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October 20, 1995

To: Members of the Executive Board

From: The Acting Secretary

Subject: Macroeconomy of the Middle East and North Africa - Exploiting Potential for Growth and Financial Stability

Attached for the information of the Executive Directors is a paper on macroeconomy of the Middle East and North Africa. It is intended that this paper be made available to the public and circulated at the forthcoming Middle East/North Africa Economic Summit to be held in Jordan on October 29-31, 1995. A summary and conclusions appear on pages 30 and 31.

Mr. El-Erian (ext. 37357) or Ms. Eken (ext. 36511) is available to answer technical or factual questions relating to this paper.

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Macroeconomy of the Middle East and North Africa

Exploiting Potential for Growth and Financial Stability

INTERNATIONAL MONETARY FUND

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MACROECONOMY OF THE MIDDLE EAST AND NORTH AFRICA:
EXPLOITING POTENTIAL FOR GROWTH AND FINANCIAL STABILITY

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Executive Summary

1. The MENA region is an important entity in the world economy. It is rich in natural resources, labor and entrepreneurial endowments with a large GDP and population. It is also a very heterogenous region, with countries varying--in some cases considerably--in terms of economic size, population, public/private sector balances, and financial and natural resources.

2. MENA countries have made important economic gains in recent years. The structure of most economies has been strengthened by reforms in the financial sector, exchange and payments systems, and public finances. Inflation has been lowered in a number of countries and foreign assets, while reduced, remain significant.

3. Despite important achievements, the MENA region is yet to exploit fully its considerable economic potential. This is most evident in low per capita income growth, under-exploited regional trade and investment opportunities, and the low share of resident financial holdings invested within the region.

4. As widely recognized by policy makers in the region, three factors constraint most countries' ability to exploit more fully their economic potential: poor economic diversification, insufficiently responsive economic policies, and adverse external developments. The long-standing Arab-Israeli conflict and other political uncertainties have also discouraged investment.

5. The need to progress further in addressing impediments to sustained high economic growth and financial stability is accentuated by the current outlook for the region's external environment. The prospects for the terms of trade and the demand for labor services are such that the region cannot expect major windfall gains. In contrast, the eventual achievement of a comprehensive, just and durable Arab-Israeli peace, as well as growing economic integration with the European Union, provide for gains, if the overall economic and financial environment is appropriate.

6. Several countries in the region have made significant progress in adjustment and reform while others lag behind. Despite these differences, countries in the region may be thought of as facing eight policy items: intensifying privatization and deregulation, reforming public finances, improving the functioning of labor markets, strengthening human resources, enhancing domestic and foreign investments, improving financial intermediation, liberalizing external trade and payments, and ensuring a supportive fiscal, monetary and exchange rate policy mix.

7. Fulfilling this agenda is not an easy task and the stakes are high. Emphasis must be placed on strengthening the institutional backing and human capabilities. Certain countries also require timely disbursement of foreign assistance on appropriate terms to support their domestic policy efforts.

8. The potential for significant gains is accompanied by the possibility of short-term costs as economies adjust to more efficient structures that provide for high sustained economic growth, reduce vulnerability to adverse external developments, and allow countries to benefit from the changes in the world economy. The costs may be minimized through proper planning and sequencing of policies, with the remaining elements alleviated by well-targeted social safety net provisions.

9. With appropriate policies, prospects are good for a reinvigoration of the region's economic growth and development process as individual country developments are reinforced by welfare-enhancing region-wide effects. As a result, all countries in the region would be in a better position to exploit their considerable economic potential and meet the legitimate aspirations of their growing populations.

I. Introduction

The economy of the Middle East and North Africa (MENA) region offers striking contrasts. 1/ Its economic size and population make the region economically significant, as do its considerable natural-resource, human, and financial endowments. It is strategically located, has long-established economic and financial links with industrial countries, and has a respected tradition of trade.

Notwithstanding important policy gains in recent years, several MENA countries are yet to exploit fully their considerable economic potential as stagnant per capita growth and underutilized trade and investment opportunities indicate. Indeed, some countries in the region are failing to benefit sufficiently from the considerable changes taking place in the world economy.

Today, the MENA region is at a cross-roads in its economic development. One road leads to disappointing growth rates and increased marginalization in the world economy, while the other, leading to increasing integration into the world economy, promises high sustainable growth. This choice is recognized throughout the region as emphasis is placed on the private sector as the engine of growth. Policy makers are thus confronting the challenge of formulating and implementing policies that will improve their economies and allow them to benefit from the changes in the regional and international economy. The stakes are high.

This paper hopes to contribute to the understanding of the economic challenges and opportunities facing the MENA region. Chapters II and III review the economic characteristics of the region and its recent performance. This and the related analysis of the main contributing policy factors form the basis for subsequent discussions of prospects and associated policy implications. Recognizing that the region's economic prospects are a function not only of countries' domestic policies, Chapter IV assesses the potential impact of their external environment, arguing that most countries in the region cannot, and should not, look to their external environment for significant windfall gains. This accentuates the importance of adjustment policies and structural reforms discussed in Chapter V. Concluding remarks are contained in Section VI.

A paper of this type is subject to three qualifications. First, it attempts to cover a large geographical area comprising countries of differing economic size, characteristics, experience, and potential. Second, it does not provide a country-by-country analysis and accordingly indulges in some largely unavoidable generalizations by seeking to identify predominant characteristics and trends, and providing an overall framework for detailed country analyses. Third, the paper's analysis is hindered by data limitations, as well as the usual problems associated with cross-country comparisons and aggregation.

1/ For the purposes of the analysis in this paper, the MENA region is defined to include members of the Arab League, Islamic Republic of Iran, and Israel (see Box 1). Aggregate data for the region are compiled on the basis of computed GDP-weighted averages of individual countries for which data are available.

II. Overview of MENA Economy

The MENA region possesses abundant human and natural resources, accounts for a large share of world petroleum production and exports, and enjoys on average a reasonable standard of living. Within this general characterization, countries are quite diverse. They vary, in some cases substantially, in resources, economic and geographical size, population, and standards of living (see Box 1). At the same time, intra-regional interaction is relatively small, being heavily weighted toward labor flows with limited trade in goods and services.

MENA covers a surface of over 15 million square kilometers with some 6 percent of the world's *population*, about the same as the population of the European Union (EU) (Table 1). The three smallest countries (Bahrain, Djibouti, and Qatar) each have a population of about 0.5 million inhabitants. By contrast, the two largest countries (Egypt and the Islamic Republic of Iran) comprise about 60 million inhabitants each. Together with Algeria, Morocco, and Sudan, these five most populated countries account for about 70 percent of the total population. About half the population of the region lives in cities.

Most MENA countries are experiencing rapid population growth and high dependency ratios. The average annual rate of population increase during 1989-94 was about 3 percent, the same as that in sub-Saharan Africa. Underlying the population growth are fertility rates substantially higher than those in other economies with similar real per capita income. 1/ Among MENA countries, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates have registered population growth rates exceeding 3.5 percent in recent years, while Bahrain, the Islamic Republic of Iran, Lebanon, and Tunisia have recorded rates below the 2 percent average of the developing countries.

The growth in the labor force in the region has been faster than that of total population in recent years. As more than 50 percent of some countries' population is under the age of 15, this growth will be relevant for years to come; moreover, female participation rates remain very low. Not surprisingly, therefore, ***employment*** issues are on the agenda of most countries in the region. In non-GCC economies, rates of unemployment exceed those in most other regions in the world. Urban unemployment is estimated at over 30 percent in Yemen and over 50 percent in the Gaza Strip. 2/ Although countries of the GCC have in the past imported labor, with the rapid population growth cited earlier and slower economic growth, they now must absorb a growing number of nationals into the labor force.

1/ See Cohen and Hammour (1994).

2/ For a detailed discussion of and information on labor market conditions in MENA, see World Bank (1995).

Box 1

Guide to Grouping MENA Countries

There is no unique or simple way to group MENA economies given their diverse economic characteristics and experience. Not surprisingly, therefore, studies have used various criteria to group countries, some of them covering only a subset of the MENA economies.

- ***Oil economies*** *Ten MENA countries are oil-exporting countries: Algeria, Bahrain, Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. While others countries (such as Egypt, Syria, and Yemen) also export oil, this sector's role in their economies is less important at this time.*

- ***Economic diversification*** *Among the non-oil exporters, four countries (Israel, Morocco, Syria, and Tunisia) have a fairly diversified economic and export base. Four other countries (Djibouti, Mauritania, Somalia, and Sudan) have agriculture- or mineral-based economies. The remaining countries have a large service sector and are exporters of services.*

- ***Labor flows*** *Seven countries (Algeria, Egypt, Jordan, Morocco, Sudan, Tunisia, and Yemen) export labor in a significant manner and receive large inflows of remittances as a source of foreign exchange earnings. Israel and the countries of the Cooperation Council for the Arab States of the Gulf (or GCC, consisting of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates) rely relatively heavily on imported labor.*

- ***Per capita income*** *According to World Bank classifications, five countries (Egypt, Mauritania, Somalia, Sudan, and Yemen) are low income countries. Thirteen countries (Algeria, Bahrain, Djibouti, Islamic Republic of Iran, Iraq, Jordan, Lebanon, Libya, Syria, Morocco, Oman, Saudi Arabia, and Tunisia) are middle income countries, while Israel, Kuwait, Qatar, and the United Arab Emirates are classified as high income countries.*

- ***Financial flows*** *Six countries (Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates) are net creditor countries.*

- ***Geographic regions*** *The Maghreb region is usually defined as covering Algeria, Libya, Morocco, and Tunisia. The Mashreq region covers Egypt, Israel, Jordan, Lebanon, Syria and West Bank/Gaza. Of the remaining countries, six are members of the GCC.*

- ***Arab economies*** *Members of the Arab League are Algeria, Bahrain, Djibouti, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Mauritania, Morocco, Oman, Palestine, Qatar, Saudi Arabia, Somalia, Sudan, Syria, Tunisia, the United Arab Emirates, and Yemen.*

Despite unemployment in certain countries, the MENA region is fairly well off in terms of traditional indicators of *human resource development*. 1/ Average life expectancy at birth is about 65 years--close to the world average--and the infant mortality rate is only marginally above the world average (Table 2). Although the average illiteracy rate in the region is high, primary and secondary school enrollment as a percentage of school age population is above those of comparable developing countries (in terms of per capita income), as is the teacher-to-pupil ratio. There are, however, three important qualifications. First, the illiteracy and educational indicators are significantly more unfavorable for women than men. Second, MENA countries compare poorly to other countries when account is taken of spending on the social sectors, highlighting the impact of distorted labor markets, an inefficient educational delivery system, and neglect of female education, and other factors. Third, when combining various human development indicators, the region's ranking among countries in the world is less favorable than that based on income criteria. 2/

Although the region is characterized by harsh climates, limited ground water and rainfall, and scarce arable land, 3/ it possesses abundant *natural resources*. About two thirds of the world's known crude-oil reserves lie under the MENA region, with one-quarter located in Saudi Arabia. Following the breakup of the U.S.S.R., the Islamic Republic of Iran now has the world's largest proven reserves of natural gas, about 15 percent of the world's total. The region also possesses numerous non-fuel mineral and nonmineral resources. Algeria, Morocco, Tunisia, Jordan, and Syria account for about one third of the world's phosphate production, with Morocco alone having more than 30 percent of the world's phosphate rock and 40 percent of its phosphoric acid trade. The region's other natural resources include potash (Islamic Republic of Iran, Israel, and Jordan), iron ore (Iran and Mauritania), coal (Iran), ammonia and urea (Iran and Qatar), copper and gypsum (Mauritania), cotton (Egypt and Sudan), tobacco (Syria), and coffee (Yemen). In addition, almost all MENA countries have coasts and fishing grounds.

