CHAPTER 1

RECENT ECONOMIC OUTCOMES AND SHORT-TERM DEVELOPMENT PROSPECTS IN MENA

1.1 INTRODUCTION

1.1 For the fourth year in a row, the Middle East and North Africa region[1] (MENA) continued on a strong growth path with more dynamism from the private sector. Real GDP increased by 6.3 percent in 2006 up from 4.6 percent during the first four years of the decade (Figure 1.1). Indeed, the growth performance for 2006 was among the best in more-than ten years. Growth was driven primarily by the strong performance of resource-rich labor-importing (RRLI) countries and the expansion of growth in resource-poor labor-abundant (RPLA) countries, while resource-rich labor-abundant (RRLA) countries stagnated. Given rapid demographic expansion that characterizes most countries of the region, growth on a per-capita basis was less buoyant, reaching 4.2 percent in 2006, but still significantly higher than the 2.6 percent reached in the early years of the new century.

1.2 This period of strong growth has helped MENA narrow the gap with other developing regions. Growth of real per-capita incomes averaged 1.7 percent over the second half of the 1990s, contrasted with 2.8 percent for low and middle income countries. By 2006 MENA’s real per-capita income increased to 4.2 percent vis-à-vis 5.7 percent for developing countries. While still below, MENA is now growing at nearly 75 percent of the other developing countries growth. This development is to be welcomed, but it must also be recognized that prospects for sustaining growth at these or higher rates over the coming years will depend on advances in the structural reform agenda and prove a substantial challenge for policymakers in the region.

[1] The Middle East North Africa Region consists of resource poor labor abundant economies Djibouti, Egypt, Jordan, Morocco, Tunisia, Lebanon and West Bank and Gaza; resource rich labor abundant economies Algeria, Iran, Iraq, Syria, and Yemen; and resource rich labor importing economies Bahrain, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and United Arab Emirates.

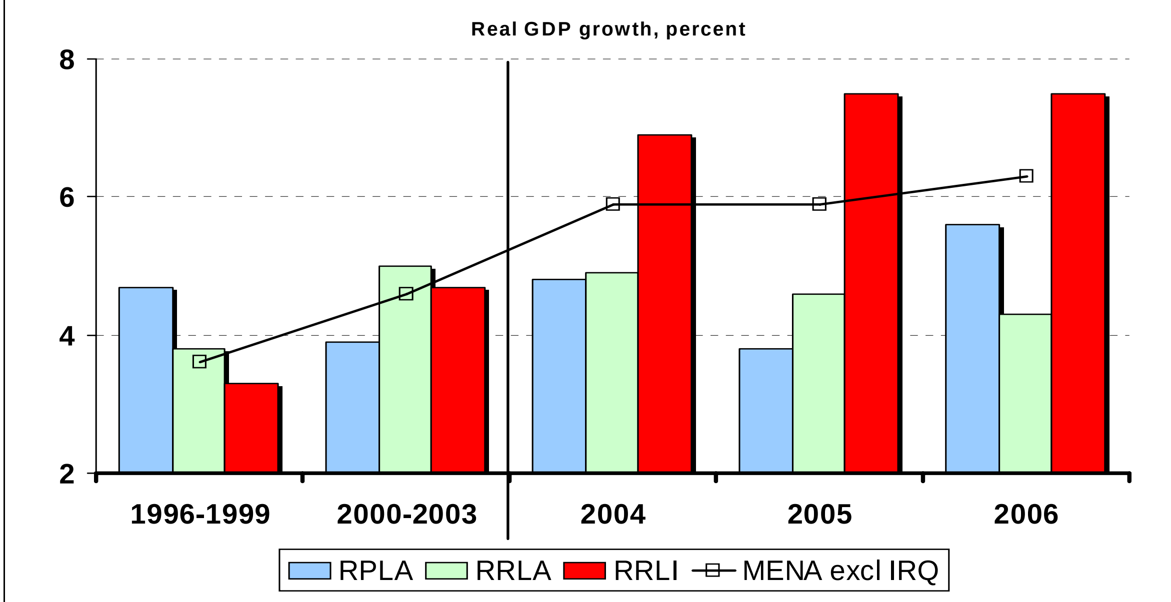
Table 1.1 Overview of recent developments, 1996-2006

Country	1996-1999	2000-2003	2004	2005	Estimate 2006
MENA Region (excluding Iraq)	**average**	**average**			
real GDP growth (%)	**3.6**	**4.6**	**5.9**	**5.9**	**6.3**
population	2.0	2.0	1.9	1.9	2.0
per-capita GDP	1.7	2.6	3.9	4.0	4.2
CPI inflation (%)	4.2	2.8	4.1	5.5	5.3
industrial production (%)	...	1.5	3.8	4.1	-0.4
fiscal balance (%GDP)	-2.8	1.5	6.8	11.8	14.5
current account balance (%GDP)	-0.1	7.1	11.0	16.9	20.7
foreign direct investment (% GDP)	1.0	0.9	0.9	1.5	1.7
Resource-poor, labor abundant (RPLA)					
real GDP growth (%)	**4.7**	**3.9**	**4.8**	**3.8**	**5.6**
population	1.8	1.8	1.7	1.7	1.9
per-capita GDP	2.7	2.0	3.1	2.1	3.6
CPI inflation (%)	3.3	2.3	4.0	7.0	5.8
industrial production (%)	...	1.3	2.8	2.2	3.4
fiscal balance (%GDP)	-3.9	-5.8	-6.0	-6.7	-6.0
current account balance (%GDP)	-4.0	-1.5	-0.6	-1.6	-1.7
foreign direct investment (% GDP)	2.4	2.2	2.1	5.4	8.0
Resource-rich, labor abundant (RRLA)					
real GDP growth (%)	**3.8**	**5.0**	**4.9**	**4.6**	**4.3**
population	1.9	1.8	1.7	1.7	1.8
per-capita GDP	1.9	3.1	3.1	2.9	2.5
CPI inflation (%)	12.6	9.0	10.5	9.4	8.7
industrial production (%)	...	2.8	4.2	4.8	-2.3
fiscal balance (%GDP)	-0.9	1.8	2.5	4.6	3.1
current account balance (%GDP)	1.7	7.3	4.7	11.0	10.6
foreign direct investment (% GDP)	0.2	0.5	0.6	0.5	0.9
Resource-rich, labor-importing (RRLI)					
real GDP growth (%)	**3.3**	**4.7**	**6.9**	**7.5**	**7.5**
population	2.9	3.1	3.1	3.2	3.2
per-capita GDP	0.4	1.5	3.6	4.2	4.2
CPI inflation (%)	0.5	0.0	1.1	2.9	3.4
industrial production (%)	...	0.8	4.0	4.6	-1.1
fiscal balance (%GDP)	-3.3	4.6	14.0	21.5	25.8
current account balance (%GDP)	1.1	11.0	19.0	25.9	32.0
foreign direct investment (% GDP)	0.7	0.5	0.7	0.7	0.3

Source: World Bank staff estimates.

Note: The MENA region includes the resource poor-labor abundant (RPLA) economies: Djibouti, Egypt, Jordan, Lebanon, Morocco, Tunisia and the West Bank and Gaza; the resource-rich labor abundant (RRLA) economies: Algeria, Iran, Iraq, Syria and Yemen, and the resource-rich labor-importing (RRLI) economies: Bahrain, Kuwait, Libya, Oman, Qatar, Saudi Arabia and the United Arab Emirates (UAE). Due to data limitations, the West Bank and Gaza is not included in regional or sub regional aggregates. In addition to the resource-based classifications, aggregates are presented for groups based on geography- and trade. The Maghreb consists of Algeria, Libya, Morocco and Tunisia. The Mashreq is comprised of Iraq, Jordan, Lebanon, Syria and WBG. The Gulf Cooperation Council (GCC) members: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and UAE. And 'other' consisting of Djibouti, Egypt, Iran and Yemen. Finally, net oil importers of the region include Djibouti, Jordan, Lebanon, Morocco and Tunisia. All others are considered net exporters.

Figure 1.1 Regional growth steps up to 6.3% in 2006



Source: National Agencies and World Bank.

1.3 In contrast to the strong GDP growth performance, industrial production declined by 0.4 percent in 2006 largely as output of hydrocarbons faced capacity constraints in the year. Among the RRLA countries, industrial production declined 2.3 percent in 2006, standing 6 percent below January 2006 levels. For RRLI countries, the decline was 1.1 percent in 2006, about 4.3 percent below January 2006 levels. In contrast, industrial production accelerated in RPLA countries to 3.4 percent in 2006.

1.4 Despite the downturn in oil production and turnaround in world oil price[2] from peaks of more-than $70 per barrel in August 2006 to near $50 by year-end, revenues for the oil exporters continued to build in the year. Petroleum and product receipts increased by more than $75 billion, to reach $510 billion in 2006 for resource rich countries. This supported current account and fiscal surplus positions for the region as a whole and for resource rich economies in particular.

[2] World Bank average oil price is a simple average of Brent, Dubai and WTI crude prices.

1.5 The run-up of surplus funds among the oil exporters and the availability of new investment opportunities across the region boosted FDI flows to new highs of more-than $24 billion in 2006. FDI in the year was concentrated in Egypt, Lebanon, Morocco, Tunisia and Jordan, as well as the United Arab Emirates.

1.6 On the fiscal front, the MENA region as a whole continued to improve. Oil revenues have been sufficient, such that—despite sharp increases in both current and capital fiscal outlays—the fiscal positions have remained in surplus, amounting to 14.5 percent of GDP in 2006. This result is dominated by RRLI economies which increased their fiscal balances to 25.8 percent. RRLA economies saw their fiscal balances deteriorate from a surplus of 4.6 percent of GDP in 2005 to 3.1 percent in 2006. In contrast, RPLA economies improved their fiscal positions slightly ending up with a fiscal deficit of 6 percent in 2006.

1.2 Overview of Recent Economic Developments

1.7 On balance, 2006 for MENA was a year mixed with continued strong economic outturns driven by double-digit gains in domestic demand, welcome advances in per-capita income growth and record fiscal- and current account surpluses. FDI and intra-region investment flows emerged as an important growth-enhancing factor for the region. And inflationary pressures have been largely subdued despite the strong pace of activity. At the same time, MENA has remained in global focus due to geo-political issues, the continued U.S. presence in Iraq and externalities related to conflict. There is little doubt that risk perceptions of investors toward the region remain elevated, and the manner in which current tensions and conflicts are resolved will play an important part in setting the stage for economic growth over the next years.

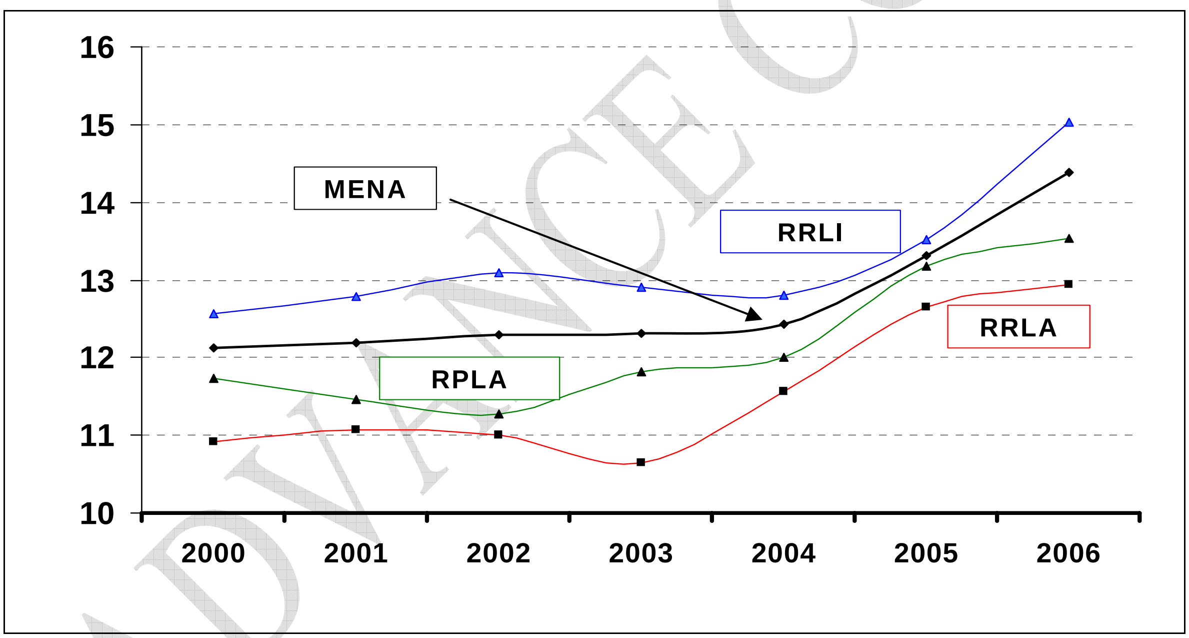
1.2.1 Sources of growth in MENA

1.8 The economies of the MENA region have experienced strong growth in the past few years, riding the wave of the current oil boom. But where is the growth coming from, domestic demand-consumption and/or investment? What is the contribution of exports and imports in the overall growth performance? What has been the role of the private sector? This section analyzes sources of growth in MENA.

1.9 Domestic demand continued to be the dominant force behind the current growth momentum. Growth decomposition analysis shows that domestic demand contributed 10.7 point to GDP growth in 2006, while net exports had a contribution of -4.4 points, as imports outpaced export performance. This tendency in growth sources has been present for the duration of the recent growth boom, but domestic demand has steadily increased its contribution to growth (Table 1.2). Both the contributions of consumption and investment have been on the rise. In particular, gross domestic investment now contributes 4.1 points to GDP growth, up from 1.3 points in the early 2000's and the private sector is playing an increasing role growing role in rising investment (Figure 1.2). Private consumption on the other hand contributed with 5 points to GDP growth.

