Chapter 3

Policies to Reduce Vulnerability and Increase Flexibility to Respond to Shocks over the Long Term

Introduction

The MENA region has implemented a variety of policies that can help to mitigate the short-run impacts of the current global economic downturn within their economies. Over the longer run, reducing vulnerability to economic crises will depend on a policy framework which can both mitigate exposure to systemic risk as well as increase the capacity for the government, the private sector, and households to cope with shocks when they occur.

The MENA region faces vulnerabilities along both the exposure and the coping fronts. MENA's integration with the world through financial markets has been limited, but the region has been heavily exposed to external shocks through merchandise trade. With both highly concentrated export structures (primarily fuels) and the world's highest food import dependency, the region leads the world in terms of exposure to commodity price shocks. The ability to rebound from shocks, meanwhile, is weakened by structural characteristics and policies in the region, including: lack of global financial integration, which has limited the potential sources of finance in a downturn; largely underdeveloped financial sectors outside the GCC, with few instruments for mitigating risk and insuring vulnerability; a business environment with discretionary enforcement of business regulations, which has limited the ability for creative destruction of firms and industries to changing economic conditions; a regulatory environment which prevents firm adjustment to economic shocks on the labor margin; piecemeal social safety nets which are not well targeted to those most affected by economic shock; and a fundamental disinterest in systemic gathering and transparent dissemination of data, which hinders the region's ability to monitor and respond appropriately to economic crises which occur.

The chapter proceeds as follows: Section 3.2 highlights the major channels for shock to the region and the pass-through of those shocks to the economy; Section 3.3 discusses the types of structural policies that can influence both the exposure and the resilience to economic shocks. The chapter addresses three of those structural policy areas in greater detail: in Section 3.4, the financial sector is evaluated with respect to its ability to mitigate external shock; in Section 3.5, the trade structure and policies are evaluated; and in Section 3.6, the private business sector is discussed. Finally, 3.7 concludes with a discussion of the role of safety nets in reducing vulnerability to shocks.

Major Channels for Shock in MENA

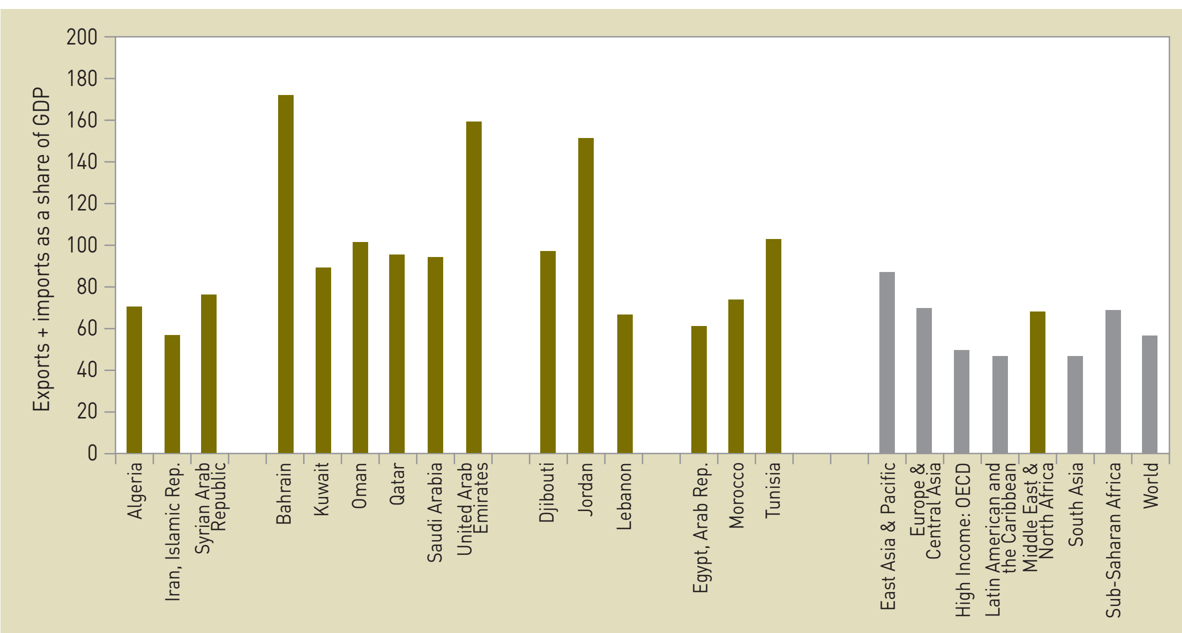
Exposure to shock has been a seminal characteristic of the modern growth experience of MENA economies. Large geopolitical shocks (such as the ongoing war in Iraq, the continuing conflict in Gaza, and the recent war in Lebanon) have captured international attention, although they are not the only, or even the greatest, source of shock to the region. Frequent droughts, which can sharply reduce rural incomes and agricultural production, are a source of repeated shocks for countries such as Morocco and Yemen. Climate change (seen through water scarcity, desertification, and rising populations in coastal areas) and high population growth represent extended and rising sources of vulnerability to the region, with increasing concentrations of the population locating in infrastructure-strained urban and hazard prone areas. The unstable security situations from countries in conflict have impacted other countries in the region through economic linkages within the region (including through refugee and labor inflows and returns, tourism and trade).

The channels for global economic integration in MENA have had a strong bearing on its exposure to shock and its ability to rebound from it. The region is reasonably well integrated into the global economy through commodity trade, with trade to GDP ratios above world averages (Figure 3.1). However, nonoil exports are considerably underdeveloped, and lack of trade diversification has exposed the region heavily to commodity price shocks. MENA is extremely dependent upon primary commodity exports (the dominant being fuels), but as a net importer of food, it is also vulnerable to food prices. As a result, the MENA region leads the world in its exposure to commodity price shocks.[1]

MENA countries are also strongly integrated into the global economy through migration, either as migrant sending or receiving countries. The MENA region sent some 15 million emigrants abroad in 2000, representing 4.5% of the total population, and in a few countries, including West Bank and Gaza, Lebanon, Jordan, Bahrain, Malta and Kuwait, emigration rates exceed 10% of the population (Table 3.1). For a few countries, including Algeria, Morocco, and Tunisia, Europe is the main destination of migrants, intensifying

[1] Hirata, et al. 2005.

Figure 3.1: Trade as a share of GDP, 2007



Source: World Bank data.
Note: Regional averages trade weighted

the links to European economic developments. In other MENA countries, including Egypt, Yemen, Syria, and to a lesser extent Jordan, the GCC economies are the main destination. On the negative side, the strong migration links have increased the vulnerability of MENA countries to external developments. Migration between non-oil MENA economies and the GCC, for example, has served to amplify the terms of trade shocks in the region. On the positive side through, migration has also provided a substantial outlet for regional labor market imbalances in the face of domestic shocks.

The region is far less integrated with the global economy through financial markets. GCC economies are the most integrated into the global financial network, particularly through Sovereign Wealth Fund investments in Western and other financial markets, but elsewhere there is limited evidence of integration with developed markets. While the limited links to the global financial community has insulated the region from the initial effects of the current crisis, the lack of financial integration also prevents the region from circumventing some of the vulnerability arising from trade shocks.

Table 3.1: Emigration from MENA countries in 2000

	Total migration			Main destination		
	Stock	Rate of growth (Annual average)	Herfin	Country	Stock	Share
MENA4						
Algeria	2070840	6.8%	0.428	France	1333587	64.4%
Egypt	2173711	3.2%	0.232	Saudi Arabia	1015124	46.7%
Morocco	2589108	9.1%	0.131	France	759011	29.3%
Tunisia	607491	6.4%	0.373	France	364498	60.0%
MENA9						
Djibouti	16990	2.4%	0.208	France	6093	35.9%
Iran	926312	1.4%	0.133	USA	291625	31.5%
Lebanon	577123	17.0%	0.084	USA	111142	19.3%
Libya	78109	1.5%	0.098	Israel	19200	24.6%
Malta	113094	28.9%	0.261	Australia	46998	41.6%
Others						
Bahrain	128719	19.2%	0.262	Philippines	54230	42.1%
Iraq	1109957	4.4%	0.163	Iran	413710	37.3%
Jordan	667754	13.4%	0.277	W.Bank Gaza	319367	47.8%
Kuwait	486861	21.8%	0.244	Saudi Arabia	210594	43.3%
Oman	17881	0.7%	0.219	United Kingdom	7841	43.9%
Qatar	15958	2.6%	0.224	United States	7065	44.3%
Saudi Arabia	243258	1.2%	0.214	United States	106230	43.7%
Syria	423764	2.5%	0.100	Saudi Arabia	109048	25.7%
United Arab Em.	123886	3.8%	0.218	India	53883	43.5%
W.Bank Gaza	1065224	33.8%	0.368	Syria	630725	59.2%
Yemen	603173	3.4%	0.371	Saudi Arabia	360438	59.8%

Source: Docquier and Marchiori, 2009.

The combined impact of the shocks to MENA countries has resulted in the region exhibiting the greatest year-to-year volatility in economic growth of any other region since the 1970s (Figure 3.2).

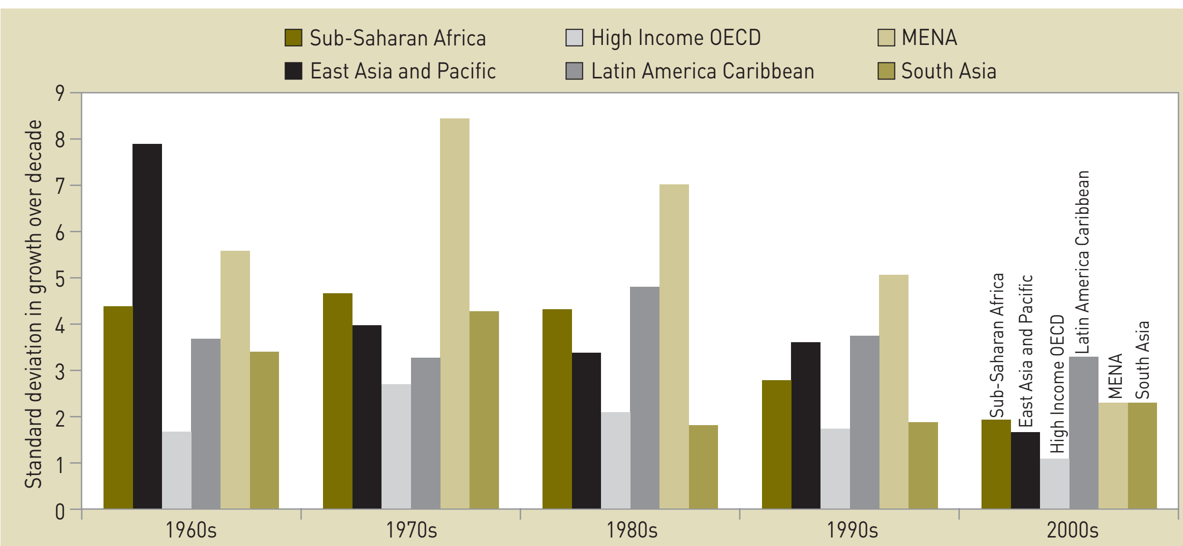
While MENA's growth volatility has diminished significantly over the past decade (the average deviation in growth over the past decade is about 60% lower than the previous decade), it is unclear whether the social impacts of adverse external shocks have declined equivalently. The region's historical models of development—with welfare systems supporting widespread subsidies, publically provided education, health care, housing and other benefits, pervasive use of price ceilings, and high levels of public sector employment—in many ways cushioned the pass-through of economic shocks to the rest of the economy. As the region has transitioned toward more market-oriented development models, shocks (though less severe) may be more heavily absorbed by households, through labor markets, prices and safety nets.