Reflecting these various considerations, the MENA region constitutes a sizable *economic entity* and enjoys, on average, a reasonable standard of living by international standards. In 1994, the nominal GDP of the region amounted to US$610 billion, equivalent to 2½ percent of world GDP and some 12 percent of the GDP of developing countries. Saudi Arabia is the largest economy, accounting for one fifth of the region's total GDP. At about half the size of Saudi Arabia, Islamic Republic of Iran and Israel are the next largest economies. The eight smallest economies (Bahrain, Djibouti, Jordan, Lebanon, Mauritania, Qatar, Somalia, and Sudan) together account for about 6 percent of the region's GDP.

The average per capita GDP in the region, at about US$2,000, is twice that of developing countries as a whole; it places MENA between the average levels of Latin America and of economies in transition. Individual MENA countries differ greatly, however. The four highest per capita income countries (Israel, Kuwait, Qatar, and the

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1/ For a detailed discussion of these issues in the MENA region, see Heyneman (1993).

2/ See, for example, the UNDP's ranking on the basis of the "human development index"--UNDP (1995).

3/ For example, in Djibouti, less than 1 percent of the land is arable, while in Egypt the area under cultivation is below 3 percent of total land mass, notwithstanding the reclamation of desert land since the 1950s.

United Arab Emirates) enjoy an average per capita GDP of around US$15,000 compared with US$250 for Somalia and Sudan, the poorest countries in the region. 1/

MENA countries, especially non-oil ones, have low *domestic savings rates* (Chart 1). The domestic savings-to-GDP ratio has averaged 19 percent in the region as a whole, but only 11 percent in the non-oil producing countries. This compares with a ratio of about 25 percent in developing countries. Fortunately (as documented below), efforts have been made recently to lower public dissaving by reducing government budget deficits.

On the *external side*, MENA countries appear, on the face of it, very open. For example, the total trade-to-GDP ratio amounts to about 66 percent (Table 3). MENA's exports and imports of goods account for 4 percent of world trade and 15 percent of the total trade of developing countries. The share of the MENA region in international trade of goods is twice that of sub-Saharan Africa, the same as that of Latin America and the economies in transition, but only about one fifth of the share of developing countries in Asia.

The region trades mainly with industrial economies (Chart 2 and Table 4), *and the* EU countries are the most important trading partners, accounting in the recent past for 30 percent of exports and 40 percent of imports of MENA countries. The United States accounts for about 12 percent of both the region's exports and imports, and Japan for 16 percent of exports and 8 percent of imports.

These indicators are heavily influenced by the region's oil trade. Oil and oil-related products are the dominant *exports* of the region, accounting for about three quarters of the region's exports and about 40 percent of world exports of these products (Chart 3). Phosphates and derivatives, iron ore, and cotton are also important exports. Per capita exports in the MENA region amount, on average, to US$650, twice that of the developing countries as a group. As discussed below, there are sharp differences among countries in the region. For example, per capita exports range from US$25 in Sudan to US$11,000 in the United Arab Emirates. 2/ There is a correspondingly large variation in openness ratios--ranging from 28 percent for Syria to 200 percent for Bahrain.

The MENA region is heavily dependent on *imports* of foodstuffs. Gross food imports of the region account for 6 percent of world food imports. All countries--except for Israel, Mauritania, and Morocco--are, on average, net food importers.

Intra-regional trade has played a limited role in integrating the MENA countries, as it accounts for only about 8 percent of both exports and imports of the region; this compares to 60 percent in the EU. 3/ The MENA region experiences large *intra-regional labor* movements. 4/ Indeed, labor movements have been the main vehicle of the region's economic integration, triggering substantial financial flows in the form of workers'

1/ As a measure of the region's income disparity, the coefficient of variation of per capita GDP is about 1.15 compared with 0.34 in the EU.

2/ In some countries (e.g., Djibouti, Lebanon and the U.A.E.), the high levels of per capita exports and the openness indicator ratios also reflect important reexport activities.

3/ Discussions of trade patterns and integration in the MENA region can be found in Fischer (1993) and Shafik (1992 and 1994).

4/ For a detailed discussion of issues related to intra-Arab labor movements, see Abdel Jaber (1993).

remittances and transmitting economic impulses across countries. 1/ Although an estimated 1.5 million workers returned home after the 1990-91 regional crisis and the number of Palestinians working in Israel has declined significantly, labor markets in the MENA region remain highly integrated relative to other regions of the world. Thus, in the recent past, remittances have amounted to about one quarter of exports of goods and services of non-oil exporters in the region and exceeded 50 percent in some countries, such as Egypt, Jordan, and Yemen. In addition to their direct balance of payments impact, labor remittances have been shown to be an important determinant of private investment in certain countries in the region (including Jordan).

Reflecting employment conditions at home as well as special historical relations with other countries, many Arab workers, especially from North Africa, have also migrated outside the MENA region--mainly to Europe. Concurrently, the MENA region has received inflows of migrant workers from outside the region, especially south and east Asia: Asian nationals account for a growing share of the nonnational labor force in the GCC countries and Israel. Israel has also absorbed in recent years a significant inflow of immigrants from the countries of the former U.S.S.R.

The MENA region enjoys sizable *interest income inflows* reflecting a high level of foreign assets, while current transfers with the rest of the world remain marginal. During 1989-94, such inflows averaged about US$6 billion per annum (with oil-producing countries receiving double that amount), while all other country groupings, including industrial countries, recorded negative flows. Meanwhile, excluding transfers in 1991 associated with the Gulf crisis, the region has maintained on average a zero balance flow on account of current transfers with the rest of the world.

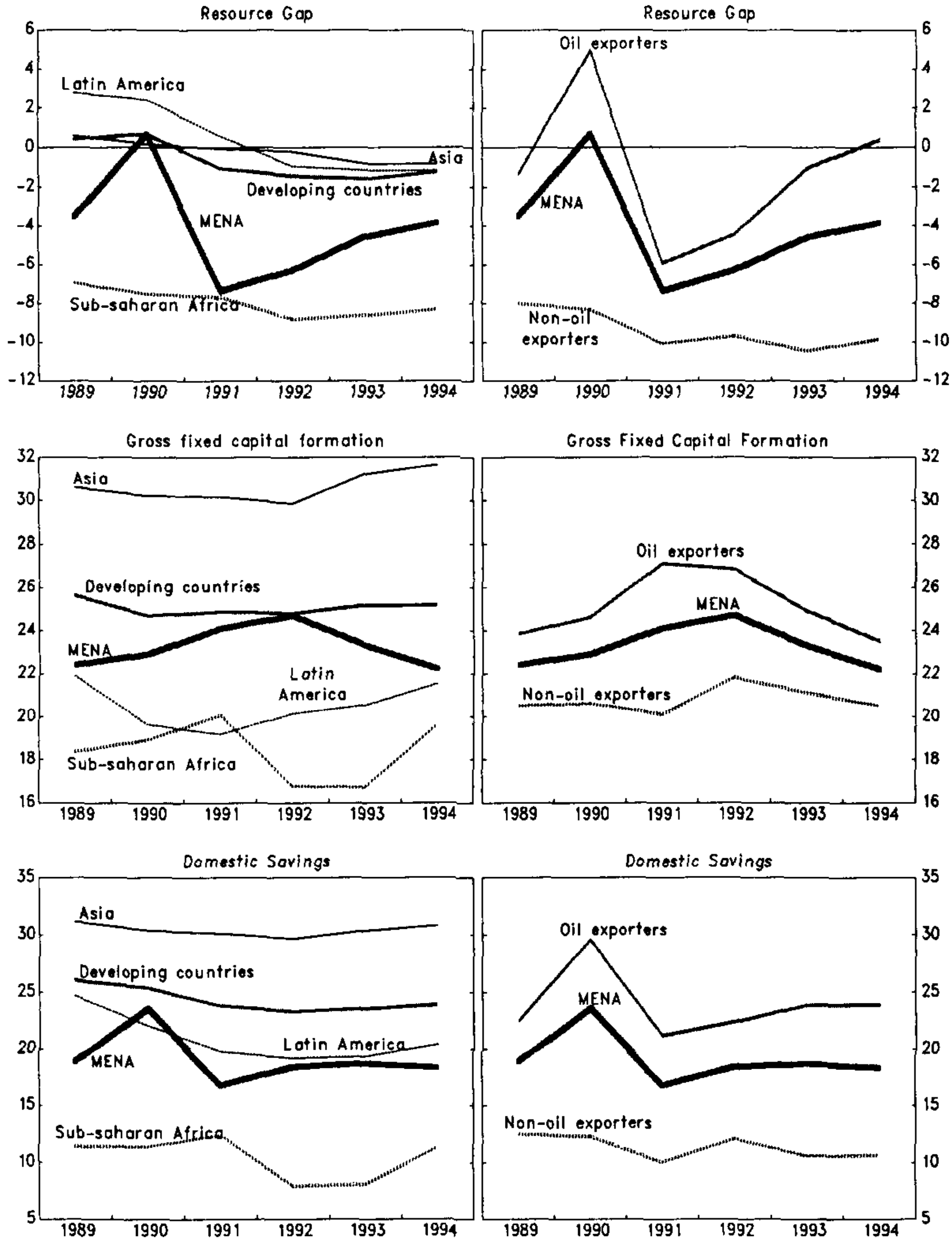
Finally, in terms of *intra-regional capital flows*, there are two distinct groups in MENA: providers of significant foreign assistance--mainly the oil exporters, such as Kuwait, Qatar, Saudi Arabia, and the United Arab Emirates--and recipients. Foreign assistance from the MENA region has been extended, for the most part, on concessional terms and is highly correlated with the donor's economic circumstances and thus with fluctuations in world-market prices of oil. 2/ Political considerations have also played an important role in this regard, but private capital flows have been relatively limited. 3/

1/ At the beginning of the 1990s, the foreign labor force, including labor from outside the region, accounted for about two thirds of the total labor force of the GCC countries.

2/ On financial assistance from Arab countries and Arab regional institutions, see van den Boogaerde (1991).

3/ On private capital flows among Arab countries, see Abisourour (1993).

