

OVERVIEW

The Middle East and North Africa (MENA¹) region has experienced exceptional growth over the last two years. Over 2003 and 2004, economic growth in MENA averaged more than 5.6 percent a year, the strongest growth in a decade, and up strongly from the 3.6 percent average yearly growth over the 1990s. On a per capita basis, the MENA region's 3.7 percent average growth over the last two years was the region's strongest growth performance since the mid-1970s (Table 1).

Accompanying this strong growth performance, unemployment – a critical development challenge affecting virtually every economy in the region – has declined with the rise in oil prices over 2000-2004. Unemployment is estimated to have fallen from about 14.9 percent of the labor force in 2000 to 13.4 percent currently, the result of a 37 percent increase in the rate of employment creation over the 1990s. In many respects, the MENA region is in the midst of an economic boom.

However, there are caveats to the region's growth acceleration. For one, it has not been especially broad based. Comparing growth over the 1990s with growth over the last two years, 97 percent of the regional growth upturn was driven by just four countries – Saudi Arabia, the Islamic Republic of Iran, Algeria and the United Arab Emirates. In fact, nearly half of the region actually experienced growth downturns relative to the 1990s.

Moreover, MENA's recent positive economic developments have been driven largely by external events – in particular, dramatically rising oil prices. The escalation in oil prices and increased production from the major MENA hydrocarbons producers boosted oil export revenues more than 75 percent between 2001 to 2004, providing the region a strong impetus to growth through acceleration of domestic spending, particularly via government consumption and investment. In all, the region's increase in government spending and investment accounts for almost two-thirds of the increase in growth experienced from the 1990s.

And importantly, on a per capita basis, the MENA region's growth over the last two years continues to lag that of other regions, a reflection of both the firming of GDP growth rates across developing regions and the MENA region's high population growth. At the regional level, per capita growth in East Asia and the Pacific, South Asia, and Europe and Central Asia all significantly outpaced MENA's per capita GDP performance in both 2003 and 2004. And, with two year averages of 4.6 percent and 4.0 percent, respectively, during 2003-2004, the sub-

¹ The MENA region, as defined in this report, includes Algeria, Bahrain, Djibouti, Egypt, the Islamic Republic of Iran, Iraq, Jordan, Kuwait, Lebanon, Libya, Morocco, Oman, Qatar, Saudi Arabia, Syria, Tunisia, the United Arab Emirates, West Bank and Gaza, and the Republic of Yemen. Iraq, Libya, Qatar and West Bank and Gaza are not included in regional trends or forecasts due to a lack of data availability (although references to individual indicators may occur where data availability permits). Lebanon is included in growth, per capita and per laborer growth, and unemployment analyses only, unless otherwise indicated. In the few cases where Djibouti data exists, this data is presented but has not entered into regional aggregates.

regional groupings of Latin America and the Caribbean (excluding Brazil) and Sub-Saharan Africa (excluding South Africa) have also outpaced MENA's average per capita growth of 3.5 percent for the same period.

The MENA region has experienced two major economic shocks in recent years. One has been skyrocketing oil prices and the resultant revenue boon. The second has been the conflict in Iraq and its subsequent reconstruction and reintegration. For Iraq itself, the changes since 2003 have been extraordinary. While the formal war ceased quickly and democratic national elections were held in early 2005, the incidence of violence and sabotage attacks continue, severely disrupting trade and investment flows and the Iraqi reconstruction effort. Answering the critical need for re-energizing the reconstruction and improving economic conditions, in order to counter widespread poverty and high unemployment, will depend on progress on the security front.

For the broader region, negative spillover effects of the conflict have been limited, in part because Iraq had been, to a large degree, economically isolated from the rest of the region. Countries with strong economic ties to Iraq – Jordan and Syria – were the most affected, primarily by way of higher energy import bills and trade disruptions. The potentially large indirect effects on the broader region – substantially reduced foreign direct investment, portfolio inflows and tourism because of increased risk perceptions – appear to have been limited. In terms of Iraq's reconstruction, however, many countries in the MENA region are poised to reap numerous potential economic dividends, including trade and business activity related to the reconstruction and reintegration effort.