On the poverty side, preliminary evidence suggests otherwise. Recent analysis of poverty trends in the MENA region over 1980–2005 suggests that while volatility (measured through the standard deviation in GDP) had a strongly positive relationship on poverty, there is an evidence of a structural breakpoint around 1993, a time when the region was able to significantly reduce economic volatility. Post 1993, the impact of volatility on poverty was no longer a significant driver of poverty, suggesting that the region was better able to absorb economic shocks without significant increases in poverty.

Labor markets, on the other hand, have been more strongly impacted by economy-wide developments than in the past, when near-full employment was a virtual mainstay in many countries in the region. Egypt's open unemployment rate, for example, was barely affected by significant changes in economic growth in both the 1960s and 1970s, but by the mid 1990s, the strong inverse relationship between unemployment and growth became visible[2] (Figure 3.3).

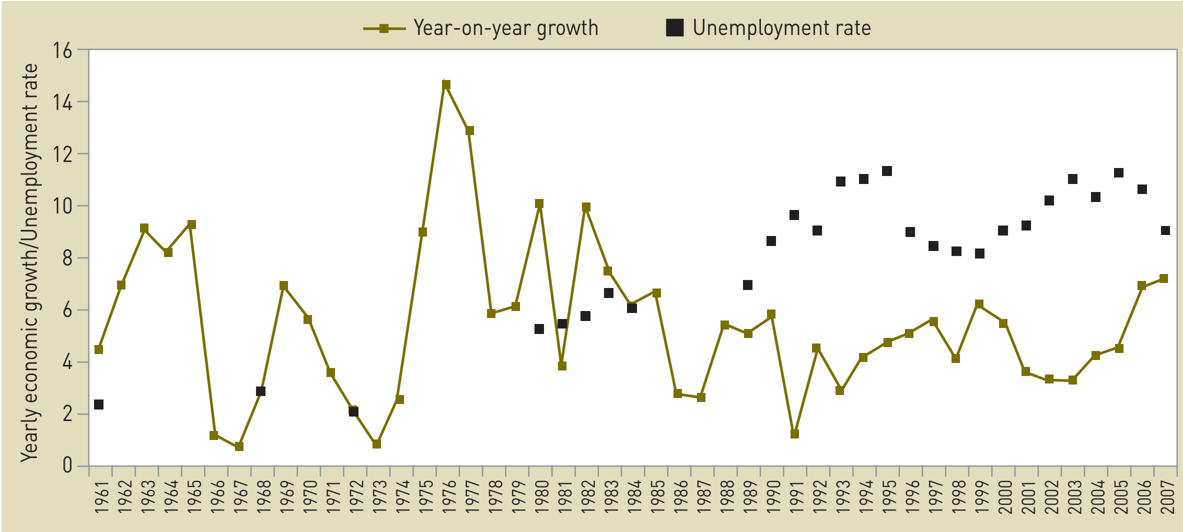
[2] At the same time, official unemployment rates often masked significant underemployment.

Figure 3.2: Regional growth volatility,1960s–2007



Source: World Bank data.
Note: Regional growth deviations weighted by mid pereiod GDP.

Figure 3.3: Unemployment and economic growth in Egypt, 1960–2007



Source: World Bank data.
Note: Regional changes in yearly growth weighted by GDP.

In the end, both elements—the degree to which countries are exposed to economic shock, as well as the resilience of economies in coping with those shocks—are important in determining how successful countries will be in achieving long term development objectives. Both elements are determined in large part by the structural and policy factors in the economy.

Reducing Vulnerability through Structural Policies

The global economic downturn has focused renewed attention on the macroeconomic policy framework, important in the immediate navigation through the crisis, and equally important in preventing external shocks from severely impacting economies. As Chapter 2 has highlighted, factors such as the level and structure of debt, the degree of fiscal space, external balances (and their financing sources), the exposure and soundness of financial systems, the flexibility of the exchange rate, and the extent of (difficult to retract) subsidies in the economy are factors which will largely determine how deeply countries in MENA will be hit by the global economic crisis, as well as the extent to which they will be able to implement countercyclical policies.

Just as important as macroeconomic policies, structural features—and the policies which influence them—will have strong bearing on an economy's exposure to and resilience from economic shocks. The degree of integration with the global economy, the level of economic diversification, factors which affect the flexibility of the economy (and actors in the economy) to shocks, the management of scarce resources, the social protection systems in place to mitigate shocks, and the accountability and credibility of authorities in managing (and avoiding) negative shocks ultimately determine the overall vulnerability of countries over the long run.

Structural policies in every sector of the economy will impact the vulnerability (or resistance) of an economy to shock. Water sector policies improving the supply and efficiency of scarce water reduce the economy's vulnerability to the host of social, economic and environmental impacts from water shortages, including poor health incidence, reduced rural incomes and poverty, and volatility in agricultural exports, among other things. Education policies that support a more competitive workforce reduce the economy's vulnerability to unemployment-induced poverty. Good governance and the rule of law diminish the risks for foreign investors, reducing the volatility of FDI flows. Good urban planning can reduce the vulnerability to man-made structural disasters.

In this chapter, three of the major structural policy areas for reducing the economic exposure to external shocks are highlighted: (i) financial sector policies for economic resilience; (ii) resilience through external trade diversification and flexibility; and, (iii) resilience through business flexibility and efficiency, with an overarching need for good governance and institutions, which will determine the success and credibility of domestic policy management. While these structural policy areas have their own individual implications on the vulnerability to shocks, the interaction among these policies also has a role to play. And, with the poor disproportionately impacted from economic shocks, a long-term strategy for reducing vulnerability to crisis depends fundamentally on adequate social safety nets and mechanisms to protect vital social expenditures which contribute to long term growth.

Financial Sector Policies for Economic Resilience

Financial system soundness, and the role that the financial system plays in the economy, is important in crisis avoidance and mitigation for a variety of reasons. Most obvious, as the current global financial crisis elucidates, a malfunctioning financial system can be the source of tremendous economic shock. For that reason, much of the attention on the financial sector focuses on its likely soundness: the capital adequacy of financial institutions, the quality of assets and off-balance sheet positions, its profitability and liquidity, the pace and quality of credit growth, its supervision and governance by central banks, etc.

Even when the source of economic shocks lies elsewhere, the financial system plays a pivotal role in transmitting and amplifying (or mitigating) economic shocks. Financial market regulations can make it more difficult for firms and economic actors to reallocate resources in an economic shock (for example through collateral constraints, which heighten the impact of a negative terms-of-trade shock), and the inefficiencies in financial markets often exacerbate financial volatility, which in turn amplifies shocks.

More indirectly, there is the fundamental role the financial system plays in supporting growth and creating a competitive and thereby resilient economy, allowing for more resources to be channeled to investment, improving the allocation of resources across investments, and raising household savings (which can mitigate the pass-through of shocks to households).

Financial sector development in MENA

Financial sector development in MENA in large part reflects the very recent nature of financial reform. Most MENA countries did not even introduce financial sector reforms until the 1990s. Before then, financial systems were heavily regulated and dominated by the public sector. Partly as a result, financial systems in MENA currently play a significantly smaller role than other economies at similar income levels (see Box 3.1).

There is great variance within the region in terms of the degree of financial sector development. On the one hand, the oil-exporters of the GCC have reasonably well-developed financial markets, with substantial diversity in financial instruments, high levels of foreign penetration, and limited state ownership. Non-oil economies, on the other hand,—particularly the economies relatively dependent upon ties with Europe—, have substantially less developed financial sectors. Banks dominate the financial systems, with varying degrees of state and foreign ownership, but they play a relatively limited role in financial intermediation or economic development. The least developed financial sectors in the region are in the oil non-GCC countries, where public sector banks either fully control or dominate financial sectors, and where the quality of financial system governance is low.

Because of the divergence in financial systems in the region, MENA's longer-term financial sector vulnerabilities to shock vary strongly as well. Among the GCC economies, the financial sector vulnerabilities have emerged largely from the decision governments have made not to intermediate large hydrocarbon revenues through the domestic financial systems. In part this decision was to insulate some of the revenues from political pressures to spend, and an acknowledgement of the supply-side constraints in the economies: rapid spending growth would result

Box 3.1: Overview of financial sector development in MENA

The banking sectors and equity markets are large by international standards in many MENA countries. Average banking assets in both the GCC and non GCC amount to about 60 percent of GDP. The large size of bank assets in GCC countries is consistent with their high per capita income, but several non GCC countries have larger banking systems than would be predicted by their income levels. The same pattern holds for equity markets—the large size of equity markets in GCC countries (market capitalization above 100 percent) is consistent with their level of development, but some non GCC countries have surprisingly large equity markets (market capitalization about 80 percent), including Egypt, Jordan, and Morocco.

By contrast, non banking financial institutions (NBFIs) are very small in most MENA countries. Fixed income markets are generally undeveloped and restricted to government debt markets. NBFIs—insurance companies, pension funds, and mutual funds are surprisingly small, even considering the income levels of MENA countries. Morocco is one of the few exceptions. Leasing and factoring companies have grown in some countries but also remain small. Some countries have made efforts to strengthen their government debt markets, but market development remains generally limited, with restricted liquidity, short maturities, and the lack of a solid benchmark yield curve for private issuers. Private fixed income and derivatives markets remain negligible.

The large size of the banking system, and of the equity market in some countries, has not yet translated into financial sector access. Although there are differences across MENA countries, on average a higher proportion of MENA firms identifies access to finance as a major constraint than firms in all other regions, except Sub-Saharan Africa. Access seems more restricted in the non GCC countries. As noted above, the ratio of loans to deposits is very low in this group (60 percent), reflecting to a good extent large holdings of government paper. Moreover, lending remains predominantly short term and focused on larger companies. There are fewer branches and loans per population than the average of emerging countries. Technologies such as mobile banking used to extend outreach in other regions are held back by regulators and lack of innovation. The equity market has not been a significant source of finance, and the number of listed firms per population is comparatively low.

The more restricted access is due to several causes, including large fiscal deficits in some countries, the large role of the state-owned banks and non-financial enterprises, weak financial infrastructure, and possibly lack of Islamic finance products. The low ratio of loans to deposits in non GCC countries reflects to a good extent the financing of large government deficits. Moreover, despite privatizations, state owned banks still account for almost 50 percent of bank assets in MENA—only in South Asia state banks have a higher market share. These banks have channeled a large amount of resources to state owned enterprises and accumulated a large volume of non-performing loans, reflecting their inefficiency in financial intermediation. This is particularly true in countries such as Algeria, Libya, and Syria, but also true in other countries such as Egypt and Tunisia. Finally, financial infrastructure remains deficient, as indicated by weak creditor rights, collateral systems, and credit information. The MENA region compares unfavorably in most relevant Doing Business indicators and other enabling environment indicators. The lack of Islamic finance products is also a possible cause of restricted access, both from the borrowing and deposit sides.

Source: World Bank, Financial Sector Group.

in inflation and real exchange rate appreciation. As a consequence, there has been limited development of long-term financing domestically.

The GCC's domestic banking sector is not well equipped to handle large scale corporate refinancing, because their deposit bases are small and heavily weighted towards short-maturities (i.e. demand or short time deposits). Furthermore, bouts of speculation related to the dollar pegs have led to fairly rapid inflows and outflows of short-term funds, complicating liquidity management for the domestic banking system.

On the other hand, stock markets have not served as a source of long-term financing either. And corporate bond markets are also poorly developed, partly a result of government's own role in financing hydrocarbon projects directly—which crowds out the capacity that might otherwise have developed for general long-term project financing.

The combined effect of these structural elements is to create a special set of vulnerabilities for the GCC financial sectors. First, because the domestic financial systems have not developed as sources of long-term finance, the non-oil sector has remained reliant on external debt financing at relatively short maturities. This has exposed investors to refinancing risks when terms expire. Of course, governments typically have sufficient liquidity to backstop affected borrowers, but the resulting uncertainty about terms and conditions attached to such support itself has the potential to be destabilizing, acting as a deterrent to equity investors.

