

## Overview

During 2007 the Middle East and North Africa region<sup>1</sup> (MENA) experienced average growth of 5.7 percent. This was the fifth year in a row in which the region grew at a rate higher than 5 percent, exceeding levels reached in the 1990s and early 2000s. This performance occurred in the context of an external environment marked by three major developments: a continued rise in the price of hydrocarbons, turbulence in international financial markets following the sharp drop in market valuations of U.S. mortgage-backed securities, and a sharp rise in the price of non-oil commodities, especially foodstuffs. These developments have affected the various MENA economies in different ways. On average, however, the region has done well, with respectable growth and comfortable external and fiscal balances. Similar performance, that is, average growth of around 5.6 percent, is expected over the next three years. Oil prices are expected to remain buoyant, leading to high levels of investment and remittance flows within the region. Food prices are also expected to remain high. Since most countries in the region subsidize food and energy, this will lead to fiscal pressures for many of them. But such pressures are not expected to choke off economic growth. Global financial turbulence and a likely slowdown of growth in the OECD countries are expected to be offset by continued robust spending among oil-exporting countries and vibrant expansion in China and India.

### ***Economic Developments and Prospects***

*Distribution of growth across region.* During 2007, GDP growth was almost evenly distributed across the sub-groups of the region. For the resource-poor labor abundant economies (RPLA), output growth slipped to 5.4 percent in 2007 from 6.3 percent in 2006. But, with the exception of

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<sup>1</sup> The region consists of *resource-poor, labor-abundant* economies (Arab Republic of Egypt, Jordan, Morocco, Tunisia, Lebanon, and Djibouti); *resource-rich, labor-abundant* economies (Algeria, Islamic Republic of Iran, Iraq, Syrian Arab Republic, and the Republic of Yemen); and *resource-rich, labor-importing* economies (Saudi Arabia, United Arab Emirates, Kuwait, Libya, Qatar, Oman, and Bahrain).

Morocco and Djibouti, GDP accelerated or equaled its 2006 pace in all other economies of the subgroup. Per-capita GDP eased to 3.8 percent in the year, still well above the 2.6 percent pace for the 2000-04 period.

High levels of hydrocarbon revenues, albeit reduced from earlier years, supported growth for oil exporters. Developments for the group of resource-rich labor-abundant economies (RRLA) were dominated by key hydrocarbon producers Iran and Algeria. GDP growth for the RRLA group rose from 4.5 percent in 2006 to 5.7 percent during 2007 on a rebound in output in both Iran and Algeria. Growth eased in the remaining countries of the group, notably so in Syria. In line with improvements in group output, per capita GDP advanced 3.6 percent in the year, above its long-term trend. For the resource-rich, labor-importing (RRLI) countries, developments were mixed. GDP growth fell to 5.8 percent from 6.2 percent in the year, as crude oil production was scaled back by a substantial 4.3 percent.

While the region has done well in comparison with its own past, the same cannot be said when comparing with other regions. For example, the 3.7 percent growth of per capita income in 2007 is almost two percentage points higher than levels achieved in the late 1990s. But it is still less than the rate achieved by other developing regions. This implies that the region must continue to pay attention to the unfinished structural reform agenda in order to assure sustained progress in a more competitive world.

*Changing sources of growth.* The role of different sources of growth has changed over the course of the decade. During the early part of the decade, growth was driven largely by domestic consumption. Since then, the contribution of investment has been rising and in 2007 investment accounted for more than 100 percent of real GDP growth (offset in part by large negative contributions from net exports.) The contribution of government consumption to growth, which had increased over 2004-2006, declined in 2007.

*Impact of global financial turbulence.* The impact of global financial turbulence has been limited. Though equity markets in the region initially tended to follow the path undertaken by emerging markets as shown by the MSCI EM index, the GCC countries, Egypt and Morocco outperformed this index over the last quarter of 2007 and into early 2008. Spreads on MENA sovereign bonds escalated, but in like fashion to the experience of all developing countries, the increase in spreads reflected the fall in U.S. Treasury yields (flight to quality) such that MENA sovereign yields were largely unchanged. And real estate developments in GCC countries were little affected by changes in the international financial environment, though a tightening of credit criteria could come into play in the coming years.

