Atlantic coast of Africa to the borders of Pakistan and Afghanistan in Central Asia and from the Mediterranean littoral to the southern boundaries of the Sahara Desert. The region, defined in this pamphlet to include members of the Arab League, the Islamic Republic of Iran, and Israel, comprises 22 countries with a population of 300 million (Box 1). Its size and population alone make the region economically significant, and this significance is enhanced by its vast human, financial, and natural-resource endowments. It is, moreover, strategically located, enjoys long-established economic and financial links with industrial countries, and boasts a respected tradition of trade. Yet, notwithstanding policy gains in recent years, several MENA countries are yet to exploit fully their economic potential, as stagnant per capita growth and underutilized trade and investment opportunities indicate. Indeed, some countries in the region are failing to benefit significantly from the momentous changes now taking place in the world economy.

Today, the MENAregion is at a crossroads in its economic development and must make a choice. One road leads to stagnant growth rates and marginalization of the region in the world economy, while the other leads to integration into the world economy and promises high sustainable growth. This choice is recognized throughout the region. Emphasizing the private sector as the engine of growth, policymakers are confronting the challenge of formulating and implementing policies to improve their economies and allow them to benefit from the changes in the regional and international economy. The stakes are high.

This pamphlet hopes to contribute to the understanding of the economic challenges and opportunities facing the MENA region, subject to three qualifications. First, it attempts to cover a large geographical area comprising countries of differing economic characteristics, experience, and potential. Second, it does not analyze each country individually and, by seeking predominant characteristics and trends and providing a generalized framework for detailed country analyses, indulges in unavoidable generalization. Third, analysis in the pamphlet is hindered by data

Box 1. MENA Countries

- **Oil economies** Ten MENA countries are oil-exporting countries: Algeria, Bahrain, The Islamic Republic of Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. While others countries (such as Egypt, Syria, and the Republic of Yemen) also export oil, this sector is less important at this time.
- **Economic diversification** Among the non-oil exporters, four countries (Israel, Morocco, Syria, and Tunisia) have a fairly diversified economic and export base. The economies of four other countries (Djibouti, Mauritania, Somalia, and Sudan) are based on agriculture or minerals. The remaining countries have a large service sector and are exporters of services.
- **Labor flows** Seven countries (Algeria, Egypt, Jordan, Morocco, Sudan, Tunisia, and the Republic of Yemen) export labor in a significant manner and receive large inflows of remittances as a source of foreign exchange earnings. Israel and the countries of the Cooperation Council of the Arab States of the Gulf (or GCC, comprising Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates) rely relatively heavily on imported labor.
- **Per capita income** According to World Bank classifications, five countries (Egypt, Mauritania, Somalia, Sudan, and the Republic of Yemen) are low-income countries. Thirteen countries (Algeria, Bahrain, Djibouti, Islamic Republic of Iran, Iraq, Jordan, Lebanon, Libya, Syria, Morocco, Oman, Saudi Arabia, and Tunisia) are middle-income countries, while Israel, Kuwait, Qatar, and the United Arab Emirates are classified as high-income countries.
- **Financial flows** Six countries (Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates) are net creditor countries.
- **Geographic regions** The Maghreb region is usually defined as covering Algeria, Libya, Morocco, and Tunisia. The Mashreq region covers Egypt, Israel, Jordan, Lebanon, Syria, and West Bank/Gaza. Of the remaining countries, six are members of the GCC.
- **Arab economies** Members of the Arab League are Algeria, Bahrain, Djibouti, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Mauritania, Morocco, Oman, Palestine, Qatar, Saudi Arabia, Somalia, Sudan, Syria, Tunisia, the United Arab Emirates, and the Republic of Yemen.

limitations, as well as by the usual problems associated with cross-country comparisons and aggregation.

Economic Overview

The MENA region commands abundant human and natural resources, accounts for a large share of world petroleum production and exports, and enjoys on average a reasonable standard of living. Within this general characterization, countries vary substantially in resources, economic and geographical size, population, and standards of living. At the same time, intra-regional interaction is weak, being restricted principally to labor flows, with limited trade in goods and services.

MENA covers a surface of over 15 million square kilometers and contains some 6 percent of the world's *population*, about the same as the population of the European Union (EU). The three smallest countries (Bahrain, Djibouti, and Qatar) each have a population of about half a million inhabitants. By contrast, the two largest countries (Egypt and the Islamic Republic of Iran) comprise about 60 million inhabitants each. Together with Algeria, Morocco, and Sudan, these five most populated countries account for about 70 percent of the region's population. About half the population lives in cities.

Most MENA countries are experiencing rapid population growth and have high dependency ratios. The average annual rate of population increase during 1989–94 was about 3 percent, the same as that in sub-Saharan Africa. Underlying the population growth are fertility rates substantially higher than those in other economies with similar real per capita income. Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates have registered population growth rates exceeding 3.5 percent in recent years, while Bahrain, the Islamic Republic of Iran, Lebanon, and Tunisia have recorded rates below the 2 percent average of the developing countries.

The labor force has grown faster than total population in recent years. As more than 50 percent of some countries' population is under the age of 15, this growth will be relevant for years to come; moreover, female participation rates remain very low. Not surprisingly, *employment* issues are on the agenda of most countries in the region. Other than in the economies of the Cooperation Council of the Arab States of the Gulf (GCC), the rate of unemployment exceeds those of most other regions in the world. Urban unemployment is estimated at over 30 percent in the

Republic of Yemen and over 50 percent in the Gaza Strip. Although countries of the GCC once imported labor, with the rapid population growth and slower economic growth, they now must absorb a growing number of their own nationals into the labor force.

Despite high unemployment in certain countries, traditional indicators of *human resource development* in the region are fairly satisfactory. Average life expectancy at birth is about 65 years—close to the world average—and the infant mortality rate is only marginally above the world average. Although the average illiteracy rate in the region is high, primary and secondary school enrollment as a percentage of school age population is above that of developing countries with comparable per capita income, as is the teacher-to-pupil ratio. Three qualifications should, however, be borne in mind. First, the illiteracy and educational indicators are significantly more unfavorable for women than for men. Second, MENA countries compare poorly to other countries when account is taken of spending on the social sectors, highlighting the impact of distorted labor markets, an inefficient educational delivery system, and neglect of female education. Third, when various human development indicators are combined (e.g., as in the UNDP human development index) the region's ranking among countries in the world is less favorable than that based on income criteria alone.

Although the region is plagued by harsh climates, limited groundwater and rainfall, and scarce arable land (for example, in Djibouti, less than 1 percent of the land is arable, while in Egypt the area under cultivation is below 3 percent of total land mass, notwithstanding the reclamation of desert land since the 1950s), it enjoys abundant *natural resources*. About two thirds of the world's known crude-oil reserves lie under the MENA region, with one quarter located in Saudi Arabia. Following the breakup of the Soviet Union, the Islamic Republic of Iran now has the world's largest proven reserves of natural gas, about 15 percent of the world's total. The region also possesses numerous non-fuel mineral and nonmineral resources. Algeria, Morocco, Tunisia, Jordan, and the Syrian Arab Republic account for about one third of the world's phosphate production, and Morocco alone has more than 30 percent of the world's phosphate rock and 40 percent of its phosphoric acid trade. The region's other natural resources include potash (Islamic Republic of Iran, Israel, and Jordan), iron ore (The islamic republic of iran and Mauritania), coal (The islamic republic of iran), ammonia and urea (The islamic republic of iran and Qatar), copper and gypsum (Mauritania), cotton (Egypt and Sudan), tobacco (the Syrian Arab

Republic), and coffee (the Republic of Yemen). In addition, almost all MENA countries have coasts and fishing grounds.

Reflecting these various advantages, the MENA region constitutes a sizable *economic entity* and enjoys a reasonable standard of living by international standards. In 1994, the nominal GDP of the region amounted to $610 billion, equivalent to 2½ percent of world GDP and some 12 percent of the GDP of developing countries. Saudi Arabia is the largest economy, accounting for one fifth of the region's total GDP. At about half the size of Saudi Arabia, the Islamic Republic of Iran and Israel are the next largest economies. The eight smallest economies (Bahrain, Djibouti, Jordan, Lebanon, Mauritania, Qatar, Somalia, and Sudan) together account for about 6 percent of the region's GDP.

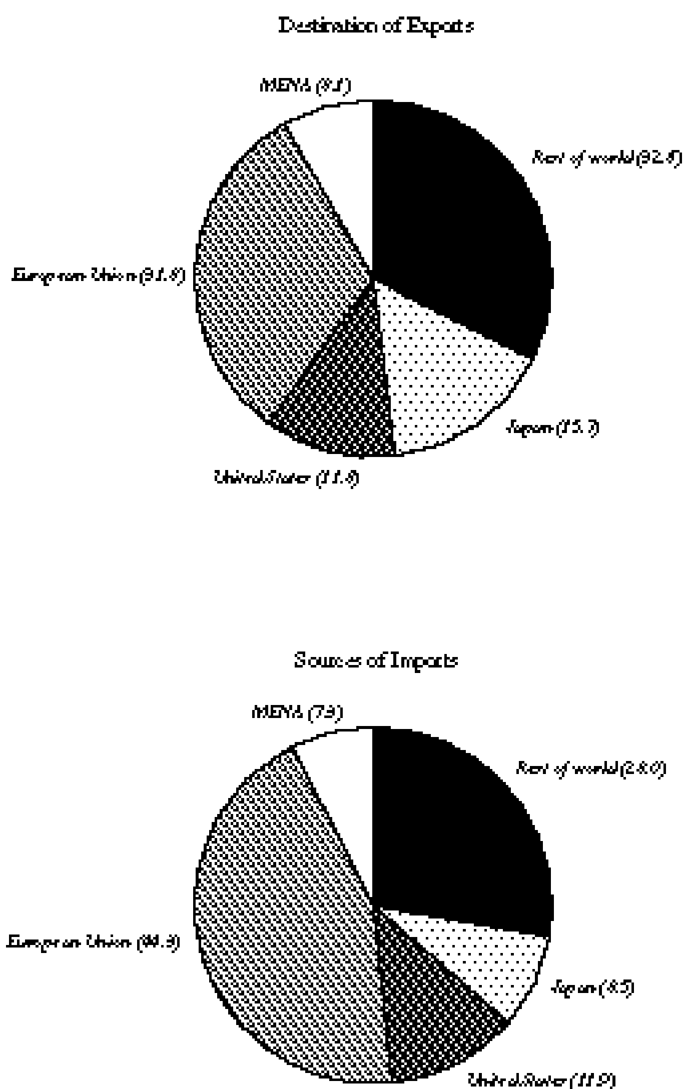
Although the average per capita GDP in the region, about $2,000, is twice that of developing countries as a whole and places MENA between the average levels of Latin America and of the economies in transition, individual MENA countries differ greatly. The four highest per capita income countries (Israel, Kuwait, Qatar, and the United Arab Emirates) enjoy an average per capita GDP of around $15,000 compared with $250 for Somalia and Sudan, the poorest countries in the region.

