

Overview

For the third year in a row, the Middle East and North Africa region¹ (MENA) enjoyed a spectacular year of growth, buoyed by record-high growth rates among the region's oil exporters. As oil prices continued their upward climb, the MENA region grew by an average of 6.0 percent over 2005, up from 5.6 percent over 2004, and compared with average growth of only 3.7 percent over the late 1990s. On an annual basis, MENA's average economic growth over the past three years, at 6.2 percent a year, has been the highest three-year growth period for the region since the late 1970s.

MENA's regional growth upturn has not been universally shared, however, and resource-poor economies² are increasingly feeling the adverse impact of higher oil prices. In earlier periods, MENA's nonoil economies also benefited from rising oil prices through a range of transmission mechanisms from the oil producers, including labor remittances and aid. Many transmission channels remain and have thrived during the current oil boom, including intraregional tourism and portfolio equity flows, but the overall magnitude of these channels is significantly diminished relative to prior booms. More-

over, with rising energy use, MENA's resource-poor countries are increasingly experiencing the negative consequences of higher oil prices on the external and fiscal fronts, in the form of higher oil import bills and energy subsidies.

Growth patterns among oil producers,³ on the other hand, have been increasingly harmonized, reflecting a trend toward common development strategies. Compared with previous oil booms, the region's oil producers are increasingly demonstrating impressive fiscal restraint. They are building up liquidity through external reserves, oil stabilization funds, and paying down debt. They are also pursuing common strategies for diversification of the oil wealth into foreign assets, as a way to transform the finite oil wealth into longer-term revenue streams. They have worked almost in unison to develop trade ties and to encourage greater foreign participation in their economies. With increased prudence, the volatile growth outcomes among oil producers that characterized the 1970s and 1980s have been increasingly supplanted by a common growth effect.

Although oil prices dominate the region's external landscape, MENA has experienced other important

¹ The Middle East and North Africa region comprises Algeria, Bahrain, Djibouti, the Arab Republic of Egypt, the Islamic Republic of Iran, Iraq, Jordan, Kuwait, Lebanon, Libya, Morocco, Oman, Qatar, Saudi Arabia, Syria, Tunisia, the United Arab Emirates, the West Bank and Gaza, and the Republic of Yemen.

² Resource-poor economies include Djibouti, Egypt, Jordan, Lebanon, Morocco, Tunisia, and the West Bank and Gaza.

³ Dominant oil producers in the region include Algeria, Bahrain, the Islamic Republic of Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, Syria, the United Arab Emirates, and the Republic of Yemen.

developments on the trade front. Resource-poor economies have dealt with the expiration of the Multifiber Agreement in 2005, which had allowed privileged access to European markets for the Arab Republic of Egypt, Morocco, and Tunisia in textile and clothing products. Textile exports in Tunisia and Morocco have been hard hit, while Egypt has managed to maintain textile exports to date, in part by cushioning the impact with a December 2004 agreement on qualifying industrial zones between Egypt, Israel, and the United States.

On the fiscal front, the sharp rise in oil prices has spotlighted the MENA region's heavy subsidization of oil prices within the domestic market. While oil-importing economies are particularly affected, the reliance on energy subsidies pervades the region, with large fiscal implications. Several resource-poor countries have implemented short-term adjustments to oil prices, but the concerns of potential poverty impacts have held back more ambitious reforms. Among oil exporters, windfall revenues have delayed the perceived urgency for reform.

Over the medium term, general conditions for maintaining a solid pace for growth appear promising. Global oil prices are now anticipated to hold above \$50 per barrel through 2008, which will provide for a moderating, yet still substantial, flow of oil revenues to MENA exporters. Should prudent budgetary policies prevail, prospects for the oil-dominant economies are upbeat, with growth easing from 6.7 percent in 2005 to 5.0 percent by 2008. For the diversified economies, the anticipated recovery in European demand will be a key external factor for growth during 2006–2008, as will the easing of oil prices, which should allow some of the costs of subsidies to be recaptured; also, growth among resource-poor economies is viewed to pick up above 5.5 percent. Overall, on a base set of assumptions, including continued moderate progress in domestic reforms, the MENA region's growth is viewed to ease modestly in 2006 to 5.6 percent and to establish a 5.2 percent pace over 2007–2008, reflecting an acceleration for the diversified economies, contrasted with some slowing for oil exporters.