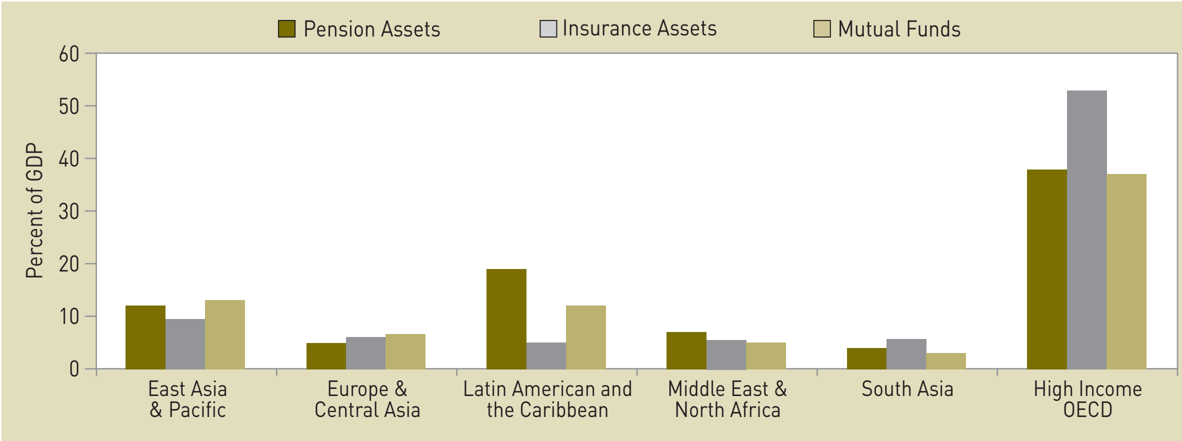
Second, given the lack of depth of banks' corporate business, their balance sheets are heavily weighted towards personal loans, which may be applied towards investments in property or the stock market (regardless of their stated purpose), leaving banks exposed to asset market crashes or a worsening of household credit risk. This is a particular issue in Kuwait.

Third, GCC countries lack a deep institutional investor base, leading to a preponderance of short-term retail speculation on stock markets. The serial nature of GCC stock market crashes—with associated demands for bailouts—points to the need to develop the long-term investor base to increase the depth of stock markets and mitigate the impact of market declines on the wider economy (e.g. through impacts and household finances and in turn to banks which have lent to households). Finally, since GCC countries remain committed to exchange rate pegs, there is the ever-present risk of a mismatch between the externally-determined level of interest rates, trends in oil prices, and the level of the dollar. The configuration seen for these variables in the first half of 2008 resulted in negative real interest rates during an oil boom, contributing to the rapid expansion of bank balance sheets and the general growth in speculative activity. The financial sector will likely be the first to experience the side effects of a similar mismatch in the future.

Outside of the GCC, the ability to cope with shocks is hampered by the limited development of the financial sector in general, as well as the limited access to financial services by households and firms. Banks dominate the financial sectors of non-GCC countries, with non-bank financial institutions significantly underdeveloped. As a result, a host of financial instruments for managing risk—from insurance products to financial derivatives—are not available to households and firms (Figure 3.4). The limited development of financial sectors (in terms of breadth of services available to the public) has implications beyond lower risk abatement on the individual level. Absence of stock markets, for example, (and limited links between the financial system and the real economy) limits transmission of signals from policy to the market, and may allow policy mistakes and vulnerability to build up over time without notice.

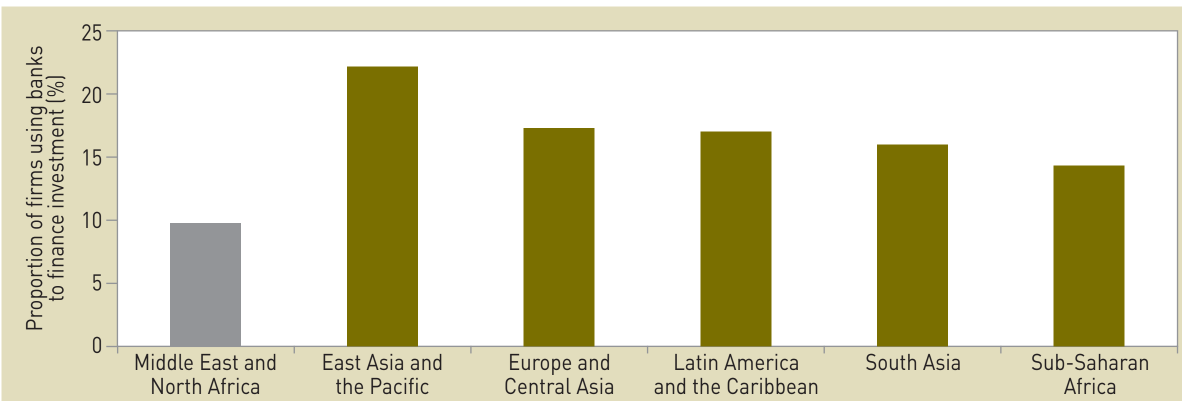
Access to the financial sector has had other implications on the ability of regional economies to manage shock. As investment climate assessments in the region reveal, few private sector firms even utilize bank credit to finance investment, relying instead primarily on retained earnings (Figure 3.5). Thirty-eight percent of firms outside the GCC identify access to finance as a major constraint to business, higher than

Figure 3.4: Selected non-bank financial assets as a share of GDP



Source: World Bank Financial Structure Database.

Figure 3.5: Use of bank credit by firms



Source: World Bank investment climate assessments, various years.
Note: Regional averages unweighted.

for all other regions but Sub-Saharan Africa.[3] Eighty-four percent of loans require collateral, which is close to the higher end of the distribution, and the collateral needed as a percentage of loan amount is 166%, which is t he highest in the world. There are fewer bank branches in MENA than in other emerging economies (per 1000 people).

The disconnect from the global financial community prevented most regional economies from suffering immediate significant impacts of the shock, but it is also true that the regional impact was muted by its relative disconnect of the financial sector from the real economy. On the positive side, this has meant that most private sector firms have not experienced the credit shortages immediately apparent in other regions.[4] However, it has also meant that the region has sacrificed long

[3] Source: World Bank Investment Climate Assessments; various years

[4] It may also have helped to mitigate the future negative feedback loops between the real and financial sectors – where limited access to bank credit affects loan repayments, weakening bank balance sheets, and causing banks to curtail credit further.

run growth, with one of the central functions of the financial sector—allocating resources toward investment—in large part disabled.

From a vulnerability perspective, this weak link to the real economy has meant the loss of one of the most effective tools an economy has for risk mitigation. The financial sector is the primary conduit through which monetary policy impacts the real economy. With limited financial intermediation outside the GCC countries, along with the prevalence of fixed exchange rate arrangements throughout the region, the ability for authorities to conduct effective monetary policy is considerably more limited.

More generally, a well developed financial sector, which provides diversified funding sources for both individuals and enterprises for mitigating risk and insuring vulnerability, and in which households and firms can borrow to smooth the consequences of an economic downturn is critical to the broader economy's resilience—its ability to mitigate and manage the impacts from shock and adjust to the changing conditions present in a dynamic economy. Worldwide experience confirms that countries with well developed financial systems grow faster and more consistently than those with weaker systems, and a high level of financial sector development equips a country to better adjust to real sector shocks[5].

Part of that asset diversification and development can come from financial sector liberalization. Although the current economic crisis points to fundamental risks associated with global financial interconnectivity—with the most financially integrated economies in the region, the GCC countries, most deeply affected by the financial impacts of the crisis—international diversification of financial assets has also served countries well. International diversification allowed many of GCC countries to invest their oil surplus into foreign assets, thus avoiding flooding small domestic markets and avoiding overheating and asset bubbles. Also, international liberalization allowed them to attract foreign investments into their hydrocarbon sectors (e.g. Saudi Arabia, Qatar) and create international hubs for finance, trade logistics and business (e.g. Dubai, Qatar, plans in Saudi Arabia). International financial liberalization also can help surplus countries manage domestic shocks by tapping into foreign assets to mitigate the impact of domestic shocks. This factor in particular played an important role in allowing GCC countries to respond to the financial impacts of the current crisis as early as the second half of 2008.

The current crisis has had an impact on virtually all countries and all asset classes, and GCC's foreign assets have suffered losses. However, over the long term, the economic argument for financial liberalization remains. The countrerfactual to international financial liberalization in the GCC in the context of the recent crisis may never be known, but past experiences from countries such Indonesia and Nigeria where oil resources were not invested through sovereign funds or foreign assets of the central bank suggests that GCC countries could have been far worse off in the *absence* of international financial diversification. In Indonesia and Nigeria, part of the oil surpluses found their way out of the countries and into foreign bank accounts in a less than transparent way, and domestic investment of part of the surplus was not as productive as seen recently in the GCC. Comparing the management of the recent oil boom with past oil booms in the GCC also offers some arguments in support of financial liberalization.

Economies in the region have taken steps forward to reform their financial sectors. Over the past decade in particular, banking sectors have slowly opened to private and/or international participation, with a handful of countries in the region granting licenses to private banks and changing foreign ownership restrictions. In Egypt, for example, majority stakes in one of the four main state owned banks, the Bank of Alexandria, were sold over 2006, and the sale of the third largest bank in Egypt, Banque du Caire (postponed in June 2008), is expected when international financial markets recover. Even among the non-GCC oil economies, where public sector banks still dominate the financial

[5] Beck, et. al. 2000.

sector, there has been progress with financial sector liberalization through both private and foreign competition.

Nonetheless, the public sector remains dominant, which has implications on the region's ability to manage shocks from a fiscal perspective. State owned banks tend to have lower profitability and higher costs than private counterparts. With high remaining state ownership in many countries,[6] the economic costs can be large. As an example, Algeria's public banks' losses have on average represented over 4% of GDP each year since the early nineties.[7] This insolvency represents a tremendous drain on the economy's fiscal ability to respond to economic shock.

The majority of MENA countries have recognized the need for greater financial access, private participation, and better regulation, standards and oversight. As the trend toward financial deepening and financial globalization increases, the MENA region will need to manage the process to take advantage of opportunities, while minimizing the risks. While the process will differ for each country, some generalities can be made. Creating an enabling structural environment for more resilient and enabling financial systems in MENA will necessarily include efforts to reduce the involvement of the government in the financial system, including through reducing state ownership of banking and non-banking financial sectors; promote non-bank financial development; strengthen the capacities within the financial sector to assess individual and systemic risk; and design and enforce appropriate regulation and supervision of the financial sector, to both safeguard the financial system's stability and mitigate procyclicality of financial sector requirements and norms. Strengthening regional financial sectors through these efforts can help MENA improve its capacity to respond to systemic shocks, as well as mitigate the pass-through to the rest of the economy.

Trade and Vulnerability to Commodity Price Shocks

Greater trade openness increases exposure to external shocks,[8] but it allows for countries to diversify from local markets, reducing the risks of domestic shocks. Trade also allows for a level of growth and social development which would be impossible without it, since trade allows for a more efficient allocation of resources. A successful trade strategy recognizes both facts, and seeks to maximize the gains that can accrue from trade, while minimizing the exposure to and impacts from external shocks.

Trade patterns in MENA are highly diverse in term of both volumes and structure, and these differences have important ramifications on exposure to shock and the ability to rebound from shock. Oil-producing countries have higher export levels, but, not surprisingly, exports are highly concentrated in fuels (more than 85% of merchandise exports emanate from fuels). As a result, fuel prices exert critical influence over these countries' export success. Among non-oil economies, meanwhile, while export concentration is also relatively high, the geography of trade flows (whether predominantly with Europe or with the GCC economies) also exerts a strong influence over the ultimate exposure of countries to external shocks.

