

**Middle East and North Africa  
Economic Developments and Prospects 2006**

***Financial Markets in a New Age of Oil***

Middle East and North Africa Region  
Office of the Chief Economist

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## FOREWORD

### MENA ECONOMIC DEVELOPMENTS AND PROSPECTS 2006

2005 was a year of major developments in the Middle East and North Africa (MENA) region. A few events made international headlines over 2005: oil prices hitting record levels, the continuing turmoil in Iraq, building tensions regarding Iran's nuclear policy, the aftermath of political upheaval in Lebanon, and the uncertain political situation and aid implications in the West Bank and Gaza. But many of the developments that have not made headlines – the deteriorating impact of high oil prices on non-oil producers in the region, increasing moves by oil producers to channel windfalls into longer term assets, and progress with structural reforms – have been just as important in determining the direction of the economies in MENA.

With oil prices continuing their soaring advances, the efficiency with which the region channels the oil-related resources into the real economy will depend critically upon the region's financial sectors. It is thus particularly opportune to examine the state of the region's financial systems, to understand how they contribute to growth, promote efficiency, and enhance productivity – through corporate governance, through savings mobilization, and through their ability to protect against systemic shocks.

This is the second volume in a new series of annual reports on the MENA region. Its aim is to shed light on recent key economic developments in the region, and the forces underlying the region's economic outcomes. It analyzes the region's medium term growth prospects given global forecasts, and, building on last year's issue, the report continues to chart the region's progress with implementing comprehensive structural reforms for longer-term growth. And in this second issue, the important topic of MENA's financial markets is highlighted, to understand how financial systems are poised to meet some of the region's development objectives. As always, it is hoped that the report deepens the understanding of the region's development progress, prospects, and challenges.

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## ABBREVIATIONS AND ACRONYMS

Bbl	Barrels
Bn	Billion
Bpd	Barrels per day
CAR	Capital Adequacy Ratio
CET	Common External Tariff
DECPG	Development Prospects Group (World Bank)
EU	European Union
FDI	Foreign direct investment
FSDI	Financial Sector Development Indicators (a World Bank database).
FTA	Free Trade Agreement
GCC	Gulf Cooperation Council
GDP	Gross domestic product
ICA	Investment Climate Assessment (a World Bank report)
IEA	International Energy Agency
ILO	International Labor Office
IMF	International Monetary Fund
LMIC	Lower middle income economies
MEDP	MENA Economic Developments and Prospects report
MENA	Middle East and North Africa
MFA	Multifibre Agreement
Mn	Million
NIM	Net interest margin
NPL	Non-performing loan
NTB	Non-tariff barrier
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of Petroleum Exporting Countries
QIZ	Qualifying industrial zone
ROAA	Return on average assets
RPLA	Resource poor and labor abundant
RRLA	Resource rich and labor abundant
RRLI	Resource rich and labor importing
SITC	Standard Industry Trade Classification
TIFA	Trade and Investment Framework Agreement
Tn	Trillion
TRAINS	Trade Analysis and Information System
UAE	United Arab Emirates
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNWTO	World Tourism Organization
WDI	<i>World Development Indicators</i>
WITS	World Integrated Trade Solutions Database.
WTO	World Trade Organization

## OVERVIEW

For the third year in a row, the Middle East and North Africa region<sup>1</sup> (MENA) enjoyed a spectacular year of growth, buoyed by record high growth rates among the region's oil exporters. As oil prices continued their upward climb, the MENA region grew by an average of 6.0 percent over 2005, up from 5.6 percent over 2004, and compared with average growth of only 3.5 percent over the late 1990s. On an annual basis, MENA's average economic growth over the last three years, at 6.2 percent a year, has been the highest three-year growth period for the region since the late 1970s.

MENA's regional growth upturn has not been universally shared, however, and resource poor economies<sup>2</sup> are increasingly feeling the adverse impact of higher oil prices. In earlier periods, MENA's non-oil economies also benefited from rising oil prices, through a range of transmission mechanisms from the oil producers, including labor remittances and aid. Many transmission channels remain and have thrived during the current oil boom, including intraregional tourism and portfolio equity flows, but the overall magnitude of these channels is significantly diminished relative to prior booms. Moreover, with rising energy use, MENA's resource poor countries are increasingly experiencing the negative consequences of higher oil prices on the external and fiscal fronts, in the form of higher oil import bills and energy subsidies.

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

Although oil prices dominate the region's external landscape, MENA has experienced other important developments on the trade front. Resource poor economies have dealt with the expiry of the Multi-Fibre Agreement in 2005, which had allowed privileged access for Tunisia, Morocco, and Egypt in textile and clothing products to European markets. Textile exports in Tunisia and Morocco have been hard hit, while Egypt has managed to maintain textile exports to date, in part by cushioning the impact with a December 2004 agreement on qualifying industrial zones between the US, Egypt, and Israel.

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<sup>1</sup> The Middle East North Africa Region consists of Egypt, Jordan, Morocco, Tunisia, Lebanon, Djibouti, West Bank and Gaza, Algeria, Iran, Iraq, Syria, and Yemen, Saudi Arabia, United Arab Emirates, Kuwait, Libya, Qatar, Oman, and Bahrain.

<sup>2</sup> Resource poor economies include Egypt, Jordan, Morocco, Tunisia, Lebanon, Djibouti and the West Bank and Gaza.

<sup>3</sup> Dominant oil producers in the region include Algeria, Bahrain, Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, Syria, United Arab Emirates and Yemen.

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

Over the medium term, general conditions for maintaining a solid pace for growth appear promising. Global oil prices are now anticipated to hold above \$50/bbl through 2008, which will provide for a moderating, yet still substantial flow of oil revenues to MENA exporters. Should prudent budgetary policies prevail, prospects for the oil dominant economies are upbeat, with growth easing from 6.7 percent in 2005 to 5 percent by 2008. For the diversified economies, the anticipated recovery in European demand will be a key external factor for growth over 2006-2008, as will the easing of oil prices, that should allow some of the costs of subsidies to be recaptured, and growth among resource poor economies is viewed to pick up above 5.5 percent. Overall, on a base set of assumptions, including continued moderate progress in domestic reforms, the MENA region's growth is viewed to ease modestly in 2006 to 5.6 percent, and to establish a 5.2 percent pace over 2007-08, reflecting an acceleration for the diversified economies, contrasted with some slowing for oil exporters.

**Overview Table 1: Global developments and MENA GDP growth**

<b>Growth, or as otherwise Specified</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>
<b>World trade<sup>a</sup></b>	<b>12.0</b>	<b>9.0</b>	<b>8.5</b>	<b>7.0</b>	<b>7.0</b>
High income imports	8.9	6.6	6.7	6.2	6.2
Euro area	6.3	4.3	5.8	5.3	5.4
United States	10.7	6.2	5.0	3.8	3.8
Oil prices (\$/bbl) <sup>b</sup>	37.7	53.4	59.0	56.0	53.0
Non-oil commodity prices <sup>c</sup>	17.3	13.4	5.4	-3.1	-5.9
MUV index <sup>d</sup>	6.9	0.0	2.4	2.6	0.8
US dollar LIBOR (%)	1.7	3.6	5.2	5.3	5.2
<b>World GDP<sup>e</sup></b>	<b>3.8</b>	<b>3.3</b>	<b>3.3</b>	<b>3.2</b>	<b>3.2</b>
High income countries	3.2	2.8	2.9	2.7	2.8
Euro area	1.9	1.4	2.1	1.7	1.9
Developing countries	6.9	6.3	6.0	5.7	5.6
<b>MENA<sup>f</sup></b>	<b>5.6</b>	<b>6.0</b>	<b>5.6</b>	<b>5.2</b>	<b>5.2</b>
Resource Poor	4.8	4.0	5.4	5.4	5.7
Resource Rich	5.9	6.7	5.5	5.2	5.0
Resource Rich Labor Abundant	4.7	5.5	5.3	5.1	4.8
Resource Rich Labor Importing	6.5	7.2	5.8	5.3	5.0

A: Goods and services (2000 \$US); b: World Bank average oil price = equal weights of Brent, WTI, and Dubai crude oil prices; c: World Bank index of non-oil commodity prices in nominal \$US terms; d: Index of manufactures unit value, G-5 countries (France, Germany, Japan, United Kingdom and United States); e: Real GDP in 2000 \$US. f: MENA geographic region comprised of resource poor, labor abundant countries (Djibouti, Egypt, Jordan, Lebanon, Morocco and Tunisia); resource rich, labor abundant countries (Algeria, Iran, Iraq, Syria and Yemen) and resource rich, labor importing countries (Bahrain, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates).

Source: World Bank, 2006c.

The oil shock MENA is experiencing has had important financial spillovers. Over the last few years, MENA has seen an upsurge in financial activity, as abundant liquidity has fed a rapid rise in credit growth, surging stock markets, and a booming real estate sector. Oil economies have been the primary recipients, but a financial market upswing has also reached some of the region's resource poor countries through increased cross border investment, remittance flows and tourism.

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

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

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

A few critical facts lie at the heart of the structural disconnect between the relatively plentiful financial resources found across MENA and the scarcity of external financing for businesses. Public sector ownership has significantly impacted the direction of credit in MENA, as well as the operating efficiency and the ability of the banking sector to conduct robust risk analysis. Bank regulatory frameworks, with limited market forms of oversight and discipline, have led to adverse credit allocation. Access to banking facilities remains comparatively limited across the region, and in many cases is restricted to public sector banking networks, concentrating credit provision upon a relatively privileged minority. Underdeveloped contractual savings and capital

markets remove a source of competition for banks and an alternate avenue for firm finance. Governance structures undermine formal financial relationships across much of MENA. And commercial-finance relationships are further undermined by a wealth of problems in MENA's business climate.

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

However, the more subdued progress made by oil exporters in these areas of reform in large part reflects lack of improvements among GCC economies, which have traditionally maintained more open and business-friendly trade and investment policies. More importantly, as a group, the oil economies have demonstrated long-awaited progress in governance, an area in which the group demonstrates significant deficit relative to the rest of the world. Specifically, notable progress has taken place over the last five years in enhancing public sector accountability mechanisms, which augers well for continuing reform success. Although oil economies continue to rank in the bottom twentieth percentile relative to the rest of the world in terms of measures of public sector accountability (including political and civil liberties, freedom of information, etc<sup>4</sup>), over the last five years, oil economies have made greater progress in improving public sector accountability than all other regions of the world, on average ranking in the 65<sup>th</sup> percentile worldwide with regard to improving public accountability.

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

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<sup>4</sup> See Appendix B for description and methodology behind governance indices.

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

Country/Region	Trade Policy		Business Climate		Governance: Quality of public administration		Governance: Public sector accountability	
	Current status	Reform progress	Current status	Reform progress	Current status	Reform progress	Current status	Reform progress
Algeria	44	71	13	38	38	91	29	91
Bahrain	..	62	..	..	77	26	23	91
Djibouti	..	51	..	74	..	..	..	..
Egypt	43	100	11	36	43	92	25	84
Iran	22	74	57	44	16	19	21	4
Iraq	..	..	66	..	..	..	..	..
Jordan	47	86	58	89	66	67	34	60
Kuwait	53	65	59	7	58	24	31	65
Lebanon	61	80	37	31	..	..	..	..
Libya	..	27	..	..	11	64	0	42
Morocco	38	52	61	54	73	83	33	81
Oman	71	11	78	15	61	75	16	81
Qatar	..	..	..	..	60	89	13	74
Saudi Arabia	39	77	80	26	57	77	5	69
Syria	18	43	30	5	15	67	7	74
Tunisia	51	57	83	93	74	87	22	22
UAE	..	..	43	14	59	6	17	41
Yemen	62	82	35	57	28	71	20	89
<b>MENA</b>	<b>46</b>	<b>63</b>	<b>51</b>	<b>42</b>	<b>49</b>	<b>63</b>	<b>20</b>	<b>64</b>
<b>Resource poor</b>	<b>48</b>	<b>71</b>	<b>50</b>	<b>63</b>	<b>64</b>	<b>82</b>	<b>28</b>	<b>62</b>
<b>Resource rich</b>	<b>44</b>	<b>57</b>	<b>51</b>	<b>23</b>	<b>44</b>	<b>55</b>	<b>17</b>	<b>65</b>
<b>RRLA</b>	<b>36</b>	<b>67</b>	<b>40</b>	<b>36</b>	<b>24</b>	<b>62</b>	<b>19</b>	<b>64</b>
<b>RRLI</b>	<b>54</b>	<b>48</b>	<b>65</b>	<b>15</b>	<b>55</b>	<b>52</b>	<b>15</b>	<b>66</b>
<b>East Asia Pacific</b>	<b>56</b>	<b>37</b>	<b>61</b>	<b>47</b>	<b>43</b>	<b>45</b>	<b>41</b>	<b>48</b>
<b>Europe Central Asia</b>	<b>51</b>	<b>69</b>	<b>48</b>	<b>64</b>	<b>47</b>	<b>46</b>	<b>52</b>	<b>51</b>
<b>Latin America / Carib</b>	<b>57</b>	<b>50</b>	<b>40</b>	<b>51</b>	<b>46</b>	<b>50</b>	<b>57</b>	<b>43</b>
<b>High Income OECD</b>	<b>70</b>	<b>64</b>	<b>84</b>	<b>50</b>	<b>89</b>	<b>47</b>	<b>91</b>	<b>49</b>
<b>South Asia</b>	<b>41</b>	<b>48</b>	<b>48</b>	<b>41</b>	<b>48</b>	<b>53</b>	<b>39</b>	<b>31</b>
<b>Sub-Saharan Africa</b>	<b>34</b>	<b>27</b>	<b>27</b>	<b>43</b>	<b>34</b>	<b>53</b>	<b>37</b>	<b>55</b>
<b>WORLD</b>	<b>50</b>	<b>50</b>	<b>50</b>	<b>50</b>	<b>50</b>	<b>50</b>	<b>50</b>	<b>50</b>

Note: Regional averages reflect the simple average of the data for the countries included. a. Current status (trade, business, or governance) reflects country's current placement in a worldwide ordering of countries based on that structural reform indicator, expressed as a cumulative frequency distribution, with 100 reflecting the country with the most friendly/open/accountable policies or structures (worldwide) and 0 representing the country with the most unfriendly/closed/unaccountable policies or structures (worldwide). b. Reform progress reflects the improvement in a country's rank between 2000 and 2005 in a worldwide ordering of countries based on that structural reform indicator, expressed as a cumulative frequency distribution, with 100 reflecting the country which exhibited the greatest improvement in rank and 0 reflecting the country which exhibited the greatest deterioration. Source: World Bank staff estimates from country data.

With diminishing positive links to the oil economies (and increasing negative impacts from higher oil prices), the resource poor economies in the MENA region have maintained a solid pace of reform, generally exceeding other regions of the world across all areas of reform. In both trade reform and business and regulatory reform, the resource poor economies have made, on average, stronger progress over the last five years than all other regions of the world. Largely in connection with recent bilateral and multilateral trade agreements, and led by deep tariff reductions undertaken in Egypt, resource poor economies on average ranked in the 71<sup>st</sup> percentile with regard to tariff reform over the last five years. With regard to reform of the business climate, the steps taken by resource poor economies placed them in the top 63<sup>rd</sup> percentile, on average. Nonetheless, much stronger progress can take place, particularly with regard to trade liberalization. The resource poor economies as a group continue to maintain some of the highest tariffs in the world, ranking in the bottom 25<sup>th</sup> percentile worldwide with regard to low tariff protection.

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

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

# RECENT ECONOMIC OUTCOMES AND SHORT-TERM DEVELOPMENT PROSPECTS IN MENA

## 1.1 INTRODUCTION

The Middle East and North Africa region<sup>5</sup> (MENA) enjoyed another exceptionally strong year of economic expansion, buoyed by the record high growth rates among the region's oil exporters. As oil prices continued their upward climb, the MENA region grew by an average of 6.0 percent over 2005, up from 5.6 percent over 2004, and compared with average growth of only 3.5 percent over the late 1990s. On an annual basis, MENA's average economic growth over the last three years, at 6.2 percent a year, has been the highest three-year growth period for the region since the late 1970s.

MENA's regional growth upturn has not been universally shared, however, and resource poor economies are increasingly feeling adverse impact of higher oil prices. In earlier periods, MENA's non-oil economies also benefited from rising oil prices, through a range of transmission mechanisms from the oil producers, including aid and labor remittances. Many transmission channels remain and have thrived during the current oil boom (including intraregional tourism and portfolio equity flows), but the overall magnitude of these channels is significantly diminished relative to prior booms. Moreover, the positive benefits from these transmission channels have been increasingly overshadowed by the detrimental external and fiscal consequences of higher oil import bills and surging oil subsidies.

Economic growth patterns among oil producers have been increasingly harmonized, reflecting a trend toward common development strategies. Compared with previous oil booms, the region's oil producers are increasingly demonstrating impressive fiscal restraint. They are building up liquidity, through external reserves, oil stabilization funds, and through paying down debt. They are also pursuing common strategies for diversification of the oil wealth into foreign assets, as a way to transform the finite oil wealth into longer-term revenue streams. With this increased prudence, the volatile growth outcomes among oil producers which characterized the 1970s and 1980s have been increasingly supplanted by a common growth effect.

Although oil prices dominate the region's external landscape, MENA has experienced other important developments on the trade front. Resource poor economies<sup>6</sup> have dealt with the expiry

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<sup>5</sup> The Middle East North Africa Region consists of resource poor labor abundant economies Egypt, Jordan, Morocco, Tunisia, Lebanon and Djibouti; resource rich labor abundant economies Algeria, Iran, Iraq, Syria, and Yemen; and resource rich labor importing economies Saudi Arabia, United Arab Emirates, Kuwait, Libya, Qatar, Oman, and Bahrain.

<sup>6</sup> See note above for description of MENA country groupings.

of the Multi-Fibre Agreement (MFA) in 2005, which had allowed privileged access to Tunisia, Morocco, and Egypt in textile and clothing products to European markets. Textile exports in Tunisia and Morocco have been hard hit, while Egypt has managed to maintain textile exports to date, in part by cushioning the impact with a December 2004 agreement on qualifying industrial zones (QIZs) between the US, Egypt, and Israel.

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

Over the medium term, two major elements are likely to shape the outlook for the broader MENA region. Developments in critical non-oil export markets for MENA will carry substantial influence on the outlook for the region's diversified economies, largely within the resource poor, labor abundant group. And at the same time, the dynamics of the oil market are anticipated to change as global demand and supply conditions evolve over the next years.

General conditions for maintaining a solid pace for growth over the next years appear promising. Global oil prices are now anticipated to hold above \$50/bbl through 2008, which will provide for a moderating, yet still substantial flow of oil revenues to MENA exporters. Should prudent budgetary policies prevail, prospects for the oil dominant economies are upbeat, with growth easing from 6.7 percent in 2005 to 5 percent by 2008. For the diversified economies, the anticipated recovery in European demand will be a key external factor for growth over 2006-2008, as will the easing of oil prices, that should allow some of the costs of subsidies to be recaptured. On a base set of assumptions, including continued moderate progress in domestic reforms, the MENA region's growth is viewed to ease modestly in 2006 to 5.5 percent, and to establish a 5.2 percent pace over 2007-08. Overall growth reflects a pick-up for the diversified economies above 5.5 percent, contrasted with a slowing for oil exporters toward the 5 percent mark.

## 1.2 RECENT ECONOMIC DEVELOPMENTS

### 1.2.1 Regional growth outcomes buoyant

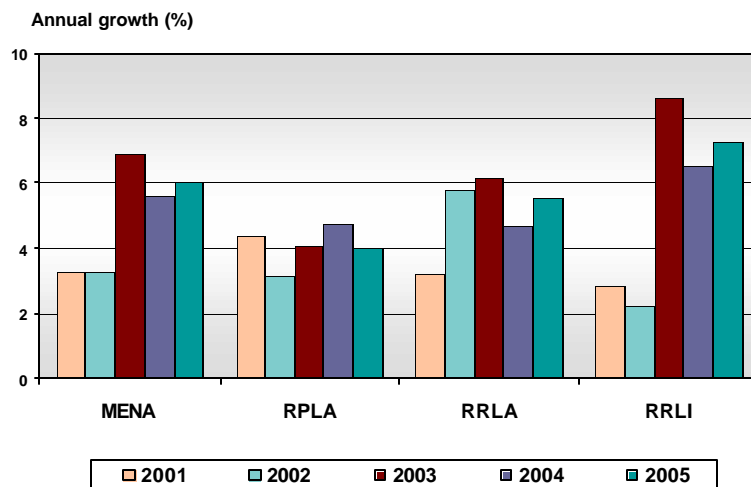
The Middle East and North Africa region experienced another stellar year of economic growth, as oil prices continued their upward climb over 2005. Growth in the region averaged 6.0 percent over 2005 (Figure 1.1). Over the past three years, GDP in the region<sup>7</sup> has grown by an average of 6.2 percent a year, the highest three year average growth rate for the region in nearly three decades.

Above all, MENA's recent growth upturn reflects the spectacular events in the oil market, where

continuing tight supply and volatility in response to external conditions have resulted in surging oil prices over the last three years. Combined with production increases, rising oil prices have fueled extraordinary economic growth among oil producers<sup>8</sup>, which together grew 6.7 percent over 2005 and accounted for 84% of regional growth last year<sup>9</sup>. Most impressive has been the economic expansion among the region's resource rich and labor importing economies, which grew by more than 7 percent over the year. Most of the group has benefited from OPEC<sup>10</sup> production increases, including Saudi Arabia, which expanded by 6.5 percent (more than a percentage point gain over growth in 2004, and behind 2003, the highest rate of economic growth experienced by the economy in fifteen years). Other OPEC producers, including Kuwait, Libya, the United Arab Emirates and Qatar, all realized economic growth rates in excess of 8 percent last year.

MENA's resource rich labor abundant (RRLA) economies (excluding Iraq) also reaped the benefits of higher oil prices, supported by expansionary fiscal policy (particularly in Iran and Yemen). Iran's economy grew by 5.9 percent last year, more than a percentage point gain over last year, while Algeria saw economic growth above 5 percent for the third year in a row.

Figure 1.1  
Economic growth in MENA, 2000-2005



Source: Staff Estimates.

<sup>7</sup> Not including Iraq.

<sup>8</sup> Includes resource rich labor importing economies (Saudi Arabia, United Arab Emirates, Kuwait, Qatar, Libya, Oman, Bahrain) and resource rich labor abundant economies (Algeria, Iran, Syria, Yemen). Does not include Iraq.

<sup>9</sup> As a comparison, the oil producers accounted for less than 70% of growth over the late 1990s.

<sup>10</sup> OPEC members include Algeria, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, the United Arab Emirates, and Venezuela.

Although higher oil prices have only partially offset the effects of the substantial drop in oil exports (stemming from both production declines and loss of oil re-exports from Iraq), Syria also managed stronger growth over 2005 as a result of sizeable expansion of non-oil exports to Iraq. Overall, RPLA economies recorded robust growth over 2005 of 5.5 percent (up from 4.7 percent last year)

But the boon to oil producers did not fully translate to resource poor economies in the region. Growth among resource poor economies averaged 4 percent over the year (down from 4.8 percent in 2004), chiefly reflecting the sharp growth contractions in Morocco and Lebanon, and slower growth in Tunisia. Stagnating European demand and a severe drought contributed to a reduction in Morocco's economic growth of almost two-thirds from 2004 (and the lowest annual growth rate for the country in five years) as well as to a drop in growth in Tunisia. Diminished investor confidence and shaken security following the February 2005 assassination of former prime minister Hariri, meanwhile, resulted in Lebanon's economic growth collapsing to 1 percent over 2005, down from more than 6 percent growth the previous year. Elsewhere, resource poor countries fared better, including Egypt, where the economic revival has been driven by both manufacturing exports and strong growth of services, including tourism and Suez Canal receipts. Jordan has also posted strong growth reflecting the rapid expansion of private spending and investment financed by surging capital inflows.

Following a strong economic rebound recorded in 2004, growth in Iraq averaged a sluggish 2.6 percent over 2005, with the country unable to capitalize from soaring oil prices. The sabotage of oilfield installations has thwarted Iraq's ability to increase oil export revenues, and continuing attacks on power and transportation facilities has seriously detracted from developing the non-oil sector of the economy, worth about 33 percent of GDP. The continued lack of security, both in terms of sectarian violence and insurgent activity, has stalled Iraqi reconstruction and remains the fundamental threat to a sustained economic recovery.

Table 1.1: MENA Growth Performance, 1995-2005

Country/Country grouping	Average 1995-1999	Average 2000-2002	2003	2004	2005
<b>MENA Region (exc. Iraq)<sup>a</sup></b>	<b>3.7</b>	<b>3.3</b>	<b>6.9</b>	<b>5.6</b>	<b>6.0</b>
<b>MENA Region (inc. Iraq)<sup>b</sup></b>		<b>3.0</b>	<b>5.6</b>	<b>6.3</b>	<b>6.0</b>
<b>Resource Poor Labor Abundant<sup>a</sup></b>	<b>4.7</b>	<b>3.7</b>	<b>4.1</b>	<b>4.8</b>	<b>4.0</b>
Egypt	5.6	3.3	3.1	4.2	4.9
Djibouti	-0.5	2.3	3.2	3.0	3.2
Jordan	3.2	5.5	4.1	7.7	7.2
Lebanon	1.9	3.5	4.9	6.3	1.0
Morocco	3.6	4.7	5.5	4.2	1.5
Tunisia	5.6	3.5	5.6	5.8	5.0
West Bank and Gaza	..	-12.5	6.2	6.2	6.3
<b>Resource Rich Labor Abundant (exc. Iraq)</b>	<b>3.4</b>	<b>4.5</b>	<b>6.1</b>	<b>4.7</b>	<b>5.5</b>
<b>RRLA Economies (inc. Iraq)</b>	<b>..</b>	<b>3.1</b>	<b>1.2</b>	<b>7.2</b>	<b>5.3</b>
Algeria	3.2	3.3	6.8	5.2	5.5
Iran	3.5	5.3	6.7	4.8	5.9
Iraq	..	-7.2	-41.4	46.5	2.6
Syria	2.4	3.3	2.5	3.6	4.0
Yemen	5.5	4.2	3.1	2.6	3.8
<b>Resource Rich Labor Importing</b>	<b>3.3</b>	<b>2.5</b>	<b>8.6</b>	<b>6.5</b>	<b>7.2</b>
Bahrain	4.3	4.9	7.2	5.4	6.9
Kuwait	1.9	2.9	13.4	6.2	8.5
Libya	1.6	3.3	9.1	9.3	8.5
Oman	3.4	4.6	1.4	3.1	4.1
Qatar	11.8	5.9	5.9	9.9	8.8
Saudi Arabia	2.7	0.3	7.7	5.2	6.5
United Arab Emirates	5.2	6.0	11.3	8.5	8.0
<i>Population (millions)</i>					
<b>MENA geographic region</b>	281.4	304.7	317.4	323.5	330.2
Resource poor labor abundant	106.2	114.1	118.1	120.0	122.1
Resource rich labor abundant	143.0	154.5	160.9	163.8	167.1
Resource rich labor importing	32.2	36.2	38.4	39.7	40.9
<i>Labor force (millions)</i>					
<b>MENA geographic region</b>	94.8	107.5	114.7	118.4	122.4
Resource poor labor abundant	39.4	44.1	46.7	48.0	49.4
Resource rich labor abundant	44.7	50.9	54.5	56.4	58.4
Resource rich labor importing	10.6	12.4	13.5	14.0	14.6
<i>Growth of GDP per capita (%)</i>					
<b>MENA geographic region<sup>b</sup></b>	1.7	1.3	4.9	3.8	4.0
Resource poor labor abundant	2.8	1.9	2.3	3.0	2.2
Resource rich labor abundant	1.5	2.6	4.3	3.1	3.7
Resource rich labor importing	0.4	-0.5	5.3	3.3	3.9
<i>Growth of GDP per laborer (%)</i>					
<b>MENA geographic region<sup>b</sup></b>	0.4	-0.2	3.4	2.1	2.5
Resource poor labor abundant	1.8	0.2	1.2	1.9	1.1
Resource rich labor abundant	-0.1	0.6	2.3	0.9	1.7
Resource rich labor importing	-0.5	-1.5	4.3	2.2	2.9

West Bank and Gaza not included in regional or sub-regional totals. b. Does not include Iraq. Source: World Bank staff estimates from country data.

On the per capita basis, MENA's recent economic expansion has been undermined by continuing rapid population growth, particularly among the resource rich labor importing economies, where 2005's growth rate of 7.2 percent amounted to only 3.9 percent on a per capita basis. Overall, MENA's per capita growth over the last two years (averaging 3.9 percent a year), while a marked improvement over the 1990s, remains off the pace of developing countries as a group (overall, and excluding China and India), and well behind the growth in other middle income regional sub-groupings (Table 1.2).

**Table 1.2: GDP growth per capita in international perspective, 1995-2005**

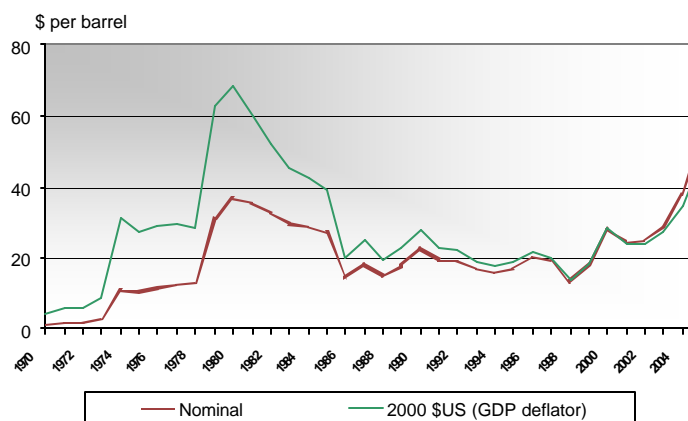
Growth of GDP per capita	1995-1999	2003	2004	Estimate 2005
<b>MENA Geographic Region (exc. Iraq)</b>	<b>1.7</b>	<b>4.9</b>	<b>3.8</b>	<b>4.0</b>
<i>MENA Geographic Region (inc. Iraq)</i>	..	3.4	4.3	3.8
Resource Poor Labor Abundant	2.8	2.3	3.0	2.2
Resource Rich Labor Abundant (exc. Iraq)	1.5	4.3	3.1	3.7
<i>RRLA Economies (inc. Iraq)</i>	..	-0.8	5.3	3.2
Resource Rich Labor Importing	0.4	5.3	3.3	3.9
Developing countries	2.1	4.2	5.5	4.7
Excluding transition economies	2.5	3.9	5.4	4.7
Excluding China and India	0.8	2.6	4.6	3.4
Low-income countries	3.5	5.3	4.7	4.8
Latin America and the Caribbean	2.5	-0.1	2.8	1.5
South Asia	4.1	6.2	5.1	5.4
Excluding India	1.9	3.3	4.1	4.8
Sub-Saharan Africa	1.8	2.1	3.3	3.0
Middle income countries	2.3	4.3	5.9	4.9
East Asia and the Pacific	5.9	7.8	7.9	7.4
Excluding China	1.3	4.3	4.9	3.0
Europe and Central Asia	1.5	5.9	7.0	5.2
Latin America and the Caribbean	0.9	0.6	4.1	3.1
South Asia	3.6	4.8	4.2	3.5
High income countries	2.0	1.3	2.6	1.9
World	1.6	1.4	2.7	2.0

a: Does not include Libya. Source: World Bank staff estimates.

## 1.2.2 Oil market developments shape regional outcomes

For the third straight year, crude oil prices rose sharply over 2005, from an average of \$38 a barrel over 2004 to more than \$53 over 2005<sup>11</sup>, an increase of more than 40 percent year on year (Figure 1.2). Oil price developments over the past three years reflect a continuing tight market, with exceptionally large demand growth (particularly emanating from China) especially for refined products driving prices upward. Over 2005, oil markets also experienced significant volatility in response to external conditions, and the year saw prices spike in August following Hurricane Katrina, subsequently weaken with a mild US winter, and spike again following a natural gas dispute between Russia and the Ukraine.

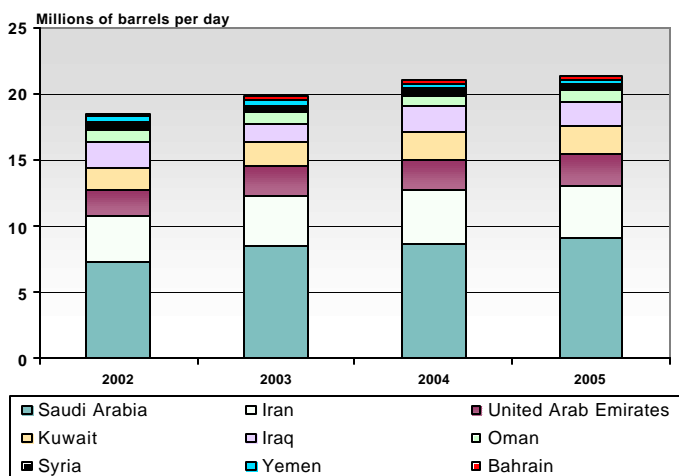
Figure 1.2: Oil prices 1970-2005



Note: Oil price = average of West Texas intermediate, Brent and Dubai crudes.

### Strong gains for region's resource rich economies

Figure 1.3  
Crude oil production among select MENA producers



As the demand for oil has expanded, additional supply has been accommodated primarily through OPEC<sup>12</sup> producers, to the benefit of several MENA economies (Figure 1.3). Over the last three years, Saudi Arabia has increased output from an average of 7.4 to 9.2 million barrels per day (an increase significantly higher than the total increase of OPEC production quotas<sup>13</sup>). Strong production drives also took place in Kuwait (with crude production up 33 percent in the last three years), Qatar (up 24 percent), and the UAE (up 23 percent).

Non-OPEC oil producers in the region,<sup>14</sup> on the other hand, have generally not been able to capitalize on higher oil prices with increased production, partly reflecting depleting reserves and

<sup>11</sup> Average of West Texas Intermediate, Brent and Dubai crude oil prices per barrel.

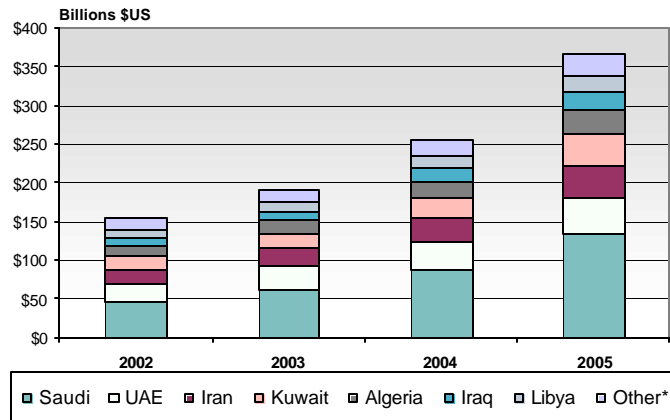
<sup>12</sup> OPEC members include Algeria, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, the United Arab Emirates, and Venezuela.

<sup>13</sup> IEA.

<sup>14</sup> Bahrain, Oman, Syria, and Yemen.

in part due to a shortage of refinery capacity. In fact, in Bahrain, Syria, and Yemen, oil production in 2005 was between 10-15 percent lower than production over 2002.

**Figure 1.4**  
Oil revenue growth among MENA oil producers, 2002-2005



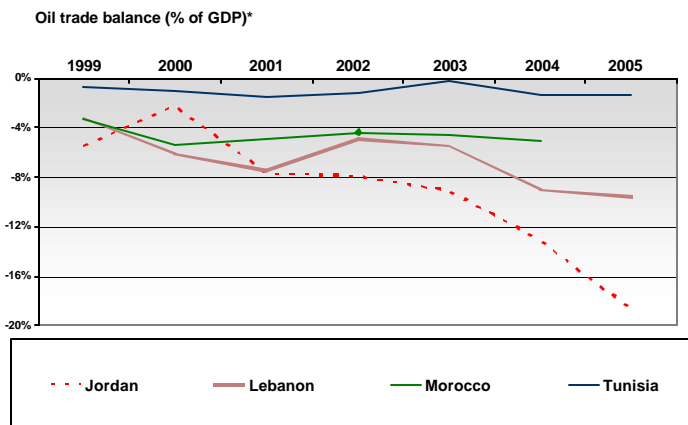
\* Other oil producers include Qatar, Bahrain, Oman, and Yemen.

With climbing oil prices and increased production, oil producers have seen substantial increases the dollar value of oil exports, and consequently, in oil export revenues accumulating to governments. Government revenues from oil have more than doubled in the last three years, from \$154 billion in 2002 to \$365 billion in 2005<sup>15</sup>, and with an accumulated gain in revenues of \$350 billion since 2002. Saudi Arabia has particularly benefited, realizing a tripling in government revenues from oil in the last three years.

### Higher import bills for resource poor economies

But higher oil prices and increased consumption has meant sharply rising oil import bills for the net oil-importing economies in the region, with Jordan, Lebanon and Morocco posting the largest increases. In Lebanon, oil and oil derivative import volumes grew by 9 percent over 2005, and since 1999 by more than 25 percent a year (in comparison, manufactured imports have only grown by an average of 4 percent a year). The impact has been most severe in Jordan, which was heavily relying on cheap oil from Iraq in the context of the oil-for-food program<sup>16</sup>. With oil imports growing significantly more rapidly than GDP, the oil trade deficit to GDP ratio jumped from only 2 percent in 2000 to almost 19 percent by 2005 (Figure 1.5).

**Figure 1.5**  
Oil trade balance among select resource poor economies



Oil trade balance represents exports minus imports of petroleum, refined petroleum, and natural gas products as a percentage of GDP.  
Source: UNCTAD.

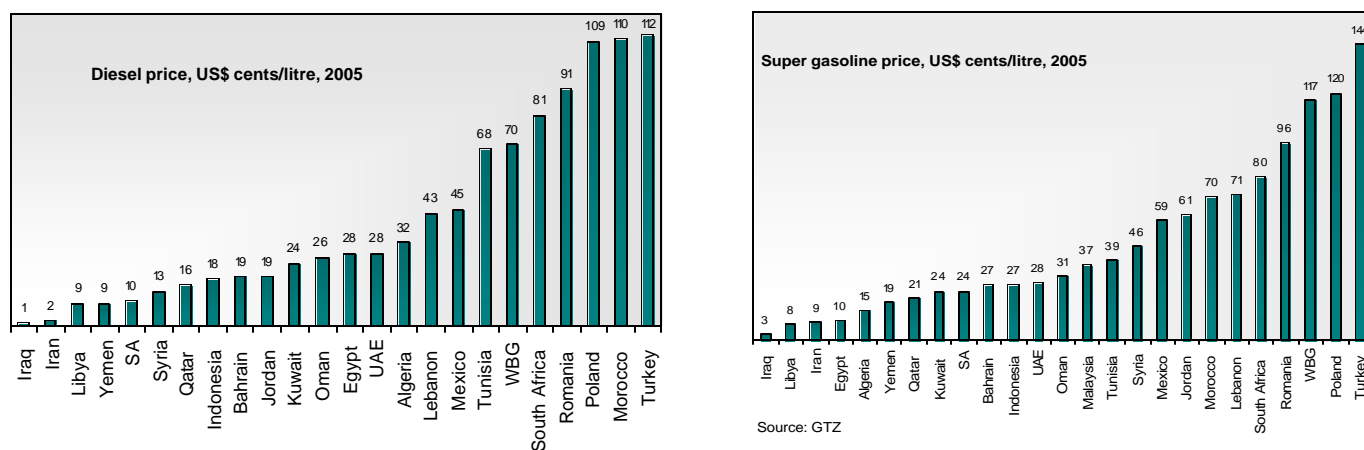
<sup>15</sup> Not including Syria or Libya.

<sup>16</sup> After the first Gulf war, Jordan imported most of its fuel products from Iraq under the food-for-oil program: around half of the imports took place in the form of a grant (3 percent of GDP in 2002), while the other half was sold at

### 1.2.3 Reliance on oil subsidies becomes a fiscal challenge

The sharp rise in oil prices has also brought to the spotlight the MENA region's heavy subsidization of oil prices within the domestic market, a policy officially designed to protect poor households (Figure 1.6). Although the resource poor economies are particularly affected, the reliance on oil subsidies pervades the region, with large implications on fiscal positions.

**Figure 1.6: Diesel and Gasoline prices in MENA, 2005**



Among oil importers, Jordan has been particularly impacted by these subsidies, not only due to rapidly rising oil prices but also the recent loss of the oil and gas arrangements with Iraq. At the end of 2004, oil subsidies represented 3.1 percent of GDP, and 11.3 percent of total current expenditures. A year later, they amounted to 5.8 percent of GDP and 19 percent of current expenditures, this despite the first round of reduction in oil subsidies in September 2005 (without this reduction, oil subsidies would have grown to an estimated 7.2 percent of GDP over 2005). In Lebanon, surging Treasury transfers to the public electricity company to cover these higher oil costs have resulted in government consumption spending increasing by more than 8 percent a year over the last two years (compared with spending reductions in the years prior).