*Impact of oil price rise.* The ramp-up in global oil prices over the course of 2007, to set all-time records above \$100/bbl during early 2008, continues to be a major factor in MENA region developments. Oil prices increased 78 percent over the course of 2007, from \$54/bbl at the start of the year to \$94.50/bbl on December 31.<sup>2</sup> Prices averaged \$71/bbl for the year, up 10.5 percent over the average for 2006. Crude oil and refined product export revenues advanced by 11.6 percent in the year—from \$585 billion to \$653 billion (including Iraq). This contrasts with a 27 percent increase in oil receipts during 2006, rising \$122 billion, and underscores the fact that production in the region has been declining—either due to binding capacity constraints, or to output in several countries being managed to remain in line with agreed OPEC quotas. Nonetheless, the \$68 billion increase in oil-related export receipts helped sustain government spending programs, while allowing a moderate buildup in international reserves and contributions to Sovereign Wealth Funds (SWFs) by several countries.

*Impact of food price shock.* The sharp rise in the price of staple foodgrains such as rice and wheat had a varying impact on different countries depending on certain risk factors. Low income countries that are relatively big food importers (in terms of proportion of imports and consumption) have been at highest risk: examples include Djibouti and Yemen. In Yemen, food price inflation exceeded 20 percent in 2007, the highest in the region. Other risk factors include the extent to which food features in the spending patterns of the lowest income groups in a country. Here countries like Djibouti, Egypt and Yemen are among the most vulnerable since the bottom two quintiles of their populations spend 50 percent or more of their household budgets on food. It is not surprising that both Egypt and Yemen experienced episodes of social unrest in recent months. For many countries, the positive impact of economic growth on poverty has most likely been offset substantially by food price inflation in 2007 although not enough information is available at this point to provide robust estimates. Also, some countries have felt the pressure of food price increases directly in national budgets since they subsidize staple foodstuffs. Thus, countries like Egypt, Iran, and Syria have seen food subsidies claim shares of between 4 percent (in Egypt) and 8 percent (in Iran) of their budgets in 2007. Among GCC countries, the chief manifestation of food price increases has been inflation.

*Foreign direct investment.* FDI continued to flow at high levels, some \$45 billion, down moderately from the record \$52 billion recorded in 2006. In contrast with 2000-2004, when FDI flows were more evenly distributed, three countries attracted the bulk of flows from 2005 forward. Saudi Arabia, Egypt and the United Arab Emirates are now the three largest FDI recipients in the region, accounting for more than half of inward FDI flows. The GCC countries

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<sup>2</sup> World Bank Average basis: a simple average of Brent, WTI and Dubai crude oil prices (spot).

are generating healthy FDI outflows as well, of which just over 10 percent is destined for other countries within the region. In several MENA countries, the inflow of FDI appears to be heavily oriented towards real estate and energy sector investments. This is generating two concerns: first, that such investments might push up inflation through raising the price of non-tradeables (especially housing) and second, that they are not likely to contribute as much to reducing unemployment as would investments in the labor-intensive manufacturing sector. These concerns should be assessed through empirical analysis since some service sector projects, especially in the tourism/hotels area, can be quite labor-intensive.

*Inflation.* Inflation has increased around the world and MENA has not been immune to this trend. The main causes relate to rising energy and food costs and, for the GCC countries in particular, their pass-through into domestic prices through a fixed dollar peg. Prices of over \$100/bbl for oil inflate energy costs from gasoline to heating oil to jet fuel. And the dramatic hike in food prices (largely grains and agricultural fats and oils) are directly linked to higher fertilizer costs (energy), massively increased use of grains and fats for bio-fuels, and shrinking acreage utilized for feed and food. Higher inflation linked to these sources may be here to stay for several years. Policy makers in the region are already flagging this as a serious concern for macroeconomic stability, export competitiveness and the welfare of the public, especially the poor.

*Future growth prospects.* Several factors are likely to shape MENA's growth profile over the medium term. A softening of industrial country demand is anticipated for 2008, primarily in the United States. This will be accompanied by continued high global oil prices, tied to robust demand in emerging markets and supply restraint. This will help support regional output growth of 5.9 percent in 2008. Food prices will also continue to stay high, putting pressure on the fiscal and external balances of several MENA countries who are net importers of food. As the global environment stabilizes by 2009 and 2010, MENA should be able to maintain growth momentum at 5.6 and 5.3 percent respectively, with per-capita gains averaging 3.3 percent in 2010. Domestic conditions will vary markedly across the economies of the region. And the flux of developments related to continuing tensions in the region will affect global and regional investor confidence. But overall, MENA countries have positive prospects and the opportunity to advance reforms and position themselves better for sustainable growth and employment creation under global competitiveness.

## ***Regional Integration Developments***

The rise in the price of hydrocarbons in recent years has revived interest in intra-regional integration as a means of sharing prosperity within the region. In this context, integration is viewed not just as a set of preferential trade agreements but also as a means to foster the flow of labor, capital and investment. Efforts to promote such deeper integration are gaining prominence, and the paradigm of open regionalism that is based on the use of regional preferences as stepping stones for global integration and competitiveness is receiving the renewed attention of policy makers.