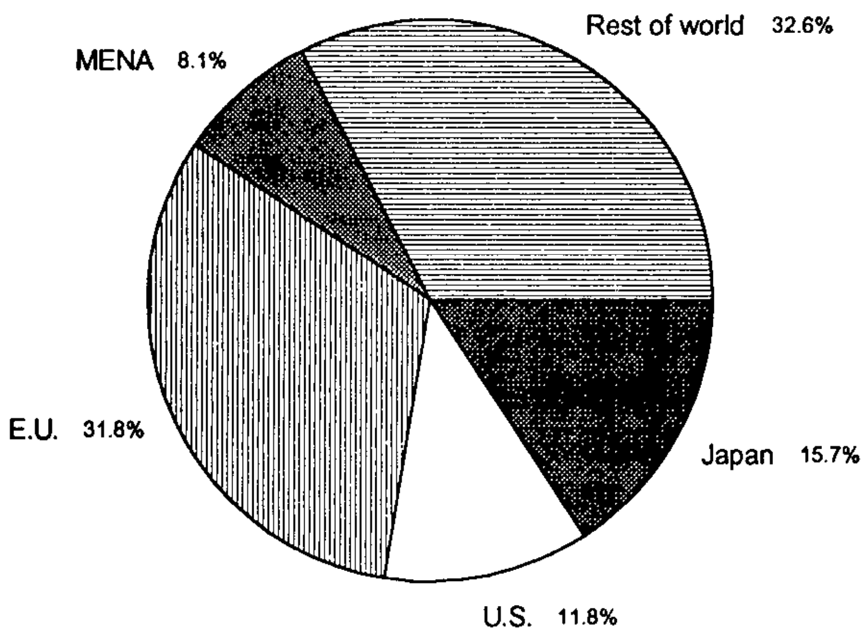
CHART 1.
DEVELOPING COUNTRIES AND MENA REGION
SAVINGS AND INVESTMENT BALANCE, 1989-94
(In percent of GDP)



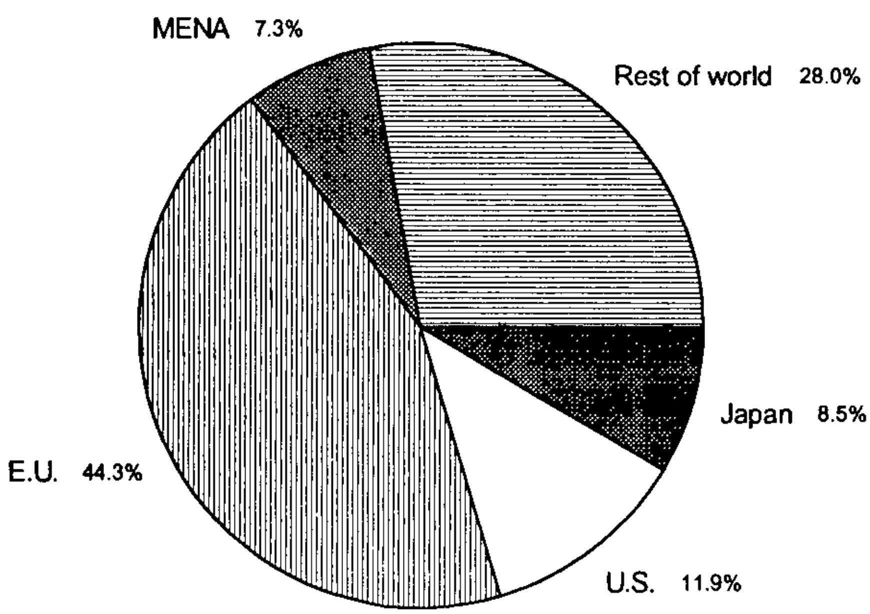
Source: IMF, World Economic Outlook.

Chart 2.
MENA: Direction of Trade
(In percent; 1989-94 averages)

Destination of Exports

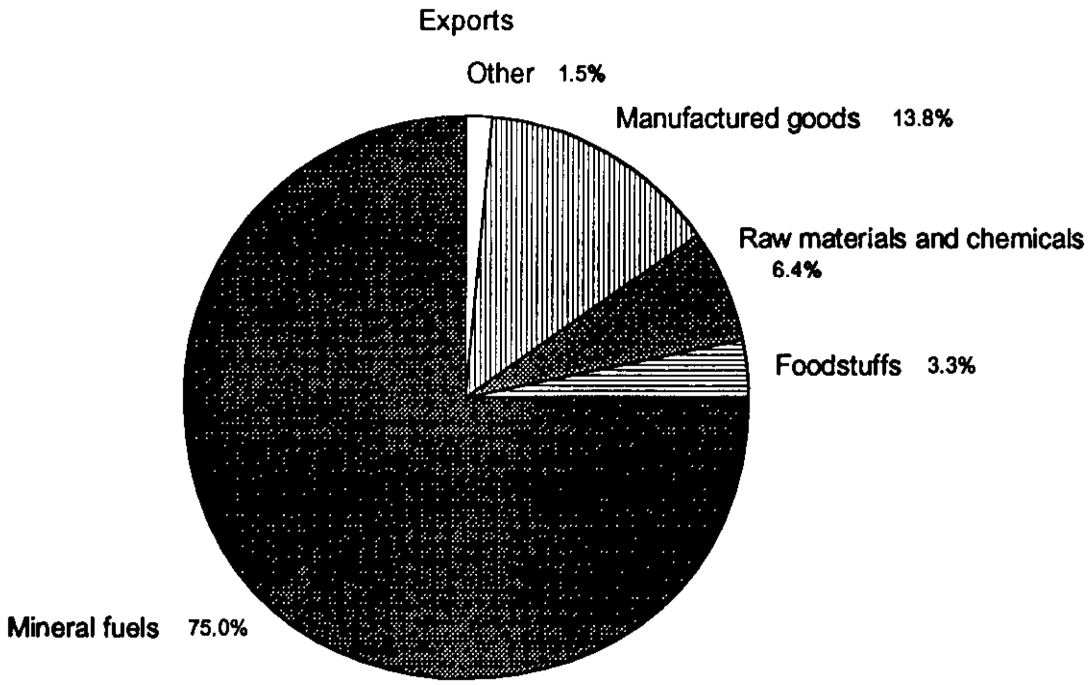


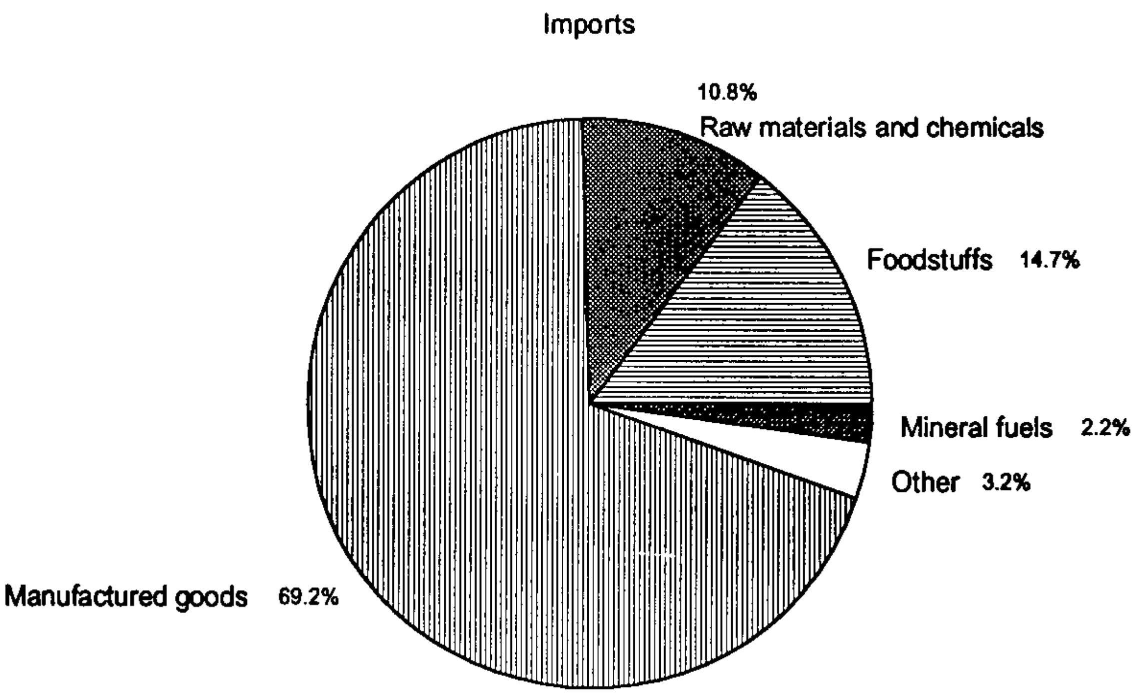
Sources of Imports



Source: IMF, Direction of Trade.

Chart 3.
MENA: Composition of Trade
(In percent; 1989-94 averages)





Source: United Nations, Trade Analysis and Reporting System.

III. Economic Performance

This chapter discusses recent economic experience--specifically, the region's performance in sustaining high economic growth in the context of domestic and external financial stability. Following an overview of developments in the main macroeconomic aggregates, it analyzes the structural aspects, recent policy actions, and terms of trade.

1. Macroeconomic aggregates

Although MENA countries suffered from the consequences of weak economic activity in industrial countries in the early 1990s, the crisis triggered by Iraq's invasion of Kuwait, and the weak oil-market conditions, the region achieved positive rates of real *economic growth* throughout 1989-94 with GDP expanding at annual average rate of 3.2 percent (Chart 4 and Table 5). This growth compares favorably with that of Africa (1.6 percent) and Latin America (2.9 percent); only Asian countries recorded a higher GDP growth (7.5 percent). Nevertheless, rapid population growth has caused annual average *per capita real GDP growth* to stagnate. In contrast, developing countries as a whole were able to increase their real per capita GDP by 3 percent and industrial countries by 1.3 percent during this period.

Growth performance varied among various country groups and countries in the region:

- Oil exporters as a group registered declines in real GDP growth since the beginning of the 1990s, reflecting weakening world oil markets.

- As regards non-oil exporting economies, countries that embarked earlier on economic adjustment and structural reform programs--including Israel, Jordan, Mauritania, Morocco, and Tunisia--performed relatively well, even though Jordan's economic adjustment was disrupted by the 1990-91 regional crisis, and Morocco and Tunisia suffered droughts.

- Countries with civil strife and armed confrontation recorded generally very low or negative GDP growth, but the ending of hostilities in a number of cases has been followed by reconstruction and rehabilitation, giving impetus to growth. 1/

The *inflation* performance of MENA countries has been fairly good relative to other developing countries (Table 6). In 1989-94, the weighted average consumer price index of the region increased annually by about 16 percent, compared with 47 percent for developing countries as a group. Within the MENA region, inflation performance of oil exporters was on average better than that of the non-oil exporters, reflecting relatively tighter monetary policies, the nominal anchor provided by the peg of most of these countries' currencies to the U.S. dollar, and the "safety valve" operating through the balance of payments to reduce excessive demand pressures, although at the cost of an erosion in international reserves and related investment income. Nevertheless, since the beginning of the 1990s the inflation rate in oil-exporting countries as a group has been

1/ On the effects of the civil war and the reconstruction program in Lebanon, see Eken and others (1995).

increasing, while that in non-oil exporting countries has been declining, culminating in a relatively better inflation performance in the latter in 1994.

At the individual country level, 12 MENA countries achieved single digit inflation during 1989-94, and five countries (Bahrain, Kuwait, Oman, Qatar, and Saudi Arabia) had better inflation performance than that of the average for industrial countries. Egypt significantly reduced inflation during this period, reflecting strengthened fiscal and monetary policies. By contrast, Sudan recorded annual inflation rates of over 100 percent throughout the period. Lebanon, Somalia, Yemen, and, to a lesser extent, Algeria and the Islamic Republic of Iran were among the countries in the region with relatively high inflation.

The *external position* of the MENA region deteriorated sharply in early 1991, but improved steadily thereafter (Chart 5 and Table 7). As a ratio to GDP, the current account deficit (including official transfers) averaged 5 percent during 1989-94, compared with 1.3 percent in developing countries as a group. Among developing countries, sub-Saharan Africa was the only region to register larger current account imbalances.