The oil shock MENA is experiencing has had important financial spillovers. Over the past few years, the region has seen an upsurge in financial activity as abundant liquidity has fed a rapid rise in credit growth, surging stock markets, and a booming real estate sector. Oil economies have been the primary

recipients, but a financial market upswing has also reached some of the region's resource-poor countries through increased cross-border investment, remittance flows, and tourism.

Many of the recent regional financial sector developments are positive. Strong credit growth and declining nonperforming loans have improved bank profitability and asset quality. Rising equity capital has increased the breadth and depth of investment opportunities to investors. In addition, many countries in the region have utilized their strengthened positions to address long-needed financial sector reforms, including public sector bank restructuring and privatization, licensing private financial entities, improving bank supervision, and upgrading prudential regulations.

However, several of the recent financial sector developments have increased exposure of some MENA economies to negative shocks. Banks have rapidly expanded financing for equity markets. Although the recent stock market gains have been built in part on impressive corporate profitability, stocks have also been increasingly speculative. Bank exposure to equity markets, through both lending and substantial income from brokerage fees, leaves bank income and asset quality vulnerable because of recent market corrections. Banks have also increased exposure to the booming real estate sector, which may be vulnerable to contagion effects from the recent equity market weaknesses and may also face slowdown with growing oversupply.

However, a more troubling aspect about MENA's financial markets is the seeming disconnect between the financial sector and the real private economy, despite the appearance of a relatively deep financial sector by macroeconomic indicators. Although regional banks have abundant liquidity, outside of the Gulf, few private businesses have access to bank finance. Even in countries with relatively high rates of lending to the private sector, credit remains concentrated among a select minority, and investment climate surveys suggest an average of more than 75 percent of private business investment in MENA is financed internally through retained earnings. As a result, few of the assets accumulating to the region are channeled toward productive investment. Moreover, key elements of a well-functioning financial sector that could help boost sustainable and efficient growth, including bond and equity markets and contractual savings instruments, remain largely undeveloped outside of the Gulf.

Overview Table 1: Global developments and MENA GDP growth

| Growth, or as otherwise specified | 2004 | 2005 | 2006 | 2007 | 2008 |
|--|-------------|-------------|-------------|-------------|-------------|
| World trade ^a | 12.0 | 9.0 | 8.5 | 7.0 | 7.0 |
| High-income imports | 8.9 | 6.6 | 6.7 | 6.2 | 6.2 |
| Euro Area | 6.3 | 4.3 | 5.8 | 5.3 | 5.4 |
| United States | 10.7 | 6.2 | 5.0 | 3.8 | 3.8 |
| Oil prices (\$/bl) ^b | 37.7 | 53.4 | 59.0 | 56.0 | 53.0 |
| Nonoil commodity prices ^c | 17.3 | 13.4 | 5.4 | -3.1 | -5.9 |
| MUV index ^d | 6.9 | 0.0 | 2.4 | 2.6 | 0.8 |
| US dollar LIBOR ^e (%) | 1.7 | 3.6 | 5.2 | 5.3 | 5.2 |
| World GDP ^f | 3.8 | 3.3 | 3.3 | 3.2 | 3.2 |
| High-income countries | 3.2 | 2.8 | 2.9 | 2.7 | 2.8 |
| Euro Area | 1.9 | 1.4 | 2.1 | 1.7 | 1.9 |
| Developing countries | 6.9 | 6.3 | 6.0 | 5.7 | 5.6 |
| MENA^g | 5.6 | 6.0 | 5.6 | 5.2 | 5.2 |
| Resource-poor | 4.8 | 4.0 | 5.4 | 5.4 | 5.7 |
| Resource-rich | 5.9 | 6.7 | 5.5 | 5.2 | 5.0 |
| Resource-rich, labor-abundant | 4.7 | 5.5 | 5.3 | 5.1 | 4.8 |
| Resource-rich, labor-importing | 6.5 | 7.2 | 5.8 | 5.3 | 5.0 |

Source: World Bank 2006c.

^a Goods and services (2000 US\$).

^b World Bank average oil price = equal weights of Brent, West Texas Intermediate (WTI), and Dubai crude oil prices.

^c World Bank index of nonoil commodity prices in nominal US\$ terms.

^d Index of manufacturers' unit value, G-5 countries (France, Germany, Japan, the United Kingdom, and the United States).

^e London Interbank Offered Rate.

