Overview

Introduction

The global financial and economic crisis that began in mid-2007 in the US and has now led to the first global recession since World War II is impacting MENA countries and compounding the impact of the generalized rise in commodity prices that peaked in mid-2008. There is no consensus on the causes of this "once in a lifetime" crisis. However, it is generally accepted that a combination of low interest rates in the US, strong global demand especially in emerging market economies, and large current account surpluses in some countries, provided impetus for the buoyancy and bubble in housing, commodities, and stock markets. Just as they were synchronized on the upside, these markets all experienced sharp declines in prices during 2007–08. This series of events are of direct consequence for MENA's economic developments in 2008 and prospects for 2009 and 2010.

The objective of this 2009 MENA Economic Developments and Prospects is to review the implication of the triple food-fuel-financial crisis for MENA economies. Chapter 1 reviews the year 2008 and the first few months of 2009. It discusses the impact of the global economic environment and MENA countries' responses to the initial impact of the food-fuel-financial crises. Chapter 2 reviews MENA countries' prospects for 2009 and 2010 and discusses policies that can be envisaged to mitigate the impact of the global financial crisis on the region. Chapter 3 goes beyond the short-term concerns about the current crisis and discusses structural factors that affect MENA countries' vulnerability to shocks and their flexibility and ability to respond to future crises.

The main conclusions of the report are: (1) the effect of the crisis depends on countries' exposure to affected markets and commodities as well as on their initial macroeconomic conditions and policies; (2) the impact of the global crisis on financial sectors in MENA has been limited so far to GCC countries whose financial sectors were more open to global financial centers but also happened to be in a good position to respond thanks to the financial cushion provided by past oil surpluses; (3) in terms of impact on the real economy, the MENA region held up well in 2008, with average GDP growth remaining steady while other regions experienced declining growth; (4) going forward, virtually all MENA countries face a serious risk of impact on the real economy, and countries' ability to rebound in the post-crisis era will be enhanced if they use the opportunity of the crisis to ease infrastructure bottlenecks and restructure ineffective—yet expensive—subsidies programs; (5) The recent crisis, as well as previous ones, have brought to the fore the need to implement structural reforms—many of which have been discussed in previous reports—to reduce MENA countries' vulnerability and improve their flexibility to respond to future shocks.

Impact of the Crisis on MENA's Financial Sector Was Limited

When the financial crisis hit the region in mid-2008, many countries in MENA were still grappling with the impact of the food and fuel crisis. High fuel prices benefited oil exporters, allowing them to accumulate unprecedented surpluses in 2008 and strengthening Gulf oil exporters' position as global investors. The subsequent decline of oil prices in the second half of 2008 and apparent stabilization at around 50% of its mid-2008 peak, do not yet represent a serious threat to oil exporters although some of the region's non-GCC oil exporters will need a higher oil price to reach breakeven price level due to their high production costs. For non-oil exporters in the region, sky-rocketing fuel prices weighed heavily on their import bills as well as on fiscal outlays as most countries have maintained high levels of fuel subsidies. The impact of high food prices was also being felt across the region. Unlike earlier commodity price booms, the recent episode (2003 to 2008) involved all commodity groups. Commodity prices increased in a synchronized fashion starting in 2003 and continued to climb for some five years. In fact, the timing of the rise in agricultural prices points strongly to the impact of energy markets. Because MENA is a large importer of food, the inflationary impact of high international food prices was higher in MENA than any other region of the world—with 25% of inflation in MENA between December 2005 and December 2007 being caused by international food prices, more than twice the level for the next affected region. High food and fuel prices did not just strain households and governments' finances; they created social tensions in some countries as consumers were reacting to high inflation.