But the problem is not limited to the oil importers, and in fact, the degree of oil price subsidization is far greater in oil producing economies. For the most part, resource rich economies have been able to more than offset the negative impacts on the budget with strongly rising revenue streams. At the same time, these rising budget surpluses have provided limited incentive for reforming the energy subsidy systems. As a result, and over the last several years, little if any progress has occurred in reducing these subsidies among the region's oil producers (discussed further in Section 1.4.3).

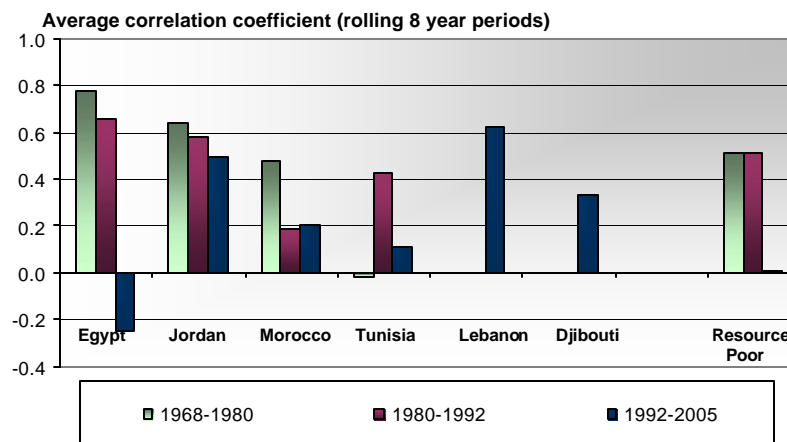
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preferential below-market prices negotiated each year between the respective governments. The government then sold the oil at preferential prices to the Jordan Petroleum Refinery Company.

## 1.2.4 Diverging relationship between oil prices and growth among non-oil economies

An important feature of the current growth environment in MENA is the substantially weaker overall ties between oil price movements and growth outcomes among the region's resource poor economies. Twenty to thirty years ago, the economic growth outcomes in MENA's resource poor economies were deeply linked to oil price movements, as the resource poor economies in the region received strong benefits from oil windfalls through vigorous transmission channels, especially labor remittances, official aid and capital inflows.

**Figure 1.7 Correlation between real oil prices and economic growth among MENA's resource poor economies**

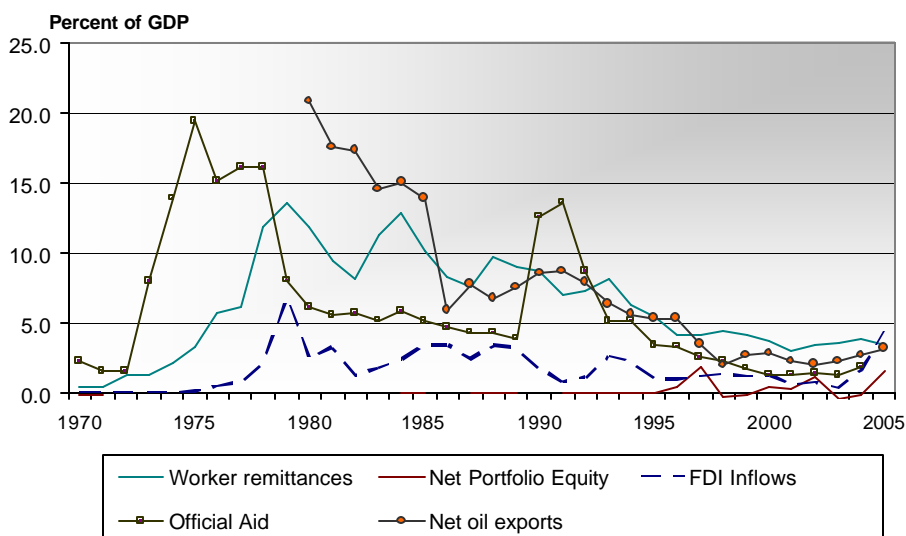


Average correlation coefficient reflects average of rolling eight-year period correlation coefficients between economic growth and oil price movements. Because the relationship between an oil price movement and a growth impact may have a time lag, each eight-year growth/oil price correlation reflects the best fitting relationship (highest correlation) between oil price changes and growth, allowing for economic growth to lag up to two years. Regional averages weighted by GDP.

Although there remain positive transmission channels from oil producers to the resource poor economies and these channels have experienced a boost under the current oil boom (particularly through rising portfolio equity inflows, FDI, and intra-regional tourism), the relative size of combined transmission mechanisms from oil producers to resource poor economies in the region has declined substantially over time. Additionally, with rising energy use among resource poor economies (relative to the past oil booms), the costs of higher oil prices (in terms of oil imports and oil import subsidies) have increased for non-oil economies. As a result, the correlation between economic growth and oil price movements has steadily declined among most of the resource poor economies in the region (Figure 1.7), and for the group, has moved from an average of 0.5 over the 1970s and 1980s to almost zero over the last decade.

Egypt is most indicative of a changing growth environment. Over the late 1960s and 1970s, Egypt's economic growth moved almost in lock-step with real oil price fluctuations (with

**Figure 1.8: Sources of oil-related wealth in Egypt  
1970-2005**



a correlation of nearly 80 percent between real oil prices and growth), cemented through Egypt's own foreign exchange earnings from oil and oil related revenues, as well as through the various transmission channels from the region's major oil producers, such as labor remittances,

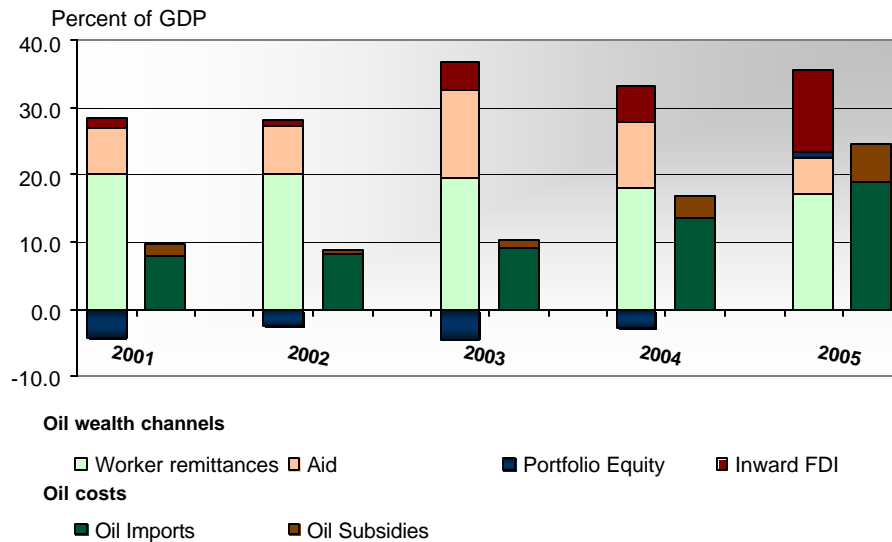
economic assistance, direct investment, and intra-regional tourism. Over the past three decades, however, many of these transmission channels have weakened. Where at the peak of the 1980s oil boom, more than 20 percent of the Egyptian labor force was employed abroad (primarily in the Gulf), today, only 7 percent of Egyptian laborers work in other Arab states<sup>17</sup>, as Gulf countries have increasingly substituted expatriate Arab for (less costly) South Asian laborers. Labor remittances to GDP in Egypt have fallen from a high of almost 14 percent in 1979 to little more than 3 percent today. Foreign direct investment (FDI) inflows reached a peak of almost 7 percent of GDP in 1979, but averaged less than 1 percent of GDP by 2003 (but recently have climbed to more than 4 percent in 2005<sup>18</sup>). Official aid, which reached more than 19 percent of GDP in 1975, accounts for less than 2 percent of GDP today. And at the same time, with rising energy consumption and a leveling off of production, Egypt's net oil exports have declined as a share of GDP from more than 20 percent in 1980 to about 3 percent currently (Figure 1.8).

<sup>17</sup> Said, 2004.

<sup>18</sup> Source: Staff estimates from UNCTAD (FDI) and country (GDP) data.

Even resource poor economies which maintain strong ties with the oil-exporting economies are beginning to carry new costs with higher oil prices. Although regional oil wealth has spurred greater foreign direct investment and capital flows into Jordan, for example, and has resulted in higher tourist receipts, rising oil prices have also become increasingly taxing on both the fiscal and external fronts (Figure 1.9). In the previous oil boom era, with significantly lower energy consumption, rising oil prices could be more easily accommodated. At the height of the 1980 oil boom, for example, oil imports in Jordan represented less than 10 percent of GDP, and oil subsidies absorbed about 3 percent of GDP<sup>19</sup>. That is little more than half of their relative costs today (oil imports representing 19 percent of GDP, and oil subsidies 6 percent of GDP).

**Figure 1.9: Jordan: Oil related wealth and costs  
2000-2005**



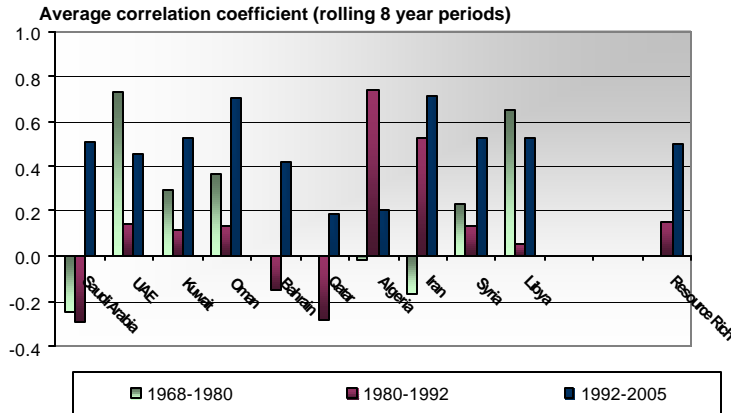
Added to weakened transmission channels and higher costs, an additional element weakening the connection between oil price movements and growth among resource poor economies has been the group's increasing progress with structural reform. Beginning in the 1980s and 1990s, many of the resource poor economies adopted programs of macroeconomic stabilization and structural reform designed to restore macroeconomic balances and promote private sector led development. Although the pace has varied, these reforms have resulted in more diversified economies than under the prior oil booms, with stronger non-oil export sectors to support growth. Between 1988 and 2005, for example, non oil exports as a share of GDP more than doubled in Jordan, Morocco and Tunisia. As outward orientation has strengthened, the dependence of resource poor economies on oil price developments has weakened.

<sup>19</sup> Staff calculations from World Bank, 1983.

## 1.2.5 ...and strengthening correlation between oil price developments and growth in resource rich economies

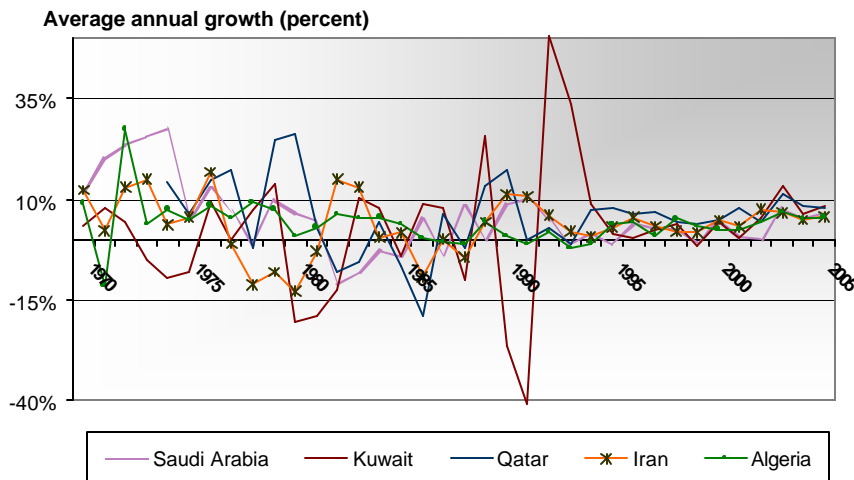
An equally important growth trend in the region has been the greater harmony among oil producers in terms of their growth outcomes. In the past, economic growth patterns among the major oil producers of the region varied widely, a reflection of diverging approaches and successes in utilizing windfall oil surpluses. Over the past decade, however, growth patterns among regional oil producers have moved progressively more in sync with oil price developments (and with each other), in part reflecting the pursuit of increasingly common development strategies (Figure 1.10). Unlike in past oil booms, MENA's oil exporters today are demonstrating significantly more fiscal restraint, building substantial external reserves, and pursuing common strategies for diversification of the oil wealth into foreign assets. With this increased prudence, the volatile growth outcomes among oil producers which characterized the 1970s and 1980s have been increasingly supplanted by a common growth effect. This is particularly evident when looking at the

**Figure 1.10 Correlation between real oil prices and economic growth among MENA's resource rich economies**



Average correlation coefficient reflects average of rolling eight-year period correlation coefficients between economic growth and oil price movements. Because the relationship between an oil price movement and a growth impact may have a time lag, each eight-year growth/oil price correlation reflects the best fitting relationship (highest correlation) between oil price changes and growth, allowing for economic growth to lag up to two years. Regional averages weighted by GDP.

**Figure 1.11 Economic growth among select MENA oil producers, 1970-2005**



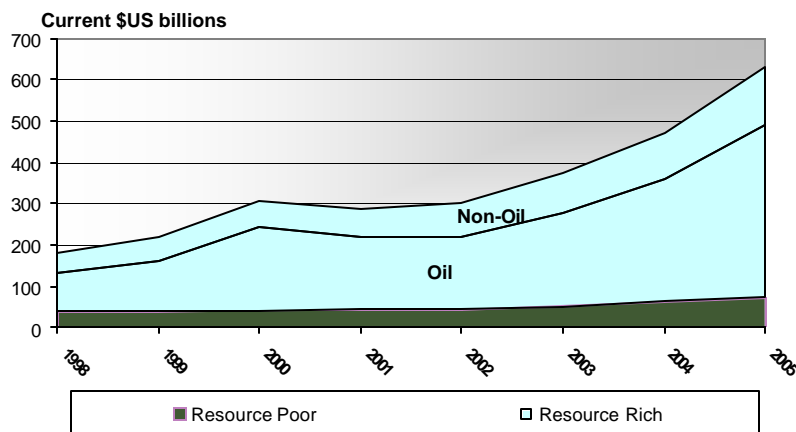
larger oil economies, which exhibited startling dissimilarity in growth outcomes in earlier periods (Figure 1.11).

## 1.3 External Sector

### 1.3.1 Export growth robust throughout the region

Riding the wave of higher oil export values, MENA has achieved exceptional export growth since 2002, primarily among oil exporters but broad-based throughout the region. With oil exporters seeing a more than doubling of oil exports as a result of terms of trade movements

**Figure 1.12**  
Composition of MENA exports of goods and services 1998-2005



Source: Country data; WITS (UNCTAD).

oil producers (Figure 1.12). With the increase in the price of oil and production increases in several MENA countries, oil has grown to account for more than two thirds of regional exports by 2005, up from only about half in 1998.<sup>21</sup>

But export growth has also been strong among the region's resource poor economies, supported in part by strong growth in service exports. Egypt's service exports increased by an average of 20 percent a year between 2002-2005 (compared with growth averaging about 4 percent a year between 1998-2002), the result of surging Suez Canal receipts and strong growth in tourism. Other RPLA economies also experienced an upswing in exports of services, primarily reflecting strong gains in tourism. International tourist

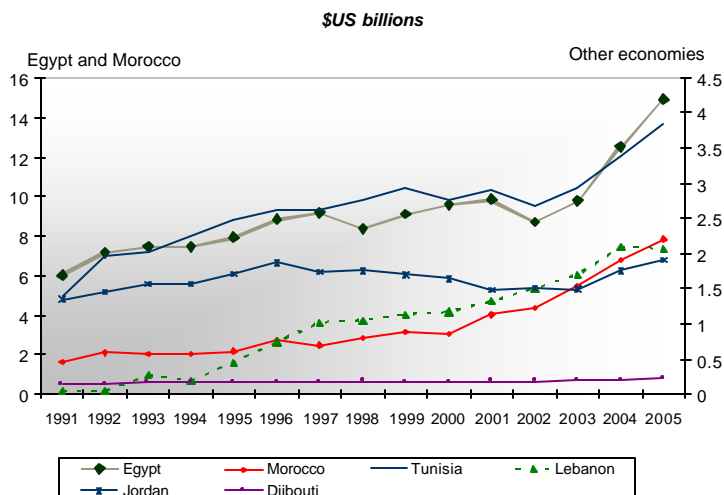
<sup>20</sup> in current \$US.

<sup>21</sup> Exports of goods and services, current \$US.

(from about \$186 billion in 2002 to \$440 billion by 2005<sup>20</sup>), MENA economies have experienced a doubling or tripling of the average annual rate of growth of exports of goods and services over the last three years.

Not surprisingly, oil dominates the region's export landscape. More than three quarters of the recent growth in exports of goods and services has come from oil exports among the region's dominant

**Figure 1.13: Growth of Service Exports among RPLA, 1991-2005**

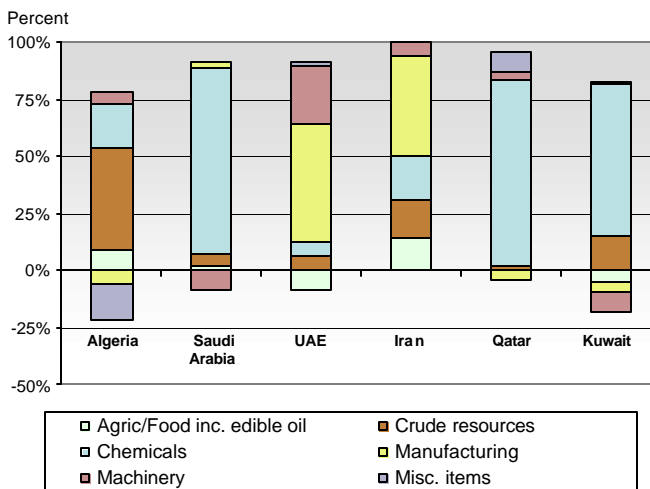


receipts to both Morocco and Tunisia grew by 15 percent a year over the last two years<sup>22</sup>, resulting in exceptional service export growth. Even in Jordan, although tourism has been hit by regional political disturbances, service exports have expanded by an average of 14 percent a year (up from negative growth of 3 percent a year), on the strength of larger remittances and strong advances in transport and communication services destined for Iraq. Although Lebanon realized strong growth in tourism up to 2004, in 2005, in the face of the difficult security situation, tourism receipts – which account for about 5 percent of GDP – are estimated to have declined by some 11 percent, and overall service exports declined by 2.4 percent from 2004.

### Oil producers have realized strong growth in energy-dependent exports

Regional oil producers have benefited not only from exceptional oil export growth, but

**Figure 1.14: Non-oil export growth among select MENA oil exporters**  
(Proportion of total non-oil export growth, 2002-2004)

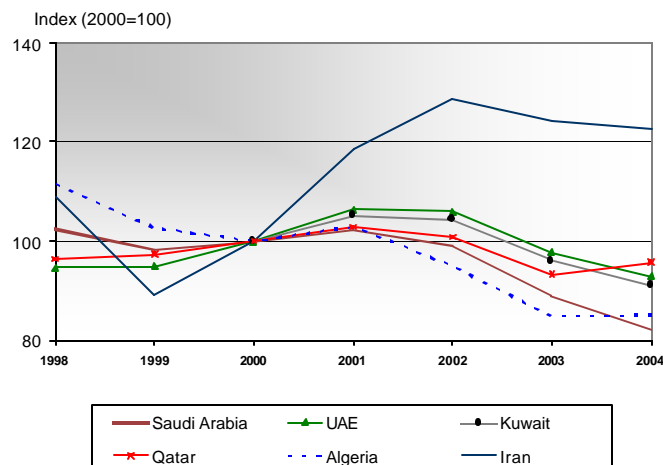


additionally from strong non-oil export growth, which between 2002 and 2004 averaged more than 16 percent a year. A strong impetus has been energy-dependent industries such as petrochemicals, which as oil prices have risen, have become increasingly expensive for traditional centers of production to manufacture (see Box 1.1). With a widening cost-advantage in the industry, many countries have bolstered their petrochemical production facilities. As a result, over the last two years, 90 percent or more of the non-oil export growth in Saudi Arabia,

Kuwait and Qatar has come from petrochemicals (Figure 1.14).

Non-oil export competitiveness has also benefited from a limited appreciation of the real effective exchange rate, despite the large export receipts accumulating to oil producers (Figure 1.15). All of the GCC countries' currencies operate a fixed exchange rate regime pegged to the US dollar, which has depreciated modestly against other major currencies over the last few years. As

**Figure 1.15: Real effective exchange rate, 1998-2004**



<sup>22</sup> UNWTO 2006.

a result, the real effective exchange rate index among GCC countries depreciated by an average of 7 percent a year between 2002-2004. And although Iran's currency appreciated substantially prior to its landmark exchange rate reform in 2002 (where the exchange rate was unified and a managed float system was adopted), it has since stabilized. Thus, the "Dutch Disease" which characterized the oil booms of the 1970s, has not yet materialized with the current increase in oil prices and oil wealth.

### **Box 1.1: Petrochemicals: Building Value into Oil and Natural Gas Production**

The global economic downturn which began over the late 1990s and the slow subsequent recovery have limited demand for petrochemicals, and the recent strong price increases for oil and natural gas, the primary feedstock for petrochemicals, have severely limited profitability, particularly in traditional centers of production in the US, Europe and Japan. In response, there has been a shift in production from these traditional centers to locations in faster growing, lower cost developing regions. The focus has shifted largely to the Gulf region of MENA, where hydrocarbons are produced in excess of domestic demand and where costs associated with primary materials are extremely low.

The countries of the GCC and Iran have taken strong steps to bolster their petrochemical production capabilities in recent years to take advantage of this shift in production and to build additional value into their oil and gas production. These countries now account for nearly 10 percent of global production in basic petrochemicals such as ethylene. By 2010, these countries are expected to provide nearly 50 percent of the world's annual new ethylene capacity and account for nearly 20 percent of total global capacity. Exports of liquid chemicals from the GCC and Iran were 16.6 million tons in 2004 and reached 18.4 million tons in 2005. This amount is expected to rise to 32 million tons by 2007 and nearly 48 million tons in 2008, as planned petrochemical facilities come on stream.

#### **Petrochemical Investment Projects in the GCC and Iran**

Iran currently maintains about 9 percent of MENA ethylene production. However, the country is building major new facilities in Bandar Imam and Assalouyeh that are expected to be some of the largest petrochemical complexes in the world. By 2006, the country is expected to produce nearly 20 percent of the region's ethylene.

Saudi Arabia's petrochemical company SABIC has initiated construction on several petrochemical plants that will produce ethylene, ethylene glycol, polyethylene, and polypropylene products by 2008. The firm has also joined several international firms in expanding or building four additional facilities that will produce styrene and olefins which will also come on line in 2008.

Other GCC countries are investing heavily in petrochemical enterprises. Kuwait is expanding its petrochemicals production with several new facilities that will be on line by 2007. Qatar is finishing a methanol plant this year, and will add two ethylene crackers producing 2.7 million tons a year by 2011. UAE has added another ethylene cracker that will be running in 2009. Oman has announced plans for a petrochemicals complex, including two methanol plants, that will produce 2 million tons by 2008.

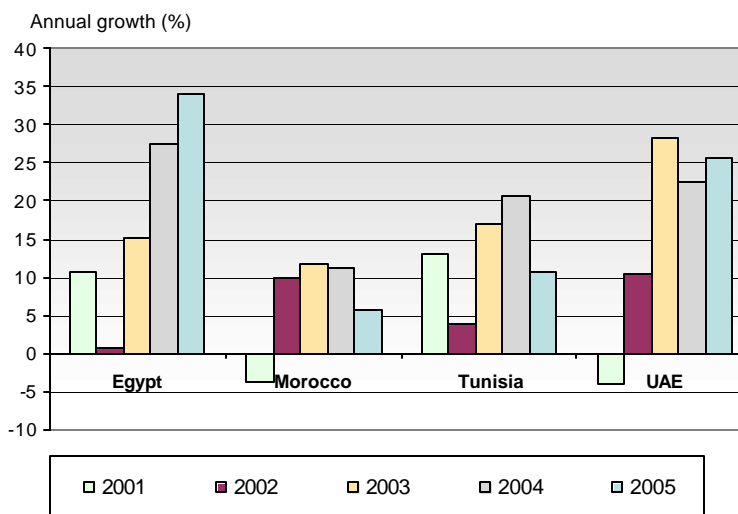
The petrochemicals industry has grown by 4 percent per year over the past two years. As MENA production facilities come online, experts expect a drop in profitability as the industry responds to an initial oversupply of petrochemicals. However, in the longer term, the MENA region is poised to benefit greatly from a strengthened position in the petrochemicals industry as demand from China and India catches up with supply and growth in the industry rebounds.

### 1.3.2 Resource poor economies face several new external challenges

Resource poor economies, on the other hand, have seen a few unfavorable changes to the external landscape over the last few years. On the export side, the expiry of the WTO Multifibre Agreement (MFA) on textile and clothing in January 2005 has impacted merchandise exports among several RPLA economies. The MFA had allowed a privileged access to a few MENA economies' (mostly from the resource poor economies: Tunisia, Morocco, Egypt, but also from the United Arab Emirates) in textile and clothing products to European markets. To date, Egypt has not experienced a major downturn in total textile exports, evidenced by woven apparel exports increasing in value by 6 percent over 2005.<sup>23</sup> In part, the effects of the MFA expiry have been cushioned by the December 2004 agreement on qualifying industrial zones (QIZs) between the US, Egypt, and Israel, providing tariff free access for Egypt's apparel exports to the US<sup>24</sup>. The Egypt textile and apparel companies represent 77 percent of the 471 companies listed under the QIZ protocol<sup>25</sup>.

But other countries have already started to feel the pinch. 2005 saw Tunisian textile exports to Europe decline by 6 percent, and textile production in the country declined by an equivalent amount over the first 6 months of 2005 (see Box 1.2). The weakening export market has affected jobs in the sector, which are down 9 percent from employment values in 2004. Thanks to a strong pickup in textile exports to the US (42 percent year on year), however, Tunisian textile exports managed to remain

**Figure 1.16: Merchandise exports in MFA countries, 2001-2005**  
(Current \$US)



a growing sector in 2005, albeit at a sluggish 1.5 percent pace. The impact on Morocco, however, has been sharper. Over the first six months of 2005, Morocco's clothing exports, representing 34 percent of merchandise exports, declined by some 13 percent from 2004 values, and of the export loss, more than 90 percent were in the textile export categories that were liberalized with the MFA removal. Partly as a result, both Morocco and Tunisia have experienced sharp downturns in merchandise export growth rates from 2004 (Figure 1.16).

<sup>23</sup> Egytex.com. 2006.

<sup>24</sup> A similar agreement on QIZs between Jordan, Israel and the US buoyed textile exports dramatically, supporting the sector's 120 percent growth between 1999 and 2003, relative to 13 percent growth of overall exports.

<sup>25</sup> Egytex.com. 2006

### Box 1.2: The Tunisian Experience with the MFA removal

**Production/Employment:** The textiles and clothing (T/C) industry is the largest contributor to the Tunisian economy, providing almost one-third of the manufacturing value-added, and about 5.7 percent of total GDP. The T/C sector constitutes one of the pillars of the Tunisian economy, employing approximately 204,460 people (or 46 percent of total industrial employment, with the largest female participation). The industry is also dominated by small and medium-size enterprises (with 10 to 100 employees). Only 25 firms have more than 500 employees. Since 1976, Tunisian products enjoyed duty-free access to European markets

The T/C industry has been an export locomotive, generating some 50 percent of Tunisia goods and services exports, with a high degree of geographic concentration. The majority (98 percent of value) of Tunisian T/C exports were destined for the European Union, mostly to three countries (France, Germany, and Italy), and represented 45 percent of the total exports of the nation's manufacturing industries.

**Recent Developments:** Over the first six months of 2005, the textile and clothing industry production registered a loss of 4.9 percent relative to the same period in 2004. With the effective completion of the MFA removal, the Tunisian textile sector faced stiffer competition. The local textile industry remained fragmented and largely operating on a subcontractor basis. The threading and weaving firms were hardest hit. A slump in investment paralleled the trend in production. During the first quarter of 2005, 74 foreign firms/affiliates in the T/C industry closed their units in Tunisia, out of a total of 115 foreign firm closures. They were mostly small units (less than 100 employees) with investment below 200 MD, and subcontractors, heavily dependent on European *donneurs d'ordre*.

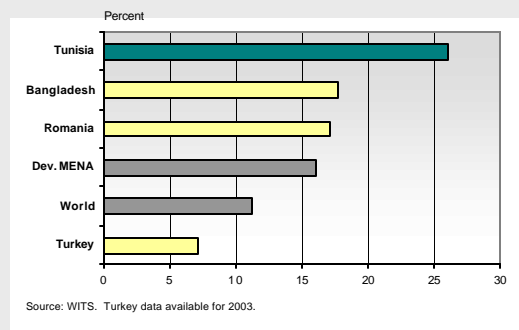
The loss of momentum has been particularly perceptible in the industry's traditional export markets, notably the EU, whereas textile exports to the United States increased during the first half of 2005. Compared to the first three quarters of 2004, Tunisia's exports to the EU in 2005 decreased by almost 6 percent. At the same time, Tunisia's exports to the United States during the first six months of 2005 increased by 42 percent relative to the same period in 2004.

	January-September 2004		January-September 2005		Change in-value (percent)
	Imports (EUR billion)	Share of EU's total imports (%)	Imports (EUR billion)	Share of EU's total imports (%)	
World	52.6	100	54.5	100	+3.7
China	11.3	21.6	16.4	30.1	+44.8
Tunisia	2.2	4.1	2.0	3.7	-5.6

The expiry of the MFA in January 2005 and the consequent stiffer competition will compel Tunisia to surpass its simple role as a subcontractor by proposing a more complete offer to clients. Certain Tunisian suppliers find themselves at the head of true platforms composed of satellite subcontractors. The head of the network centralizes the entire scope of services (grading, cutting, grouping, packaging, dispatching) in such a manner as to present to the principal only a single representative. Such a development of services should permit Tunisia to move from the mass production of basics, which is the stronghold of Asian production enjoying a competitive advantage that Tunisia simply cannot rival. On the other hand, the development and promotion of national brands is difficult, because of the financial weakness of the clothing sector and of the small size of the domestic market.

Important competitiveness gains can derive from access to cheaper inputs. The industry MFN tariffs are still very high, at 26 percent, which is above many competitors' tariffs, the world average, and least-developed and medium-income MENA countries. Tariffs are high for apparel and also for the industry's main inputs, such as fabrics and fibers. Only access to cheap inputs from competitive textile producers would enable the Tunisian T/C industry to be competitive on the world market. As far as the European market is concerned, Tunisia should accelerate the process toward the adoption of the Pan-European rules of origin.

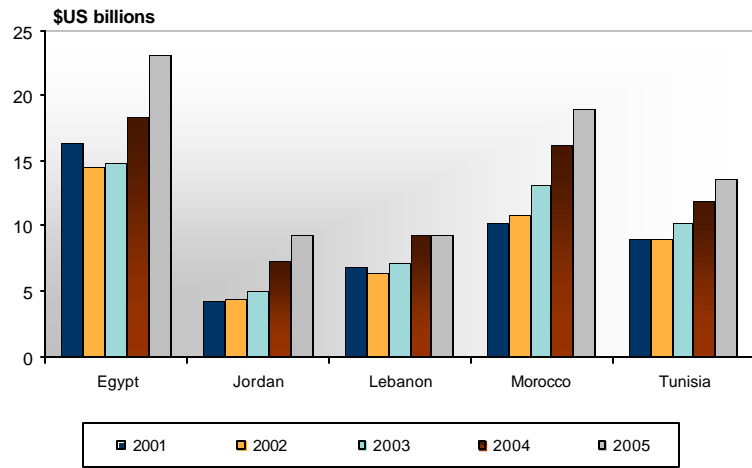
Box Figure 1: MFN rates on textiles and clothing  
Selected countries, 2004



Reduced labor costs could also help improve T/C competitiveness. In 2004, the T/C labor cost in Tunisia was about US\$2 an hour, lower than Morocco (at about US\$2.50), but higher than its competitors Bulgaria (US\$1.30 an hour), Egypt (US\$0.90 an hour) and China (about US\$0.50 an hour).

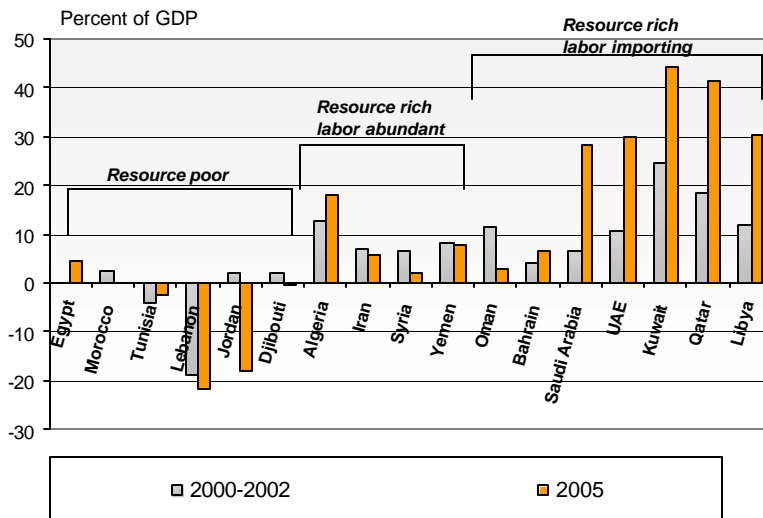
But far more challenging to the external landscape among resource poor economies has been the impact of surging oil import bills. Since 2002, merchandise imports among the RPLA economies have increased by about 18 percent a year in dollar terms (Figure 1.17), and from about 26 percent of GDP in 2002 to about 35 percent by 2005 (that compares with the resource rich economies, in which as a share of GDP, merchandise imports have remained virtually unchained since 2002, averaging between 24-25 percent). Primarily the result of oil import bills, all of the RPLA economies, without exception, have seen a large upturn in the ratio of merchandise imports/GDP since 2002.

**Figure 1.17: Merchandise import growth among RPLA, 2001-2005**  
*\$US billions*



### 1.3.3 Current account positions diverge

**Figure 1.18: Current Account Balance, Early 2000s versus 2005**



With conflicting external developments, the MENA region's current account positions have likewise diverged strongly between the resource poor and resource rich economies. With rising oil import bills, resource poor economies have seen widening current account deficits, which have become most evident in Jordan (where the current account moved from surplus of about 5.6 percent of GDP to a deficit of almost 18 percent of

GDP by 2005). Oil exporters, on the other hand, have built up sizeable current account surpluses, from an average of only 6 percent of GDP in 2002 to almost 23 percent of GDP by 2005. In the last year alone, the current account surplus has risen from 15 percent to 22.7 percent of GDP.

### ***Oil producers have substantially improved their external positions***

Oil producers have also significantly raised their external reserves, providing a substantial buffer for the external account, and partially insulating them from the exchange rate appreciation which marked earlier oil booms. In the past three years, external reserves among the oil exporters has risen from about \$140 billion to more than \$300 billion in 2005 (and from 12 percent of goods imports to almost 15 percent).

**Table 1.3 External reserves, in months of imports**

<b>Country</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
<b>MENA Total</b>	<b>11.4</b>	<b>12.0</b>	<b>11.7</b>	<b>12.7</b>	<b>13.2</b>	<b>13.7</b>
<b>Resource Poor</b>	<b>8.7</b>	<b>9.0</b>	<b>10.5</b>	<b>12.3</b>	<b>10.6</b>	<b>10.0</b>
Egypt	10.2	10.4	11.6	12.0	9.7	10.0
Jordan	10.1	8.9	11.0	12.7	9.0	7.1
Lebanon	16.9	12.2	15.5	23.5	18.0	18.7
Morocco	5.8	10.4	12.0	13.3	13.0	11.8
Tunisia	2.7	2.7	3.1	3.4	4.1	3.7
Djibouti	3.9	4.3	4.5	5.1	4.1	4.2
<b>Resource Rich</b>	<b>12.5</b>	<b>13.2</b>	<b>12.1</b>	<b>12.9</b>	<b>14.0</b>	<b>14.8</b>
<b>Resource Rich Labor Abundant</b>	<b>11.7</b>	<b>14.5</b>	<b>15.1</b>	<b>15.8</b>	<b>15.9</b>	<b>18.5</b>
Algeria	15.8	23.2	23.3	29.9	29.1	33.8
Iran	9.7	11.2	11.7	10.2	10.8	14.6
Syria	8.9	9.1	9.9	11.1	8.1	5.4
Yemen	12.9	15.5	15.8	15.0	15.9	14.2
<b>Resource Rich Labor Importing</b>	<b>12.7</b>	<b>12.6</b>	<b>10.8</b>	<b>11.6</b>	<b>13.1</b>	<b>13.1</b>
Bahrain	4.3	5.0	3.8	3.5	3.3	2.4
Kuwait	13.4	17.0	13.8	9.3	8.3	8.4
Oman	6.4	5.5	6.8	7.1	5.4	4.6
Qatar	3.4	3.4	3.9	6.4	8.4	8.9
Saudi Arabia	20.7	20.4	17.1	21.1	25.5	21.2
United Arab Emirates	5.4	5.1	4.9	4.0	4.1	4.5
Libya	38.3	35.3	24.3	31.5	33.7	43.8

Source: World Bank staff estimates from country sources.

Oil stabilization funds have also been utilized for reserve building. Established to collect surplus hydrocarbons receipts, the funds are designed to lower the impact of volatile oil prices on government spending and on the economy. Oil producers in the region have set exceedingly conservative assumptions for the average price of oil for the purposes of their budgets (in 2005, for example, both Qatar and Algeria budgets called for an average price of oil over the year of only \$19; Saudi Arabia's budgetary estimate was \$25). As a result, with the real oil prices substantially higher than budgeted assumptions, significant revenues have accumulated within the funds.

Not all of these surplus revenues have actually gone into the stabilization funds, however. In Iran, for example, the fund was established in 2000 as part of the country's Third Five-Year Plan (Third Plan), conceived to absorb all foreign exchange earnings above the reference price (which between March 2000 and March 2005 has averaged between \$12 a barrel and \$19 a barrel). However, the unexpectedly robust rise in oil prices (averaging more than \$35 over the period) resulted in both increases in the regular "oil share" of the budget and repeated withdrawals from the fund. As a result, while some \$74 billion should have been accumulated in the fund between March 2000 and 2005 according to the original guidelines, instead the total deposits have amounted to a mere \$29 billion<sup>26</sup>. Despite these draw-downs, the build-up in both oil stabilization fund assets and foreign reserves have provided oil producers in the region significant cushions against future oil price slides and sudden reversals in capital flows.

#### **1.3.4 Capital flows reflect increasing desire among resource rich economies to diversify**

The rising liquidity accruing to oil producers has brought forth a strong move toward overseas investment, particularly among Gulf economies, as part of an overall drive to diversify oil dependent economies and transform finite oil reserves into longer term revenue streams. A sizeable portion of the oil windfall has returned to US dollar holdings following a shift away from such assets following the events of September 11, 2001, but the Bank for International Settlements finds that MENA's financial outflows in the present boom have become more geographically dispersed and allocated across more asset classes<sup>27</sup>, thus diversifying their portfolios with the objective of spreading risk.

Some of these large surplus funds have been recycled through the region to direct investment projects in industry, finance and commerce, and particularly in the Mashreq. GCC countries in particular are looking to build investment with large-scale flows, having been drawn at first into GCC equity and real estate. During 2003, share prices rose 70 percent across the region and 2004 showed more spectacular returns—Saudi Arabia 80 percent, UAE 95 percent. But such opportunities are limited, and capital is now flowing into neighboring states, principally

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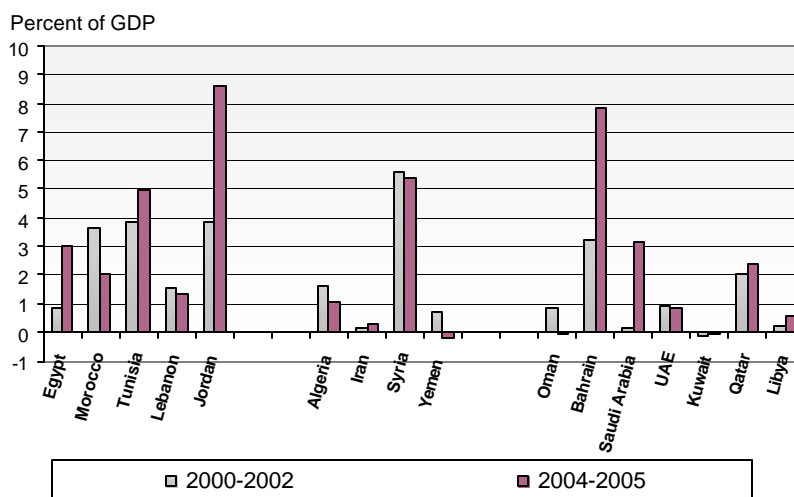
<sup>26</sup> Amuzegar, Jahangir. 2005.