The volume of *exports* of the MENA region increased at an annual average rate of 5.6 percent during 1989-94, compared with 8.4 percent for developing countries as a whole (Table 8). On average, export growth in oil exporters was better than in non-oil exporters, but the export volume growth in the latter increased during 1991-94. The growth in *import* volumes in the MENA region was lower than the growth in export volumes during 1989-94--amounting to an annual average of 2.8 percent. Within the region, the annual average growth in imports of oil exporters was slower than that of the remaining countries, reflecting the sharp decline in imports by the oil exporters during 1993-94, but also the increased access to financing by some non-oil countries associated with their adjustment process.

The method of *financing* external current account deficits differed significantly among MENA countries. The GCC countries relied heavily on using their gross foreign assets, but also resorted to some external borrowing. Non-GCC countries mainly relied on medium- and long-term loans from official sources. Private debt flows constituted important financing only in a few countries (such as Egypt, Israel, and Lebanon), while most foreign direct investment to the region was accounted for by flows to Egypt, Israel, Morocco, and Tunisia.

During 1989-94 several countries resorted to exceptional financing in the form of rescheduling and the build-up of arrears on debt service. 1/ Foreign exchange reserves of oil countries declined, while those of other countries as a group increased more or less steadily during this period both in absolute terms and as a ratio to their imports of goods and services.

The total *external public and publicly guaranteed debt* of MENA countries increased by US$44 billion during 1989-94, of which one third was accounted for by oil exporting

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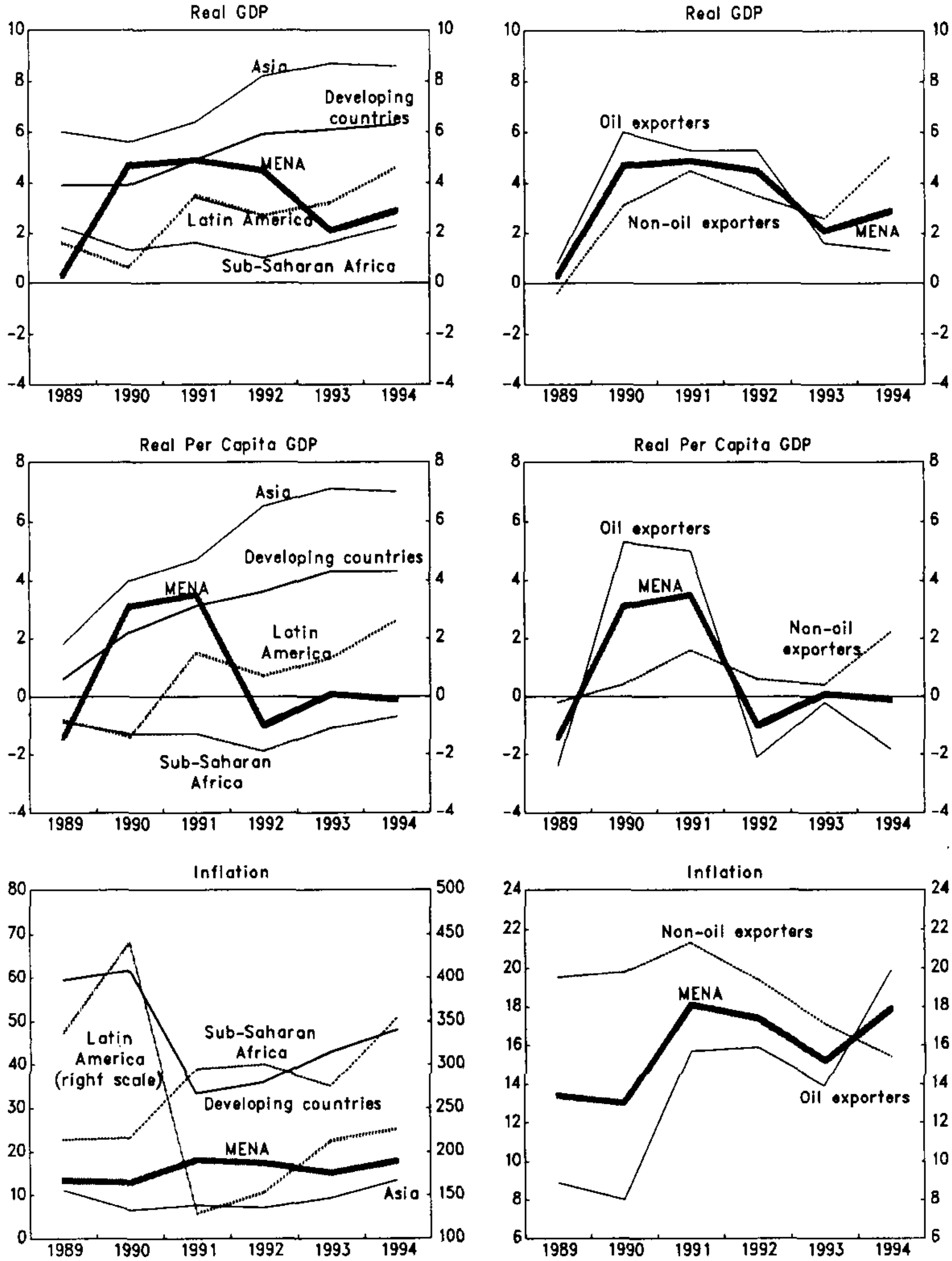
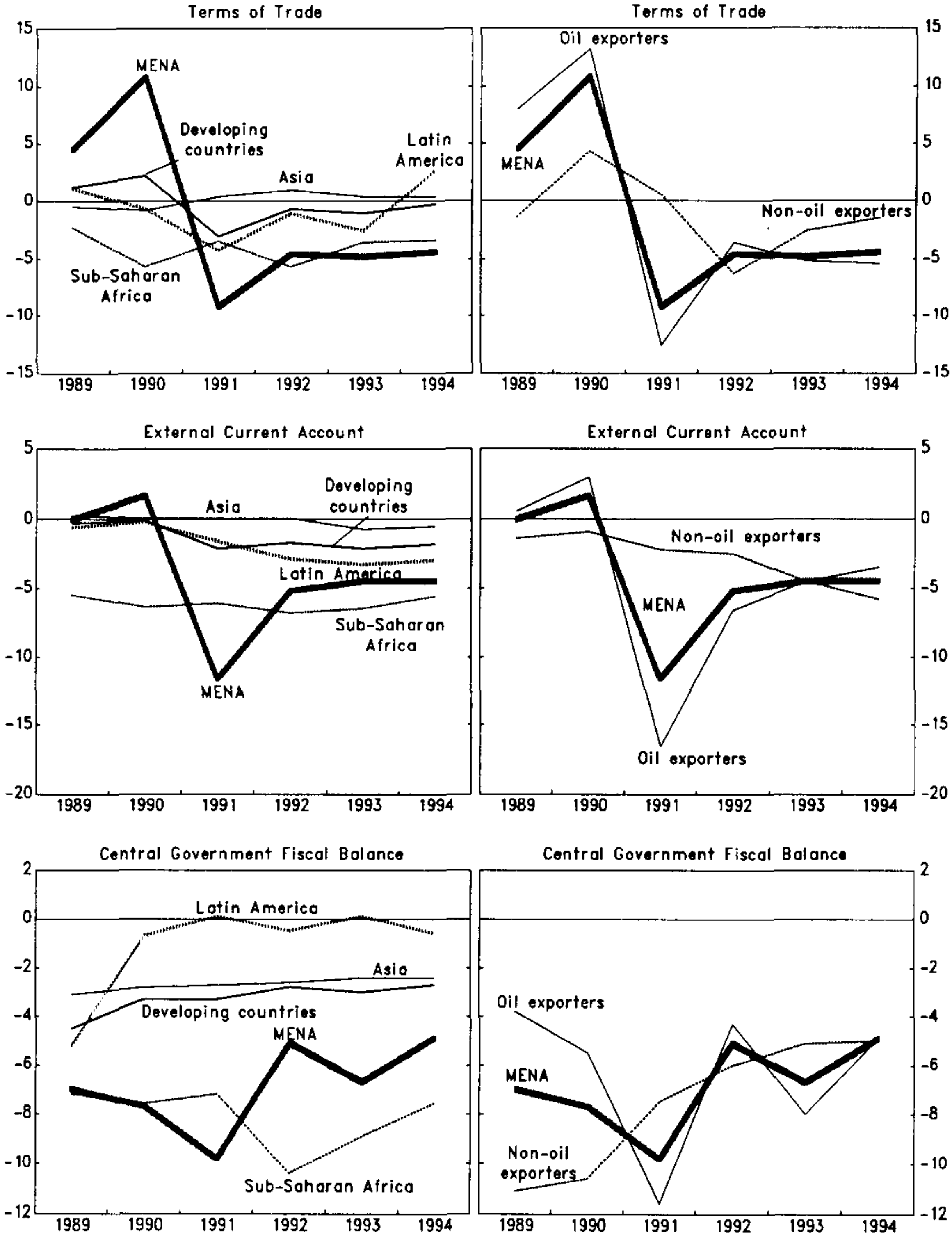
1/ Paris Club reschedulings were concluded for Algeria (1994 and 1995), Egypt (1991), Jordan (1989, 1992, and 1994), Mauritania (1989 and 1993), and Morocco (1990 and 1992). Rescheduling of commercial banks debt took place for Algeria (1992), Jordan (1993), and Morocco (1990).

CHART 4.
DEVELOPING COUNTRIES AND MENA REGION
GROWTH AND INFLATION, 1989-94
(Annual changes, in percent)



Source: IMF, World Economic Outlook.

CHART 5.
DEVELOPING COUNTRIES AND MENA REGION SELECTED ECONOMIC INDICATORS, 1989-94
(In percent of GDP)



Source: IMF, World Economic Outlook.

countries. 1/ As a percentage of GDP, the external debt of the region remained more or less stable (Chart 6 and Table 9). The debt-to-GDP ratio of oil-exporting countries, although relatively small, increased gradually, while that of non-oil exporting countries declined sharply from 100 percent in 1989 to 69 percent in 1994. This decline was mainly accounted for by developments in Egypt, Jordan, and Morocco. In Egypt, the decline in the early 1990s was largely due to the debt-stock reductions granted by official bilateral creditors. Jordan undertook debt-reduction operations with commercial banks and also implemented reschedulings with, and was granted debt forgiveness by, some bilateral official creditors. Morocco benefited from the cancellation of the entire stock of debt it owed to Saudi Arabia.

The *debt-service burden* of the region remained at comfortable levels during this period. Oil-exporting countries' debt service, as a percentage of exports of goods and services, showed a marked pick-up, with amortization payments coming due at the same time as export earnings fell. Debt servicing of the non-oil exporting countries declined because of lower stocks of outstanding debt and the impact of debt rescheduling. 2/

2. Accounting for macroeconomic performance

The region's economic performance has reflected the interaction of the underlying structural aspects of the MENA economies, the stance of macroeconomic and structural reform policies, and developments in the countries' terms of trade.

a. *Underlying structure*

Even though there is considerable economic and financial diversity among MENA countries, several share similar structural economic characteristics that have impacted on their recent economic performance. Four structural aspects stand out in particular: 3/

- a poorly diversified economic and export base at the individual country level;
- continued high vulnerability to exogenous shocks;
- limited integration into international capital markets;
- continued dominance of economic activity by the public sector.