Figure 1.2 Private Investment as share of GDP

(in percent)



Source: National agencies and World Bank estimates. MENA and RRLA averages exclude Iran due the difficulty in separating pure private investment data.

1.10 RPLA countries witnessed a pick-up in GDP growth driven by several factors: recovery from drought in the Maghreb, onset of economic recovery in the Euro Area, strong flows of tourism revenues, remittances-and increasingly FDI. The acceleration in growth occurred on the back of a sharp revival in domestic demand (notably of private consumption) during 2006.

Table 1.2 Sources of growth for MENA groups, 1996-2006

Country	1996-1999	2000-2003	2004	2005	2006
			Estimate		
MENA Region (excluding Iraq)	average	average			
real GDP growth (%)	**3.6**	**4.6**	**5.9**	**5.9**	**6.3**
contributions to GDP growth (points) from:	*3.6*	*4.6*	*5.9*	*5.9*	*6.3*
domestic demand	3.4	3.5	6.7	8.7	10.7
private consumption	1.5	2.2	3.8	4.3	5.0
government consumption	0.6	0.0	1.0	1.8	1.6
gross domestic investment	1.3	1.3	1.8	2.6	4.1
net exports GNFS /a	0.2	1.1	-0.8	-2.8	-4.4
Resource-poor, labor abundant (RPLA)					
real GDP growth (%)	**4.7**	**3.9**	**4.8**	**3.8**	**5.6**
contributions to GDP growth (points) from:	*4.7*	*3.9*	*4.8*	*3.8*	*5.6*
domestic demand	4.4	3.2	4.9	3.9	6.8
private consumption	2.1	2.6	3.3	2.2	4.9
government consumption	0.5	0.6	0.1	0.6	-0.1
gross domestic investment	1.7	0.1	1.4	1.1	2.1
net exports GNFS	0.3	0.6	-0.1	-0.1	-1.2
Resource-rich, labor abundant (RRLA)					
real GDP growth (%)	**3.8**	**5.0**	**4.9**	**4.6**	**4.3**
contributions to GDP growth (points) from:	*3.8*	*5.0*	*4.9*	*4.6*	*4.3*
domestic demand	2.7	6.0	7.3	4.5	7.1
private consumption	1.3	2.9	4.8	1.4	3.0
government consumption	0.0	0.7	0.6	0.9	1.0
gross domestic investment	1.4	2.5	2.0	2.3	3.1
net exports GNFS	1.1	-1.1	-2.4	0.1	-2.7
Resource-rich, labor-importing (RRLI)					
real GDP growth (%)	**3.3**	**4.7**	**6.9**	**7.5**	**7.5**
contributions to GDP growth (points) from:	*3.3*	*4.7*	*6.9*	*7.5*	*7.5*
domestic demand	3.3	3.8	7.2	12.9	14.1
private consumption	1.4	1.7	3.6	6.7	6.0
government consumption	0.9	0.9	1.7	2.9	2.6
gross domestic investment	1.0	1.2	1.9	3.4	5.5
net exports GNFS	0.0	0.9	-0.4	-5.4	-6.6

Source: World Bank staff calculations. Data note: /a change in net exports of goods and non-factor services as a share of GDP [-1], includes residual. Also see footnotes to Table 1.1.

1.11 Consumption and investment were the key factors supporting outturns for the latter year. While exports were helped by increasing demand from abroad, RPLA own imports yielded a net drag from the external sector, subtracting 1.2 points from 2006 growth outturn. RPLA activity recovered despite a substantial flare-up in geo-political tensions, contributing in part to conflict in Lebanon, and to the isolation of the West Bank and Gaza from trade and financial flows. These economies suffered significant GDP losses as their GDPs declined by 5.5 and 12 percent respectively in 2006.

1.12 Among oil exporters of the region, the group of RRLA economies[3] excluding Iraq, experienced a moderate decline in growth in 2006. Domestic demand stepped-up to 7.1 points of growth in 2006, with an upward shift in all segments of demand, but especially private consumption. However, this development was fully offset by substantial imports of capital and consumer goods, providing a negative 2.7 point to growth from trade. Output for the RRLA economies would have been much more robust in 2006, had growth in Algeria not being disappointing. Latest estimates indicate that Algeria's GDP growth was only 1.4 percent in 2006, due in part to poor performance in hydrocarbons output as well as delays in implementation of public sector investment programs.

1.13 In contrast with the modest downturn in growth for the RRLA group in 2006, RRLI economies[4] maintained their robust growth performance in 2006 at 7.5 percent, supported by double-digit contributions from domestic demand, with a shift from consumption toward investment over the course of 2006. Net exports subtracted 6.6 percent from RRLI growth during 2006.

1.2.2 Strong regional growth but with significant heterogeneity

1.14 The dispersion of growth across MENA's diverse group of economies remains wide, from 12 percent growth in Qatar in 2006, to decline of the same magnitude in the West Bank and Gaza (WBG). This is due in part to the fundamental "split" between oil-dominant and more

[3] The group of resource-rich, labor-abundant economies is comprised of Algeria, the Islamic Republic of Iran, Iraq, Syria and the Republic of Yemen. It should be noted that, due to data limitations and uncertainties regarding data quality, Iraq is often excluded, in the context of this report, from the group of resource-rich economies and from the MENA region as well. References highlight this point in all tables and Figures.

[4] The resource-rich, labor-importing economies are Bahrain, Kuwait, Libya, Oman, Qatar, Saudi Arabia and the United Arab Emirates.

diversified economies of the region, affected by differing trends in the external environment; but also to economic policy and attitudes toward reform, as well as to the present set of geopolitical tensions carrying strong direct and indirect effects across regional economies.

The resource-poor economies

1.15 For the RPLA economies, distributed across the Maghreb (Morocco, Tunisia), the Mashreq (Lebanon, Jordan and WBG) and including Egypt and Djibouti, growth improved significantly in 2006. During the latter year, four of seven economies enjoyed a boost to growth, notably Morocco, experiencing relief from a severe 2005 drought, and enjoying a rebound in agricultural output and rural incomes, where real output growth surged to 7.3 percent in 2006. The start of stronger economic recovery in the Euro Area (the destination for 70 percent of Morocco's goods exports), and implementation of a free trade agreement (FTA) with the United States on January 1, 2006, also offered better conditions for trade, following adverse effects on Morocco's textiles and apparel exports in the wake of the removal of the agreement on textile and clothing (ATC) in 2005 (Table 1.3).

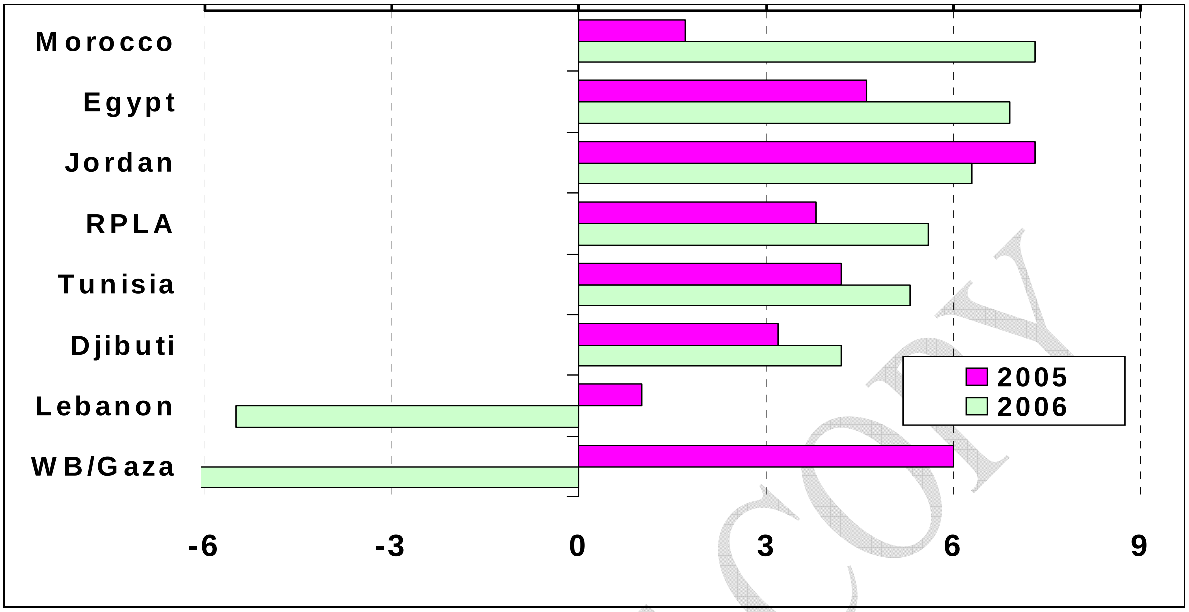
1.16 Growth in Tunisia also moved higher in the year. Affected less severely than Morocco by drought conditions, Tunisia's growth acceleration was grounded in stronger manufacturing output, moderate pickup in goods exports and continued gains in tourism receipts. FDI flows to Tunisia more-than doubled to $2.8 billion in the year (about 9.6 percent of GDP), attracted to telecoms- and other assets undergoing privatization, as well as to tourism and related infrastructure. And conditions in Egypt improved with the country benefiting from strong investment and construction outlays, and tax cuts which boosted household spending. On the external front, goods exports were powered by the start of LNG shipments, while increases in service receipts—though reduced from 2005 boom levels—continued high: 12.5 percent gains for tourism revenues, 9 percent for Suez canal dues, with remittances approaching 4.5 percent of GDP. Growth picked up to 6.9 percent in 2006, the strongest since 1984 (Figure 1.3). Finally, GDP advanced 4.2 percent in Djibouti, on increased port construction outlays and a pick-up in activity in the country's Free Trade Zone.

Table 1.3 MENA region: real GDP growth, 1996-2006

Country	1996-1999	2000-2003	2004	2005	Estimate 2006
MENA region (incl. Iraq)	**...**	**4.0**	**6.5**	**5.9**	**6.2**
MENA (excl. Iraq)	**3.6**	**4.6**	**5.9**	**5.9**	**6.3**
By resource-based classification	average	average			
Resource-poor, labor abundant	**4.7**	**3.9**	**4.8**	**3.8**	**5.6**
Djibouti	-0.7	2.1	3.8	3.2	4.2
Egypt, Arab Republic of	5.2	3.8	4.2	4.6	6.9
Jordan	2.9	4.9	8.4	7.3	6.3
Lebanon	2.6	3.4	6.3	1.0	-5.5
Morocco	4.2	4.0	4.2	1.7	7.3
Tunisia	5.9	4.2	6.0	4.2	5.3
West Bank and Gaza	...	-6.4	6.2	6.0	-12.0
Resource rich	**3.2**	**4.8**	**6.2**	**6.6**	**6.5**
Resource-rich, labor abundant (inc Iraq)	**...**	**2.8**	**7.3**	**4.6**	**4.3**
Resource-rich, labor abundant (exc Iraq)	**3.8**	**5.0**	**4.9**	**4.6**	**4.3**
Algeria	3.1	4.1	5.2	5.3	1.4
Iran, Islamic Republic of	4.0	5.8	5.1	4.4	5.8
Iraq	...	-16.6	46.5	3.7	4.0
Syrian Arab Republic	4.1	3.4	3.9	4.5	5.1
Yemen, Republic of	5.5	4.0	2.6	3.8	3.9
Resource-rich, labor-importing	**3.3**	**4.7**	**6.9**	**7.5**	**7.5**
Bahrain	4.3	5.6	5.4	6.9	7.0
Kuwait	1.9	5.9	6.2	8.5	6.2
Libya	1.6	4.8	8.2	8.4	8.1
Oman	3.4	4.4	5.6	5.6	6.4
Qatar	11.8	7.1	11.4	11.0	12.1
Saudi Arabia	2.7	3.3	5.2	6.6	5.8
United Arab Emirates	5.2	7.1	9.7	8.5	10.7
By geographic sub-region					
Maghreb	3.2	4.2	5.8	5.1	5.0
Mashreq (excl WBG, IRQ)	3.2	3.7	5.7	3.7	1.4
GCC	3.5	4.7	6.7	7.5	7.4
Other	4.6	4.8	4.6	4.5	6.2
By oil-trade group					
Oil-exporting countries (excl. Iraq)	3.8	4.7	6.0	6.4	7.0
Oil-importing countries (excl WBG)	3.7	4.0	5.6	2.8	4.0
Memorandum items: Comparator regions					
MENA (excl Iraq)	**3.6**	**4.6**	**5.9**	**5.9**	**6.3**
All Developing countries	**4.0**	**4.5**	**7.3**	**6.6**	**6.9**
East Asia and the Pacific	6.2	7.7	9.1	9.0	9.1
Europe and Central Asia	2.0	4.7	7.2	6.0	6.4
Latin America and the Caribbean	3.0	1.3	6.0	4.5	5.0
South Asia	5.7	5.1	8.0	8.1	8.2
Sub-Saharan Africa	3.4	3.7	5.2	5.5	5.2

Source: World Bank staff estimates.
See footnotes to Table 1.1

Figure 1.3 Diverse outturns across RPLA economies in 2006
Real GDP growth, percent



Source: National agencies and World Bank estimates. West Bank and Gaza's GDP is estimated to have declined by 12 percent in 2006.

1.17 Of RPLA economies witnessing deterioration in growth during 2006, Jordan' stands out with a one-point decline to 6.3 percent, linked in part to higher oil prices and further deteriorating current account deficits. Despite this, Jordan's growth in 2006 was the third best from the group, and continues to be one of the most successful growth experiences in the past years, accumulating 24 percent growth in the past three years. The domestic economy remains strong, with investment in real estate and tourism projects leading the way. Demand for services for those working in-or with Iraq continues, while record levels of remittances (near $2.5 billion, or 18 percent of GDP) offers ongoing support for consumer spending.