^f Real GDP in 2000 US\$.

^g MENA geographic region comprising resource-poor, labor-abundant countries (Djibouti, Egypt, Jordan, Lebanon, Morocco, and Tunisia); resource-rich, labor-abundant countries (Algeria, the Islamic Republic of Iran, Iraq, the Syrian Arab Republic, and the Republic of Yemen); and resource-rich, labor-importing countries (Bahrain, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates).

A few critical facts lie at the heart of the structural disconnect between the relatively plentiful financial resources found across MENA and the scarcity of external financing for businesses. Public sector ownership has significantly impacted the direction of credit in MENA, as well as the operating efficiency and the ability of the banking sector to conduct robust risk analysis. Bank regulatory frameworks, with limited market forms of oversight and discipline, have led to adverse credit allocation. Access to banking facilities remains comparatively limited across the region and in many cases is restricted to public sector banking networks, concentrating credit provision upon a relatively privileged minority. Underdeveloped contractual savings and capital markets remove a source of competition for banks and an alternate avenue for firm finance. Governance structures undermine formal financial relationships across much of MENA. In addition, commercial-finance relationships are further undermined by a wealth of problems in MENA's business climate.

The region's recent strong liquidity creates a window for the governments of the MENA region to either accelerate or postpone the complicated process of reform, both within the financial sector and in the economy in general. With the large windfall revenues accruing to oil producers since 2002, a natural question emerges as to what impact oil is having on the reform process. To date, the large budget surpluses appear to have delayed the imperative for reform of the oil subsidy system in resource-rich economies. Oil producers have also exhibited weaker reform progress over the past several years than have the region's resource-poor economies along two major structural reform fronts: improving the business climate and liberalizing trade.

However, the more subdued progress made by oil exporters in these areas of reform in large part reflects lack of improvements among the economies of the GCC (Cooperation Council for the Arab States of the Gulf, formerly named and still commonly called the Gulf Cooperation Council), which

have traditionally maintained more open and business-friendly trade and investment policies. More important, as a group, the oil economies have demonstrated long-awaited progress in governance, an area in which the group demonstrates a significant deficit relative to the rest of the world. Specifically, notable progress has taken place over the past five years in enhancing public sector accountability mechanisms, which augers well for continuing reform success. Although oil economies continue to rank in the bottom 20th percentile relative to the rest of the world with regard to measures of public sector accountability (including political and civil liberties, freedom of information, and so forth⁴), over the past five years, oil economies have made greater progress in improving public sector accountability than have all other regions of the world, ranking (on average) in the 65th percentile worldwide with regard to improving public accountability.

Worldwide, successful reform efforts have depended critically upon the support and participation of those in society whom reforms will impact. The governance improvements in MENA, with regard to enhancing the accountability of governments and granting greater voice in development to MENA's people, are important not only to take into account the needs and values of those who are affected by reforms but also to ensure that in the transition to a new development model, the economic outcomes are socially acceptable among those who have benefited from the old systems. The MENA region continues to have the greatest gap with the rest of the world with regard to accountable and inclusive governance structures, ranking (on average) in the bottom quintile worldwide. It is thus an important development that both resource-rich and resource-poor economies in MENA are making a start at these vital changes.

With diminishing positive links to the oil economies (and increasing negative impacts from higher oil prices), the resource-poor economies in the MENA region have maintained a solid pace of reform, generally exceeding other regions of the

world across all areas of reform. In both trade reform and business and regulatory reform, the resource-poor economies have made (on average) stronger progress over the past five years than have all other regions of the world. Largely in connection with recent bilateral and multilateral trade agreements and led by deep tariff reductions undertaken in Egypt, resource-poor economies ranked (on average) in the 71st percentile with regard to tariff reform over the past five years. With regard to reform of the business climate, the steps taken by resource-poor economies placed them (on average) in the top 63rd percentile. Nonetheless, much stronger progress can take place, particularly with regard to trade liberalization. The resource-poor economies as a group continue to maintain some of the highest tariffs in the world, ranking in the bottom 25th percentile worldwide with regard to low tariff protection.

In the area of governance, resource-poor economies have also demonstrated significant progress. In the area of improving public sector accountability, resource-poor countries ranked (on average) in the 62nd percentile with regard to reform progress, second only to the gains made by the MENA region's resource-rich economies. In improving the quality of public sector administration, the group ranked in the 82nd percentile with regard to reform—the strongest progress worldwide, led by strong achievements in Egypt, Morocco, and Tunisia.