MENA's high export concentration (particularly for oil producing countries in the region) has meant both higher volatility, and lower growth. The international evidence on trade suggests that the level of export variety raises productivity, allowing for greater knowledge spillovers to the rest of the economy, while highly concentrated exports are negatively associated with economic growth.[9] Heavy reliance on any one export creates a vulnerability to changes in demand for that good, with detrimental effects on planning public and private investment, import capacity, foreign exchange cash flow, inflation, and growth, lowering the expected

[6] In Algeria, for example, though twelve foreign banks have been established since liberalization efforts began, the public sector continues to hold more than 90 percent of the economy's deposits and credit; in Syria, despite eight private banks in operation, state banks still account for 80 percent of the assets of the banking sector.

[7] World Bank, 2009c.

[8] Loayza and Raddatz, 2007.

[9] See literature survey in Naudé and Rossouw 2008.

gains from trade.[10] As a result, with MENA's merchandise exports concentrated heavily among so few export categories, this means that not only is MENA's exposure to terms-of-trade shocks larger, but the expected gains from trade are lower.

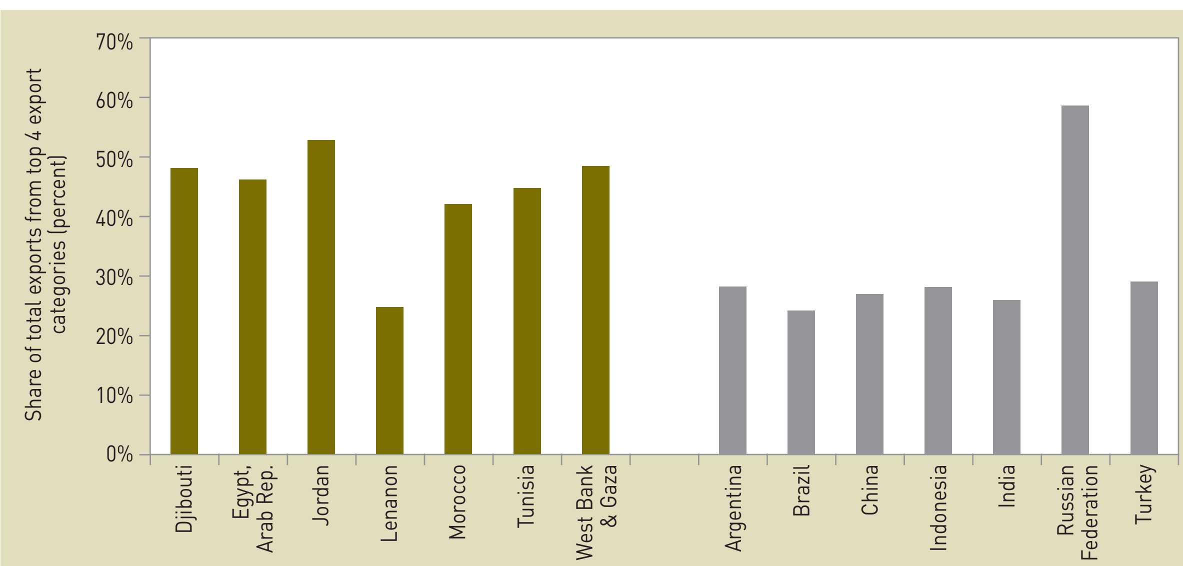
Non oil producers in the region are not immune from the high degree of export concentration. Merchandise exports from MENA's non-oil exporting economies, though more diversified than oil exporters, are still considerably more concentrated than comparator middle-income economies (Figure 3.6), with the bulk of exports in either primary products or products of low technological structure, such as clothing, footwear, and textiles. Nor has export concentration fallen significantly over the past fifteen years (with the exception of Jordan).[11] Terms of trade shocks (on agricultural products) constitute an important source of vulnerability in non-oil economy export structures, but perhaps of even greater importance from a vulnerability perspective is the increasing competition MENA's non-oil economies face on low-tech exports from lower-cost suppliers such as China, India, and Bangladesh.

There is some encouraging news, however. Recent analysis suggests the source of export growth for MENA's non-oil countries is tilting more towards new products and markets. Table 3.2 decomposes the recent export growth among the region's non-oil economies into intensive margins (based on existing products and markets) and extensive margins (based on new products and markets). Only in Jordan and Tunisia is the contribution of the intensive margin larger than the contribution of the extensive margin. This suggests a changing industrial structure which is adapting to the new competitive pressures it is facing by moving towards new markets and products.[12]

Diversification is a much more difficult prospect for the region's oil producers. Diversifying petroleum-dependent economies is one of the more complex economic challenges, and the

[10] See Dawe 1996. The geographic concentration (in terms of export destinations and strategic import sources) likewise creates vulnerability to relations or circumstances with key trading partners.
[11] World Bank, 2007a.
[12] World Bank, 2008a.

Figure 3.6: Export concentration among MENA's non-oil economies



Source: World Bank staff estimates from UN Comtrade data. Note: Export concentration measured by the share of total Exports emanating from the 4 four export categories, measured at the 4-digit ISIC.

Table 3.2: Decomposition of export growth into intensive and extensive margins, 1995–2005

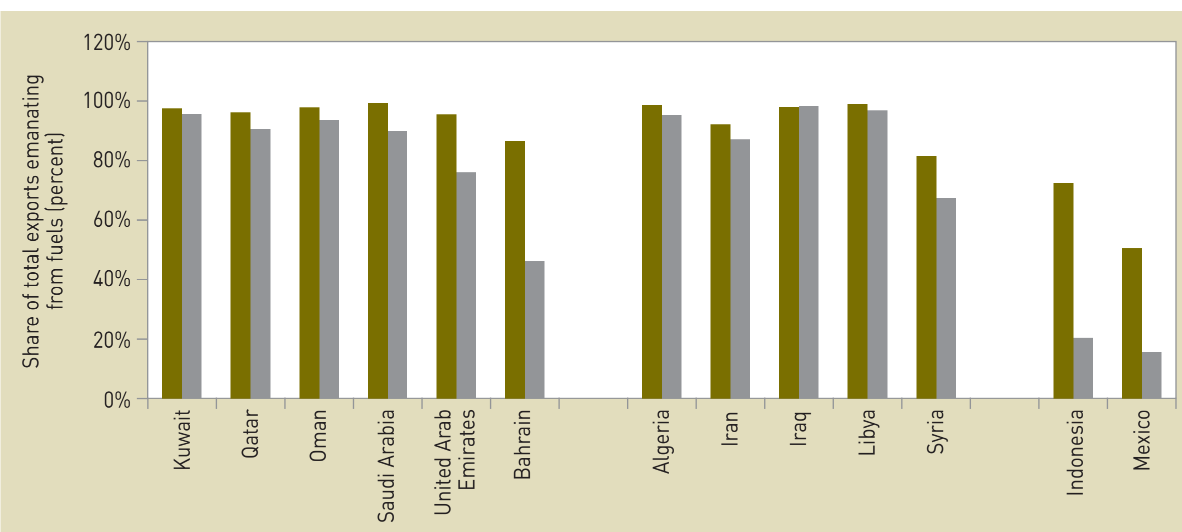
	Egypt	Jordan	Lebanon	Morocco	Tunisia
Increase of existing products to existing markets	57.2	78.1	81.8	110.6	101.6
Decrease of existing products to existing markets	–19.1	–9.0	–21.8	–47.2	–25.0
Extinction of existing products to existing markets	–12.1	–6.9	–22.1	–13.4	–14.2
Total Intensive Margin	**26.0**	**62.2**	**37.9**	**50.0**	**62.5**
New products to existing markets	10.1	12.7	14.9	4.5	8.4
Existing products to new markets	63.9	25.0	47.0	45.6	29.2
New products to new markets	0.0	0.1	0.1	0.0	0.0
Total Extensive Margin	**74.0**	**37.8**	**62.1**	**50.0**	**37.5**

Source: World Bank 2008c.

path for achieving economic diversification is not well charted. Only a handful of oil-producing countries have achieved notable success in diversifying their export bases out of oil (for example, Indonesia and Mexico). Within the MENA region, only a few oil producers have managed to substantially reduce the concentration of exports from fuel and fuel-related commodities (Figure 3.7), including Bahrain and the United Arab Emirates.

Because export diversification for oil-producers is challenging, GCC countries have increasingly sought diversification through other means. On the export side, the development of petro-chemicals and other fuel-related commodities have allowed countries like Saudi Arabia to move up the value chain and at least diversify exports within fuels. Elsewhere, sovereign wealth funds have allowed the countries to convert their finite oil and gas wealth into longer-term revenue

Figure 3.7: Oil in total exports, 1980 and 2006



Source: World Bank staff estimates from UN Comtrade data.

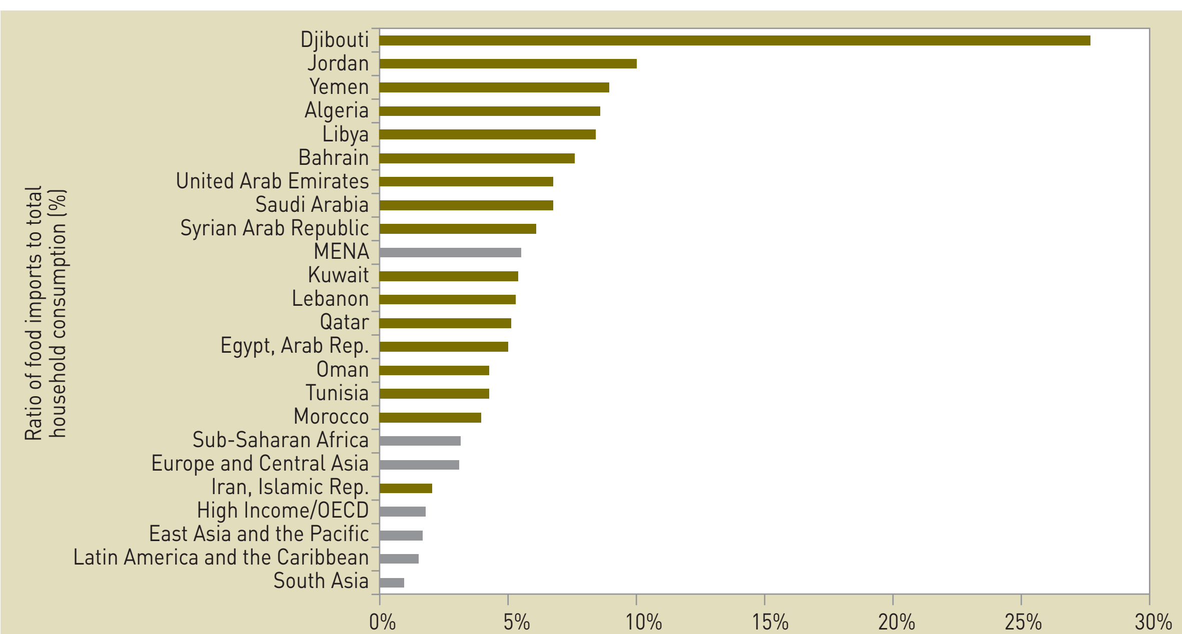
streams. And the development of service export activities, including financial and legal services, trading, tourism, and transport, has provided a major avenue for economic diversification and economies of scale outside of oil. Three of the GCC economies have developed regional and international financial centers: Qatar (which is also laying plans to make the country a regional hub for knowledge industry, education and healthcare), Bahrain (the hub for Sharia finance, now also developing plans to be a regional hub for information technology and for private aviation), and the United Arab Emirates. Kuwait meanwhile has made investments to establish itself as a trade and financial center. Tourism has become one of the most important vehicles for diversification in the GCC, providing job creation and horizontal capital flows.