1.18 Developments in Lebanon and WBG damaged growth prospects in those countries. WBG's GDP declined by 12 percent in 2006, after a 6 percent gain in 2005. In Lebanon, estimates put the decline of GDP at 5.5 for 2006. Prior to the onset of military action, conditions appeared to be improving, with increased tourism, real estate investment and capital inflows from the Gulf. The recent gathering of donors in Paris, consisting of individual countries with interest and multilateral institutions pledged some $7.5 billion to facilitate the rebuilding process, grounded in a renewed program of fiscal and economic reform. Estimates of war damage reparations from the month-long Israel-Hezbollah conflict of July-August 2006, were significant (Box 1.1).

Box 1.1 Economic Consequences of Conflict

During 2006 conflict continued to undermine the capacity of some countries in the MENA region to benefit from the current regional and global growth trends. Iraq, Lebanon and West Bank and Gaza were affected directly by conflict, but spillover effects were present in countries like Syria and Jordan that ended up with large flows of refugees.

Plagued by continuing violence and strife, the Iraqi economy grew at a sluggish 3-4 percent in 2006. Non-oil GDP grew at about 10 percent, reflecting enhanced household activities in the non-tradable sector, as is typical for conflict environments. However, oil GDP did not grow at all, reflecting stagnant production and export levels. Investment activity was weak in both the public and private sectors. Dollarization has grown notably, and there is a high and steady outflow of private Iraqi capital as reported by Jordan, Syria, Lebanon, and lower Gulf countries. The Central Bank's has responded with measures to appreciate the nominal value of the Iraqi dinar. This has not yet reduced inflation since other key drivers—security risks, supply bottlenecks, rising public spending—remain unchecked.

Unemployment fell from the peaks of 2003-2004, but still exceeds 20 percent despite massive out migration flows. As a result of the war, an estimated 2 million Iraqis have fled to Jordan, Syria and Lebanon, and an additional 1.7 million have relocated to safer areas within Iraq. These flows have put high pressure on the Jordan economy, where controls now are tightening and the share of illegal migrants is increasing.

In Lebanon, the hostilities in the summer of 2006 resulted in serious human and physical losses and caused both short- and long-term damage to the Lebanese economy. The war killed more than 1,200 individuals, damaged nearly 107,000 housing units and nearly one million people (a quarter of the national population) were displaced during the height of the hostilities. The direct damages were estimated at around US$2.8 billion by the Lebanese government, (the biggest cost being for housing). The loss of investor confidence, the damage to the image of Lebanon as a tourist destination and the emigration of skilled workers will have a long-term impact on the private sector and on the economy as a whole. It is estimated that 30,000 jobs may have been permanently lost. Some 200,000 people may have emigrated during the hostilities. Many of those who left were the young and highly skilled

The hostilities put an end to expected significant economic recovery in 2006. While economic performance in 2005 was adversely affected by the assassination of Prime Minister Rafic Hariri, growth in 2006 was shaping up to produce the highest growth rate in a decade at around 5.0-6.0 percent. Post-conflict real GDP for 2006 is currently projected to have contracted by about 5.5 percent in 2006—a significant 10-11 percent reversal in output.

Extensive destruction of physical capital and disruption of trade, tourism and supply channels affected negatively growth performance of all sectors of the economy. Services, which generate about 70 percent of Lebanon's GDP, have shrunk by an estimated 5 percent. The agriculture sector has been hit severely and is expected to have witnessed a negative growth rate of at least 17 percent. As for industry, it has registered a loss of output estimated at 2.5 percent with manufacturing suffered the largest decline of around 9 percent. Expressed in monetary terms, total foregone output due to the conflict could be as high as US$2.3 billion.

BOX 1.1. cont.

On the fiscal side, Lebanon's public finance was also strongly affected in 2006. On the revenue side, figures indicate a decline by 16.6 percent over the same period in 2005; thus eliminating the 15 percent increase registered in the first half of 2006. Such decline in revenues –estimated at US$500 million- was mainly due to lost trade taxes and VAT. Expenditures increased due to higher outlays on early relief interventions and repairs to key public infrastructure. Thus, primary expenditure increased by 26.5 percent in the second half of 2006, after a 7 percent decline in the first half.

Consequently, after four years of registering surplus the primary balance turned into a deficit by the end of the year (excluding grants). Fiscal deficits in 2006 estimated to reach 14 percent of GDP. As a result, Lebanon's ratio of debt-to-GDP, which had begun declining in the first half of 2006 on the back of Government reforms and a growing economy, is estimated to have reach 190 percent by end-2006, with debt service increasing to 14 percent of GDP.

In West Bank and Gaza, after a modest recovery in 2004-2005, the Palestinian economy once again went into decline in 2006. The cut off of donor assistance to the Palestinian Authority (PA) as well as tax revenue clearance by Israel following the election of the Hamas government, and increasing border closures all served to choke off the nascent recovery.

In early 2006 the World Bank predicted a major crisis and estimated that GDP could fall as much as 25-30 percent due to the cut off in aid and tax clearance. However, the economy fared better than expected and the actual decline in GDP was around 12 percent. Yet per-capita GDP remains way below its 1999 level.

The economy was more resilient than expected because large amounts of money still found its way to the population. Many donors devised ways to inject money in the form of humanitarian assistance. In addition, there were large inflows of remittances from family members abroad. These funds, along with borrowing and selling assets, supported consumption.

However, this masks the true damage caused by the hollowing out of the economy. The cutoff of aid to the PA has made the government unable to pay salaries and resulted in a long strike by civil servants. Critical government institutions, such as the financial management system, the customs department, statistics bureau and others, which have taken years to develop, have begun to deteriorate. More troubling still, is the steep drop in investment, the depletion of savings and increase in debt. This situation is unsustainable and indicates that unless there is a resumption of direct aid and a loosening of the movement and access restrictions, the economy is poised for a rapid deterioration and increase in poverty.

The fiscal position of the PA continued to deteriorate as a result of conflict. Taxes and domestic and external financing fell by some 40 percent in 2006 compared to the previous year. External support in 2006 was more than twice the amount received in 2005, but this was not enough to offset the reduction in bank lending and the sharp drop in tax revenues As a result, government investment has fallen and government employees received on average only 50-55 percent of their normal incomes. This had a significant effect on poverty rates since one quarter to one third of the population is directly dependent upon a PA wage earner. The PA's fiscal position was brought to crisis by the cutoff of budget support. However, it has been a growing and unsustainable problem for some time associated with the rapidly rising level of both government employment and wage level.

Source: World Bank staff estimates.

The resource-rich economies

1.19 As a group, the resource-rich economies have seen GDP increased but significant differences exist between RRLA and RRLI countries and between countries within each group. The RRLA countries experienced a small decline in GDP growth during the year, while RRLI countries continue to grow at fast rates.

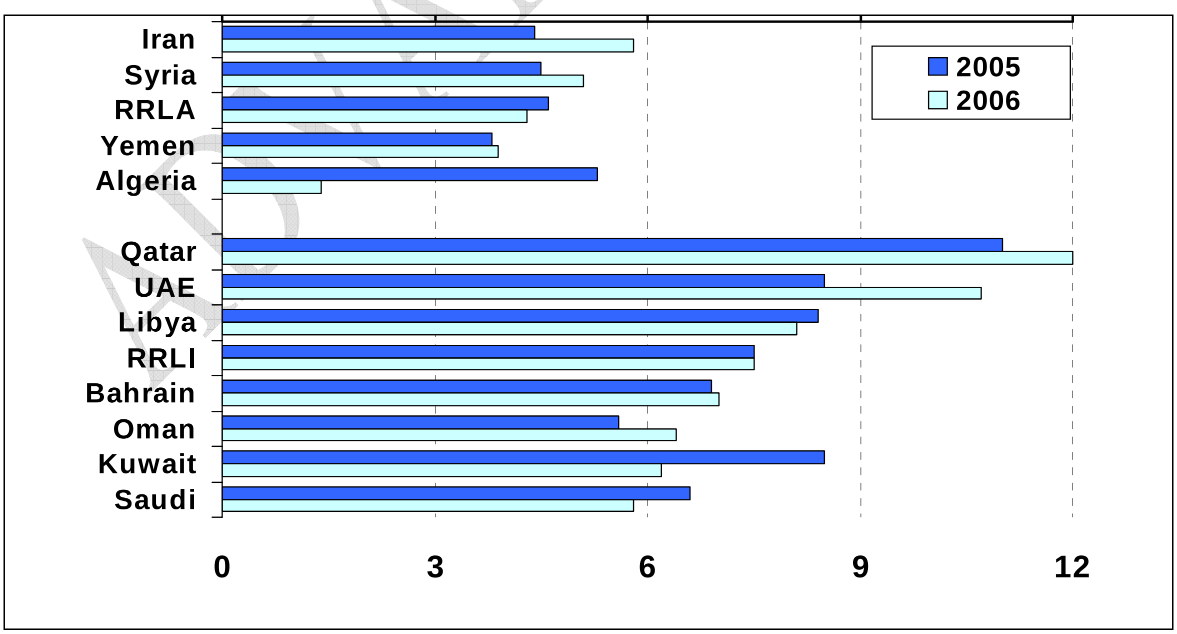
1.20 For the group of RRLA developments continue to be dominated by key hydrocarbons producers Iran and Algeria. Syria and Yemen fall much down the scale of oil supply (with diminishing reserves), and with economies more diversified in manufacturing and basic services.

1.21 The drop in GDP growth for the RRLA group masked the fairly strong pick-up in Iran that was offset by a collapse in Algeria to 1.4 percent. GDP growth accelerated in Syria while activity in Yemen improved (Figure 1.4).

1.22 In Iran, high oil prices, and an expansionary fiscal policy were driving forces for growth. Public sector spending increased in 2006, with current outlays moving-up by nearly 5 points of GDP since 2004. Capital spending increased significantly in the current fiscal year, concentrated in transport and other infrastructure projects.

Figure 1.4 General step-up in growth for MENA oil exporters in 2006

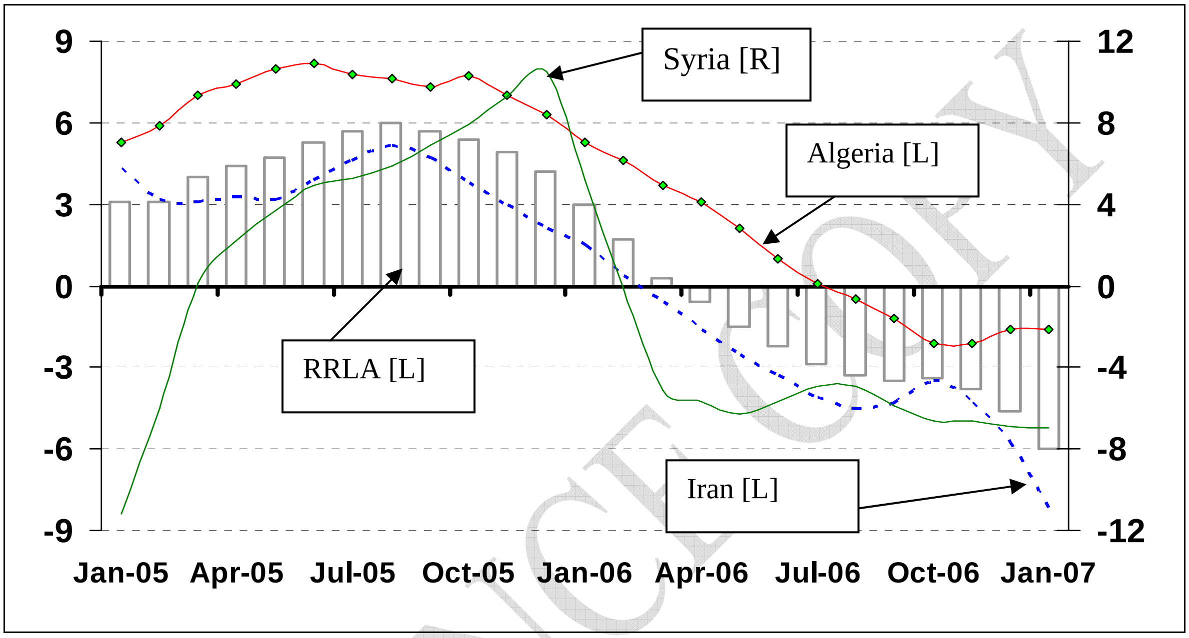
Real GDP growth, percent



Source: National agencies and World Bank estimates.

1.23 Capacity constraints in oil production are serving as a limit to growth in the hydrocarbons sector for all exporters of the RRLA group (Figure 1.5). And with growing import demand, drag from the external side may be expected for some time to come.

Figure 1.5 Oil production faces capacity constraints in RRLA economies
Industrial production, ch% 3mma y/y



Source: World Bank (DECPG) through National Agencies.

1.24 The 2006 growth slowdown in Algeria is related to stagnation in hydrocarbon output volumes. As witnessed in all Maghreb countries, agricultural production rebounded after the 2005 drought. And government is using enhanced oil revenues to bolster consumer spending, construction and investment. A supplementary budget passed in July 2006 increased expenditures by 35 percent against initial budget allocations. Proceeds were targeted to civil servant wage increases, a doubling of capital outlays and offering additional finance for Algeria's 'Peace and Reconciliation Charter' program for infrastructure rehabilitation. But as hydrocarbons account for 50 percent of GDP, developments there continue to dominate. Recovery of oil (and gas) output is essential if higher growth is to be recovered. The resource-rich, labor-importing (RRLI) countries witnessed for the fourth year in a row the fastest growth performance among all MENA groups. GDP increased by 7.5 percent in 2006. Among RRLI economies the United Arab Emirates, Oman and Qatar stand out with strong acceleration of real output grow.

1.25 GDP gains for several oil-dominant countries (Saudi Arabia, Kuwait) remained strong, but diminished in 2006. Several factors contributed to these outcomes: (a) a shift in expenditure from exceptionally strong current consumption outlays (public-and household) in 2004-2005, toward capital spending in 2006, focused on public infrastructure, complemented by a moderate pick-up in private investment outlays; (b) a decline in the volume of hydrocarbon exports, given OPEC attempts from mid-year 2006 to restrict supply and stem incipient declines in global oil price; and (c) the dampening effects on GDP growth stemming from several years of exceptionally robust import demand.