The early impacts of the global financial crisis on MENA's financial system were visible mostly in the high income oil-exporting countries of the GCC due to their strong links to global financial markets. In most other MENA countries, the banking sector has not been much affected to date, mainly because of its limited integration into global financial markets. Stock markets in GCC countries saw sharp decline in the last two quarters of 2008, mimicking trends in mature markets. Stock declines in other MENA countries were less severe. MENA sovereign funds, mostly in GCC countries, have also taken some losses on their investments in global financial institutions. Some early estimates by the Council on Foreign Relations suggest that GCC sovereign funds have, on average, lost 27% in portfolio value between December 2007 and December 2008, with losses reaching as high as 40% among funds that heavily invested in global equities. Borrowing spreads increased for MENA countries as much as for other emerging markets. However MENA countries were able to avoid going to the international bond market in the latter part of 2008 thanks to generally good balance of payments positions coming into the crisis, or thanks to relatively resilient tourism receipts, remittances and FDI.

The MENA region held up well in 2008 in terms of impact of the crisis on the real economy. The region as a whole saw a slight increase in GDP growth to 6.1% in 2008 compared to 5.6% the previous year. MENA's resilience to the crisis in 2008 is in stark contrast with other developing regions where growth fell from 2007 levels. The region's growth in 2008 was helped by high oil price for the year on average despite the sharp decline observed in second half of the year, and by strong growth in the construction sector. But signs of increasing weakness were apparent moving through the final quarter of the year and into the first months of 2009.

MENA's Short-Term Prospects Are Clouded by an Uncertain Global Environment

With the persistence of the crisis and the lackluster global economic environment going into 2009 and 2010, MENA faces prospects of a high impact of the global crisis on its real economy due to adverse developments or uncertainty in international trade, oil prices, tourism, remittances and international financing conditions. First, global trade volume is projected to decline sharply by 9.7% in 2009, the first decline since 1982 and the biggest drop in 80 years. The trade decline affects directly oil exports and oil revenues as well as exports of manufactured and other products from MENA; and MENA's trade related services such as the Suez Canal passage in Egypt and the use of the Dubai-operated port in Djibouti will be affected.

Second, oil prices are projected at $55.5 bbp in 2009 and $63 bbp in 2010, sufficient to avoid a major crisis in oil producing countries, but much lower than the boom of 2008. Oil prices in 2009 are unlikely to be much affected on the upside by factors that contributed to high prices before mid-2008. Global demand is likely to remain low. With recent OPEC production cuts and with Saudi Arabia having increased its production capacity to 12.5 million barrel per day (thanks to recent investments), there is sufficient slack to absorb any decline in supply that might be caused by unanticipated supply disruptions in other markets. Similarly, speculation is unlikely to create pressure on the upside given the lack of appetite on stock markets. As a leading indicator of oil prices, global industrial production is projected to decline by 12% in 2009 following a sharp fall in the fourth quarter of 2008.

Third, even though tourism has been somewhat resilient, it has not been immune and a decline is expected in 2009. Apart from GCC countries which are expected to show positive albeit slower growth in tourism receipts in 2009 and 2010, other countries are likely to move to negative territories in 2009 but are expected to see some improvements in 2010.

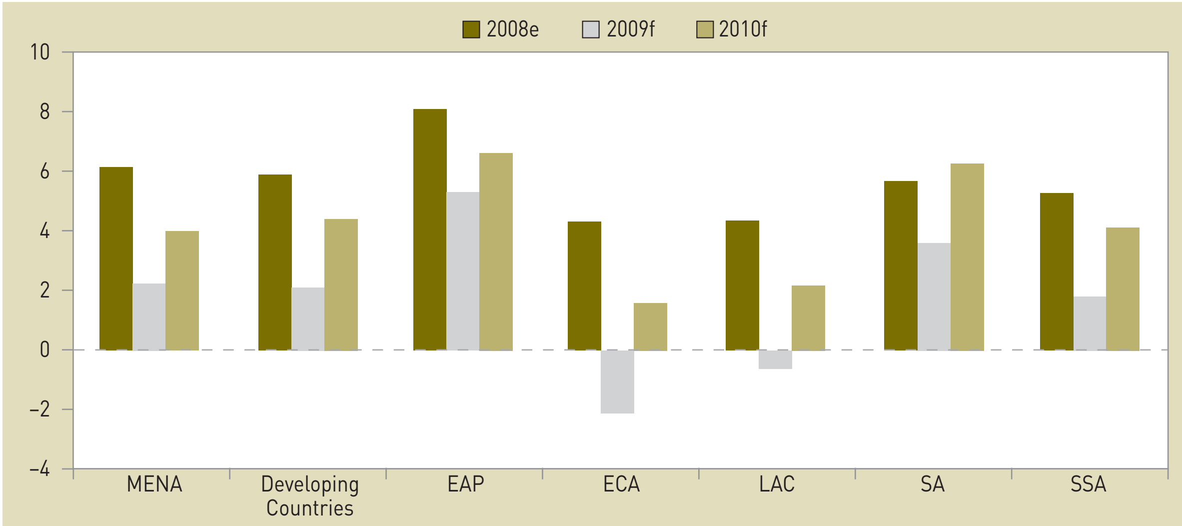
Fourth, although remittances proved resilient in 2008, they are projected to fall by 6.2% in MENA in 2009. Although this decline is consistent with global trends, it is likely to have a particularly large impact in MENA given the region's high dependence on remittances.