MENA countries, especially the non-oil countries, have low *domestic savings rates.* The domestic savings-to-GDPratio has averaged 19 percent in the region as a whole, but only 11 percent in the non-oil producing countries, compared with a ratio of about 25 percent in developing countries. Fortunately efforts have been made recently to lower public dissaving by reducing government budget deficits.

On the *external side*, MENA countries appear, on the face of it, very open. For example, the total trade-to-GDP ratio amounts to about 66 percent. MENA's exports and imports of goods account for 4 percent of world trade and 15 percent of trade of developing countries. The share of the MENAregion in international trade of goods is twice that of sub-Saharan Africa, equal to that of Latin America and the economies in transition, but only about one fifth of the share of developing countries in Asia.

The region trades mainly with industrial economies (Chart 1). The countries of the EU are the most important trading partners, accounting recently for 30 percent of exports and 40 percent of imports of MENAcountries. The United States accounts for about 12 percent of both the region's exports and imports, and Japan for 16 percent of exports and 8 percent of imports.

Chart 1. Direction of Trade
(In percent; 1989–94 averages)



Source: International Monetary Fund, *Direction of Trade.*

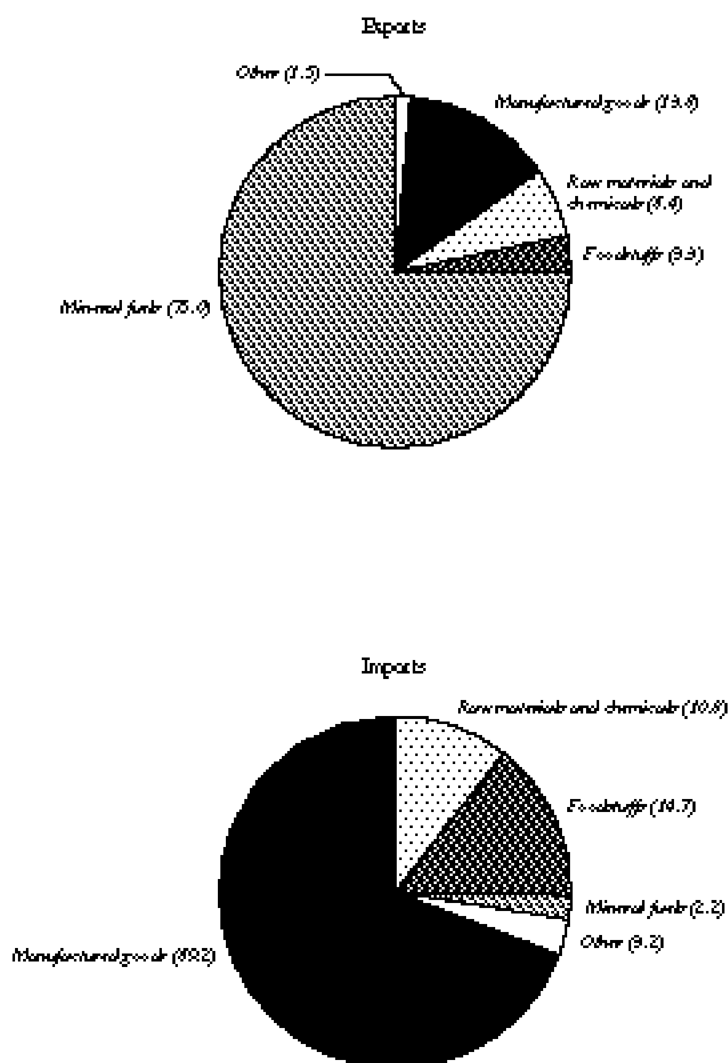
The region's oil trade heavily influences these indicators. Oil and oil-related products account for about three quarters of the region's *exports* and about 40 percent of world exports of these products (Chart 2). Phosphate, its derivatives, iron ore, and cotton are also important exports. Per capita exports in the MENAregion amount on average to $650, twice that of the developing countries as a group. Countries in the region differ dramatically in per capita exports, ranging from $25 in Sudan to $11,000 in the United Arab Emirates. Openness ratios (trade as a percent of GDP) also vary, ranging from 28 percent for the Syrian Arab Republic to 200 percent for Bahrain.

The MENA region depends on *imports* of foodstuffs. Gross food imports of the region account for 6 percent of world food imports. All countries—except for Israel, Mauritania, and Morocco—are, on average, net food importers.

Intra-regional trade plays a limited role in integrating the MENAcountries, accounting for only about 8 percent of both exports and imports of the region (compared to 60 percent in the EU) but the region experiences large *intra-regional labor* movements, which have been the main vehicle of the region's economic integration, triggering substantial financial flows in the form of workers' remittances and transmitting economic impulses across countries. (At the beginning of the 1990s, the foreign labor force, including labor from outside the region, accounted for about two thirds of the total labor force of the GCC countries.) Although an estimated 1.5 million workers returned home after the 1990–91 regional crisis triggered by Iraq's invasion of Kuwait and the number of Palestinians working in Israel has declined significantly, labor markets in the MENA region remain highly integrated relative to other regions of the world. Remittances have recently amounted to about one quarter of exports of goods and services of non-oil exporters in the region and have exceeded 50 percent in Egypt, Jordan, and the Republic of Yemen. In addition to their direct balance of payments impact, labor remittances account for much of private investment in certain countries in the region (including Jordan).

Reflecting employment conditions at home as well as special historical relations with other countries, many Arab workers, especially from North Africa, have also migrated outside the MENA region—mainly to Europe. Concurrently, the MENA region has received inflows of migrant workers from outside the region, especially south and east Asia. Asian nationals account for a growing share of the nonnational labor force in the GCC

Chart 2. Composition of Trade
(In percent; 1989–94 averages)



Source: United Nations, Trade Analysis and Reporting System.

countries and in Israel. Israel has also absorbed in recent years a significant inflow of immigrants from the former Soviet Union.

The MENA region enjoys sizable *interest income inflows*, reflecting a high level of foreign assets, while current transfers with the rest of the world remain marginal. During 1989–94, such inflows averaged about $6 billion a year (with oil-producing countries receiving double that amount), while all other country groupings, including industrial countries, recorded negative flows. Meanwhile, excluding transfers in 1991 associated with the Gulf crisis, the region has maintained on average a zero balance flow on account of current transfers with the rest of the world.

Finally, in terms of *intra-regional capital flows,* two distinct groups exist in MENA: providers of significant foreign assistance—mainly the oil exporters, Kuwait, Qatar, Saudi Arabia, and the United Arab Emirates—and recipients. Foreign assistance from the MENA region has been extended mainly on concessional terms and is highly correlated with the donor's economic circumstances and thus with fluctuations in world-market prices of oil. Political considerations have also played an important role in this regard, but private capital flows have been relatively limited.

Economic Performance

This section discusses the region's recent performance in sustaining economic growth in a context of domestic and external financial stability. Following a look at developments in the main macroeconomic aggregates, it analyzes structural aspects, recent policy actions, and terms of trade.

Macroeconomic Aggregates

Although MENA countries suffered the consequences of weak economic activity in industrial countries in the early 1990s, the crisis triggered by Iraq's invasion of Kuwait, and unsatisfactory oil-market conditions, the region achieved positive rates of real *economic growth* throughout 1989–94 with GDP expanding at annual average rate of 3.2 percent. This growth exceeded that of Africa (1.6 percent) and Latin America (2.9 percent); only Asian countries recorded higher GDP growth (7.5 percent). Nevertheless, burgeoning population has caused annual average *per capita real GDP growth* to stagnate. In contrast, developing countries as a whole were able to increase their real per capita GDP by 3 percent and industrial countries by 1.3 percent during this period.

Growth performance varied among various country groups and countries in the region.

- Oil exporters as a group have registered declines in real GDP growth since the beginning of the 1990s, reflecting weakening world oil markets.
- As regards non-oil exporting economies, countries that embarked earlier on economic adjustment and structural reform programs—including Israel, Jordan, Mauritania, Morocco, and Tunisia—performed relatively well, even though Jordan's economic adjustment was disrupted by the 1990–91 regional crisis, and Morocco and Tunisia suffered droughts.
- Countries with civil strife and armed confrontation—such as Algeria, Djibouti, Lebanon, Somalia, Sudan, and the Republic of Yemen—recorded generally very low or negative GDP growth, but the ending of hostilities in a number of cases has been followed by reconstruction and rehabilitation, giving impetus to growth.

Inflation in MENAcountries has been fairly restrained. In 1989–94, the weighted average consumer price index of the region increased annually by about 16 percent, compared with 47 percent for developing countries as a group. Within the MENA region, inflation in oil-exporting countries was on average lower than in non-oil exporters, reflecting tighter monetary policies, the nominal anchor provided by pegging most of these countries' currencies to the U.S. dollar, and the "safety valve" operating through the balance of payments to reduce excessive demand, although at the cost of erosion in international reserves and related investment income. Nevertheless, since the beginning of the 1990s the inflation rate in oil-exporting countries as a group has been increasing, while that in non-oil exporting countries has been declining, culminating in a relatively better inflation performance in the latter group in 1994.

At the individual country level, 12 MENA countries achieved single-digit inflation during 1989–94, and five countries (Bahrain, Kuwait, Oman, Qatar, and Saudi Arabia) had better inflation performance than that of the average for industrial countries. Egypt significantly reduced inflation during this period by strengthening fiscal and monetary policies. By contrast, Sudan recorded annual inflation rates of over 100 percent throughout the period. Lebanon, Somalia, the Republic of Yemen, and, to a lesser extent, Algeria and the Islamic Republic of Iran also suffered high inflation.

The *external position* of the MENA region deteriorated sharply in early 1991, but then improved steadily (Chart 3). As a ratio to GDP, the current account deficit (including official transfers) averaged 5 percent during 1989–94, compared with 1.3 percent in developing countries as a group. Among developing countries, sub-Saharan Africa was the only region to register larger current account imbalances.