While the region as a whole is relatively diversified, most countries have a relatively poorly diversified *economic base*. In many countries, a single sector--indeed a single product--constitutes a significant portion of domestic output. The most vivid example is oil, which accounts for over 50 percent of GDP in almost all oil-exporting countries. Agriculture accounts for a similar proportion of GDP in Somalia and Sudan, and around a

1/ This was an historical aberration reflecting the aftermath of the 1990-91 regional conflict. Saudi Arabia has repaid the bank loan syndication contracted after the conflict and Kuwait is in the process of doing so.

2/ Declines in the debt-service ratio were substantial in Algeria, Egypt, Israel, and Jordan. During 1989-94, the largest increase in debt and debt-service ratios, albeit from very low levels, was observed in Lebanon--associated with the financing of the reconstruction program.

3/ For a detailed discussion of structural issues, refer to El-Erian and Tareq (1993).

quarter of GDP in the Islamic Republic of Iran, Mauritania, and Yemen. Manufacturing is significant and well diversified in only a few countries, such as Israel, Morocco, and Tunisia. Despite disruptions caused by the 1990-91 regional crisis and civil unrest, tourism is an important component of output in a number of MENA countries (Egypt, Israel, Morocco and Tunisia) and has enjoyed a higher growth rate than agriculture or manufacturing in several MENA countries since 1989.

The narrow productive and export bases make several MENA economies vulnerable to *exogenous shocks*. In oil-exporting countries, fluctuations in the international price of oil have a major direct impact on export receipts and government revenues (Chart 7), 1/ as well as an indirect impact through the role of government expenditure in determining overall economic activity and employment. Furthermore, as discussed below, economic developments in oil-exporting countries have important consequences for other countries in the region, particularly through labor market links.

Concurrently, several MENA countries are very much affected by fluctuations in international commodity prices as non-fuel primary commodities are important in their exports. Moreover, because of their heavy import reliance, many countries are vulnerable to fluctuations in price of foodstuffs. Furthermore, in the countries heavily dependent on agricultural output and exports, economic performance remains vulnerable to weather conditions (e.g., Morocco, Sudan, and Tunisia).

MENA's participation in the globalization and integration of *international capital markets* has been limited especially in comparison with Asian and Latin American countries. Thus, capital flows into the MENA region have been small. 2/ In addition, countries in the region have had almost no direct access to the capital markets of industrial countries, notwithstanding the growing incidence of joint ventures (domestic/foreign) in certain countries following the liberalization of their financial sectors. The region has made only limited use of market-based income-hedging devices (such as product insurance and forward markets) despite its vulnerability to international price developments. Foreign direct investment (FDI) inflows to the MENA region have been lower than to other developing regions, except sub-Saharan Africa (Chart 8). 3/ In recent years, the completion of a number of oil- and gas-related investments in the GCC countries has been reflected in a reduction of FDI inflows. Portfolio flows into the region have remained low, because MENA countries have limited access to international capital markets and the region's capital markets are at the development stage. 4/

An important qualification is warranted, however, in discussing the region's relations with international capital markets. Private capital inflows have shown more diversity and response in countries that have made steady progress in macroeconomic and structural

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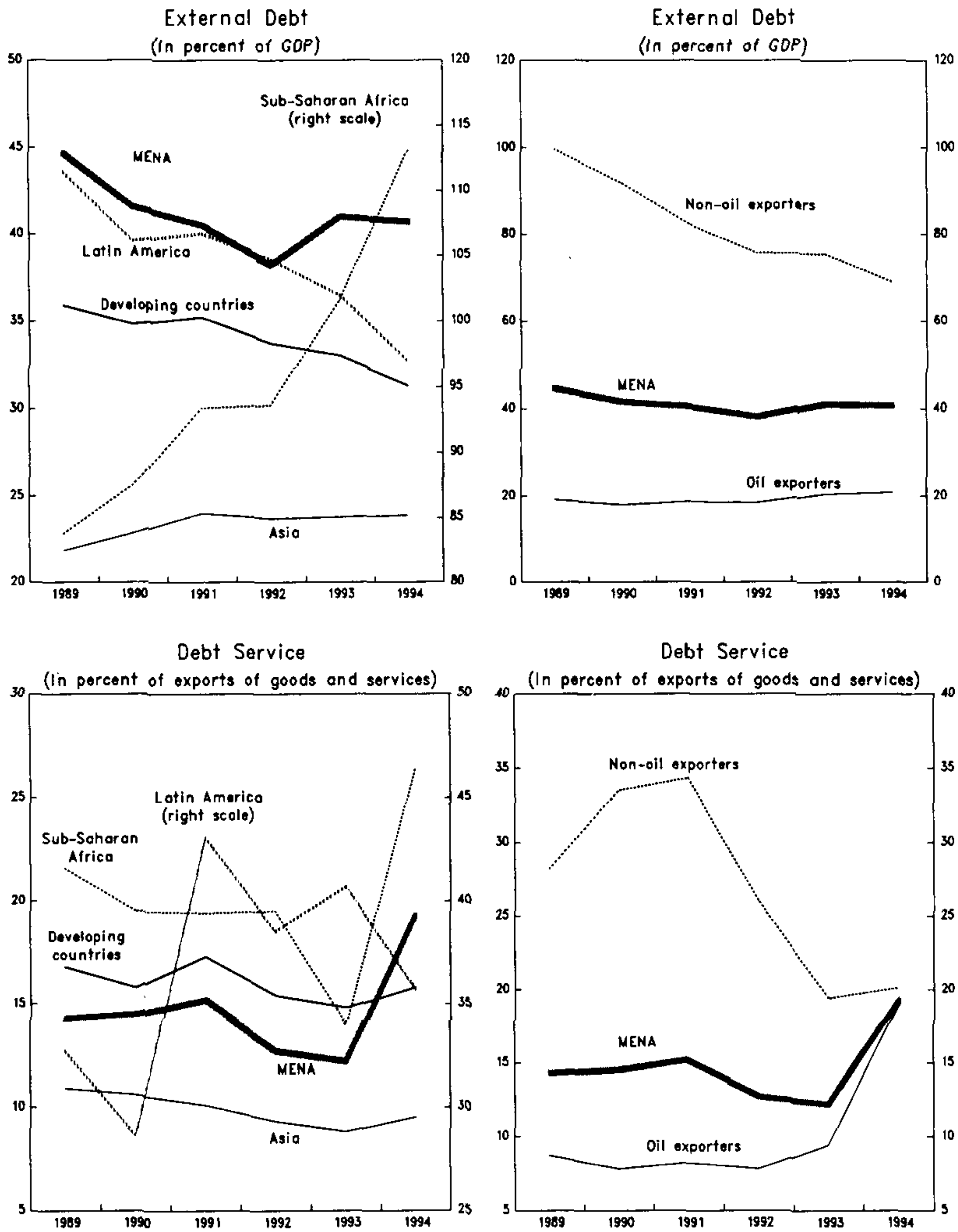
1/ In GCC economies, the share of oil revenues in total revenues ranges from about 60 percent in Bahrain to about 80 percent in the United Arab Emirates.

2/ For a discussion of capital flows to and from Arab countries, see Abisourour (1993 and 1994) and El-Rifai (1993).

3/ During 1989-94, foreign direct investment inflows to the region amounted to about US$10 billion, compared with a total of about US$212 billion to the developing countries as a whole.

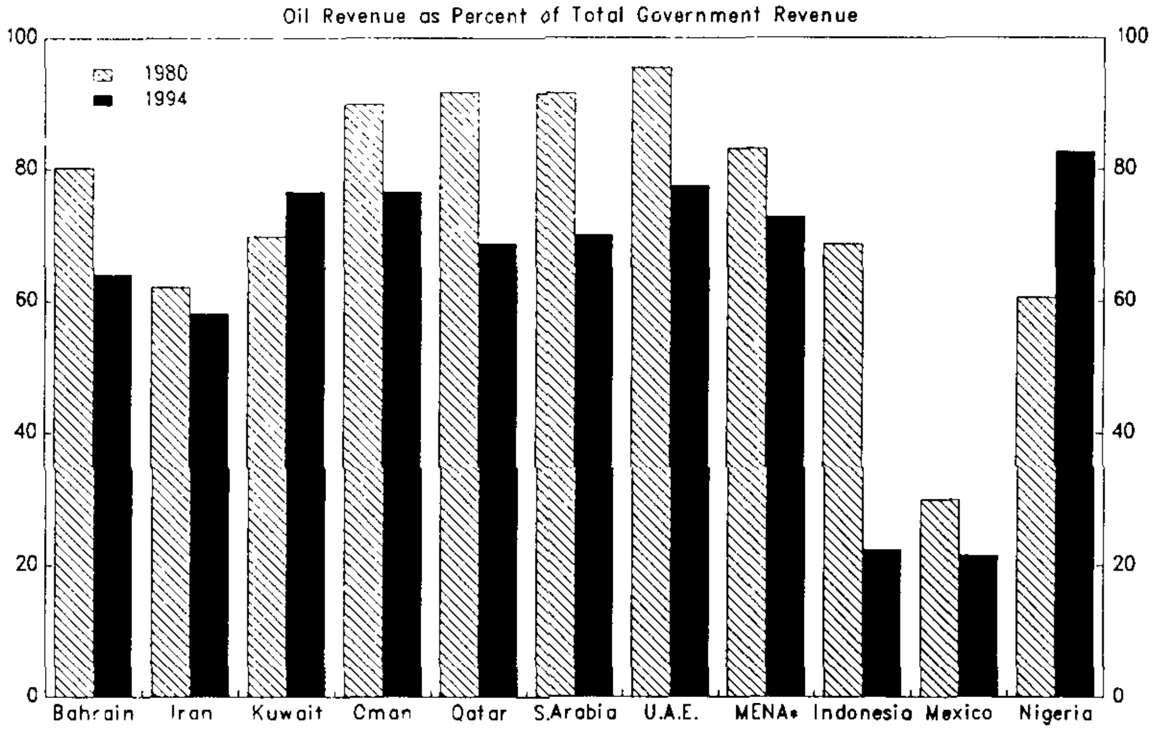
4/ See Abisourour (1994), Azzam (1995), and El-Erian and Kumar (1995). Cashin and McDermott (1995) discuss the impact on market efficiency of a reduction in regulatory barriers and greater foreign participation.