The MENA region faces additional sources of exposure on the import side, primarily through the region's heavy dependence on food imports. The MENA region leads the world in terms of food import dependency,[13] well above any other region (Figure 3.8). As a result, changes in the price of grains, rice, and other staples can have a strong impact on import costs. Moreover, with food representing about half of the expenditures of the poor in MENA,[14] changes in food prices can dramatically impact household budgets. Beyond food imports, although the region is a net fuel exporter, many countries in the region depend heavily on fuel imports, and the region's pervasive use of fuel subsidies has had strong fiscal and current account implications for both non-oil economies and oil-exporters alike.

The goal of reducing an economy's exposure to shocks is not to insulate a country from the global economy, which would sacrifice the long-run efficiency and growth gains provided by global integration and market exposure, but rather to manage that external exposure in a way which reduces the potential impact of external shocks.

[13] Food import dependency measured as share of food imports in total household consumption.
[14] World Bank, 2008b.

Figure 3.8: Food import dependency, 2007



Source: World Bank staff estimates from UN Comtrade data (food imports) and World Bank World Development Indicators (household consumption).

On the import side, MENA's dependence on food imports is likely to increase over time, as scarce water supplies are increasingly strained. Increasing domestic production through more efficient agricultural processes can help cushion countries from erratic commodity markets, but MENA countries will need to rely on trade for food security over the long term. Several countries in the GCC, including Saudi Arabia, the United Arab Emirates, and Bahrain, have sought to limit their exposure to food trade vulnerabilities by pursuing agricultural offshoring agreements with other countries, renting or buying land abroad to ensure food security (See Box 3.2). On the food trade side, to deal with this permanent source of external shock, MENA

Box 3.2: Land-for-food deals for food security

With global crop shortages and high food prices, food security has become an increasing concern throughout the MENA region. GCC countries are particularly concerned. Cereal production in the Gulf has declined significantly because of depletion of water resources. At the same time, the population is expected to rise from below 40 million today to nearly 60 million in 2035. The need for food imports, which already meet 60 per cent of total demand, will grow. It is estimated for example that Saudi Arabia will be fully dependent on imports for food by 2016. In an effort to safeguard food security, several GCC countries have initiated schemes to invest in land in other countries where agriculture and cultivation are a more conducive venture. Saudi Arabia has expressed its interest to invest in countries like Pakistan, Thailand, Sudan and even Turkey, with a decided budget of $5 billion. Qatar and Sudan have established a joint holding company with the specific intent of serving the Arab food markets. Abraaj Capital, a large private company in the UAE, has acquired 800,000 acres of farmland in Pakistan along with other business entities.*

But it remains doubtful whether a buy-to-produce strategy will be effective in reducing the GCC countries vulnerabilities to volatile commodity price fluctuations and food import shortages even in the short term. Government-to-government dealings often draw opportunistic transactions automatically into the political domain. For one thing, the policy of buying up arable land in countries with sometimes high levels of poverty and undernourishment (such as Sudan and Pakistan), or with physical water shortages themselves is not very popular. Changing geopolitical situations can put the land agreements at risk, and even under friendly circumstances, and there is no guarantee host countries will honor the agreements in times of food shortage, particularly if their own citizens are in crisis. As a result, some GCC investments have run into opposition from local stakeholder groups.

To best ensure these agreements are honored and that they result in a win-win situation, countries need to design them with significant awareness and consideration for host country concerns and vulnerabilities. If this approach is to be pursued further, land acquisition processes need to be transparent, and transaction structures need to account for several categories of stakeholders: for example, on terms which benefit farmers and local consumers, as well as local land owners, and whose compliance is assured by development institutions like the World Bank or the Islamic Development Bank. Agricultural investments yield the greatest benefits when the investments result in greater employment of locals, and result not only in land purchase but in the collateral purchases of seed, fertilizer and the like. A range of local priorities, including labor conditions, land ownership rights, environmental degradation, and, most importantly, local food security need to be taken into consideration to ensure the interests of host countries are not overlooked. GCC investments should strive improve local food security in tandem with safeguarding their own food security.

In agriculturally intensive economies which might be candidates for investment several conditions apply which suggest a different approach to the one-off negotiated deal approach which has been followed to date: i) productivity in these countries falls well below the level of Best Agricultural Practice; ii) farm to market linkages are weak and frequently a major cause of production loss as well as a cause of price

(*continued on next page*)

Box 3.2: Land-for-food deals for food security (*continued*)

distortions; iii) supply chain infrastructure is weak. Hence, handling, transport and transaction costs are high; iv) access to working capital required to diversity into higher value crops and to raise productivity is extremely limited. Opportunities exist to address these more systemic problems with win-win solutions, which might entail the development of " nuclear farms" which could be used to disseminate best appropriate technologies, create rural labor markets and link farmers to markets. Other solutions might include the forward contracting with local commercial farmers to fill multi-year purchase agreement which would involve incentive payments for productivity enhancement. To this end, a brand for Halal Meat or organic product might be developed jointly with MENA based supermarkets and equity in this brand offered to participating poor farmers. Yet, another alternative might involve water for food programs which would entail the development of regional irrigation systems in return for forward commitments to repay loans in food equivalent value. Simply removing a critical factor input, "land", from the agricultural production mix without increasing productivity is likely to backfire over the medium term, with increases in commodity price volatility, contraction in liberal food trade and a further politicization of global food markets.

A recently announced agriculture investment firm owned by the Saudi Public Investment Fund is a step in the right direction, which will participate with Saudi investors to invest in agro-industrial projects abroad. Large-scale investments in infrastructure funded by these projects can open up untapped water resources in host countries, while also ensuring food production for home.

*"In Search of Hidden Water: GCC Nations & Food Security"; Gitanjali Bakshi; *Turkish Weekly*; March 20, 2009

countries can better manage the exposure to food price fluctuations by increasing their use of future markets, future contracts and other modern instruments to hedge against supply risks, while ensuring that the impact of food price shocks is cushioned for those chronically food insecure households through well-developed and targeted safety nets. Universal food subsidies, prevalent throughout the region, are not well targeted to those in need. In addition, they represent a serious fiscal burden (in Egypt and Morocco, averaging 1.3% of GDP, and reaching as high as 2.1% in Syria), greatly limiting the fiscal scope for other better-targeted programs. More generally, the region will need to continue to develop and implement broad pro-poor growth strategies, which can generate foreign exchange earnings to pay for food imports and create incomes for the poor, the best defense against food price shocks.

On the export side, MENA countries can best manage their vulnerability by creating a trading environment which both develops competitiveness (allowing existing firms to better withstand global demand shifts), as well as advances export diversification in terms of product quality, geography, and diversification into service exports (as the GCC has undertaken). Achieving this broad level of diversification requires an equally broad portfolio of policies, including improving the incentives for goods and services trade, lowering the cost of critical backbone services to trade, and proactive policies to support trade.[15] Even with product diversification, external shocks can hit segments of the economy more heavily than others and put economies at risk. The recent crisis has shown that countries with diversified manufactured exports, such as Germany, China and Japan, are not immune to strong shocks, since aggregate demand fell in all segments of consumer goods. Because diversification cannot provide full, a key companion of diversification is the development and reliance on leading indicators to prepare for and respond quickly to shocks that do occur.

Previous editions of the MENA Economic Developments and Prospects Reports have out-

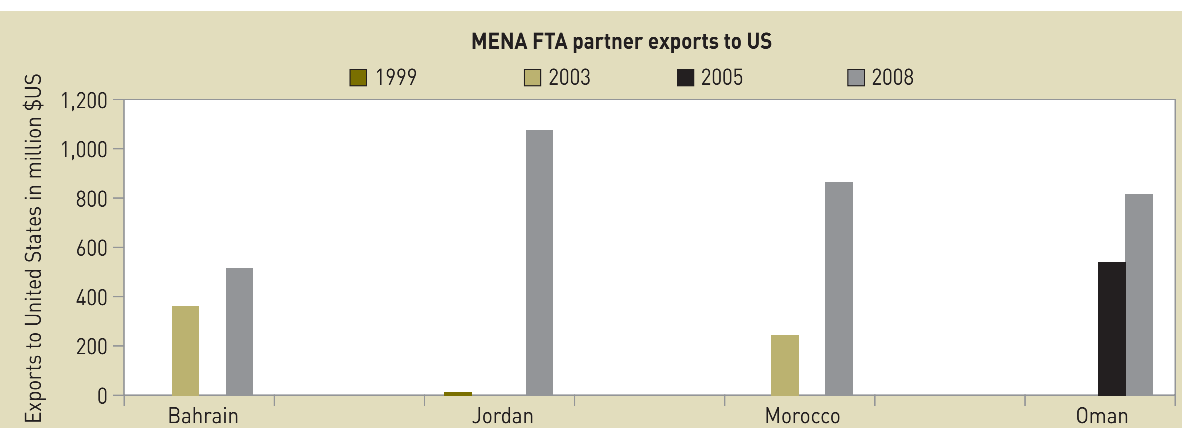
[15] Newfarmer, et al. 2009.

lined the many measures undertaken by countries to enhance merchandise trade, including efforts to expand markets through bilateral and regional trade agreements—perhaps most importantly through the Association Agreements with the EU signed by Algeria, Egypt, Jordan, Lebanon, Morocco, Syria, Tunisia and the West Bank and Gaza—, through extensive liberalization of key services for trade to domestic and foreign competition, and through trade policy reforms. The Barcelona Process toward a free trade area between MENA members and the EU has led to the dismantling of tariff rates on EU industrial and agro-industrial goods within most MENA countries, and several are initiating the reduction on other goods. More than half of the region's economies are members of the World Trade Organization (WTO). Free trade agreements with the United States have been signed by Bahrain, Jordan, Morocco and Oman, which combined have contributed to export growth to the US market averaging more than 20% a year (see Figure 3.9). The region has also entered into various intraregional trade and investment agreements, including the Agadir Agreement (between Egypt, Morocco, Tunisia and Jordan) and the Greater Arab Free Trade Agreement (GAFTA), while the GCC countries have formed a customs union, and plans for a monetary union between the states are progressing.[16]

At the same time, the architecture and policies governing trade in most of MENA have limited its ability to achieve significant gains in competitiveness and diversification. The way in which goods are produced and exported worldwide has changed dramatically in recent years, with technology and economies of scale motivating global production networks. MENA countries are poorly integrated into cross-border production networks, reducing the potential for higher foreign direct investment, the collateral knowledge spillovers that usually occur within production networks, and opportunities for expanding vertical integration. The reasons for this poor integration vary, but include low levels of FDI in manufacturing, poor regional integration (which might allow for important economies of scale), high logistics and transport costs, and for countries outside the GCC, Lebanon, Jordan and Yemen, still high trade barriers[17.] According to the new World Tariff Profiles,[18]

[16] Although the United Arab Emirates, at least, decided in May, 2009 not enter into the monetary union.
[17] World Bank 2008a.
[18] In contrast to previous editions of the MENA Economic Developments and Prospects Reports, this report now utilizes the new World Tariff Profiles to assess import protection. In the World Tariff Profiles, the WTO, ITC, and UNCTAD have made an effort convert Non-ad valorem duties into their ad valorem equivalents. As a result, it is not possible to assess tariff reform from 2000 to the present (as in previous editions), since the WTO no longer calculates tariffs by ad-valorem duties alone.

Figure 3.9: Growth in MENA FTA exports



Source: World Bank staff estimates from UN COMTRADE data.

average most-favored nation (MFN) tariffs for non-oil Europe integrated economies averages some 22%, while non-GCC oil exporters maintain an average MFN tariff of 18%. This places both groups of countries in the bottom quintile of economies, worldwide, with regard to tariff import protection (Table 3.3).[19] Despite reductions in the MFN tariffs on imports of inputs and intermediate products from the rest of the world, MENA's Europe-dependent countries have average applied MFNs two-three times higher than the average Europe preferential tariff, raising incentives for trade diversion and greatly limiting the possibility of integrating into European and other production chains.