Along with across-the-board policy reform, MENA economies continue to look to selective industrial policies designed to enhance specific sector competitiveness and growth to complement more broad-based structural reform. Although the views on industrial policy are changing and a variety of economic justifications can be made for their use, MENA's own unsuccessful history with industrial policies (and the difficulty in transitioning out of them) should serve as a cautious reminder that the most effective policies for promoting growth rely on strategies to create a neutral and internationally competitive business environment.

⁴ See appendix B for a description and the methodology behind governance indexes.

Overview Table 2: Structural reform progress in MENA, 2000–2005

| Country/region | Trade policy | | Business climate | | Governance: quality of public administration | | Governance: public sector accountability | |
|---------------------------------|----------------|-----------------|------------------|-----------------|--|-----------------|--|-----------------|
| | Current status | Reform progress | Current status | Reform progress | Current status | Reform progress | Current status | Reform progress |
| Algeria | 44 | 71 | 13 | 38 | 38 | 91 | 29 | 91 |
| Bahrain | .. | 62 | .. | .. | 77 | 26 | 23 | 91 |
| Djibouti | .. | 51 | .. | .. | .. | .. | .. | .. |
| Egypt, Arab Rep. of | 43 | 100 | 11 | 36 | 43 | 92 | 25 | 84 |
| Iran, Islamic Rep. of | 22 | 74 | 57 | 44 | 16 | 19 | 21 | 4 |
| Iraq | .. | .. | 66 | .. | .. | .. | .. | .. |
| Jordan | 47 | 86 | 58 | 89 | 66 | 67 | 34 | 60 |
| Kuwait | 53 | 65 | 59 | 7 | 58 | 24 | 31 | 65 |
| Lebanon | 61 | 80 | 37 | 31 | .. | .. | .. | .. |
| Libya | .. | 27 | .. | .. | 11 | 64 | 0 | 42 |
| Morocco | 38 | 52 | 61 | 54 | 73 | 83 | 33 | 81 |
| Oman | 71 | 11 | 78 | 15 | 61 | 75 | 16 | 81 |
| Qatar | .. | .. | .. | .. | 60 | 89 | 13 | 74 |
| Saudi Arabia | 39 | 77 | 80 | 26 | 57 | 77 | 5 | 69 |
| Syrian Arab Rep. | 18 | 43 | 30 | 5 | 15 | 67 | 7 | 74 |
| Tunisia | 51 | 57 | 83 | 93 | 74 | 87 | 22 | 22 |
| United Arab Emirates | .. | .. | 43 | 14 | 59 | 6 | 17 | 41 |
| Yemen, Rep. of | 62 | 82 | 35 | 57 | 28 | 71 | 20 | 89 |
| MENA | 46 | 63 | 51 | 42 | 49 | 63 | 20 | 64 |
| Resource-poor | 48 | 71 | 50 | 63 | 64 | 82 | 28 | 62 |
| Resource-rich | 44 | 57 | 51 | 23 | 44 | 55 | 17 | 65 |
| Resource-rich, labor abundant | 36 | 67 | 40 | 36 | 24 | 62 | 19 | 64 |
| Resource-rich, labor importing | 54 | 48 | 65 | 15 | 55 | 52 | 15 | 66 |
| East Asia and Pacific | 56 | 37 | 61 | 47 | 43 | 45 | 41 | 48 |
| Europe and Central Asia | 51 | 69 | 48 | 64 | 47 | 46 | 52 | 51 |
| Latin America and the Caribbean | 57 | 50 | 40 | 51 | 46 | 50 | 57 | 43 |
| High-income OECD | 70 | 64 | 84 | 50 | 89 | 47 | 91 | 49 |
| South Asia | 41 | 48 | 48 | 41 | 48 | 53 | 39 | 31 |
| Sub-Saharan Africa | 34 | 27 | 27 | 43 | 34 | 53 | 37 | 55 |
| World | 50 | 50 | 50 | 50 | 50 | 50 | 50 | 50 |

Source: World Bank Staff estimates from country data.

Note: For each index, current status reflects a country's current (2005) placement in a worldwide ordering of countries 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). Reform progress reflects the improvement in a country's rank between 2000 and 2005 (2003 and 2005 for business and regulatory reform) in a worldwide ordering of countries based on the 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).