<sup>27</sup> Bank for International Settlements, 2005.

into industrial projects in Egypt, Jordan and Syria (e.g. cement, oil refineries). Inroads are also being made in the tourism infrastructure, as well as the financial sector and real estate (discussed in Chapter 2). Though figures are largely anecdotal, direct and portfolio investment on the order of \$5-10 billion appears to have been committed over the last year—substantial for the scope of industry in the Mashreq.

In addition to diversifying their assets geographically, many of the oil producing economies of the GCC have substantially increased their exposure to foreign investment into their own economies. A strong drive is underway among GCC countries to capture greater foreign investment, and almost all of the economies have passed legislation to open up key sectors to foreign ownership, to encourage greater foreign direct investment (see Chapter 3). Partly as a result, a few of the GCC countries, including Bahrain, Saudi Arabia, and Qatar, have seen large increases over the last three years in inward FDI (Figure 1.19).

**Figure 1.19: FDI inflows as a share of GDP, 2000-2005\***



\* or closest year available. Source UNCTAD, 2005; Country sources.

## 1.4 Fiscal Developments

### 1.4.1 Strong upturn in fiscal balances among oil producers

Record revenues from oil exports have swelled state coffers for the region’s oil producers, who collectively have seen total revenues more than double over the last three years, from \$202 billion in 2002 to \$433 billion in 2005<sup>28</sup>. Over the last year alone, revenues as a percent of GDP among oil producers rose from 40.5 percent to more than 45 percent.

By and large, the phenomenal growth in government revenues has been met with fiscal restraint. Total expenditures as a percent of GDP among resource rich economies are below pre-oil boom levels, although in current dollar terms they have increased by about 12 percent a year between 2002-2005 (slightly higher than over the period 2000-2002, where expenditure growth averaged 7.9 percent per year). Resource rich and labor importing economies in particular have shown fiscal prudence with this oil boom, where expenditure growth has only averaged 10

<sup>28</sup> Does not include Iraq.

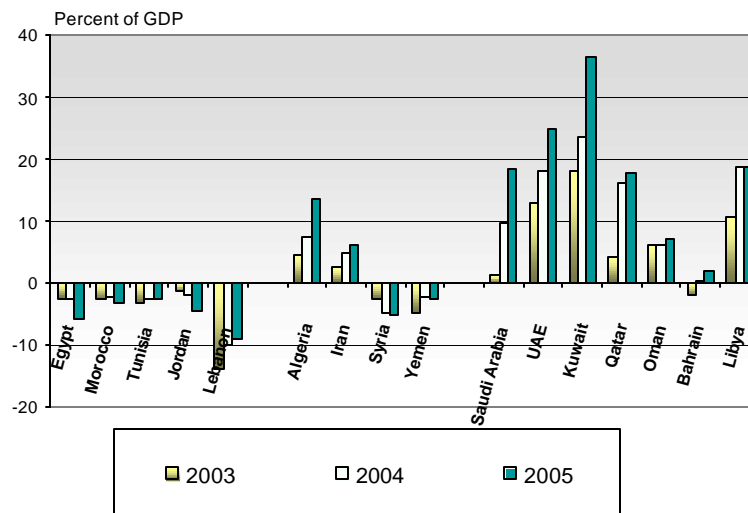
percent a year, despite extraordinary spending outlays in Saudi Arabia to pay down public domestic debt (see Box 1.3 on debt reduction among oil producers). While there is evidence of higher spending on the horizon, including a strong expansion of infrastructure spending, the resource rich and labor importing economies have to date maintained unprecedented fiscal discretion.

Spending advances have been more robust among the resource rich and labor abundant countries, with a tripling in the rate of growth of government spending in Algeria (a result of strong increases in the wage bill, but also reflecting significant payments toward external debt reduction) and a surge in Iran’s public spending, particularly in the run-up to presidential elections. With rapid revenue advances and only moderate spending increases, fiscal positions have improved sharply for MENA oil producers, who posted a fiscal surplus of 16 percent of GDP over 2005, up from 10 percent in 2004, and only 2 percent of GDP in 2002 (Figure 1.20).

### 1.4.2 Deteriorating fiscal balances among resource poor countries

But results have been sharply divided along resource allocation lines, with resource poor economies remaining in fiscal deficit, and acute deteriorations in the fiscal deficit in Egypt, Morocco and Jordan. A strong rise in public sector wages in Egypt, along with rising costs of energy subsidies throughout the region, resulted in total expenditures increasing by almost 13 percent over 2005 for RPLA economies as a group. Although Egypt actually cut current expenditures by almost 7 percent over 2004, in 2005, current expenditures rose by about 21 percent, reflecting a 50 percent increase in subsidies (primarily fuel), and a 27 percent increase in consumption expenditures (primarily wages and salaries, which rose 20 percent on the year). With revenue growth only modest, fiscal deficits among resource poor economies have increased from slightly more than 3 percent of GDP in 2004 to almost 5 percent of GDP in 2005.

**Figure 1.20**  
Fiscal balances in MENA



In the West Bank and Gaza, the fiscal worries are perhaps most challenging, given recent uncertainty about (primarily Western) donor aid payments, on which the Palestinian Authority strongly depends. Over 2005, the PA's budget deficit reached about \$800 million, of which some \$340 million was financed by donors in the form of direct budget support. With both strong increases in the public sector wage bill and social transfers, the Palestinian Authority's fiscal situation is increasingly unstable.

### Box 1.3: Debt reduction among MENA's oil producers

Many of the oil producers have reacted to the windfall revenues with remarkable prudence, not only evidenced through relative small spending advances, large surpluses, and the build-up of foreign assets, but also through a draw-down of external and government debt obligations. On the external debt front, the most significant debt reduction has come from Algeria, where sizable surpluses in the balance of payments have allowed Algeria to initiate a process of early payoff of external debt. As a result, the external debt-to-GDP ratio has declined from 41 percent of GDP in 2001 to 16 percent of GDP by 2005, and by November 2005, Algeria's debt to the IMF was fully repaid.

Although countries in the GCC carry some external debt, the majority of debt is domestic, and a few countries have utilized the oil wealth to substantially draw-down domestic debt obligations. Most notably, Saudi Arabia has initiated a massive debt repayment process, and in the span of just three years has reduced the stock of domestic debt from 97 percent of GDP to just 41 percent by 2005. Debt reductions have also occurred in Kuwait and Oman.

Box Table 1: Stocks of external, domestic debt among MENA oil exporters

Country/debt indicator	Debt as a proportion of GDP				
	2001	2002	2003	2004	2005
Algeria (external debt)	41	41	35	26	16
Iran (external debt)	7	6	7	8	9
Syria (external debt)	110	106	101	90	..
Yemen (external debt)	53	51	48	42	33
Saudi Arabia (Govt. debt)	94	97	82	65	41
Bahrain (Govt. debt)	30	32	37	34	31
Oman (Govt. debt)	25	19	18	13	11
UAE (external debt)	27	27	24	..	..
Qatar (Govt. debt)	16	38	44	44	51
Kuwait (external debt)	32	32	27	23	17

Source: World Bank staff estimates.

Thus, unlike in the past oil booms, many of the region's oil economies seem to be viewing the recent oil wealth as a window of opportunity. Drawing down their debt obligations represents one of the several constructive actions undertaken by many oil economies to strengthen fiscal positions and enhance private sector confidence.

### 1.4.3 The special case of oil subsidies in MENA

Energy subsidies represent a special, and significant, expenditure item in many of the economies in MENA, and with the recent rise in oil prices, the impact on the budget has been particularly evident. Energy subsidy rates vary in the region. Estimates of energy subsidies as a percent of GDP in a few MENA countries demonstrate diverging burdens for the region, ranging from 5.8 percent of GDP in Jordan to some 15.7 percent in Iran, the highest in the region. Other recent estimates include 6.5 percent in Yemen, 8.1 percent in Egypt, and 12 percent of GDP in Syria.

Aside from the enormous fiscal drain of these subsidies, with the exception of Jordan, energy subsidies in MENA are also regressive and untargeted. With energy consumption generally more modest among the poor, energy subsidies disproportionately benefit rich rather than poor households. In Egypt, individuals in the richest quintile receive more than two-and-a-half times the energy subsidy received by the poor, the disproportion being the greatest for gasoline, for which 93 percent of the benefits go to the richest quintile<sup>29</sup>. And the artificially low prices result in energy inefficiency, excessive consumption, and environmental damage.

#### ***Price adjustments and other energy policies***

Aware of the large fiscal impacts, authorities of a few economies in MENA have, with varying success, undertaken to mitigate the budget impact of subsidies and transfers by adjusting retail prices (See Box 1.4 for details). However, with the exception of Jordan, the reforms to date have been timid, and in no country in the region are oil prices currently market determined. Part of the hesitancy to undertake ambitious price reforms is explained by concerns about the poverty impact, as well as the fear of political backlash. In both Lebanon and Yemen, efforts to reduce or offset these oil subsidies were met with riots. Governments have also worried about the inflationary impacts of rising oil prices to consumers.

But surging budget surpluses among oil producers have also seemed to contribute to a backing off from oil subsidy reform. In Iran, the government asked parliament in October to approve a new pricing formula that would ration the availability of subsidized gasoline (the draft bill stipulated that car owners be provided with “smart cards”, fixing subsidized petrol allowance and forcing drivers to pay full price when they exceeded the ration). But parliament has backed off from implementing the scheme – a modest step in the right direction -- until 2007 at the earliest. Energy subsidies will continue throughout 2006 according to revised bill, which froze any adjustments to domestic prices of oil products, gasoline, electricity, and water and postal services, for the budget period. In Saudi Arabia, meanwhile, the heavily subsidized domestic prices of gasoline and diesel have actually been lowered in early 2006 by nearly 30 percent, in an effort to soften the impact of the country’s recent stock market declines. And equally telling, no other resource rich economy has attempted to enact subsidy reform since the oil boom began.

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<sup>29</sup> World Bank, 2005d.

While short term adjustments have been limited, a few resource poor economies are working to put into place longer-term measures. Both Morocco and Tunisia are recently taking steps to reduce consumption and dependence upon oil. The Tunisian government adopted an Energy Control Law in August 2004<sup>30</sup>. It also targets a 20 percent reduction in energy consumption by government administration, firms and households, a greater use of natural gas, and the development of renewable energies. In that context, the Tunisian government launched in 2005 a public awareness campaign to reduce household energy consumption. It is also developing its use of both solar and wind energy. Likewise, the Moroccan government is considering the adoption of more long-term energy saving measures, including a rolling work schedule to eliminate mid-day traffic, as well as the use of renewable energies.

In Jordan and Egypt, on the other hand, the issue is being approached by price reform. In Egypt, there is a general consensus to move from implicit to explicit, and from direct to indirect cash subsidies, and to strengthen the safety nets. And in Jordan, the government voted for measures to allow a gradual reduction of the oil subsidies on diesel, fuel oil, liquefied petroleum gas, and kerosene and to liberalize the domestic market for petroleum products over three years. The first round of reduction in oil subsidies became effective in September 2005, and despite the continual rise in oil prices, subsidies for the last four months of the year increased only by 49 percent, compared to the same period of 2004—in contrast, subsidies up to September increased by 139 percent over the same period in 2004.

### ***The poverty impact of higher oil prices***

Although energy subsidies have contributed to significant deterioration of fiscal positions among resource poor countries, many governments in the region have been hesitant to remove them, mainly because these subsidies have buffered the poor from the direct shock of higher oil prices. But rising oil prices may have poverty impacts beyond consumer budgets, through growth itself. To the degree that higher growth benefits the poorest households, there may still be a poverty impact from the higher oil prices, even if it has not been directly passed on to consumers. A recent World Bank study estimated the impact of the recent increase in oil-price on poverty through the growth channel<sup>31</sup>, and three resource poor economies are found to be particularly affected: Djibouti, Jordan and Lebanon. In Djibouti and Jordan, the impact was especially large, estimated as a 4.7 percent rise in the poverty headcount, and in Lebanon, the increase in the poverty headcount was estimated at approximately 2.6 percent.<sup>32</sup>

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<sup>30</sup>Law no 2004-72 of August, 2 2004: the bill pertains to energy consumption and the use of renewable energies. It includes incentives and other promotional measures destined to boost the use of renewable energies in the country's private and public sectors.

<sup>31</sup> The study considered a US \$10 increase with respect to the average oil price in 2003, and a rise in the long-run oil price of about \$5 a barrel in real terms. The study accounted for country-specific growth elasticities of poverty (see World Bank 2005c).

<sup>32</sup> The World Bank, 2005c.

#### Box 1.4: The experience with oil price adjustments in some MENA economies

In **Morocco**, oil products have been subsidized since 1995. Prices were indexed on the Rotterdam oil price up until 2000, but increasing oil prices pushed the Moroccan government to interrupt this indexation in September 2000, which has translated in the widening of the *Caisse de la Compensation* deficit. Prices were kept unchanged until 2004, when they were raised by between 2.9 and 3.5 percent, depending on the product. Further increases were introduced in May<sup>1</sup> and August 2005, and in January 2006. As of May 2005, the energy bill was evaluated at MD 7 billion (Ministry of Finance), however, the recent price adjustments will reduce it to MD 5 billion, equivalent to a 20 percent cutback.

The **Tunisian** government has controlled for the budget deficit by increasing several times the retail oil prices. In 2004, prices were adjusted up by about 5 percent (February and August), but the decision was offset by a three percent increase of the minimum wage to attenuate the burden on some 280,000 workers. More rises followed in February, June and September 2005.

The Government of **Jordan** made its first reforms of the oil and gas subsidies by raising the price of gasoline and fuel oil by 10.6 and 33.3 percent, respectively on July 9, 2005. In September, the government announced additional increases, varying from 5 percent for gasoline, 20-22 percent for diesel and kerosene, and JD 0.25 for LPG cylinders. Prices are likely to further increase as the Jordanian government has embarked in long-term reform toward the removal of oil subsidies.

In **Egypt**, prices were adjusted upward in 2004, when the Government introduced two new types of gasoline with higher octane levels at higher prices, and increased the prices of diesel to LE 0.6/litre (up by 50 percent), fuel oil to LE 300/ton (up by 65 percent), and natural gas to LE 0.21/cubic meter (up by 49 percent). This is a major step given that there was no change in the nominal domestic price of any petroleum product between 1997 and 2004. While the price of LPG froze at its 1991 level (LE 2.5/12.5 kg cylinder), prices of gasoline were last adjusted in 1992 (LE 0.9/litre for octane 80 and LE 1.0/litre for octane 90), kerosene and diesel in 1993 (LE 0.4/litre for kerosene and ordinary diesel), and natural gas and fuel oil in 1997 (LE 0.141/cubic meter and LE 182/ton, respectively). In addition, the depreciation of the exchange rate by 30 percent over 2003-04 widened the gap between domestic and international domestic prices of all energy products.

In **Yemen**, the government has been trying to phase-out subsidies on oil derivatives for at least seven years. A first rise in gasoline of 40 percent in 1998 led to riots and a death toll of 50. In July 2005, the government raised the price of diesel and oil as well as kerosene and cooking gas significantly: pump prices for diesel jumped from YR17/litre (8 US cents/liter) to YR45/litre, while those for oil almost doubled. These price hikes were combined this time with pro-poor supportive measures such as sales tax cut, production and consumption taxes cancellation, and 200,000 additional individual covered under the Social Care System. However, despite safety measures, riots led to 13 dead and the government withdrew part of the price hike: new prices were cut by 20-30% and oil prices remain at around half their market rate..

In **Lebanon**, the government imposed in May 2004 a price cap on gasoline and increased excise taxes to offset the rise in world oil prices. As in Yemen, these price hikes resulted in riots, occurring in the Southern suburb of Beirut and claiming five lives.

In **Iran**, oil and gas prices are among the cheapest in the world, but gas subsidies have had the largest fiscal implications. Because of refining limitations, some 40 percent of the country's gas consumption is imported at market prices, and consumption has risen. In 2005, the government introduced a proposed rationing scheme for gas, in which each car owner would have a "smart card" allowing the purchase of a certain amount of gas at the subsidized rate, after which further fuel would have to be purchased at market prices. The scheme was intended to be implemented in 2006, but mixed reaction by the Majlis to the bill has resulted in freezing any adjustments to domestic oil prices, gasoline or electricity. As a result, prices will remain unchanged until at least 2007.

**Table 1.4: Poverty impact of oil price rise: most severely affected countries**

Country	Total growth (%) <sup>a</sup>	Poverty Elasticity <sup>b</sup>	Poverty impact <sup>c</sup> (%)
Mauritania	4.08	-2.12	8.65
Moldova	3.22	-2.45	7.87
Belarus	2.13	-3.20	6.81
Kyrgyzstan	1.83	-3.34	6.11
Uzbekistan	1.61	-3.63	5.84
Armenia	2.49	-2.22	5.53
Tajikistan	2.09	-2.56	5.35
Guyana	3.06	-1.73	5.28
<b>JORDAN</b>	<b>1.93</b>	<b>-2.45</b>	<b>4.73</b>
<b>DJIBOUTI</b>	<b>3.40</b>	<b>-1.39</b>	<b>4.72</b>
Ukraine	1.20	-3.34	4.02
Georgia	1.63	-2.33	3.80
Jamaica	1.63	-2.22	3.63
Sao Tome and Principe	2.50	-1.39	3.48
Singapore	1.75	-1.82	3.18
Estonia	1.33	-2.33	3.10
Mongolia	1.83	-1.64	3.01
Macedonia	0.86	-3.48	2.98
Tonga	1.29	-2.22	2.88
Lithuania	0.95	-2.93	2.78
Guinea-Bissau	1.98	-1.39	2.75
Latvia	0.93	-2.93	2.73
Bulgaria	0.93	-2.93	2.71
<b>LEBANON</b>	<b>1.01</b>	<b>-2.56</b>	<b>2.58</b>
Pakistan	0.88	-2.81	2.47

a: Total growth effect = sum of direct and indirect effects. b. Poverty elasticity calculated according to Ravallian, 2004. c. Poverty impact = product of total growth effect \* poverty elasticity. Source: Herrera, et al. 2005.

With growing recognition among MENA governments that, in order to ensure fiscal sustainability, they must reevaluate present energy subsidy systems, there has been increasingly interest on understanding the impact on the poor from reducing energy subsidies. To that end, poverty simulations undertaken in three MENA countries attempted to approach this question by analyzing the impact of setting all energy prices to import parity. In all cases, potential impact on the poor would be great, without compensatory measures. In Iran, such a policy would be equivalent to an across-the-board price increase of 308 percent on all energy products, and would result in an increase in household expenditure by 33 percent for the urban poor and 47.6 percent of the rural poor. The estimated results for Yemen were similar, where price increases for oil products would correspond to 104 percent increase on average, and the increase in expenditure would account for, on average, 14.4 percent of household budgets for the poorest households and 7.1 percent of household budgets for the richest. Most of the expenditure increase originates from LPG consumption, the major energy product of poor households in Yemen. In Egypt, another approach to simulate the poverty impact of subsidy removal took into account other relevant effects, namely the welfare-enhancing effect of energy reform in the production sector as well as

likely quantity responses to the price increase. The study simulated a 50 percent reduction in overall energy subsidies without any compensation for potential losses through other social protection schemes, and resulted in an estimated increase in the incidence of poverty of 4.5 percentage points, with most of the increase in poverty arising from the phasing out of LPG subsidies. In absolute numbers, the reduction of energy subsidies by half would increase poverty in Egypt by almost 3 million people.

But the simulations above only point to the potential increase in poverty without compensatory measures. With a large portion of energy subsidies currently benefiting the non-poor, removing oil subsidies and directing some of these budgetary savings to the poor could eliminate these negative impacts on the poor. In Egypt, for example, it was shown that if only half of the savings from the subsidy reduction were used in a new, untargeted cash transfer program, the negative impact on the poor would be largely eliminated.<sup>33</sup> And in Iran, a seminal study of the oil subsidy scheme found that the wealth that would be freed up from the subsidy removal could be far better invested to create jobs, while developing a well-targeted and efficient social safety net system that could replace the transitory transfer system<sup>34</sup>.

With the vast proportion of energy subsidies benefiting the non-poor, removing energy subsidies and replacing them with programs that are better targeted to the poor could have strong positive social impact. Moreover, although these subsidies emerged with the aim to protect the poor, they now represent an ever-growing fiscal burden, a burden which ironically may present its greatest risk to the poor, in terms of preserving important social expenditures.

## **1.5 NEAR-TERM PROSPECTS**

In the wake of quite strong performance over the last three years, two major elements are likely to shape the outlook for the broader MENA region over the period through 2008. First, the external environment for growth will be shifting over this period in line with the business cycle in the OECD countries, affecting global growth and trade patterns. Developments in critical non-oil export markets for MENA will carry substantial influence on the outlook for the region's diversified economies, largely within the resource poor, labor abundant group. At the same time, the dynamics of the oil market are anticipated to change as global demand and supply conditions evolve over the next years. In this context, OPEC policy will play an important role in establishing the price level that emerges, and consequently, the level of hydrocarbon revenues anticipated to accrue to regional oil exporters.

### **1.5.1 External environment for growth**

In broad terms, the external environment for growth in the MENA region appears favorable (Table 1.5). Long dormant, economic activity in the Euro Area is showing signs of

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<sup>33</sup> The World Bank, 2005d.

<sup>34</sup> World Bank, 2003f.

increased vigor, with expectations that GDP growth and import demand will be picking up in 2006 and 2007 to be benefit of MENA exporters of manufactured goods, especially textiles, clothing and similar products. At the same time, the balance of supply and demand forces suggest that global oil prices will remain at fairly high levels through 2008, continuing to rise into 2006 (to \$59/bbl)<sup>35</sup>, before easing to \$53/bbl by 2008. This pattern of global oil price (a base case with substantial associated risks) would serve to sustain oil revenue flows to MENA exporters at high, albeit diminishing levels. Together these factors point to a pick-up in growth for those countries more dependent upon economic conditions in Europe, and a moderate easing in activity for most oil exporters in the region—both as revenues scale back to a degree, and as outlays (domestic and import spending) gradually adjust toward new equilibrium levels consistent with government policy.

**Table 1.5: The External Environment 2004-2008**

<b>Growth, or as otherwise Specified</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>
<b>World trade<sup>a</sup></b>	<b>12.0</b>	<b>9.0</b>	<b>8.5</b>	<b>7.0</b>	<b>7.0</b>
High income imports	8.9	6.6	6.7	6.2	6.2
Euro area	6.3	4.3	5.8	5.3	5.4
United States	10.7	6.2	5.0	3.8	3.8
<b>World GDP<sup>b</sup></b>	<b>3.8</b>	<b>3.3</b>	<b>3.3</b>	<b>3.2</b>	<b>3.2</b>
High income countries	3.2	2.8	2.9	2.7	2.8
Euro area	1.9	1.4	2.1	1.7	1.9
Developing countries	6.9	6.3	6.0	5.7	5.6
Oil prices (\$/bbl) <sup>c</sup>	37.7	53.4	59.0	56.0	53.0
Non-oil commodity prices <sup>d</sup>	17.3	13.4	5.4	-3.1	-5.9
MUV index <sup>e</sup>	6.9	0.0	2.4	2.6	0.8
US dollar LIBOR (%)	1.7	3.6	5.2	5.3	5.2

a: Goods and services (2000 \$US); b: Real GDP in 2000 \$US; c: World Bank average oil price = equal weights of Brent, WTI, and Dubai crude oil prices; d: World Bank index of non-oil commodity prices in nominal \$US terms; e: Index of manufactures unit value, G-5 countries (France, Germany, Japan, United Kingdom and United States). Source: World Bank, 2006c.

For the MENA region, the tenor of the external environment offers clear opportunities for oil exporters to make use of continuing high revenue flows, and for diversified economies to make the most of the revival in a key export market. These driving forces for growth come with challenges as well.

*For oil-exporting economies*, clear opportunities exist to place continuing high revenue streams into productive use in domestic spending, as job growth will be essential to quell booming demographic pressures. Challenges facing policy makers include continuing cautious management of the financial windfall to avoid domestic overheating and inflationary

<sup>35</sup> World Bank average price; equal weighting to Brent, WTI and Dubai crudes.

consequences; and importantly, to avoid the tendency for high revenues to cloud the need for structural change. *For resource poor, labor abundant countries*, growth in the European Union, sluggish since 2000, now shows signs of picking-up, and could offer stronger support for goods exports, tourism and remittances over the next years.

On a base set of assumptions—continued moderate progress in domestic reforms—MENA growth is viewed to ease modestly in 2006 to 5.6 percent, and to establish a 5.2 percent pace over 2007-08. As shown in Table 1.6, overall growth reflects a pick-up for the diversified economies above 5.5 percent by 2008, contrasted with a slowing for oil exporters toward the 5 percent mark.

**Table 1.6: GDP growth for the MENA region**

<b>Growth, or as otherwise specified</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>
<b>MENA</b>	<b>5.6</b>	<b>6.0</b>	<b>5.6</b>	<b>5.2</b>	<b>5.2</b>
<b>Resource poor labor abundant</b>	<b>4.8</b>	<b>4.0</b>	<b>5.4</b>	<b>5.4</b>	<b>5.7</b>
Egypt	4.2	4.9	5.5	5.8	6.0
Jordan	7.7	7.2	6.0	6.0	6.0
Lebanon	6.3	1.0	..	..	..
Morocco	4.2	1.5	5.0	4.0	4.5
Tunisia	5.8	5.0	5.5	5.5	6.0
<b>Resource rich labor abundant</b>	<b>4.7</b>	<b>5.5</b>	<b>5.3</b>	<b>5.1</b>	<b>4.8</b>
Algeria	5.2	5.5	5.7	5.4	5.0
Iran	4.8	5.9	5.5	5.3	5.0
Syria	3.6	4.0	4.0	4.0	4.0
Yemen	2.6	3.8	3.5	3.0	3.0
<b>Resource rich labor importing</b>	<b>6.5</b>	<b>7.2</b>	<b>5.8</b>	<b>5.3</b>	<b>5.0</b>
Bahrain	5.4	6.9	7.0	6.8	6.5
Kuwait	6.2	8.5	6.2	5.0	4.0
Libya	9.3	8.5	..	..	..
Oman	3.1	4.1	6.0	5.5	5.0
Qatar	9.9	8.8	8.0	7.5	7.0
Saudi Arabia	5.2	6.5	5.1	4.8	4.5
United Arab Emirates	8.5	8.0	6.5	6.0	6.0
Memo item					
<b>Oil Exporters</b>	<b>5.9</b>	<b>6.7</b>	<b>5.5</b>	<b>5.2</b>	<b>5.0</b>
<b>Diversified exporters</b>	<b>4.8</b>	<b>4.0</b>	<b>5.4</b>	<b>5.4</b>	<b>5.7</b>

### ***Oil-exporting countries***

Among the resource rich, labor importing economies, the strong trend of recent growth is anticipated to ease from 7.2 percent to 5.8 percent in 2006, as additional gains in oil and gas production generally come up against capacity constraints, although efforts are being made to enhance capacity in the medium and long term (see Box 1.5). Though GDP measures of output fall in line with this development, there remains much accrued hydrocarbon revenues to be expended through fiscal accounts and capital outlays. GDP growth in Kuwait, Qatar, Saudi Arabia and the United Arab Emirates is anticipated to remain strong, while new oil production capacity in Oman should help to bolster growth there. For the group, hydrocarbon revenues are anticipated to remain at quite high levels despite the moderation in oil price, easing from \$260 billion in 2005 toward \$225 billion by 2008. The current account surplus is seen diminishing from some \$185-to \$80 billion, as more of the windfall is expended on imports, and the overall fiscal position is seen to drop from current surplus of 21 percent of GDP to a still-high 15 percent.

For the *resource rich, labor abundant countries*, economic activity will be driven by a combination of factors. In Algeria, increased oil and gas output, in several cases through massive new facilities will serve as a driving force for growth. In contrast, shift of paradigm is underway in Iran, in which large-scale increases in domestic subsidies and transfers underpin a revival of private consumption spending. While in Syria and Yemen dwindling natural resources, and in the former country, increasing geopolitical tension and lack of market opening are likely to restrain growth potential. Still advances in GDP are respectable, easing from 5.5 percent in 2005 toward 4.8 percent by 2008.

### ***Resource poor, labor abundant countries***

After suffering slowdown in 2005 linked to poor export performance across the Maghreb, and devastating drought in Morocco, several of the RPLA economies are positioned to enjoy a revival of growth over 2006-08. At the same time, fuel prices, if maintained at their current high levels, will continue to exert important pressure on the balance of payments (through the import bill) and on fiscal accounts (through oil subsidies). Part of this negative impact may be compensated with higher capital and tourism inflows from the Gulf, and Jordan is well situated to garner economic spillovers from the continuing conflict in Iraq, in the form of real-estate, administrative and other supporting work efforts. And Egypt's improving track record of reforms, together with revival of growth in European demand for goods and tourism services, hold the promise of accelerating GDP growth over the period to 2008. Following the subdued GDP outturns of 2005, activity is viewed to pick-up quickly toward 5.4 percent and above, as the situation in Morocco normalizes and export growth across the group enjoys a fillip.

## 1.5.2 Risks.

A number of economic and geo-political risks present tensions to the base outlook. Among these: The potential for much *lower* oil prices in the intermediate term should demand ease-or actually contract in response to the much heightened level of price. It appears that MENA exporters have budgeted oil prices in a conservative fashion, and adjustment to weaker revenues may present fewer problems than might be envisioned. More problematic is the potential for much *higher* oil prices in the intermediate term, should one-or more of the currently heated geo-political situations in the region give way to upward bidding on futures prices. In this case, the primary risk is to the health of the global economy, and in turn for the potential of a sharp slump in oil price in the aftermath. Finally, there is the risk of a reversion to difficult growth conditions in Europe, implying a volatile export market for the diversified economies of the region. If the removal of the Agreement on Textiles and Clothing results in complete domination of the textile-clothing market by large Asian producers, growth in the Maghreb could be quite adversely affected.

Although the external environment is a principal determining factor of regional growth over the medium term, MENA's longer term growth prospects will be driven in large part by changes in the policy environment, which will determine the climate for growth of the private sector and the prospects for job creation. Gauging the region's recent progress with structural reform, then, can provide important insight into longer term growth prospects (Chapter 3).

### **Box 1.5: Building Greater Oil Production Capacity in MENA**

Rising oil prices and burgeoning demand have pushed MENA oil producers towards the limits of their upstream crude oil production in the past year. In August 2005, spare capacity among the six primary oil producers in the Gulf (Iran, Iraq, Kuwait, Qatar, Saudi Arabia, and the UAE) was estimated at 1.7 million barrels per day (bpd), the lowest spare capacity they have maintained since 2003. The lack of spare oil capacity has largely been shaped by the fact that OPEC countries, particularly Saudi Arabia, have boosted production to meet global demand. However, there are underlying concerns about future capabilities of the region to generate spare capacity due to limitations on manpower, equipment shortages and, more importantly for the long term, aging oil reservoirs.

Supply shortages have triggered a renewed effort at exploration in the region. Kuwait most recently discovered new oil and gas deposits which could boost the country's reserves by some 10 percent. Algeria made 13 discoveries in 2004 and at least 6 in 2005. The country plans to increase production capabilities from a current 1.4 million bpd to 2 million bpd. UAE has agreed to add 200,000 bpd, increasing total production capacity to 2.7 million bpd. In an effort to develop greater upstream production to improve their spare capacity, most MENA producers are having to exploit heavy crudes. Heavy crude oils are sold at a discount rate due to the higher costs of refining them before they become end-use products. As spare capacity decreases, producers are more inclined to increase upstream production on heavy crudes despite the price discounts. Saudi Arabia currently produces 11 million bpd of heavy crudes and is planning to produce 12.5 million bpd by 2009, by investing heavily in oil field developments. Kuwait has taken similar steps, launching a pilot heavy crudes scheme in 2005.

Regional oil producers are also attempting to develop new technology and extraction techniques to extend the life of aging reservoirs and boost production in existing wells. Oman, which has heavier crudes than its neighbors, has invested heavily in new techniques that will boost well production, such as steam and polymer injection. Such investment is also key for Iran and Iraq. However, Iran's ability to import new oil production technology is limited by economic sanctions. Iraq's adoption of new technology is limited by the security environment. Currently, these countries are depending largely on the reinjection of gas and water into wells, and in Iraq, the reinjection of excess fuel oil. Although reinjection is a standard practice in many older wells, it can negatively affect the long term health of a well if not managed properly.

On the downstream side of oil production, producers in the Gulf are investing heavily in refining. Recent global supply constraints are largely the result of a lack of global refining capacity, not a lack of crude oil production upstream. Refining capacity has been particularly hampered in developing nations given the diverse product requirements due to varying environmental standards and local resistance to the development of new refineries. To bolster global refining capacity and to help cover their own growing domestic needs, MENA oil producers are increasingly investing in refineries. Together, they are planning to add more than 4 million bpd capacity in the next decade, and many of these refineries are being built primarily for export purposes.

Saudi Arabia is planning to double its total oil refining capacity, both within the Kingdom and abroad, to 6 million bpd by 2010. Proposed refineries in Saudi Arabia will add a capacity of 400,000 bpd within the next 3 years. These refineries are designed specifically to produce high end cleaner fuels to meet the demands in the key export markets of Europe, Asia and the US. Iran plans to raise its refining capacity to 2 million bpd in the near term. Currently, the country produces 1.64 million bpd, having raised that from 1.35 million bpd in 2000 by increasing refining efficiency. The country plans to build three refineries for medium crude in coming years. However, much of this increased capacity will be directed towards the domestic market, as Iran currently imports 132,000 bpd of gasoline. Kuwait plans to spend some \$10 billion through 2011 to upgrade and increase its petroleum refining capacity. And Iraq expects to bolster its refining capacity to 1 million bpd by the end of 2006 to meet domestic fuel needs. Current refineries in Iraq, if operating at maximum capacity, can produce 750,000 bpd, but due to outdated technology, power outages, and sabotage, they are operating much below capacity.

Smaller oil producers have also taken steps to expand their refining capacities this year. Yemen has announced the development of a private refinery in Ras Issa that will begin construction in mid-2006, a \$450 million project supported by the IFC that will provide an additional 60,000 bpd. Its end products will primarily be targeted to the domestic market. Syria has also announced that it will move forward on increasing production at its two current facilities and reconstructing a third. Syrian efforts are focused on maintaining a position in regional oil markets as its own upstream production slows.

Alleviating the supply situation in MENA countries in the long term will arguably require greater cooperation between industry producers, refiners and associated contractors along the production train. Important to this is enhancing relationships between national oil companies and international firms, which would improve production and refining capacity and boost overall investment in the oil infrastructure of the region. However, the national oil companies in the region remain resistant to such suggestions, at least in the area of upstream production. Saudi Arabia has welcomed limited participation by internationals in its downstream sector, but upstream production continues to exclude international firms. The Kuwaitis government proposed a greater role for international firms in upstream production several years ago, but the proposal remains under intense political debate in the Kuwaiti parliament. Of countries in the Gulf, only Qatar and the UAE have created significant roles in production for international firms. Algeria passed a law in 2005 that strips Sonatrach of its monopoly on oil distribution, storage and refining, while allowing international firms more independence in taking on research and exploration contracts. However, it is too early to judge the true impact of this legislation on the role of Sonatrach and international firms in Algeria.

### FINANCIAL SECTORS IN A NEW AGE OF OIL

#### 2.1 INTRODUCTION

MENA's oil shock has had important financial spillovers. Over the last few years, MENA has seen an upsurge in financial activity, as abundant liquidity has fed a rapid rise in credit growth, surging stock markets, and a booming real estate sector. Oil economies have been the primary recipients, although a financial market upswing has also reached some of the region's resource poor countries through increased cross border investment, remittance flows and tourism.

Increased liquidity has directly or indirectly fed a rapid rise in bank deposits and a simultaneous demand for credit from the real economy. Lending has accordingly expanded, improving access to finance for corporations, households and consumers alike, and facilitating some of the strongest growth in investment and consumption that MENA has seen for decades. In addition, many countries in the region have utilized their strengthened positions to address long-needed financial sector reforms, including public-sector bank restructuring and privatization, licensing private financial entities, improving bank supervision, and upgrading prudential regulations.

Many authorities have looked to invest this oil windfall, building upon long held ambitions to become regional hubs for finance, business and tourism, and bank credit has flowed into a series of gargantuan real estate, tourist and commercial ventures. Project finance has also boomed, with banks competing to supply long-term finance to a wave of new industrial and infrastructure initiatives, largely in the Gulf. In the process, bank profitability has reached record levels.

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

But a more troubling aspect about MENA's financial markets is the seeming disconnect between the financial sector and the real private economy, despite the appearance of a relatively deep financial sector by macroeconomic indicators. Although regional banks have abundant liquidity, outside of the Gulf, few private businesses have access to bank finance. Even in countries with relatively high rates of lending to the private sector, credit remains concentrated among a select minority, and investment climate surveys suggest an average of more than 75

percent of private business investment in MENA is financed internally through retained earnings. As a result, few of the assets accumulating to the region are channelled toward productive investment. Moreover, key elements of a well-functioning financial sector that could help boost sustainable and efficient growth, including bond and equity markets and contractual savings instruments, remain largely undeveloped outside of the Gulf.

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

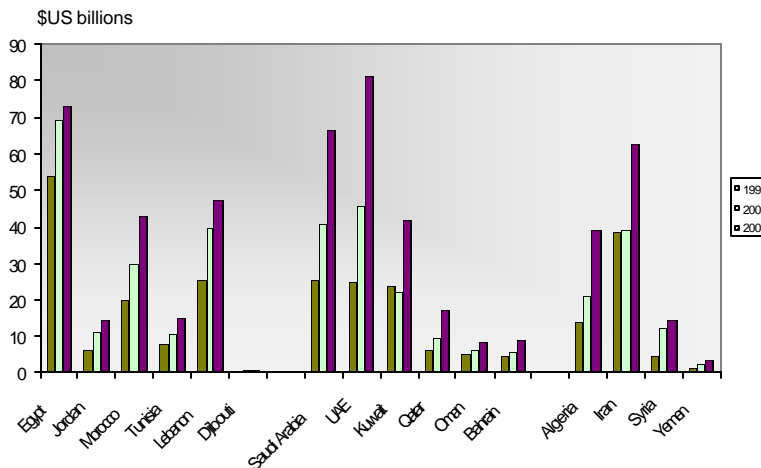
Record oil receipts and strong economic growth present an important challenge for the financial systems of MENA, to channel this liquidity into the real economy, boosting sustainable, efficient and equitable growth. To do so, the region must address a range of underlying structural deficiencies that inhibit efficient and sound resource allocation.

## 2.2 RECENT UPTURN IN FINANCIAL ACTIVITY IN MENA

### 2.2.1 Windfall liquidity drives strong credit growth

Banks dominate MENA's financial systems, and over the last three years, the exceptional increases in liquidity from oil and oil-related wealth in MENA have fed a rapid rise in bank deposits and a simultaneous demand for credit from the real economy.

**Figure 2.1: Bank Deposits in MENA, 1998-2005\***



\* Or closest year available. Source: IMF IFS.

Between 2002 and 2005, deposits to the banking sector<sup>36</sup> rose in real terms by an average of 15 percent a year<sup>37</sup>, led by strong deposit growth among resource rich economies (Figure 2.1). Among resource rich and labor importing economies, bank deposits increased in current dollar terms by \$95bn between 2002 and 2005, or more than \$30

billion a year, more than three times the pace established over the previous four years (about \$10bn a year). Resource rich and labor abundant economies saw even greater deposit growth in banking institutions, with deposits growing by \$45bn over the last three years, and with the average annual growth in deposits increasing almost four-fold relative to the 1998-2002 period. But the frenetic pace was not matched among resource poor countries, despite the transmission of parts of the oil wealth through capital flows and remittances. Deposits among resource poor countries grew by some \$33 billion over the last three years (about \$11bn a year), a pace down slightly from the four year period prior to the start of the oil boom (about \$12bn a year).

<sup>36</sup> Deposits include time and savings as well as demand deposits. Does not include Libya.

<sup>37</sup> Total deposit growth, deflated by CPIs.

### **Box 2.1: A broad categorization of financial market development in MENA**

In Chapter 1, the developments within the Middle East and North Africa region are often discussed in terms of three broad country groupings, corresponding to countries with similar resource endowments: the resource poor and labor abundant economies (Egypt, Jordan, Morocco, Tunisia, Lebanon, Djibouti, and the West Bank and Gaza), resource rich and labor importing economies (the six countries of the GCC: Saudi Arabia, United Arab Emirates, Bahrain, Oman, Qatar, and Kuwait, as well as Libya), and the resource rich and labor abundant economies (Algeria, Iran, Iraq, Syria and Yemen).

These categorizations are also useful in discussing the broadly similar characteristics of countries in the region in terms of financial sector size, ownership, access and governance. The resource rich and labor importing economies are generally high income states and, on average, these countries have large financial markets, low levels of state ownership and high foreign penetration. Governance is broadly good and access to credit in line with income levels (Libya is a notable exception).