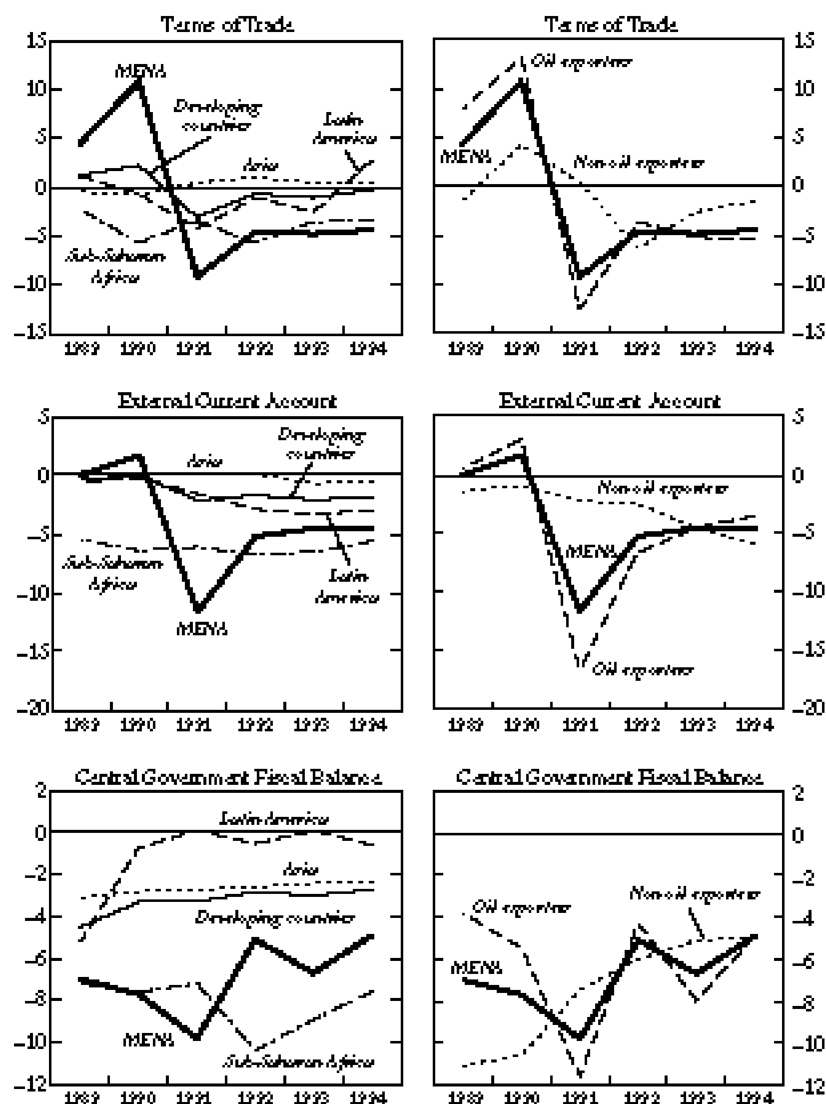
The volume of *exports* of the MENA region increased at an annual average rate of 5.6 percent during 1989–94, compared with 8.4 percent for developing countries as a whole. On average, export growth in oil exporters was better than in non-oil exporters, which nevertheless experienced increased export volume growth during 1991–94. The growth in *import* volumes in the MENA region was lower than the growth in export volumes during 1989–94—amounting to an annual average of 2.8 percent. Within the region, the annual average growth in imports of oil exporters was slower than that of the remaining countries, reflecting the sharp decline in imports by the oil exporters during 1993–94, but also the increased access to financing by some non-oil countries associated with their adjustment process.

MENA countries adopted various approaches to *financing* external current account deficits. The GCC countries relied heavily on using their gross foreign assets, but also resorted to some external borrowing. Non-GCC countries mainly relied on medium- and long-term loans from official sources. Inflows from private sources were important for only a few countries (Egypt, Israel, and Lebanon), while most foreign direct investment in the region was accounted for by flows to Egypt, Israel, Morocco, and Tunisia.

During 1989–94 several countries resorted to exceptional financing in the form of rescheduling and accumulating arrears on debt service. Paris Club reschedulings were concluded for Algeria (1994 and 1995), Egypt (1991), Jordan (1989, 1992, and 1994), Mauritania (1989 and 1993), and Morocco (1990 and 1992). Rescheduling of commercial bank debt took place for Algeria (1992), Jordan (1993), and Morocco (1990). Foreign exchange reserves of oil countries declined, while those of other countries as a group increased more or less steadily during this period both in absolute terms and as a ratio to their imports of goods and services.

The total *external public and publicly guaranteed debt* of MENA countries increased by $44 billion during 1989–94, of which one third was accounted for by oil-exporting countries. This was a historical aberration reflecting the aftermath of the 1990–91 regional conflict. Saudi Arabia has

Chart 3. Developing Countries and MENA Region:
Selected Economic Indicators, 1989–94
(In percent of GDP)



Source: International Monetary Fund, *World Economic Outlook.*

repaid the bank loan syndication contracted after the conflict and Kuwait is in the process of doing so. As a percentage of GDP, the external debt of the region remained more or less stable. The debt-to-GDP ratio of oil-exporting countries, although relatively small, increased gradually, while that of non-oil exporting countries declined from 100 percent in 1989 to 69 percent in 1994. Developments in Egypt, Jordan, and Morocco mainly accounted for this decline. In Egypt, the decline in the early 1990s was largely due to reductions in the stock of debt granted by official bilateral creditors. Jordan undertook debt-reduction operations with commercial banks and also implemented reschedulings with, and was granted debt forgiveness by, some bilateral official creditors. Morocco benefited from the cancellation of the entire stock of debt it owed to Saudi Arabia.

The *debt-service burden* of the region remained at comfortable levels during this period. Oil-exporting countries' debt service, as a percentage of exports of goods and services, picked up, with amortization payments coming due at the same time as export earnings fell. Debt servicing of the non-oil exporting countries declined because of lower stocks of outstanding debt and the impact of debt rescheduling. Declines in the debt-service ratio were substantial in Algeria, Egypt, Israel, and Jordan. During 1989–94, the largest increase in debt and debt-service ratios, albeit from very low levels, was observed in Lebanon and was associated with the financing of the reconstruction program.

Accounting for Macroeconomic Performance

Interaction among the underlying structural elements of the MENA economies, the stance of macroeconomic and structural reform policies, and developments in the countries' terms of trade have determined the region's economic performance.

Underlying Structure

Even though there is considerable economic and financial diversity among MENA countries, several share similar structural economic characteristics that have influenced their recent economic performance. Four structural aspects stand out in particular:

- a poorly diversified economic and export base at the individual country level
- vulnerability to exogenous shocks

- limited integration into international capital markets
- public sector dominance of economic activity.

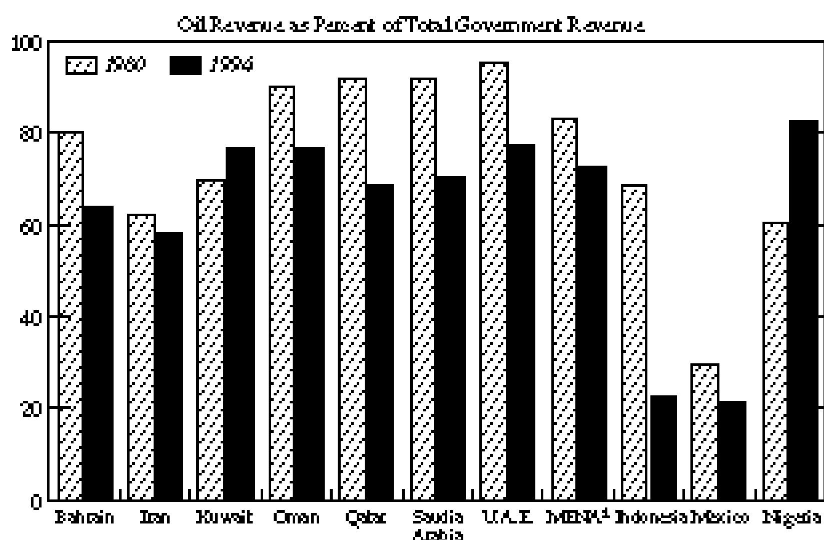
While the economy of the region as a whole is relatively diversified, most countries have a narrow *economic base*. In many countries, a single sector—indeed a single product—constitutes most domestic output. The most vivid example is oil, which accounts for over 50 percent of GDP in almost all oil-exporting countries. Agriculture accounts for a similar proportion of GDP in Somalia and Sudan, and around a quarter of GDP in the Islamic Republic of Iran, Mauritania, and the Republic of Yemen. Manufacturing is significant and well diversified only in Israel, Morocco, and Tunisia. Despite disruptions caused by the 1990–91 regional crisis and civil unrest, tourism remains an important component of output in a number of MENA countries (Egypt, Israel, Morocco, and Tunisia) and has enjoyed a higher growth rate than agriculture or manufacturing in these countries since 1989.

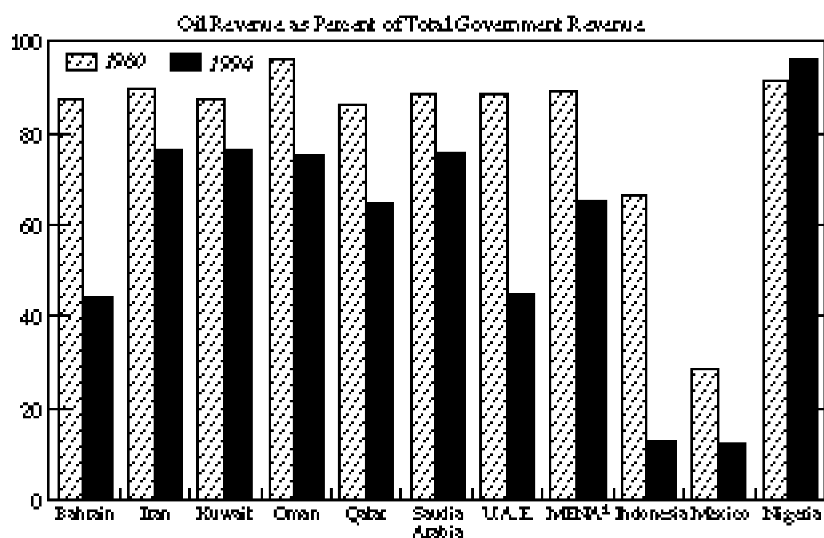
The narrow productive and export bases make several MENA economies vulnerable to *exogenous shocks*. In oil-exporting countries, fluctuations in the international price of oil have a direct impact on export receipts and government revenues (in GCC economies, the share of oil revenues in total revenues ranges from about 60 percent in Bahrain to about 80 percent in the United Arab Emirates), as well as an indirect impact through the role of government expenditure in determining overall economic activity and employment (Chart 4). Furthermore, economic developments in oil-exporting countries have important consequences for other countries in the region, which are dependent on transfers from workers in oil-producing countries.