Fifth, like for most emerging markets and developing countries, external financing conditions will remain tight for MENA in 2009 and possibly 2010. Global FDI flows are projected to fall sharply in 2009, and MENA will be directly affected. FDI flows are low in MENA, and while they avoided a decrease in 2008, they are expected to decline markedly in 2009 as investors complete large projects that started before the global financial crisis and could not be easily interrupted without incurring large financial losses, and as new projects get postponed, cancelled or scaled back. As in many developing regions, short-term capital flew out of MENA quite suddenly in 2008. The phenomenon was more apparent in GCC countries that had both attracted short-term flows and had open capital accounts. With large stimulus packages in developed countries needing to be financed, there are fears that emerging market sovereign bonds will be crowded out by bonds issued by developed countries. Official development assistance (ODA) is expected to decline somewhat in 2009, with the risks that this will impose pro-cyclical forces in ODA dependent countries—such as Yemen, Djibouti, and West Bank & Gaza; with the synchronized global crisis, source countries, affected by the crisis, are likely to reduce ODA at a time when recipient countries need ODA increases to implement counter-cyclical fiscal policies.

With this backdrop, the MENA region is projected to see deterioration in its economic conditions in 2009 compared with 2008—a deterioration exemplified by a sharp decline in overall growth from 6.1% in 2008 to about 2.2% in 2009. This sharp decline contrasts with the situation in 2008 when the region was able to maintain a growth rate comparable to the previous year (2007) while all other regions saw a decline in their GDP growth rates in 2008. Moreover, despite the projected sharp decline in its GDP growth in 2009, MENA's growth rate is expected to be close to the developing country average of 2.1% in 2009 and is expected to rebound mildly to 4% in 2010 (figure 1). MENA's GDP growth in 2009 and 2010 is expected to be supported mostly by public consumption (helped by fiscal stimulus spending) in the face of sharp falls in private investment and exports. Current account balances and fiscal balances will deteriorate sharply in most countries largely due to a 50% decline in oil prices from the previous year's level. Some countries will nevertheless see an improvement in current account balances as sluggish domestic demand drives down imports more sharply than exports. Fiscal space will shrink significantly, as MENA governments continue to pay for subsidies and wage increases committed in 2008 in response to the food and fuel price increases or strive to pay for additional fiscal stimuli in response to the financial crisis.

For many MENA countries, inflation is likely to be the silver lining of the global financial crisis

Figure i: Regional Growth Rates, % 2008–2010



Source: World Bank data.

in 2009 and possibly in 2010 but this will not be sufficient to prevent the crisis from having serious social impacts. The decline in prices of global commodities, including food, and the strengthening of the dollar vis-à-vis major international currencies, have contributed to lowering consumer price indices across MENA. However, despite easing inflation, the human impacts of the crisis are likely to be significant in 2009–10. For one thing, economic slowdown has caused a weakening of the region's already lackluster ability to create jobs in the private sector; and the International Labor Organization (ILO) projects an increase in unemployment rate of about 25% in the Middle East and 13% in North Africa in 2009 compared to 2007.