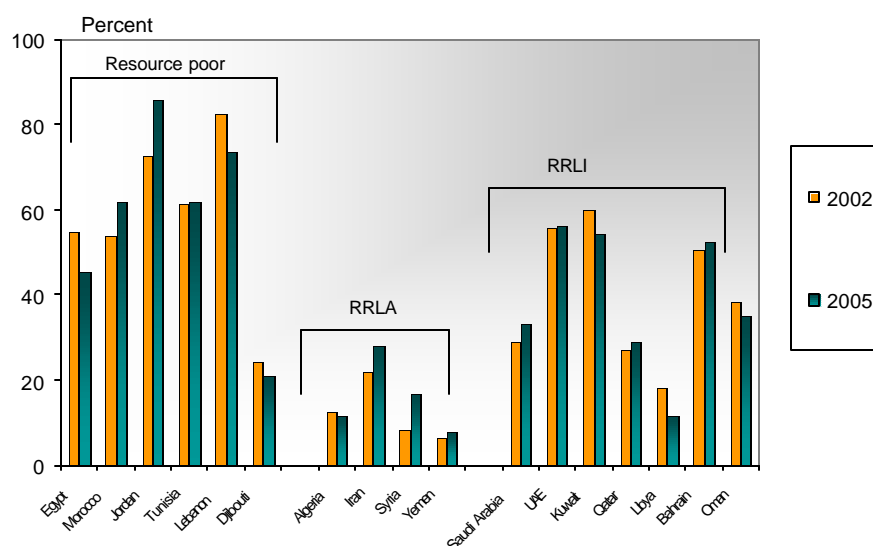
Resource poor and labor abundant economies, on the other hand, generally share a high level of financial market development relative to their income level as well as relative to the rest of the region. Levels of governance are better than those in transition markets and generally are ahead of their income peer group. The degree of state and foreign ownership within the banking sector varies widely, as does the concentration of banking systems. In addition, the financial systems of these emerging markets provide relatively limited access to finance given their income level and shareholder protection is particularly low.

Finally, the resource rich and labor abundant economies display a more state-led approach to financial sector development, in line with their approach to general economic management. Broadly categorized as lower middle income (Yemen is an exception), their financial markets exhibit some depth, but considering their income levels, their banking systems are relatively small in terms of assets and private credit relative to GDP. The banking sectors are also highly concentrated and largely state owned and the quality of financial system governance is below the resource rich labor importing Gulf or resource poor economies.

Rising liquidity in the banking sector, combined with increased demand for credit stemming from high-return investment opportunities, have helped trigger substantial loan growth to private sectors. Bank credit to the private sector as a percent of GDP has risen across most countries of the region, with the strongest loan growth occurring among the region's resource rich economies. Between 2002 and 2005, bank claims to the private sector rose from an average of 17.4 percent of GDP to 21.1 percent for resource rich and labor abundant economies, and from 38 percent of GDP to 42.5 percent among resource rich and labor importing economies (Figure 2.2). But the upturn in private sector credit has not been universal, and a large portion of the region – some 40% in terms of population -- have not benefited from the liquidity or credit upturn<sup>38</sup>. Corresponding to the slower growth in deposits, private sector credit growth has been more subdued among the

resource poor economies in the region, and as a share of GDP has fallen slightly, from 59% to 57%, although a few countries, including Jordan and Morocco, have also seen strong gains in private sector lending. Corresponding to rising capital inflows and worker remittances, increased commercial bank deposits in Jordan have translated into private sector lending as a share of GDP increasing from an average of 73 percent in 2002 to almost 86 percent by 2005. Overall, credit to MENA's private sector as a share of regional GDP has risen from an average of 35 percent to 39 percent over the last three years.

**Figure 2.2: Private sector credit to GDP, 2002-2005\***



\*Or closest year available. Claims on the private sector by deposit money banks as a percentage of GDP. Sources: IMF IFS; World Bank country data.

A strong beneficiary of the credit upturn has been consumer lending, which in a few countries has been extended at startling rates. In Saudi Arabia, consumer lending grew by an average of 57 percent a year over 2004 and 2005 (compared with overall private sector credit growth of 39 percent), and now represents more than 40% of all loans.<sup>39</sup> In Jordan, consumer credit, including credit destined for stock markets, saw a 58 percent increase over 2005 (relative to a 30 percent increase in total credit to the private sector). Loans to finance investments into soaring stock markets almost certainly contributed to part of the dynamic consumer credit growth. While margin lending to stock investors is estimated to account for between 5-15 percent of total bank

<sup>38</sup> Measured by countries who either had an increase in the ratio of private credit to GDP between 2002 and 2005, or countries whose average annual increase in bank deposits (in current terms) between 2002-2005 exceeded the average annual deposits over the previous four years.

<sup>39</sup> EIU (Saudi Arabia Country Report; May 19, 2006).

loans in the GCC, for example, the total proportion of bank credit exposed to stock markets is almost certainly higher, with widespread evidence that much of consumer and even corporate lending also flowed into stocks.

But additionally, MENA's credit growth has supported real estate loans and sizeable increases in corporate business. Corporate finance volumes in MENA are thought to have increased from US\$11bn in 2003 to almost US\$19bn in 2004<sup>40</sup>, with project finance among the GCC accounting for some three quarters. Over 2005, some \$19bn in project finance was extended among the GCC countries alone (a 34% increase over 2004), dominated by credit activity in the UAE (about \$8 billion over 2005, or some 6 percent of GDP, with a single project, the Dolphin Energy's Dolphin Gas Project, accounting for almost forty percent of the overall corporate finance extended by the UAE of 2005).<sup>41</sup> Corporate credit facilities among GCC countries advanced strongly in several key sectors, including oil and gas and finance.

Mortgage lending has also been a beneficiary of the increased credit, particularly in high target real estate segments such as Dubai. This has been partially supported by housing finance reform efforts throughout the region, although mortgage markets remain significantly underdeveloped (Box 2.2). Particularly in the Gulf economies, the banking sector has increased credit and relaxed financing terms to the real estate sector, and loans of up to 95% of the principal have become available with maturities of 20 to 25 years. Across Bahrain, Oman and Qatar personal loans and construction lending have risen to 53%, 44% and 37% of total lending respectively. In the UAE 13% of the banking sector's loan portfolio is dedicated solely to real estate and construction.<sup>42</sup>

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<sup>40</sup> The Banker 08/05

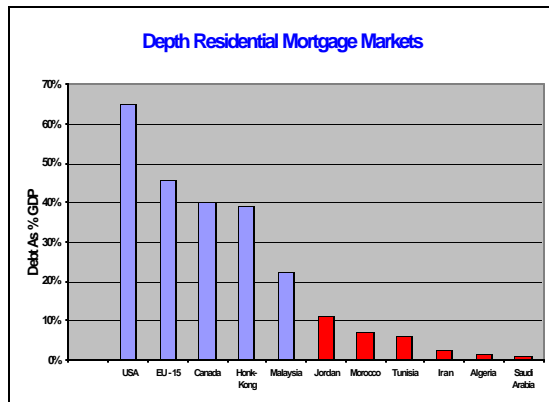
<sup>41</sup> World Bank staff estimates from MEED, March 24-30, 2006.

<sup>42</sup> CIG. 'Personal Loans' may include lending to family businesses.

### Box 2.2: Housing Finance in MENA

With an average growth rate of 2.1 percent a year over the last 15 years, MENA has one of the world's most rapidly expanding populations. Urban areas have been the main recipients of this population growth. Cities' share of the population in the region has grown from 48 percent in 1980 to close to 60 percent by 2000, and they are expected to account for nearly 70 percent of the region's populations by 2015 (this compares with an expected average of 54 percent in 2015 for all developing countries).

Despite the fundamental importance of housing in the economy, the stock of housing-related financial assets – largely mortgage loans – varies from less than one percent of GDP to nearly eleven percent.



#### **Main issues in the MENA mortgage market**

Formal housing finance in many MENA countries has historically been the prerogative of state-owned housing finance institutions, whose presence in some countries has often deterred private-sector lenders in some countries from offering housing finance products, and has tended to constrain the development of the real estate sector for low- and middle-income households. Until the mid-nineties, in countries such as Algeria, Morocco, and Jordan mortgages were mainly channeled through one public financial institution. Iran and Yemen continue to function under this model.

Moreover, the operations of these state owned housing finance institutions have often imposed significant financial burdens and contingent liabilities on government finances. For instance, in past years interest rate subsidies have been a main feature of housing finance policies in many MENA countries<sup>1</sup>. Although well-designed subsidies can help to tap private savings and facilitate home ownership by lower income groups in particular, in practice they have frequently been poorly designed, not well targeted to intended beneficiaries, and promoted financial market distortions.

The development of market-based housing finance in MENA has also been constrained by weaknesses in legal and judicial frameworks, affecting in particular the reliability of property titling and the ability of lenders to foreclose on delinquent borrowers. For example, in Algeria, due to the multiple layers and sources of laws and regulations, property rights are sometimes confusing and contradictory and as a result give rise to conflicting interpretations. This is the case, in particular, with the transfer of ownership for newly built or condominium units. In Egypt, the most serious obstacle is the property registration system. Today, few residential properties in Egypt are registered in the names of their current owners and occupants.

#### **Reforms in the housing finance market**

In recent years, several MENA countries have been taking concerted actions to reform their housing finance systems and pursue more market-based and sustainable alternatives through the development of formal mortgage finance markets **(continued)**.

### Box 2.1 (continued)

At the core of such reforms are the opening of the housing finance systems to market competition, the leveling of the playing field among institutions in the primary market, the development of mechanisms to provide long term funds, as well as to manage credit risk.

In **Algeria**, until 1999, housing finance used to be entirely channeled through CNEP, the savings and housing bank. CNEP was transformed into a public commercial bank and now provides only about half of all housing loans. Five other public banks share the remaining half. To provide banks with long-term refinancing the Algerian authorities established the *Société de Refinancement Hypothécaire* (SRH) in 1997. As of 2005, loans refinanced by SRH stood for DHD 8 billion. A year later, the *Société de Garantie des Crédits Immobiliers (SGCI)* was established to provide banks with mortgage credit risk insurance.

In **Morocco**, until 1998, the state-owned housing bank CIH was the main player in bank mortgage financing with more than 70 percent of all mortgage loans. As a result of its financial problems the CIH had to restrict its activities. In addition, interest rate subsidies for mortgages provided through the state-owned housing bank were extended to the other banks, which rapidly began to compete in the mortgage market. Overall, the mortgage finance market has expanded significantly; the outstanding mortgage amount grew from 3 percent of GDP in the mid-nineties to about 7 percent of GDP in 2004. More recently, the Moroccan authorities opted to create three mortgage guarantee funds whose development is currently underway. The objective of these funds is facilitate access to bank financing for populations with modest and/or irregular incomes

In **Jordan**, the mortgage finance market was relatively small a decade ago. A government-supported housing bank was the main provider, supplying a modest number of loans at below-market rates—but at high government cost. Commercial banks were reluctant to enter the mortgage business mainly because the housing bank still retained competitive advantages from its government support. It was only when the state housing bank withdrew from the sector that banks started to enter the housing finance market. In addition, the *Jordan Mortgage Refinance Company* (JMRC) was established in 1996 to help primary lenders address the liquidity risks associated with long-term lending. Loans refinanced since JMRC's inception have exceeded JD 100 million, covering more than 9000 housing loans. Today, more than ten banks are competing actively in the sector, and the percentage of mortgage loans to GDP has increased from 2% in 1997 to 11% in 2004. Most recently, the United Arab Investors Company (UAIC) announced that it has signed an agreement with the Canada Mortgage and Housing Corporation to establish the first mortgage insurance company in Jordan, which will allow borrowers to finance houses with lower down payments, increasing the number of borrowers in the market.

#### **Emergence of secondary mortgage markets**

Policy makers in MENA have recognized that the capital markets can provide an attractive and potentially large source of long-term funding for housing, and solutions to better allocate part of the risks. As described in the cases of Algeria and Jordan, some countries have pursued the creation of secondary mortgage institutions to help link primary mortgage markets to capital markets. The authorities in the **West Bank and Gaza**, have also followed the same route. In the mid-1990s, the government was considering how best it could enhance the affordability of housing without having to resort to subsidy programs that could impose heavy financial burdens on the state. The concept of creating a financial intermediary working between retail lenders and capital markets was deemed the best alternative, with affordability being enhanced through the lengthening of the maturities of mortgage loans offered at market rates. The *Palestine Mortgage and Housing Corporation* (PMHC) was established in 1997 as the parent company of two separate but affiliated institutions, a liquidity facility company and a mortgage insurance facility. As of 2005, PMHC had extended approximately 500 residential mortgage loans totaling about \$25 million, and was preparing for a first bond issuance in order to move its operations closer to financial sustainability on a market basis.

Other countries such as **Morocco** have securitized mortgage loans without creating secondary mortgage institutions. For instance, the CIH has securitized DM 1.5 billion in mortgage loans through a mutual fund run by a management and depository firm, Maghreb Titrisation.<sup>1</sup>

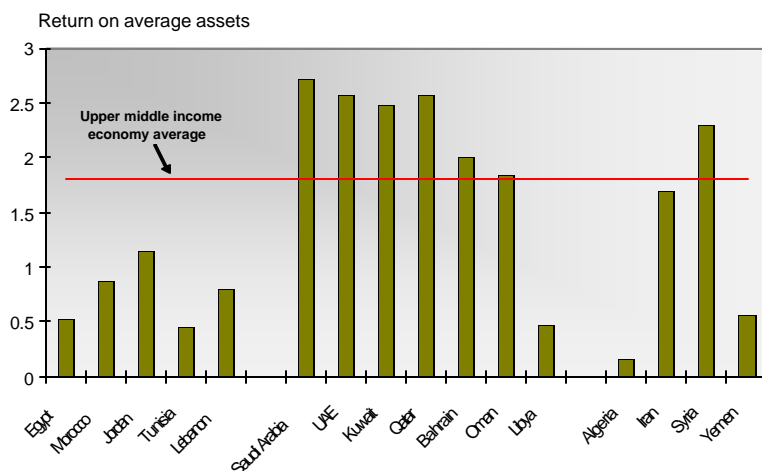
Considering that the success of secondary mortgage markets are dependent on many factors (starting with a strong legal and regulatory framework, a liberalized financial sector, and a well-established primary market), it is not surprising that these markets have only recently begun to emerge in the MENA region.

For most countries in the region, the next challenge relates to further improving the accessibility of housing finance services to lower-middle income households. This includes offering loans with fixed rates for a longer period, and improving the various subsidies schemes, as well as developing systems to better manage credit risk, and mobilize savings.

## 2.2.2 Enhanced bank profitability in the Gulf

The surge in low cost funding from deposits, increased lending, particularly to the consumer segment, and declining delinquency rates has translated into soaring profitability,

**Figure 2.3: Return on Average Assets, 2005\***



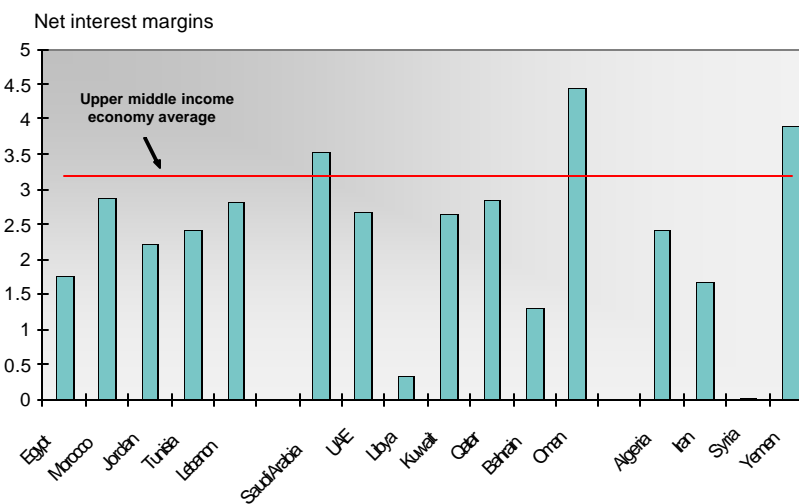
\* Or closest year available. Source: Bankscope.

assets (ROAA) within MENA, at 2.4%. This compares well to other upper middle income countries, at 1.8% on average (Figure 2.3). Net interest margins have also increased, although for most countries remain off the levels in upper middle income economies worldwide (Figure 2.4).

Strong credit growth and declining non-performing loans over 2002 to 2005 contributed toward rising profitability. Lending deposit spreads have widened thanks to the increase in higher margin consumer lending as well as the rise in low cost demand deposits and strong fee income has also been an increasingly important

factor in many Gulf countries. As with credit growth, however, resource poor economies have largely not benefitted from rising bank profitability, with several countries, including Egypt and Tunisia, experiencing a rise in non-performing loans as a proportion of total gross loans over the last few years.

**Figure 2.4: Net Interest Margins, 2005\***



\* Or closest year available. Source: Bankscope.

<sup>43</sup> The Banker 11/05

### 2.2.3 Exposure to economic shocks heightened

At the same time that bank profitability has risen across the Gulf economies in particular, the acceleration in credit to the consumer and real estate segments has also raised the exposure of banking systems to economic shocks. Financing for equity initial public offerings (IPOs) has expanded rapidly in a number of countries, but substantial bank income is also derived from brokerage fees, raising the overall exposure to stock markets. In Saudi Arabia, for example, more than 70 percent of some bank's operating income stems from brokerage fees.<sup>44</sup>

Banks have also increased their exposure to the booming real estate sector (see Box 2.3), both through lending and more directly, as some banks have activity sought to diversify their assets through the creation and syndication of funds invested in high yield projects and property. The increasing exposure of MENA banks to these two high-return segments makes bank portfolios increasingly open to contagion effects. The real estate segment of bank assets may be vulnerable to recent sharp equity corrections, as investors unwind leveraged positions. Real estate oversupply may also take its toll on profitability and loan quality, should the region experience an economic slowdown.

MENA's expansion in real estate has been particularly excessive across the Gulf. In Qatar, construction permits increased 23% year on year in 2004<sup>45</sup> while the annual value of traded land permits in Bahrain rose by over 70% between 2002 and 2004.<sup>46</sup> Kuwait has also enjoyed a rebound in activity, with annual building permits rising by 40% in 2002 and 2003.<sup>47</sup> In some cases this has translated into increased housing and rental prices, and there is evidence of localized speculation emerging in some property markets, with undeveloped real estate lots trading hands on secondary markets.<sup>48</sup> Outside of the Gulf, construction has accelerated in markets such as Jordan and Iran. In the former, construction activity has grown due to the impact of reconstruction and the decision of many Iraqis to reside there, causing annual residential construction to double over 2000-2004.<sup>49</sup> Iran's construction sector has also seen substantial growth, with private sector investment in urban construction rising by 170% between 1999 and 2003.<sup>50</sup>

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<sup>44</sup> GARP.

<sup>45</sup> EIU.

<sup>46</sup> BMA.

<sup>47</sup> EIU.

<sup>48</sup> MEED (01/27/2006) and EIU(2005 UAE Country Profile)

<sup>49</sup> EIU.

<sup>50</sup> Private sector investment in construction projects has risen from IRbn 22,069 in 1999 to IRbn 59,765 in 2003 (EIU).

### **Box 2.3: 'The World' comes to Dubai, Real Estate in the Gulf**

MENA's capacity to absorb the wave of new real estate development that has been commissioned in the last 12-18 months carries some risk for the banking system, which has substantially increased its financing toward this segment over recent years.

#### **Entire new cities are being commissioned**

From Saudi Arabia to Bahrain entire cities have been commissioned by national governments and vast swathes of coastline are set to be reclaimed and reengineered. King Abdullah City, currently the largest single project to be initiated, will cost US\$26bn, comprise 55mn square meters of green-field land and stretch 35 km along Saudi Arabia's western coastline. Similar developments include the US\$15bn Blue City in Oman, designed to accommodate 2mn tourists each year along with 250,000 permanent residents, the New Town and Industrial Projects in Bahrain, costing over US\$2.2 bn and being formed from reclaimed land, and Qatar's US\$5bn Lusail development for 200,000 inhabitants.

With projects valued at some US\$200bn Dubai stands out among the Gulf states. The emirate has four headline projects, including the US\$9.5bn Dubailand theme park, due for completion in 2010, as well as The World and Palm Islands developments. These two land reclamation projects, comprising literally hundreds of islands, will increase UAE's beachfront by over 160% and are being developed by a variety of real estate consortiums for a mixture of exclusive residential, leisure and commercial purposes. Topping the list comes the Burj Dubai which, at half a mile high, will be the world's tallest building, comprising a hotel, luxury apartments as well as the largest shopping mall in the world at 12 mn sq ft. Whether Gulf property markets can absorb this quantity of new and high-end development remains to be seen and, with a 1001 meter building under consideration in Kuwait, there is a danger of 'beggar thy neighbor' competitive development.

#### **And tourism is recovering as Gulf airports link Europe and Asia**

Hotel development and tourist infrastructure provide another important driver of real estate growth. The region has enjoyed a marked recovery in tourist and business activity such that occupancy and average room rates recorded record growth in 2004 and 2005. The Gulf has been at the forefront of this trend, with average hotel occupancy rates reaching over 70% and new hotel projects continue apace with most of the large developments inside and outside of the Gulf incorporating one or more new five star hotels. Eighty new hotels are currently planned across the Arabian Peninsula by 2008 and, over the long term, government projections are for continued and substantial growth, with 30,000 new rooms in Dubai by 2010 and a further 50,000 in Saudi Arabia by 2020.

The recovery in tourism has as much to do with a structural increase in international visitors to MENA as a cyclical recovery from recent political events. From 1995 to 2005 international arrivals into the region increased from 14mn to over 38mn, a compound growth rate of over 12%, and Emirates, the UAE's national carrier, has seen passenger numbers grow from 6mn in 2001 to 12mn by 2005. Such strong traffic growth has been central to the ambition of many Gulf states to become strategic transportation and business hubs connecting Europe and North America with the burgeoning markets of South and East Asia, and further airport capacity is set to come on stream. The Dubai International Airport expansion, costing US\$4 bn and expected to be completed in 2006, is expected to raise total annual passenger capacity from 25mn to 70mn. In Bahrain, current plans should take passenger capacity from 10mn to 45mn passengers, a tenfold increase from its actual flow of 4mn. To put these figures in perspective, Chicago's O'Hare Airport handled 75mn passengers in 2004, placing it as the second busiest airport in the world.

Box sources: UAE Property Trends; MEED 2006; EIU 2005; Deloitte Hotel Benchmark Survey 2005.

The increase in bank exposure has prompted intervention on the part of some regulatory authorities. The Qatari Central Bank has limited bank mortgage lending to the lower of 150% of shareholder funds or 15% total bank customer deposits<sup>51</sup> while Saudi Arabia has limited the proportion of an individual's total salary that can be assigned for the repayment of debt. Loan to deposit ceilings were set at 87.5% and 80% in Oman and Kuwait respectively in 2004<sup>52</sup> and share dealing limits have been enforced, with the UAE's Central Bank imposing fines on 4 banks that had breached the 1:4 leverage ceiling on IPO financing in 2005.

While such action is extremely timely, regulators region-wide need to consider the wider implications of both a growth shock as well as a gradual deceleration in economic activity upon the financial health of the banking system. Recent profitability improvements in the Gulf are undoubtedly, in part, the result of one off windfall gains, spurred by the speculative excess on equity and real estate markets, as well as rising consumer lending. Although balance sheets appear robust enough to withstand some form of adjustment, the early consideration of vulnerabilities would be prudent.

#### **2.2.4 Rising equity markets, with recent corrections**

The region's windfall liquidity has also had important spillovers to MENA's equity markets, which by any measure performed impressively between 2002-2005. Against a backdrop of accelerating economic growth, expanding private credit, and growing corporate profitability, the region's equity markets rose almost fivefold between 2002 to the end of 2005 (and some markets, including Dubai and Egypt rose more than ten-fold over the period). These equity market gains have provided a valuable source of financing to private sector companies and an important route for state divestment of assets and wider public ownership. In tandem with capital gains, the markets greatly expanded in terms of liquidity, with average daily traded volumes rising from under US\$1bn per day to over US\$6bn during 2005. This has proved advantageous for capital raising by both the private and public sector, and there had been an increasing number of initial public offerings (IPOs) and rights issues across a variety of corporate sectors. Increased activity has also had advantageous effects in terms of widening domestic share ownership as well as further liberalization of market access to foreign investors both from within the region as well as outside.<sup>53</sup>

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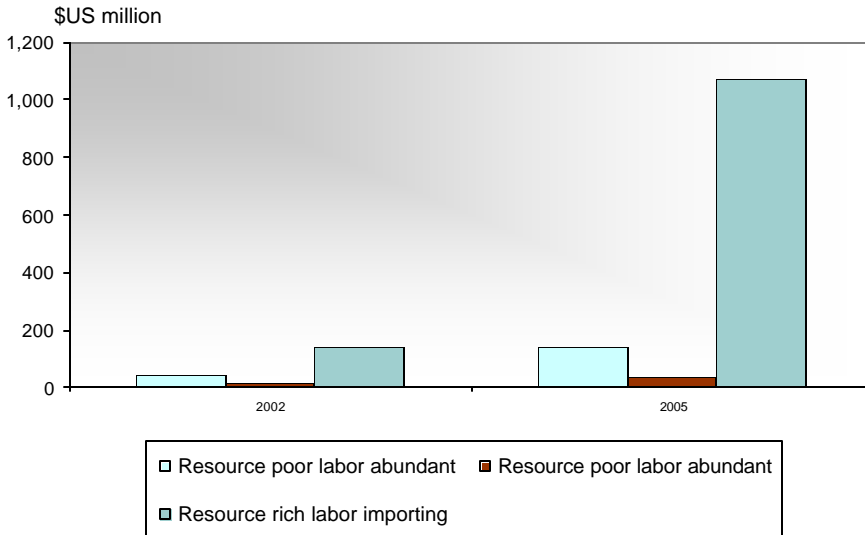
<sup>51</sup> Qatar Central Bank Annual Report 2004.

<sup>52</sup> As several Kuwaiti banks had already lent over 100% of their deposit base, exposure had to be reduced by the July 2005 deadline (The Banker (11/05) and Central Bank Oman Annual Report 2004).

<sup>53</sup> See Box 'Regional Integration through Competitiveness'

Over US\$1tn was gained in market value between 2002 and late 2005. Of this, the Gulf countries saw the bulk of the gain in market capitalization at over US\$ 984bn, a rise of 675% (Figure 2.5).

**Figure 2.5: Market capitalization in MENA, 2002-2005**



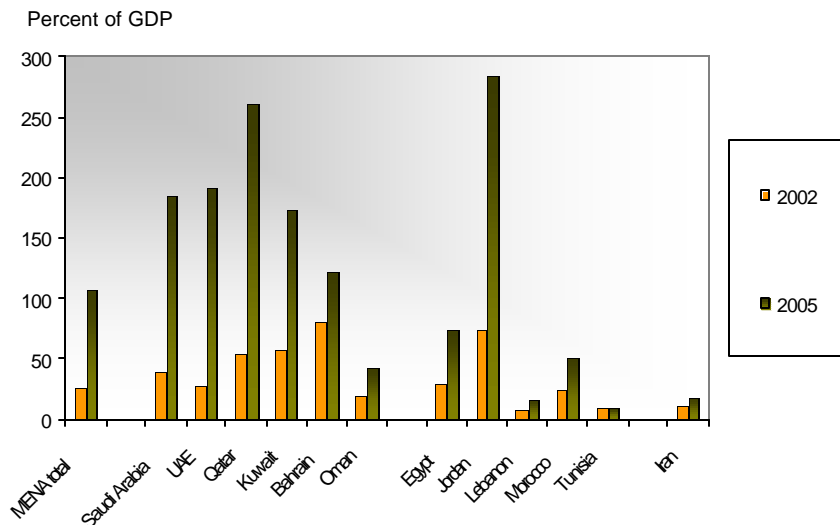
Source: World Bank, WDI; Bloomberg.

In comparison the rest of the region gained US\$112bn in market capitalization. Resource rich and labor abundant economies saw market capitalization rise by about 138%. Resource poor economies also benefited, with equity markets which were some of the strongest targets of petrodollar recycling. It is estimated for

example that by the end of 2005, 30% of investment in Egypt's stock markets emanated from the Gulf, while non-Jordanian investment made up more than 45% of Jordan's stock market capitalization<sup>54</sup>. Together, resource poor economies saw market capitalization rise by more than 200% over the last three years.

With market capitalization to GDP rising from just over 26% in 2002 to almost 110% in late 2005, and in some individual cases to almost 300%, clear signs emerged of excess in some markets (Figure 2.6). IPOs, in particular, showed signs of increasing speculation. The 2004 IPO of a telecom company in Saudi Arabia attracted SR50bn for an issue valued at only

**Figure 2.6: Market capitalization to GDP in MENA, 2005 versus 2002**



Source: World Bank WDI.

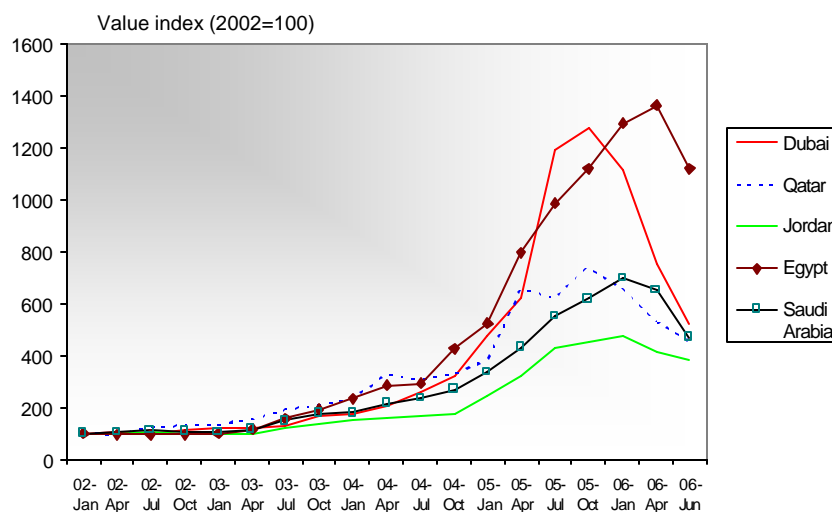
<sup>54</sup> Oxford Analytica 02/08/06.

SR200mn while the 2005 sale of a petrochemical company in the UAE was more than 800 times oversubscribed, attracting over US\$100bn (or over 100% of the country's GDP), for an issue valued at US\$135mn.<sup>55</sup> Such speculative excess around new stock offerings was an early warning sign of 'overheating' in many of MENA's equity markets which, on certain valuation criteria, looked stretched relative to past history.

In early 2006, MENA equity markets fell sharply in a few countries, particularly in Saudi Arabia, Qatar, and the United Arab Emirates. Since the start of 2006, Saudi and Qatari stock indices have fallen by more than 30%, while the major Dubai index has plummeted to half its value (Figure 2.7).

This is not to say that MENA's extraordinary stock market gains over the 2002-2005 were built entirely on speculation. Earnings growth also accelerated at an impressive pace, and growing corporate profitability has been a strong source of valuation support for the markets. Earnings per share in Saudi Arabia have been consistently strong for the past years, rising 30% in 2002, 87% in 2003 and almost 60% in 2004.<sup>56</sup> In Qatar the net income of the constituents of the Doha stock exchange rose by 59% in 2004, led by industry and the insurance sector at 104% and 81% respectively, and Kuwait's corporate sector enjoyed a 74% rise in net income over the first half of 2005 compared to the prior year.<sup>57</sup> However, most markets saw valuation measures increase quite steeply relative to their historic multiples and those of major developed markets in the US, UK and Germany (Table 2.1).

**Figure 2.7: MENA Equity Markets, 2002-2006**



Source: Bloomberg.com: World Indices. Egypt=Egypt CSE Case 30 Index; UAE=Dubai Financial Mkt. Index; Saudi Arabia=Tadawul All Share Index; Jordan=Amman SE General Index; Qatar=DSM 20 Index.

<sup>55</sup> Ittihad Etisalat in Saudi Arabia (Tadawul Stock Exchange Annual Report 2004) and Aabar Petroleum in Abu Dhabi (The Banker 09/05).

<sup>56</sup> Average EPS growth weighted by market capitalization of the fifteen largest listed companies (The Banker 08/05).

<sup>57</sup> Qatar from Doha Stock Exchange Annual Report 2004 and Kuwait from GCC Market Review August 2005.

**Table 2.1: Market ratios of MENA stock markets, 2003-2005**

Growth of GDP per capita	Price Earnings Ratio		Price to book ratio		Dividend yield (%)	
	2003	2005	2002	2005	2005	2005
<b>Oman</b>	9	11	1.5	2.9	8.8	3.1
<b>Saudi Arabia</b>	29	47	3.7	9.6	1.9	1.3
<b>Bahrain</b>	31	16	1.4	2.0	3.6	3.3
<b>UAE (Abu Dhabi)</b>	18	34	3.2	6.7	3.1	1.0
<b>Egypt</b>	12	43	2.1	8.7	4.9	1.2
<b>Morocco</b>	25	22	1.7	2.4	4.7	4.2
<b>Jordan</b>	22	39	1.9	4.4	2.4	1.2
<b>US (S&amp;P500)</b>	..	21	..	2.8	..	1.8
<b>US (NASDAQ)</b>	..	35	..	2.5	..	0.6
<b>UK (FTSE100)</b>	..	15	..	2.4	..	3.9
<b>Germany (DAX)</b>	..	16	..	1.8	..	2.1

a: Source: AMF, Bloomberg and IFCG for Morocco. Historic figures throughout: MENA figures as at 06/05 & 02/06 for UK, USA and Germany.

It is still too early to determine the full potential impact of these recent market corrections on the real economy. The banking sector is likely to experience some losses and a decrease in trading activity will diminish profitability. Similarly many individuals will have suffered substantial losses, often smaller investors who may have the least financial capacity to absorb them. Contagion effects appear to be working through to other regional equity markets, with Gulf investors unwinding intra-regional investments. These pull-outs may come from markets which have demonstrated relative stability and stand within historic valuation parameters. There may also be some danger of contagion to other asset classes such as real estate, as investors liquidate holdings to pay for equity market related losses.

On the negative side, even after the recent market corrections, many equity markets still appear considerably overvalued, should earnings growth ease to a more sustainable pace. On the positive side, with oil prices still high, the region's financial markets remain flush with liquidity to create shareholder value and drive demand for equity investments, and there is reason to believe that confidence in markets may be rebuilt.

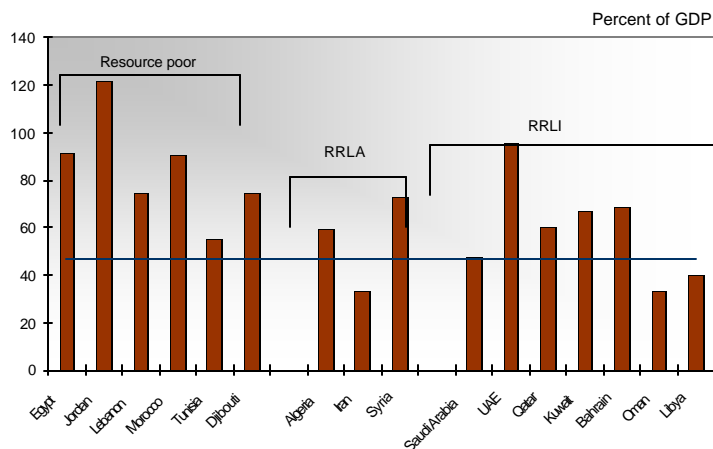
## 2.3 DISCONNECT BETWEEN FINANCIAL SECTORS AND THE REAL PRIVATE ECONOMY IN MENA

MENA has had something of a mixed record with financial sector developments since the oil boom. Increased liquidity, credit, and equity market gains have provided an important new source of finance to private sector companies. Bank profitability has improved with the surge in low cost funding from deposits, increased lending, and declining delinquency rates. But for the most part, these positive developments have benefited only about 60% of the region (in terms of population). And the increasing interests of MENA banks into the booming but volatile equity and real estate markets have heightened the exposure of MENA's dominant financial market segment to economic shock.

But a more troubling aspect about MENA's financial markets is the seeming disconnect between the financial sector and the real private economy, despite the appearance of a relatively deep financial sector by macroeconomic indicators. Although many MENA's banks are flush with liquidity, throughout most of the region they play a limited role in financial intermediation and economic development. Credit remains concentrated among a select minority, and few private businesses can access finance. As a result, little of the region's recent and dramatic increase in assets over the last few years can be accessed by the domestic economy to channel toward productive investment.

### 2.3.1 Macroeconomic indicators demonstrate a relatively deep financial sector across MENA

Figure 2.8: M2 to GDP in MENA



•Source: FSDI. Results plotted against middle income economy average.

(Figure 2.8). At the same time, there is wide variation across the region, with resource poor countries having significantly higher ratios of broad money to GDP than resource rich economies.

Several indicators would point to a relatively high degree of financial intermediation in MENA. The ratio of broad money (or M2) to GDP, which generally provides a useful indication of the overall degree of financial intermediation in MENA,<sup>58</sup> stands at over 60% of GDP for the region as a whole, and has remained largely constant since 1999. This is well ahead of the 47% recorded by middle income countries (MIC average), but below the 84% of GDP in high income countries

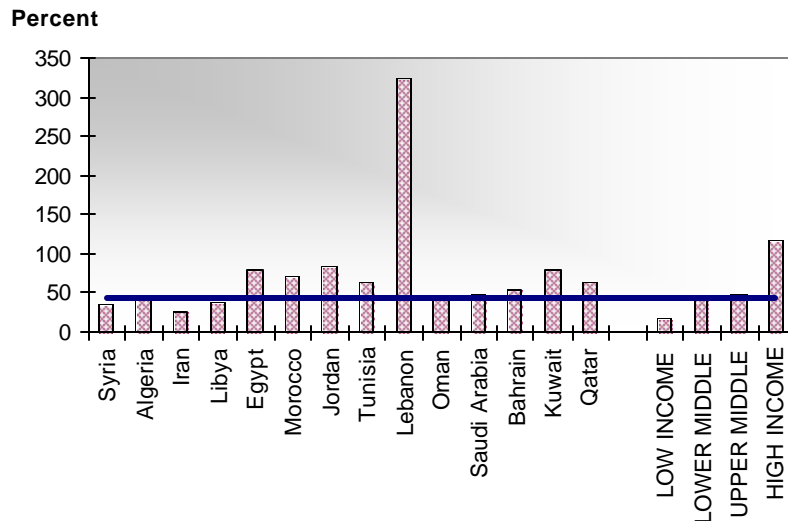
<sup>58</sup> Care must be taken with M2:GDP as the ratio may decrease as the financial system develops and individuals invest in longer term and / or less liquid financial instruments that are not included in M2.

Bank assets to GDP are also high, averaging 75%, and ahead of the average for middle and low income countries. Even excluding Lebanon, with its extraordinarily high level of bank assets, the region records an average of over 50% of GDP.

Even turning to the provision of credit by deposit money banks to the private sector, MENA's ratio of private credit to GDP averages over 39% (Figure 2.2), higher than the average for middle income countries (37.5 percent), although only a fraction of the

112% average recorded among high income nations. Most resource poor economies in MENA and several Gulf states, including Bahrain, Kuwait and the UAE, have ratios of 50% and over. And as recalled in section 3.2, private credit has increased markedly in a number of countries including Jordan and Morocco, many of the Gulf economies and, off an extremely low base, Syria and Iran.

**Figure 2.9: Bank Assets to GDP in MENA**

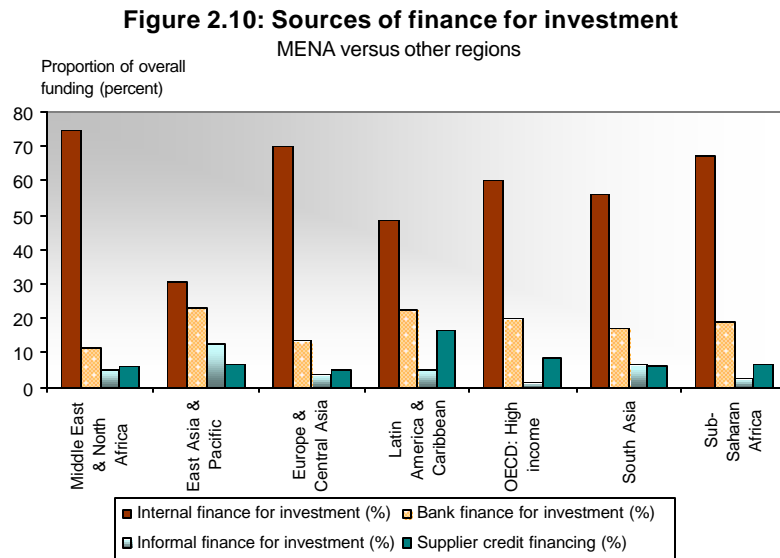


Source: FSDI. Results plotted against average for all middle income economies.