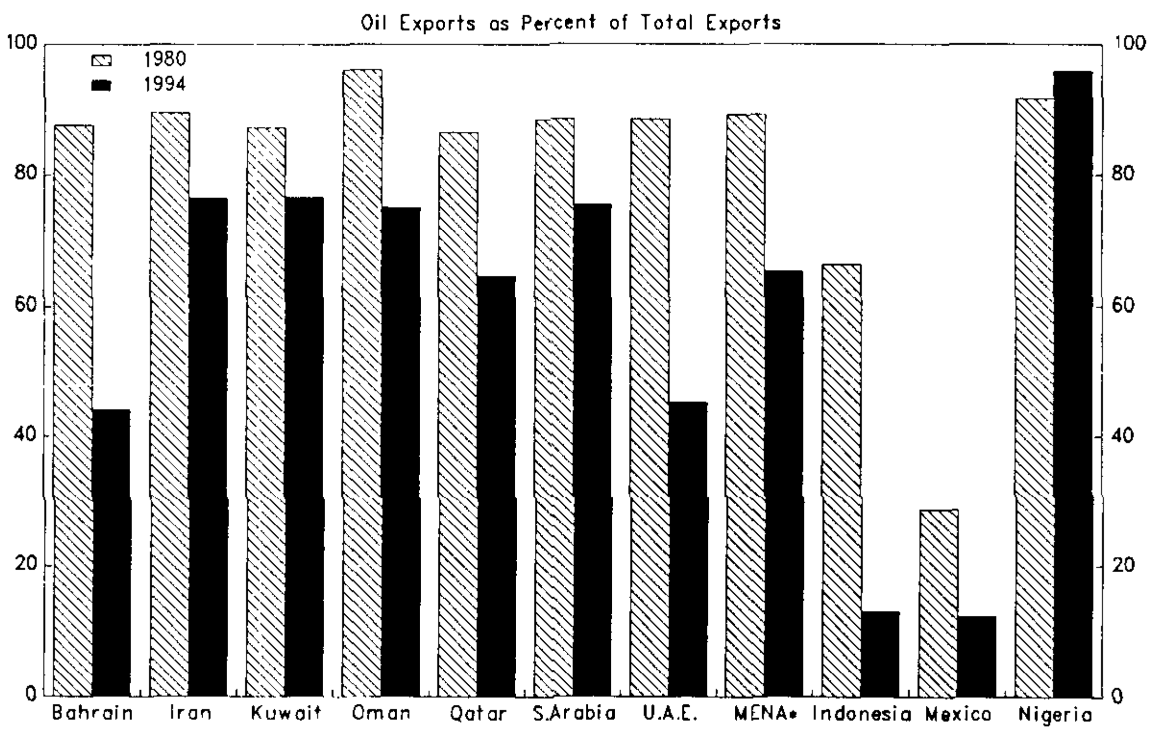
CHART 6.
DEVELOPING COUNTRIES AND MENA REGION
EXTERNAL DEBT AND DEBT SERVICE, 1989-94



Source: IMF, World Economic Outlook.

CHART 7.
OIL EXPORTERS
VULNERABILITY TO DEVELOPMENTS IN OIL MARKETS

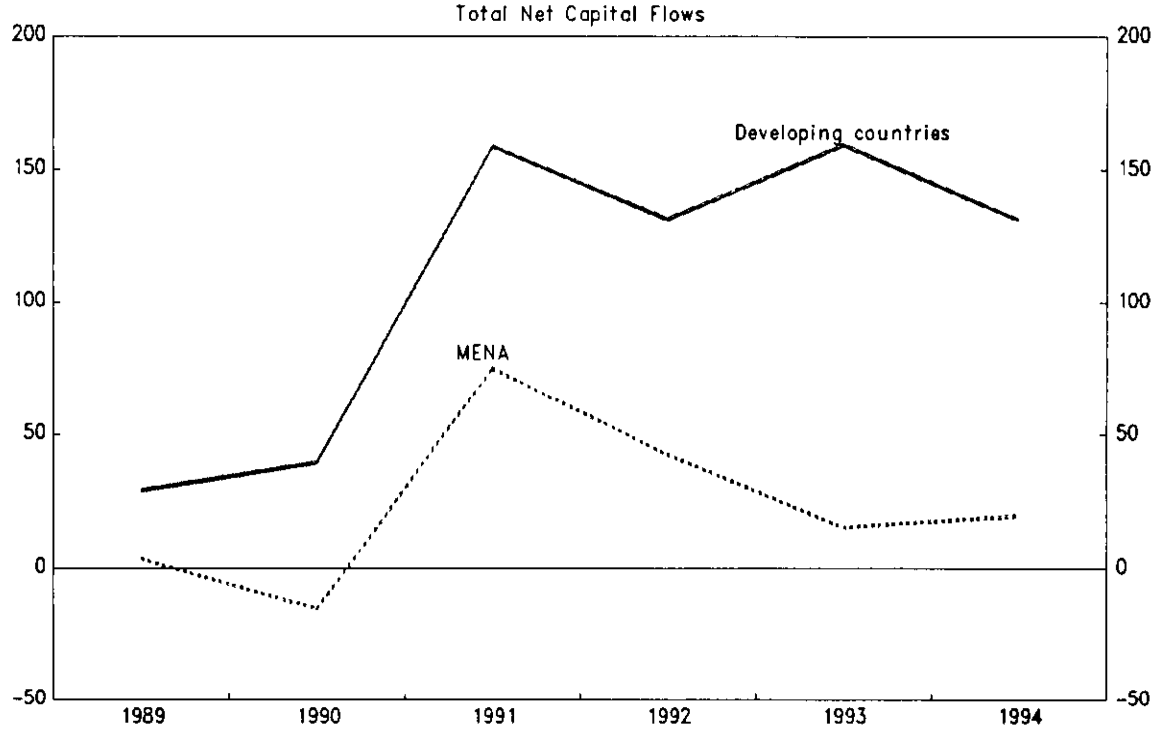


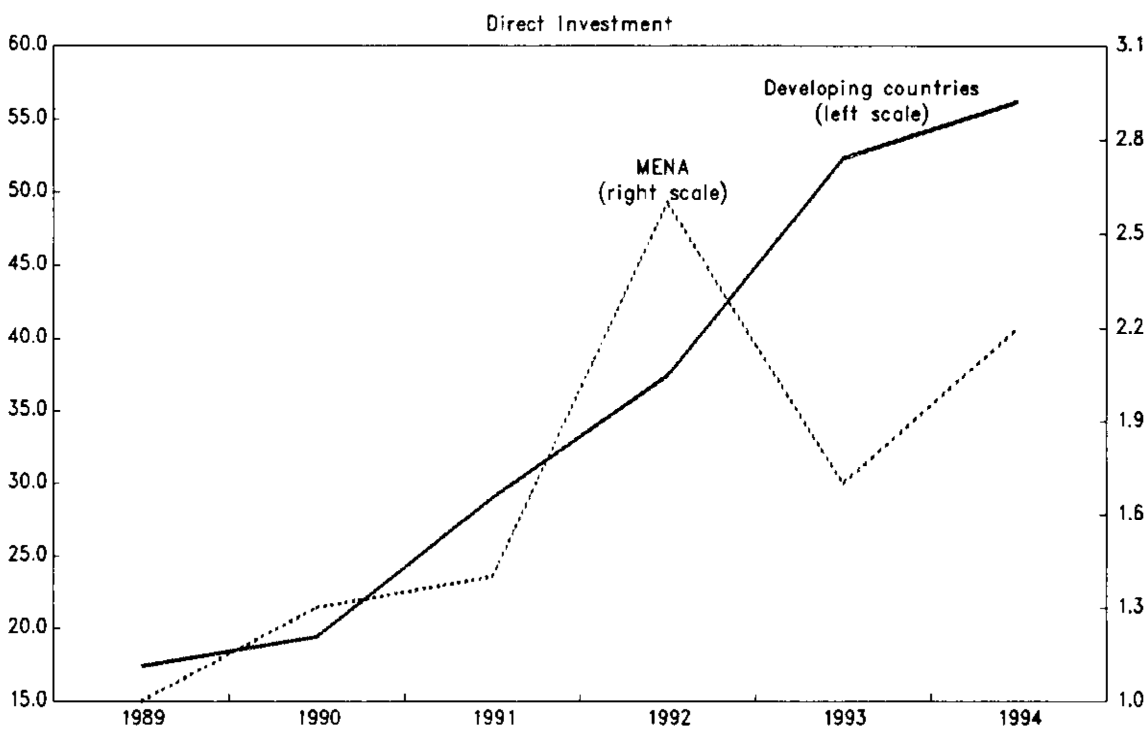


Sources: IMF, WEO database; and various Recent Economic Development Reports.

* Average of the seven oil exporting countries from the region included in the chart.

CHART 8.
EXTERNAL FINANCING
(In billions of U.S. dollars)





Source: IMF, WEO database.

adjustment (such as Egypt, Israel, Jordan, Morocco, and Tunisia), as well as those recovering from domestic unrest (viz., Lebanon).

Finally, on the structural front, an important common feature of most MENA countries is the dominant role of the *public sector* in total domestic output, as well as in transfers and subsidies to the private sector. Its finances are the primary determinant of domestic liquidity and aggregate demand. 1/ Moreover, it has been associated with certain economic distortions that have hindered productive efficiency and obfuscated the environment in which producers and consumers must operate.

The public sector has traditionally been a major source of employment, accounting for about 30-60 percent of the labor force in most MENA countries and as high as 95 percent of the national labor force in some countries of the GCC. Furthermore, public enterprises have had weak financial performance because they have been largely immune from competitive forces and have suffered from organizational and managerial shortcomings, administrative controls, inappropriate pricing policies, and overemployment. *Consequently, this sector has become dependent on government transfers and subsidies,* placing a major burden on fiscal and monetary policies in most MENA countries and lowering the productivity of these economies.

Other structural constraints on investment and employment are evident in some MENA countries. For example, the dominant role of public sector employment and its recruitment, job security, and wage setting practices have led to segmented labor markets. Moreover, labor legislation in both public and private sectors has circumscribed the employer's scope for hiring, firing, or wage setting.

b. Macroeconomic and structural policies

The impact of these structural realities on recent economic performance has depended in part on the accompanying policy stance. In some cases, the determined implementation of macroeconomic reform has offset structural weaknesses. In other cases, inappropriate policies have accentuated them. Several MENA countries have adopted *structural reform measures* in recent years to enhance productivity through improved competition and better allocation of resources. These measures included steps to liberalize prices, reform public enterprises, liberalize the external trade system, and reduce exchange controls.

Several MENA countries (most importantly, Algeria, Egypt, Jordan, the Islamic Republic of Iran, Morocco, Sudan, and Tunisia) made progress in liberalizing domestic *prices* during 1989-94. Direct controls have been gradually eased or removed on agricultural prices, producer prices in the manufacturing sector, retail prices, and distribution margins. Furthermore, partly reflecting concern about budgetary costs and waste, subsidies on a wide range of products have been reduced and their scope limited to essential consumer goods.

1/ On the role of the public sector and indicators of public sector activities, see El-Naggar (1987) and Heller and Schiller (1989).

Several countries, with technical and financial assistance from the World Bank, launched *public enterprise reform* programs in the late 1980s. These programs aimed at improving overall resource allocation, reducing the burden on government budgets, and limiting the absorption of domestic and external financing by these enterprises. They were also directed toward increasing the administrative autonomy and accountability of public enterprises, improving their financial performance, and reducing the scope of the public enterprise sector through privatization, restructuring, or liquidation of nonviable firms.

Implementation was slow in the initial stages as these reforms needed diagnostic studies to assess financial viability of enterprises, amendments to existing legal framework, and policy adaptations in other sectors. Nevertheless, a number of countries made progress by the use of management performance contracts (Algeria, Morocco, and Tunisia), enactment of related laws (Egypt, Morocco, and Tunisia) and partial or total privatization (Egypt, Israel, Jordan, Kuwait, Morocco, Oman, Tunisia, and the United Arab Emirates).

During 1989-94, a number of countries (Algeria, Jordan, Morocco, and Tunisia) undertook comprehensive *trade liberalization* by reducing quantitative restrictions and lowering and rationalizing import duties. 1/ In general, the liberalization of imports of raw materials, intermediate products, and capital goods progressed faster than those of finished goods as the authorities sought to strengthen the ability of domestic industries to adjust to increased foreign competition. The reductions in tariff rates in some cases fell behind initial schedules because of budgetary considerations.