At the country level, the economic impact of global slowdown will vary depending on the degree of economic integration with highly impacted regions or dependence on impacted commodities. Additionally countries' ability to respond will depend upon their fiscal space as well as their institutional capacity to implement sound macroeconomic and structural policies. With these characteristics in mind, the report organizes the countries in four groups for the purpose of analyzing the impact of the crisis.

- The GCC countries, or oil exporters with high hydrocarbon revenue per capita are highly exposed to oil and hydrocarbon price fluctuations, somewhat exposed to events in mature economies (through private flows), but do have fiscal space and some institutional capacity to implement macroeconomic and structural policies.
- Other oil exporters with relatively less hydrocarbon revenue per capita and relatively large populations are highly exposed to oil, face pressing social demands, have limited fiscal space, and limited institutional capacity to implement macroeconomic and structural policies.
- Non-oil exporters with significant financial flows with the GCC economic area or dependent on foreign development assistance are highly exposed to financial developments in the GCC and OECD countries (through public flows), have virtually no fiscal space and limited institutional capacity to implement macroeconomic and structural policies.
- Non-oil exporters with diversified economies and strong trade ties with the Euro area, are highly exposed to European and OECD countries (through trade), have limited fiscal space, but have good institutional capacity to implement macroeconomic and structural policies.

In virtually all *GCC oil exporters with large financial capacity relative to populations (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and United Arab Emirates)*, the sharp decline in oil prices since mid-2008 and depressed demand for oil on global markets will usher in significantly lower economic growth in 2009. For the GCC as a whole, growth is projected to decline sharply from an average of 5.7% during 2004–08 to 1.1% and 4.2% respectively in 2009 and 2010 (table i). The two MENA countries projected to enter recession zone, Saudi Arabia and Kuwait, are among the GCC. The UAE's growth prospects are lumbered by Dubai where the financial crisis has coincided with the bursting of the real estate bubble and sharp contractions in the construction sector and financial services. Qatar will stand out with a breathtakingly strong GDP growth projected to increase from 16.4% in 2008 to 18.2% in real terms in 2009, propelled by the coming on stream of major LNG plants. However, with their significant financial reserves, GCC countries are likely to be able to maintain countercyclical fiscal stances in 2009 and possibly in 2010 and ride the storm comfortably if oil prices stay above US$50 bbl throughout 2009 and 2010. While their fiscal revenues are projected to decline by 40% of GDP in 2009, expenditure is projected to remain at its 2008 level, leading to a sharp decline in fiscal balances, financed mostly with drawdown of past

Table i: Real GDP Growth, %, 2008–2010

Country	Estimate 2008	Forecast 2009	Forecast 2010
MENA Region	**6.1**	**2.2**	**4.0**
GCC countries	**6.3**	**1.1**	**4.2**
Bahrain	6.1	2.6	4.0
Kuwait	5.2	−1.2	2.4
Oman	6.2	3.0	3.8
Qatar	16.4	18.2	16.2
Saudi Arabia	4.6	−0.9	3.0
United Arab Emirates	7.4	0.3	3.3
Oil exporters with large populations	**5.6**	**2.7**	**3.5**
Algeria	3.0	2.2	3.5
Iran, Islamic Republic of	6.9	2.5	3.0
Iraq	9.8	6.9	6.7
Libya	6.3	2.9	4.8
Syrian Arab Republic	5.2	3.0	3.5
Yemen	4.0	7.7	5.0
Diversified exporters with strong GCC links	**6.1**	**2.5**	**4.2**
Djibouti	5.8	5.0	5.5
Jordan	5.5	2.5	3.5
Lebanon	6.5	2.5	4.5
Diversified exporters integrated with Europe	**6.5**	**4.0**	**3.9**
Egypt	7.2	3.8	4.2
Morocco	5.6	5.0	3.0
Tunisia	4.5	3.0	4.0

Source: National agencies and World Bank staff estimates and projections.

reserves. Capital expenditures in particular are expected to be sustained at high levels. Inflation is expected to ease to 7.6% and 4.7% on average in 2009 and 2010 respectively, down from 11.4% in 2008, partly because of a drop in world commodity prices in 2009 and the stabilization of the US dollar—to which most GCC currencies are pegged—against the euro and other world currencies. The external current account balance is expected to decline sharply to 13.2% and 16.7% of GDP on average respectively in 2009 and 2010 from its peak level of 33.6% in 2008 while fiscal balances will deteriorate sharply from an average of 26.6% of GDP in 2008 to 5.3% and 7.2% of GDP in 2009 and 2010 respectively.