### 2.3.2 However financial sector has limited links to real private economy

Barring a few exceptions, most countries in MENA therefore enjoy a reasonably high level of financial intermediation, deep bank assets and robust onward lending to the private sector. Given the strong observed linkages between finance and development, this would suggest a supportive environment for new investment, economic growth and employment generation at the firm level.

However, World Bank Investment Climate Assessments (ICAs) undertaken within the region provide strong evidence to the contrary. A low proportion of firms access finance and many businesses report that one of the major impediments to growth is both access to and the cost of finance: firms from Algeria, Saudi Arabia and Morocco all highlight finance as a major constraint to their operations.<sup>59</sup> Indeed, evidence suggests that firms in the MENA region have less recourse to bank finance than any other region of the world, with 75% of funding for investment being sourced from retained earnings and only 12% from the banking sector (Figure 2.10).



The phenomenon is widespread across the region. In the case of the resource rich and labor abundant economies, where aggregate private credit is relatively low and much economic activity is still conducted through the public sector, this may be less surprising: the survey of Algerian companies records a mere 16% of investment financing from banks and almost three quarters of all financing from retained profits<sup>60</sup>. In Syria, the level of bank finance is even lower, with less than 5% of working capital or investment financing being secured from the banking sector<sup>61</sup>.

However, a low penetration of bank finance to enterprises is also recorded in resource poor and labor abundant economies such as Egypt and Morocco as well as the Gulf economies of Saudi Arabia and Oman. In Egypt and Morocco, with private credit representing a high 48% and 56% of GDP respectively, banks and financial institutions provide a mere 20% or less of new investment finance<sup>62</sup>. Over 80% of new investments by Egyptian firms were sourced from retained profits and less than 10% from the banking sector, while under 20% of all firms have some form of loan from a financial institution. A similar picture emerges in Saudi Arabia, where internal funds account for 70 – 80% of financing for working capital and new investment, against 10-15% from bank finance. Indeed, less than 40% of all Saudi Arabian firms report having an overdraft facility and just over 20% a loan from a bank<sup>63</sup>.

<sup>59</sup> World Bank Investment Climate Assessments: 29% of firms in Algeria (World Bank 2003h), 80% in Morocco (World Bank 2005f) and 40% in Saudi Arabia (World Bank 2006d).

<sup>60</sup> World Bank 2003h.

<sup>61</sup> World Bank 2005g.

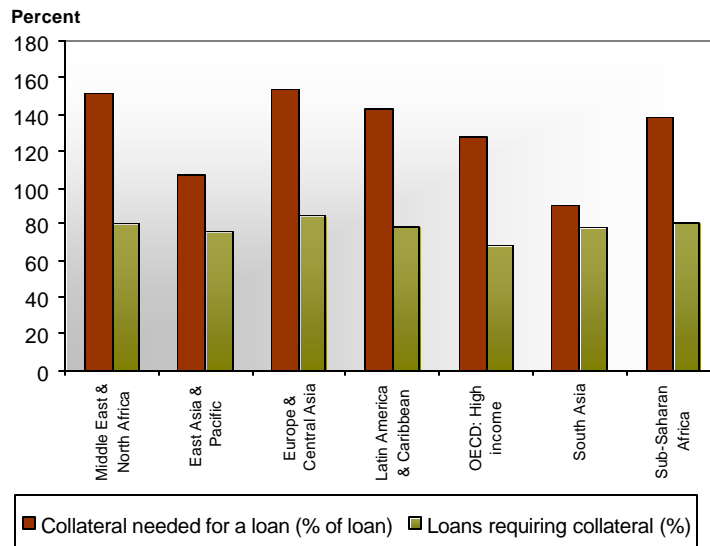
<sup>62</sup> World Bank 2005h (Egypt), World Bank 2005f (Morocco).

<sup>63</sup> World Bank 2006d.

This disconnect between a relatively deep financial sector and the level of firm finance is particularly apparent in the case of smaller companies, where access to bank credit is rarer still. In the case of Algeria, small firms source only 7% of working capital and 13% of investment financing from the banking sector as against 13% and 29% respectively for larger firms. Furthermore, only 23% of smaller companies have an overdraft facility compared to 69% for larger companies. Egyptian companies report a similar divide: of the 17% of firms utilizing the formal credit market, this comprised only 13% of small companies compared to 36% of larger companies. And in Oman, small businesses represent a mere 25% of most banks' lending portfolios, contributing to a low rate of new business formation in the country.

The ICAs also reveal stringent conditions under which loans are made by banks, principally the extremely high level of collateral required. As a region, over 80% of all loans require collateral to be put up by the company, and the average level of collateral represents 151% of the loan (Figure 2.11). This places MENA towards the highest end of regional comparisons, with some countries recording average collateral requirements of over 200% of loan value. A similar disparity in conditionality applied by the size of company, with smaller Syrian companies being required to pledge collateral worth 230% of the loan as against 160% and 182% for large and medium firms respectively.

**Figure 2.11: Collateral requirements in MENA**

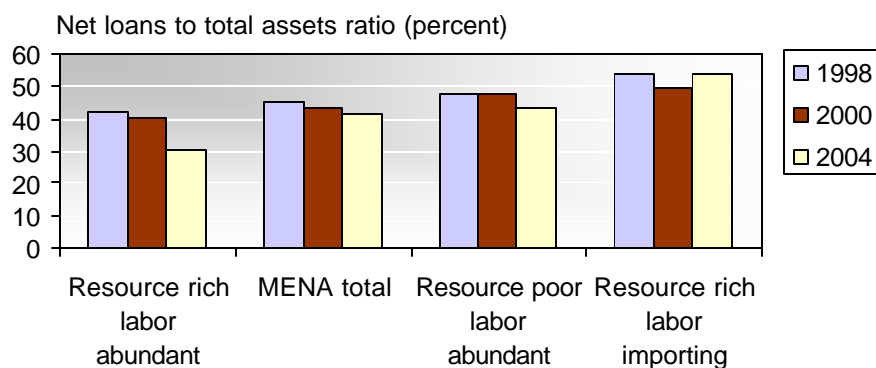


182% for large and medium firms respectively.

## Banking sector demonstrates a marked aversion to lending

A close examination of MENA's banking sector suggests that such low levels of corporate lending are not a function of limited capacity. Indeed, the relative share of loans to total assets fell across MENA from 46% in 1998 to 41% in 2004 (Figure 2.12).<sup>64</sup> Gulf economies exhibit the highest proportion of total assets dedicated to lending at 54%, unchanged since 1998. By contrast, Egypt, Morocco, Jordan and Tunisia all saw a significant expansion in the banking sector's asset base relative to GDP such that, with the exception of Tunisia, the proportion of loans to total assets fell over the period to an average of 43% by 2004.<sup>65</sup> Lebanon also saw a

**Figure 2.12: Lending to assets in MENA**



decrease in loans to total assets, with the ratio for four leading banks standing at below 20% by 2004.<sup>66</sup>

Among the resource rich and labor abundant economies, save Iran, all

saw a substantial fall in the ratio between 1998 and 2004, with the sub-regional average falling from 43% to 31%.

In place of lending, the region's banking systems exhibit a bias toward liquid assets, with cash, deposits with the Central Bank and other financial institutions as well as holdings of government debt forming a large proportion of the sector's asset base, particularly among resource rich and labor abundant economies. Thus, though the oil boom has translated into widespread gains in liquidity for MENA, several factors have acted to undermine access to credit by the wider corporate market as well as the majority of consumers in spite of a seemingly deep financial sector.

<sup>64</sup> Loans is measured net of provisioning.

<sup>65</sup> Tunisia alone saw a high and growing proportion of assets dedicated to lending at 75% (Bankscope).

<sup>66</sup> CIG 2004.

## 2.4 FACTORS INHIBITING THE GROWTH-FINANCE NEXUS IN MENA

In the long-term, the degree to which the financial intermediation of oil related flows will enhance economic efficiency, per capita GDP growth and stability across MENA will depend upon whether assets have been and will continue to be channelled toward productive investment.

Ample empirical evidence exists on the positive and robust relationship between finance to growth. Countries with well developed financial systems tend to grow faster, and financial intermediaries can impact long run equilibrium growth rates through a variety of mechanisms, including mobilizing savings, collecting and analyzing information, screening potential entrepreneurs, allocating investment to highest return projects, exerting corporate control, sharing risk, providing liquidity as well as overcoming asymmetric information problems that typically exist in financial markets.<sup>67</sup>

The channels by which the financial sector can enhance growth include improving resource allocation, enhancing the efficiency of investment, accelerating the pace of total factor productivity growth and technological change and hence contributing to long run economic growth<sup>68</sup>. Another important channel linking financial development to economic growth is the role of well- functioning financial intermediaries in improving borrowing firms' access to external sources of funding hence easing their financing constraints and promoting their investment and growth.

But in MENA, six critical factors lie at the heart of the structural disconnect between the relatively plentiful financial resources found across MENA and the scarcity of external financing for enterprises: (1) high levels of public sector ownership significantly impact the direction of credit, operating efficiency, and the ability of the banking sector to conduct robust risk analysis; (2) regulatory frameworks, with limited market forms of oversight and discipline, have created adverse outcomes for credit allocation; (3) banking access remains comparatively limited across the region and in many cases is restricted to public sector banking networks, concentrating credit provision upon a relatively privileged minority; (4) contractual savings and capital markets remain underdeveloped, removing a source of competition for the banks and an alternate avenue for firm finance; (5) governance structures undermine formal financial relationships across much of MENA; and, (6) a host of problems with the business climate further undermine commercial-finance relationships.

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<sup>67</sup> For a detailed discussion of the role of the financial system in economic growth, see Levine (1997).

<sup>68</sup> Levine, Loayza & Beck (2000a) find evidence of strong links between financial sector development and each of real per capital GDP growth and total factor productivity growth. Wrugler (2000) shows that countries with well developed financial systems improve the allocation of capital by increasing investment in their growing industries and decreasing investment in declining ones, than those countries with underdeveloped financial systems. Kugler & Neusser (1998) establish a positive link between financial depth and technical progress in the manufacturing sector, as measured by manufacturing total factor productivity, in a number of OECD countries.

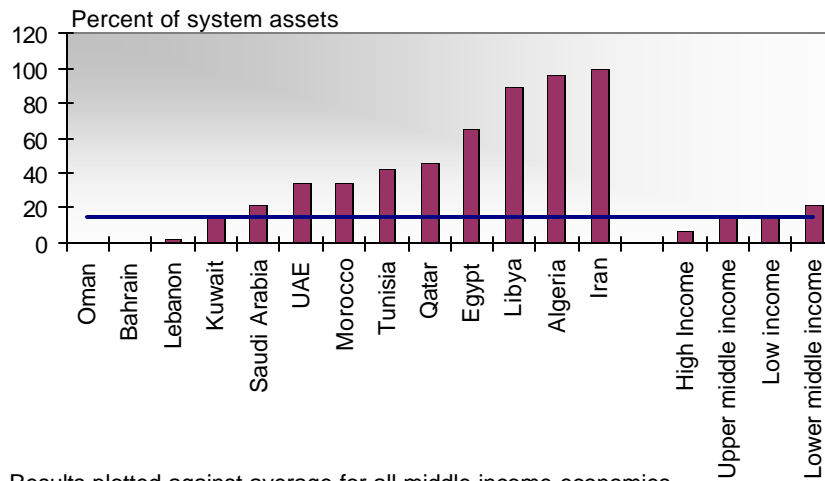
## 2.4.1 Public sector ownership of banking in MENA

As the banking system is the primary conduit for savings and investment in the MENA region, the ownership of the banking sector is a matter of considerable importance to efficient financial intermediation and fostering long-term economic growth.

State ownership in MENA remains high, at 42% of bank assets, double that in middle income countries and six times that in high income countries.

In Libya, Algeria and Iran, 89% to 100% of banking assets is majority controlled by the state while at the other end of the spectrum lie the Gulf states of Bahrain and Oman that have no direct majority state ownership in any bank.

**Figure 2.13: State Ownership of Bank Assets in MENA**



Results plotted against average for all middle income economies.

Morocco, Egypt, Tunisia, Qatar and the UAE stand between these extremes with majority state control of 35% to 65%. Still, these figures understate the often substantial though minority stakes that MENA governments have in the banking sectors: the Omani government owns 40% of the nation's leading bank and the Saudi Arabian state also has a substantial minority positions in 5 banks.<sup>69</sup>

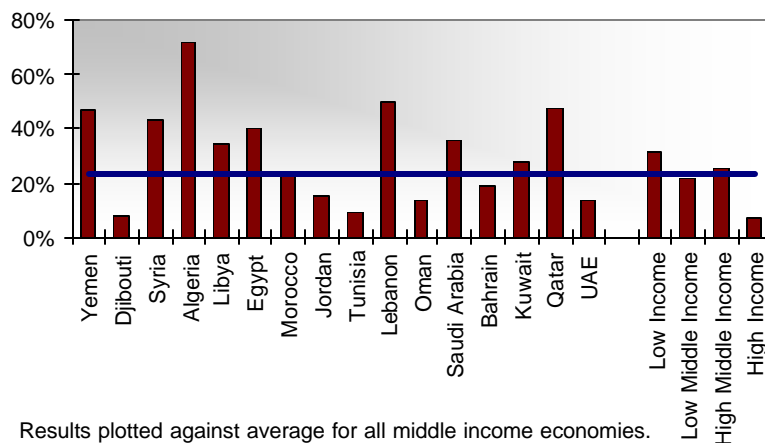
The impact of state ownership appears to have been felt in three key respects: first, high credit provision to the public sector, second, a weak credit culture and endemic inefficiencies and third, low profitability and high non-performing loans.

<sup>69</sup> It is also worth noting the ownership of leading banks or financial conglomerates by individuals closely tied to the ruling family.

## Skewed credit provision across MENA

Even after a decline in exposure to the public sector witnessed in recent years, MENA's banks continue to extend significant credit to the state. At an average of 18% GDP, claims on the public sector by deposit money banks in MENA stand ahead of all comparable income groups in absolute terms. Even after adjusting for the relative share of public credit in total bank credit, MENA stands with a high exposure to the state. At over 30% of total credit, MENA's banking system extends a far higher proportion to the public sector than the 7% found in high income countries or the 20-25% across middle income countries (Figure 2.14). Many of the countries with the

**Figure 2.14: Credit to the public sector, as a percent of total bank credit**



greatest relative exposure to the public sector also exhibit the highest share of majority state ownership of banking assets such as Syria, Algeria, Libya, Qatar and Egypt. The clear implication is that state directed lending to the public sector is a significant driver of resource allocation in many countries, a finding echoed in many ICA reports.

## Weak credit culture

A more intangible effect of high state ownership is the impact of state control on banking practices and risk assessment. A culture of risk aversion and centralized credit allocation appears to be a common theme across MENA's state controlled banks, and is manifested in a lack of qualified credit officers who are capable of assessing business risk. In many countries in MENA, public banks exhibit classic characteristics of unwieldy bureaucracy, poor management and over-centralization of decision making, inhibiting lending to enterprises and efficient resource allocation. In Algeria, for example, state owned banks – the only ones with a large enough network to service SMEs, the bulk of the enterprise sector in Algeria – are bureaucratic, not business-friendly and lack modern information and payments systems. They also have little incentive to take responsibilities or manage risk – partly because of bureaucratic human resource management, as well as explicit constraints imposed by their State shareholder. Decision processes in the public banks are also complex and highly centralized.”<sup>70</sup> In Egypt, the aversion to risk is disproportionate among branch managers and credit officers, because of fear that the

<sup>70</sup> World Bank 2003h.



### ***However, patterns of ownership are beginning to change***

Although state ownership of bank assets and the share of the public sector in total credit remain high, recent years have seen an encouraging trend toward state bank privatisations and the selective opening of domestic banking systems to foreign entrants. Increased profitability, greater integration into the global economy and the prospect of monetary union in the GCC by 2010 has helped drive a wave of cross border investment in the Gulf. Merger and acquisition activity has also accelerated outside of the Gulf and governments are proving more amenable to the entry of foreign banks.

In the resource rich and labor abundant countries, a notable feature has been the issuance of new licenses for private sector banks. In 2004 and 2005 the Syrian authorities issued a total of 6 new bank licenses and in Iran 4 new private banks have come into operation since a law was passed in 2001 (with 2 more licenses issued in 2005).<sup>73</sup> In Algeria, some 15 private banks were issued licenses between 1998-2003, although the six state-owned banks continue to control the overwhelming majority of bank assets.

Privatization and the divestment of residual stakes held by state banks have also been prevalent in Egypt, reducing the total number of banks from 57 at the end of 2004 to 46 by late 2005.<sup>74</sup> Tunisia has also privatized two banks since 2002, while Morocco has seen some consolidation and has announced its intention to sell public stakes in the banking sector. Finally, the Lebanese banking sector has clearly outgrown its borders and banks have acquired positions across MENA in the last few years.

With a monetary union planned for 2010 the GCC financial markets are becoming increasingly integrated. Bahrain, Qatar, Dubai and, as of May, Saudi Arabia<sup>75</sup> are all moving ahead with competing plans to become regional financial hubs and considerable cross-border activity has been seen within the GCC (see Box 2.4). Banks from across the region have opened branches and sought new licenses within each others jurisdictions.

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<sup>73</sup> The Banker 11/05 (Syria) and 08/05 (Iran).

<sup>74</sup> World Bank 2003 g.

<sup>75</sup> Financial Times 05/10/06

#### **Box 2.4: GCC Capital Markets Integration through Competitiveness**

How will the capital markets in the Gulf Cooperation Council (GCC) region continue to evolve? The rules of the game have apparently been changing. The private sector has been taking over the public sector as the driving force of the regional integration of GCC capital markets. As such, competitiveness appears to be more effective than harmonization for expediting capital market integration in the GCC. The initiatives that were launched almost simultaneously by Dubai, Qatar and Bahrain for being a regional financial center illustrate this shift.

Harmonization or compatibility underlies government-backed market integration across the countries in the GCC region. With the exception of Saudi Arabia, the generally small economies of the GCC have had to urge their capital market policymakers to seek cross-border expansion and diversification of supply and demand bases. GCC stock exchanges as national flagship institutions sought the benefits of a substantially larger market in a cooperative manner. Cooperative attempts took the form of cross-listing, trading system networking, and a common settlements system. However, none of them has yet been successful, typically due to delays in technology development, cross-jurisdictional legal problems, disagreements over governance, and difficulties in creating continuing contractual commitments.

Instead, competitiveness has begun integrating GCC capital markets by attracting investors and issuers across borders to particular stock exchanges. Lowering cross-border information costs, coupled with regulatory liberalization in the GCC region, has allowed exchanges to compete for investors and issuers on a regional basis. The average investor and issuer are now able to cross borders in search of return, liquidity, reliability, integrity, variety and transparency at an affordable cost. Information technology and regulatory liberalization have also enabled intermediaries to operate in all the national markets, while placing most of their people and headquarters in a single country. As a result, trading liquidity and/or financial assets converge on a particular market or markets. Furthermore, given the sheer size and the uniqueness of the Saudi market, GCC capital market integration through competitiveness the region may end up with more than one financial centers with own unique focus.

The GCC capital markets have been structurally mutating in favor of market integration through competitiveness. Investment companies, in contrast to operating companies, have been becoming increasingly dominant among companies listed on the GCC stock exchanges. On top of the traditionally oil/gas-centric economy in the GCC countries, excess liquidity due to the recent oil price hike has made financial services one of the industries most in demand in the region. Meanwhile, intermediaries have become increasingly polarized between regional wholesale and local retail institutions. Regional wholesale investment banks have emerged to cover the entire GCC region and some non-GCC Arab countries, providing a broad scope of investment banking services. The separation of wholesale and retail functions in the financial industry normally help to make a wider range of financial products available to end-investors. On the demand side, mass affluent investors have been “massively” joining high net-worth investors or ultra high net-worth investors<sup>1</sup> in capital market activity. They are generally sensitive to delivery costs of financial services. Mobilizing them and integrating their investment behavior are likely to lead to regional market integration.

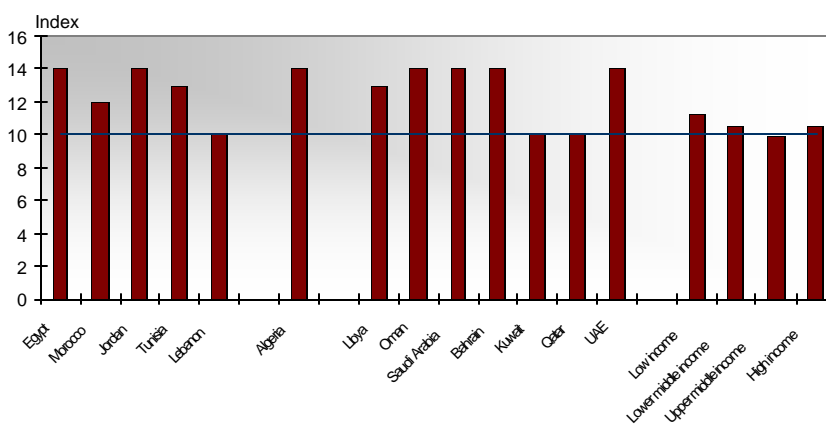
Yet, it is still too early to determine which market has achieved capital market integration with its competitiveness. Relatively new markets like the Dubai and Doha markets have not experienced a full market cycle. They have yet to be tested for their sustainability and resilience in all aspects of market function. As mass affluent investors learn lessons, the competitiveness factors in the GCC region may further evolve. In addition, competitiveness factors leading to market integration are likely to differ between fund-flow activity (e.g. trading, corporate finance) and fund-stock activity (e.g. asset management). We have so far only been seeing the cars running simply straight ahead.

## 2.4.2 Regulatory frameworks and limited private monitoring

Another manner in which MENA's public sector exhibits substantial influence over the financial sector concerns official powers to regulate and supervise the banking industry. In terms of both official supervision as well as the restrictions placed upon bank activities, authorities exhibit significant control. However, this is not unambiguously positive for efficient outcomes. While regulatory regimes are designed to address the host of principal agent problems that the banking sector faces, recent evidence suggests that the institutional environment and ownership of bank assets can have a significant effect, both positive and negative, upon the manner in which supervision and regulation actually impacts financial intermediation.<sup>76</sup>

MENA is characterized by extremely powerful 'hands-on' supervisory authorities with wide ranging powers to prevent and correct problems and regulate activities. Supervisory officials have considerable powers to investigate and take action against banks suspected of fraud or negligence, including the power to intervene and restructure banks, remove management and supersede

**Figure 2.16: Official bank supervisory powers in MENA**



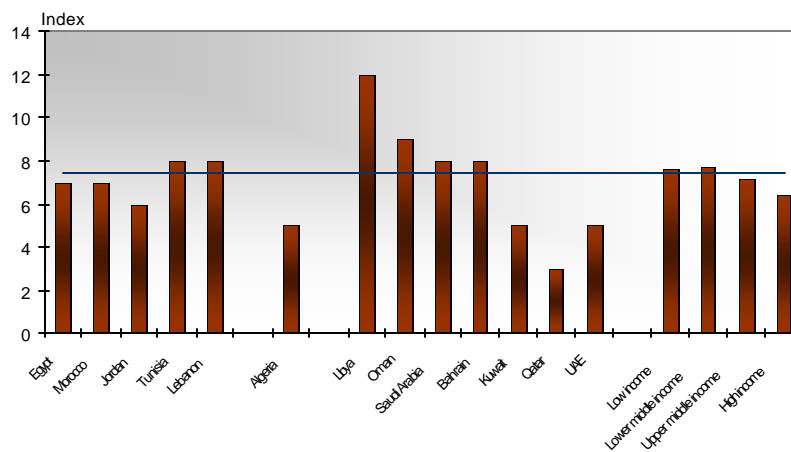
Official Supervisory Powers Index from 1-14, with higher values indicating greater official supervisory powers: the right to meet with external auditors to discuss their report without the approval of the bank, take legal action against external auditors for negligence, force a bank to change its internal organizational structure and order the bank's directors or management to constitute provisions to constitute provisions to cover actual or potential losses. Results plotted against average for all middle income economies  
Source: World Bank 2003g.

shareholder rights where it is considered necessary. Only a few countries, including Kuwait, Lebanon and Qatar, exhibit supervisory regimes with lesser powers of intervention than the average for middle income economies worldwide.

<sup>76</sup> See Barth, Caprio and Levine 2006.

MENA economies are also relatively restrictive in terms of range of activities they allow to be conducted within the banking system, with few countries falling far below the average for all middle income economies, and a few countries maintaining relatively restrictive regimes, including Libya, Tunisia and Lebanon (Figure 2.17). Turning to market discipline and the degree to which private market forces monitor and enforce prudential standards upon the banking sector, MENA registers a strong degree of private monitoring, ahead of the high income average and in line with countries such as the US and Japan.

**Figure 2.17: Restrictions on bank activities**



Restriction on Bank Activities Index from 1-12, with higher values indicating greater restrictiveness: whether banks can engage in certain activities, such as securities, insurance and real estates. Results plotted against average for all middle income economies  
Source: World Bank 2003g.

### ***What kind of regulation may matter more than how much there is***

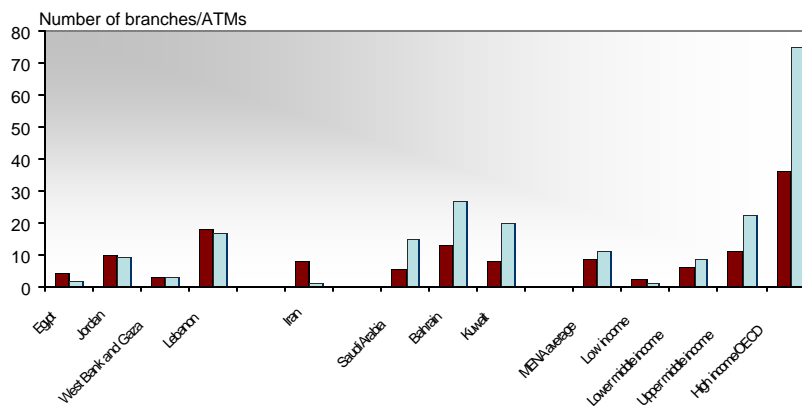
But recent analysis of banks worldwide suggests a broad separation between those countries which rely less on official supervision and more on private sector monitoring to ensure efficiency and transparency in the banking sector, and those countries which tend to have higher state ownership of the banking sector and tight supervisory and regulatory regimes with limited market monitoring. The latter were found to have banking systems that were at a relatively low level of development and exhibited a higher tendency toward inefficient resource allocation.<sup>77</sup> Looked at through this prism, the relatively high state ownership and tight supervisory and regulatory regimes across MENA may mean that many banking systems are at risk of performing poorly *because* of a combination of high supervisory powers and low private monitoring.

<sup>77</sup> Barth, Caprio, and Levine 2006. The report finds an empirical relationship between tight regulation of bank activity, high state ownership and poor bank performance and less stability. In addition, the authors find little relationship between the strength of capital requirements in a banking system and bank development, efficiency, governance or corruption.

### 2.4.3 Limited bank access

As a whole, MENA also exhibits below average access to banking facilities, in part due to poor physical access. In terms of number of bank branches and ATMs per 100,000 people, MENA

**Figure 2.18: Financial Access in MENA**



Source: FSDI.  
Number of branches and ATMs per 100,00 persons.

ranked ahead of low and lower-middle income countries, but still falls far short of high income comparisons (Figure 2.18). In addition, relative to GDP per capita, average loans and deposits are large.<sup>78</sup> Both measures indicate that the banking sector may currently serve a relatively wealthy

segment of the population. Given the importance in providing basic banking services to the smaller firms and the poorer segments of the population, skewed access is an issue to address.

### 2.4.4 Underdeveloped capital markets

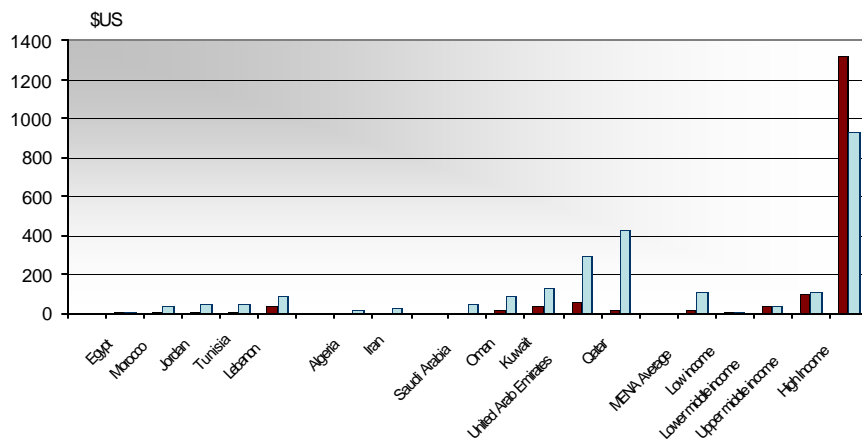
Deepening contractual savings markets and ensuring wider access to these instruments are of great importance to the development of financial markets as well as long-run economic growth. The creation of transparent and accessible instruments for insuring against risk can generate a valuable pool of long-term savings for investment. These can provide the building blocks for market liquidity and create new financing options for the corporate sector and the state: from venture capital to the securitization of mortgages. At the level of the household or individual, contractual savings provides a critical risk management tool, enabling savers to insure against death, disability or retirement.<sup>79</sup>

<sup>78</sup> World Bank 2004a (Jordan, Lebanon and Saudi Arabia).

<sup>79</sup> See Catalan, Impavido and Musalem 2000 for discussion on contractual savings benefits for the real economy.

At present, the contractual savings industry remains relatively underdeveloped in MENA, with asset accumulation overstated and its performance is often marred by high state intervention. The failure to develop a substantial pool of contractual savings across MENA has inhibited the

**Figure 2.19: Premiums per capita in MENA**



Sources: Swiss' SIGMA; World Insurance 2004.

with total written premiums worth 2% to 3% GDP. On a per capita basis insurance premiums average US\$120 per capita in MENA, ahead of low and lower middle income countries, however the majority of written premiums consist of non-life (casualty and property) insurance, at US\$103 per capita. The more discretionary life insurance sector amounts to only US\$17 per capita (Figure 2.19).

At just over 14% of GDP, accumulated state pension assets in MENA are significantly lower than the 43% recorded for G10 countries.<sup>81</sup> But some state schemes within the region appear large, at least on paper, such as Saudi Arabia and Bahrain with over 50% of GDP in accumulated assets, Egypt at 45%, Yemen at 34% and Jordan at 23%. To put these figures in perspective, the United States and United Kingdom have pension assets worth some 66% GDP, while Japan stands at only 13%.<sup>82</sup>

However, current asset values can be hard to determine, as the true value of accumulated state assets in MENA is rarely well accounted for. For example, some 85% of the 'surplus' assets of the Egyptian state pension fund is by law invested in government debt, creating a circular relationship in which the 'virtual' reserves of the fund are swamped by the government's total implicit deficit to the system of 140% GDP. But also, a seemingly large stock of assets can still fall short of pension liabilities. Excessively generous state retirement benefits, often extended to a small proportion of the population, have led to massive unfunded future liabilities in much of the region. Typically state pensions in MENA are guaranteed at an average 80% of earnings prior to retirement. As an example, a retiree in Egypt can earn more income following retirement than

<sup>80</sup> In terms of total written premiums (life and non-life) for domestic business by registered insurers.

<sup>81</sup> MENA data from Robalino 2005. G10 data from OECD 2005a.

<sup>82</sup> OECD 2005b.

while working due to differential tax treatment. Besides creating massive actuarial liabilities, these schemes also act as a strong disincentive to save outside the mandatory state structure. The final result is actuarial deficits as high as 50% in Iran and 170% in Jordan.<sup>83</sup>

Even where pension and insurance assets have been accumulated there is significant evidence of these funds being diverted away from the real economy toward state deficit financing. In Egypt some 40% of insurance assets were placed on deposit at public sector banks with a further 25% placed in government securities. In Lebanon and Libya 50% and 64% of pension fund assets are invested in government debt, while the supposedly independent public pension fund managers in Morocco saw the minimum required asset allocation in government securities raised from 80% to 88%.<sup>84</sup>

### ***Equity markets remain concentrated in the GCC***

As noted in section 2.2.4, equity markets in MENA enjoyed a spectacular run up over 2002 – 2005. However, with the notable exception of Iran, equity markets remain absent from most of the resource rich and labor abundant economies, and with the obvious exception of Jordan, the majority of markets within the resource poor and labor abundant economies remain small relative to the size of their underlying economies. As a result, the Gulf states have come to represent a greater proportion of the region's total market capitalization, rising from 73% in 2002 to 86% by late 2005. Liquidity has become similarly concentrated, with the majority of markets outside of the Gulf trading less than US\$10mn per day in 2005 in comparison to the US\$4.6bn average daily turnover in the Saudi market.

As markets became more liquid after 2002, many of MENA's largest companies raised equity capital for the first time, somewhat decreasing dependence upon the banking sector and raising the breadth and depth of investment opportunities to investors. However, the scale of new listing must not be overstated. The shortage of new supply may have been, in fact, as large contributory reason for the dramatic increase in stock prices over the period. The total number of stocks in the GCC rose by only 50 between 2003 and 2005 and 62 across all the emerging economies. In addition, the majority of new corporate listings were concentrated in the markets of Jordan and the UAE.

The partial privatization of state companies through equity offerings to nationals has been characteristic of many MENA markets in recent years: both Jordan in 2002 and Morocco in 2004 divested of minority stakes in their respective state-owned telecom carriers, in the latter case almost doubling the size of the equity market. In the Gulf, state utilities from the UAE, Saudi Arabia and Oman were issued onto the market. This often had a catalytic effect, as in the case of Saudi Arabia, where the listing of the national telecom carrier increased the size of the market by over 40% and encouraged a wider participation by Saudi Arabians in equity investment.

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<sup>83</sup> While many countries, including Egypt, Jordan, Morocco and Lebanon, are in the process of addressing this issue, other countries, such as Algeria, Libya and Syria, have yet to adequately tackle the problem (Robalino, 2005).

<sup>84</sup> Robalino, 2005.

However, public sector divestment has lagged potential supply, with substantial state ownership of assets prevalent across the region.

The increased competition between countries to develop regional financial centers has encouraged some loosening in the historically tight control on non-national participation in the local equity markets. To the degree to which this encourages mediating foreign flows of capital and new sources of research and evaluation this should heighten the knowledge base of the market. However, despite recent changes in the Gulf, foreign investment in the markets remains very limited and regulators will need to tackle not only legal restrictions on non-GCC participation, but also corporate transparency and minority shareholder rights before there will be increased flows into the region. Even where non-GCC investors have had increased latitude to invest, actual participation has been limited: in Bahrain, non-GCC investors represented only 2% of traded stocks by value while non-GCC ownership stood at around 7% in Oman.

The consequence of foreign ownership restrictions has been most obvious in the relative under-representation of the MENA region in global equity indices. Taking the index weighting of the unrestricted S&P/IFC Emerging Markets General index it is clear that the region gained considerable representation by late 2005, in particular Saudi Arabia with a weight of almost 12%, in line with established market heavyweights such as Korea and Taiwan and ahead of Russia and Brazil (Table 2.2). However, within the S&P/IFC Investible index, which takes into account the ability of foreign investors to actually participate in the market, the region's representation falls to 1.4%, comprising only Egypt and Morocco. It is illustrative to note that if the region had been ranked purely on market capitalization it would have represented some 17.5% of the entire emerging market's universe toward the end of 2005.

**Table 2.2: MENA equity market representation in Global indices**

As of November 2005	IFCG Market Cap (\$USbn)	Weight in IFCG composite	IFCI Market Cap (\$USbn)	Weight in IFCI composite
Egypt	20	0.8	19	1.0
Morocco	8	0.3	7	0.4
Jordan	21	0.8	..	..
Oman	5	0.2	..	..
Saudi Arabia	304	11.9	..	..
Bahrain	8	0.3	..	..
Korea	390	15.3	369	19.5
Taiwan	287	11.2	283	15.0
Russia	228	8.9	122	6.4
Brazil	207	8.1	196	10.3

Sources: S&P; IFCG.

## ***Bond markets almost non-existent outside of GCC***

In the long-term, the creation of liquid bond markets would prove enormously beneficial to the majority of MENA's economic actors. The state can benefit from decreased dependence upon external debt and be provided with an additional tool to manage domestic liquidity. Corporations, both private and public, would have access to a new pool of long-term capital, particularly well suited to large infrastructure projects. Savers too would be provided with a range of new instruments and this will be of particular use to the contractual savings industry which requires assets to match long term.

Largely absent from MENA's financial system until recently, secondary bond markets have begun to develop, particularly in the Gulf region. A combination of rising liquidity, substantial domestic investor appetite for longer term assets and local ambitions to launch regional financial hubs has helped create a favourable momentum for the establishment of local infrastructure. Principally this has comprised the creation of tradable government securities which has facilitated some local corporate issuance. Both public and private issuers have launched bonds that accord to the principles of Islamic finance and these have met strong demand from local and international investors who face a shortage of such instruments.

However, while an encouraging start has been made, outside of the Gulf and a few resource poor economies, bond markets remain almost non-existent. Even within the Gulf, the liquidity of secondary markets remains low and actual trading is slight. The number of corporate issues is also small relative to the size of local economies.

Despite a preponderance of domestic debt financing in the Gulf, the region had not developed liquid secondary markets for government debt by the late 1990s. Instead, states historically used captive institutions such as state banks and pension funds to fulfil the majority of their financing needs. This inhibited the creation of a benchmark yield curve and restricted the corporate sector's financing options.

Recent years have seen some signs of change. Several borrowers have begun to construct market infrastructure and commenced issuance programs.<sup>85</sup> However, liquidity remains low in absolute terms and relative to the size of the local economy, resulting in constant excess demand for issuance and bonds that are tightly held once issued.

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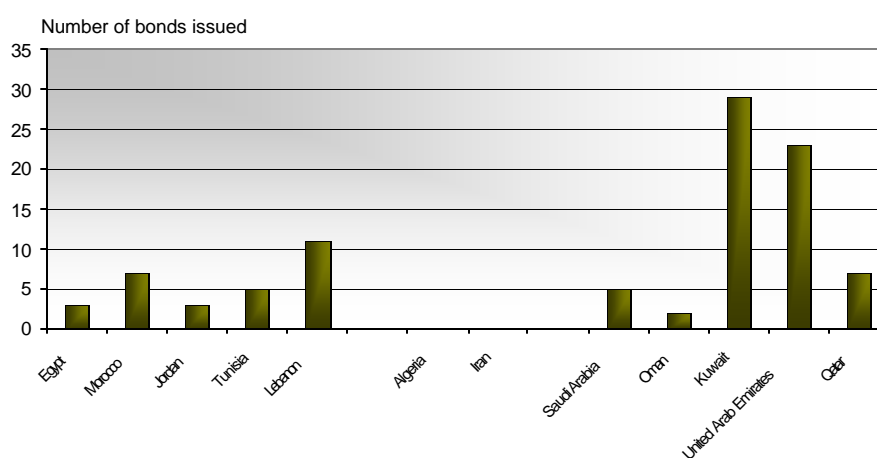
<sup>85</sup> In Kuwait and Oman, a limited market for domestic government debt has arisen, with the issuance of Treasury and Development bonds. In both cases however overall supply remains limited relative to demand and greater liquidity will be needed before bonds are less tightly held by their buyers. Bahrain has issued over 20 bonds locally, primarily Islamic, establishing a range of maturities which it issues according to a pre-announced calendar. However, the overall size of issued instruments remains small relative to the size of the economy and these also seldom trade. In Saudi Arabia the process remains at a very early stage, with a government initiative to establish a market for public debt only initiated in 2005.

### **...and this has created a limited market for corporate bonds**

With the development of formal market mechanisms and an investor base keen to access fixed income instruments, corporations have taken advantage of abundant domestic liquidity and the number and sophistication of corporate issues has increased, particularly in the area of Islamic finance. A sample of corporate sector debt across MENA reveals increasing issuance over recent years with the annual total rising from below 10 over 1999-2001, to 15 in 2002, 23 in 2004 and 41 in 2005.<sup>86</sup>

However, issuance has been concentrated within the Gulf economies and largely in only three countries: the UAE, Kuwait and Bahrain (Figure 2.20). By contrast in Saudi Arabia, the GCC's largest economy, the corporate debt market remains very small, though may begin to expand as a result of government initiatives concerning public debt as well as likely issues from leading state enterprises.<sup>87</sup>

**Figure 2.20: Bond Issuance in MENA**



Sources: Bloomberg.

#### **2.4.5 Poor quality governance can undermine financial intermediation**

There is an established link between the effectiveness of the institutional environment and a well-functioning financial system. As a result, issues relating to the quality of public sector administration have important implications for the growth-finance link. In addition to fair and transparent legal systems, limited corruption and bureaucratic effectiveness are critical to effective financial intermediation and assuring proper financial sector regulation and supervision.

<sup>86</sup> All listed corporate debt taken from Bloomberg and includes some international bond issues 1999 – 2005.

<sup>87</sup> SABIC and the Saudi Electricity Company are expected to issue in 2006, the first a SAR1bn issue is anticipated to be Islamic (The Banker 04/2005 and EuroMoney 09/2005).