Expanding and diversifying trade in the MENA region to reduce vulnerability to terms of trade and global demand shocks will require supportive measures along many fronts, which have been analyzed in great depth in other publications. A few key measures to support the process include analyzing particular export failures—in access to export finance or access to overseas market information—to identify the specific failures in the process. That can help to guide interventions which can support trade, including export and investment promotion agencies, standards bodies, and improvements in transport logistics. Continuing trade reform is needed to encourage MENA's resources to move to higher productivity activities, which will be critical for the region's competitiveness, as the potential of remaining competitive in low-technology activities is limited. Reducing barriers to trade will also help regional integration efforts, which can provide the needed economies of scale to participate in global production networks. Improving the backbone services for trade is also essential for competitiveness, and the analysis of export failures (through such analysis as investment climate assessments) can help to identify to the key stumbling blocks along the way. Combined, these measures can help MENA producers become more competitive, to expand their product and geography base, and to entice firms (both local and foreign) to use MENA countries as platforms from which to conduct business.

Business Flexibility and Vulnerability

One of the greatest weapons against external shock is entrepreneurship. An economy in which the private sector is able to respond to market changes by innovating, diversifying production, and adopting new technologies when circumstances change is able to rebound more quickly after negative shocks.[20] And, the development of a robust private sector is crucial to diversify regional economies and reduce their high dependency on hydrocarbons exports.

There is no precise "measure" of private sector dynamism. Standard indicators of performance—such as size, levels of investment, or outputs of the private sector—capture only parts of what is the broad notion of private sector strength, and even these indicators can vary sharply depending upon the manner of measurement and the period of time analyzed. By many measures, the private sector in MENA does not appear much different than the private sector in other regions. While (publically owned) oil sectors dominate many of the regional economies (thus the private sector is small, if one includes the oil sector), the majority of the non-oil productive base is private sector-held, and there has been substantial progress in the past fifteen to twenty years in increasing the size of the private sector (Figure 3.10).

Several indicators suggest that the private sector in MENA is considerably less dynamic than in other regions, in ways that are important from an economic resilience perspective.

While the goal of a dynamic private sector is for it to respond to economic shocks, doing so requires firm destruction and creation. The ability for new firms to enter and less productive

[19] A similar result is found using the Overall Trade Restrictiveness Index, where non-GCC oil exporters rank in the bottom 22 percent of countries worldwide with regard to tariff and non-tariff measures on imports. Non-oil Europe dependent countries, meanwhile, rank in the bottom 8 percent.

[20] See Duval, et al (2008) for evidence from the OECD on policies and institutions and shock persistence.

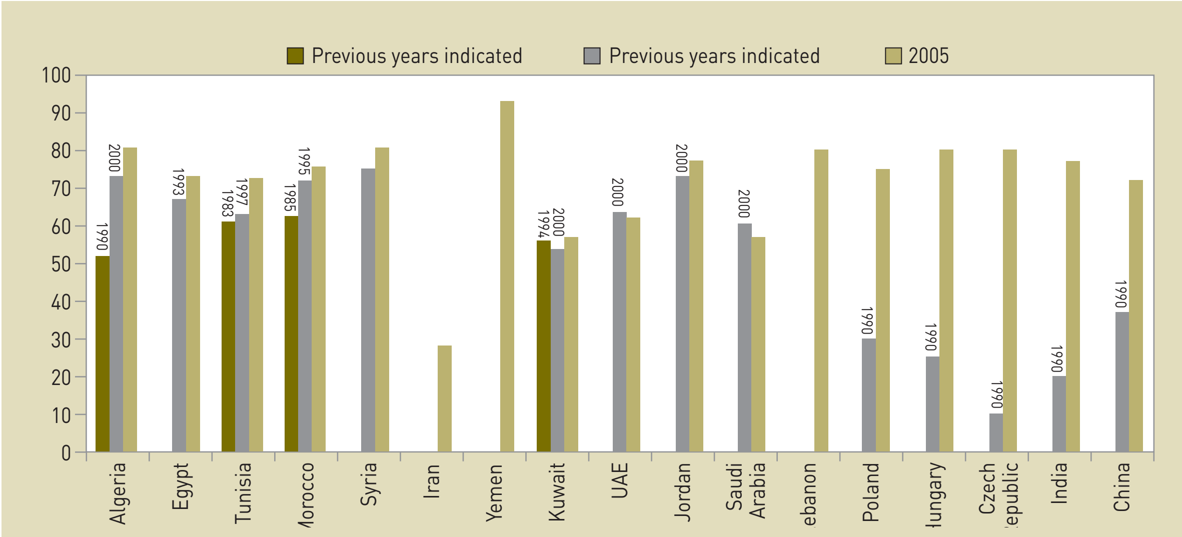
Table 3.3: Average tariff protection in MENA, 2008

Country/region	Average tariff	Average tariff (index)*	Time for export clearance (index*)	Time for import clearance (index*)	Overall trade policy index*
Algeria	18.6	8	67	50	43
Bahrain	5.0	89	77	76	91
Djibouti	27.8	1	59	72	49
Egypt	16.7	14	77	76	64
Iran	26.2	2	33	18	11
Jordan	11.2	37	59	53	56
Kuwait	4.6	91	55	61	79
Lebanon	6.9	66	30	20	39
Morocco	23.0	3	77	68	56
Oman	5.5	73	43	40	61
Qatar	4.9	89	50	61	76
Saudi Arabia	5.0	89	67	68	85
Syria	19.4	6	72	57	50
Tunisia	26.8	2	67	50	41
United Arab Emirates	5.0	89	85	89	94
West Bank and Gaza	—	—	36	19	—
Yemen	7.1	63	21	36	42
MENA	13.4	47	54	51	58
GCC	5.0	91	63	66	81
Oil, non-GCC	17.8	51	39	32	36
Non-oil, Europe-integrated	22.2	7	74	65	53
Non-oil, GCC dependent	15.3	36	46	41	48
East Asia/Pacific	8.7	67	47	50	59
Europe/Central Asia	7.3	67	50	51	46
High Income/OECD	5.6	78	84	85	92
Latin America/ Caribbean	9.6	52	59	57	64
South Asia	14.3	25	33	41	32
Sub-Saharan Africa	12.8	32	27	27	27
World	**10.1**	**50**	**50**	**50**	**50**

Note: Index relates country's average tariff (export clearance/import clearance/overall trade policy) to the world by calculating its position in a worldwide distribution of countries according to that trade indicator, where 100 reflects the economy with the "best" trade policies and 1 reflects the economy with the "worst" trade policies.
Sources: World Bank staff estimates from WTO Tariff Profiles; Doing Business Indicators.

firms to exit is a key indicator in the dynamism and resilience of the private sector in the long run (although it may entail substantial economic costs in the short run). In the MENA region, that creative destruction appears to be significantly more constrained. One of the notable characteristics of the private sector is its age. At 19 years, the median local manufacturing firm's age is higher than any other developing region in the world, and about the same as that in more

Figure 3.10: Private sector as a share of non-oil GDP



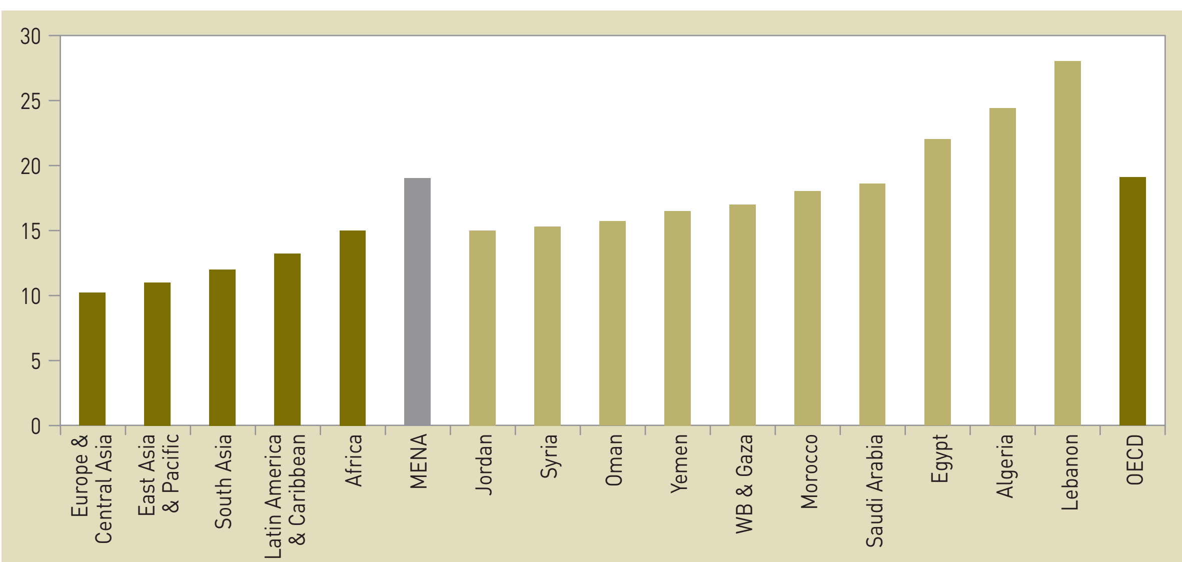
Source: World Bank, 2009c.

mature OECD economies (Figure 3.11).[21] The persistence of older firms in MENA suggests that creative destruction in MENA is substantially weaker than in other regions.

While exit and entry form the cornerstone for private sector resilience as a whole, private sector

[21] World Bank, 2009c.

Figure 3.11: Median age of manufacturing firms (*years*)



Source: World Bank, 2009c.

resilience at the firm level depends on the ability to adjust activities to accommodate shock, and especially on the labor margin. Recent research, in fact, suggests that labor market flexibility is the most important factor for dampening the effect of terms-of-trade shocks on per capita GDP.[22] Outside the GCC, however, the degree of labor flexibility in MENA is strikingly low, particularly from the standpoint of the difficulties with worker dismissal (see Table 3.4).

[22] Loayza and Raddatz. 2007. Other factors analyzed included trade openness, financial depth, financial openness, and ease of firm entry.

Table 3.4: Doing business indicators of labor flexibility

Country/Region	Difficulty of Hiring Index (standardized)	Difficulty of Firing Index (standardized)	Firing Costs, in weeks of wages (standardized)
Algeria	30	41	77
Bahrain	89	23	92
Djibouti	13	52	32
Egypt	89	12	4
Iran	67	23	14
Iraq	47	64	98
Jordan	67	12	92
Kuwait	89	88	22
Lebanon	30	52	77
Morocco	1	23	19
Oman	47	88	92
Qatar	89	64	25
Saudi Arabia	89	88	22
Syria	67	23	22
Tunisia	48	1	77
UAE	89	88	20
West Bank Gaza	47	64	14
Yemen	89	41	98
MENA	**60**	**47**	**49**
GCC	82	73	46
Other oil	53	38	53
Non-oil, Europe integrated	46	12	34
Non-oil, GCC dependent	49	44	59
East Asia/Pacific	62	63	57
Europe/Central Asia	45	50	65
Latin America/Caribbean	45	58	38
High Income/OECD	54	55	66
South Asia	62	39	43
Sub-Saharan Africa	42	38	38
World	**50**	**50**	**50**

Source: Staff estimates from Doing Business Indicators, The World Bank. Indices represent a country's placement in a worldwide cumulative frequency distribution according to that indicator, with high values representing the countries in the world which have the "easiest" policies for hiring and firing workers, and low values representing the countries which have the most difficult (or costly).

Both features point to a more limited ability in MENA to self-restructure, in part as a result of policies designed precisely to protect jobs and industries. MENA's historical development models, based on state-led industrial development and economic and social policies designed for redistribution and equity have also created a business environment in which there is little space for creative destruction and labor adjustment. Although the region has made strong progress in moving to more market-oriented economies, legacies of past policies remain. And while these policies may dampen the initial impact of a shock, they also may actually increase its persistence. The relative difficulty in job destruction, for example, while protecting workers in the short-run response to a negative shock, also hinder the wage adjustment process and the relocation towards other productive jobs[23], and may also increase the fiscal impact of a shock.