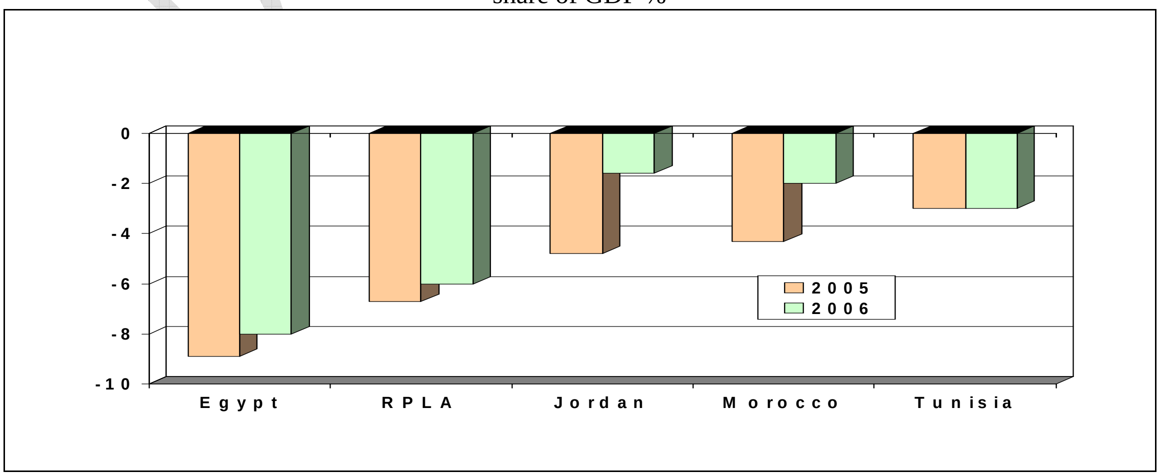
1.3 FISCAL DEVELOPMENTS

1.26 In the current oil-price cycle, a fiscal surplus position has characterized the aggregate for MENA countries since 2003—increasing from 1.5 percent of the region's GDP in early 2000s' to 14.5 percent by 2006. But this high regional surplus masks a diversity of conditions underlying both country groupings and individual countries. Fiscal balances during 2006 range a deficit of 6 percent for RPLA countries which continue to adjust to high oil prices, to a surplus of 25.8 percent for RRLI countries. High diversity also exists among individual countries in the region, from a surplus of nearly 42 percent of GDP for Kuwait, to a deficit of 13.4 percent in Lebanon.

1.27 As a group, the RPLA economies experienced and improvement during 2006. Their fiscal deficit declined to 6 percent of GDP in 2006, due to global and more importantly, country-specific factors. As Figure 1.6 shows, there has been a degree of improvement for many of the resource-poor countries, particularly Egypt, Jordan and Morocco.

Figure 1.6 Fiscal balances show improvement among RPLA*

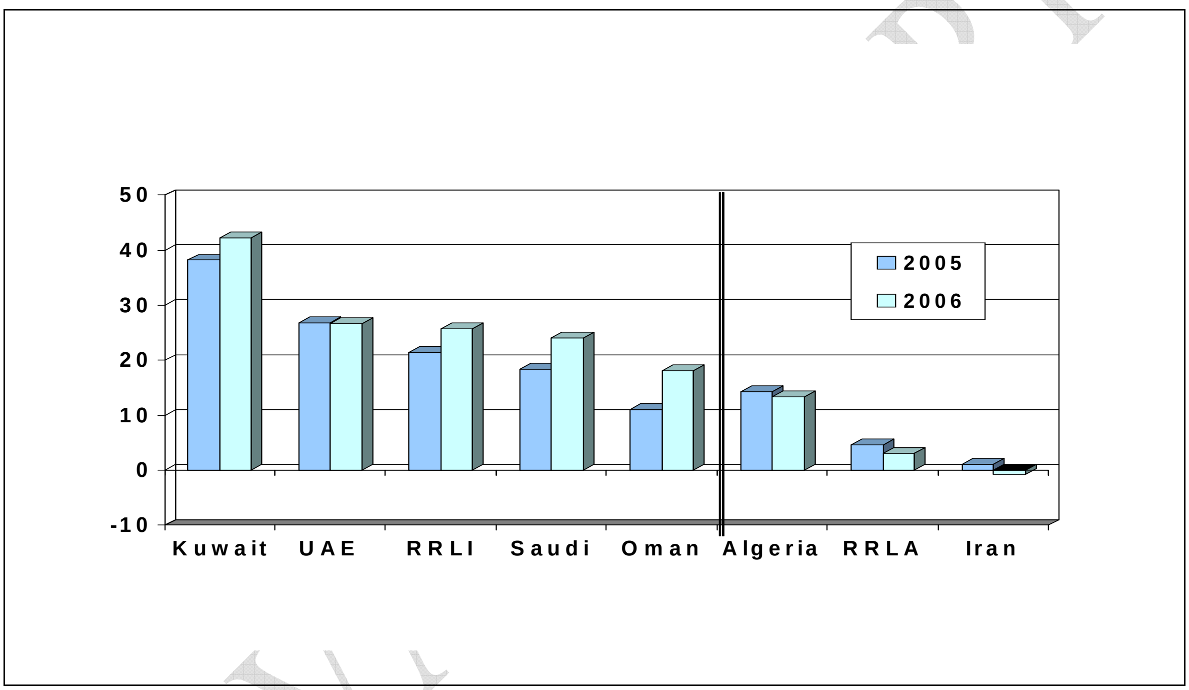
share of GDP %



Source: National Agencies and World Bank. *excludes Lebanon and WBG

1.28 Differences in the fiscal stance across the resource rich economies is also quite large, reflecting the degree to which the countries are benefiting from higher oil prices, and other revenue sources. There has been a distinct shift in the pattern of aggregate expenditure across the RRLI countries with a halving of current spending growth while investment spending has increased, reflecting large-scale infrastructure and other projects to be found across the Gulf Cooperation Council (GCC) (Figures 1.7 and 1.8).

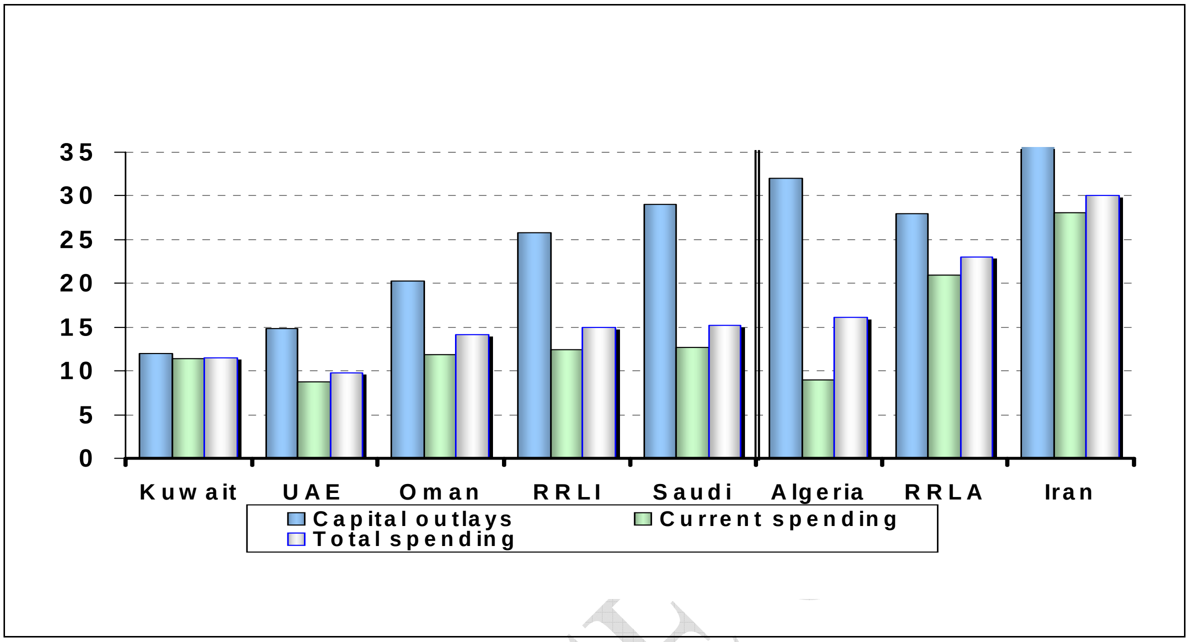
Figure 1.7 RRLI fiscal surplus continues at high levels
Fiscal balance as a share of GDP %



Source: National Agencies and World Bank. *selected economies.

1.29 Developments among the RRLA countries, particularly in Iran, have led to a much reduced fiscal surplus for the group in 2006 to 3.1 percent of GDP. Algeria's surplus has diminished by one point of GDP as revenue growth slowed given setbacks in hydrocarbon production in the year. But strong expenditure growth in Iran (continuing near 30 percent growth, against little gain in fiscal revenue in the year, produced a deficit of 0.7 percent of GDP—this in contrast with fiscal surpluses in the previous three years.

Figure 1.8 Resource Rich: Capital spending grows 26% per year
Current, capital and total fiscal spending, average ch% 2004-2006



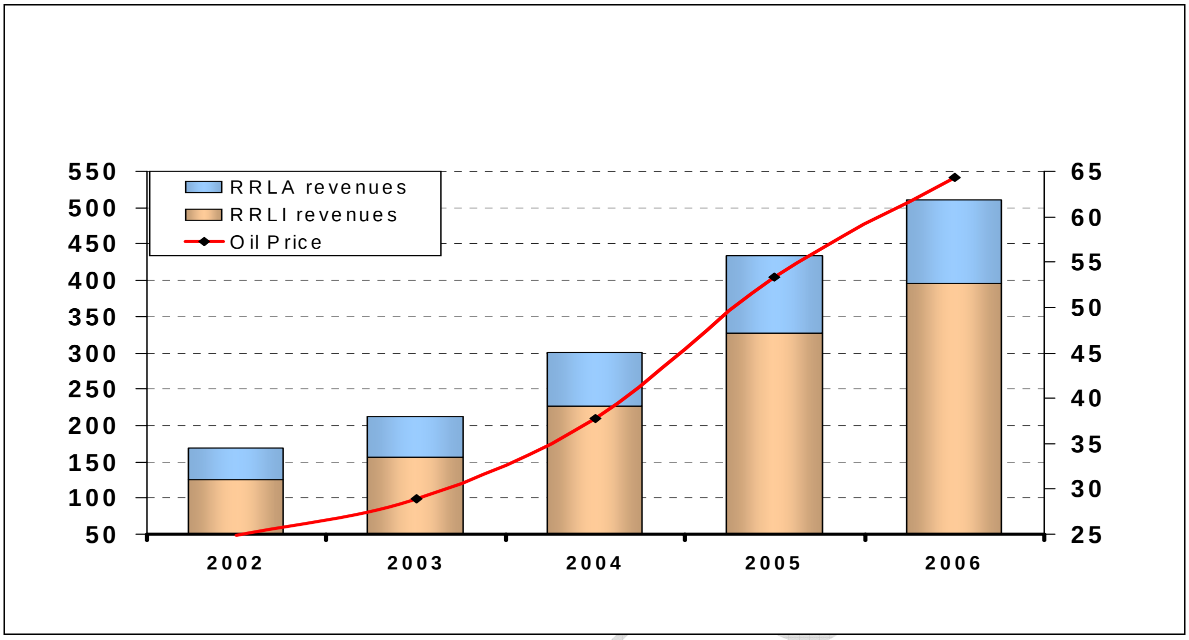
Source: National Agencies, IMF and World Bank.

1.4 DEVELOPMENTS IN THE EXTERNAL SECTOR

1.30 Economic activity among the resource-rich economies had gathered substantial momentum by 2006 from the preceding years of escalating oil prices and heightened external revenue flows (Figure 1.9). And to a degree, the accrual of further oil receipts in 2006 offered an opportunity to engage in shifting expenditure—from consumption to capital outlays—and to intensify efforts to encourage spillovers from the oil-to the non-oil economy by involving the domestic private sector. Additional revenues also supported a move to payoff outstanding overseas- or domestic debt, clearing financial overhang for several large economies.

1.31 For the resource-poor economies, developments in the external environment offered the prospect of reviving growth in goods exports, as well as other critical revenue flows—including tourism and remittances. In broader terms, the "growth rotation" taking place in the context of the global economy—the engine of growth shifting from the United States, toward Europe, Japan and East Asia—began to offer more support for growth among diversified economies.

Figure 1.9 Surge in oil revenues underpins growth of MENA exporters
Crude oil and product revenues $bn [left]; oil price, WB $/bbl [right]



Source: UN Comtrade, IMF, IEA, World Bank.