As for o*il exporters with larger population relative to their oil wealth than GCC (Algeria, Iraq, Iran, Libya, Syria and Yemen)*, they will see sharp deteriorations in fiscal and external balances but will avoid recessionary growth in 2009–10. Oil GDP will decline sharply but non-oil GDP will help keep economic growth in positive territories. Real growth is projected to decline from an average of 5.6% in 2008 to 2.7% and 3.5% respectively in 2009 and 2010. Oil production provides them with significantly less wealth per capita than GCC countries. Moreover, these oil exporters entered the global financial crisis with weaker fiscal and external positions, and even those with large initial fiscal or current account surpluses are expected to see a sharp decline in 2009 as trade surpluses contract with lower oil prices and fiscal expenditures rise with costly policy responses to high food and fuel prices in 2008. Although public finances will benefit somewhat from declining outlays for fuel subsidies on account of lower oil prices, countries in this group will see large swings in fiscal balances from a group average of 5.5% of GDP in 2008 to a projected negative 6.6% and negative 1.8% of GDP in 2009 and 2010. Large swings will also be observed in current account balances from an average of 22.7% of GDP in 2008 to 2.2% and 3% of GDP respectively in 2009 and 2010. Due to a shrinking fiscal space, the government response in those countries appears thus far to be generally pro-cyclical, with a reduction of fiscal spending, as governments struggle to meet long-term social commitments (such as subsidies and income transfer programs) in the face of limited or lack of reserves in oil surplus funds (with the exception of Algeria and Libya). In addition to expensive social commitments, the policy response in this group of countries is likely to be constrained by long-delayed or hesitant structural reforms.

Non-oil exporting countries with strong economic linkages with GCC and/or aid dependent (Jordan, Lebanon, Djibouti, and West Bank & Gaza) are seeing a stagnation of financial flows from the GCC and face the challenge of mobilizing aid at a time when source countries are affected by the crisis. For countries in this group, growth is projected to slow on average to 2.5% and 4.2% in 2009 and 2010 compared with 6.1% in 2008. Inflation will ease to 5–6% from its high level of 12.5% in 2008. Countries in this group entered the crisis with generally weak macroeconomic frameworks characterized by high fiscal deficits, high debt levels, and tight external positions. The group's average fiscal balance will remain negative in 2009 and 2010 (around negative 4% and 2.6% respectively, compared to negative 8.4% in 2008). The average current account balance will remain in negative territories but will improve over 2008 and reach negative 9.9% and 6.9% of GDP respectively in 2009 and 2010. The improvements in fiscal and external balances will be driven by contractionary policies in the absence of space for large fiscal stimuli. The ability of countries in this group to fight the contractionary forces of the crisis will be dependent on fresh external flows or rollover of existing debt, combined with a rationalization of public expenditure patterns. With stock market contractions and lower oil prices ushering in reduced personal wealth in the GCC as well as reduced employment opportunities for migrant workers, remittances and FDI from GCC countries are reported to be declining in some countries of this group. Moreover, return of migrant workers from GCC countries could represent a challenge from the employment and social policy point of view.