*Trade.* As far as trade integration is concerned, the region does not lack formal agreements. Many intra-regional agreements have been signed in the last few decades and at least one geographically comprehensive agreement, the Pan Arab Free Trade Agreement, is under implementation. The general impression, however, is that intra-regional trade is low compared to potential and to levels achieved by economic blocs elsewhere in the world. For example, intra-regional merchandise exports among PAFTA members is around 9 percent of total bloc exports. This is much less than the levels achieved by blocs such as NAFTA and ASEAN although comparable to the levels achieved by other blocs, such as MERCOSUR and COMESA.

Low levels of intra-regional trade can partly be explained by the lack of complementarity in production and trade structures across the region. Bilateral complementarity indices show that the match between desired imports and available exports within the region is generally poor, and remains significantly below the level found in successful regional communities. Other impediments, arising in policy choices, consist of uneven levels of import protection (widely dispersed tariff rates), high levels of nontariff barriers and poor logistics (involving customs, port and transport arrangements). While most trade agreements focus on reciprocal tariff reductions, studies show that the removal of nontariff barriers and improvement of logistics would provide greater welfare benefits at this stage in MENA.

*Labor Mobility.* The region is more integrated through labor mobility than through trade and investment. While its share of global trade flows is below 5 percent, 16 percent of all remittances paid out to migrants in the world originate in the MENA region and 10 percent of global remittances are received by residents of MENA countries. In recent years, the oil boom has led to increased migration to the oil-exporting countries, though this tendency is also constrained by the desire in such countries to reserve many jobs for nationals and the competition for available jobs provided by migrants from South and Southeast Asian countries. As migration flows become

larger, remittances may also be expected to increase, thus reversing a declining trend observed over the past decade or so in several MENA countries.

*Capital Flows.* Two trends frame the current context for intra-regional capital flows. First, on the demand side, a number of economies, previously dominated by the public sector, are opening up and have embarked on a series of structural reforms. Second, on the supply side, ample liquidity is available in the Gulf States from the oil boom and investors are searching for opportunities everywhere. How much capital actually does flow intra-regionally depends on regulatory developments applying to banks, stock markets, and foreign investments.

With respect to portfolio flows, investors from the GCC are showing interest in stocks of non-GCC countries seeing upside potential in these markets. Market capitalization in MENA increased from only 13 percent of GDP a decade ago to 50 percent by 2005, partly on the strength of cross-border portfolio flows. However, barriers and restrictions on portfolio capital movements continue to hinder deeper capital market integration and stock markets remain thin as far as trading and participation is concerned.

Direct foreign investment flows have been boosted by the improved business climate in some MENA countries, coupled with some economic liberalization and increased privatization. Project-based investments are targeting countries such as Syria, Tunisia, Lebanon, and Egypt covering several sectors including telecommunications, real estate, tourism, banking and financial institutions.

*Intra-regional infrastructure links.* The region is becoming more integrated through cross-border infrastructure projects in energy, transport and telecommunications. With the support of the European Union, Egypt, Jordan, Lebanon, and Syria have embarked in the establishment of a regional gas market which will be ultimately integrated with the EU internal gas market. Likewise, positive steps have been taken regarding the interconnection of power grids in the region even though energy trade between member countries remains limited to emergency situations. In the transport sector, the integration agenda is framed by two agreements: the International Road Agreement and the International Railways Agreement in the Arab Mashreq. In telecommunications, major regional equity investors have emerged as a result of the adoption of sector reforms and common regulatory guidelines. These investors are currently accelerating the regional integration of telecommunications markets.

Despite progress in regional integration in recent years, much remains to be done if MENA is to keep up in an increasingly competitive global environment. More effective integration calls for further reduction of tariff and nontariff barriers. In addition, large, untapped opportunities are

discernible in areas that have been largely neglected so far in regional integration efforts, notably trade and transport facilitation, services market opening, and factor market integration. These issues clearly deserve a higher profile on the policy agenda. Fortunately, all the associated policy reforms are not only suitable for bringing MENA countries closer together, but will also tend to make the economies of the region more competitive in international markets.

### ***Structural Reform Progress***

In recent years, MENA has embarked on wide-ranging reforms to improve the overall environment for growth. This review focuses on reforms in three key areas, trade, business climate and governance. The main findings may be summarized as follows:

*Trade reforms.* Substantial progress has been made in reducing tariffs and the time required for import and export processing. Tariffs have been reduced from a simple average of 20 percent in 2000 to 13 percent by 2007, a decline not matched in any other region over this period. However, non-tariff barriers remain high and trade logistics performance, reflecting the quality of customs, ports and transport arrangements, remains sub-par.