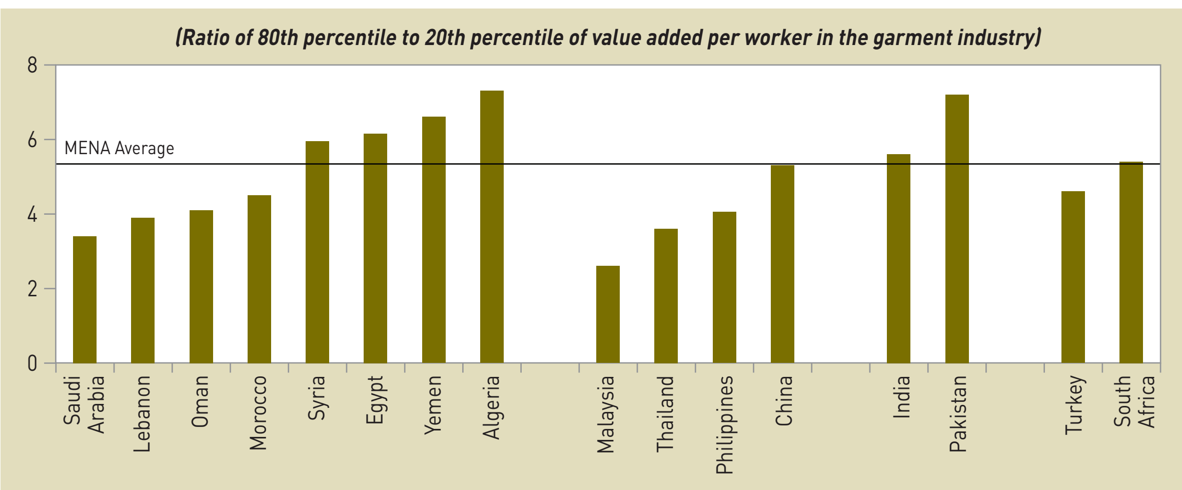
Beyond a legacy of policies designed to protect jobs and industries, recent research paints a picture of a region in which private sector dynamism, investment, and innovation is significantly constrained by an unlevel playing field between established and new firms, with high entry barriers to competition. This lack of dynamism, while an obstacle to stronger growth, is also a key obstacle to the resistance to shocks, as it prevents the critical resource shifts needed to bounce back from economic shock. One of the telling indicators of that uneven playing field is the high productivity dispersion of firms within an industry. If markets are competitive, with relatively free entry and exit, the dispersion should be quite low, because efficient competitive firms will drive less competitive firms out of business (or force them to raise productivity). And studies bear out the fact that lower productivity dispersion is associated with increased openness and greater competition with foreign firms.[24]

In MENA, the dispersion of value added per worker is considerably higher than in comparator countries (Figure 3.12), particularly in non-GCC oil producing economies like Algeria, Yemen and Syria.

In the past several years, the region as a whole has made progress in lowering some of the constraints to business activity, particularly in the area of reducing the costs (both financial and other) of starting a business. A few countries in particular, including Egypt, Saudi Arabia, Syria

[23] Duval, et al. 2007.
[24] World Bank, 2009c.

Figure 3.12: Dispersion in value-added per worker



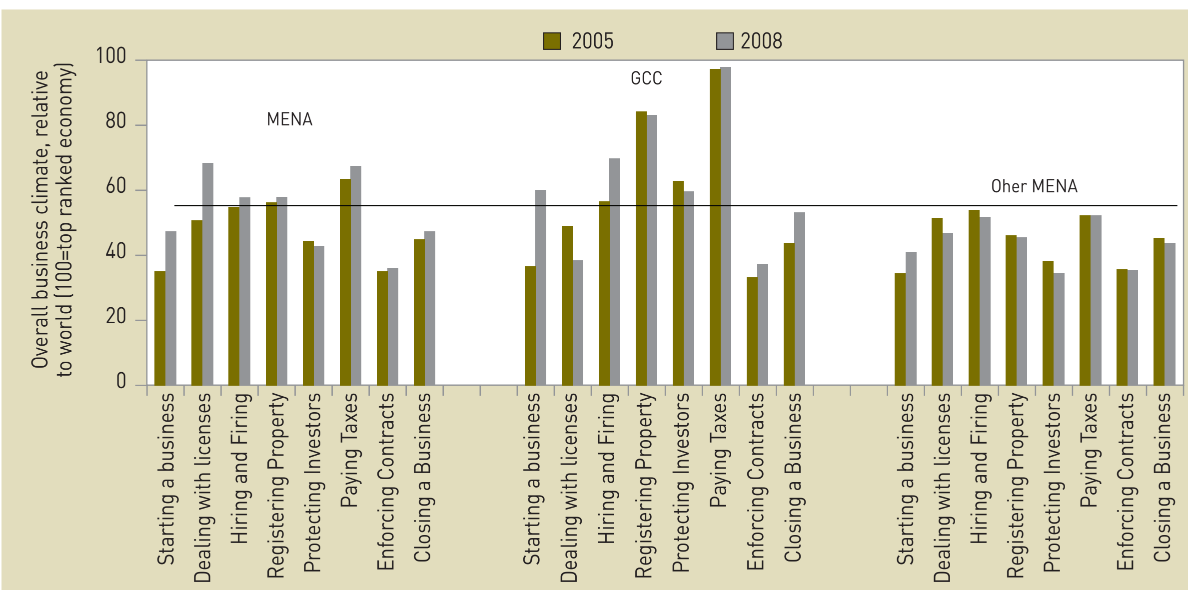
Source: World Bank, 2009c.

and Yemen, undertook reforms which resulted in significant improvement in their world rankings according to the World Bank Doing Business Indicators.

Overall several areas of reform remain very low by international standards and have not been tackled by the region. Contract enforcement remains the weakest area of the business environment both within the GCC and the rest of the region, greatly limiting business dealings outside those built by long-term relationships, repeated interactions and trust. And while the process for closing a business has improved over the past few years, that area also remains problematic for the region, especially among non-GCC economies. The frameworks for insolvency make bankruptcy difficult. Legal rules for reorganizing troubled companies are out of date, and the institutions that support the insolvency framework (courts and the regulation of insolvency professionals) are also inadequate in dealing with these matters (the insolvency law of the Dubai International Financial Center is the strongest insolvency law in the region but, given its unique structure and resources, is not particularly helpful in guiding other countries). More useful are the positive steps being taken to ameliorate the ICR framework including legislation consistent with best practice (Egypt, Tunisia), the role of regulators (the Companies Controller in Jordan) and the potential development of specialized courts or 'chambers' (Egypt, Jordan, Saudi Arabia).

A systemic problem with measuring structural reform is that one cannot determine the binding constraints to conducting business. Without knowing the true constraints to investment and growth in each country, it is impossible to know whether improvements in a particular area(s) of the regulatory front will materially change the business environment for investors. If the binding constraints to investment remain, so-called 'top reformers' may not have substantially improved the de facto business climate at all. While an average ranking can be indicative of the prevalence of problems in the business and regulatory environment, it is less useful in

Figure 3.13: Reform of business policies in MENA



Note: Bars reflect where country/region stands in a worldwide distribution of countries ranked according to the ease of doing business, according to the World Bank Doing Business Indicators. High values indicate policies in country relatively easy for conducting business.
= World median. Source: World Bank Doing Business Indicators 2009.

diagnosing the true nature of the constraints to private sector growth.

There is reason to suspect that binding constraints to private investment remain intact in many MENA countries. Looking at the broad range of business and regulatory indicators in the *Doing Business* reports, there is a high degree of 'regulatory dispersion' in MENA, with some areas of the business regulatory environment significantly more cumbersome than others (for example, in Egypt, while the time needed for starting a business is less than in 90% of countries worldwide, the costs associated with firing workers, in weeks of wages, is higher than in 95% of countries worldwide). Table 3.5 highlights MENA countries' "most cumbersome" areas of doing business[25], calculating where, on average, any business indicator would place a country within a worldwide distribution, and averaging the bottom third indicators for each country. On average, MENA countries' most cumbersome business regulatory areas would rank them in the bottom 20% of countries worldwide—were they only evaluated against the world by their most cumbersome areas of business, not significantly different from world averages. However, outside the GCC, MENA countries' more difficult business regulations would rank in the 17th percentile, only higher than Sub-Saharan Africa and South Asia. And for non-GCC oil countries, the most cumbersome aspects of their business environments would rank in the 13th percentile worldwide, lower than any other region of the world. This suggests that while the region may have taken substantial steps forward to improve the business environment, there remain significant obstacles to doing business, sufficient to hinder the ability for the private sector to respond in the face of exogenous shock.

Moreover, while the individual characteristics of the business environment matter, the lack of policy certainty and discretion in implementing the rules constrains investment in the region. Investors in MENA—especially managers of small and medium-sized firms— consistently point to policy uncertainty and an uneven playing field that favors some incumbent firms at the expense of new entrants and competitors. Despite a favorable macroeconomic environment for the past decade, macroeconomic uncertainty remains a leading concern for business. Corruption, anticompetitive practices, and regulatory policy uncertainty all rank high in the minds of business managers. In many countries, businesses also point to reform gaps in the regulatory environment, in access to finance, and in access to land. Rather than policies as they are appear on paper, a large part of the problem seems to lie with the unequal, discretionary, and preferential implementation of policies[26].

This point to the overarching need for governance not only for improving the business environment, but for reducing vulnerability to shocks in general. Poor governance, in particular through domestic policy mismanagement, can directly and significantly contribute to volatility and the exposure to shocks (through high inflation, overvalued exchange rates, or sustained budget deficits, etc).[27] Additionally, and related, governance sends key signals about credibility of policy and the ability for the economy to emerge from crisis, affecting both household and private sector responses. While good governance cannot ensure shocks will not hit, bad governance can arguably ensure that the impacts of shocks will persist.

Previous editions of the MENA Economic Developments and Prospects reports have outlined the two major governance challenges facing the region, and both are important in preventing and adjusting to external shock. First, it faces the challenge of modernizing governance structures and operations for more efficient public sector management. For countries to successfully absorb external shocks, they need to be able to

[25] For each business regulatory category, a country was ranked relative to the world by placing it in a worldwide frequency distribution according to that indicator, with 100 reflecting the country with the "best" policies and 0 reflecting the country with the worst. Utilizing the 31 indicators of business regulation across eight broad areas of reform in the Doing Business 2009 report, the most difficult aspects of doing business index was calculated by averaging each country's placement in the worldwide frequency distribution for their "most cumbersome" areas of doing business (the bottom third, and with different business areas for each country).

[26] World Bank, 2009c.

[27] Bacchetta, et. al 2007.

Table 3.5: Business and regulatory environment: Most cumbersome business areas (Relative to rest of world, for those areas of the business environment)

Country/Region	Areas of most cumbersome business regulation
Algeria	13
Bahrain	37
Djibouti	8
Egypt	14
Iran	14
Iraq	16
Jordan	24
Kuwait	22
Lebanon	23
Morocco	15
Oman	26
Qatar	28
Saudi Arabia	35
Syria	12
Tunisia	17
UAE	17
West Bank Gaza	18
Yemen	25
MENA	**20.2**
GCC	27.5
Non-GCC	16.6
Oil, other	13.5
Non-oil, GCC dependent	19.7
Non-oil, Europe integrated	15.4
East Asia Pacific	23.3
Europe Central Asia	21.4
High Income OECD	36.1
Latin America Caribbean	18.6
South Asia	15.0
Sub-Saharan Africa	13.5
World	**20.9**

respond quickly and effectively, adjusting fiscal expenditures, removing bottlenecks and institutional constraints to growth, and safeguarding the most vulnerable in the population, all of which require the institutional capacity for effective policy making and implementation. Improving public sector efficiency in MENA involves administrative reform to enhance the efficiency of the bureaucracy, to improve mechanisms of internal accountability, and to reduce corruption.