Diversified economies with strong trade and tourism linkages with Europe and OECD (Morocco, Tunisia and Egypt) entered the crisis in relatively good macroeconomic positions, initially saw limited impact of the crisis on their financial systems but are now seeing a significant impact on their real economy as recession deepens in their major export markets in Europe. Growth is expected to decline to about 4.0% in 2009 and 3.9% in 2010. Inflation should be contained at about 5.2% in 2009 and 4.3% in 2010. Recession in the EU, reduced tourism arrivals and weaker remittance flows are likely to cause sharp contraction in manufacturing SMEs in export-oriented sectors in 2009 and 2010. The average fiscal deficit in 2009 and 2010 is projected to remain at the 2008 level of about 4.5% of GDP. However, if the crisis persists, fiscal positions could turn out to be worse because weak export demand is affecting jobs in export-oriented SMEs, and unemployment is likely to increase and put further pressure on public finances as governments try to provide financial incentives to firms to maintain or to provide income transfers to affected households. The current account deficit is expected to average about 5% of GDP in 2009 and 2010. Countries in this group can build on their good track record of sound macroeconomic policies and structural reforms to mobilize financing needed to implement countercyclical policies. However, financing is likely to be constrained by market conditions. Public finances are being impacted, and it is not clear whether governments will be in a position to issue sovereign bonds given that spreads remain high (although they have declined markedly from their peaks in late 2008). It is expected that governments will increase their reliance on domestic borrowing and external financing from public sources.

MENA's prospects for 2009–10 remain subject to significant downside risks, and the endurance of MENA countries will be tested by the depth of the global crisis and the timing of global recovery. Three risks are worth highlighting. First, a deeper and more protracted global recession than currently envisaged or a delayed global recovery could continue to depress demand for MENA's exports of hydrocarbon and manufactures. Even if global growth turns positive again in 2010, the level of GDP will remain well below potential due to large spare capacity and necessary corrections in global consumption patterns. Second, unchecked protectionist tendencies from MENA's trading partners or among MENA countries could jeopardize MENA's contribution to global recovery through trade and affect MENA's growth and employment prospects in the short term. Third, there are risks that a sharp or persistent deterioration in MENA's real economy could affect the financial sector through feedback loop effects. If the crisis persists and affects the financial position of export-oriented SMEs and eventually other domestic firms, there is a risk that the balance sheets of domestic banks could deteriorate due to emergence or growth of non-performing loans.

In the second half of 2009 and in 2010, MENA countries' endurance in facing the impact of the crisis will very much depend on the depth and length of the global economic recession. The projections in this report assume that global recovery will occur in 2010. However, this cannot be taken for granted. In the scenario where the crisis lingers on in 2010 but does not deepen, oil prices could stay above levels that would help GCC countries avoid any hardship even if economic growth remains anemic. Apart from GCC countries, all other country groupings are likely to see serious hardship emerge, if the crisis lingers on in 2010. Not only economic growth would remain low, but government's ability to cushion the impact of the crisis on households and workers would be eroded by the long crisis. In the scenario where the crisis not only lingers on in 2010 but deepens, all MENA countries, including GCC countries could see their endurance seriously shaken by a combination of depressed commodity prices, exports, tourism, FDI and remittances.

Policy Options to Mitigate Impact of the Ongoing Global Recession

Dealing with Shrinking Fiscal Space

MENA countries face diverse situations in terms of remaining fiscal space and therefore ability to mitigate the impact of the financial crisis in the months ahead. The report uses the levels of fiscal deficit and public debt to assess fiscal space. This suggests that half of GCC countries (Qatar, Oman and the UAE) have comfortable fiscal space, while the other half (Bahrain, Saudi Arabia and Kuwait) have some fiscal space but might be constrained by a moderate fiscal deficit (Kuwait) and/or a limited fiscal surplus (Saudi Arabia and Bahrain). Going forward, they will need to use their remaining fiscal surplus moderately. All other oil exporters (except Iraq) have some fiscal space that needs to be managed carefully going forward. Thanks to high oil revenues in the recent past, they have been able to maintain a low level of debt. Although they are all expected to run a fiscal deficit in 2009, they have some space to increase the level of public debt in hopes that oil prices will not fall below levels that jeopardize their governments' ability to accumulate surpluses and repay debt. However, in countries where debt issuance may be constrained by other factors than debt level, it may not be advisable to increase public debt. Countries with declining oil production (Yemen, Syria) should refrain from increasing their debt-to-GDP ratio as their repayment capacity may be constrained going forward.