*Business climate reforms.* Despite notable improvements in some countries (e.g., Egypt and Saudi Arabia), as a whole the region has failed to keep pace with business climate reforms elsewhere. In terms of reform effort, it ranks in the bottom third worldwide (29th percentile).

*Governance reforms.* Progress with regard to governance has been mixed.<sup>3</sup> On the one hand, the quality of public administration remains relatively high in MENA, ranking above East Asia, Latin America, South Asia and Sub-Saharan Africa. However, this ranking has slipped relative to last year. On the other hand, the quality of public accountability remains very low in MENA, ranking below all other regions of the world. However, in terms of reform efforts devoted to improving accountability, MENA ranked in the 67th percentile, above all other regions. The latter ranking reflects a range of improvements in combating corruption, addressing weaknesses in the judiciary, improving property rights, and streamlining bureaucracy, especially among the GCC countries.

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<sup>3</sup> The data used to assess progress in governance is drawn from a variety of sources. The interpretations provided in this report do not necessarily reflect the views of the Management and Board of Directors of the World Bank.

Table 1: Progress with structural reform

Country/region	Trade policy		Business climate <sup>c</sup>		Governance: Quality of administration		Governance: Public sector accountability	
	Current status <sup>a</sup>	Reform progress <sup>b</sup>	Current status <sup>a</sup>	Reform progress <sup>b</sup>	Current status <sup>a</sup>	Reform progress <sup>b</sup>	Current status <sup>a</sup>	Reform progress <sup>b</sup>
Algeria	58	69	30	51	32	11	27	56
Bahrain	—	71	—	—	75	62	25	94
Djibouti	52	47	11	—	—	—	—	—
Egypt, Arab Republic of	72	96	20	61	42	94	23	75
Iran, Islamic Republic of	1	73	21	1	30	38	22	8
Iraq	—	—	37	—	—	—	—	—
Jordan	50	91	49	37	54	22	34	62
Kuwait	58	7	77	12	55	29	32	77
Lebanon	13	91	42	3	—	—	—	—
Libya	—	—	—	—	4	15	0	45
Morocco	64	55	31	17 <sup>c</sup>	75	90	32	77
Oman	44	70	76	69	56	28	17	88
Qatar	—	8	—	—	61	82	14	65
Saudi Arabia	61	87	87	55	71	92	5	68
Syrian Arab Republic	32	38	23	8 <sup>c</sup>	13	48	8	67
Tunisia	56	57	49	52	73	75	20	30
United Arab Emirates	77	—	54	6	44	2	20	84
West Bank and Gaza	—	—	33	—	—	—	—	—
Yemen, Republic of	20	87	63	10	23	18	19	57
<b>Regional averages (unweighted)</b>								
<b>MENA</b>	<b>47</b>	<b>63</b>	<b>44</b>	<b>29</b>	<b>47</b>	<b>47</b>	<b>20</b>	<b>64</b>
Resource-poor	51	73	32	42	61	70	27	61
Resource-rich, labor- abundant	28	67	35	17	24	29	19	47
Resource rich, labor-importing	60	49	73	35	53	44	16	74
East Asia and Pacific	49	43	63	45	46	50	39	41
Europe and Central Asia	50	55	56	63	54	64	53	56
Latin America and Caribbean	60	57	47	46	43	42	57	42
High-Income OECD	82	63	84	63	89	48	91	48
South Asia	23	40	46	33	34	51	37	29
Sub-Saharan Africa	29	30	26	46	31	45	36	53
<b>World</b>	<b>50</b>	<b>50</b>	<b>50</b>	<b>50</b>	<b>50</b>	<b>50</b>	<b>50</b>	<b>50</b>

Source: World Bank staff estimates .

a. For each index, the country's current status reflects its 2007 placement in a worldwide ordering based on a variety of relevant indicators, expressed as a cumulative frequency distribution, with 100 reflecting the country with the "best" policies worldwide, and 0 representing the country with the "worst" policies worldwide.

b. Reform progress reflects the improvement in a country's rank between 2000 and 2007 (or between 2003 and 2007 in the case of business and regulatory reform) in a worldwide ordering of countries based on changes in a variety of relevant indicators, expressed as a cumulative frequency distribution, with 100 reflecting the country with the greatest improvement in rank worldwide, and 0 reflecting the country with the greatest deterioration in rank worldwide.

c. The business climate index reported in this year's MENA Economic Developments and Prospects Report has been substantially revised (reflecting both changes in the indicators used and considerable revisions to historical data) and is not comparable with the index that appeared in last year's MENA Economic Developments and Prospects report.

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