Secondly, the MENA region faces the more difficult challenge of increasing public sector accountability. This challenge requires improving transparency in governance mechanisms and enhancing contestability in government policies. Public accountability impacts the exposure to the persistence of shocks through two major channels. First, the lack of accountability in the public sector, either through policy uncertainty or through the lack of transparency and discretion in the implementation of rules, reduces the credibility in the government's capacity to effectively manage the shock, thus reducing private investment needed for the recovery. Second, the lack of contestability puts countries at greater risk of implementing poor policies, increasing the potential persistence of shocks. On this front, the MENA region faces its largest challenge, ranking below every other region of the world with regard to accountability (Table 3.6).

One of the strongest indicators of the gap in public sector accountability is a general disinterest in systemic gathering and transparent dissemination of data, which greatly hinders the ability for the region to monitor shocks and design policies to respond to them. While there are differences across the region, access to data of all types is severely limited in MENA: for some countries, the data of the sort that would be important for understanding the impacts of economic policy (or the leading indicators needed to predict shocks) is simply not collected, or is collected so infrequently as to be of little use. In other countries, while data may be collected, the data is retained within government agencies and not made public. In still others, data is only shared with a restricted group. With access to data useful in monitoring and responding to crisis so constrained, the ability to analyze and use data atrophies in general because there is little pressure to improve analytical skills and techniques, which has longer term implications on reducing vulnerability to shock. Improving data collection and unfettered availability to the comprehensive data needed to adequately monitor and respond to shock is thus an important component of reducing vulnerability to shock over the long term.

Safety nets and shock

The most severely affected by economic crisis will often be the poor and near-poor, who lack the resources to smooth consumption, thus the state of safety nets will be an important deterrent to vulnerability in all economies. MENA has the advantage of having low levels of poverty, compared with other regions. Nevertheless, a few structural features about MENA make the region particularly vulnerable to economic crisis from a poverty perspective.

Firstly, although poverty in MENA is low relative to other regions, it is characterized by a significant number of people living above but close to the poverty line. As a result, the sensitivity of poverty to external shocks is high. Overall, less than 5% of MENA's population lives on less than US$1.25 a day but some 19% of the regional population lives on less than US$2 a day. Moreover a considerable share of the population hovers just above the poverty line: in 2005, close to one fifth of Egyptians and Moroccans had per capita daily consumption falling into a narrow band between US$2 and US$2.50. This is as many as those who were under the US$2 poverty line in these countries. About 15% of Yemen and Djibouti populations are in the same 0.50 cents a day band. With such deep clustering of large proportions around the poverty line, even a moderate shock represents a serious risk to wider-scale poverty in many countries of the MENA region (see Figure 3.14).

Secondly, few countries in the region have well-developed, well-targeted safety nets. Most programs rely heavily on consumer subsidies, highly expensive but usually suffering from both poor coverage and a high degree of leakage to the non-poor. Egypt's food and energy subsidies, for example, which absorb some 30% of public expenditure (and about 10% of GDP), are not available to a large segment of the poor, due to the geographic areas in which the poor tend to live (rural Upper Egypt) and to the eligibility criteria for ration cards, and on average, the wealthiest quintile of the population receive about twice the resources from the subsidies scheme as the poorest.[28] In Morocco, meanwhile, the poor are receiving only 10% of what the

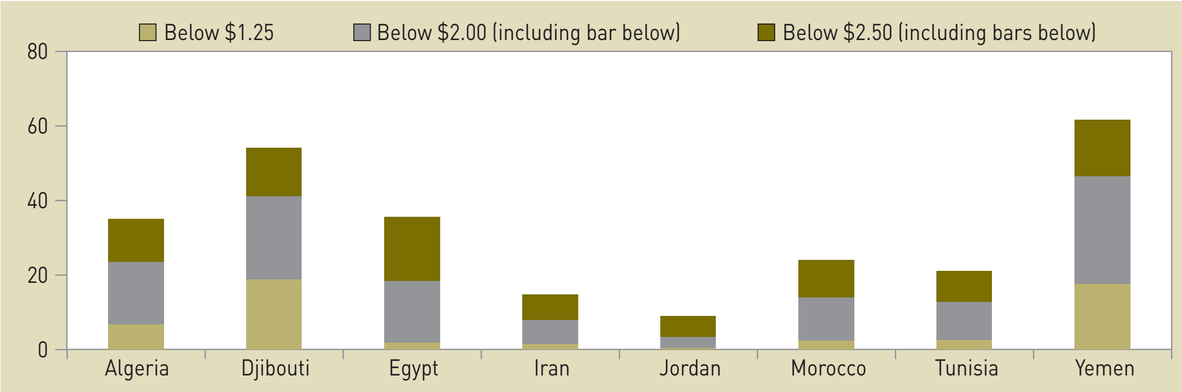
[28] World Bank, 2005.

Table 3.6: Indicators of governance in MENA, 2007

Country/region	Voice and Accountability	Political Stability	Government Effectiveness	Regulatory Quality	Rule of Law	Control of Corruption
Algeria	20	13	36	26	26	41
Bahrain	25	34	68	79	69	73
Djibouti	18	41	14	21	40	40
Egypt	12	22	39	43	52	36
Iran	8	11	24	4	21	37
Iraq	10	0	2	7	1	2
Jordan	27	34	65	62	65	67
Kuwait	34	60	63	61	71	72
Lebanon	34	4	29	48	30	31
Libya	2	64	12	17	32	22
Morocco	29	27	55	51	51	53
Oman	19	72	67	70	72	73
Qatar	28	76	58	67	80	82
Saudi Arabia	7	25	51	52	59	58
Syria	5	25	16	10	37	19
Tunisia	13	47	69	57	60	60
United Arab Emirates	23	73	79	72	70	82
West Bank Gaza	10	5	9	7	22	24
Yemen	17	8	13	24	18	33
MENA	**18**	**34**	**41**	**41**	**46**	**48**
GCC	23	57	64	67	70	73
Non-GCC	16	23	29	29	35	36
Oil, non GCC	10	20	17	15	23	26
Non oil, GCC dependent	22	21	29	34	39	41
Non oil, Europe integrated	18	32	54	50	54	50
East Asia Pacific	34	44	47	44	43	37
Europe Central Asia	48	46	49	54	43	43
High Income OECD	90	78	91	91	90	90
Latin America Caribbean	58	48	53	52	46	53
South Asia	26	25	35	31	34	32
Sub Saharan Africa	33	34	27	28	28	31
World	**50**	**50**	**50**	**50**	**50**	**50**

Note: Index values represent country's placement in a worldwide distribution of countries based on that indicator, with 100 representing the country with the "best" governance and 0 representing the country with the "worst" governance.
Source: Staff calculations from World Bank Governance Matters database.

Figure 3.14: Poverty incidence at alternative poverty lines, late 1990s



Source: World Bank POVCAL data.

government spends on universal price subsidies, while 90% goes to subsidies goods consumed by the non-poor.[29] Even more diversified social safety net programs, such as in Jordan and Yemen, suffer from poor coverage and high leakage. Countries in MENA have taken steps to improve the efficiency, targeting and coverage of social safety net mechanisms as a core element of their development agenda, but the progress has been slow. Nowhere has progress been more difficult than in the area of energy subsidy reform. Only Jordan has moved forward aggressively with energy subsidy reform, although a few others are in the process of developing plans for reform (including Morocco, Egypt, Syria and Yemen). In Iran, although energy subsides exceed 20% of GDP,[30] political constraints have prevented the introduction of subsidy reform, despite years of attempts. The most recent bill to reduce energy subsidies as part of an overall economic reform package presented to the Iranian parliament was rejected on the grounds that ending energy subsidies, particularly during this time of economic crisis and high inflation, would only serve to stoke inflationary pressures. The continued low domestic energy prices have caused production inefficiency, excessive consumption, corruption, smuggling, and environmental degradation.

Nor does the region have well-developed mechanisms of social insurance. Guarding against vulnerability is not just protecting the most poor from starving. It is also protecting the non-poor from drifting dangerously close to poverty. And for this group, the programs designed for the poor will not help in their crisis. For them, other mechanisms of social protection will be important to mitigate the effects of shocks, including labor market programs and social insurance programs. Many of these programs also suffer from deficiencies, which limit their ability to be effect shock absorbers.

Labor market programs, which have evolved from the region's history as employer of the last resort (particularly within the oil-producing economies), have focused on job protection rather than income protection. Rigid labor legislation, designed to protect workers from being laid off in the short run in response to a negative shock, also slow down the wage adjustment process as well as workers' reallocation towards other productive jobs, thereby delaying the return of employment and output to their initial levels. Over the long run, they reduce the incentives to hire workers and create imbalances between worker protection within and outside the firm. Other ad-hoc programs such as supply-driven vocational training, limited job-search assistance, and wage subsidies that attempt to stimulate job creation

[29] World Bank 2009e.
[30] Estimated based on 2007/08 data.

have received substantial public resources, yet their effectiveness remains in doubt. Most of these programs have continued to operate in the absence of appropriate monitoring and impact evaluation systems. Unemployment insurance, which could significantly cushion the impact of economic shocks, is only available in a handful of countries, including Algeria, Egypt, and Iran, and the systems face problems in terms of design that affects financial sustainability, incentives and equity.

Health insurance and pension systems also have deficiencies which reduce their effectiveness in times of economic shock. Health insurance systems are affected by weak institutional capacity to manage, regulate, and supervise. In all cases, there is little or no information regarding utilization patterns and unit costs and it is therefore not possible to price health insurance plans. As a result, contributions to the health system are ad-hoc and often insufficient to finance generous benefits packages. At the same time, the free health care offered through the public system reduces incentives to enroll in the insurance scheme and thus impairs and reduces the contributory base. Another issue is related to inadequate payment mechanisms for providers, mostly public providers. Current practices do not generate incentives to control costs and improve the quality of care.

The region's defined benefit pension systems, which provide old-age, disability, and survivorship pensions, represent an exceptional vulnerability for the region's macroeconomic stability and fiscal framework. The estimated accrued-to-date pension liabilities in MENA range between 6% of GDP (Morocco) and more than 170% (Jordan), which, in the absence of any intervention, will be unsustainable (increasing the vulnerability of those currently in the system) or will require significant tax increases or reductions in the budget for other items (for example, education and health). At the individual level, the large mandates reduce the incentives for saving for retirement outside of the mandatory pension system, so retirement savings are not diversified.

And perhaps most fundamental, MENA's ability to respond effectively to the social impacts of economic shock is hindered by a general disinterest in systemic gathering and transparent dissemination of data. The ability to design safety nets and social insurance programs equipped to deal with a variety of sources of household vulnerability, as well as to monitor and respond to economic crises which occur, depends on access to a variety of reliable, high-frequency data, including nationwide longitudinal studies of households which capture as many sources of shock and dimensions of poverty as possible. Data which allows for rapid and in-depth analysis on risk-induced poverty and vulnerability, risk management strategies and instruments, and an analysis of existing safety net programs, are essential in better informing the safety net design to adequately deal with the consequences of economic shock. In this area especially, the MENA region falls short. Data collection is limited, and there are few sources which might aid in monitoring social impacts of crisis. Moreover, access to information throughout the region is severely curtailed. As a result, the ability for MENA countries to design appropriate social policies to address the impacts of shock (or prevent them) is severely constrained.

More generally, the ability for the region to prevent future crises and design policies to respond to *all* of the potential impacts of economic shock—be it financial regulations in the face of rising contingent risks, policies to shore up specific markets or firms, monetary and fiscal policies to combat generalized recession, or policies to mitigate widespread drops into poverty, will depend over the long run on the region's improvement in the collection and distribution of complete, timely and reliable statistics.