Due to high fiscal deficits, most non-oil exporters have limited or no fiscal space. Some non-oil exporters (Lebanon, Jordan and Djibouti) have no fiscal space left. Lebanon in particular suffers from a high fiscal deficit combined with a high debt-to-GDP ratio. Among non-oil exporters integrated with European and OECD markets, Morocco and Tunisia have some fiscal space thanks to moderate levels of public debt, whereas Egypt has no fiscal space and will find it difficult to finance additional stimulus spending in 2009–10 over and above the package already announced by the authorities, unless it can secure low interest financing for the fiscal deficit. With falling fiscal revenues in almost all the countries in the region and with tightening external financing conditions, domestic public debt can be an appealing alternative for financing fiscal stimulus packages. However, MENA governments will need to carefully manage the risks of crowding-out the private sector. Moreover, in countries where the cost of servicing domestic debt is already high (Lebanon), the government may want to avoid adding to that cost.

Rationalizing Subsidies to Create Fiscal Space

One way of dealing with shrinking fiscal space is to rationalize existing subsidy programs. In fact, now may be a propitious time to rationalize MENA countries' high levels of subsidies and social spending that tie up a significant share of public resources that rarely benefit the social groups or sectors for which they are intended. In the majority of countries, all fuels and electricity are subsidized. While removing entrenched subsidies is not an easy task, and while there is no ideal time to do so, the time may be ripe for governments in MENA to rationalize their expensive subsidy programs. First, the argument can be made that the global financial crisis strengthens the case for restructuring poorly targeted safety net programs and other social programs in order to free up resources to finance critical social programs and job creation that would benefit the poor and those who are deeply or directly affected by the crisis. Second, as fuel and food prices have come down somewhat, the restructuring of subsidy program will not represent an inordinate increase in household expenditure for wealthy households who may have to forgo subsidies they formerly received. Finally, in some countries, subsidies have created heavy reliance on imports, public companies, rent-seeking situations, corruption and smuggling, which in turn have stifled competition and private sector development. The need to spur private sector activity and growth should be an important component of any stimulus package for economic recovery. So removing the "institutional bottlenecks" created by subsidy programs is yet another reason for using the opportunity of the crisis to rationalize subsidies in MENA.

However, subsidies should be rationalized with care so as to maintain—and perhaps increase—benefits to the poor. In some cases, price subsidies, especially food subsidies, do reach the poor and play an important role in their livelihood. Beyond subsidies, countries are considering other social spending for rationalization. Although not all the efforts are directly related to the global financial crisis, lessons from previous crises suggest that in restructuring social spending, countries should favor projects that can act as automatic stabilizers such as means-tested social benefit programs whose extension will occur naturally and should be financed during downturns as more people fall below the eligibility threshold, and this will reverse as the economy recovers.

Removing Bottlenecks to Growth

To benefit from global recovery once the crisis is over, MENA countries will need to use the crisis as an opportunity to remove infrastructure bottlenecks and institutional constraints that have suppressed regional growth for decades. MENA's pre-crisis growth rate was higher than historical levels but compared poorly with other regions' growth rates. Given the large needs and low level of investment to date, care should be taken not to cut too sharply MENA's investment rates as a result of the crisis as seen in Argentina in the late 1980s and in 2001–02, or in Thailand in the late 1990s. Growth resumption in the MENA region is likely to be driven by an expansion of investments at home as well as foreign direct investment in, and export to, emerging and developing economies where the potential for incremental growth is largest. Recognizing the infrastructure challenge, some GCC countries (Saudi Arabia, Qatar and Bahrain) have committed to maintaining high levels of infrastructure spending to stimulate their economy.