With a move toward a more outward-looking trade policy, several MENA countries (Algeria, Jordan, Morocco, and Tunisia) took steps to ease *foreign exchange controls* while others (Egypt, the Islamic Republic of Iran, and Sudan) abolished multiple exchange rate systems. 2/ The liberalization of foreign exchange controls on current account transactions, the strengthening of macroeconomic policies, and the implementation of comprehensive structural reforms enabled Israel, Lebanon, Morocco, and Tunisia to make their domestic currencies convertible for current account transactions in 1989-94 and to assume the obligations under Article VIII of the IMF's Articles of Agreement.

During this period, progress in liberalizing *capital account transactions* was slow in MENA countries. Nevertheless, several countries including Egypt, Jordan, Morocco, and Tunisia took steps to ease payments restrictions on capital transactions by residents and to liberalize rules governing the use by residents of foreign currency accounts in domestic banks. In general, nonresident capital transactions, involving repatriation of capital, dividends, and profits, have been made more liberal to encourage non-debt-creating external financing, and transfers of technology.

The most important aspect of *demand management policies* has been the stance of fiscal policy, particularly the overall budget deficit and the underlying revenue and expenditure patterns.

1/ For a comprehensive discussion of foreign and intra-regional trade policies of Arab countries, see El-Naggar (1992), Thalwitz and Havrylyshyn (1992), and Zarrouk (1992).

2/ The unification of exchange rates was subsequently reversed in the Islamic Republic of Iran and Sudan.

The MENA region has recorded *fiscal* deficits that are large by international standards, even though some countries have made progress in addressing fiscal imbalances (Chart 5). The central government fiscal deficit of 7 percent of GDP was more than double that of developing countries as a group. In oil-exporting countries, a sharp deterioration in public finances during 1989-91 occurred as oil prices fell. The higher fiscal deficits were initially financed by running down foreign assets, but subsequently addressed through the adoption of adjustment measures. Other countries in the region continuously improved their fiscal positions during 1989-94, and by 1994, both country groupings had reduced their fiscal deficit to about 5 percent of GDP. At the individual country level, Egypt, Israel, Jordan, Mauritania, and Tunisia tightened the stance of their fiscal policy during 1989-94. In a few countries (Syria and Yemen), fiscal tightening during the earlier part of this period proved unsustainable and was followed by some easing during the latter part.

In addressing their fiscal imbalances, countries initially focused on cutting expenditures to bring about rapid improvement. In the second phase, the focus shifted toward enhancing revenue through improving tax systems and administration. In countries where adjustments relied almost totally on cuts in expenditures, especially capital expenditure, fiscal tightening proved unsustainable and was quickly reversed. In contrast, countries in which expenditure restraints were complemented at an early stage by structural reform on the revenue side, experienced more durable reductions in fiscal imbalances.

The overall objectives of tax reforms were to simplify the tax system and increase its transparency, improve its buoyancy and elasticity, reduce its distortionary effects on the allocation of resources, and strengthen tax administration. Regarding direct taxation, a number of countries embarked on or continued efforts to simplify income taxation, as well as broaden its base. With regard to indirect taxes, most reforms involved the replacement of various taxes and fees, imposed at various stages of production, by a value-added tax. 1/ In some cases, the number of rates under the value-added tax was also reduced (Morocco) and the coverage was expanded to sectors previously excluded, such as wholesale trade activities (Tunisia). For social reasons, a few basic consumption goods were generally exempted from VAT. Several countries (Egypt, Jordan, Morocco, and Tunisia) made further progress in customs tariff reform with a view to rationalizing and reducing tariffs. Meanwhile, tax administration was strengthened in most MENA countries through improvements in tax assessment and collection procedures, the reinforcement of tax auditing procedures, and increased use of computers.

With regard to *monetary policy*, the growth in broad money registered an increasing trend in 1989-93 in the MENA region as a whole, before declining in 1994. Similar trends were observed in oil- and non-oil export countries, although the latter recorded larger monetary expansion (annual growth of broad money averaged 31 percent as compared with 11 percent in the oil-exporting countries) primarily reflecting financing requirements of fiscal deficits in the context of limited reserve funding.

The effectiveness of monetary policy has been enhanced by changes in the financial system aimed at improving the mobilization and allocation of financial savings and strengthening the system of monetary control. To improve the mobilization and allocation

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1/ In Jordan, a general sales tax was introduced with a view to establishing a broad-based value-added type of tax.

of financial savings, first, the role of market forces in the determination of rates of return and credit allocation has been enhanced (Chart 9). Several countries made progress in liberalizing their rate structure, initially focusing on deposit rates, and in reducing the scope of preferential rates, especially for public enterprises. Second, the menu of assets available to domestic savers was broadened through the introduction of new instruments with market-determined rates. These instruments included certificates of deposits (Jordan), negotiable treasury bills (Egypt and Tunisia), and commercial paper (Morocco). Third, most MENA countries made significant progress in strengthening the financial system through recapitalization of financial institutions and improvements in prudential regulations and supervision. Finally, efforts to develop capital markets involved the implementation of new securities market laws with a view to improve trading, reporting, and accounting systems.

To improve the system of monetary control, especially in the context of financial liberalization, there was a move away from quantitative credit restrictions toward indirect instruments of monetary control. In several countries, rediscount mechanisms were made more sensitive to market conditions, and the sale and purchase of central bank paper and treasury bills were used more widely in the management of liquidity. Furthermore, reserve requirements were made more uniform across financial institutions.

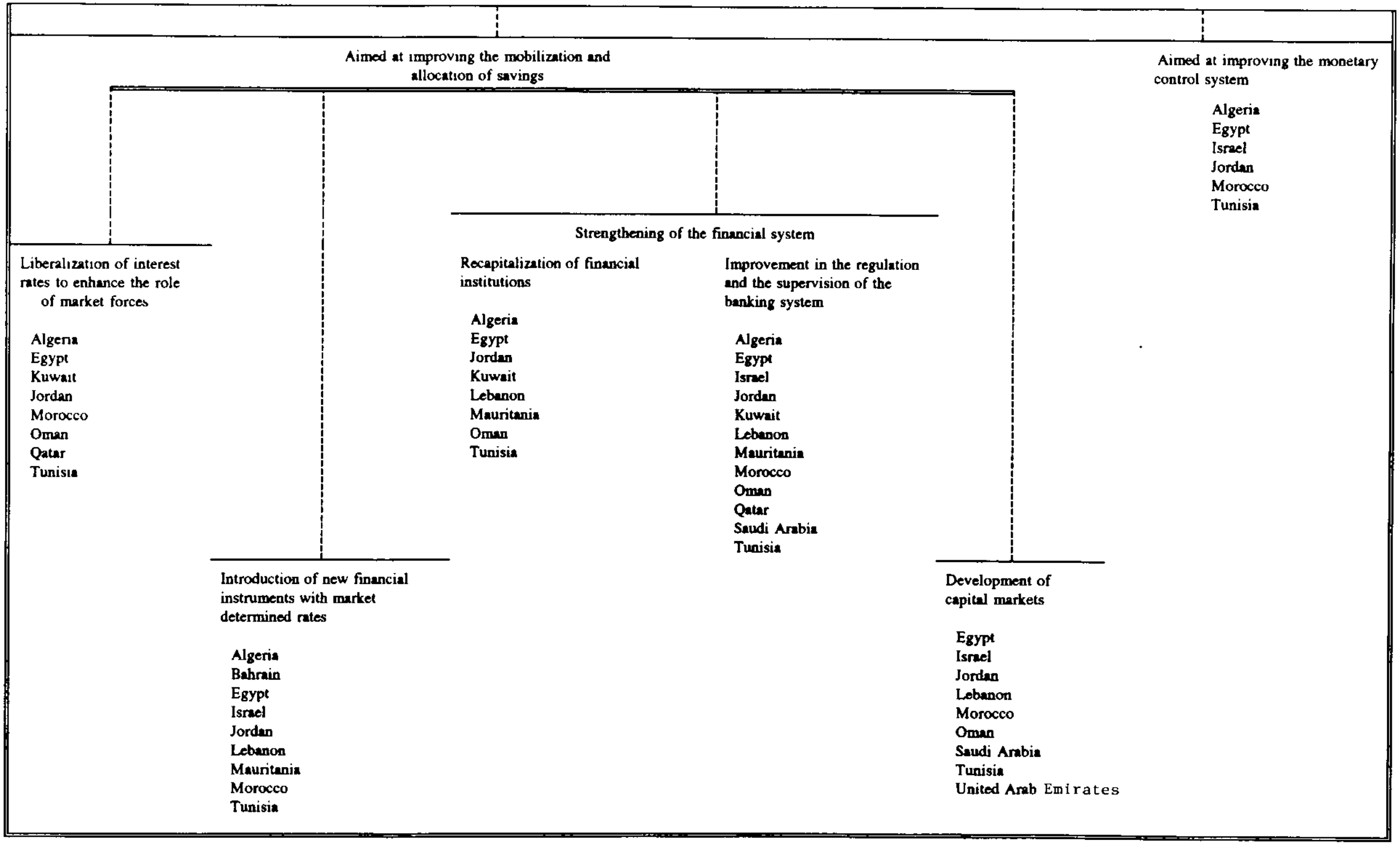
Exchange rate adjustments in the face of terms of trade losses in most MENA countries varied during 1989-94. Countries with flexible exchange rate arrangements (Table 10) underwent nominal effective exchange rate depreciations, but only Algeria, Iran, Israel, and Tunisia experienced depreciations in their real effective exchange rates. Countries pegged to the U.S. dollar (except Syria) also had nominal effective exchange rate depreciations owing to the depreciation of the U.S. dollar vis-à-vis other currencies during this period. Reflecting their superior price performance, only the GCC countries had both nominal and real exchange rate depreciations. Among countries with currencies linked to the SDR or another basket of currencies, only Jordan had nominal and real exchange rate depreciations. Downward adjustments in real effective exchange rates compensated for worsening terms of trade in Algeria, Bahrain, the Islamic Republic of Iran, Israel, Kuwait, and Saudi Arabia, thus cushioning the impact of the terms of trade on domestic economic activity.

c. *External terms of trade*

The external environment in the MENA region has been particularly difficult in recent years. The cumulative deterioration in the region's terms of trade during 1989-94 amounted to 7.7 percent as compared with 1.8 percent for developing countries as a whole (Chart 5 and Table 7). Among developing countries, only sub-Saharan Africa registered worse terms of trade developments during the same period, while the Asian countries benefited from improvements in their terms of trade.

In addition to a significant overall worsening, MENA countries have been subject to considerable fluctuations in their terms of trade--further undermining economic performance. The variance in the region's terms of trade was more than 15 times greater than that for developing countries as a group and 30 times greater than for industrial countries. Not surprisingly, oil-exporting economies faced the greatest variance in terms of trade within the MENA region.

Chart 9. Financial Sector Reforms in MENA Countries, 1989-94



IV. External Environment

The external environment affects individual MENA countries through the goods market, the labor market, and to a lesser extent, capital flows. The importance of each of these three transmission channels depends on the circumstances of individual countries.