At the same time, several MENA countries are much affected by fluctuations in international commodity prices since they rely heavily on the export of non-fuel primary commodities. Conversely, because of heavy import reliance, many countries are vulnerable to fluctuations in price of foodstuffs. Furthermore, in countries heavily dependent on agricultural output and exports, economic performance remains vulnerable to weather conditions.

MENA has participated less in the globalization and integration of *international capital markets* than have Asian and Latin American countries. Capital flows into the MENA region have been small. Countries in the region have had almost no direct access to the capital markets of in-

Chart 4. Vulnerability to Oil Markets





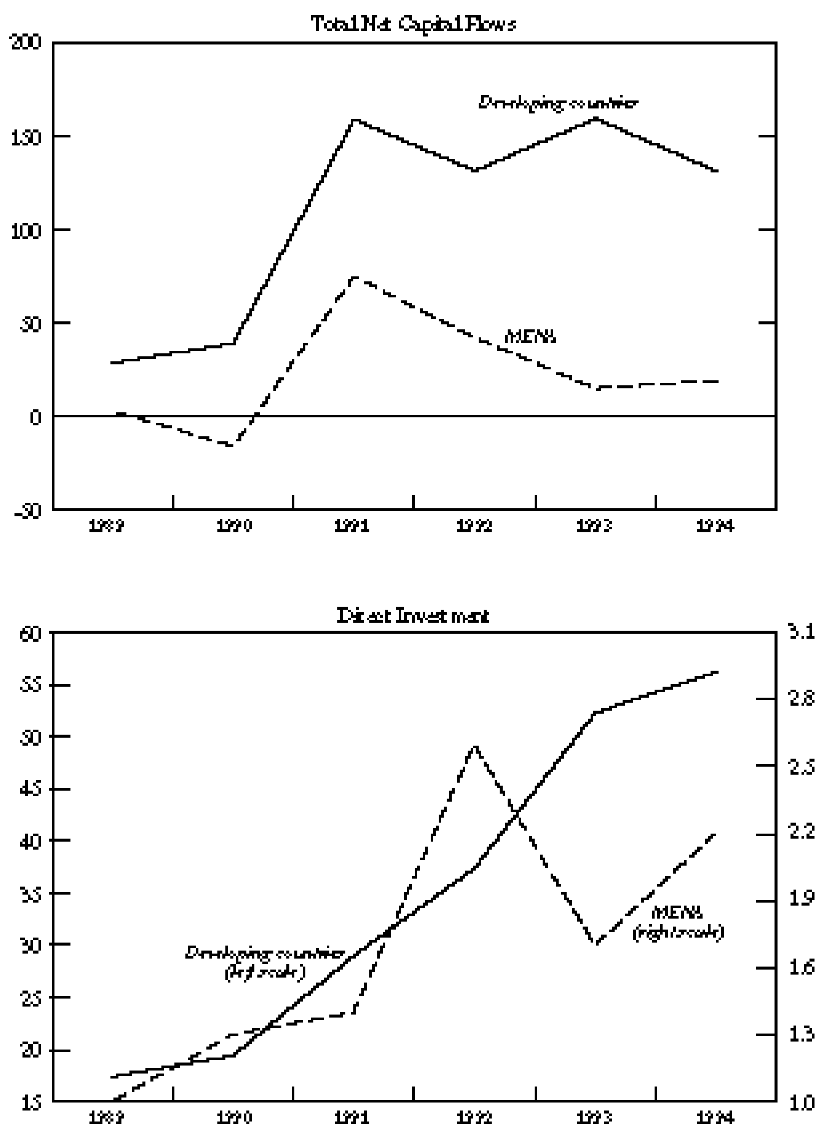
Sources: International Monetary Fund, World Economic Outlook database; and various Recent Economic Development Reports.

[1] Average of the seven oil exporting countries from the region included in the chart.

dustrial countries, notwithstanding the growing incidence of joint ventures (domestic/foreign) following the liberalization of financial sectors in certain countries. The region has made only limited use of market-based income-hedging devices (such as product insurance and forward markets) despite its vulnerability to international price developments. Foreign direct investment (FDI) inflows to the MENA region have been lower than to other developing regions, except sub-Saharan Africa (Chart 5). During 1989–94, foreign direct investment inflows to the region amounted to about $10 billion, compared with a total of about $212 billion to the developing countries as a whole. In recent years, the completion of a number of oil- and gas-related investments in the GCC countries has been reflected in a reduction of FDI inflows. Portfolio flows into the region have remained low, because MENA countries have limited access to international capital markets and the region's capital markets are at the development stage. Private capital inflows have shown more diversity and response in countries that have made steady progress in macroeconomic and structural adjustment (such as Egypt, Israel, Jordan, Morocco, and Tunisia), as well as those recovering from domestic unrest (Lebanon).

Finally, on the structural front, in most MENA countries the *public sector* dominates domestic output. Its finances are the primary determinant of domestic liquidity and aggregate demand. On the other hand, it has been associated with economic distortions that have hindered productive efficiency and obfuscated the environment in which producers and consumers must operate. The public sector accounts for 30–60 percent of the labor force in most MENA countries and as high as 95 percent of the national labor force in some countries of the GCC. Public enterprises have had weak financial performance because they have been largely immune from competition and have suffered from organizational and managerial shortcomings, administrative controls, inappropriate pricing policies, and overemployment. Consequently, this sector has become dependent on government transfers and subsidies, placing a major burden on fiscal and monetary policies and lowering productivity in most MENA countries. Other structural constraints on investment and employment are evident in some MENA countries. The dominant role of public sector employment and its recruitment, job security, and wage-setting practices have led to segmented labor markets. Moreover, labor legislation in both public and private sectors has circumscribed the employer's scope for hiring, firing, or wage setting.

Chart 5. External Financing
(In billions of U.S. dollars)



Source: International Monetary Fund, World Economic Outlook database.

Macroeconomic and Structural Policies

The impact of these structural realities on recent economic performance has depended in part on the accompanying policy stance. In some cases, macroeconomic reform, singlemindedly implemented, has offset structural weaknesses. In other cases, inappropriate policies have accentuated them. To enhance productivity, several MENA countries have, in recent years, adopted *structural reform measures* to improve competition and better allocate resources. These measures included steps to free prices, reform public enterprises, liberalize the external trade system, and reduce exchange controls.

Several MENAcountries (especially Algeria, Egypt, Jordan, the Islamic Republic of Iran, Morocco, Sudan, and Tunisia) made progress in liberalizing domestic *prices* during 1989–94. Direct controls have been gradually eased or removed on agricultural prices, producer prices in the manufacturing sector, retail prices, and distribution margins. Furthermore, partly reflecting concern about budgetary costs and waste, subsidies on a wide range of products have been reduced and their scope limited to essential consumer goods.

Several countries, with technical and financial assistance from the World Bank, launched *public enterprise reform* programs in the late 1980s. These programs sought to improve overall resource allocation, reduce the burden on government budgets, and limit the absorption of domestic and external financing by these enterprises. They were also directed toward increasing the administrative autonomy and accountability of public enterprises, improving their financial performance, and reducing their number through privatization, restructuring, or liquidation of nonviable firms. Implementation was slow in the initial stages as these reforms needed diagnostic studies to assess the financial viability of enterprises, amendments to the existing legal framework, and policy adaptations in other sectors. Nevertheless, a number of countries made progress. Algeria, Morocco, and Tunisia used management performance contracts, Egypt, Morocco, and Tunisia enacted related laws, and Egypt, Israel, Jordan, Kuwait, Morocco, Oman, Tunisia, and the United Arab Emirates engaged in partial or total privatization.

During 1989–94, several countries (including Algeria, Jordan, Morocco, and Tunisia) undertook comprehensive *trade liberalization* by reducing quantitative restrictions and lowering and rationalizing import du-

ties. In general, the liberalization of imports of raw materials, intermediate products, and capital goods progressed faster than those of finished goods as the authorities sought to strengthen the ability of domestic industries to adjust to increased foreign competition. The reductions in tariff rates in some cases fell behind initial schedules because of budgetary considerations.

With a move toward a more outward-looking trade policy, these same countries took steps to ease *foreign exchange controls*, while Egypt, the Islamic Republic of Iran, and Sudan abolished multiple exchange rate systems, although the unification of exchange rates was subsequently reversed in the Islamic Republic of Iran and Sudan. The liberalization of foreign exchange controls on current account transactions, the strengthening of macroeconomic policies, and the implementation of comprehensive structural reforms enabled Israel, Lebanon, Morocco, and Tunisia in 1989–94 to make their domestic currencies convertible for current account transactions and to assume the obligations under Article VIII of the IMF's Articles of Agreement.

During this period, progress in liberalizing *capital account transactions* was slow in MENA countries. Nevertheless, several countries, including Egypt, Jordan, Morocco, and Tunisia, took steps to ease payments restrictions on capital transactions by residents and to liberalize rules governing the use by residents of foreign currency accounts in domestic banks. In general, nonresident capital transactions, involving repatriation of capital, dividends, and profits, have been made more liberal to encourage non-debt creating external financing and the transfer of technology.

The most important aspect of *demand management policies* has been the stance of fiscal policy, particularly the overall budget deficit and the underlying revenue and expenditure patterns. The MENA region has recorded *fiscal* deficits that are large by international standards, even though some countries have made progress in addressing fiscal imbalances. The central government fiscal deficit of 7 percent of GDPwas more than double that of developing countries as a group. In oil-exporting countries, a sharp deterioration in public finances during 1989–91 occurred as oil prices fell. The higher fiscal deficits were initially financed by running down foreign assets, but subsequently addressed through the adoption of adjustment measures. Other countries in the region continuously improved their fiscal positions during 1989–94, and by 1994 both country groupings had reduced their fiscal deficit to about 5 percent of GDP. At

the individual country level, Egypt, Israel, Jordan, Mauritania, and Tunisia tightened the stance of their fiscal policy substantially during 1989–94.