An increasing and potentially important development in the region has been an apparent strengthening of intra-regional economic ties, strongly heightened after 2001 and evidenced through trade and financial flows and tourism. With a temporary pullback from US financial markets, MENA investors have increasingly sought returns in markets closer to home, which has supported a sharp rise in regional real estate and equity prices. Over 2004 alone, Middle East equity markets rose by more than 60 percent, the strongest performance in the world. Intra-regional tourism has also advanced sharply, partly as a response to the imposition of travel restrictions in the US and in parts of Europe. Tourist arrivals from within the region rose from only 22.4 percent of total tourists in 1999 to 40.8 percent in 2002. And intra-regional trade, while still largely unexploited, has ticked up from 6.8 percent of total exports in 2000 to 8.0 percent in 2003.

The strong upturn in oil prices and the rapid accumulation of financial assets by MENA oil producers in many ways evokes memories of the oil price booms of the 1970s and 1980s. And with those memories emerge questions of what the fall-out of this current oil boom will be – particularly whether the way the revenues have been managed has changed from past booms and whether the current windfall revenues will slow the reform process.

Overview Table 1
Summary: Global developments and MENA GDP growth

<i>growth, or as specified otherwise</i>	Averages 1990-2000	2002	2003	Estimate 2004	Projections 2005	2006
World trade /1	6.6	3.7	5.6	10.3	7.7	7.7
Industrial country imports	6.7	2.4	3.2	7.6	6.1	6.8
Euro Area	6.1	0.7	2.0	5.8	6.1	7.1
United States	9.3	3.4	4.4	9.9	5.0	6.4
Oil prices (\$/bbl) average /2	19.1	24.9	28.9	38.0	40.0	36.0
Non-oil commodity prices /3	-1.4	5.1	10.2	17.5	4.7	-5.2
MUV index /4	-0.3	-1.3	7.5	7.0	3.0	2.8
U.S. dollar LIBOR (6-month)	5.6	1.8	1.2	1.6	3.5	4.6
World GDP /5	2.7	1.7	2.5	3.8	3.1	3.1
Industrial countries	2.5	1.3	1.8	3.1	2.3	2.5
Developing countries	3.2	3.4	5.3	6.6	5.7	5.2
MENA /6	3.6	2.9	6.1	5.2	4.9	4.3
Resource-poor, labor-abundant	4.0	3.0	4.0	4.2	4.4	5.0
Resource-rich, labor-abundant	3.4	6.1	6.3	6.0	5.7	4.8
Resource-rich, labor-importing	3.5	0.5	7.2	5.2	4.8	3.6
Memo: per capita GDP						
Developing countries	1.6	2.1	4.0	5.3	4.4	4.0
MENA	1.4	0.7	4.0	3.1	2.9	2.3
Resource-poor, labor-abundant	2.0	1.0	2.2	2.4	2.6	3.2
Resource-rich, labor-abundant	1.2	4.1	4.4	4.1	3.7	2.9
Resource-rich, labor-importing	0.5	-2.9	3.7	1.7	1.3	0.1

Source: World Bank, Global Development Finance-2005

Notes: /1 World imports of goods and non-factor services in 1995 dollars. /2 World Bank average oil price (WTI, Brent, Dubai).

/3 World Bank index of non-oil commodities. /4 Manufactures unit value in US dollar terms. /5 GDP in constant 1995 dollars.

/6 MENA geographic region, comprised of: Resource-poor, labor-abundant countries (Egypt, Jordan, Morocco and Tunisia); Resource-rich, labor-abundant countries (Algeria, Iran, Syria and Yemen) and Resource-rich, labor-importing countries (Bahrain, Kuwait, Oman, Saudi Arabia and the United Arab Emirates).

Although fiscal expenditures have risen sharply with rising oil revenues (supporting the exceptional growth upturn), there is evidence—given generally large fiscal and external surpluses—of the adoption of a more prudent spending stance by oil exporters compared to previous boom periods. Comparing net changes in oil export revenues with net changes in the current account balance gives a clearer indication of how much of the windfall revenue has been saved and of how much has been spent. During the current boom, roughly 25 percent of the additional export revenue has been spent. This compares with nearly 60 percent during the 1973 boom.

In addition to relatively smaller spending advances, there has been a draw-down of external debt obligations across the board during the current oil revenue boom, as well as a significant accumulation of foreign exchange reserves, which can provide a buffer for the external account, should oil revenues unexpectedly decline rapidly. The reserve build-up can also help to partially insulate MENA's oil exporters from the short-run disturbances of Dutch disease. To date, non-oil export growth has been healthy, even outpacing oil export growth over the last three years. The beneficial impacts from the US dollar depreciation (to which many oil exporter currencies are pegged) have aided the competitiveness of the non-oil export sector.