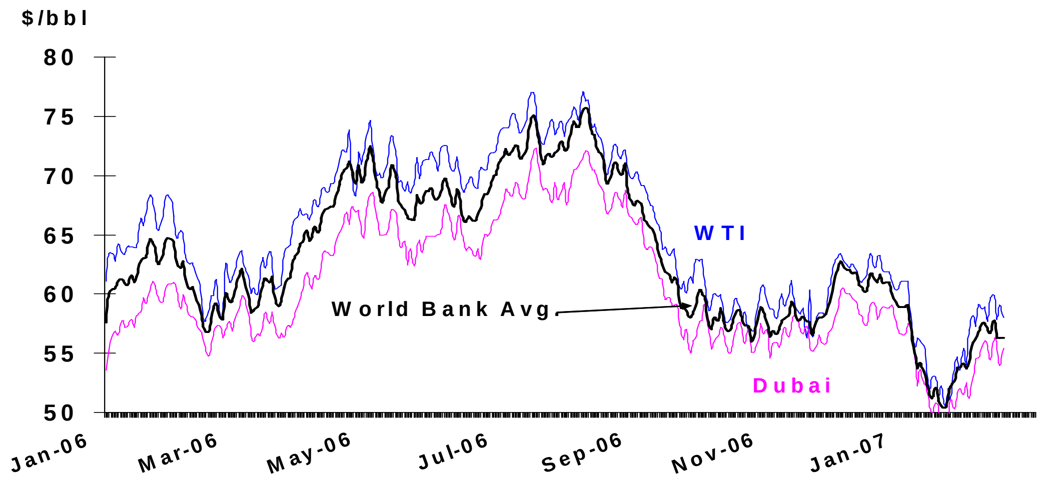
1.4.1 Oil market conditions peaked at mid-year 2006

1.32 World oil prices increased sharply over 2004-06, with the World Bank price (average of WTI, Brent and Dubai) exceeding $75/bbl in early August 2006. After a brief fall in prices in late-2004 and accommodating production increases from the Organization of the Petroleum Exporting Countries (OPEC), oil prices surged higher in 2005 and 2006, despite slowing oil demand growth and rising inventories. Prices were driven higher by expectations of continued strong growth in demand, capacity constraints, and fears of supply disruption in a number of countries, e.g. Iraq (insurgency), Nigeria (civil strife), and Iran (sanctions). In addition there were concerns about reliability of supplies from other countries, e.g. Russia (following cut off gas supplies to the Ukraine) and Venezuela, as well as unexpected accidents and weather disruptions (hurricanes in the Gulf of Mexico).

1.33 Following the peak in oil prices in August, prices fell by a third to near $50/bbl by late 2006 (Figure 1.10). The decline was due to high stocks, easing of political tensions, and weak demand from mild winter weather, and investors liquidated positions on futures markets. In addition, it was felt that OPEC would keep sufficient oil off the market to support much higher price than in the 1990s, or than during the early part of this decade when their target range was

$22-28/bbl for its basket of crude (since abandoned). It is presently viewed that OPEC will try to defend a price floor above $50/bbl.

Figure 1.10 Oil prices drop sharply then rebound in February 2007
World Bank average price $/bbl



Source: DECPG Commodities Group.

1.4.2 Export market growth for resource poor economies brightens

1.34 GDP growth in the Euro Area is likely to have reached 2.8 percent in 2006, the fastest expansion in six years. Business and consumer sentiment remains buoyant, the former linked to exceptional export performance despite appreciation of the euro against the dollar over 2006; the latter tied to record low rates of unemployment in Germany and France (key MENA export markets) that evolved over the last years.

1.35 A substantial share of goods exports from countries such as Egypt, Algeria, Syria, Morocco and Tunisia are destined for the European Union market; at the same time, though shifting in recent years, Europe remains the dominant origin for tourism to these countries from outside the MENA region. And Europe is now the primary host supporting a rising stream of remittance receipts in the RPLA economies.

1.36 Reflecting the onset of stronger recovery, imports of goods and services into the Euro Area increased by 20 percent in dollar terms in 2006. Goods exports from the above noted MENA countries to Europe are estimated to have increased 24 percent in the year,. Tourism revenues have also shown strong gains for the Maghreb countries, Egypt and Jordan, and worker remittance inflows are viewed to have established new highs at $19.3 billion for MENA recipient countries during the year.

1.4.3 Developments in merchandise trade

1.37 Trade during 2006 was characterized by continued strong growth in exports for the group of resource-poor economies, but they were outweighed by adverse terms of trade developments and continued rapid import demand to yield a widening trade deficit of 15.7 percent of GDP. For the resource-rich economies of MENA, oil export receipts eased to 17 percent of GDP. Though import demand among the resource-rich economies continued to grow fast, trade surpluses widen further for the group, reaching 32.5 percent of GDP.

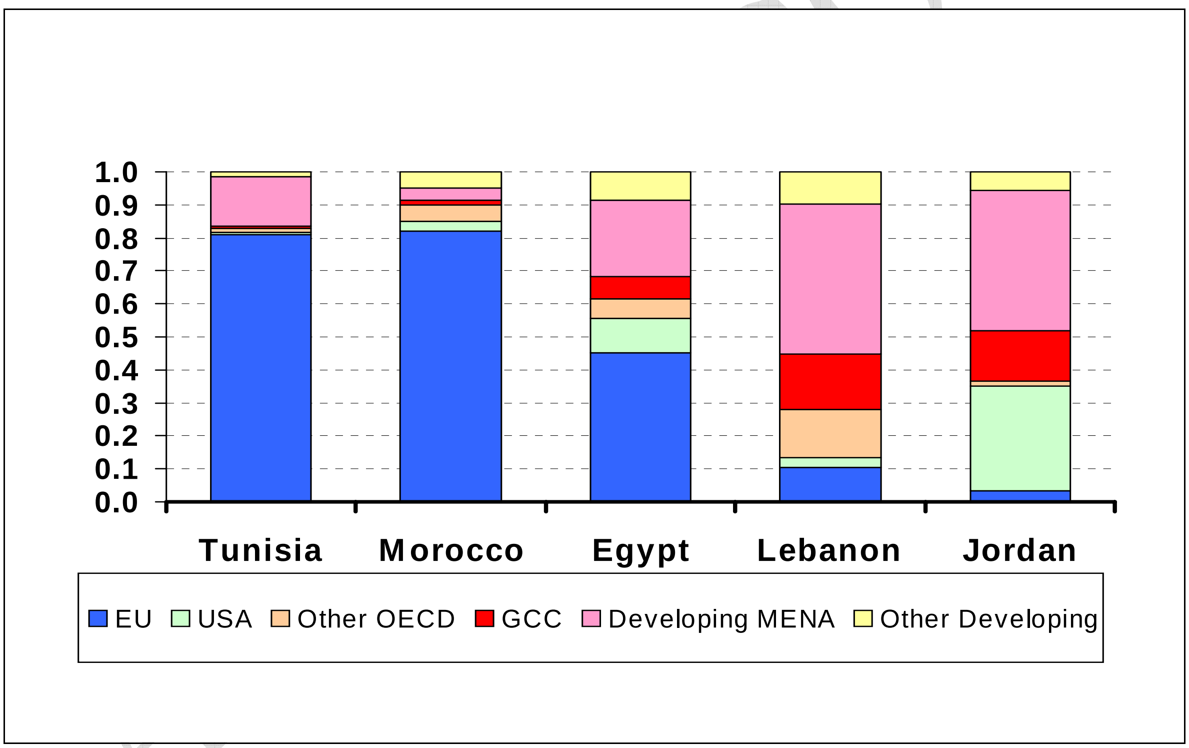
Exports of Goods

1.38 For the MENA region as a whole, merchandise exports grew 28 percent in 2006, yet falling below the growth boom of 2004-05, when exports achieved 38 percent gains on the back of the hydrocarbons market. As petroleum and related products constitute some 80-85 percent of the region's exports, global oil demand was the fundamental driver for the region's export performance over 2005-2006. But other factors combined to influence outcomes for the resource poor economies during the year, which, on balance yielded favorable results.

1.39 Of the five larger economies of the RPLA group, four enjoyed a boost to export growth during 2006; Egypt's exports jumped by 34 percent reflecting the earlier coming-on-line of oil and LNG export facilities. Morocco, Tunisia, and Jordan witnessed a pick-up in exports over the course of the year. Lebanon performed well during the first half or the year, however the conflict in Lebanon produced a reversal and exports declined for the year by 32 percent.

1.40 Demand conditions in export markets can carry a powerful influence in shaping export performance, and for a number of RPLA countries, they appear to have done so over 2005-2006. As noted, the European Union remains a key export market for several RPLA countries, especially for Tunisia, Morocco and Egypt. Up to 80 percent of Tunisia's exports are destined for the EU, with 10 percent remaining within the MENA region (Figure 1.11). Morocco's export base is also EU-focused (70 percent), but more diverse across developing regions of the world, with some 10 percent destined for developing Asia. Egypt's export market profile is well diversified across the EU (one-third), developing countries (one-third), of which MENA (one-fifth), and other high-income countries (one-third) including the United States, Singapore, Hong Kong and Taiwan. Destinations for Lebanon and Jordan reflect the dominance of MENA partners in the market, and in the case of Jordan, the United States as an important destination, following the FTA agreement.

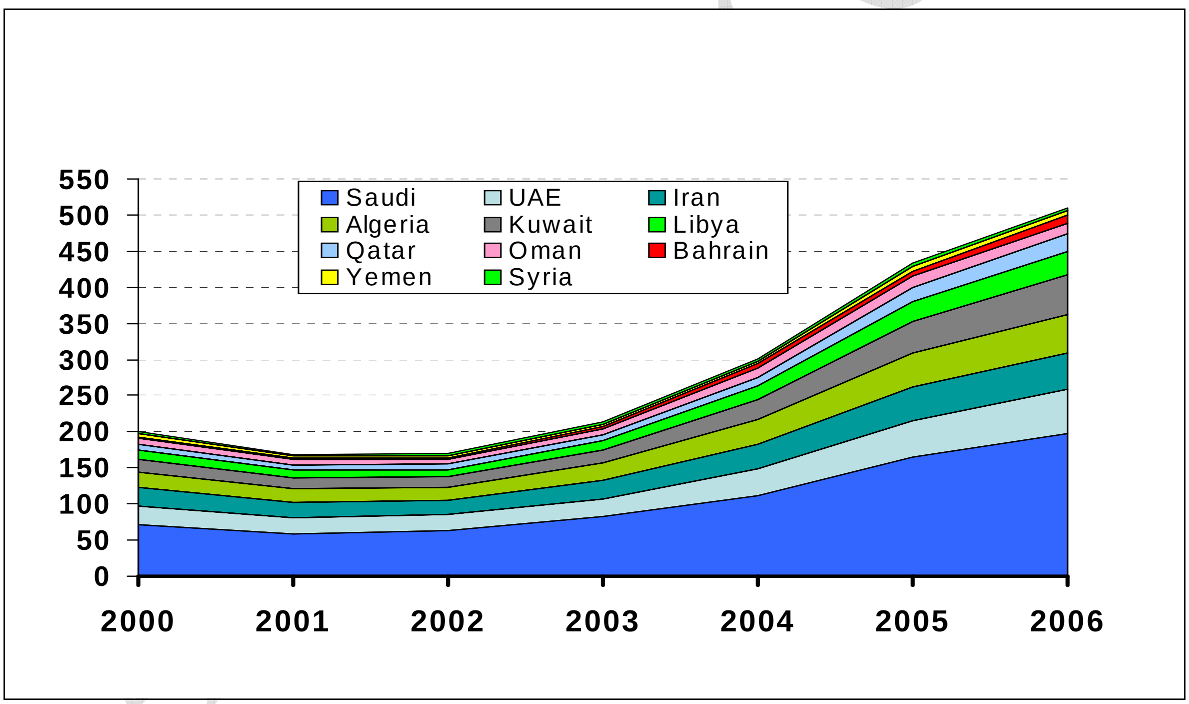
Figure 1.11 RPLA export orientation diverse across countries
Exports by destination country / region, share of total exports



Source: U.N. COMTRADE Database System.

1.41 Europe import demand growth during 2006 was supportive for both Tunisia and Morocco, which enjoyed a pick-up in export growth. Despite massively increased competition in the EU market for apparel and textiles from China, and other lower-cost Asian developing countries, upon final phase-out of the ATC in 2005, Tunisia and Morocco were apparently able to cushion loss of market share over 2005-06. In particular, the traditional close links among French and Italian apparel firms and the North African producers (travaux á façon) allowed several market niches to be maintained. MENA oil exporters possess more-than 60 percent of the world's reported oil reserves, and account for 36 percent of world oil production, a situation which has largely been maintained over the last decade. Oil export revenues have fluctuated greatly (Figure 1.12). Recovery in oil production and the large jump in oil price underpinned export revenues over the period since 2004. Receipts are estimated to have reached $510 billion in 2006 for the resource rich economies (excluding Iraq). The RRLI group accounts for three-quarters of the total at $395 billion with the RRLA countries capturing the remainder near $115 billion (Table A12). The escalation in oil receipts during 2006 was such that, in real terms, revenues breached previous peak levels last witnessed in 1980.

Figure 1.12 Resource-Rich* oil exports balloon through 2006
Exports of crude oil and refined products, billions US dollars



Source: World Bank, IEA and OPEC. * excl Iraq

1.42 The level of MENA's oil exports in 2006 likely represent a near-to-medium term peak, given the degree to which global oil prices have fallen, and against the background of slowing global economic activity moving into 2007. Nevertheless, petroleum revenues accumulated just since 2004 have neared $1.25 trillion, a substantial portion of which held as international reserves-, in stabilization funds- or invested globally. And those funds invested within the MENA region should provide a cushion for economic growth as revenue on the margin declines through 2009.

Imports and trade balances

1.43 For the MENA region as a whole, imports of goods advanced 23 percent in 2006. This, in combination with the export performance yielded an aggregate trade surplus of 24.6 percent of regional GDP. Though imports registered similar growth to that of 2005, changes in demand were notable across MENA sub-regions. RPLA imports featured a loss of momentum over the course of 2006. Nonetheless the trade deficit of the sub-group deteriorated to 16 percent of GDP. In contrast, imports into the resource rich countries grew by 25 percent, a pace similar to 2005, resulting in an increased trade surplus to 32.5 percent of the group's GDP.

1.44 Several factors influenced the pattern of imports into the RPLA economies over 2005 and 2006. Aside from economic fundamentals, weather played a key role, as severe drought afflicted the Maghreb, adversely affecting Morocco and Tunisia. Morocco's imports of emergency coarse grains to replenish lost harvests was key in lifting imports in the summer 2005; to a lesser degree Tunisia's imports increased to cover crop shortfalls.