In addressing their fiscal imbalances, countries initially focused on cutting expenditures to bring about rapid improvement. In the second phase, they shifted toward enhancing revenue through improving tax systems and administration. In countries where adjustment comprised mostly cuts in expenditures, especially capital expenditure, fiscal tightening proved unsustainable and was quickly reversed. In contrast, countries that complemented expenditure restraints at an early stage by structural reform on the revenue side experienced more durable reductions in fiscal imbalances.

The overall objectives of tax reform were to simplify the tax system, increase its transparency, improve its buoyancy and elasticity, reduce its distortionary effects on the allocation of resources, and strengthen tax administration. To make direct taxation more efficient, a number of countries embarked on or continued efforts to simplify income taxation, and to broaden its base. With regard to indirect taxes, most reforms involved the replacement of various taxes and fees, imposed at various stages of production, by a value-added tax (VAT). Jordan introduced a general sales tax with a view to establishing a broad-based value-added type of tax. Morocco reduced the number of rates under the VAT, and Tunisia expanded its coverage to sectors previously excluded, such as wholesale trade activities. For social reasons, a few basic consumption goods were generally exempted from VAT. Egypt, Jordan, Morocco, and Tunisia made further progress in rationalizing and reducing tariffs. Meanwhile, tax administration was strengthened in most MENAcountries through improvements in tax assessment and collection procedures, the reinforcement of tax auditing procedures, and increased use of computers.

With regard to *monetary policy*, broad money grew in 1989–93 in the MENA region as a whole, before declining in 1994. Similar trends were observed in both oil- and non-oil export countries, although the latter recorded larger monetary expansion (annual growth of broad money averaged 31 percent as compared with 11 percent in the oil-exporting countries), primarily reflecting financing requirements of fiscal deficits in a context of limited reserve funding.

Monetary policy was made more effective by changes in the financial system aimed at better mobilizing and allocating financial savings and strengthening the system of monetary control. First, the role of market forces in determining rates of return and credit allocation has been en-

hanced (Chart 6). Several countries made progress in liberalizing their rate structure, initially focusing on deposit rates, and in reducing the scope of preferential rates, especially for public enterprises. Second, the introduction of new instruments with market-determined rates broadened the menu of assets available to domestic savers. These instruments included certificates of deposits (Jordan), negotiable treasury bills (Egypt and Tunisia), and commercial paper (Morocco). Third, most MENA countries strengthened the financial system through recapitalization of financial institutions and improvements in prudential regulations and supervision. Fourth, new securities market laws were implemented with a view to improve trading, reporting, and accounting systems in capital markets.

To improve monetary control, especially in the context of financial liberalization, indirect instruments of monetary control began to replace quantitative credit restrictions. Several countries made rediscount mechanisms more sensitive to market conditions and used the sale and purchase of central bank paper and treasury bills more widely in the management of liquidity. They also made reserve requirements more uniform across financial institutions.

Exchange rate adjustments in the face of terms of trade losses in most MENA countries varied during 1989–94. Countries with flexible exchange rate arrangements underwent nominal effective exchange rate depreciations, but only Algeria, The islamic republic of iran, Israel, and Tunisia experienced depreciations in their real effective exchange rates. Countries whose currencies were pegged to the U.S. dollar (except the Syrian Arab Republic) also had nominal effective exchange rate depreciations owing to the depreciation of the U.S. dollar. Reflecting their superior price performance, only the GCC countries experienced both nominal and real exchange rate depreciations. Among countries with currencies linked to the SDR or another basket of currencies, only Jordan had nominal and real exchange rate depreciations. Downward adjustments in real effective exchange rates compensated for worsening terms of trade in Algeria, Bahrain, the Islamic Republic of Iran, Israel, Kuwait, and Saudi Arabia, thus cushioning the impact of the terms of trade on domestic economic activity.

External Terms of Trade

The external environment in the MENA region has been particularly difficult in recent years. The cumulative deterioration in the region's terms

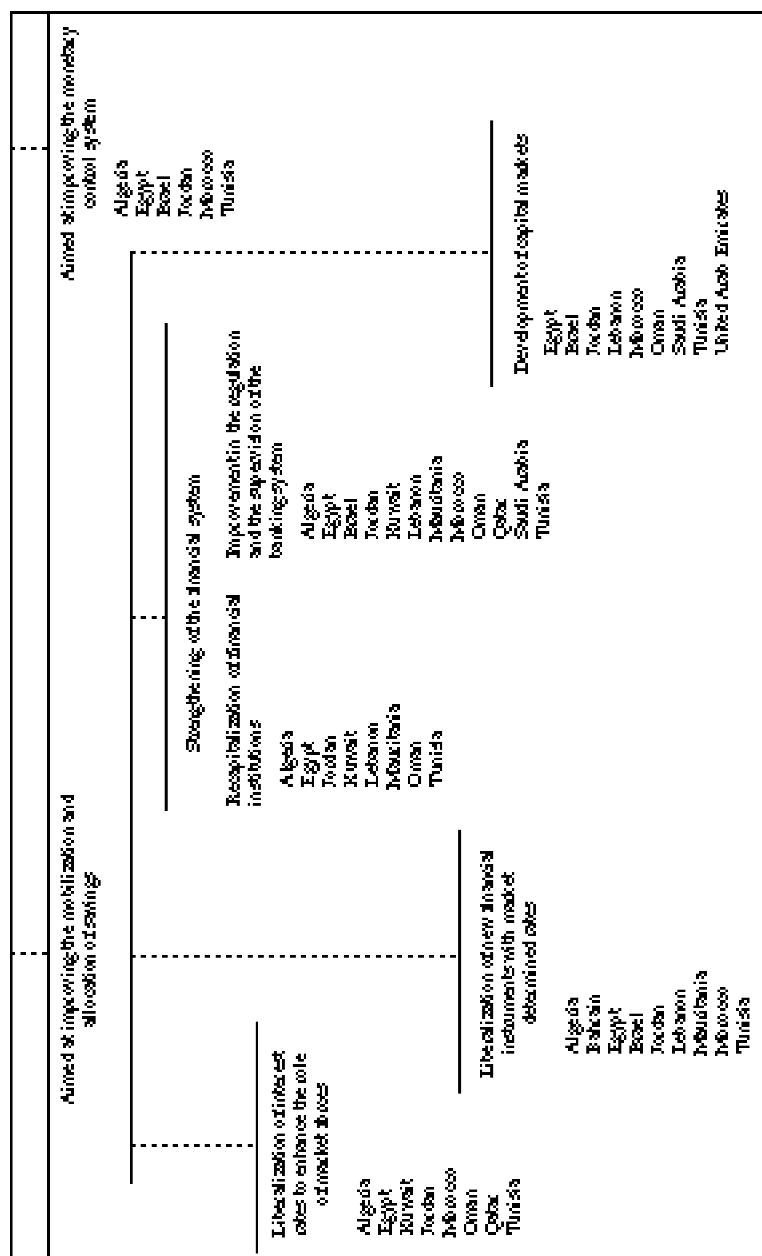


Chart 6. Financial Sector Reforms in MENA Countries, 1989–94
Aimed at improving the mobilization and allocation of savings
Aimed at improving the monetary control system
Algeria
Egypt
Israel
Jordan
Morocco
Tunisia
Liberalization of interest rates to enhance the role of market forces
Algeria
Egypt
Kuwait
Jordan
Morocco
Oman
Qatar
Tunisia
Liberalization of new financial instruments with market determined rates
Algeria
Bahrain
Egypt
Israel
Jordan
Lebanon
Mauritania
Morocco
Tunisia
Strengthening of the financial system
Recapitalization of financial institutions
Algeria
Egypt
Jordan
Kuwait
Lebanon
Mauritania
Oman
Tunisia
Improvement in the regulation and the supervision of the banking system
Algeria
Egypt
Israel
Jordan
Kuwait
Lebanon
Mauritania
Morocco
Oman
Qatar
Saudi Arabia
Tunisia
Development of capital markets
Egypt
Israel
Jordan
Lebanon
Morocco
Oman
Saudi Arabia
Tunisia
United Arab Emirates

of trade during 1989–94 amounted to 7.7 percent as compared with 1.8 percent for developing countries as a whole. Among developing countries, only sub-Saharan Africa registered worse terms of trade developments during the same period, while the Asian countries benefited from improvements in their terms of trade. In addition to a significant overall worsening, MENA countries have been subject to considerable fluctuations in their terms of trade—further undermining economic performance. The variance in the region's terms of trade was more than 15 times greater than that for developing countries as a group and 30 times greater than for industrial countries. Not surprisingly, oil-exporting economies faced the greatest variance in terms of trade within the MENA region.

External Environment

The external environment affects individual MENA countries through the goods market, the labor market, and to a lesser extent, capital flows. The importance of each of these three transmission channels depends on the circumstances of individual countries. Looking forward, several countries face, at best, a neutral outlook with substantial downside risks associated with oil-market developments. Consequently, these countries cannot look to their external environment either as a source of substantial windfall gains or as a significant stimulus for growth. This, as well as the legacy of the underexploited opportunities of recent years, strengthens the case for the economic reform policies. Fortunately, the possibility of more favorable regional sociopolitical conditions following the eventual attainment of a comprehensive, just, and durable peace provides support for the effectiveness of such policies, as do the prospects for increased economic interactions with the EU.

Goods Market

Medium-term analyses suggest that the region faces buoyant markets for non-oil products but a subdued international price outlook for commodities of particular importance to the region.

Projections prepared by the IMF staff during the 1995 *World Economic Outlook* exercise suggest a favorable outlook for the region's *non-oil exports,* as real demand in partner countries (weighted by their share in the region's exports) is expected to grow at an average annual rate of just over 5 percent in 1996–2000. Accordingly, the non-oil sector can provide an

engine of growth for several countries and its development should be encouraged. The scope for expansion is significant: non-oil exports account currently for only a quarter of the region's exports, with Israel accounting for almost half this total.

As regards *petroleum prices*, there seems to be a consensus that, at best, nominal prices will increase moderately and real prices will remain constant or will decline. The consensus reflects expectations of restrained growth in world demand as further reduction in energy intensity offsets new demand, particularly by developing countries. At the same time, non-OPEC suppliers are expected to maintain broadly their current market shares, albeit with some uncertainty about developments in the republics of the former Soviet Union. The potential timing and conditions of Iraq's return to the oil market are also uncertain. Such a return would impose downward pressure on international prices and require some reallocation of shares among existing producers in order to limit the price decline.