As will be discussed further in Chapter 3, most of the resource rich labor importing economies of the GCC register well across many dimensions relating to the quality of public sector administration, but there is variation among the group, and countries continue to fall short of best practice established among high income OECD countries. Additionally, the severely poor showing in overall quality of public sector administration by some countries, particularly among the resource rich and labor abundant group, raises fundamental questions as to how well their financial systems are currently operating. The governance deficiencies exhibited in a few countries suggests development will be stunted unless these issues are addressed (see Chapter 3).

#### **2.4.6 A business climate not conducive for lending**

Finally, a range of issues related to the business climate impinge on a well functioning relationship between the financial sector and the real economy. Deficiencies in MENA's business and regulatory structures have been strongly felt in contract enforcement and the availability and quality of financial information. The natural outcome has been a bias on the part of MENA's banks toward relationship banking, lending to larger companies with sufficient collateral as well as the public sector or high net worth individuals. Regional surveys suggest that such conservatism is widespread in MENA. Moroccan banks appear to compete for business from a relatively small pool of large corporate borrowers, typically where there has been a long term relationship of ten years or more and the borrower can demonstrate significant collateral.<sup>88</sup> Elsewhere, the ability to secure loans directly against salaries has made the high end of the retail market an attractive proposition for banks. In Oman, the high profits and perceived lower risk of lending secured by salaries has lessened bank penetration into the smaller company segment. Similarly, Saudi Arabian banks continue to compete fiercely in the retail segment to the detriment of the enterprise sector:

The low likelihood of collecting collateral in the face of default as well as difficulties in valuing collateral or even registering it in the first place have made MENA's banks reluctant to lend. In addition, a lack of reliable financial information and shortages in sufficiently skilled credit officers has pushed many banks toward demanding very substantial collateral when loans are extended: in Syria and Morocco collateral stands on average at 217% and 230% of the value of the loan while in Egypt collateral represents a still high 130%.

Not only is the rule of law inadequate across much of the region, but so is the capacity of the judicial system and the specific design of collateral and bankruptcy laws. ICAs across MENA point to acute deficiencies in legal systems: in Morocco, one third of surveyed firms cited the judiciary system as a major constraint on growth with almost a fifth mentioning corruption and administrative constraints (such as obtaining licenses and permits) as further obstacles.<sup>89</sup> In Syria and Algeria the judicial system was repeatedly pinpointed as a major impediment to financial intermediation, with cost, lengthy procedures, insufficient staffing and expertise and poor enforcement deterring enterprises from utilizing legal redress. Only 1% of Syrian firms surveyed

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<sup>88</sup> World Bank 2005f.

<sup>89</sup> World Bank 2005f.

had used the legal system to resolve business conflicts over the prior three years<sup>90</sup> and in Algeria 93% of cases involving smaller companies had been settled privately and only 2% through the judicial system.<sup>91</sup>

In terms of securing collateral in bankruptcy proceedings. ICA evidence and cross regional surveys paint a similarly difficult picture. ICA evidence from Algeria and Syria suggests that collateral collection is not only time consuming, but difficult to enforce while in Egypt repossession of immovable collateral can take 7-8 years for court approval and making a public sale. World Bank Doing Business surveys support these country specific findings, with contracts proving time consuming to enforce, with numerous procedures and creditors ending with a very low recovery rate on their loans. Not only does this lessen the likelihood of lending, but can seriously impede the development of important segments of the financial marketplace. One of these has been the leasing business across MENA, with an inability to collect upon collateral a serious obstacle to establishing what, in many countries, is often a vital source of finance for smaller companies: Saudi Arabia and Egypt's volume of leasing business relative to GDP stands at only 0.1% and 0.8% respectively as against 1.8% in North America and 3.4% in Asia.<sup>92</sup>

As important as enforcing collateral contracts in the event of bankruptcy is the ability to register property in the first place and many companies face difficulties and high costs in doing so. Often land and other immovable assets prove to be the chief asset of smaller companies and an inability to record title can lock companies out of the credit market.

Corruption is also cited in a number of ICAs as an impediment to financing. Many firms choose to opt out of the formal sector rather than surmount the repeated inspections, taxes and administrative red tape that are required to operate a business, often negotiated with the help of 'informal' payments. The impact of corruption upon financing is two-fold: first, firms may prefer to self finance or seek financial support through informal networks of friends and family rather than deal with formal institutions, second, where formal channels are used, a separate set of books may be presented to financiers, presenting difficulties of risk assessment. The ICA for Algeria notes that most firms underreport sales and have no certified balance sheets, self selecting out of the formal credit market while in Syria the typical business experiences around 25 inspections a year. Typically over half of these encounters involve some expectation of informal payment."<sup>93</sup>

Banks across the region cite poor quality of information and a lack of high quality investment projects as a severe impediment to increased enterprise finance. Evidence from ICAs paints a picture of poor transparency and limited disclosure by firms. In Morocco, less than 20% of firms have financial statements that have been certified by an external audit and the banking sector notes a lack of creditworthy or viable investment projects.<sup>94</sup> In both Algeria and Syria, ICAs point to systematic under-reporting of sales. In the latter less than 35% of firms have audited financial statements and many firms are reported to keep two sets of accounts.

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<sup>90</sup> World Bank Syria 2005g.

<sup>91</sup> World Bank Algeria 2003h.

<sup>92</sup> Data taken from the World Leasing Yearbook 2001 to 2005.

<sup>93</sup> World Bank 2005g.

<sup>94</sup> World Bank 2005f.

## **2.4.7 Improving the impact of financial sectors on growth in MENA**

Record oil receipts and strong economic growth present an important challenge for the financial systems of MENA, to channel this liquidity into the real economy, boosting sustainable, efficient and equitable growth.

In some countries, particularly the GCC, the financial system is beginning to act as a more efficient conduit for savings: lending to the private sector is rising, capital markets have somewhat deepened and national systems have become more integrated into the global financial system. With several states vying to become regional financial hubs, competitive pressures are likely to accelerate further market development and opening, with positive spillover effects for the wider economy.

At the other end of the spectrum lie several financial systems that, despite recent growth in lending to the private sector, are relatively underdeveloped in scale and sophistication, characterized by high operational costs, weak risk management practices and poor asset quality. Largely isolated from outside influence and with sometimes non-existent capital markets, the real economy remains dependent upon a fragile banking system that is inadequate to the task ahead. Not only has this impeded current growth, but may create future vulnerabilities when the present pace of economic growth subsides.

For the region to meet the challenge of effectively intermediating the large oil related flows, and to build the financial infrastructure that can be an engine for growth and productivity improvements, the region must address a range of underlying structural deficiencies that inhibit efficient and sound resource allocation. In the chapter that follows, the recent progress with some of these reforms is evaluated.

## STRUCTURAL REFORM PROGRESS FOR LONG-TERM GROWTH

### 3.1 INTRODUCTION

Although continuing high oil prices are expected to contribute to solid growth for oil producers in the medium term, and an anticipated recovery in European demand should provide for stronger economic growth among the region's resource poor labor abundant economies, longer term growth prospects throughout the region depend upon the progress that is made in transitioning to sustainable sources of stronger economic growth and job creation, through implementing broad-based structural reform.

Over the last three to five years, MENA has taken a number of steps to transition to more open, private-sector oriented economies with more efficient and accountable governments. With the large windfall revenues accumulating to oil producers since 2002, a natural question emerges as to what impact oil is having on the reform process. As noted in chapter one, the large budget surpluses accumulating to oil producers appear to have delayed the imperative for reform of the oil subsidy system in resource rich economies. Based on structural reform measurements, oil producers<sup>95</sup> have also exhibited weaker reform progress over the last several years than the region's resource poor<sup>96</sup> economies along two major structural reform fronts: improving the business climate and liberalizing trade.

However, the more subdued progress made by oil exporters in these areas of reform in large part reflects lack of improvements among GCC economies, which have traditionally maintained more open and business-friendly trade and investment policies. Perhaps more importantly, as a group, the oil economies have demonstrated long-awaited progress in governance, an area in which the group demonstrates significant deficit relative to the rest of the world. Specifically, notable progress has taken place over the last five years in enhancing public sector accountability mechanisms, which augers well for continuing reform success. Although oil economies continue to rank in the bottom twentieth percentile relative to the rest of the world in terms of measures of public sector accountability (including political and civil liberties, freedom of information, etc<sup>97</sup>), over the last five years, oil economies have made greater progress in improving public sector accountability than all other regions of the world, on average ranking in the 66<sup>th</sup> percentile worldwide with regard to improving public accountability.

Worldwide, successful reform efforts have depended critically upon the support and participation of those in society whom reforms will impact. The governance improvements in

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<sup>95</sup> Resource rich (oil) economies include resource rich labor importing economies Bahrain, Kuwait, Oman, Qatar, United Arab Emirates, Saudi Arabia, and Libya, and resource rich labor abundant economies Algeria, Iran, Iraq, Syria, and Yemen.

<sup>96</sup> Resource poor economies include Djibouti, Egypt, Jordan, Lebanon, Morocco, Tunisia, and the West Bank and Gaza.

<sup>97</sup> See Appendix B for description and methodology behind governance indices.

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

With diminishing positive links to the oil economies (and increasing negative impacts from higher oil prices), the resource poor economies in the MENA region have maintained a solid pace of reform, generally exceeding other regions of the world across all areas of reform. Strong achievements have come in improving the business and regulatory environment (resource poor economies rank, on average, in the 63<sup>rd</sup> percentile worldwide with regard to improving the business environment, higher than all other regions of the world but Europe and Central Asia). Trade reform (in terms of reducing average tariffs) has also advanced strongly, largely in connection with recent bilateral and multilateral trade agreements. Led by deep tariff reductions undertaken in Egypt, progress among resource poor economies, on average, outpaced all other regions of the world, with resource poor countries on average ranking in the 71<sup>st</sup> percentile with regard to tariff reform. Nonetheless, much greater trade liberalization can take place. The resource poor economies as a group continue to maintain some of the highest tariffs in the world, ranking in the bottom quartile worldwide with regard to low tariff protection.

Resource poor economies also made strong advancements in the area of governance. Measures to improve public sector accountability resulted in resource poor economies ranking, on average, in the 62<sup>nd</sup> percentile with regard reform progress over the last five years, second only to the gains made by the region's resource rich economies. In improving the quality of public sector administration, however, the group realized even stronger progress. With a number of efforts toward public sector modernization, civil service reform, and anti-corruption legislation, resource poor economies ranked on average in the 82<sup>nd</sup> percentile with regard to reform, the strongest progress worldwide, led by achievements in Egypt, Tunisia and Morocco.

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

## 3.2 MEASURING STRUCTURAL REFORM

The World Bank Middle East and North Africa region's recent flagship reports on trade<sup>98</sup>, governance<sup>99</sup>, employment<sup>100</sup>, and gender<sup>101</sup> highlight an extensive list of development challenges facing MENA countries over the coming decades. Many of these challenges are well known, and they encompass a broad range of sectors and themes, from managing scarce water resources, to reducing poverty, to promoting gender equity. But one issue: employment creation, was identified as perhaps the single most important economic development challenge facing the region<sup>102</sup>, requiring three fundamental and interrelated realignments on the part of MENA economies: (1) *from closed to more open economies*, to create more competitive industries, to benefit from international best practice, and to gain access to new technology; (2) *from public sector-dominated to private sector-led economies*, to provide the basis for improved efficiency and expansion of employment; and (3) *from oil-dominated to more diversified economies*, to reduce the region's dependence on volatile sources of growth, maintain fiscal stability, and preserve important social expenditures. Achieving these realignments require interrelated policy actions on several fronts, including improved governance, particularly with regard to strengthening inclusiveness and accountability<sup>103</sup>.

For the first MENA Economic Developments and Prospects report (MEDP) published in 2005, we attempted to better understand how the region is faring with this economic realignment by constructing a set of structural reform indicators – indicators which could allow us to both see where the MENA region stood relative to the rest of the world in various areas of reform, and as importantly, indicators which could allow us to monitor the progress the region is making in this transition. For that report, structural reform indices were constructed in three key areas of reform: *trade orientation*, *business climate* and *governance*. Incorporating a range of relevant indicators available at the time of the report's publication, composite indices of reform were constructed in each reform area for 2000 and 2004 (the most recent available data at that time), to analyze the region's reform progress.

In this year's MEDP, we again aim to evaluate reform across these three broad areas, to both understand where countries currently stand relative to one another, and to monitor reform progress over time. In the meantime, across all three areas of reform, additional indicators have become available which strengthen our true understanding of the current reform status in each country. In the area of trade orientation, for example, new information has become available on behind-the-border constraints to trade, as well as the extent of non-tariff barrier coverage. New

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<sup>98</sup> World Bank 2003a.

<sup>99</sup> World Bank 2003b.

<sup>100</sup> World Bank 2003c.

<sup>101</sup> World Bank 2003d.

<sup>102</sup> World Bank 2003e.

<sup>103</sup> World Bank, 2005a.

indicators have also been added to our measurements of governance reform and business climate reform, particularly in the area of financial sector development, the theme of this year's MEDP<sup>104</sup>.

Utilizing these reform indicators, the following chapter evaluates the recent progress that has been made by the region on the structural reform front. Since many economic reforms take time to result in measurable development outcomes, we also discuss the region's more recent efforts and emerging trends. The chapter proceeds as follows: In section 3.3, the region's progress with trade reform is examined, highlighting the trade initiatives undertaken and measuring progress in lowering trade barriers. In section 3.4, progress on improving the business climate is discussed, highlighting the region's recent efforts at liberalization and measuring progress in improving the business environment based on a range of business climate indicators. In section 3.5, we highlight the region's progress with governance reform, both in improving the quality of administration and in improving government accountability.

### **3.3 OUTWARD ORIENTATION IN MENA**

#### **3.3.1 Developments in trade reform**

Much of the region's recent progress with structural reform has occurred in the area of trade policy, especially in connection with a recent proliferation of bilateral and regional trade agreements. The region entered the new millennium with high average tariffs (averaging 19 percent), and with pervasive use of non-tariff barriers (NTBs), on average covering more than 14 percent of tariff lines (Table 3.1). Add to that, the MENA region had extensive behind the border constraints, including high transport, logistics and communication costs, raising the overall costs (and disincentives) to trade.

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<sup>104</sup> Because much of this new information is only available for 2005, it is not possible to evaluate progress with reform utilizing the new information. As a result, the evaluation of the current status of structural reform (based on the widest set of indicators available in 2005) is not entirely comparable our measures of structural reform progress (based on a more limited set of indicators available in both 2000 and 2005). For a fuller description of the data and methodology behind the structural reform indicators, see Appendix B.

**Table 3.1: Trade protection in MENA, 2000<sup>a</sup>**

Country/region <sup>b</sup>	Simple Average Tariff	Non-tariff barrier coverage <sup>c</sup>
Algeria	24.0	7.4
Bahrain	7.9	7.7
Djibouti	31.0	..
Egypt	21.4	26.6
Iran	41.1	39.1 <sup>d</sup>
Jordan	23.1	0.1
Kuwait	3.6	..
Lebanon	10.7	22.3
Libya	17.0	..
Morocco	30.5	18.2
Oman	5.7	1.7
Saudi Arabia	12.0	1.9
Syria	21.0	..
Tunisia	29.1	16.8
Yemen	12.8	..
<b>MENA</b>	<b>19.4</b>	<b>14.2</b>
Resource Poor	24.3	16.8
Resource Rich	16.1	11.6
Resource Rich Labor Abundant	24.7	23.2
Resource Rich Labor Importing	9.2	3.8
ECA4	9.1	13.2
LAC4	14.5	10.5
EAP5	13.0	28.8

a. . Or closest available year. b. Regional average represents the simple averages of the data for the respective countries they represent. c. Non-tariff barrier coverage refers to the number of tariff lines that have at least one core non-tariff barrier (quantitative restriction). d. Number of tariff lines requiring license from Ministry of Industry (from World Bank, 2001). The comparators are ECA4 (four countries in the Europe and Central Asia region – Czech Republic, Hungary, Poland and Turkey), LAC4 (four countries in the Latin America and Caribbean region – Argentina, Brazil, Chile, and Mexico), and EAP5 (five countries in the East Asia and Pacific region – China, Indonesia, Malaysia, Republic of Korea and Thailand). Source: UNCTAD (UNCTAD staff estimates provided for this report).

Since 2000, the MENA region has made significant strides in reducing obstacles to trade, partly in conjunction with bilateral and multilateral trade agreements. In many economies in the region: Algeria, Egypt, Jordan, Lebanon, Morocco, the WBG, Syria, and Tunisia, tariffs have been reduced and non-tariff barriers dismantled with the region's largest trading partner, the European Union (EU), as part of the EU Association Agreements. Other bilateral and regional agreements (including free trade agreements with the United States in Jordan, Morocco, and Bahrain; the Pan-Arab Free Trade Agreement; and, the Agadir Agreement between Morocco, Jordan, Tunisia and Egypt) have also helped the process of trade liberalization in the MENA region.

Resource poor economies, with higher initial levels of protection, have seen the greatest reduction in tariffs. Jordan significantly strengthened its trade reform program beginning in 2000, cutting tariffs sharply and lowering other trade barriers, joining the World Trade

Organization (WTO) and launching an economic-integration project with Israel, providing tariff free access for clothes, jewelry and other goods from joint Jordanian-Israeli factories into the United States. They also completed a free-trade agreement with the United States. Egypt undertook unprecedented tariff reform in the fall of 2004, reducing the number of tariff bands, annulling import fees and surcharges incompatible with the GATT, and instituting strong tariff rate cuts on most imports. Lebanon's implementation of the Association Agreement with the EU and negotiations to joining the WTO have also resulted in substantial trade liberalization efforts over the last few years.

A few of the resource rich economies also undertook a series of trade liberalization measures. Iran's trade reform strategy, adopted in its third five year development plan (2000/01-2004/05), consisted of trade reform in two stages; in the first stage, emphasizing the elimination of export restrictions and replacing NTBs with tariffs, and in the second, rationalizing the tariff structure, reducing tariff bands and lowering the average tariffs. Algeria, early in 2000, began a wave of trade reform measures including abolishing remaining NTBs to trade, comprehensive tariff reform, signing an Association Agreement with the EU, and beginning negotiations toward accession to the WTO.

Among the resource rich and labor importing economies, which had historically maintained more open trade, the GCC countries have worked almost in unison to develop trade ties and to encourage greater foreign participation in their economies. Almost all have taken further steps to cement greater ties with the West. All of the GCC economies have pursued Free Trade Agreements (FTA) or Trade and Investment Framework Agreements (TIFA) with the United States. To date, Bahrain has an FTA, and similar agreements are being pursued or negotiated with the Oman (signed but not yet completed), United Arab Emirates, Kuwait and Saudi Arabia. TIFAs are in force in Bahrain, Kuwait, Qatar, the United Arab Emirates and Saudi Arabia. They have also worked to strengthen ties with emerging economies in Asia, particularly China and India. Most implemented further tariff reform (from already relatively low levels) with the introduction of the common external tariff (CET) among the GCC in 2003.

### ***Progress over 2005***

Over the last year, achievements have been made on the trade policy front by several of the resource poor economies which had not yet undertaken deep reform. Under the EU Association Agreement, Tunisia's tariffs on imports originating in the European Union (EU) were lowered, while imports from the 16 other members of the Greater Arab Free Trade Area have been admitted completely duty free since January 2005. In addition, Tunisian customs carried out reforms to simplify import procedures, with special emphasis on documentation and the implementation of the WTO Agreement on Customs Valuation. Although technical import inspection procedures remain lengthy and complex, a start was made on reforming these procedures in 2005.

Morocco also made some progress over the year in deepening trade liberalization. Although the level and dispersion of multilateral tariffs remain high (the simple average tariff is 30 percent), over 2004, MFN tariffs were reduced for goods freely traded with the EU, and in the context of the FTA with the EU, and further tariff reductions were applied in March 2005 on selected intermediate and consumption goods. Customs services have been streamlined, and implementation of the free-trade agreement with the United States began January 2006. Morocco signed an important agreement with Turkey, which will allow it to take advantage of cheaper Turkish inputs in the production of its own textiles to European markets<sup>105</sup>.

Among resource rich economies, in December, Saudi Arabia joined the World Trade Organization (WTO), following 12 years of negotiations. In meeting the WTO requirements, the Kingdom undertook important steps in liberalizing its trade regime, particularly for import licensing, customs valuation and fees, standards and technical regulations, and revising its legislation for intellectual property rights and patent registration. In terms of specific markets, Saudi Arabia has agreed to revise the rules it applies to agricultural imports, including shelf-life restrictions and other non-tariff measures that have long hindered the importation of agricultural goods to the Kingdom. Almost all agricultural tariffs will be lowered to 15 percent or less. Membership in the WTO is expected help the Saudi economy diversify more rapidly, improve competitiveness, and create new employment opportunities. Oman, meanwhile, completed its negotiations to conclude its free-trade agreement with the United States.

Among the resource rich and labor abundant economies, widespread smuggling of imported goods in Yemen, combined with a desire to harmonize tariff rates with GCC, prompted the Yemeni government to move strongly in lowering import tariff rates over 2005, reducing the number of bands from 4 to 3, with the maximum rate still at 25 percent, but with two-thirds of the commodities attracting only a 5 percent tariff rate. After the recent changes, the unweighted tariff rate fell to 7 percent, the lowest average tariff outside GCC in MENA.

### **3.3.2 Quantifying progress with trade reform**

MENA's trade policy was evaluated in two ways. First, the trade policy status in 2005 was assessed based on current information on average tariffs, the prevalence of non-tariff barriers (in terms of percent of tariff lines), and behind-the-border constraints to trade, including average time required for both exporting and importing goods. Second, the region's progress with trade policy reform was evaluated, based on the progress made with reducing average tariffs (the only trade policy indicator widely available in 2000, the initial period for comparison).

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<sup>105</sup> One of the major constraints faced by textiles exporters in Morocco is the EU's restrictive rules of origin (ROO). For Moroccan clothing products to satisfy EU rules of origin and qualify for duty-free access in that market, they must be made from domestically produced fabrics, fabrics from EU countries, or fabrics from Tunisia or Algeria (countries that are considered as qualifying areas through full accumulation). These rules force suppliers to forgo cheaper inputs from third-country suppliers in order to qualify for duty-free entry to the EU. With its recent Free Trade Agreement with Turkey, Morocco has positioned itself to exploit an accumulation of origin with that country as part of the Pan-Euro Med initiative, to reduce Morocco's costs and improve competitiveness.

Based on these evaluations, MENA countries have demonstrated strong progress over the last five years in the area of trade reform, with continued progress by many countries to lower barriers to trade and to establish trade ties through regional and bilateral trade agreements. MENA countries, on average, rank in the 63<sup>rd</sup> percentile in terms of their progress in lowering import tariffs, only slightly behind developing countries of Europe and Central Asia and high income/OECD economies (Table 3.2).

Particularly strong progress has occurred among the resource poor economies of the region, led by deep tariff reform in Egypt. With average tariffs declining from around 21 percent to 9 percent, Egypt's progress in reducing import tariffs places it at the top of the worldwide ordering of countries in terms of tariff reductions<sup>106</sup>. But strong progress also occurred in Jordan and Lebanon, and as a group, the region's resource poor economies ranked in the 71<sup>st</sup> percentile with regard to reducing tariffs over the last 5 year, greater than any other region of the world.

Resource rich economies exhibited weaker progress, but this partly reflects the lower average tariffs initially (with an average tariff level in 2000 of 16.1 percent, compared with more than 24.3 percent among resource poor economies [see Appendix Table B1]). Among resource rich economies, relatively strong progress was made among the resource rich labor abundant economies of Syria, Yemen, Iran and Algeria, which as a group had higher average tariff protection initially (averaging 24.7 percent in 2000, relative to only 9.2 percent among the labor importing economies). Average tariffs for the group fell from an average of 24.7 percent in 2000 to 16.9 percent in 2005, led by significant tariff reductions in Iran (between 2000 and 2005, Iran's average tariff fell from about 41 percent to around 22 percent). On average, oil producing labor abundant economies ranked in the 67<sup>th</sup> percentile worldwide with regard to lowering tariffs.

Among the region's oil producing labor importing economies of the GCC and Libya, though tariff reform has been more limited (on average, the group ranked in the 49<sup>th</sup> percentile worldwide with regard to lowering tariffs), this partly reflects lower initial tariff protection. Still, relatively strong progress in lowering tariffs occurred in Saudi Arabia, where the simple average tariff declined from an average of 12 percent in 2000 to an average of 6 percent in 2005.

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<sup>106</sup> Progress with tariff reform is measured by the change made by a country in its placement in a worldwide ordering of countries based on their simple average tariffs. Egypt, which moved from the bottom decile of countries worldwide in 2000 (based on simple average tariff) to almost the 50<sup>th</sup> percentile in 2005, improved its ranking by the greatest amount over the period (in terms of progress, it thus ranked in the 100<sup>th</sup> percentile with regard to tariff reform). See Annex B for further description of methodology.

**Table 3.2: Structural reform progress: Trade reform**

Country/region	Current trade policy, 2005 <sup>a</sup>	Trade policy reform progress, 2000-2005 <sup>b</sup>
Algeria	43.6	70.7
Bahrain	..	62.0
Djibouti	..	51.1
Egypt	42.8	100.0
Iran	22.3	73.9
Jordan	47.1	85.9
Kuwait	52.6	65.2
Lebanon	61.1	80.4
Libya	..	27.2
Morocco	38.4	52.2
Oman	70.8	10.9
Saudi Arabia	39.5	77.2
Syria	18.4	43.5
Tunisia	50.9	56.5
Yemen	61.7	81.5
<b>Middle East North Africa</b>	<b>45.8</b>	<b>62.5</b>
<b>Resource Poor</b>	<b>48.0</b>	<b>71.0</b>
<b>Resource Rich</b>	<b>44.1</b>	<b>56.9</b>
<b>Resource rich labor abundant</b>	<b>36.5</b>	<b>67.4</b>
<b>Resource rich labor importing</b>	<b>54.3</b>	<b>48.5</b>
<b>East Asia and Pacific</b>	<b>56.2</b>	<b>37.2</b>
<b>Europe and Central Asia</b>	<b>50.9</b>	<b>69.5</b>
<b>Latin America and Caribbean</b>	<b>56.6</b>	<b>50.2</b>
<b>High Income OECD</b>	<b>70.2</b>	<b>64.4</b>
<b>South Asia</b>	<b>41.4</b>	<b>47.6</b>
<b>Sub-Saharan Africa</b>	<b>34.4</b>	<b>26.9</b>
<b>WORLD</b>	<b>50</b>	<b>50</b>

Note: Regional averages reflect the simple average of the data for the countries included. a. Current trade policy status reflects country's current placement in a worldwide ordering of countries based on a variety of trade policy indicators, expressed as a cumulative frequency distribution, with 100 reflecting the country with the most open trade policies (worldwide) and 0 representing the country with the most closed trade policies (worldwide). b. Reform progress reflects the improvement in a country's rank between 2000 and 2005 in a worldwide ordering of countries based on the simple average tariff (the only trade policy indicator available for a large group of countries in 2000), expressed as a cumulative frequency distribution, with 100 reflecting the country which exhibited the greatest improvement in rank and 0 reflecting the country which exhibited the greatest deterioration.

Although the region has made strong progress with tariff reform over the last five years, MENA's trade liberalization remains far from complete. The region continues to be one of the most trade-restrictive in the world, on average, ranking on average in the bottom 46<sup>th</sup> percent of countries worldwide with regard to trade regime openness, only higher than Sub-Saharan Africa and South Asia.

Much of this stems from continuing high tariff protection (on average, MENA countries rank in the bottom 38<sup>th</sup> percentile worldwide with regard to average tariffs<sup>107</sup>) which remains commonplace. About half the countries in the region – Algeria, Djibouti, Iran, Jordan, Libya, Morocco, Syria and Tunisia, maintain simple average tariffs in excess of 10 percent, the world average. This is especially true among resource poor economies, where simple tariffs continue to average close to 20 percent, placing them in the bottom quartile worldwide in terms of tariff protection. In Tunisia, the simple average of the most favored nation (MFN) tariffs applied in 2005 was more than 28 percent<sup>108</sup>. The heavy MFN tariff protection of the domestic market has changed only slightly in the course of the last 10 years. The average duty on agricultural products (WTO definition) is 67 percent, with a maximum rate of 150 percent; the average duty on nonagricultural products is 23 percent. MFN customs duties in the manufacturing sector average 30 percent, with rates extending up to 150 percent. The modal rate (that most frequently applied) is 43 percent, and products corresponding to only 15 percent of tariff lines are admitted duty free.

But the region also suffers from proliferation of non-tariff barriers, as well as lengthy processes for both importing and exporting. Trade protection is most acute among the oil-exporting labor-abundant economies, particularly on account of high levels of protection in Iran and Syria, not only in terms of tariff protection, but also in terms of cumbersome processes for both exporting and importing. Syria, for example, ranks in the bottom 15<sup>th</sup> percentile worldwide in terms of both the time required to export as well as the time required to import. On average, it requires some 63 days to complete the processes associated with importing, and 49 days to complete the processes associated with exporting<sup>109</sup>. And with tariffs that average close to 20 percent, it ranks in the bottom decile in terms of tariff protection. Iran, with average tariffs of 22 percent despite significant tariff reduction, ranks in the bottom 5<sup>th</sup> percentile with regard to tariff protection. It also faces lengthy processes to comply with import and export regulations, ranking in the bottom quintile (20<sup>th</sup> percentile) with regard to the time needed to export and in the bottom 30<sup>th</sup> percentile with regard to the time needed to import (Table 3.3).

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<sup>107</sup> See Appendix Table B.2

<sup>108</sup> Staff estimates from UNCTAD TRAINS database.

<sup>109</sup> World Bank, 2006a.

**Table 3.3: Current trade policy in MENA\***

*(Based on simple average tariffs, NTB coverage, average time required for exporting and average time required for importing)*

Country/region	Average tariff	Tariff index	NTB coverage (% tariff lines)	NTB index	Average time for exports (days)	Export time index	Average time for imports (days)	Import time index	Overall trade policy index (1-100)
Algeria	18.7	8	0.0	88	29	52	51	27	44
Bahrain	5.2	71	0.5	40	..	..	..	..	..
Djibouti	31.0	0	2.7	24	..	..	..	..	..
Egypt	9.1	48	6.1	7	27	55	29	62	43
Iran	22.1	5	0.5	40	45	17	51	27	22
Jordan	13.1	21	0.3	51	28	54	28	63	47
Kuwait	3.6	92	2.1	26	30	50	39	44	53
Lebanon	5.4	71	0.2	53	22	67	34	54	61
Libya	17.0	14	2.2	26	..	..	..	..	..
Morocco	30.1	1	0.3	51	31	47	33	55	38
Oman	5.7	67	0.0	88	23	64	27	65	71
Qatar	5.0	74	1.0	32	..	..	..	..	..
Saudi Arabia	6.0	63	1.2	30	36	32	44	33	39
Syria	19.6	6	0.5	40	49	14	63	13	18
Tunisia	28.3	3	0.0	88	25	58	33	55	51
Yemen	7.0	58	0.0	88	33	43	31	59	62
<b>MENA</b>	<b>14.2</b>	<b>38</b>	<b>1.1</b>	<b>48</b>	<b>31.5</b>	<b>46</b>	<b>38.6</b>	<b>46</b>	<b>46</b>
<b>Resource Poor</b>	<b>19.5</b>	<b>24</b>	<b>1.6</b>	<b>46</b>	<b>26.6</b>	<b>56</b>	<b>31.4</b>	<b>58</b>	<b>48</b>
<b>Resource Rich</b>	<b>11.0</b>	<b>46</b>	<b>0.8</b>	<b>50</b>	<b>35.0</b>	<b>39</b>	<b>43.7</b>	<b>38</b>	<b>44</b>
<b>RRLA</b>	<b>16.9</b>	<b>19</b>	<b>0.2</b>	<b>64</b>	<b>32.5</b>	<b>32</b>	<b>42.0</b>	<b>31</b>	<b>36</b>
<b>RRLI</b>	<b>7.0</b>	<b>64</b>	<b>1.2</b>	<b>40</b>	<b>29.7</b>	<b>49</b>	<b>36.7</b>	<b>47</b>	<b>54</b>
<b>East Asia and Pacific</b>	<b>7.4</b>	<b>57</b>	<b>0.6</b>	<b>52</b>	<b>27.6</b>	<b>60</b>	<b>31.3</b>	<b>63</b>	<b>56</b>
<b>Europe and Central Asia</b>	<b>7.0</b>	<b>67</b>	<b>5.7</b>	<b>36</b>	<b>31.3</b>	<b>53</b>	<b>42.8</b>	<b>51</b>	<b>51</b>
<b>Latin America and Caribbean</b>	<b>10.2</b>	<b>43</b>	<b>0.5</b>	<b>72</b>	<b>29.7</b>	<b>50</b>	<b>36.8</b>	<b>49</b>	<b>57</b>
<b>High Income OECD</b>	<b>3.7</b>	<b>90</b>	<b>9.2</b>	<b>18</b>	<b>12.0</b>	<b>86</b>	<b>13.4</b>	<b>88</b>	<b>70</b>
<b>South Asia</b>	<b>16.8</b>	<b>14</b>	<b>0.0</b>	<b>69</b>	<b>33.7</b>	<b>39</b>	<b>39.3</b>	<b>44</b>	<b>41</b>
<b>Sub-Saharan Africa</b>	<b>13.7</b>	<b>30</b>	<b>6.6</b>	<b>57</b>	<b>49.2</b>	<b>24</b>	<b>61.1</b>	<b>4</b>	<b>34</b>
<b>LMIC Average</b>	<b>10.4</b>	<b>47</b>	<b>2.3</b>	<b>52</b>	<b>28.5</b>	<b>55</b>	<b>33.8</b>	<b>56</b>	<b>53</b>
<b>WORLD</b>	<b>10.0</b>	<b>50</b>	<b>2.7</b>	<b>50</b>	<b>32.2</b>	<b>50</b>	<b>40.4</b>	<b>50</b>	<b>50</b>

Note: \* 2005 or closest year available. Regional averages reflect the simple average of the data for the countries included. For each index, a country's value represents the country's current placement in a worldwide ordering of countries based on that trade characteristic, expressed as a cumulative frequency distribution, with 100 reflecting the countries with the most open/friendly trade policies, and 0 reflecting the country with the most closed/burdensome trade policies. LMIC= Low and middle income economies. Sources: See Appendix B.

Even among the relatively open GCC economies (in terms of tariff barriers to trade), when accounting for behind the border constraints to trade (particularly prevalent in Saudi Arabia), the group ranks on average only in the 54<sup>th</sup> percentile worldwide, below the Latin America region, East Asia and the Pacific, and high income economies.

Thus, while MENA has made relatively strong progress with trade reform over the last several years, much work remains on the trade liberalization front. Factoring in tariffs, NTBs, and trade procedures, the MENA region ranks only ahead of Sub-Saharan Africa and South Asia

in terms of trade openness, and only one country in the region (Oman) ranks in the top third of countries worldwide with regard to trade facilitation. Many countries in the region have lowered tariffs in parallel with integration efforts with the EU, but the region needs to continue liberalization efforts on a multi-lateral basis to tap into the trade potential with non-EU countries.

## **3.4 BUSINESS CLIMATE**

### **3.4.1 Developments in business and regulatory reform**

Just as MENA's trade policies will impact the development of competitive export-oriented businesses, MENA's policies and practices regulating business will impact the development of a productive, competitive private sector which can drive economic development and job growth. Thus, a critical focus of MENA's economic transition relates to creating a pro-competitive business environment, free of excessive regulation.

With diminishing links to oil economies, resource poor economies in MENA have led the way in improving the regulatory environment for private investment. Both Morocco and Tunisia, as part of their industrial modernization efforts under the *Mise a niveau* program, undertook various measures to create a more favorable investment climate. Major achievements in Morocco include the strengthening the legal, regulatory and supervisory framework of the financial sector, strengthening property rights, the passage of a new labor code, and as part of their national privatization program, liberalization of many sectors of the economy, including air transport (significantly improving potential for tourism) and telecommunications. Structural reforms in Tunisia have included significant progress in privatizing state enterprises, some strengthening of the banking sector, streamlining several business procedures, and reforming the legal framework for asset recovery and bankruptcy.

But a strong drive to attract business has also emerged from resource rich labor importing countries, particularly through opening up and capturing greater foreign investment. Bahrain passed an amended Commercial Law in 2003, streamlining the conditions for the operation of private enterprises and easing the restrictions on foreign ownership<sup>110</sup>. Under the new law, Bahrain has become one of the first countries in the GCC to abolish the sole agency commercial law. In 2003-2004, a number of key sectors such as telecommunications, electricity generation and petrochemicals were opened to competition. The UAE has also established new laws on foreign ownership, and has set its sights on several new industrial free trade zones targeted at attracting more foreign firms<sup>111</sup>. Plans to attract FDI to Qatar are leading to the creation of a "one-stop-shop" for investors. A recent law allowing foreign ownership in pre-specified sectors, with the approval of the Finance Minister in each case is being proposed (with up to 100 percent ownership in selected sectors such as tourism, health and education). Under the terms of Saudi Arabia's accession to the WTO, significant steps are also being taken toward removing the

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<sup>110</sup> Under the existing rules, foreign ownership of commercial activities is permitted up to 100% of unlisted companies, up to 49% of public shareholding companies. Furthermore, foreigners can buy property in certain designated areas of the country.

<sup>111</sup> Economist Intelligence Unit UAE Country Report February 2006.

barriers to foreign direct investment. Among the sectors expected to witness foreign entry are insurance, banks and other financial intermediaries (banks can now set up branches and existing banks can increase their foreign equity from 40 percent to 60 percent), and energy companies operating in the downstream and midstream sectors.

The Gulf economies have also moved aggressively over the past few years to establish themselves as regional and international hubs for a variety of services, including financial services, trading, tourism, and transport. Bahrain and Qatar have established themselves as regional financial hubs, and in 2005, the Qatar Financial Center created a financial free-zone for international banks and investment companies. But other services are also emerging. Kuwait is developing a technology free-trade zone. Qatar is positioning itself as a regional education and health services hub, most recently establishing Education City and Hamad Medical City.

### ***Progress over 2005***

Over 2005, continued progress has been made by several of the resource poor economies to improve aspects of the business environment. Morocco's recent achievements included selling a second fixed-line telephone license to a private company, consolidating financial reforms, and accelerating civil service reform with a successful program of 38,000 civil servants (8 percent of the total) voluntarily retiring. Tunisia's preparations for the implementation of a broad money-targeting framework are at an advanced stage and will lay the groundwork for more flexible exchange rate management in the future. With respect to the financial sector, the government pursued measures to strengthen financial stability. A new round of reforms is expected to be gradually implemented, in preparation for the opening of the banking sector to foreign competition. The reforms involve tighter operating standards and a strategy to deal with nonperforming loans and bank restructuring.

Starting in July 2004, Egypt's privatization program was resurrected, and the speed was further accelerated over 2005. The government has sold stakes in a number of commercial banks and companies, the largest privatization thus far being the sale of a 20 percent stake in Telecom Egypt in December 2005, which brought in revenues of more than LE 5.1 billion (close to \$900 million). The government announced in January that it is considering the sale of 45 companies, both minority stakes via public offerings and controlling stakes to corporate investors. This should result in continued strong FDI inflows for 2006.

Egypt also signed into law a new, more simplified income tax in 2005 which substantially cuts the personal and corporate tax rates, resurrected the privatization program, and undertook several reforms in the financial sector, including restructuring the banking and non-banking sectors, a program relying on both privatization and bank consolidation as two major pillars in the drive to strengthen the banking sector by reducing the number of institutions.

For Lebanon, on the other hand, 2005 was a lost year for structural reforms, with government changes, practical inability to convene parliamentary sessions, boycott of cabinet

meetings, and a very divisive political situation hindering Lebanon from implementing significant structural reforms. A number of laws prepared in the fields of trade, competition, intellectual property rights, e-commerce, public procurement and auditing, public enterprises management, public debt management, public and private pensions, and capital markets are still pending in Parliament. The budget law for 2005 was only passed by the end of the year. On the other hand, the establishment of a large taxpayer's office and the completed registration of private sector employees permitted the MOF to raise its collection efficiency.

Among the resource rich labor abundant economies, however, recent progress with structural reforms has been more mixed. Algeria strengthened performance contracts of public bank managers and shareholder oversight, initiated the privatization of a public bank, and made progress in modernizing the payments system. A new hydrocarbon law was adopted that further liberalizes investment in this sector. In Iran, however, structural reforms slowed, with little government activity in pursuing the reform agenda prior to the June presidential elections, and a new government only formed in late August. Syria's reforms have been limited to date, but over the year several policy reforms have been initiated, including taking steps to liberalize the banking sector and modify taxation.