In part, the more prudent spending stance reflects the fact that the initial positions of the oil producers have substantially changed. The overhang from spending in earlier booms has in many ways guided current spending. In part, the greater prudence reflects a change of thinking over past decades in terms of economic direction. In virtually every oil-producing economy in the region, significant challenges in employment creation have emerged. With this challenge has come the widespread recognition that oil exporters need to move to alternative sources of growth and job creation. At least notionally, all of the oil producing economies espouse reform. At the same time, oil continues to provide a powerful buffer to addressing fundamental economic reforms, partly evidenced by the current build-up in temporary public employment schemes.

In looking forward, shifts in external factors are again likely to predominate the shaping of the short-term growth profile for MENA. Oil prices are expected to ease moderately by 2006—affecting prospects for the oil-dominant MENA economies, countered in part as European growth conditions improve and support stronger recovery among the diversified economies of the region. Oil prices are viewed to ease only moderately from \$38/bbl in 2004 to \$36/bbl by 2006² as the current strength in demand begins to unwind with a maturing global expansion. But prospects for continued gains during 2005 have risen, with global oils prices approaching \$40/bbl in the interim. Recovery in Europe should eventually be abetted by diminishing inflation, boosting real incomes and domestic spending—though the current strength of the Euro remains an impediment to exports. And assuming that a generally favorable outturn to the current uncertain situation in Iraq transpires over the period, the outlook for MENA is one of continued solid growth, amounting to 4.9 percent and 4.3 percent in 2005 and 2006, respectively.

Despite the enhanced growth prospects (relative to the last decade), current forecasted growth rates remain insufficient for fundamentally addressing the large development challenge in MENA with regard to employment creation. Close to 100 million³ new jobs will be needed over the next 20 years to keep pace with new labor force entrants and absorb the current unemployed. This means that the number of jobs in the region needs to double during that period, which will require real economic growth rates averaging 6 to 7 percent a year for a sustained period of time. This is close to double the region's rate of economic growth over the 1990s and still a quarter higher than the exceptional growth rate of the past year.⁴

For the region to be able to meet this extraordinary challenge, it will need to transition to an economic model that enables it to substantially develop its employment-creating growth potential. At its foundation, this structural transition will require three fundamental and interrelated realignments: (1) *from closed to more open economies*, to create more competitive industries, benefit from international best practice, and gain access to new technology; (2) *from public sector dominated to private sector led economies*, providing the basis for improved efficiency and

² World Bank average price, which gives equal weighting to WTI, Brent and Dubai crude oil prices.

³ Includes Iraq, Libya, Qatar and West Bank and Gaza.

⁴ Required economic growth calculated assuming an optimistic elasticity of employment growth to economic growth of 0.6 – the same employment elasticity exhibited by several the high-performing East Asian economies during the height of their employment generation.

expansion of employment; and (3) *from oil dominated to more diversified economies*, to reduce the region's dependence on volatile sources of growth, maintain fiscal stability, and preserve important social expenditures. Achieving this realignment requires interrelated policy actions on several fronts, including improved governance, particularly with regard to strengthening inclusiveness and accountability, as well as enhancing the inclusion of female labor in the private sector to increase the flexibility of the labor force and make better use of the region's talents.⁵

The impact of such an integrated realignment is potentially very large, with conservative estimates of the increase to output growth per worker from actions on all fronts of between 2.5 and 3.5 percent per year⁶. This is an enormous potential boost to output per worker. Over the 1990s, output growth per worker in the region averaged less than 1.0 percent per year. The importance of the region's success with this transition can thus hardly be overstated. Examining the region's efforts on the structural reform front, then, is paramount to understanding the region's longer term economic prospects.

In evaluating the recent progress in various aspects of reform, the region has, by and large, not kept pace with worldwide progress. Trade reform stands apart as an area in which the region has exhibited notable progress. Motivated in part within the context of regional and bilateral trade agreements, several MENA countries have made considerable progress in reducing tariffs and dismantling non-tariff barriers to trade. On average, simple tariffs in the region declined from an average of 22 percent in 2000 to slightly more than 15 percent by 2004, a 30 percent decline in the tariff rate – well above the 19 percent decline observed in the developing world. As a result, the MENA region ranks in the 71st percentile worldwide in terms of improving its world standing with regard to import tariffs (Table 2).