Turning to the region's *imports*, the 1995 *World Economic Outlook* projections suggest moderate increases in import unit values (in U.S. dollar terms). Thus, after the nearly 8 percent increase estimated for 1995, prices of non-oil imports are expected to rise by an annual average of 1½ percent during 1996–2000. A source of upward pressure in this context is the price of food imports, an important component of the region's total import bill. The moderate increase projected in import unit values incorporates a limited rise in food prices as the overall supply, particularly from producers in nonindustrial countries, responds to reductions in subsidies induced by the Uruguay Round in industrial countries. Slower output responses in nonindustrial countries would place upward pressure on international food prices, worsening MENA's external terms of trade.

The Uruguay Round is expected to have other effects on the goods market for the MENA region through the recent *agreements on multilateral trade liberalization*:

- the liberalization of the agricultural, textile, and clothing sectors through reductions in tariff and nontariff barriers
- the improvement in the overall trading environment because of strengthened rules applicable to subsidies, countervailing duties, antidumping, and safeguards
- the reinforcement of the institutional structure through the establishment of the World Trade Organization.

A potential benefit currently of lesser operational importance to the MENAregion is the extension of multilateral rules to trade in services and intellectual property rights. This potential will be exploited most effectively by countries with responsive supply structures and financial stability. Other countries will face net costs in addition to that associated with the expected initial increase in imported food bills as industrial countries curtail the unfair competitive advantage emanating from their hitherto substantial agricultural subsidization system. Thus, in the absence of changes in the overall level of preferential treatment, several countries will suffer an erosion in their "favored treatment," be it through a reduction in the value of their tariff concessions following the scheduled decline in overall tariff levels worldwide or through a loss in privileged access to certain markets. These developments are particularly important for the MENA region, which benefits from a wide range of preferential trading arrangements.

Labor Market

As noted above, labor remittances help the balance of payments accounts of several countries in the region and favorably influence investment performance as well. These remittances comprise

- transfers of earnings of workers residing outside the region, such as those employed in Europe
- transfers from workers in oil-producing countries of the MENA region
- earnings of Palestinians working in Israel.

The prospects for MENA labor migration to Europe must be viewed in the context of the European labor market. Unemployment in the EU is currently high, having averaged almost 12 percent in 1994. Although economic growth in these countries as a group is projected to remain at about 2½–3 percent a year through the rest of the decade, 1995 *World Economic Outlook* projections indicate that unemployment will remain over 10 percent on average in the period through 2000, reflecting structural rigidities in the labor market. Reforming the extensive network of institutional constraints and policies contributing to the high level of structural unemployment will inevitably take time. Dim prospects for reducing unemployment in the short term, together with the pressure that will arise as a result of changes in social policies and labor market practices, will limit demand

for migrant labor. Finally, the demand for MENA labor will likely be affected by the continued influx into the EU of workers from Eastern Europe and the former Soviet Union.

At the same time as employment opportunities in Europe are projected to decline, the potential for intra-regional migration—from the non-oil to the oil-exporting countries (mainly the GCC countries)—is expected to decline as well. With the current outlook for the oil market, the oil-exporting countries of the MENA region need to adopt strong fiscal adjustment and reform measures. In the short term, these measures will inevitably involve expenditure reduction with dampening effects on activities in which MENA nationals from the non-oil exporting countries are typically employed. Furthermore, structural reforms to reduce the size of government (typically the largest employer of nationals) need to be accompanied by improved employment opportunities for nationals, including types of work traditionally available to immigrant workers. Indeed, in the face of economic contraction, several countries have already adopted policies to encourage greater participation of nationals in the labor force.

Finally, the market for Palestinian labor in Israel will continue to depend on security issues influencing Israel's border policy. In addition, the increasing influx of Asian labor is likely to reduce the demand for Palestinian labor in the Israeli economy.

International Capital Markets

A dramatic integration and globalization of capital markets occurred in the first half of the 1990s, providing some developing countries with access to external financing to supplement domestic resources in funding investment opportunities. This financing took the form of foreign direct investment flows to "emerging equity markets" and access by developing countries to bond and equity markets in industrial countries. Net capital inflows to developing countries rose from an annual average of $10 billion over 1983–89 to $125 billion in 1994. While foreign direct investment—which rose from $12 billion to $56 billion over this period—represented an important component of this increase, the rise in portfolio investment—from $1 billion to $62 billion—was even more striking. However, these aggregate figures mask the regional diversity in the composition of flows. The surge in portfolio flows has been much more marked in Latin America than in Asia, where foreign direct investment has

been the largest component of capital inflows. At the same time, and as demonstrated by the December 1994 financial crisis in Mexico, the process has involved risk, particularly increased vulnerability to capital outflows triggered by changing market sentiment in response to weakening economic fundamentals or adverse contagion effects.

The development of local capital markets and their integration into the international capital market are less advanced in MENAcountries than in Latin American and Asian economies. Typically, equity markets in the region are undercapitalized and in a number of cases are closed to foreign investors. As a result, Arab countries account for only a negligible flow of funds into equity markets in developing countries.

In recognition of the need to attract sustainable inflows of private capital and given the potential for capital markets to finance productive investments, many MENA countries are emphasizing financial sector reform (bank and capital markets) to encourage the mobilization of funds from domestic, regional, and international sources, and to minimize the associated risks. However, these efforts coincide with a reassessment of market perceptions regarding flows from industrial to developing countries. The reassessment reflects two developments. First, after declining sharply in 1991–93, short-term nominal yields rose in 1994 in several industrial countries (the United States in particular). This rise has, ceteris paribus, reduced the attractiveness of developing country instruments. Second, the Mexican crisis of December 1994 by heightening perceptions of developing country risk, has slowed international diversification by investors in industrial countries. As a result, developing countries need to compete for private flows from more cautious investors—this at a time of growing pressure on aid budgets in most industrial countries.

Regional Environment

Changes in the regional environment have affected the region's economic outlook and the way trading partners and domestic and foreign investors view the region.

Peace Process

The region is closer than ever to resolving the long-standing Arab-Israeli conflict. This conflict has adversely affected economic development in certain countries of the region. By contributing to what is the largest military outlay among developing country regions, the conflict has

accentuated macroeconomic imbalances and diverted resources from productive investments in infrastructure and in the social sectors. By aggravating perceptions of sociopolitical risks, it has discouraged investment in certain countries. It has also inhibited efficient regional projects for electricity, water management, and tourism.

The establishment of a comprehensive, just, and durable peace in the Middle East is expected to result in a significant economic peace dividend, provided it is accompanied by sound economic policies. How much the peace dividend is worth is difficult to estimate, but military spending cuts could over time lead to higher capital formation and less severe resource misallocation. The impact is expected to be large but will probably materialize with some lag.

This impact will be compounded by efficient welfare-enhancing regional projects, particularly in infrastructure. Water management is most frequently identified as a source of potential gain from regional integration, and discussions among the various parties on how to develop and manage the limited and rapidly depleting water resources have already begun. Similar growth and development opportunities would clearly be enhanced for all MENA countries by a regional approach to sharing energy resources and developing an efficient energy distribution system. A coordinated approach to the development of a regional transport network would also be advantageous for all parties. Tourism has growth potential in many countries of the region, and larger tourist inflows would benefit from both a more integrated transport system and a regional approach to the promotion of this sector.

Closer Integration with the EU

The EU's Mediterranean Basin Initiative aims, in the economic field, at the gradual creation of a Euro-Mediterranean Economic Area. This initiative emphasizes the private sector as the engine of growth and the establishment of a free trade area, initially between the EU and individual MENA countries and subsequently between the EU and MENA as a region. Agreements on free trade areas have already been reached with Israel, Morocco, and Tunisia. Negotiations are under way for Algeria, Egypt, Jordan, and Lebanon. Establishing the Euro-Mediterranean Economic Area will involve transitional costs for countries in the region, particularly as their economic structure adjusts to a higher degree of foreign competition. To alleviate these costs, the EU Council will provide

ECU 4.7 billion of grant assistance in 1996–99; a similar amount (in loans) is to be forthcoming from the European Investment bank. Accordingly, some $12.5 billion will be available, to be disbursed on the basis of each recipient country's progress in implementing economic reforms. The welfare gains associated with this initiative would materialize from improved efficiency as a result of growing competition, somewhat better (albeit not dramatically better given existing preferential arrangements) access to EU markets, and improved domestic and foreign investment flows associated with "policy credibility" resulting from closer integration with the EU.

Policy Challenges

This pamphlet's historical analysis suggests that, with notable country exceptions, the region's broad policy response has been insufficient to exploit fully its considerable potential. Looking forward, the economic challenge is made more grave by the subdued outlook for the external environment. In this context, this section presents an overview of various countries' policy initiatives and a review of the eight policy issues facing most, if not all, the economies in the region. Detailed specification, prioritization, and sequencing of the policy measures are left to individual country analyses, which are beyond the scope of this pamphlet.

Background

Several countries (including Egypt, Israel, Jordan, Mauritania, Morocco, and Tunisia) have implemented more or less sustained macroeconomic policy reforms in recent years, focusing on fiscal adjustment supported by a tight monetary policy. In these countries, except Israel, the adjustment was supported by International Monetary Fund arrangements for at least two years during 1989–94. They have made headway in reducing their budget deficits, bringing down inflation rates, and improving external performance (growth and diversification of exports, size of current account deficits, and level of foreign exchange reserves). The improved economic performance was aided by progress in implementing structural reforms, particularly by Israel, Jordan, Morocco, and Tunisia.

The oil-exporting economies have also intensified adjustment efforts and structural reform. Initially, these countries focused on expenditure reduction in the face of lower oil revenues and a reduced flow of investment

BOX 2. SAUDI ARABIA: SIXTH DEVELOPMENT PLAN

Saudi Arabia's Sixth Development Plan (1995–2000) targets the elimination of the budget deficit, continued restructuring and diversification of the Saudi Arabian economy in the context of increased private sector participation, and the development of human resources. The budget deficit is to be eliminated by the year 2000 through increases in non-oil revenues and containment of expenditures. Revenues are to be mobilized mainly through higher fees and charges for publicly supplied goods and services (including utilities) and reduced subsidies. Such an approach would also improve resource allocation in the Kingdom, thus facilitating efficient economic diversification.