### **3.3.2 Quantifying progress with business and regulatory reform**

As with trade policy, MENA's business climate was evaluated in two ways. First, the business climate in 2005 was evaluated based on current information on eight different areas important for doing business (ease of starting a business, ease of closing a business, access to finance, ease of hiring and firing, ease of contract enforcement, ease of dealing with pertinent licenses, and ease of registering property). In each of these areas, a variety of information about the ease of doing business was utilized, often including average time, cost, and total number of procedures required for each business obligation (see Appendix B for fuller description). In addition to evaluating the current status of the business environment, the progress with reform of the business climate was evaluated, based upon progress made along four different fronts (the four areas for which information was available in both 2003 and 2005): starting a business, hiring and firing, access to credit, and enforcing contracts. From these data, an overall reform progress index was calculated, reflecting the average progress along all four fronts, expressed as a cumulative frequency distribution.

Based on the composite reform index, the MENA region's progress over the last five years in improving the environment for investment was below the world average. MENA countries, on average, ranked in the 42<sup>nd</sup> percentile worldwide with regard to business and regulatory reform, about on par with the reform progress in South Asia and Sub-Saharan Africa, and well behind the progress made in Europe and Central Asia (Table 3.4).

**Table 3.4: Structural reform progress: Business and regulatory reform**

Country/Region	Current business environment, 2005 <sup>a</sup>	Reform Progress, 2003-2005 <sup>b</sup>
Algeria	13.1	37.6
Egypt	11.1	35.9
Iran	56.9	43.7
Iraq	66.0	..
Jordan	58.2	88.6
Kuwait	58.8	6.7
Lebanon	37.3	31.4
Morocco	60.8	54.4
Oman	77.8	15.1
Saudi Arabia	79.7	25.8
Syria	30.1	5.0
Tunisia	83.0	92.5
United Arab Emirates	43.1	14.0
Yemen	35.0	56.6
<b>Middle East North Africa</b>	<b>50.7</b>	<b>41.5</b>
<b>Resource Poor</b>	<b>50.1</b>	<b>62.8</b>
<b>Resource Rich</b>	<b>51.1</b>	<b>23.5</b>
RRLA	40.1	35.8
RRLI	64.9	15.4
<b>East Asia and Pacific</b>	<b>61.1</b>	<b>46.8</b>
<b>Europe and Central Asia</b>	<b>48.1</b>	<b>64.4</b>
<b>Latin America and Caribbean</b>	<b>40.4</b>	<b>51.4</b>
<b>High Income OECD</b>	<b>83.5</b>	<b>50.3</b>
<b>South Asia</b>	<b>48.0</b>	<b>41.0</b>
<b>Sub-Saharan Africa</b>	<b>27.4</b>	<b>43.1</b>
<b>WORLD</b>	<b>50</b>	<b>50</b>

Note: Regional averages reflect the simple average of the data for the countries included. a. Current business environment reflects country's current placement in a worldwide ordering of countries based on a variety of business environment indicators, expressed as a cumulative frequency distribution, with 100 reflecting the country with the most friendly business policies (worldwide) and 0 representing the country with the most unfriendly business policies (worldwide). b. Reform progress reflects the improvement in a country's rank between 2003 and 2005 in a worldwide ordering of countries based on business and regulatory policies, expressed as a cumulative frequency distribution, with 100 reflecting the country which exhibited the greatest improvement in rank and 0 reflecting the country which exhibited the greatest deterioration

The greatest progress has occurred among MENA's resource poor economies, averaging in the 63<sup>rd</sup> percentile worldwide, driven by strong achievements in Jordan (89<sup>th</sup> percentile) and Tunisia (93<sup>rd</sup> percentile), stemming mainly from progress in removing obstacles to starting a business, but also in improving access to finance.

Much more limited progress occurred among the resource rich economies, on average, ranking only in the 23<sup>rd</sup> percentile with regard to reform, with the weakest progress among the resource rich and labor importing economies (15<sup>th</sup> percentile). In part, this reflects an overall friendlier business climate initially among the GCC economies. Resource rich and labor importing economies, as a group, rank on average in the 65<sup>th</sup> percentile with regard to all aspects of the business environment. Resource rich and labor importing economies, however, which rank

the lowest in the region (and second lowest in the world, behind Sub-Saharan Africa) with regard to a conducive business environment also managed relatively limited progress. On average, RRLA economies ranked in the 36<sup>th</sup> percentile worldwide with regard to business reforms, with the strongest progress from Yemen (primarily through improvements in hiring and firing, the result of a revision to the labor code facilitating the hiring of foreign labor by private investors).

Despite the progress made by a few MENA countries, there remain large impediments to conducting business in the region, evidenced in several key areas. Region-wide, starting a business remains exceptionally cumbersome, with MENA countries on average ranking in the bottom third of countries worldwide with respect to time, cost and procedures necessary to start a business (Table 3.5). Investors in resource poor economies also face particular impediments with regard to labor laws, with RPLA economies ranking, on average, in the 41<sup>st</sup> percentile worldwide with regard to the ease of hiring and firing workers. Resource rich and labor abundant economies face obstacles in a number of key areas. Of the eight key areas of doing business, in only two (closing a business and paying taxes) do the RPLA economies rank, on average, in the top half of countries worldwide. Impediments are particularly large in terms of contract enforcement, access to finance, and business entry requirements. Resource rich and labor importing economies, meanwhile, though generally more business friendly (in a few areas, such as access to finance, registering property, and paying taxes, they average in the top quintile of countries, worldwide), there remain areas with especially burdensome regulations, including contract enforcement and the procedures for starting a business.

**Table 3.5: Current business and regulatory environment in MENA\***

Country/ Region	Contract Enforcement	Access to Finance	Hiring/ Firing	Starting a Business	Closing a Business	Dealing with Licenses	Registering Property	Paying taxes	OVERALL BUSINESS CLIMATE
Algeria	16	13	35	30	73	34	11	3	13
Egypt	24	51	13	26	14	3	14	46	11
Iran	64	63	28	65	34	3	39	74	57
Iraq	53	..	30	25	..	53	72	..	66
Jordan	63	75	59	23	45	60	34	92	58
Kuwait	38	79	84	43	68	37	49	..	59
Lebanon	9	82	71	36	20	39	45	73	37
Morocco	82	43	16	67	67	17	58	19	61
Oman	43	31	76	60	47	24	89	98	78
Saudi Arabia	39	80	84	5	45	78	99	97	80
Syria	5	22	42	13	48	48	48	74	30
Tunisia	97	64	34	74	87	41	55	58	83
UAE	15	52	58	14	6	81	94	97	43
WBG	43	..	54	3	..	49	44	..	..
Yemen	63	4	65	3	63	77	74	28	35
<b>MENA</b>	<b>44</b>	<b>53</b>	<b>50</b>	<b>32</b>	<b>48</b>	<b>44</b>	<b>55</b>	<b>66</b>	<b>51</b>
<b>Resource poor</b>	<b>53</b>	<b>63</b>	<b>41</b>	<b>38</b>	<b>47</b>	<b>46</b>	<b>42</b>	<b>58</b>	<b>50</b>
<b>Resource rich</b>	<b>37</b>	<b>40</b>	<b>56</b>	<b>29</b>	<b>48</b>	<b>43</b>	<b>64</b>	<b>71</b>	<b>51</b>
<b>RRLA</b>	<b>40</b>	<b>27</b>	<b>40</b>	<b>27</b>	<b>55</b>	<b>46</b>	<b>49</b>	<b>56</b>	<b>40</b>
<b>RRLI</b>	<b>34</b>	<b>80</b>	<b>75</b>	<b>31</b>	<b>42</b>	<b>39</b>	<b>83</b>	<b>97</b>	<b>65</b>
<b>EAP</b>	<b>41</b>	<b>53</b>	<b>71</b>	<b>61</b>	<b>35</b>	<b>63</b>	<b>62</b>	<b>73</b>	<b>61</b>
<b>ECA</b>	<b>59</b>	<b>51</b>	<b>42</b>	<b>56</b>	<b>49</b>	<b>38</b>	<b>56</b>	<b>42</b>	<b>48</b>
<b>LAC</b>	<b>38</b>	<b>58</b>	<b>46</b>	<b>42</b>	<b>45</b>	<b>52</b>	<b>52</b>	<b>25</b>	<b>40</b>
<b>OECD</b>	<b>84</b>	<b>90</b>	<b>56</b>	<b>77</b>	<b>85</b>	<b>78</b>	<b>68</b>	<b>71</b>	<b>84</b>
<b>South Asia</b>	<b>37</b>	<b>48</b>	<b>51</b>	<b>62</b>	<b>50</b>	<b>50</b>	<b>39</b>	<b>56</b>	<b>50</b>
<b>SS Africa</b>	<b>38</b>	<b>24</b>	<b>40</b>	<b>29</b>	<b>37</b>	<b>32</b>	<b>24</b>	<b>36</b>	<b>26</b>
<b>LMIC Average</b>	<b>49</b>	<b>58</b>	<b>52</b>	<b>51</b>	<b>46</b>	<b>50</b>	<b>55</b>	<b>50</b>	<b>53</b>
<b>WORLD</b>	<b>50</b>	<b>50</b>	<b>50</b>	<b>50</b>	<b>50</b>	<b>50</b>	<b>50</b>	<b>50</b>	<b>50</b>

Note: \* 2005 or closest year available. Regional averages reflect the simple average of the data for the countries included. For each column, a country's value represents the country's current placement in a worldwide ordering of countries based on that business climate characteristic, expressed as a cumulative frequency distribution, with 100 reflecting the countries with the most friendly policies for doing business, and 0 reflecting the country with the most cumbersome policies for doing business. EAP=East Asia and the Pacific; ECA=Europe and Central Asia; LAC=Latin America and the Caribbean; OECD=High income/OECD economies; LMIC=Low and Middle Income Economies. Sources: See Appendix B.

### ***Industrial policy as a complement to market forces***

Along with across-the-board reforms of the business environment, several MENA economies continue to utilize industrial policies (designed to promote specific industries or sectors) to complement more broad-based, policies that promote market forces. In Morocco, for example, a new industrial strategy—"Emergence"—was adopted in 2005, designed to enhance specific sector competitiveness and employment creation and improve the country's growth potential. The strategy focuses on the identification of specific sectors' weaknesses and strengths, and upgrading the industrial sector through the modernization of its production processes and the consolidation of its competitive edge (see Box 3.1).

Tunisia as well, in the midst of progress along certain structural reform fronts, continues to maintain a dualistic system of investment promotion and trade policy. Generous privileges are

extended for investments in selected economic activities and for exporting, by supporting the creation of “offshore” firms, but the government still discourages foreign investment in protected service sectors. For more than 30 years, the strategy pursued by Tunisia has consisted of promoting exports, especially manufactured goods, while heavily protecting enterprises that supply the local market. This strategy has created a dualism within the economy between an export sector whose competitiveness depends largely on concessions (including tax exemptions, transport cost subsidies, facilitated customs procedures, and foreign exchange concessions) and a domestic sector that is still heavily protected (despite the opening up of bilateral trade in nonagricultural products under the Association Agreement with the European Union).

The continued use of industrial policies throughout MENA comes at a time of renewed interest in their effectiveness. Although economists agree that market forces and private entrepreneurship need to be the driving forces behind growth and productivity enhancements, increasing analysis of late has focused on the complementary role to market forces that that industrial policies can play.<sup>112</sup>

While a variety of economic justifications can be made for the use of selective industrial policy (including coordination problems and information externalities) several caveats for their use are warranted, particularly for MENA economies. MENA has a long history with industrial policy (from infant industry protection to state planning to widespread consumer subsidies), and though the limits of the region’s protective interventions were realized as early as the 1980s, the transition out of these policies has been painstaking, in large part because it has involved the profoundly difficult task of cutting back economic rents that have been built over years.

Moreover, the international history of industrial policy has demonstrated, if nothing else, the ability to “get it wrong.” Well motivate or not, worldwide experience with industrial policies has been remarkably divergent, with as many (or more) failures as successes, and with significant unintended consequences (including rent-seeking and corruption).

MENA’s recent selective interventions to promote various industries appear on the surface, at least, to be intrinsically different than the past (less aimed at protecting domestic industries than improving their chances for international competitiveness). And indeed, most countries maintain a mixture of both mainstream free-market measures and industrial policies. Nonetheless, given the region’s difficulty with extracting itself from the legacy of past industrial policies, MENA should be cautious in looking to a new system of industrial policies to promote growth, but instead look to create neutral and internationally competitive business environment.

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<sup>112</sup> See for example, Rodrik, 2004.

### **Box 3.1: Morocco's Emergence Program**

Morocco's Emergence Program is aimed at overhauling the industrial apparatus while enhancing its competitiveness and carrying out voluntarist policies in favor of emerging sectors. The strategy takes into account changing regional and international environments. It encompasses a set of measures designed to improve the access of Morocco's domestic products to world markets and to the attraction of foreign investment. The industrial sector has been divided into three poles: the first, made of expanding activities, needs little public help; the second requires public support, given the tough competition it faces; and the third is composed of new global activities in which Morocco could position itself favorably. The latter two poles comprise eight sub-sectors, namely the aeronautics, agro-processing, automotives, crafts, electronics, off-shoring, seafood, and textiles industries.

Within the textiles industries, in close partnership with the Association of the Textile and Garment Industries (AMITH), the government is aiming to restructure the competitiveness of the textiles and clothing sectors. The two interrelated strategic goals of this plan are: (i) to move the textile and garment industry from its present position as subcontractors for EU suppliers to full-service providers, working directly with the final buyers; and (ii) to upgrade from the production of commodity garments to higher-value-added fashion garments. The main instruments of the plan include tariff and customs reforms; transport and logistics improvement; financial and fiscal incentives to boost new investments, establish export platforms, and help firms to restructure their balance sheets; and education and training.

The vision of moving away from basic garment products and subcontracting is consistent with the global dynamics of retailing. This will provide some advantages to nearby suppliers of fashion goods and will require additional services. The focus of the plan is on skills development (including design, merchandising, and material sourcing). Trade and customs reforms as well as trade facilitation are also pertinent. The real test, however, is that of implementation since Morocco lags slightly behind most major competitors in terms of putting in place reforms to adjust to the MFA removal. A swift and effective implementation of the plan is crucial to the survival of the industry.

## **3.5 GOVERNANCE**

Improving governance in the region is at the forefront of improvements in economic policy. Parallel to the economic reforms the region faces, it must strengthen the incentives, mechanisms, and capacities for public institutions, both to improve economic policies and to forge the broad social consensus that is needed to successfully enact reform.

The governance challenges facing MENA are two-fold. Firstly, it faces the challenge of modernizing governance structures and operations for more efficient public sector management. It involves administrative reform of the public sector, to enhance the efficiency of the bureaucracy, to improve mechanisms of internal accountability, and to reduce corruption. But additionally, the MENA region faces the more difficult challenge of increasing public sector

accountability. This governance challenge requires improving the transparency in governance mechanisms and enhancing contestability in government policies.

### 3.5.1 Developments in governance reform

Several important steps toward governance reform have been taken by MENA countries over the last several years. On the administrative side, there have been various achievements, both from resource poor economies and oil-exporters. Jordan, Morocco, and Yemen have each embarked on ambitious programs of civil service management reform, and in Egypt, civil service reform was advanced with the announcement of a new system of early retirement for public sector employees in December 2005. There has been additional progress by the region in attacking corruption, including in Algeria, Jordan, Egypt and Libya, which recently enacted anti-corruption legislation (although implementation is forthcoming).

But additionally, several countries in the region have taken important steps in opening up the political space and allowing for greater accountability in public policy. Many of these steps have been taken by the economies of the GCC. In 2001, Bahrain became a constitutional monarchy with a bicameral parliament, full suffrage to all male and female citizens, and the creation of an independent judiciary. Qatar's political environment has also undergone rapid changes, including introducing electoral process in conjunction with the Municipal Council. In May 2003, Qatar established a Human Rights Committee and became the first country in the Gulf to have a female holding a public office. In 2004, the government introduced a new legislation granting more freedoms and permitting demonstrations, labor unions formation and public meetings. These steps toward allowing greater voice in development are an important element in moving further with the economic reform agenda, ensuring that in the transition to a new development model, the economic outcomes are socially acceptable. And in Oman, a consultative parliament was established in 2003, enabling all eligible adults to vote.<sup>113</sup> Political rights have been extended to women, and starting in 2004, a number of other key appointments of women to ministerial and ambassadorial posts has occurred. Allowing greater information about domestic economic policies has also begun to enter the agenda. In 2005, the Omani government granted a license for private television and radio stations for the first time. Taken together, these steps provide greater incentives to regional governments to pursue sound and effective policies.

Elsewhere, a major achievement in enhancing public sector accountability has occurred with Morocco's recent adoption of the Law on Political Parties, which helps consolidate the credibility and efficiency of political parties and institutions. In particular, the law aims, first, at enabling the political parties to take more responsibility and be more accountable to their constituencies. Second, the law seeks a more efficient Parliament with two or three homogeneous groups becoming healthy coalitions. The law also includes provisions to ensure good governance inside political parties by allowing the judicial system to abolish parties that do not abide by internal regulations.

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<sup>113</sup> Despite the parliamentary elections, however, the powers of the parliament are still limited.

### 3.5.2 Quantifying progress with governance reform

Governance in the MENA region is evaluated based upon the set of governance indicators established in the World Bank's 2003 report on governance in the MENA region<sup>114</sup>. From that report, two separate spheres of governance were examined: governance related to public accountability and governance related to the quality of public administration. For comparability, those governance indicators have been computed again, utilizing the methodology established, but with a minor adjustment to the underlying data utilized and with an adjustment to the computation methodology (see Appendix B).

From these two governance spheres, we evaluated both the current status of governance in MENA (in terms of quality of public administration, and public sector accountability), as well as the progress with governance over the period 2000-2005. Based on the composite reform indices, the MENA region has made significant strides in the realm of governance over the last few years.

In the area of improving the quality of public administration, the MENA region ranked, on average, in the 63<sup>rd</sup> percentile worldwide, ahead of all other regions of the world. The strongest reform effort has occurred among resource poor economies in the region, which on average ranked in the top quintile worldwide with regard to improving the quality of public administration, led by strong achievements in Egypt, Morocco and Tunisia. But a few resource rich economies also made strong gains, including Algeria, Oman, Qatar, Saudi Arabia, and Yemen.

But perhaps even more importantly, the region has made strong progress in improving mechanisms for greater government accountability. Between 2000 and 2005, MENA countries, on average, ranked in the 64<sup>th</sup> percentile with regard to improving mechanisms for government accountability, stronger progress than any other region of the world. The greatest improvement has emanated from the resource rich and labor importing economies, where a few countries, such as Bahrain, Oman, and Qatar, have taken significant steps to open up the political space for greater participation in public policy.

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<sup>114</sup> World Bank 2003b.

**Table 3.5: Structural reform progress: Governance reform**

Country/Region	Quality of Administration, Current Status <sup>a</sup>	Reform Progress, 2000-2005 <sup>b</sup>	Public Sector Accountability, Current Status <sup>a</sup>	Reform Progress, 2000-2005 <sup>b</sup>
Algeria	37.6	91	29.1	91
Bahrain	76.6	26	22.7	91
Egypt	42.6	92	24.8	84
Iran	16.3	19	20.6	4
Jordan	66.0	67	34.0	60
Kuwait	58.2	24	31.2	65
Libya	10.6	64	0.0	42
Morocco	73.0	83	32.6	81
Oman	61.0	75	15.6	81
Qatar	59.6	89	13.5	74
Saudi Arabia	57.4	77	5.0	69
Syria	14.9	67	7.1	74
Tunisia	74.5	87	22.0	22
UAE	58.9	6	17.0	41
Yemen	28.4	71	19.9	89
<b>Middle East North Africa</b>	<b>49.0</b>	<b>63</b>	<b>19.7</b>	<b>64</b>
<b>Resource Poor</b>	<b>64.0</b>	<b>82</b>	<b>28.4</b>	<b>62</b>
<b>Resource Rich</b>	<b>43.6</b>	<b>55</b>	<b>16.5</b>	<b>65</b>
<b>Resource rich labor abundant</b>	<b>24.3</b>	<b>62</b>	<b>19.1</b>	<b>64</b>
<b>Resource rich labor importing</b>	<b>54.6</b>	<b>52</b>	<b>15.0</b>	<b>66</b>
<b>East Asia and Pacific</b>	<b>43.3</b>	<b>45</b>	<b>41.0</b>	<b>48</b>
<b>Europe and Central Asia</b>	<b>47.0</b>	<b>46</b>	<b>51.8</b>	<b>51</b>
<b>Latin America and Caribbean</b>	<b>45.8</b>	<b>50</b>	<b>57.0</b>	<b>53</b>
<b>High Income OECD</b>	<b>89.2</b>	<b>47</b>	<b>91.2</b>	<b>49</b>
<b>South Asia</b>	<b>47.5</b>	<b>53</b>	<b>38.9</b>	<b>31</b>
<b>Sub-Saharan Africa</b>	<b>39.4</b>	<b>53</b>	<b>36.7</b>	<b>55</b>
<b>WORLD</b>	<b>50.0</b>	<b>50</b>	<b>50.0</b>	<b>50</b>

a. Current status reflects country's current placement in a worldwide ordering of countries based on a variety of governance indicators, expressed as a cumulative frequency distribution, with 100 reflecting the country with the most efficient/accountable governance processes (worldwide) and 0 representing the country with the most inefficient/unaccountable governance processes (worldwide). b. Reform progress reflects the improvement in a country's rank between 2000 and 2005 in a worldwide ordering of countries based on governance indicators, expressed as a cumulative frequency distribution, with 100 reflecting the country which exhibited the greatest improvement in rank and 0 reflecting the country which exhibited the greatest deterioration. Regional averages reflect unweighted average of countries included.

These essential reforms toward greater public sector accountability are particularly important for the successful implementation of other areas of the reform agenda. Worldwide, successful reform efforts have depended critically upon the support and participation of those in society whom reforms will impact. The governance improvements in MENA, in terms of granting greater voice in development to MENA's people, are important not only to take into account the needs and values of those who are affected by reforms, but also to ensure that in the

transition to a new development model, the economic outcomes are socially acceptable among those who have benefited from the old systems.

At the same time, it must be emphasized that the MENA region continues to have the greatest gap with the rest of the world in terms of accountable and inclusive governance structures, on average ranking in the bottom quintile worldwide, by far, the lowest average ranking worldwide. Moreover, there is almost no diversity in the region in terms of accountable governance structures. Every country in the region but one – Jordan – ranks in the bottom third with regard to public sector accountability (and Jordan is only marginally higher). Given this especially large gap in public sector accountability with the rest of the world, it is thus an important development that both resource rich and resource poor economies in MENA are making a start at these vital changes.

## APPENDIX A: STATISTICAL TABLES

**Appendix Table 1: Gross Domestic Product and Prices**  
**Real GDP Growth (percent per year), 1995-2005**

Country	1995-2000	2000-2002	2003	2004	2005
MENA region (incl. Iraq)	..	3.0	5.6	6.3	6.0
MENA (excl. Iraq)	3.7	3.3	6.9	5.6	6.0
Resource Poor Labor Abundant	4.7	3.7	4.1	4.8	4.0
Egypt	5.6	3.3	3.1	4.2	4.9
Jordan	3.2	5.5	4.1	7.7	7.2
Lebanon	1.9	3.5	4.9	6.3	1.0
Morocco	3.6	4.7	5.5	4.2	1.5
Tunisia	5.6	3.5	5.6	5.8	5.0
Djibouti	-0.5	2.3	3.2	3.0	3.2
West Bank and Gaza	..	-12.5	6.1	6.2	6.3
Resource Rich Labor Abundant (incl. Iraq)	..	3.1	1.2	7.2	5.3
Resource Rich Labor Abundant (excl. Iraq)	3.4	4.5	6.1	4.7	5.5
Algeria	3.2	3.3	6.8	5.2	5.5
Iran	3.5	5.3	6.7	4.8	5.9
Iraq	..	-7.2	-41.4	46.5	2.6
Syria	2.4	3.3	2.5	3.6	4.0
Yemen	5.5	4.2	3.1	2.6	3.8
Resource Rich Labor Importing	3.3	2.5	8.6	6.5	7.2
Saudi Arabia	2.7	0.3	7.7	5.2	6.5
United Arab Emirates	5.2	6.0	11.3	8.5	8.0
Kuwait	1.9	2.9	13.4	6.2	8.5
Qatar	11.8	5.9	5.9	9.9	8.8
Oman	3.4	4.6	1.4	3.1	4.1
Bahrain	4.3	4.9	7.2	5.4	6.9
Libya	1.6	3.3	9.1	9.3	8.5

The MENA region includes the resource poor labor abundant (RPLA) economies of Egypt, Jordan, Tunisia, Morocco, Lebanon, Djibouti, and the West Bank and Gaza, the resource rich and labor abundant (RRLA) economies of Algeria, Iran, Iraq, Syria, and Yemen, and the resource rich and labor importing (RRLI) economies of Saudi Arabia, the United Arab Emirates, Kuwait, Qatar, Bahrain, Oman, and Libya. West Bank and Gaza is not included in the regional or sub-regional aggregates.

**Appendix Table 2: Gross Domestic Product and Prices  
GDP (in constant \$US billions), 1995-2005**

Country	Average 1995-2000	Average 2000-2002	2003	2004	2005
MENA region (incl. Iraq)	..	779.3	846.6	899.7	953.4
MENA (excl. Iraq)	660.2	755.1	833.5	880.5	933.8
Resource Poor Labor Abundant	156.4	184.9	199.0	208.5	216.8
Egypt	84.4	102.8	109.5	114.1	119.7
Jordan	7.6	8.9	9.8	10.5	11.3
Lebanon	16.0	17.2	18.6	19.8	20.0
Morocco	31.2	35.1	38.6	40.2	40.8
Tunisia	16.7	20.2	21.9	23.2	24.4
Djibouti	0.5	0.6	0.6	0.6	0.6
West Bank and Gaza	..	4.0	3.8	4.0	4.3
Resource Rich Labor Abundant (incl. Iraq)	..	208.6	218.3	234.0	246.4
Resource Rich Labor Abundant (excl. Iraq)	161.5	184.4	205.2	214.9	226.7
Algeria	48.8	55.1	61.0	64.1	67.7
Iran	87.2	100.8	113.9	119.4	126.5
Iraq	..	24.1	13.1	19.2	19.7
Syria	17.2	18.6	19.7	20.4	21.3
Yemen	8.2	9.9	10.6	10.9	11.3
Resource Rich Labor Importing	342.3	385.8	429.3	457.2	490.2
Saudi Arabia	174.7	189.2	204.2	214.9	229.0
United Arab Emirates	61.1	75.0	87.9	95.3	103.0
Kuwait	34.7	37.8	44.4	47.2	51.2
Qatar	13.3	18.7	21.1	23.2	25.2
Oman	18.1	21.0	22.0	22.7	23.6
Bahrain	7.0	8.4	9.4	9.9	10.6
Libya	33.3	35.7	40.2	43.9	47.6

The MENA region includes the resource poor labor abundant (RPLA) economies of Egypt, Jordan, Tunisia, Morocco, Lebanon, Djibouti, and the West Bank and Gaza, the resource rich and labor abundant (RRLA) economies of Algeria, Iran, Iraq, Syria, and Yemen, and the resource rich and labor importing (RRLI) economies of Saudi Arabia, the United Arab Emirates, Kuwait, Qatar, Bahrain, Oman, and Libya. West Bank and Gaza is not included in the regional or sub-regional aggregates.

**Appendix Table 3: Gross Domestic Product and Prices  
Real GDP per capita growth (percent per year), 1995-2005**

Country	1995-2000	2000-2002	2003	2004	2005
MENA region (incl. Iraq)	..	0.9	3.4	4.3	3.8
MENA (excl. Iraq)	1.7	1.3	4.9	3.8	4.0
Resource Poor Labor Abundant	2.8	1.9	2.3	3.0	2.2
Egypt	3.7	1.5	1.3	2.4	3.0
Jordan	0.1	2.5	1.4	5.1	4.4
Lebanon	0.4	2.2	3.6	5.0	-0.3
Morocco	1.8	3.1	3.9	2.6	-0.1
Tunisia	4.2	2.1	4.4	4.6	3.8
Djibouti	-3.2	0.3	1.4	1.5	1.4
West Bank and Gaza	..	-15.7	2.5	2.4	2.7
Resource Rich Labor Abundant (incl. Iraq)	..	0.8	-0.8	5.3	3.2
Resource Rich Labor Abundant (excl. Iraq)	1.5	2.6	4.3	3.1	3.7
Algeria	1.5	1.8	5.1	3.4	3.9
Iran	1.9	3.8	5.4	4.0	4.6
Iraq	..	-10.3	-43.3	41.6	-0.8
Syria	-0.2	0.8	0.1	1.3	1.6
Yemen	2.6	1.1	0.0	-0.5	0.7
Resource Rich Labor Importing	0.4	-0.5	5.3	3.3	3.9
Saudi Arabia	0.0	-2.4	4.6	2.1	3.6
United Arab Emirates	-0.9	-1.4	3.7	2.1	0.8
Kuwait	-2.0	-0.4	10.5	3.5	5.4
Qatar	8.5	3.7	3.6	7.6	6.5
Oman	0.9	1.9	-1.0	0.8	1.6
Bahrain	1.2	2.8	5.1	3.4	4.8
Libya	-0.4	1.3	6.9	7.1	6.3

The MENA region includes the resource poor labor abundant (RPLA) economies of Egypt, Jordan, Tunisia, Morocco, Lebanon, Djibouti, and the West Bank and Gaza, the resource rich and labor abundant (RRLA) economies of Algeria, Iran, Iraq, Syria, and Yemen, and the resource rich and labor importing (RRLI) economies of Saudi Arabia, the United Arab Emirates, Kuwait, Qatar, Bahrain, Oman, and Libya. West Bank and Gaza is not included in the regional or sub-regional aggregates.

**Appendix Table 4: Gross Domestic Product and Prices  
Consumer Prices (average annual change)**

Country	Average 1995-2000	Average 2000-2002	2003	2004	2005
MENA region (incl. Iraq)	..	..	..	..	..
MENA (excl. Iraq)	5.2	2.8	4.5	5.1	6.1
Resource Poor Labor Abundant	3.3	2.3	4.4	5.6	5.6
Egypt	3.8	2.8	7.1	9.5	8.9
Jordan	2.8	1.8	1.6	3.4	3.5
Lebanon	4.1	0.7	3.9	4.7	1.3
Morocco	1.9	1.7	1.2	1.5	3.9
Tunisia	3.2	2.3	2.8	3.6	2.6
Djibouti	2.5	1.2	2.0	3.1	3.0
West Bank and Gaza	6.5	3.4	..	..	..
Resource Rich Labor Abundant (incl. Iraq)	..	9.9	11.7	12.6	14.0
Resource Rich Labor Abundant (excl. Iraq)	14.1	9.0	10.5	10.9	12.1
Algeria	6.3	2.8	2.6	3.6	3.5
Iran	19.3	13.6	15.6	15.6	17.9
Iraq	..	17.8	34.0	31.7	32.8
Syria	1.8	0.1	1.3	3.3	3.0
Yemen	11.1	8.7	11.9	12.0	14.6
Resource Rich Labor Importing	0.5	-0.1	1.1	1.6	3.0
Saudi Arabia	-0.3	-0.3	0.6	0.3	1.1
United Arab Emirates	2.3	2.9	3.1	4.6	6.0
Kuwait	1.8	1.5	1.2	1.3	4.0
Qatar	3.3	1.2	2.3	6.8	7.8
Oman	-1.0	-0.6	0.2	0.8	1.9
Bahrain	-0.2	-0.8	1.7	2.3	2.7
Libya	..	-9.3	-2.1	-3.4	3.4

The MENA region includes the resource poor labor abundant (RPLA) economies of Egypt, Jordan, Tunisia, Morocco, Lebanon, Djibouti, and the West Bank and Gaza, the resource rich and labor abundant (RRLA) economies of Algeria, Iran, Iraq, Syria, and Yemen, and the resource rich and labor importing (RRLI) economies of Saudi Arabia, the United Arab Emirates, Kuwait, Qatar, Bahrain, Oman, and Libya. West Bank and Gaza is not included in the regional or sub-regional aggregates.

**Appendix Table 5: Government Finance  
Total Expenditures (as percent of GDP)**

Country	Average 1995-1999	Average 2000-2002	2003	2004	2005
MENA region (incl. Iraq)	..	..	..	31.9	30.6
MENA (excl. Iraq)	32.0	32.3	31.3	30.2	29.2
Resource Poor Labor Abundant	28.9	30.9	30.7	30.0	30.6
Egypt	26.8	29.9	30.1	29.3	29.4
Jordan	35.3	34.9	37.6	38.1	38.2
Lebanon	35.4	38.8	35.8	32.7	31.2
Morocco	29.3	30.8	30.0	29.8	33.1
Tunisia	29.0	27.8	27.0	26.5	26.5
Djibouti	35.1	31.9	36.6	38.1	36.5
West Bank and Gaza	..	..	41.1	42.3	49.7
Resource Rich Labor Abundant (incl. Iraq)	..	..	..	33.5	33.8
Resource Rich Labor Abundant (excl. Iraq)	27.0	27.2	27.7	27.6	29.4
Algeria	30.8	32.2	32.4	28.8	26.6
Iran	25.2	24.1	24.2	25.3	29.2
Iraq <sup>115</sup>	..	..	..	98.3	78.9
Syria	27.0	30.5	27.8	28.0	28.0
Yemen	30.1	32.9	35.7	34.2	40.5
Resource Rich Labor Importing	36.8	35.6	33.6	31.7	28.6
Saudi Arabia	33.8	35.5	33.3	32.1	29.6
United Arab Emirates	38.5	33.6	28.2	24.4	20.0
Kuwait	48.1	40.2	38.6	36.9	30.7
Qatar	44.6	31.7	31.4	30.7	26.7
Oman	39.7	37.4	39.7	39.9	40.1
Bahrain	31.0	31.1	33.4	31.1	30.6
Libya	..	38.8	44.2	40.8	40.8

The MENA region includes the resource poor labor abundant (RPLA) economies of Egypt, Jordan, Tunisia, Morocco, Lebanon, Djibouti, and the West Bank and Gaza, the resource rich and labor abundant (RRLA) economies of Algeria, Iran, Iraq, Syria, and Yemen, and the resource rich and labor importing (RRLI) economies of Saudi Arabia, the United Arab Emirates, Kuwait, Qatar, Bahrain, Oman, and Libya. West Bank and Gaza is not included in the regional or sub-regional aggregates.

<sup>115</sup> Current expenditures.

**Appendix Table 6: Government Finance  
Current Expenditures (as percent of GDP)**

Country	Average 1995-1999	Average 2000-2002	2003	2004	2005
MENA region (incl. Iraq)	..	..	..	25.9	24.5
MENA (excl. Iraq)	25.4	25.8	24.1	23.9	22.6
Resource Poor Labor Abundant	23.1	25.0	25.1	24.7	25.5
Egypt	21.1	23.7	24.4	24.0	24.4
Jordan	28.0	28.5	28.7	28.3	31.2
Lebanon	28.3	35.9	32.8	29.5	28.9
Morocco	24.9	25.5	25.3	25.4	28.3
Tunisia	22.0	19.9	19.6	19.9	19.1
Djibouti	30.8	28.6	29.9	30.3	28.4
West Bank and Gaza	..	..	33.9	36.6	39.7
Resource Rich Labor Abundant (incl. Iraq)	..	..	..	25.8	26.2
Resource Rich Labor Abundant (excl. Iraq)	17.5	18.6	20.0	19.2	21.0
Algeria	23.1	22.9	22.6	19.0	15.1
Iran	14.8	16.1	18.4	18.7	23.2
Iraq	..	..	..	98.3	78.9
Syria	15.4	18.5	15.6	15.6	15.6
Yemen	24.1	26.2	26.7	24.7	31.2
Resource Rich Labor Importing	31.6	30.0	27.1	26.5	23.0
Saudi Arabia	29.6	31.0	28.5	28.1	25.0
United Arab Emirates	31.7	28.9	23.2	20.3	16.5
Kuwait	42.5	36.3	33.8	32.2	26.5
Qatar	38.6	26.9	25.3	22.1	18.6
Oman	32.2	29.5	29.4	28.9	27.2
Bahrain	25.6	24.9	26.3	25.3	25.5
Libya	..	21.5	14.7	..	..

The MENA region includes the resource poor labor abundant (RPLA) economies of Egypt, Jordan, Tunisia, Morocco, Lebanon, Djibouti, and the West Bank and Gaza, the resource rich and labor abundant (RRLA) economies of Algeria, Iran, Iraq, Syria, and Yemen, and the resource rich and labor importing (RRLI) economies of Saudi Arabia, the United Arab Emirates, Kuwait, Qatar, Bahrain, Oman, and Libya. West Bank and Gaza is not included in the regional or sub-regional aggregates.

**Appendix Table 7: Government Finance  
Total Revenues (as percent of GDP)**

Country	Average 1995-1999	Average 2000-2002	2003	2004	2005
MENA region (incl. Iraq)	..	..	..	39.2	43.1
MENA (excl. Iraq)	29.2	34.6	34.3	37.8	41.6
Resource Poor Labor Abundant	25.0	26.9	27.0	26.8	25.7
Egypt	25.1	27.9	27.7	26.8	23.6
Jordan	33.3	32.5	36.3	36.2	33.6
Lebanon	16.8	20.5	22.1	22.8	22.1
Morocco	27.0	27.4	27.3	27.6	29.8
Tunisia	24.5	24.4	23.9	24.1	24.0
Djibouti	31.5	29.6	34.3	35.9	34.3
West Bank and Gaza	..	..	24.3	26.4	30.3
Resource Rich Labor Abundant (incl. Iraq)	..	..	..	37.3	42.0
Resource Rich Labor Abundant (excl. Iraq)	25.4	31.4	30.1	32.2	26.7
Algeria	30.8	36.7	37.0	36.2	40.1
Iran	22.8	28.8	26.7	30.3	35.3
Iraq	..	..	..	93.6	96.3
Syria	25.8	28.1	24.8	23.0	23.0
Yemen	27.0	36.0	30.9	32.0	38.1
Resource Rich Labor Importing	33.9	40.0	39.9	45.2	49.7
Saudi Arabia	28.6	33.3	34.5	41.8	48.0
United Arab Emirates	34.5	41.0	41.1	42.7	45.0
Kuwait	57.7	67.1	56.6	60.5	67.1
Qatar	37.0	37.9	35.8	46.8	44.5
Oman	39.4	45.7	45.6	46.0	47.2
Bahrain	26.6	33.4	31.4	31.4	32.5
Libya	..	46.6	54.8	59.5	59.5

The MENA region includes the resource poor labor abundant (RPLA) economies of Egypt, Jordan, Tunisia, Morocco, Lebanon, Djibouti, and the West Bank and Gaza, the resource rich and labor abundant (RRLA) economies of Algeria, Iran, Iraq, Syria, and Yemen, and the resource rich and labor importing (RRLI) economies of Saudi Arabia, the United Arab Emirates, Kuwait, Qatar, Bahrain, Oman, and Libya. West Bank and Gaza is not included in the regional or sub-regional aggregates.

**Appendix Table 8: Government Finance  
Overall Fiscal Balance (as percent of GDP)**

Country	Average 1995-1999	Average 2000-2002	2003	2004	2005
MENA region (incl. Iraq)	..	..	..	6.4	11.8
MENA (excl. Iraq)	-2.9	2.3	3.0	7.6	12.4
Resource Poor Labor Abundant	-3.9	-4.0	-3.7	-3.2	-4.9
Egypt	-1.7	-2.0	-2.4	-2.4	-5.8
Jordan	-2.0	-2.4	-1.4	-1.9	-4.6
Lebanon	-18.6	-18.3	-13.7	-9.9	-9.1
Morocco	-2.3	-3.4	-2.7	-2.3	-3.3
Tunisia	-4.4	-3.4	-3.2	-2.5	-2.5
Djibouti	-3.6	-2.2	-2.3	-2.1	-2.2
West Bank and Gaza	..	..	-16.8	-15.9	-19.4
Resource Rich Labor Abundant (incl. Iraq)	..	..	..	0.9	5.6
Resource Rich Labor Abundant (excl. Iraq)	-2.0	4.3	2.3	4.6	7.3
Algeria	-0.1	4.5	4.6	7.4	13.5
Iran	-2.8	4.7	2.5	5.0	6.1
Iraq	..	..	..	-40.5	-10.9
Syria	-1.3	-2.3	-3.1	-5.0	-5.0
Yemen	-3.1	3.1	-4.8	-2.3	-2.4
Resource Rich Labor Importing	-2.9	4.4	6.3	13.4	21.0
Saudi Arabia	-5.2	-2.2	1.2	9.6	8.4
United Arab Emirates	-4.0	7.4	13.0	18.3	24.9
Kuwait	9.6	26.9	8.0	23.6	36.5
Qatar	-7.7	6.2	4.3	16.2	17.9
Oman	-0.3	8.3	6.0	6.1	7.1
Bahrain	-4.4	2.3	-2.0	0.3	1.9
Libya	..	7.8	10.6	18.7	18.7

The MENA region includes the resource poor labor abundant (RPLA) economies of Egypt, Jordan, Tunisia, Morocco, Lebanon, Djibouti, and the West Bank and Gaza, the resource rich and labor abundant (RRLA) economies of Algeria, Iran, Iraq, Syria, and Yemen, and the resource rich and labor importing (RRLI) economies of Saudi Arabia, the United Arab Emirates, Kuwait, Qatar, Bahrain, Oman, and Libya. West Bank and Gaza is not included in the regional or sub-regional aggregates.