1.45 Oil and critical non-oil commodity prices (grains and other foodstuffs in particular) have also come to affect terms of trade adversely for RPLA countries. For the group, food and beverages account for 12 percent of the import basket, fuels, another 12 percent, and raw-and intermediate industrial materials some 37 percent. On balance, nearly 60 percent of the import bill stands exposed to the potential for adverse developments in international commodity markets, a particularly difficult vulnerability for policymakers to manage. For instance, the oil import bill increased from $3.2 to $4.2 billion in Morocco between 2005 and 2006, accounting for 60 percent of the country's trade deficit in the latter year. In the case of Jordan it increased from $2 billion to $2.5 billion, or three-quarters of the trade deficit.

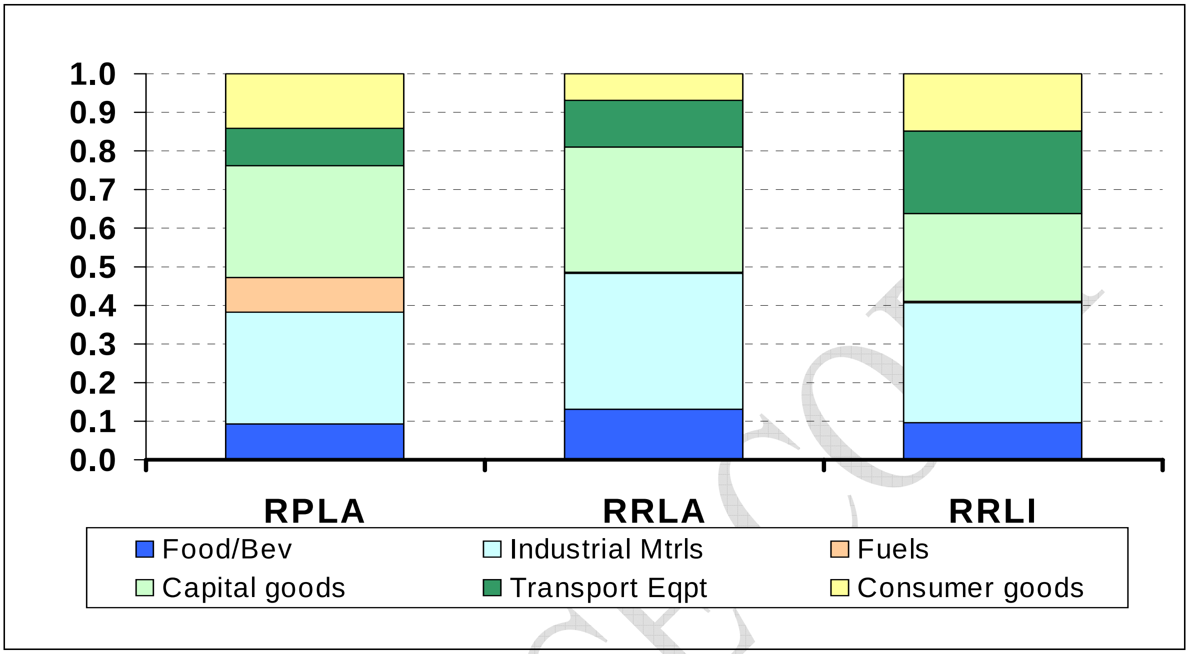
1.46 Egypt, Morocco and Tunisia also face a nexus, in the fact that manufactured exports tend to be highly import-intensive. This is especially true for textiles, apparel and the higher-end clothing sectors, light manufacturing and other industries. Hence a welcome pick-up in export growth often implies step-up in imports of intermediate material inputs, semi-finished goods and capital equipment. The pickup in domestic demand growth in 2006 boosted imports for a number of RPLA economies.

1.47 The combination of continued strong growth in both exports and imports yielded an increase in the RPLA goods deficit in 2006. The magnitude of the trade gap, the numerous exposures faced by RPLA economies, and the likelihood of a further pick-up in economic activity suggests that such deficits may persist into the medium term. For these economies, however, growing receipts associated with tourism, other services and worker remittances help to offset the shortfall on trade, supporting current account positions that-, for the majority of RPLA countries-, continue to be sustained at levels near balance.

1.48 Imports into the resource-rich countries increased by 25 percent in 2006 stimulated by oil revenues. Capital goods accounted for 45 percent of imports, given the wide-spread emphasis among oil exporters on infrastructure development and other public-sector investment initiatives. Consumer goods accounted for a fairly small 13 percent of total goods imports, suggesting that, in contrast with previous oil booms, the current period appears to be characterized by a more focused effort to encourage longer-term development. Capital goods (excluding transport equipment) accounted for one-third of imports for the RRLA countries, dominated by Algeria and Iran in 2005-06, echoing large scale public projects underway in these countries (Figure 1.13).

1.49 For the RRLA economies, import growth picked up to 28 percent in 2006. The revival was of similar magnitude in Algeria and Iran, reflecting a shift in emphasis from initial efforts to support household incomes and spending, to greater emphasis on capital projects. For the RRLI countries, estimates suggest a moderate increase in import growth levels in 2006. Though trade surplus positions are likely to have peaked in 2006, the rate at which these diminish over time is likely to be gradual, assuming a smooth- rather than disruptive- normalization in global oil markets.

Figure 1.13 Resource-rich imports reflect strong demand for capital goods plus transport equipment
Exports by destination country / region, share of total exports



Source: U.N. COMTRADE Database System.

1.4.4 Tourism and remittances

1.50 Tourism revenues form a significant portion of external receipts in, and account for a sizeable share of GDP for a number of countries in the MENA region, especially for the RPLA countries. For the region as a whole, growth of tourism revenues[5] picked up to a 14.5 percent pace in 2006, up from a 12.6 percent growth in 2005. In retrospect, the 2006 results for MENA show a strong performance, in light of heightened tensions associated with the ongoing conflict in Iraq, as well as the mid-July 2006 conflict in Lebanon, where the promising tourism prospects for 2006 came to a halt.

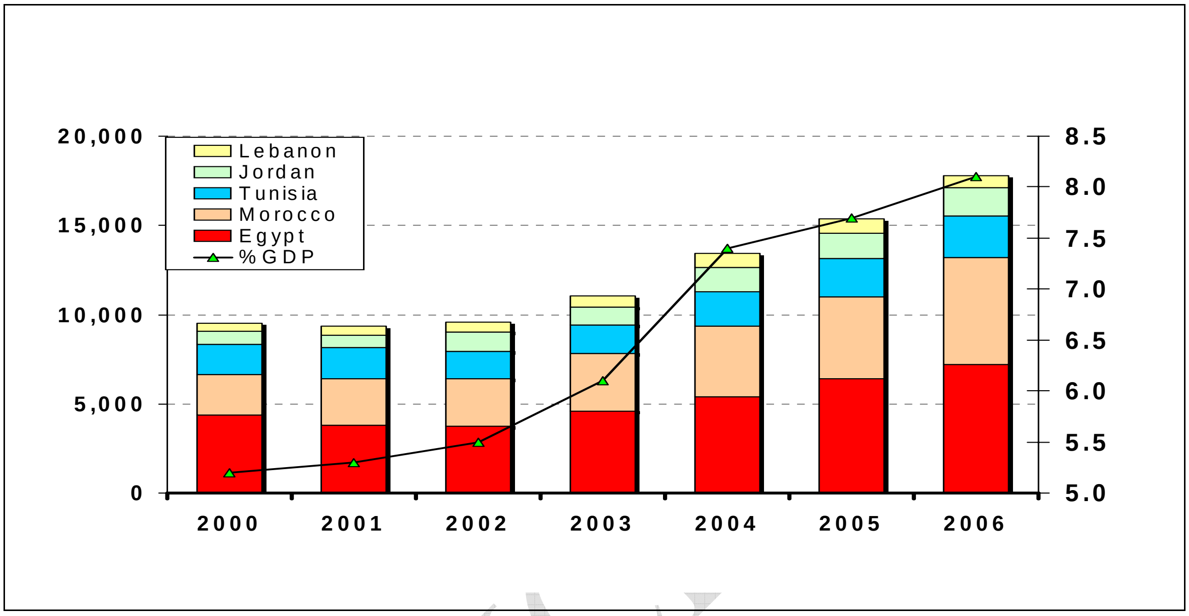
1.51 Among RPLA tourism destination countries, the importance of this revenue stream is greatest for Jordan (11.3 percent of GDP in 2006), followed by Morocco (10.6 percent), Tunisia (8 percent), and Egypt (7.6 percent) and Lebanon (2.8 percent). For many countries, tourism receipts (along with remittances) offset a good portion of merchandise deficits to keep current

[5] Tourism revenues here measured as the IMF Balance of Payments (BOP) services category ‘travel credit’. Does not include second-round effects of tourism-related spending on the domestic economy.

accounts near balance. For the countries noted earlier, tourism revenues increase to 8.1 percent of the group's GDP (Figure 1.14).

Figure 1.14 RPLA tourism revenues pick-up up on 2005 outturns

Tourism (BOP) receipts, millions USD [left]; %GDP [right]



Source: World Bank, IMF, World Tourism Organization.

1.52 Gains in 2006 were powered by Morocco, with an extraordinary 29 percent increase in revenues, while in near-by Tunisia tourism receipts grew by 9.4 percent in the year, with tourists originating increasingly from within the MENA region. In the Mashreq, Jordan experienced an advance of 10 percent in tourism revenues, though concentrated in the first half of the year (prior to the outbreak of conflict in Lebanon) with a sharp fall-off in arrivals thereafter. And in Lebanon itself, tourism arrivals surged by 49 percent in the first six months of 2006. Arrivals dropped by 50 percent in the July-September period, as closure of Beirut's airport carried devastating effects on the tourism business. Revenues dropped an estimated 25 percent in the year[6].

1.53 Developments in Egypt—the key destination for western tourism in the region, with revenues of some $7.2 billion—were mixed in 2006. Lebanon's main tourism clientele—Gulf State nationals and Saudis, switched to other regional destinations, including Egypt, in the summer months, helping to compensate for weak arrivals from key European sources, such as

[6] World Tourism Organization. "UN-WTO World Tourism Barometer", October 2006. UNWTO, Madrid.

France and Italy. As a result of these events tourism receipts increased by 12.5 percent contrasted with 18.5 percent in 2005.

1.54 Gross remittance inflows to countries in the MENA region increased 9 percent for a second year in succession during 2006 to $19.3 billion. Morocco stands out as the largest recipient of remittances, amounting to $5.2 billion in 2006, up 10 percent from 2005 levels, in part reflecting the onset of stronger economic activity in the Euro Area. As a share of GDP, however, Jordan is most reliant on this income, notably from the GCC countries, registering 17.5 percent of GDP in 2006. And fastest growth in remittances during 2006 was experienced by Algeria, gaining 30 percent after a sharp 20 percent contraction in the year preceding.

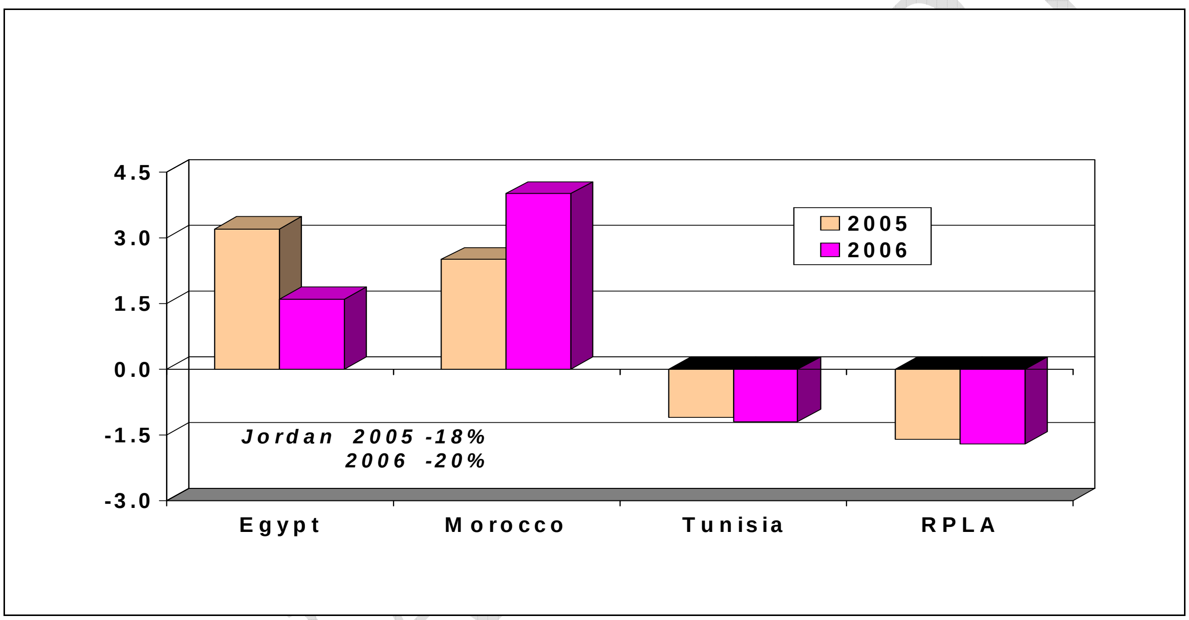
1.55 Among the resource-rich laboring importing countries, gross remittance payments increased moderately in 2006. Saudi Arabia retains first place in the group standings, with remittance outflows of $15 billion. As a proportion to GDP, payments are largest for Qatar (4.8 percent), while rapid growth is underway in the UAE (12-15 percent over 2005-06), reflecting a surge in construction, services and other activities requiring extensive use of the expatriate labor force. For the region as a whole, remittances continue to record net outflows ($11.2 billion in 2006), reflecting a longer-term trend among the GCC toward increased sourcing of labor from South-and East Asia- while diminishing that from countries within the MENA region.