To expand the private sector, the plan calls for privatizing a range of commercial activities currently undertaken by the Government and for identifying new investment opportunities for the private sector. Foreign direct investment is to be emphasized and domestic capital markets further developed to mobilize private investment. For human resource development, the plan targets a shift in education and training priorities to meet the expanding demand for skilled manpower in the private sector and to employ efficiently the growing number of nationals entering the labor force. Expenditures are to be shifted toward expanding the capacity of technical and vocational training, as well as higher education institutions.

income. Then they concentrated on enhancing non-oil revenues, as illustrated by the measures introduced in the 1995 Saudi Arabian budget. In addition, several countries (including Algeria, Kuwait, the Islamic Republic of Iran, Oman, and Saudi Arabia) have elucidated medium-term programs with a defined path for further deficit reduction, structural reform measures, and human development policies in a general framework emphasizing the private sector in production and investment (Box 2).

A number of other countries (such as Djibouti, Iraq, Libya, Somalia, Sudan, the Syrian Arab Republic, and the Republic of Yemen) are yet to put in place sufficiently comprehensive adjustment and reform programs, although some (including Djibouti, Sudan, and the Republic of Yemen) have initiated important policy efforts. Given the nature of the countries' economic difficulties, these efforts aim, in the first instance, at reducing unsustainable domestic financial imbalances pending the full effectiveness of structural reform measures. In the case of Lebanon, policymakers face the twin challenge of reconstruction and stabilization.

BOX 3. ISRAEL: SOME ECONOMIC CHARACTERISTICS

Israel differs in its economic circumstances from most countries in the region.

- Its economic structure is the most akin to that of an industrial country. Moreover, a distinguishing feature of its industrial sector is the preponderance of high-tech industries.
- Its economy is highly integrated in the world economy. This integration has deepened in recent years as a result of free-trade agreements with the United States and the EU. It is presently engaged in a program of unilateral tariff reduction with "third" countries in the Far East, Latin America, and Eastern Europe.
- Israel passed in 1992 a Domestic Deficit Reduction Law requiring the progressive elimination of the budget deficit. In compliance with this law, and notwithstanding the absorption of over 700,000 immigrants from the former Soviet Union since 1989, Israel's overall budget deficit was reduced to 2 percent of GDP in 1994. This was done in the context of significant tax reforms accompanied by financial sector liberalization.
- Since December 1991, Israel has followed a "diagonal" exchange rate policy in terms of which the central rate of the currency is depreciated at a preannounced rate and a band of plus or minus 7 percent is maintained around the central rate. This exchange rate system is complemented by specific annual inflation targets. These policies have contributed to a reduction in inflation from around 20 percent following the 1985 Stabilization Plan to its present level of less than 10 percent.

Remaining Policy Challenges

Since MENA countries differ in progress made in recent years in addressing macroeconomic imbalances and implementing comprehensive structural reforms, their starting point and the nature of the remaining policy challenge vary from country to country (Box 3). Nevertheless, the region faces a demanding economic and financial policy agenda, with priorities depending on individual country circumstances.

Even countries that have made significant progress in recent years recognize that adjustment and reform are a continuous process. The process places a premium on maintaining the momentum of a comprehensive approach, sequencing major policy initiatives appropriately, undertaking the necessary adjustments in a timely manner especially in response to unan-

ticipated exogenous developments, and establishing and maintaining the required institutional backing and human capabilities.

Most reform measures involve short-term costs. While this is unfortunate, it is virtually unavoidable, given the resource reallocation requirements. The focus must, therefore, be on minimizing these costs through proper planning and sequencing of policies, offsetting the costs by the gains realized by adjustment and reform and protecting the most vulnerable members of society.

With these factors in mind—and at the cost of unavoidable overgeneralization in a paper covering so many countries—MENA's policy agenda may be thought of as consisting of eight items:

- intensifying measures to privatize and deregulate economic activity
- reforming public finances
- improving the functioning of labor markets
- strengthening human resources
- enhancing domestic and foreign investments
- improving financial intermediation
- liberalizing external trade and payments
- ensuring a supportive macroeconomic (fiscal/monetary/exchange rate) policy mix.

Privatization and deregulation policies improve the productivity of the overall economy and strengthen its ability to compete in international markets. First, such policies can improve the operational efficiency of public enterprises, and thereby limit the drain on government budgets. Second, given the potential availability of substantial domestic and external investible resources, these policies can help upgrade the region's capital stock. Third, given the legacy of government dominance in many countries in the region, they are the authorities' most potent policy instruments to signal to the private sector their commitment to growth led by that sector. Fourth, more realistic pricing of goods and services (including critical resources such as water) can enhance efficiency.

The experience of other countries (industrial and developing) suggests that the region's largely ad hoc approach to privatization will give way to a more systematic approach. This implies the formulation of multiyear programs, which in addition to dealing with small enterprises also extend the policy effort to large corporations in the utilities, airline, finance, and telecommunication sectors (Box 4). The design of these programs must

Box 4. Morocco: Privatization

Following a program of public enterprise restructuring starting in 1981, the Moroccan parliament enacted a privatization law that came into effect in 1990. The law listed 112 enterprises to be privatized, accounting for 40 percent of the state's portfolio, including major commercial banks, financial holdings, large industrial enterprises, and a number of hotels. Based on the law, the regulatory and administrative framework for privatization was subsequently put in place. Actual sales of enterprises started in 1993, and the pace gathered momentum during 1994–95. In early 1995, the parliament amended the privatization law to include two large refineries and extended the period during which privatization was authorized from end-1995 to end-1998.

By mid-1995, 34 enterprises had been privatized, including a large commercial bank, the state's biggest financial holding company, and various smaller enterprises and hotels, yielding about DH 5.3 billion in total budget receipts (US$0.6 billion or 1.9 percent of the 1994 GDP). The methods of privatization varied, and included tenders, direct negotiations, and sales through the stock market. In a number of cases, a small part of the company's shares was sold to its employees at discounted prices. Sales to "core" investors were conducted on the basis of competitive tenders or direct negotiations; buyers typically had to commit to a number of obligations concerning investments and to a minimum duration of involvement. The privatization program contributed to the development of the stock market and attracted foreign equity investment. Furthermore, employment generally increased in the privatized firms.

The Government is now preparing a second phase that would extend privatization to hitherto excluded sectors. In addition, it is opening to private sector activity certain services that were previously in the exclusive domain of the state or the municipalities, such as electricity generation and management of urban water and energy distribution.

identify the potential sources of financing, including tapping external markets. Finally, the programs need to be closely linked to social safety net/labor retraining measures to minimize associated welfare costs.

Reform of public finances is of utmost importance in most MENA countries to strengthen domestic savings and reduce the vulnerability to exogenous shocks. On the revenue side, efforts need to focus on improving elasticity and the efficiency of the tax system. In several countries, this involves a reorientation away from trade taxes and in favor of broad-based

BOX 5. EGYPT: FISCAL ADJUSTMENT

Egypt undertook a significant fiscal correction as part of the adjustment and reform program launched in early 1991. The fiscal correction aimed at reducing fiscal deficits and improving the structure of the budget.

After averaging 16.5 percent of GDP annually between 1985/86 and 1990/91, the overall deficit was cut to 5 percent of GDP in 1991/92 and reduced further to under 2 percent of GDP in 1994/95. The primary budget surplus amounted to 8 percent of GDP in that year.

A number of structural fiscal reforms were implemented to ensure the sustainability of the fiscal adjustment. Tax reforms focused on addressing low elasticity, inefficiency, and heavy reliance of the tax system on external trade through the introduction of a broad-based domestic sales tax, the unification of income tax schedules, and the implementation of trade reform. Expenditure reform centered on streamlining the extensive system of general food and non-food subsidies. In addition, current transfers to public economic authorities were eliminated through improved efficiency, rationalization of their operations, and self-generation of revenues.

domestic consumption taxes (Box 5). In the oil economies, changes in the structure of revenue would need to reduce dependence on oil revenues. Finally, new tax measures need to be accompanied by improvements in administrative efficiency and tax enforcement.

On the expenditure side, improving the quality of public expenditure programs will enhance their contribution to economic growth. Such a strategy implies reductions in unproductive outlays, including defense spending, and rationalization and better targeting of subsidies. Such efforts need to be accompanied by civil service reform aimed not only at reducing the government's wage bill but also at improving the efficiency of government operations. For some countries in the GCC, civil service reform entails reducing the predominant role of the government as supplier of jobs and removing wage distortions that bias employment in favor of the public sector. In contrast, for other countries (such as Egypt, the Islamic Republic of Iran, and the Syrian Arab Republic), a reduction in numbers would need to be accompanied by *upward* adjustments in the salary packages of the remaining civil servants. Moreover, most countries in the region would benefit from a rationalization of government departments and agencies.

These factors can improve the overall efficiency of the economy by limiting the cost to the private sector of dealing with the bureaucracy. Surveys of private investment decisions suggest that the now infamous bureaucratic structure of several Middle Eastern economies acts as a major disincentive to investment, especially foreign investment. Once again, it is critical that the civil reform be sequenced properly with social safety net/retraining measures to limit the cost of unemployment.

Reform of the labor markets is the other essential component in limiting unemployment and in improving the potential of MENA countries to create jobs. First, the cost of private employment should be reduced by eliminating various direct and indirect surcharges. Second, the hiring and firing process should be more flexible. International experience indicates that constraints on firing (such as obtaining government approval for layoffs) can be a disincentive to hiring and can increase informal market activity, which in some cases does not provide labor with minimum safeguards. Third, government employment guarantees should be replaced by a transparent system of closed-end unemployment schemes. Moreover, in some countries where wide-scale privatization and public sector reform is needed, labor retraining schemes should be emphasized.

The *human resource* base of countries in the region must be strengthened through better education systems, particularly the education of women. The experience of other developing countries shows that better female education can also reduce population growth. Recent studies also support shifting limited resources from the tertiary sector to the primary and secondary sectors, and, in some countries, favoring vocational training over academic studies.

These four measures can contribute to *enhancing domestic and foreign direct and portfolio investment* (Box 6). In several countries, additional steps are needed to facilitate investment procedures at the local level and to reduce barriers to entry for foreign investors. Determined actions in these areas, along with a stable macroeconomic environment, promise greater returns than the current approach based largely on incentives, concessions, and "offset programs." (Under the offset programs in operation in several GCC countries, foreign firms awarded government contracts are required to invest a certain portion of the contract value in joint ventures with locally owned firms.) The current approach entails for certain countries in the region significant fiscal costs without clear additional investment; it can also obfuscate the pricing of contracts.