However, in other areas of reform, the region has lost considerable ground compared with the progress taking place worldwide. MENA's progress on reforming the business environment has been the weakest in the world, and on average, the MENA countries rank in the bottom third of the world in terms of improvements across a range of business regulatory and financial sector reforms. The pace of reform in politically difficult areas, such as reform of the judiciary for improved contract enforcement, has been especially weak.

⁵ World Bank 2003c.

⁶ World Bank 2003e.

Overview Table 2: Progress with structural reform, 2000-2004^a

Country	Trade Reform		Business and Regulatory Reform		Governance Reform	
	Current status	Reform progress	Current status	Reform progress	Current status	Reform progress
Algeria	5	66	26	54	32	61
Bahrain	..	..	..	..	42	30
Djibouti	..	..	..	..	30	17
Egypt	60	100	29	11	28	24
Iran, Islamic Republic	4	76	63	37	36	14
Jordan	20	86	57	43	44	61
Kuwait	..	..	77	16	42	14
Lebanon	81	87	33	9	32	1
Libya	..	..	..	..	3	10
Morocco	1	49	62	62	40	42
Oman	..	..	60	58	37	56
Qatar	..	..	..	..	31	57
Saudi Arabia	76	88	52	47	26	35
Syrian Arab Republic	..	..	17	2	21	..
Tunisia	1	49	79	74	35	6
United Arab Emirates	..	..	32	4	36	3
West Bank and Gaza	..	..	..	..	23	..
Yemen, Republic	..	..	42	24	24	79
MENA	35	71	48	34	30	32
Sub Saharan Africa	29	21	27	36	34	47
East Asia Pacific	55	49	47	40	41	49
Europe Central Asia	72	64	52	61	51	54
Latin America	49	56	39	45	56	46
OECD	93	67	89	73	88	65
South Asia	25	43	49	48	35	55
LMIC (excluding MENA)	38	63	44	47	45	47
World	50	50	50	50	49	50

Notes: /a Periods of analysis may vary, depending upon indicator. For each indicator, current status reflects the country's current placement in a worldwide ordering (distribution) of countries based on that (composite) indicator, with 100 reflecting the country with "best" policies, and 0 reflecting the country with the most burdensome/restrictive policies. Reform progress reflects the improvement in a country's rank between 2000 and 2004 (or period available), with 100 reflecting the country which exhibited the greatest improvement in rank and 0 reflecting the country which exhibited the greatest deterioration. LMIC = Lower middle income economies, defined as countries with gross national income per capita between US\$765 and \$3,035 in 2003.

Of greater concern is the lack of progress that has been made in improving governance in the region. Although it has many facets, governance can broadly be separated into two broad areas: the *quality of public administration* – the efficiency of the bureaucracy, the strength of the rule of law and protection of property rights, and the control of corruption and quality of regulations; and, *public sector accountability* – how well citizens can access government information and hold their political leaders accountable. Although the region can point to a few successes in improving the quality of public administration since 2000, in the area of public sector accountability, the region's progress has been the poorest in the world. Despite the fact that the region ranks at the bottom in terms of public sector accountability and has the longest reform path to travel (on

average, ranking in the 27th percentile worldwide), virtually no country improved its worldwide standing in this area, and most countries showed a marked deterioration relative to the progress occurring worldwide. As a result, the MENA region on average ranked in the 27th percentile worldwide in terms of progress in improving public sector accountability, and in the 32nd percentile worldwide in terms of improving overall governance.

Although each area of structural reform is important in its own right, the lack of progress in governance reform, and in particular public sector accountability reform, is of concern because of what it implies for the success of a broader economic reform effort. International experience with structural reform suggests that where reforms have been successful, there have been strong coalitions for change. But the ability for coalitions to press for reforms depends on access to information to formulate choices, the ability to mobilize, and the ability to contest policies that are poor, all areas of governance in which the region ranks poorly worldwide and demonstrates limited progress.

The region's weak progress with business regulatory reform is evidence of current governance limitations. MENA has demonstrated some success with implementing the broader, top-down reforms, including tariff reform, which has been relatively easier to execute especially within the framework of international trade agreements. However, progress in improving the business environment has been weaker than all other regions, in part because it has required a much deeper level of economic reform. In areas like contract enforcement, which requires the profoundly difficult task of reforming the judiciary, the MENA region has demonstrated the greatest difficulties in implementing reform. Addressing fundamental governance weaknesses will be a critical success factor for achieving the second generation of policy reform.