**Appendix Table 9 : External Sector  
Exports of Goods and Services (as percent of GDP), 1995-2005**

Country	Average 1995-1999	Average 2000-2002	2003	2004	2005
MENA region (incl. Iraq)	..	..	..	49.1	..
MENA (excl. Iraq)	34.2	39.9	43.8	48.6	54.4
Resource Poor Labor Abundant	24.5	24.5	28.5	33.2	34.6
Egypt	18.1	17.0	21.7	29.2	31.1
Jordan	48.5	43.9	47.5	52.0	51.1
Lebanon	12.8	14.8	18.8	20.5	20.8
Morocco	28.0	32.7	32.5	33.1	35.0
Tunisia	42.8	45.7	43.9	46.4	47.2
Djibouti	38.9	37.0	39.9	37.3	36.9
West Bank and Gaza	..	..	..	..	..
Resource Rich Labor Abundant (incl. Iraq)	..	..	..	37.3	..
Resource Rich Labor Abundant (excl. Iraq)	23.6	32.0	31.8	34.4	37.7
Algeria	27.5	38.2	38.3	40.2	45.3
Iran	19.0	27.4	28.2	31.8	34.1
Iraq	..	..	..	69.1	..
Syria	39.9	37.5	32.0	28.7	29.2
Yemen	38.2	39.4	39.0	38.1	43.1
Resource Rich Labor Importing	45.4	51.6	57.1	62.5	69.1
Saudi Arabia	36.8	41.6	46.1	52.7	60.8
United Arab Emirates	77.7	72.8	79.1	81.9	84.9
Kuwait	49.4	50.8	53.9	60.5	66.5
Qatar	47.1	65.0	62.3	71.5	73.2
Oman	46.8	57.6	56.2	57.0	59.1
Bahrain	78.5	85.2	82.3	83.3	79.8
Libya	26.0	42.4	65.4	72.0	86.7

The MENA region includes the resource poor labor abundant (RPLA) economies of Egypt, Jordan, Tunisia, Morocco, Lebanon, Djibouti, and the West Bank and Gaza, the resource rich and labor abundant (RRLA) economies of Algeria, Iran, Iraq, Syria, and Yemen, and the resource rich and labor importing (RRLI) economies of Saudi Arabia, the United Arab Emirates, Kuwait, Qatar, Bahrain, Oman, and Libya. West Bank and Gaza is not included in the regional or sub-regional aggregates.

**Appendix Table 10 : External Sector  
Merchandise exports (current \$US billions): 1995-2005**

Country	Average 1995-1999	Average 2000-2002	2003	2004	2005
MENA region (incl. Iraq)	..	272.8	337.1	436.7	600.0
MENA (excl. Iraq)	182.4	260.1	327.0	418.9	577.3
Resource Poor Labor Abundant	20.5	24.9	30.6	36.7	42.4
Egypt	4.9	6.9	8.2	10.5	14.0
Jordan	1.8	2.3	3.1	3.9	4.3
Lebanon	1.1	1.3	2.1	2.4	2.6
Morocco	7.1	7.5	8.8	9.7	10.3
Tunisia	5.6	6.4	8.0	9.7	10.7
Djibouti	0.0	0.0	0.0	0.0	0.0
West Bank and Gaza	..	0.5	0.4	0.5	0.6
Resource Rich Labor Abundant (incl. Iraq)	..	68.4	77.6	103.9	141.2
Resource Rich Labor Abundant (excl. Iraq)	36.5	55.7	67.6	86.1	118.5
Algeria	12.0	19.8	24.5	32.2	45.8
Iran	18.7	26.9	33.8	44.4	61.0
Iraq	..	12.7	10.1	17.8	22.8
Syria	3.8	5.4	5.4	4.9	5.3
Yemen	2.1	3.6	3.9	4.7	6.4
Resource Rich Labor Importing	125.4	179.5	228.8	296.1	416.4
Saudi Arabia	52.2	72.6	93.1	125.9	180.6
United Arab Emirates	36.4	49.9	67.3	82.3	109.5
Kuwait	12.8	17.0	21.8	30.1	45.1
Qatar	4.8	11.4	13.6	19.4	24.9
Oman	6.8	11.2	11.7	13.3	16.3
Bahrain	4.2	5.9	6.7	7.6	10.4
Libya	8.4	11.5	14.7	17.4	29.6

The MENA region includes the resource poor labor abundant (RPLA) economies of Egypt, Jordan, Tunisia, Morocco, Lebanon, Djibouti, and the West Bank and Gaza, the resource rich and labor abundant (RRLA) economies of Algeria, Iran, Iraq, Syria, and Yemen, and the resource rich and labor importing (RRLI) economies of Saudi Arabia, the United Arab Emirates, Kuwait, Qatar, Bahrain, Oman, and Libya. West Bank and Gaza is not included in the regional or sub-regional aggregates.

**Appendix Table 11 : External Sector  
Imports of Goods and Services (as percent of GDP), 1995-2005**

Country	Average 1995-1999	Average 2000-2002	2003	2004	2005
MENA region (incl. Iraq)	..	..	..	37.9	..
MENA (excl. Iraq)	32.3	32.1	34.4	36.5	35.8
Resource Poor Labor Abundant	34.1	32.2	34.0	40.0	42.2
Egypt	25.6	22.3	23.6	29.6	31.3
Jordan	69.8	67.6	68.7	81.8	92.0
Lebanon	49.0	38.1	37.0	44.0	43.2
Morocco	32.3	36.9	36.4	39.3	43.9
Tunisia	45.5	49.9	47.6	49.3	50.2
Djibouti	50.7	46.6	49.1	54.6	54.0
West Bank and Gaza	..	..	..	..	..
Resource Rich Labor Abundant (incl. Iraq)	..	..	..	35.0	..
Resource Rich Labor Abundant (excl. Iraq)	20.8	23.7	27.6	29.8	29.0
Algeria	24.3	23.2	23.9	25.8	23.5
Iran	15.4	21.2	27.6	30.1	28.8
Iraq	..	..	..	92.7	..
Syria	38.4	32.1	31.5	37.6	50.3
Yemen	47.4	38.6	42.5	37.8	36.9
Resource Rich Labor Importing	38.2	36.5	38.4	38.9	37.2
Saudi Arabia	27.2	28.9	27.5	28.2	29.1
United Arab Emirates	72.3	60.0	65.1	65.3	57.6
Kuwait	44.2	34.1	35.6	36.0	30.3
Qatar	50.1	35.0	33.7	26.7	26.7
Oman	39.5	34.8	37.7	42.9	47.0
Bahrain	69.8	63.8	64.0	64.2	64.6
Libya	22.7	26.7	38.0	41.7	37.2

The MENA region includes the resource poor labor abundant (RPLA) economies of Egypt, Jordan, Tunisia, Morocco, Lebanon, Djibouti, and the West Bank and Gaza, the resource rich and labor abundant (RRLA) economies of Algeria, Iran, Iraq, Syria, and Yemen, and the resource rich and labor importing (RRLI) economies of Saudi Arabia, the United Arab Emirates, Kuwait, Qatar, Bahrain, Oman, and Libya. West Bank and Gaza is not included in the regional or sub-regional aggregates.

**Appendix Table 12 : External Sector**  
**Current account balance (as percent of GDP): 1995-2005**

Country	Average 1995-1999	Average 2000-2002	2003	2004	2005
MENA region (incl. Iraq)	..	..	..	10.7	17.4
MENA (excl. Iraq)	0.2	6.9	7.8	11.9	18.3
Resource Poor Labor Abundant	-3.9	-1.8	0.1	-0.5	-1.7
Egypt	-0.9	-0.2	2.3	4.4	4.6
Jordan	-0.3	2.1	11.6	-0.2	-17.8
Lebanon	-29.2	-18.7	-19.4	-22.7	-21.6
Morocco	-0.9	2.5	3.6	2.2	0.1
Tunisia	-3.1	-4.0	-2.9	-2.0	-2.6
Djibouti	1.5	2.0	6.6	-0.5	-0.5
West Bank and Gaza	..	..	..	..	..
Resource Rich Labor Abundant (incl. Iraq)	..	..	..	2.1	7.3
Resource Rich Labor Abundant (excl. Iraq)	2.8	8.5	4.3	5.6	9.5
Algeria	0.4	12.5	13.0	13.1	17.8
Iran	4.1	6.9	1.4	2.5	5.9
Iraq	..	..	..	-36.8	-14.4
Syria	0.9	6.5	-2.2	2.3	2.2
Yemen	2.9	8.1	-0.1	2.0	7.6
Resource Rich Labor Importing	0.9	10.3	13.2	20.3	29.7
Saudi Arabia	-2.7	6.3	13.1	20.6	28.3
United Arab Emirates	5.5	10.5	8.7	11.9	29.8
Kuwait	18.5	24.6	20.4	31.4	44.1
Qatar	-18.6	18.2	23.9	38.3	41.5
Oman	-6.2	11.5	6.6	3.3	3.1
Bahrain	-1.1	4.2	2.1	3.8	6.4
Libya	4.1	11.9	51.9	30.3	30.3

The MENA region includes the resource poor labor abundant (RPLA) economies of Egypt, Jordan, Tunisia, Morocco, Lebanon, Djibouti, and the West Bank and Gaza, the resource rich and labor abundant (RRLA) economies of Algeria, Iran, Iraq, Syria, and Yemen, and the resource rich and labor importing (RRLI) economies of Saudi Arabia, the United Arab Emirates, Kuwait, Qatar, Bahrain, Oman, and Libya. West Bank and Gaza is not included in the regional or sub-regional aggregates.

**Appendix Table 13 : External Sector**  
**External reserves (current \$US, billions): 1995-2005**

Country	Average 1995-1999	Average 2000-2002	2003	2004	2005
MENA region (incl. Iraq)	..	..	229.1	296.9	373.3
MENA (excl. Iraq)	..	167.3	227.9	289.0	364.0
Resource Poor Labor Abundant	..	36.4	51.8	56.1	62.3
Egypt	..	14.5	14.8	14.8	19.2
Jordan	2.1	3.6	5.4	5.5	5.5
Lebanon	9.1	7.9	14.0	14.1	14.6
Morocco	4.5	8.3	14.6	17.6	18.7
Tunisia	1.9	2.0	3.0	4.1	4.2
Djibouti	0.1	0.1	0.1	0.1	0.1
West Bank and Gaza	..	..	..	..	..
Resource Rich Labor Abundant (incl. Iraq)	..	..	67.6	93.8	126.3
Resource Rich Labor Abundant (excl. Iraq)	..	41.7	66.5	85.9	117.0
Algeria	5.4	18.0	33.2	43.5	57.4
Iran	6.8	16.8	24.4	33.0	49.8
Iraq	..	..	1.1	7.9	9.3
Syria	..	3.4	4.5	4.3	4.4
Yemen	1.1	3.5	4.4	5.1	5.4
Resource Rich Labor Importing	35.1	89.2	109.6	147.0	184.6
Saudi Arabia	14.0	46.2	59.8	86.8	101.9
United Arab Emirates	8.9	14.5	15.1	18.6	23.0
Kuwait	1.0	8.8	7.7	8.4	9.5
Qatar	0.9	1.3	2.9	3.4	4.9
Oman	2.2	2.7	3.6	3.6	4.1
Bahrain	1.3	1.6	1.5	1.7	1.7
Libya	6.6	14.1	18.9	24.6	39.5

The MENA region includes the resource poor labor abundant (RPLA) economies of Egypt, Jordan, Tunisia, Morocco, Lebanon, Djibouti, and the West Bank and Gaza, the resource rich and labor abundant (RRLA) economies of Algeria, Iran, Iraq, Syria, and Yemen, and the resource rich and labor importing (RRLI) economies of Saudi Arabia, the United Arab Emirates, Kuwait, Qatar, Bahrain, Oman, and Libya. West Bank and Gaza is not included in the regional or sub-regional aggregates.

**Appendix Table 14 : External Sector**  
**External reserves (months of goods imports): 1995-2005**

Country	Average 1995-1999	Average 2000-2002	2003	2004	2005
MENA region (incl. Iraq)	..	..	..	12.6	..
MENA (excl. Iraq)	..	11.7	12.7	13.2	13.7
Resource Poor Labor Abundant	..	9.4	12.3	10.6	10.0
Egypt	..	10.7	12.0	9.7	10.0
Jordan	6.3	10.0	12.7	9.0	7.1
Lebanon	15.7	14.8	23.5	18.0	18.7
Morocco	5.8	9.4	13.3	13.0	11.8
Tunisia	3.0	2.8	3.4	4.1	3.7
Djibouti	4.6	4.3	5.1	4.1	4.2
West Bank and Gaza	..	..	..	..	..
Resource Rich Labor Abundant (incl. Iraq)	..	..	..	13.3	..
Resource Rich Labor Abundant (excl. Iraq)	..	13.8	15.8	15.9	18.5
Algeria	7.5	20.8	29.9	29.1	33.8
Iran	..	10.8	10.2	10.8	14.6
Iraq	..	..	..	4.8	..
Syria	..	9.3	11.1	8.1	5.4
Yemen	5.9	14.7	15.0	15.9	14.2
Resource Rich Labor Importing	5.3	12.0	11.6	13.1	13.1
Saudi Arabia	6.4	19.4	21.2	25.5	21.2
United Arab Emirates	3.9	5.1	4.0	4.1	4.5
Kuwait	1.8	14.7	9.3	8.3	8.4
Qatar	3.0	3.6	6.4	8.4	8.9
Oman	5.9	6.2	7.1	5.4	4.6
Bahrain	4.4	4.4	3.5	3.3	2.4
Libya	13.6	32.6	31.5	33.7	43.8

The MENA region includes the resource poor labor abundant (RPLA) economies of Egypt, Jordan, Tunisia, Morocco, Lebanon, Djibouti, and the West Bank and Gaza, the resource rich and labor abundant (RRLA) economies of Algeria, Iran, Iraq, Syria, and Yemen, and the resource rich and labor importing (RRLI) economies of Saudi Arabia, the United Arab Emirates, Kuwait, Qatar, Bahrain, Oman, and Libya. West Bank and Gaza is not included in the regional or sub-regional aggregates.

**Appendix Table 15: External Sector**  
**Real Effective Exchange Rate Index, 1995-2005 (2000=100)<sup>116</sup>**

Country	Average 1995-1999	Average 2000-2002	2003	2004	2005
MENA region (incl. Iraq)	..	..	..	..	..
MENA (excl. Iraq)	87.8	105.5	103.0	101.1	..
Resource Poor Labor Abundant	85.2	97.3	85.9	80.4	78.0
Egypt	99.6	89.8	69.7	62.2	56.7
Jordan	89.2	101.2	91.9	88.4	94.3
Lebanon	20.7	98.0	96.1	93.7	94.9
Morocco	86.5	104.0	91.0	83.9	82.2
Tunisia	100.9	98.0	92.6	89.0	88.2
Djibouti	..	..	..	..	..
West Bank and Gaza	..	..	..	..	..
Resource Rich Labor Abundant (incl. Iraq)	..	..	..	..	..
Resource Rich Labor Abundant (excl. Iraq)	74.7	123.1	145.2	154.9	144.7
Algeria	102.1	99.2	84.7	85.0	85.5
Iran	57.5	141.5	188.1	205.2	198.6
Iraq	..	..	..	..	..
Syria	..	..	..	..	..
Yemen	69.8	98.3	91.4	87.9	..
Resource Rich Labor Importing	93.3	102.0	93.1	87.5	..
Saudi Arabia	97.3	100.4	89.1	82.3	..
United Arab Emirates	87.8	104.1	97.7	92.8	98.3
Kuwait	..	103.2	96.0	91.0	..
Qatar	89.5	101.2	93.3	95.8	..
Oman	96.3	100.4	87.1	78.8	..
Bahrain	95.7	100.9	92.0	86.9	..
Libya	..	..	..	..	..

The MENA region includes the resource poor labor abundant (RPLA) economies of Egypt, Jordan, Tunisia, Morocco, Lebanon, Djibouti, and the West Bank and Gaza, the resource rich and labor abundant (RRLA) economies of Algeria, Iran, Iraq, Syria, and Yemen, and the resource rich and labor importing (RRLI) economies of Saudi Arabia, the United Arab Emirates, Kuwait, Qatar, Bahrain, Oman, and Libya. West Bank and Gaza is not included in the regional or sub-regional aggregates.

<sup>116</sup> Regional REER indices weighted by total trade.

## **APPENDIX B: STRUCTURAL REFORM INDICATORS FOR 2006**

### **B1. Trade Openness**

In the 2005 MENA Economic Developments and Prospects (MEDP) Report, the index for trade policy was constructed using a single policy based measure due to data limitations: the average simple tariff on imports. In the 2006 MEDP Report, a larger range of trade openness and facilitation measures were available. For comparability, Appendix table B1 presents the abbreviated trade policy index, reflecting the status of tariff policy in 2000 versus 2005 (or the closest years available). Appendix Table B2 presents the enhanced trade policy index, utilizing not only the (1) information on tariffs (above) from UNCTAD's TRAINs database; but also information on : (2) the average number of tariff lines subject to non-tariff barriers (NTBs) from the World Trade Organization's (WTO) statistical database; in addition, the trade reform index now includes information on behind-the-border constraints to trade, captured through (3) the average time (in days) necessary to comply with all procedures required to export goods, from the World Bank's Doing Business indicators; and (4) the average time (in days) necessary to comply with all procedures required to import goods, from the World Bank's Doing Business Indicators.

A given country's value for the abbreviated trade policy index (utilizing only information on simple average tariffs) reflects where the economy is located in a normalized cumulative frequency distribution of world-wide tariffs, where a value of 100 indicates the economy which has the lowest average tariff rate worldwide, 0 indicates the economy which has the highest average tariffs, and by design, the world average tariff index value is 50. The index is constructed for two periods of time (2000 and 2005).

In constructing the enhanced trade policy index, in addition to the index on tariff policy mentioned above, indices on trade policy were constructed in a similar manner across the other three areas of trade policy information (NTBs, average time to export goods, and average time to import goods), such that for each area, a country's policy value reflected where the economy was located in the normalized cumulative frequency distribution of that policy feature worldwide, where 100 indicated the economy which had the "best" policy (lowest NTBs, lowest time to export, lowest time to import), 0 indicated the economy which had the "worst" policy, and the world average value was 50.

The composite trade policy index (enhanced trade policy index) was constructed by averaging across all four sub-indices (recalling, each sub-index reflects where the economy is located in the worldwide distribution with regard to that policy feature), and expressing the final value as a normalized cumulative frequency distribution. Thus, a score of 100 reflects the

economy which, on average, had the best trade policies (relative to the world) across a range of trade policy measures, 0 reflects the economy which on average had the “worst” trade policies, and the world average value was 50. Regional averages for all of the structural reform indices reflects the simple average of the countries in that regional grouping.

Finally, trade reform *progress* was estimated as the change in each country’s rank according to the (abbreviated) trade policy index between 2000-2005, expressed as a point in the relative cumulative frequency distribution (100 being the highest value, representing the greatest change in rank over the period).

**Appendix Table B1: Abbreviated Trade Policy Index, 2000 and 2005, and Trade Reform Progress**  
(Based on simple average tariffs)

Country/Region	Average Tariff 2000	Abbreviated Trade Policy Index 2000	Average Tariff 2005	Abbreviated Trade Policy Index 2005	Trade Reform Index (2000-2005)
Algeria	24.0	7	18.7	8	71
Bahrain	7.9	73	5.2	71	62
Djibouti	31.0	3	31.0	0	51
Egypt	21.4	9	9.1	48	100
Iran	41.1	1	22.1	5	74
Jordan	23.1	8	13.1	21	86
Kuwait	3.6	92	3.6	92	65
Lebanon	10.7	63	5.4	71	80
Libya	17.0	27	17.0	14	27
Morocco	30.5	4	30.1	1	52
Oman	5.7	85	5.7	67	11
Qatar	..	..	5.0	74	..
Saudi Arabia	12.0	57	6.0	63	77
Syria	21.0	12	19.6	6	43
Tunisia	29.1	5	28.3	3	57
Yemen	12.8	50	7.0	58	82
<b>MENA</b>	<b>19.3</b>	<b>33</b>	<b>14.2</b>	<b>38</b>	<b>63</b>
<b>Resource Poor</b>	<b>24.3</b>	<b>15</b>	<b>19.5</b>	<b>24</b>	<b>71</b>
<b>Resource Rich</b>	<b>16.1</b>	<b>45</b>	<b>11.0</b>	<b>46</b>	<b>57</b>
<b>RRLA</b>	<b>24.7</b>	<b>17</b>	<b>16.9</b>	<b>19</b>	<b>67</b>
<b>RRLI</b>	<b>9.2</b>	<b>67</b>	<b>7.1</b>	<b>64</b>	<b>48</b>
<b>East Asia and Pacific</b>	<b>10.4</b>	<b>60</b>	<b>7.5</b>	<b>57</b>	<b>37</b>
<b>Europe and Central Asia</b>	<b>8.9</b>	<b>69</b>	<b>6.8</b>	<b>67</b>	<b>69</b>
<b>Latin America and Caribbean</b>	<b>13.4</b>	<b>45</b>	<b>10.2</b>	<b>43</b>	<b>50</b>
<b>High Income OECD</b>	<b>3.2</b>	<b>93</b>	<b>3.7</b>	<b>90</b>	<b>64</b>
<b>South Asia</b>	<b>24.2</b>	<b>21</b>	<b>16.8</b>	<b>14</b>	<b>48</b>
<b>Sub-Saharan Africa</b>	<b>13.5</b>	<b>44</b>	<b>13.7</b>	<b>30</b>	<b>27</b>
<b>LMIC Average</b>	<b>15.0</b>	<b>43</b>	<b>10.4</b>	<b>47</b>	<b>56</b>
<b>WORLD</b>	<b>13.3</b>	<b>50</b>	<b>10.0</b>	<b>50</b>	<b>50</b>

\* or closest years available.

### Appendix Table B2: Enhanced Policy Index, 2005

(Based on simple average tariffs, NTB coverage, average time required for exporting and average time required for importing)

Country/region	Average tariff	Tariff index (1-100)	NTB coverage (% tariff lines)	NTB index (1-100)	Average time for exports (days)	Export time index (1-100)	Average time for imports (days)	Import time index (1-100)	Enhanced trade policy index 2005 (1-100)
Algeria	18.7	8	0.0	88	29	52	51	27	44
Bahrain	5.2	71	0.5	40	..	..	..	..	..
Djibouti	31.0	0	2.7	24	..	..	..	..	..
Egypt	9.1	48	6.1	7	27	55	29	62	43
Iran	22.1	5	0.5	40	45	17	51	27	22
Jordan	13.1	21	0.3	51	28	54	28	63	47
Kuwait	3.6	92	2.1	26	30	50	39	44	53
Lebanon	5.4	71	0.2	53	22	67	34	54	61
Libya	17.0	14	2.2	26	..	..	..	..	..
Morocco	30.1	1	0.3	51	31	47	33	55	38
Oman	5.7	67	0.0	88	23	64	27	65	71
Qatar	5.0	74	1.0	32	..	..	..	..	..
Saudi Arabia	6.0	63	1.2	30	36	32	44	33	39
Syria	19.6	6	0.5	40	49	14	63	13	18
Tunisia	28.3	3	0.0	88	25	58	33	55	51
Yemen	7.0	58	0.0	88	33	43	31	59	62
<b>MENA</b>	<b>14.2</b>	<b>38</b>	<b>1.1</b>	<b>48</b>	<b>31.5</b>	<b>46</b>	<b>38.6</b>	<b>46</b>	<b>46</b>
Resource poor	19.5	24	1.6	46	26.6	56	31.4	58	48
Resource rich	11.0	46	0.8	50	35.0	39	43.7	38	44
RRLA	16.9	19	0.3	64	39.0	32	49.0	31	36
RRLI	9.3	58	0.9	46	28.6	52	34.0	52	54
East Asia and Pacific	7.5	57	0.6	52	27.6	60	31.3	63	56
Europe and Central Asia	6.8	67	3.7	36	31.3	53	42.8	51	51
Latin America and Caribbean	10.2	43	0.4	72	29.7	50	36.8	49	57
High Income OECD	3.7	90	9.7	18	12.0	86	13.4	88	70
South Asia	16.8	14	0.2	69	33.7	39	39.3	44	41
Sub-Saharan Africa	13.7	30	1.8	57	49.2	24	61.1	24	34
LMIC Average	10.4	47	2.3	52	28.5	55	33.8	56	53
WORLD	10.0	50	2.7	50	32.2	50	40.4	50	50

Note: All trade policy data for 2005, or closest year available.

## B2 Business Environment

In the 2005 MEDP, the business environment was measured across a range of World Bank *Doing Business Indicators*<sup>117</sup> of business regulation and procedures, supplemented with financial sector information from *World Development Indicators*. Composite indices were developed across five separate areas of business regulation and financial and legal development, and based on these, a composite index of business reform was developed.

In the 2006 MEDP, much of that information is retained, but where possible, additional information (including with regard to the financial sector) has been supplemented to enhance our evaluation of the business and regulatory environment.

The abbreviated business climate index is constructed utilizing information in four areas of the business regulatory environment, across two periods of time (generally 2003 and 2005)<sup>118</sup>.

- (1) *Starting a business*: Comprising four separate components from the *Doing Business* indicators– the number of procedures for starting a business, the time required to complete the procedures, the cost for starting a business (in terms of income per capita) and the minimum capital required to start a business (in terms of income per capita). Available for 2003 and 2005.
- (2) *Hiring and firing*: Comprising two *Doing Business* indices measuring the difficulty of hiring and the difficulty of firing. The difficulty of hiring index measures a variety of aspects of hiring, including (i) whether term contracts can only be used for temporary tasks; (ii) the maximum duration of term contracts; (iii) the ratio of the mandated minimum wage (or apprentice wage, if available) to the average value-added per working population. The difficulty of firing index has eight components: (i) whether redundancy is not grounds for dismissal; (ii) whether the employer needs to notify the labor union or the labor ministry for firing one redundant worker; (iii) whether the employer needs to notify the labor union or the labor ministry for group dismissals; (iv) whether the employer needs approval from the labor union or the labor ministry for firing one redundant worker; (v) whether the employer needs approval from the labor union or the labor ministry for group dismissals; (vi) whether the law mandates training or replacement prior to

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<sup>117</sup> World Bank 2004a, 2005.

<sup>118</sup> One area of business and regulatory reform: the ease of closing a business, is not presented in the abbreviated reform index although it was originally available in the 2005 MEDP, since the information used to construct that index has been revised and historical information is no longer available. That area of reform is now only covered in the enhanced business reform index.

dismissal; (vii) whether priority rules apply for dismissals; and (viii) whether priority rules apply for re-employment. Available for 2003 and 2005.

- (3) *Access to credit*: Comprising two separate measures of credit from the World Development Indicators database: domestic credit provided by the banking sector as a share of GDP, and domestic credit provided to the private sector as a share of GDP. Available for 2002 and 2004.
- (4) *Enforcing contracts*: Comprising three separate *Doing Business* components – the average number of procedures required to enforce a contract, the number of days required to enforce a contract, and the average cost to enforce a contract, in terms of country income per capita. Available 2003 and 2005.

In addition to composite indices for each area of business regulation and financial and legal infrastructure, an overall business environment index (abbreviated business reform index) was computed as the average of the five area composite scores, expressed as a relative cumulative frequency, with a score of 100 reflecting the country which on average had the “best” policies across the five areas of the business environment measured.

For the 2006 MEDP, several new information was incorporated into the business climate index. In addition to the four areas mentioned above, four new areas were added:

- (5) *Closing a business*: Comprising two *Doing Business* components – the average time (in years) to close a business and the cost (in terms of percent of estate).
- (6) *Dealing with licenses*: Comprising three *Doing Business* components – the average number of procedures to build a warehouse, the average time (in days) spent during these procedures, and the average cost (in terms of income per capita) to comply with these procedures.
- (7) *Registering property*: Comprising three *Doing Business* components: the number of procedures legally required to register property, the time spent in completing the procedures (in days), and the costs (as a percent of property value) for these procedures, including fees, transfer taxes, stamp duties, and any other payments to the property registry, notaries, public agencies or lawyers.
- (8) *Paying taxes*: Comprising three *Doing Business* components: the total number of taxes paid (number), the time it takes to prepare, file, and pay (or

withhold) the corporate income tax, the value added tax, and the social security contributions (in hours), and the total amount of taxes payable by a business, except for labor taxes (as a percent of gross profit).

In addition, the previous reform area, Access to Credit, was enhanced to include, in addition to the two components mentioned, information on two Doing business components of access to credit: (1) the legal rights index, measuring the degree to which collateral and bankruptcy laws facilitate lending; and, (2) the credit information index, measuring the scope, access, and quality of credit information. Information available for 2005.

As with the trade policy index, the business and regulatory climate index (both the abbreviated and the enhanced version) was constructed by initially evaluating each sub-indicator based on a worldwide cumulative frequency distribution of that area, with a maximum value of 100 (best policies), a minimum value of 0 (worst policies), and a worldwide mean of 50. The composite index for any area of the business climate (for example, the composite index for ease in closing a business) represents the average of the underlying distributions, expressed as a normalized cumulative frequency distribution with mean 50. Thus, a score of 100 reflects the economy which, on average, had the best policies for closing a business (relative to the world) across the range of measures of ease of closing a business, 0 reflects the economy which on average had the “worst” policies for closing a business, and the world average value was 50.

The composite business climate index (both the abbreviated and the enhanced version) reflects the average of each composite sub-index (the average of the composite indices for closing a business, hiring and firing, etc), expressed as a normalized cumulative frequency distribution.

Finally, business reform *progress* was estimated in two steps. A composite progress index was calculated for each of the four sub-indices used in constructing the abbreviated business reform index (enforcing contracts, etc) by calculating the country’s change in ranking worldwide according to that indicator, and expressing as a cumulative frequency distribution (where 100 reflects the country which made the strongest progress worldwide in terms of improving its worldwide ranking according to that index, and 0 reflects the country which made the weakest progress). The overall business reform progress index then represents the average of those four composite progress indices, expressed again as a cumulative frequency distribution. Thus 100 reflects the country which made the strongest progress along all areas of business and regulatory reform, while 0 reflects the country which made the weakest progress.

**Appendix Table B3: Abbreviated Business Climate Index, 2003 and 2005, and Business Reform Progress**  
*(Based on five areas of business and regulatory reform)*

Country/Region	2003					2005					BUSINESS REFORM PROGRESS
	Contract Enforcement	Access to Finance	Hiring Firing	Starting a Business	Abbreviated Business Climate Index	Contract Enforcement	Access to Finance	Hiring Firing	Starting a Business	Abbreviated Business Climate Index	
Algeria	18	39	33	28	14	16	36	35	30	17	38
Bahrain	..	70	..	..	..	..	..	..	..	..	..
Egypt	26	78	37	15	31	24	85	13	26	27	36
Iran	64	49	46	69	67	64	63	28	65	61	44
Iraq	54	..	..	..	..	53	..	30	25	25	..
Jordan	64	76	58	4	50	63	84	59	23	64	89
Kuwait	42	82	77	49	74	38	82	84	43	71	7
Lebanon	11	91	60	41	51	9	92	71	36	54	31
Libya	..	47	..	..	..	..	12	..	..	..	..
Morocco	82	73	32	34	61	82	79	16	67	69	54
Oman	48	58	59	68	65	43	58	76	60	66	15
Qatar	..	49	..	..	..	..	49	..	..	..	..
Saudi Arabia	42	71	85	5	52	39	77	84	5	52	26
Syria	6	26	56	18	13	5	..	42	13	8	5
Tunisia	97	75	34	59	80	97	81	34	74	85	93
UAE	16	67	62	19	35	15	67	58	14	29	14
WBG	46	..	..	3	..	43	..	54	3	22	..
Yemen	65	2	56	2	16	63	7	65	3	24	57
<b>MENA</b>	<b>45</b>	<b>60</b>	<b>53</b>	<b>30</b>	<b>47</b>	<b>44</b>	<b>62</b>	<b>50</b>	<b>32</b>	<b>45</b>	<b>42</b>
Res. poor	54	79	44	26	54	53	84	41	38	54	63
Res. rich	39	51	59	32	42	37	48	56	29	39	23
RRLA	41	29	48	29	28	40	33	40	27	27	36
RRLI	37	66	70	35	56	34	67	75	31	54	15
EAP	41	54	69	63	60	41	60	71	61	61	47
ECA	57	35	46	51	46	59	47	42	56	53	64
LAC	38	50	47	41	39	38	52	46	42	40	51
OECD	84	88	56	78	86	84	87	56	77	79	50
South Asia	37	45	50	69	56	37	57	51	62	49	41
SSAfrica	39	28	37	32	27	38	25	40	29	29	43
LMIC Average	51	51	51	45	49	51	56	49	48	51	53
WORLD	50	50	50	50	50	50	50	50	50	50	50

Notes: WBG = West Bank and Gaza; EAP=East Asia Pacific region; ECA=Europe and Central Asia region; LAC=Latin America and the Caribbean region; OECD = High income/OECDRegion; SSAfrica=Sub-Saharan Africa region. Access to finance reflects 2002 and 2004, respectively.

**Appendix Table B4: Enhanced Business Climate Index, 2005**  
*(based on eight areas of business and regulatory reform)*

Country/Region	Contract Enforcement	Access to Finance	Hiring/Firing	Starting a Business	Closing a Business	Dealing with Licenses	Registering property	Paying taxes	ENHANCED BUSINESS CLIMATE INDEX
Algeria	16	13	35	30	73	34	11	3	13
Egypt	24	51	13	26	14	3	14	46	11
Iran	64	63	28	65	34	3	39	74	57
Iraq	53	..	30	25	..	53	72	..	..
Jordan	63	75	59	23	45	60	34	92	58
Kuwait	38	79	84	43	68	37	49	..	59
Lebanon	9	82	71	36	20	39	45	73	37
Morocco	82	43	16	67	67	17	58	19	61
Oman	43	31	76	60	47	24	89	98	78
Saudi Arabia	39	80	84	5	45	78	99	97	80
Syria	5	22	42	13	48	48	48	74	30
Tunisia	97	64	34	74	87	41	55	58	83
UAE	15	52	58	14	6	81	94	97	43
West Bank Gaza	43	..	54	3	..	49	44	..	..
Yemen	63	4	65	3	63	77	74	28	35
<b>MENA</b>	<b>44</b>	<b>53</b>	<b>50</b>	<b>32</b>	<b>48</b>	<b>44</b>	<b>55</b>	<b>66</b>	<b>51</b>
Resource poor	53	63	41	38	47	46	42	58	50
Resource rich	37	40	56	29	48	43	64	71	51
RRLA	40	27	40	27	55	46	49	56	40
RRLI	34	80	75	31	42	39	83	97	65
East Asia and Pacific	41	53	71	61	35	63	62	73	61
Europe and Central Asia	59	51	42	56	49	38	56	42	48
Latin America and Caribbean	38	58	46	42	45	52	52	25	40
High Income OECD	84	90	56	77	85	78	68	71	84
South Asia	37	48	51	62	50	50	39	56	48
Sub-Saharan Africa	38	24	40	29	37	32	24	36	27
LMIC Average	51	59	48	48	49	47	53	46	50
WORLD	50	50	50	50	50	50	50	50	50

Note: All Business Climate data for 2005 or closest year available. Access to finance indicator above differs from access to finance indicator utilized in constructing the abbreviated business climate index (Appendix Table B3); additional financial information was added, which gives a truer sense of a country's access to finance (however, some of this additional information was not available before 2005; thus, to evaluate structural reform progress, an abbreviated version of the financial sector indicator was utilized). See discussion above on construction of business environment indicators.

### **B3 Governance and public sector reforms**

In the 2005 MEDP, governance indicators were developed based on the methodology developed in the World Bank's 2003 report on governance in the MENA region<sup>119</sup>. From that report, two separate spheres of governance were examined: governance related to public accountability and governance related to the quality of public administration. For comparability, those governance indicators have been computed again, utilizing the methodology established, but with a minor adjustment to the underlying data utilized and with an adjustment to the computation methodology (see discussion).

*Index of public accountability (IPA):* Comprised of 11 separate measures:

- i. Freedom House political rights measure
- ii. Freedom House civil liberties measure
- iii. Freedom House freedom of the press ranking
- iv. Center for International Development and Conflict Management (CIDCM) Polity IV database polity score
- v. CIDCM Polity IV database regulation of executive recruitment regulation
- vi. CIDCM Polity IV database competitiveness of executive recruitment competition
- vii. CIDCM Polity IV database openness of executive recruitment openness
- viii. CIDCM Polity IV database regulation of participation
- ix. CIDCM Polity IV database competitiveness of participation
- x. CIDCM Policy IV database executive constraints
- xi. Political Risk Services (PRS) index of democratic accountability

2) *Index of quality of public administration (IQA):* Comprised of 5 separate measures:

- i. Political Risk Services index of corruption
- ii. Political Risk Services index of bureaucratic quality.
- iii. Heritage Foundation index of property rights
- iv. Heritage Foundation index of regulation
- v. World Bank Doing Business indicator of starting a business: number of procedures

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<sup>119</sup> World Bank 2003b.

- vi. World Bank Doing Business indicator of contract enforcement (average time)
- vii. World Bank Doing Business indicator of closing a business (average time)

According to the methodology established in the 2003 Governance Report, principal component analysis (PCA) was performed on the eleven and seven measures listed above to derive the two broad governance indicators. Unlike in last year's MEDP, however, the methodology has been revised. The set of countries was reduced to 142 to remove countries with a large share of missing data in the sub indicators. While PCA approach was retained, the weights applied to the normalized underlying variables were derived from the first principal component. (see Appendix Box for a brief explanation of PCA). The same weights generated for 2000 are now used for 2005 to ensure consistency and comparability across time. In addition, the scale of the resulting index was adjusted such that a maximum score of a 100 is given to a (hypothetical) country that is at the top in each underlying variable that supports a particular index while the lowest score of 0 would be for a country that is at the bottom of each sub-indicator. Finally, these governance indices were also used to determine a country's position relative to others using percentile ranking. A country which is in the 90<sup>th</sup> percentile for a particular governance index in a selected year implies that it performed better than 90 percent of all other countries in that year.

Finally, as with the other structural reform areas, governance reform progress was estimated as the change in each country's rank according to the given governance reform index between 2000-2005, expressed as a point in the relative cumulative frequency distribution (100 being the highest value, representing the greatest change in rank over the period).

**Appendix Table B5: Governance Indices, 2000 and 2005, and Governance Reform Progress**

Country/Region	Quality of Administration, 2000	Quality of Administration, 2005	Quality of Administration, Reform	Public Sector Accountability, 2000	Public Sector Accountability, 2005	Public Sector Accountability, Reform
Algeria	26	38	91	22	29	91
Bahrain	80	77	26	16	23	91
Egypt	29	43	92	19	25	84
Iran	23	16	19	35	21	4
Jordan	63	66	67	33	34	60
Kuwait	62	58	24	30	31	65
Libya	9	11	64	1	0	42
Morocco	66	73	83	28	33	81
Oman	56	61	75	11	16	81
Qatar	49	60	89	10	13	74
Saudi Arabia	52	57	77	3	5	69
Syria	12	15	67	4	7	74
Tunisia	65	74	87	26	22	22
UAE	74	59	6	18	17	41
Yemen	24	28	71	13	20	89
<b>Middle East North Africa</b>	<b>46</b>	<b>49</b>	<b>63</b>	<b>18</b>	<b>20</b>	<b>64</b>
Resource Poor	56	64	82	27	28	62
Resource Rich	42	44	55	15	17	65
RRLA	21	24	62	19	19	64
RRLI	55	55	52	12	15	66
East Asia and Pacific	44	43	45	43	41	48
Europe Central Asia	47	47	46	51	52	51
LAC	46	46	50	58	57	53
High Income OECD	89	89	47	92	91	49
South Asia	47	48	53	47	39	31
Sub-Saharan Africa	35	34	53	35	37	55
<b>WORLD</b>	<b>50</b>	<b>50</b>	<b>50</b>	<b>50</b>	<b>50</b>	<b>50</b>

LAC = Latin America and the Caribbean. Governance indices reflect data for 2000 and 2005, or closest available years.

### **Appendix Box: Principal Component Analysis (PCA)**

PCA is an aggregation technique designed to linearly transform a set of interrelated variables into a new set of uncorrelated principal components which account for all of the variance in the original variables. Each computed principal component is a linear combination of the underlying variables weighted to capture as much of the variance across observations in the variables as possible. There are as many principal components as there are explanatory variables. Each component is uncorrelated with the others, and each succeeding principal component accounts for as much of the variation in the explanatory variables as possible that was unaccounted for by the preceding principal components. PCA extracts from the data the true source of variation by giving more weight to those variables that vary most across countries. That is, the analysis gives more weight to underlying variables that have more useful information relative to other variables with less useful information. It should be noted that typically in PCA work, only the first one or two principal components are retained, as they generally explain most of the variance among all standardized linear combinations of the original data.

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