Box 6. Jordan: Improvements in Investment Environment

As part of its macroeconomic adjustment and structural reform program, Jordan has implemented several measures to strengthen private investment. This recently accelerated effort includes improvements in investment legislation, the rationalization of the income tax law, and the liberalization of the exchange and payments system.

The new Investment Law allows for equal treatment of all investors, eliminates the need for cabinet approval for foreign investment, specifies clearly the sectors open to 100 percent foreign ownership, provides firm guarantees against nationalization and expropriation, specifies the sectors eligible for tax incentives, eliminating discretionary judgment, opens the financial market to all foreign investors, and provides for third-party dispute settlement consistent with international practice.

This new law is to be complemented by another law governing the operations of the Amman Financial Market (AFM). The latter aims to improve and restructure the operations of the AFM, increase the number of instruments traded, and establish transparent rules and uniform treatment for all foreign investors.

Amendments to the Income Tax Law were also passed by parliament. Elements under the amendment to the Corporate Income Tax Law include (1) the reduction of the number of tax rates and of the maximum tax rates of corporate income taxes; (2) the rationalization of corporate income tax rates, treating all sectors equally; (3) the simplification of exemptions; and (4) a withholding tax of 10 percent on distributed profits, encouraging capital accumulation.

Consistent with its private sector and outward-oriented growth strategy, Jordan has also taken steps to further liberalize its exchange and payments system, eliminating restrictions on current account transactions. Furthermore, a draft law on the Regulation of Foreign Exchange Transactions submitted for parliamentary approval guarantees complete current account convertibility for residents and nonresidents, and capital account convertibility for nonresidents, including lifting all restrictions on the repatriation of profits and dividends for foreign investors. It also allows residents to engage in a number of capital account transactions and to take out any funds originally brought into Jordan through the banking system.

The *strengthening of the financial intermediation system* will enhance financial savings, channel resources to the most productive sectors (Box 7), and ensure that larger inflows of foreign investment do not destabilize the domestic financial system. Such strengthening comprises three

BOX 7. TUNISIA: FINANCIAL SECTOR REFORM

In the context of a comprehensive economic adjustment and reform program, Tunisia has since 1987 liberalized the banking system, strengthened the position of financial institutions, and promoted the development of the financial sector. Bank-specific credit ceilings have been replaced by indirect instruments of credit control, the elimination of the requirement for prior authorization of loans, the partial deregulation of interest rates and the simplification of their structure, and the creation of an interbank money market.

Central bank intervention in the money market has become the main instrument of monetary policy. Since 1994, interest rates have been liberalized (with only small exceptions), and the mandatory acquisition of public debt instruments abolished. The new banking law provides for the creation of investment banks and a gradual introduction of universal banking. To reinforce the financial position of the banking system, prudential regulations were upgraded, banking supervision improved, and the capital base of several institutions strengthened.

Other efforts support the development of financial markets. Certificates of deposit, commercial paper, investment certificates, and treasury bills have been introduced and the creation of investment funds has been encouraged. Also, in March 1994, an interbank foreign exchange market was established. With large participation by the banks, 80 percent of all foreign exchange transactions now take place outside the central bank.

To support rapidly increasing equity activities, the reform of November 1994 separates the activities of the stock exchange, which has become a private entity, from the supervisory functions, which are entrusted to a new independent institution. The volume of transactions on the stock market rose from D 162 million in 1993 to D 531 million in 1994, and the volume of stocks traded increased from 4 to 15 million during the same period. Capitalization rose to 15.8 percent of GDPin 1994 as compared with 6.8 percent of GDP in 1993.

elements. First, exposing financial institutions to competition involves for some countries privatizing large public sector banks (for example, Algeria, Egypt, and Tunisia), and for others facilitating the entry of foreign financial institutions (for example, in the GCC). Second, removing remaining controls on rates of return, charges for loans, and credit allocation as a further step toward indirect monetary control will facilitate transparent and nondistortionary financing of a wider range of productive activities.

Third, bringing the prudential regulatory and supervisory regimes into line with international standards will reduce the risks of costly financial problems and enable institutions in the region to compete in international markets on a more firm footing.

The largely bank-based financial systems of MENA countries need to be broadened and those markets internationalized. Equity markets could mobilize resources from domestic, regional, and international sources and allocate them to productive investments in support of growth and development. The need to exploit this potential is especially important now because aid flows appear to be slowing and international competition for private capital is increasing. Conditions need to be established for clear property rights, more effective settlement and custody systems, more transparent conditions for trading, a level playing field among financial instruments, and appropriate repatriation of capital and dividends.

The *liberalization of the external trade and payments regime* complements domestic deregulation and enhances welfare-improving competition. It also reduces the cost of production, encourages the inflow of productivity-enhancing foreign capital and technology, and leads to a rapid growth of exports (particularly of the non-oil sector). It removes distortions that undermine economies' ability to respond to unanticipated changes in internal prices and demand and reduces costs to consumers.

Trade reforms should aim to reduce tariffs and simplify the tariff structure. These efforts need to be accompanied by reducing non-tariff barriers, eliminating remaining state trading monopolies, and harmonizing the institutional structure with that in most other market economies.

These efforts are indispensable to the region's attempt to promote non-oil exports and benefit from the globalization and integration of markets. They are also consistent with membership of the World Trade Organization and certain countries' ongoing efforts to increase their economic integration with the EU, as discussed in the previous chapter. It is widely accepted that credible membership in the multilateral trading system can enhance the effectiveness of countries' liberalization policies. Owing to the potential dislocation of trade reforms on certain firms, these efforts should be closely calibrated with the strengthening of the social safety net. Moreover, given the fiscal costs, trade reform must also be considered integral to budgetary-tax and expenditure reform.

The seven measures discussed so far aim at enhancing the supply responsiveness of the economies—an essential component of a sustained

growth and development strategy for the MENA region. International experience confirms that since the effectiveness of such measures also depends on the prevailing macroeconomic environment, a consistent and supportive *fiscal/monetary/exchange rate policy mix* is needed.

An appropriate mix requires careful calibration of these three policies to avoid crowding out private production, to restrain inflationary pressure, and to contribute to a strong and viable external position. Such a mix can be achieved through various configurations of policy measures. It is important in this regard that the measures be sustainable—that is, be part of strengthening the structure of the budgetary accounts (as discussed above in the case of the GCC) and a transparent and predictable system of exchange rate determination.

Conclusion

The MENA region possesses abundant human and natural resources, accounts for a large share of total world petroleum production and exports, and by international standards enjoys on average a reasonable standard of living. Countries of the region differ considerably in economic size, population, standards of living, public/private sector balance, natural resource endowments, external indebtedness, and trade and financial links with the rest of the world. At the same time, intra-regional interaction is small, being heavily weighted toward labor flows between certain countries, with rather limited trade in goods, and inadequate integration of capital markets.

The review of developments in the MENA economy during 1989–94 paints a mixed picture. On the positive side, overall GDP has grown and domestic financial imbalances have been reduced, reflecting efforts to lower budget deficits and enhance private savings. Financial sectors have been reformed, as have exchange rate regimes in a number of countries. Foreign assets, while reduced by recent drawdowns, are still significant.

Nevertheless, with a rapidly growing population, the region's per capita income has stagnated. Unemployment and underemployment have been insufficiently addressed, thereby aggravating social problems. Domestic saving remains low and constrains higher investment. Meanwhile, because the region's economy remains highly exposed to changes in its external environment, considerable fluctuations in the external terms of trade have been superimposed on a sharp deterioration of the terms.

As widely recognized by policymakers in the region, two basic issues ought to be addressed: long-standing structural weaknesses that have inhibited the economy's growth responsiveness and diverted productive resources out of the region and a poorly diversified economic and export base that has rendered most countries vulnerable to exogenous shocks.

Developments in the external environment will continue to affect the economies of the region. While growth of the world economy is expected to remain fairly robust, the indications are that MENA countries face an uncertain overall environment, with significant downside risks. The sensitivity of the region to international prices of oil and food is clear. The effects of the trade liberalization within the context of the Uruguay Round are more difficult to predict. It is clear, however, that policy changes are needed if potentially dynamic gains are to offset the static losses. Prospects for increased labor migration to Europe, as well as for intra-regional labor flows, are less favorable than in the past. Furthermore, recent developments in emerging capital market financing suggest that the countries of the region that have not yet attracted significant capital inflows may well have to compete in a more cautious investor climate.

To reduce the downside risks associated with the external environment and to strengthen their potential for achieving sustainable economic growth, the MENA countries will need to address rapidly their policy challenges. In view of this need, it is not surprising that structural reform is on the top of the economic policy agenda of virtually all countries in the region.

With these factors in mind, MENA's policy challenge may be thought of as consisting of eight items:

- intensifying measures to privatize and deregulate economic activity
- reforming public finances
- improving the functioning of labor markets
- strengthening human resources
- enhancing domestic and foreign investments
- improving financial intermediation
- liberalizing external trade and payments
- ensuring a supportive macroeconomic policy mix.

While such an agenda needs to be specified in greater detail at the individual country level, it is of relevance to most, if not all, countries in the

region. Its effective implementation would serve not only to increase MENAcountries'economic growth and employment potential, but also to reduce their vulnerability to adverse exogenous shocks. In the implementation, it is essential to address the short-term costs associated with resource reallocation. This involves proper planning and sequencing of policies and well-targeted social safety net provisions.

The policy challenges come at a time of renewed emphasis on integration efforts—within the region as well as with the EU. These efforts can help MENA economies to become more competitive internationally and exploit complementarities. They can contribute to improved resource allocation and boost investor confidence, but important qualifications must be kept in mind. First, regional integration efforts should support rather than substitute for multilateral trade liberalization. Second, integration schemes should be consistent and mutually reinforcing. Third, the rewards of integration will take some time to materialize and will materialize only if they are supported by appropriate domestic policy reforms.

For several countries in the MENA region—particularly the low-income economies—determined policy implementation needs to be accompanied by significant external assistance. Such assistance facilitates adjustment and reform provided it is available on a timely basis and on appropriately concessional terms.

With the combination of forceful domestic policies and external financial assistance to certain countries, MENA can look forward to reinvigorated growth and development. It would thus have a better opportunity to benefit from globalization and integration of the world economy while minimizing associated risks. Given the economic links in the region—through labor flows and, looking forward, more trade and private capital transactions—the beneficial impact of a generalized reform is substantial as individual country developments are augmented by welfare-enhancing region-wide effects. As a result, all countries in the region would be in a better position to exploit their considerable economic potential and meet the legitimate aspirations of their growing populations.

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