The role of the private sector in infrastructure should be actively encouraged as part of MENA's crisis response framework. This is particularly important given the limited or shrinking fiscal space faced by many MENA governments. In the past fifteen years, a country like Egypt has taken slow but steady steps towards strengthening the role of markets in the allocation of resources. These policy changes have yielded a high return in terms of growth and employment, which shows that changes are possible. Tunisia has also had some success in private sector-led growth. But even in Egypt and Tunisia, and more so in most other MENA countries, much remains to be done to create a leveled playing field for all investors, domestic and foreign, public and private. In the post crisis era, countries with adequate infrastructure and a conducive business environment will have a particular edge over other countries as investors are likely to look for profit opportunities while taking minimal risks in order to make up for the losses of the crisis period. Despite the heavy impact of the crisis, Dubai appears to be well positioned to take advantage of a global rebound—although it is unlikely to regain the pre-crisis level of enthusiasm—helped by a high level of investment and a conducive business environment.

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

The current global financial crisis and economic downturn is only the most recent shock to hit MENA economies, a region confronted with large terms of trade shocks, geopolitical shocks, frequent droughts, climate change and unstable security situations.

The region's exposure to and ability to rebound from economic shocks is a factor of underlying economic structures, the channels of integration into the global economy, and the policies that influence them. Over the long term, reducing vulnerability to economic shocks depends on a structural policy framework which can both lower exposure to systemic risk as well as increase the resilience of economies to cope with shocks when they occur.

Limited development of financial sectors

MENA's weak integration with global financial markets partially insulated the region from the first-round effects of the current economic downturn. But over the longer term, the region's ability to cope with shocks is hampered by the limited development of the financial sector, limited access to financial services by households and firms, and limited exposure to global financial markets.

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. Few private sector firms even utilize bank credit to finance investment, relying instead primarily on retained earnings. This disconnect of the financial sector from the real economy has meant the loss of one of the most effective tools an economy has for risk mitigation, through monetary policy. More generally, a well developed financial sector, which provides diversified funding sources for both individuals and enterprises for mitigating risks 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.

While global financial integration—limited outside the GCC—has implied relatively limited financial impacts from the current crisis, over the longer term, financial asset diversification in MENA countries will benefit from financial sector liberalization. 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. In addition, it allowed them to attract foreign investments into their hydrocarbon sectors and create international hubs for finance, trade logistics and business.

High exposure to terms-of-trade shocks

MENA also faces long-term vulnerabilities to shock on the trade side. Exports are highly concentrated around a few products. Among oil exporting countries, more than 85% of merchandise exports come from fuel. Among the region's non-oil exporters, the degree of export concentration is high, 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. As a result, the MENA region leads the world in exposure to commodity price shocks. MENA also faces terms of trade exposure on the import side, primarily through the region's heavy dependence on food imports.

To deal with this food import dependency, likely a permanent source of external shock, MENA 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. But they represent a serious fiscal burden, limiting the fiscal scope for other better-targeted programs.

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.[1] MENA countries are poorly integrated into cross-border production networks, reducing the potential for higher FDI, 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.

[1] Newfarmer, et al. 2009.

Lack of business flexibility limiting shock rebound

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. 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. At 19 years, the median local manufacturing firm's age is higher than any other developing region in the world, suggesting significantly weaker firm creative destruction in MENA. Furthermore, private sector resilience at the firm level depends on the ability to adjust activities to accommodate shock, and especially on the labor margin. Outside the GCC, however, the degree of labor flexibility in MENA is strikingly low, particularly from the standpoint of the difficulties with worker dismissal. Both features point to a more limited ability in MENA to self-restructure.

While the region as a whole has made progress in lowering some of the constraints to business activity, several areas of reform remain very low by international standards and have not been tackled by the region. Moreover, aside from specific rules and regulations, 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. 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.

Governance and the ability to manage shock

This problem points to an overarching need for governance reform, not only for improving the business environment, but also 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). 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.

Protecting the poor from shock

Finally, MENA countries are distinctly vulnerable to economic shocks from a poverty perspective. 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. Additionally, few countries in the region have well-developed, well-targeted safety nets. Nor does the region have well-developed mechanisms of social insurance.

The importance of access to data to predict and respond to shocks

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. 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 MENA to prevent future crises and design policies to respond to all of the potential impacts of economic shock will depend over the long run on the region's improvement in the collection and access to complete, timely, and reliable statistics.