1.4.5 Current account balances

1.56 For the MENA region as a whole the current account of the balance of payments improved to almost 21 percent of GDP, but changes in current account positions showed wide variation in 2006 with continued widening of surplus positions for the resource rich countries, contrasted with a very small deterioration for the resource poor economies. Dominated by the oil-exporting countries, the surplus position of the region increased by some $90 billion in 2006, to nearly $290 billion. This was distributed across the RRLA countries: seeing a modest increase of $3 billion, given an easing surplus position in Iran; the RRLI economies: an increase of $88 billion; and the RPLA countries an aggregate deterioration of $0.7 billion.

1.57 Current account results for 2006 expressed as a proportion to GDP displayed variation across MENA subgroups and individual economies. The resource poor economies witnessed a moderate deterioration from -1.6 percent- to -1.7 percent of GDP (Figure 1.15). Among RPLA countries, Jordan's position moved deeper into deficit, as oil prices increased, while Lebanon continued to register deficits around 20 percent of GDP. In Egypt, the current account surplus declined to 1.6 percent of GDP in the year, as a $3 billion deterioration in the trade balance outweighed strong performance across Egypt's set of secondary current account revenues, including Suez Canal dues (up 9.5 percent), tourism and remittance inflows. In contrast, Morocco's current account surplus increased to 4 percent of GDP.

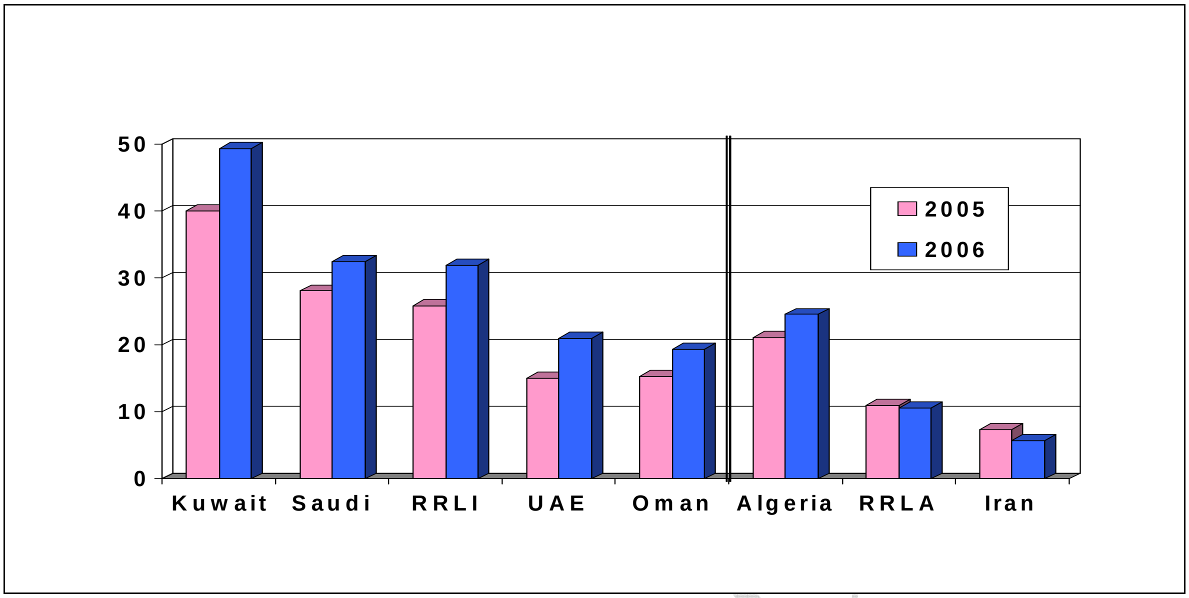
Figure 1.15 RPLA current account shows moderate deterioration
Current account balance as a share of GDP %



Source: National Agencies and World Bank. *excludes Lebanon and WBG.

1.58 The resource-rich economies saw a continued step-up in surplus position to 25.1 percent of GDP (Figure 1.16). The gain was driven by the RRLI economies. Saudi Arabia—which had stepped-up oil and natural gas production in the first half of 2006 in an effort to soften global oil prices that were rising—saw a sharp increase in current surplus to almost 33 percent of GDP. And Oman's surplus increased due to the coming-on line of a third LNG train, as well as implementation of an FTA with the United States at mid-year 2006. In contrast with the GCC countries, the RRLA group witnessed a modest decline in current surplus position to 10.6 percent of GDP in the year driven by deteriorations in Iran and Yemen. Iran's current account surplus diminished to 5.8 percent of GDP as oil production was cut by some 13.5 percent, in part due to capacity constraints, and as imports continued on a double-digit growth path. Yemen slipped to a deficit position of 5 percent, given severe capacity constraints in oil production.

Figure 1.16 Resource-rich* current account surplus at high levels
Current account balance as a share of GDP %



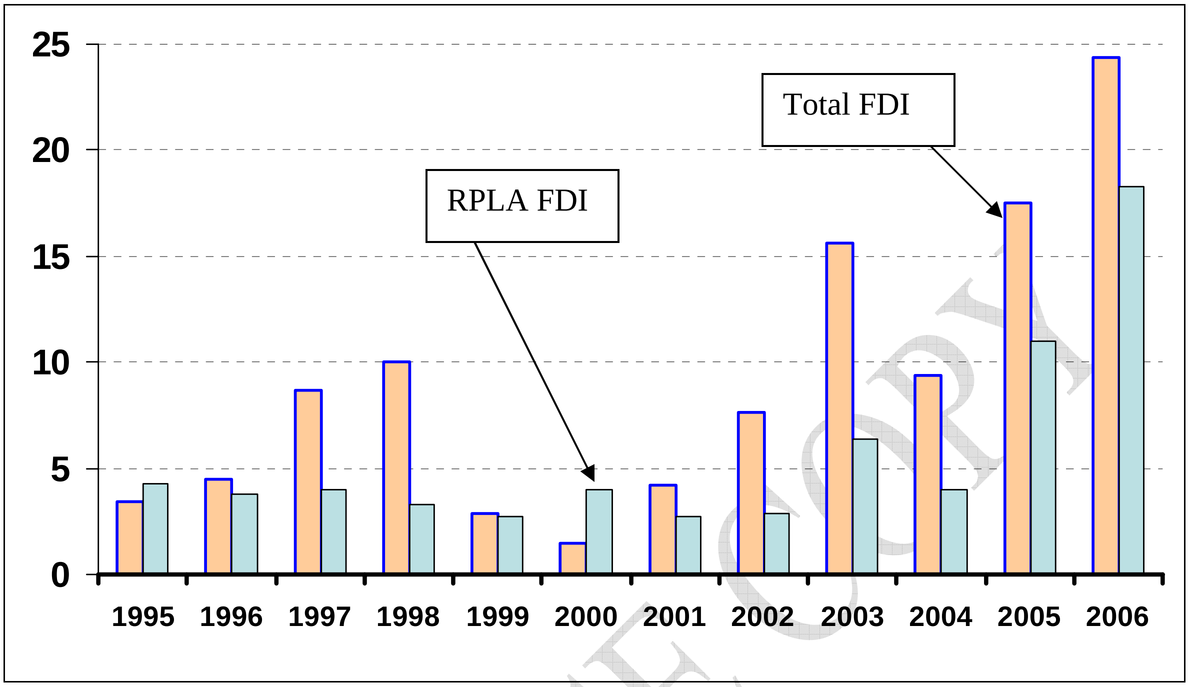
Source: National Agencies and World Bank. *selected economies.

1.4.6 Foreign direct investment strong in 2006

1.59 The MENA region experienced a sharp increase in FDI flows in 2006 to a record $24.4 billion, up almost 40 percent in the year, and triple the level of 2004 (Figure 1.17). This is due in part to completion of major privatization deals and increased investments in the energy sector. Intra-regional FDI flows increased not only in the energy sector, but also in sectors such as infrastructure, real estate and tourism. Investors from countries such as Qatar and the UAE are expanding their sights rapidly to MENA countries.[7] RPLA economies garnered the bulk of FDI flows in 2006 ($18.3 billion) increasing some 66 percent in the year. Among RPLA recipients, FDI into Egypt increased further to $6.1 billion in 2006 due to a telecoms license and privatization in the banking sector.[8] FDI in oil and gas in Egypt has also been significant in recent years, and is expected to increase considerably more in coming years.

[7] Bahrain-based firm announced a $1.4bn investment in Morocco in early 2006—equestrian city in Marrakech and a seaside resort in Tangier—Bahrain, UAE and Kuwait are participants. UAE earlier announced $9billion investment plan in Marrakech tourism and other real estate.
[8] Etisalat of the United Arab Emirates bought Egypt's third mobile network license in July in a deal worth around $2.9 billion. Italy's Sanpaolo won an auction to buy 80 percent of the state-owned Bank of Alexandria for $1.6 billion in October. A Gulf Arab consortium led by Bahrain's Ahli United Bank agreed

Figure 1.17 FDI flows to MENA mark new highs in 2006
Foreign direct investment, $ billion



Source: National agencies, IMF, UNCTAD and World Bank.

1.60 In Tunisia, a major privatization deal in the telecoms sector and investment in the oil and gas sector led also to record high FDI flows.[9] Similarly, in Morocco, FDI flows remained high due to privatization and two telecom licenses.[10] And despite the summer conflict, FDI to Lebanon is expected to have increased substantially, due to a major South-South merger and acquisition deal by a South African telecoms company, and real estate investments that had largely been committed before the dispute.[11]

1.61 For the resource-rich labor abundant economies, FDI doubled (from low levels) to $3.4 billion in the year. Algeria secured $1.4 billion in FDI, mostly as investments in oil and gas. Iran continued to receive limited amounts of FDI, even though foreign oil companies—including those from China and India—increased their presence in the country.

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to buy 89.3 percent of Delta International Bank in August. The consortium had earlier said the deal values the bank at $322 million.

[9] The value of Tunisie Telecom's partial privatization was around $2.2 billion. The energy sector investment reached almost $0.4 billion in 2006.

[10] In 2006, Italy's Eni has signed an exploration deal with Morocco that will last for a year and will involve geological and geophysical surveys in order to assess reserves.

[11] In April 2006, South African cellular operator, MTN, concluded its largest outward M&A buyout by purchasing Lebanese Investcom for $5.5 billion.

1.5 NEAR TERM ECONOMIC PROSPECTS, 2007-2009

1.62 A number of factors are likely to shape the profile for growth in the MENA region. The external environment is anticipated to be fairly conducive for activity in MENA over 2007-09. At the same time, domestic conditions will vary decidedly across the different economies of the region, as will efforts at reform.

1.63 Prospects for MENA are potentially favorable for the period through 2009. A gradual easing of growth among the resource-rich economies, in tandem with softening in oil prices and MENA oil revenues appears to be at hand. At the same time, this slack is anticipated to be picked-up by the resource-poor economies, as the group's momentum gains stronger traction in 2007 and 2008. On balance, MENA activity eases from recent peak 6.3 percent growth of 2006 to 5.2 percent by 2009. Current and fiscal positions among the resource rich economies decline. RPLA fiscal positions show improvement, but external shortfalls hold steady near 3 percent of GDP.

1.5.1 Global assumptions underlying the projections

1.64 For the oil dominant countries of the MENA region, the future path of oil prices, the underlying determinants of global oil demand and supply, as well as OPEC policy measures to hold prices within an acceptable band are all fundamental to prospects for oil revenues and growth. The general growth outlook for the OECD and developing countries, in turn helps to determine global oil demand—in recent years a large step-up in the importance of the latter group. Oil supply growth from non-OPEC sources also has the potential to increase in importance, providing competition for OPEC (and MENA) for world markets.

Oil market conditions 2007-2009

1.65 Following the average $64.29/bbl oil price in 2006, underlying assumptions posit a gradual softening to $49.72/bbl by 2009. Still, oil prices remain relatively elevated, as global oil demand is viewed to provide fundamental support for these levels.

1.66 As highlighted in Table 1.5, oil prices in the near-to medium term are expected by most forecasters to stay elevated-, and MENA oil production levels to increase gradually through 2009.

However, there is substantial uncertainty about the path of oil prices and of oil supply and demand. Strong oil demand in developing countries may well support such projections but unexpected supply disruptions and policies to sustain ever-higher prices could once again lead to large upheavals in the oil market and for MENA oil revenues in particular.

Table 1.4 Global Environment Assumptions to 2009

			Estimate	Forecast		
	2000-2004	**2005**	**2006**	**2007**	**2008**	**2009**
	average					
Oil market developments						
World Bank average price ($/bbl) /a	28.83	53.39	64.29	55.89	52.72	49.72
Growth in world demand (mb/d) ch%	**1.9**	**1.5**	**1.0**	**1.7**	**1.9**	**2.0**
OECD demand	0.8	0.5	-0.6	0.7	0.8	0.8
Developing country demand	3.7	2.8	3.3	3.1	3.5	3.7
Growth in world supply (mb/d)	**1.9**	**1.5**	**1.0**	**1.7**	**1.9**	**2.0**
OPEC supply	1.6	3.4	2.1	0.0	0.6	2.2
o/w MENA	2.3	3.6	2.1	0.0	0.8	2.2
Non-OPEC supply	2.1	0.3	-1.3	2.9	2.7	1.9
GDP growth in MENA export markets /b						
World	**2.5**	**3.5**	**3.9**	**3.2**	**3.5**	**3.7**
OECD countries	**1.9**	**2.6**	**3.0**	**2.4**	**2.8**	**3.0**
United States	2.5	3.2	3.3	2.1	3.0	3.2
Euro Area	1.3	1.5	2.8	2.0	2.1	2.2
Japan	1.0	1.9	2.2	2.0	2.3	2.5
Developing countries	**4.9**	**6.6**	**7.0**	**6.4**	**6.1**	**6.2**
China	9.4	10.2	10.4	9.6	8.7	8.7
Other East Asia and Pacific	4.7	5.4	5.4	5.7	5.9	6.0
Europe and Central Asia	4.9	6.0	6.4	5.7	5.5	5.5
Financial- and non-oil commodity markets						
U.S. LIBOR 6-months (%)	3.0	3.6	5.4	5.6	4.9	4.8
U.S. ten-year T-note	4.8	4.3	4.8	4.9	5.0	5.0
U.S. dollar effective exchange rate (ch%) /c	-1.1	-2.4	-1.5	-3.0	-0.5	-0.5
Dollar per Euro exchange rate	1.027	1.250	1.255	1.345	1.290	1.260
Average spread on EM Debt (basis points)	640	306	200	…	…	…
Average spread on MENA Debt	495	324	325	…	…	…
MSCI EM equity index (USD) ch%	5.5	30.3	29.2	…	…	…
MSCI MENA equity index (USD) ch%	7.8	41.7	23.4	…	…	…
Gross capital inflows to EM ($bn) /d	195	361	490	...	...	…
to developing MENA region	9	22	11	...	...	...
Non-oil commodity prices (ch%)	5.5	13.4	24.6	-1.0	-7.5	-7.7
Manufactures unit value index (ch%)	2.4	0.0	3.2	3.8	0.4	0.7

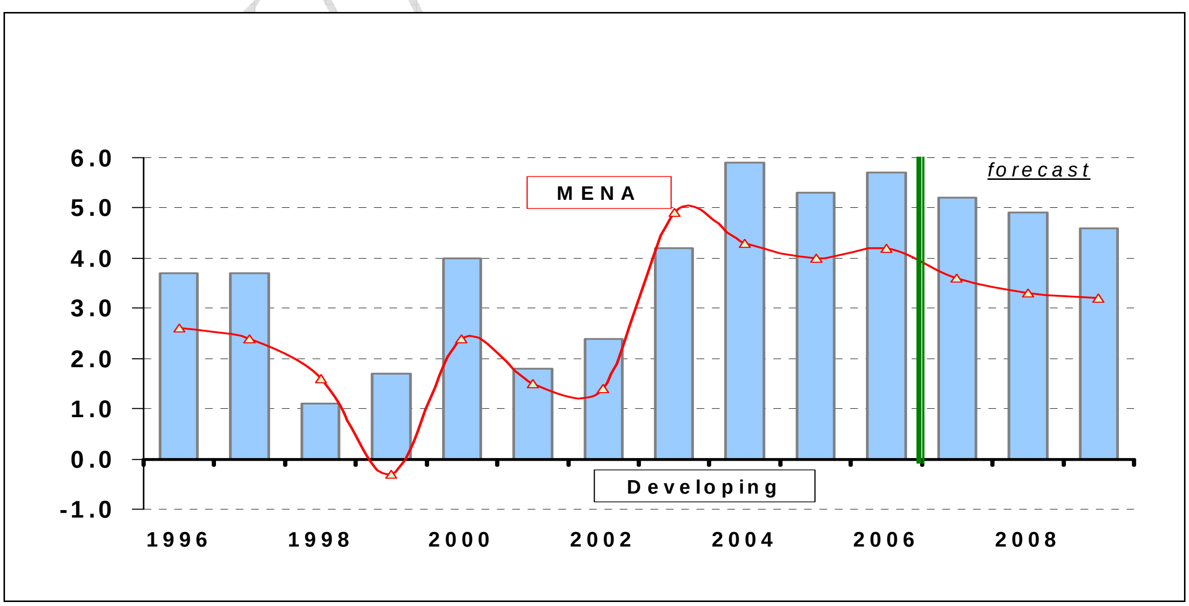
Source: International Energy Agency, JP Morgan-Chase, Morgan-Stanley, OPEC, World Bank and IEA projections.
Notes: /a Average of Brent, WTI and Dubai crude prices. /b GDP in 2000 U.S. dollars. /c Nominal, broad measure. /d Comprised of bonds, bank borrowing and equity flows, on a gross basis.

1.5.2 *Overview of near term prospects*

1.67 GDP per capita growth for the aggregate MENA region is expected to ease from 6.3 percent during 2006 (4.2 percent in per-capita terms) to 5.2 percent in 2009 (3.2 percent in per-capita terms) (Figure 1.18). The resource rich countries determine in large measure the down-slope of the regional growth path, with GDP gains for the RRLI economies falling more by 2009, on the back of diminished oil revenues and slackening in the pace of fiscal outlays, coupled with continued strong momentum in import demand. Growth for the RRLA economies eases as well, and largely for similar reasons. Yet, given the more-moderate upturn in recent years, the slowdown for this group appears more measured.

1.68 In contrast, a more-favorable international environment (turnaround in the terms of trade and pick-up in export market growth) supports GDP growth for the aggregate of RPLA economies. From 5.6 percent output gains in 2006, these countries are viewed to dip in 2007, before advancing moderately to 5.5 growth by 2009. Though the proximate cause of the step-up in growth for the resource poor economies may be stronger export performance (accompanied by continued strength in secondary revenue streams from tourism and remittances), continuation of domestic reforms which empower private sector growth will be key, as will the emerging trend of increasing FDI flows from within the MENA region.

Figure 1.18 MENA per-capita growth to move in-line with LMIC* countries
Real GDP per capita: developing, MENA-, East Asia, Africa



Source: National Agencies and World Bank projections. *Low and middle income.

Table 1.5 Real GDP growth, 2000-2009

			Estimate	Forecast		
Country	**2000-2004**	**2005**	**2006**	**2007**	**2008**	**2009**
MENA region (incl. Iraq)	**4.5**	**5.9**	**6.2**	**5.6**	**5.3**	**5.2**
MENA (excl. Iraq)	**4.8**	**5.9**	**6.3**	**5.7**	**5.3**	**5.2**
By resource-based classification	average					
Resource-poor, labor abundant	**4.1**	**3.8**	**5.6**	**4.9**	**5.0**	**5.5**
Djibouti	2.4	3.2	4.2	4.7	5.0	5.0
Egypt, Arab Republic of	3.9	4.6	6.9	5.3	5.4	6.0
Jordan	5.6	7.3	6.3	5.0	5.0	5.5
Lebanon	4.0	1.0	-5.5	4.5	2.9	3.5
Morocco	4.0	1.7	7.3	3.5	4.5	4.6
Tunisia	4.6	4.2	5.3	5.6	6.0	6.2
West Bank and Gaza	…...	6.0	-12.0	…...	…...	…...
Resource rich	**5.1**	**6.6**	**6.5**	**5.9**	**5.4**	**5.1**
Resource-rich, labor abundant (inc Iraq)	**3.7**	**4.6**	**4.3**	**4.0**	**4.2**	**4.2**
Resource-rich, labor abundant (exc Iraq)	**5.0**	**4.6**	**4.3**	**4.0**	**4.2**	**4.1**
Algeria	4.3	5.3	1.4	2.5	3.5	4.0
Iran, Islamic Republic of	5.7	4.4	5.8	5.0	4.7	4.5
Iraq	-6.7	3.7	4.0	3.5	4.0	4.5
Syrian Arab Republic	3.5	4.5	5.1	3.2	3.5	3.2
Yemen, Republic of	3.7	3.8	3.9	2.5	3.0	2.5
Resource-rich, labor-importing	**5.1**	**7.5**	**7.5**	**6.8**	**5.9**	**5.6**
Bahrain	5.6	6.9	7.0	6.7	6.0	5.8
Kuwait	5.9	8.5	6.2	5.6	4.8	4.5
Libya	5.5	8.4	8.1	7.5	7.3	6.5
Oman	4.6	5.6	6.4	5.7	4.8	4.8
Qatar	7.9	11.0	12.1	10.6	9.5	8.0
Saudi Arabia	3.6	6.6	5.8	5.7	5.3	5.0
United Arab Emirates	7.6	8.5	10.7	8.5	6.5	6.2
By geographic sub-region						
Maghreb	4.6	5.1	5.0	4.5	5.1	5.1
Mashreq (excl WBG)	4.1	3.7	1.4	4.1	3.6	3.8
GCC	5.1	7.5	7.4	6.7	5.8	5.5
Other (excl Iraq)	4.8	4.5	6.2	5.0	4.9	5.1
By oil-trade group						
Oil-exporting countries (excl. Iraq)	4.9	6.4	7.0	6.1	5.5	5.3
Oil-importing countries (excl WBG)	4.3	2.8	4.0	4.4	4.6	4.9
Memorandum items: Comparator regions						
MENA (excl Iraq)	**4.8**	**5.9**	**6.3**	**5.7**	**5.3**	**5.2**
All Developing countries	**5.0**	**6.6**	**6.9**	**6.4**	**6.1**	**5.9**
East Asia and the Pacific	8.0	9.0	9.1	8.7	8.1	7.8
Europe and Central Asia	5.2	6.0	6.4	5.7	5.5	5.2
Latin America and the Caribbean	2.2	4.5	5.0	4.2	4.0	3.8
South Asia	5.7	8.1	8.2	7.6	6.9	6.7
Sub-Saharan Africa	4.0	5.5	5.2	5.4	5.3	5.1

Source: National Agencies and World Bank staff estimates.
See footnotes to Table 1.1

1.69 In the immediate term, OPEC appears to be motivated to remove surplus overhang in the market and stabilize prices at a relatively high level (consensus currently is $50-60/bbl). OPEC's present challenge is to stabilize prices at its preferred level, but also prevent prices from rising too rapidly as the oil market balance is tightened.

1.70 CPI inflation appears to reach peak rates in 2006-2007 at 5.2 percent before diminishing to 4.7 percent by the end of the forecast. Overall fiscal positions decline in surplus during 2007, echoing deficit positions among the RPLA countries, partially offset by continued, albeit much reduced increments- to oil revenue for selected RRLI economies. The aggregate current account position for the region begins to diminish in 2007 (continuing on this path though 2009.

1.71 As has been the case historically, so the forecast attributes of the MENA regional groups are likely to exhibit quite diverse outturns. The resource poor economies are likely to be influenced by a host forces as growth eases at first from 5.6 percent in 2006, before reviving toward 5.5 percent by 2009.

1.72 Among the RRLA countries, developments in Iran and Algeria will tend to shape the sub-regional outlook, with Syria and Yemen growing at modest rates, dependent on levels of hydrocarbons, exports of non-oil goods, and tourism (for Syria). For the group, GDP growth is viewed to ease though 2007 to 4 percent, after which stronger recovery in Algeria from recent difficult conditions is viewed to turn a corner, reaching 4.1 percent by the forecast end. Developments in oil markets are central to prospects for Iran and Algeria, but policy developments in both countries will play a major role in the outlook. In Iran, GDP is projected to ease steadily from 5.8 percent in 2006 to 4.5 percent by 2009, on an assumption of unchanged economic policy. Among other factors and policy developments, capacity constraints in oil production are placing a substantial crimp on growth.

1.73 For the RRLI economies, easing global oil prices and a slower-paced rebuild of oil production levels over the projection period implies a gradual dissipation of current account- and fiscal surplus positions. Given the ramp-up in infrastructure and other longer-term investment programs, domestic demand is anticipated to continue at strong rates of growth, underpinning robust import demand, which in turn furthers the process of normalizing excessive external surplus positions. As this adjustment process unfolds, GDP growth is expected to drop from the robust 7.5 percent of 2006 to 5.6 percent by 2009. This pattern of growth characterizes most of the GCC economies, though dynamics will differ based on initial conditions and underlying demand momentum. Oil export revenues for the RRLI economies are slated to peak in 2006 at $395 billion, easing to $356 billion by 2009, a decline of 10 percent from 2006 outturns.

1.74 In examining external accounts and fiscal balances over the forecast period, two points stand out. For the region as a whole, both current account and fiscal positions are viewed to diminish as a proportion of the region's GDP over time—but that decline is not—at the end of the day—excessive. Moreover, the buildup of reserves, as well as of foreign assets by the GCC and other oil-exporting countries should serve to cushion a large proportion of decline in the fiscal surplus, should this be deemed required by policy makers.

1.75 MENA's overall external balance is viewed to remain in surplus by the close of the projections period, easing from a peak of 20.7 percent of MENA GDP in 2006 to a still-substantial 12 percent by 2009. In turn, the fiscal side is characterized by a peak surplus position of 13.2 percent of GDP in 2007, easing to 7.7 percent by 2009. Balances will differ across MENA subgroups, with the resource-poor economies showing improvement on the fiscal side combined with a degree of deterioration on external accounts. And the resource-rich economies are characterized by a gradual mark-down to both external and fiscal positions through 2009.

1.5.3 Risks

1.76 The external environment continues to be a key determinant of regional growth, but domestic policies and how much reform takes place also have important influences on performance (see chapter 3). For the oil rich exporters of MENA, management of the hydrocarbon windfalls of the last years remains a continuing challenge. The risk of overheating domestic demand, with potential inflationary consequences looms as an overarching threat. Moreover, judicious use of oil stabilization funds to counter such trends and to offer a cushion for future growth should be a priority, as should prudent disposition of surplus funds across asset classes. Importantly, domestic reform efforts stand at some risk against the background of abundant liquidity and rapid growth, particularly for RRLA countries. Should oil prices take a sudden and sustained downturn, economies may find adjustment to become a difficult transition.

1.77 The surge in oil revenues and government spending among oil exporters has yet to generate substantial inflationary pressures, with the notable exception of Iran. However, rapidly rising credit and external flows present challenges for economic policy management. Moreover, regional stock and housing markets have appreciated enormously; valuations remain high in many countries while in the Gulf the downward adjustment in stock prices that took place in mid 2006 has not recovered. Finally, downside risks stemming from uncertain trends in geo-political conditions remain an element of substantial concern for regional prospects.

1.78 Conflict continues to drag developments in the region, either directly in countries like Iraq, Lebanon, and West Bank and Gaza, or indirectly elsewhere through spillover effects that affect government policy and influence oil prices, investment prospects and migration flows. This places a heavy burden on many economies of the region. If conflict and tensions in the region subside, the peace dividend could be quite significant. Reforms are gradual but in general moving forward to change the balance between the public and private sectors. This, in combination with the peace dividend could boost growth, incomes and development in the entire MENA region.