Looking forward, several countries face, at best, a neutral outlook with substantial downside risks associated with oil-market developments. Consequently, these countries cannot look to their external environment either as a source of substantial windfall gains or as a significant stimulus for growth. This, as well as the legacy of the underexploited opportunities of recent years, strengthens the case for the economic reform policies discussed in Chapter V. Fortunately, the possibility of more favorable regional sociopolitical conditions following the eventual attainment of a comprehensive, just, and durable peace provides support for the effectiveness of such policies, as do the prospects for increased economic interactions with the EU.

1. Goods market

Medium-term analyses suggest that the region faces opposing external influences: buoyant markets for non-oil products but a subdued international price outlook for commodities of particular importance to the region.

Projections prepared by the IMF staff in the context of the *World Economic Outlook* exercise suggest a relatively favorable outlook for the region's *non-oil exports.* 1/ Specifically, real demand in partner countries (weighted by their share in the region's exports) is expected to grow at an average annual rate of just over 5 percent in 1996-2000. Accordingly, the non-oil sector can provide an engine of growth for several countries, highlighting the importance of expanding the role of this sector in the economy of the region. The scope is significant in this respect; non-oil exports account currently for only a quarter of the region's exports, with Israel accounting for almost half this total.

As regards *petroleum prices*, there seems to be a consensus on the outlook for, at best, moderate increases in nominal prices and constant or declining real prices (Chart 10). 2/ This reflects expectations of relatively restrained growth in world demand as increasing demand, particularly by certain developing countries, is offset by further reduction in energy intensity. At the same time, non-OPEC suppliers are expected to broadly maintain their current market shares, albeit with some uncertainty about developments in the republics of the former U.S.S.R. There is also uncertainty about the potential timing and conditions of Iraq's return to the oil market. Such a return would impose downward pressure on international prices and require some reallocation of shares among existing producers in order to limit the price decline.

1/ A discussion of trends in the overall international economy is contained in IMF (1995a).

2/ For the eight largest oil producers in the region at this time (i.e., Algeria, Bahrain, the Islamic Republic of Iran, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates), a US$1 change in international oil prices translates, ceteris paribus, into a US$6 billion variation in total export receipts.

Turning to the region's *imports*, IMF staff projections prepared in the context of the *World Economic Outlook* exercise suggest moderate increases in import unit values (in U.S. dollar terms). Thus, after the sharp estimated increase for 1995 (nearly 8 percent), prices of non-oil imports are expected to increase by an annual average of 1½ percent in the 1996-2000 period. A source of upward pressure in this context emanates from the price of food imports--an important component of the region's total import bill. Specifically, the moderate increase projected in import unit values incorporates a limited rise in food prices as the overall supply, particularly from producers in nonindustrial countries, responds quickly to the impact of reductions in subsidies induced by the Uruguay Round in industrial countries. Slower output responses in nonindustrial countries would place upward pressure on international food prices, worsening MENA's external terms of trade.

The Uruguay Round is expected to have other effects on the goods market for MENA region. The positive effects may be expected to come from three features of the recent *agreements on multilateral trade liberalization*:

- the significant liberalization of the agricultural, textile, and clothing sectors through reductions in tariff and non-tariff barriers;
- the improvement in the overall trading environment associated with the strengthening of rules applicable to subsidies, countervailing duties, anti-dumping, and safeguards;
- the reinforcement of the institutional structure through the establishment of the World Trade Organization.

A potential benefit currently of lesser operational importance to the MENA region is the extension of multilateral rules to trade in services and intellectual property rights. 1/

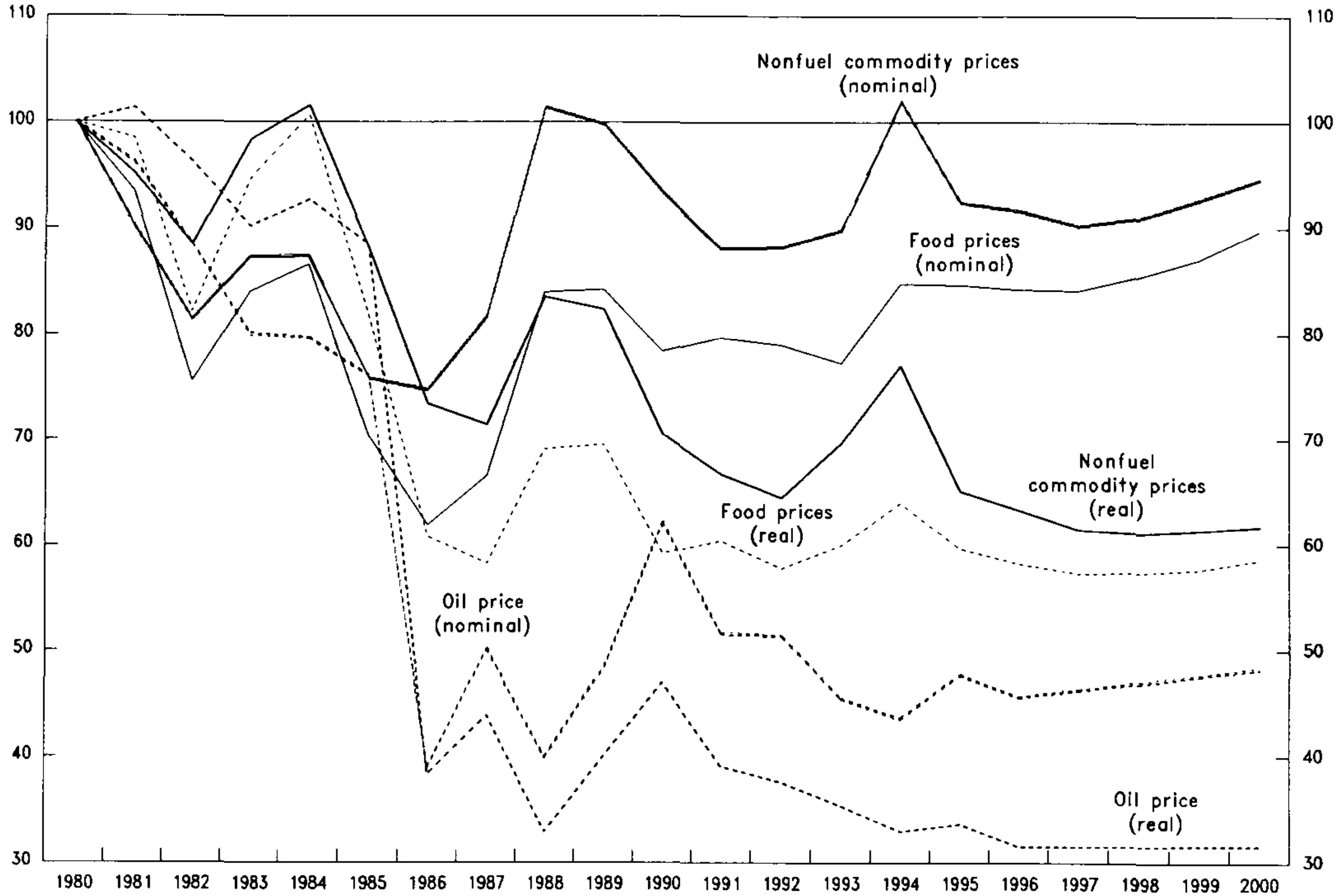
This potential will be exploited most effectively by countries that have responsive supply structures and are experiencing financial stability. Other countries will face net costs in addition to that associated with the expected initial increase in imported food bills as industrial countries curtail the unfair competitive advantage emanating from their hitherto substantial agricultural subsidization system. Thus, in the absence of changes in the overall level of preferential treatment, several countries will suffer an erosion in their "favored treatment," be it through a reduction in the value of their tariff concessions following the scheduled decline in overall tariff levels worldwide or through a loss in privileged access to certain markets. This is particularly important for the MENA region, which benefits from a wide range of preferential trading arrangements.

2. Labor market

As noted in the previous section, labor remittances help the balance of payments accounts of several countries in the region and favorably influence investment performance as well. These remittances consist of:

1/ For an analysis of the real income effects of the Uruguay Round on the MENA region, see Goldin, Knudson, and van der Mensbrugghe (1993). A more general discussion of the relevance and implications of the Uruguay Round for the Arab countries is presented in Chabrier, El-Erian, and Moalla-Fetini (1995). Sector specific studies may be found in El-Naggar (1995).

CHART 10.
REAL AND NOMINAL COMMODITY PRICES
(1980=100)



Source: International Monetary Fund, World Economic Outlook (database).

- transfers of earnings of workers residing outside the region, such as those employed in Europe;
- transfers from workers in oil-producing countries of the MENA region;
- earnings of Palestinians working in Israel.

The prospects for MENA labor migration to Europe must be viewed in the context of European labor market. Unemployment in the EU is currently high, having averaged almost 12 percent in 1994 (with double-digit rates typical in most countries). Although growth in these countries as a group is projected to remain at about 2½-3 percent a year through the rest of the decade, projections prepared in the context of the *World Economic Outlook* exercise indicate that unemployment will remain over 10 percent on average in the period through 2000, reflecting structural rigidities in the labor market. Reforms needed to overcome the extensive network of institutional constraints and the policies that have contributed to the high level of structural unemployment will inevitably take time to implement. Dim prospects for reducing unemployment in the short term, together with the pressure that will arise as a result of changes in social policies and labor market practices, will limit demand for migrant labor. Finally, the demand for MENA labor will likely be affected by the continued influx into the EU of workers from Eastern Europe and the countries of the former U.S.S.R.

At the same time that employment opportunities in Europe are projected to decline, the potential for intraregional migration--from the non-oil to the oil-exporting countries (mainly the GCC countries)--is expected to be reduced. With the current outlook for the oil market, the oil exporting countries of the MENA region are faced with the need to adopt strong fiscal adjustment and reform measures. In the short term, these measures will inevitably involve an important expenditure reduction component with dampening effects on non-oil activities--areas in which MENA nationals from the non-oil exporting countries are typically employed. Furthermore, structural reform measures to reduce the size of government (which typically represents the largest employer of nationals) need to be accompanied by steps to improve employment opportunities for nationals in other areas, including those traditionally occupied by immigrant workers. Indeed, in the face of a contraction in economic activity, a number of countries have already adopted policies to encourage greater participation of nationals in the labor force.

Finally, the market for Palestinian labor in Israel will continue to depend on security issues, insofar as they influence Israel's border policy. In addition, the increasing influx of Asian labor is likely to reduce the demand for Palestinian labor in certain segments of the Israeli economy.

3. International capital markets

Several developing countries experienced a dramatic integration and globalization of their capital markets in the first half of the 1990s. This provided them with access to significant external financing as a potential supplement for domestic resources to fund productive investment opportunities. The financing took the form of foreign direct investment, flows to "emerging equity markets" and tapping by developing countries of bond and equity markets in industrial countries. 1/ At the same time, and as demonstrated by the December 1994 financial crisis in Mexico, the process involved certain risks, of which the most important is the increased vulnerability to large outflows triggered by changes in market sentiments in response to weakening economic fundamentals or adverse contagion effects.

As noted in the preceding chapter, the development of capital markets and their integration into international capital markets are less advanced in most MENA countries than in Latin American and Asian economies. Typically, equity markets in the region are undercapitalized and are in a number of cases are closed to foreign investors. As a result, Arab countries accounted for only a negligible amount of the funds which have flowed to developing countries' equity markets.

In recognition of the need to attract higher inflows of sustainable private capital and given the potential for capital markets to finance productive investments, countries in the region are emphasizing financial sector reforms that encourage the mobilization of funds from domestic, regional, and international sources, while they minimize the associated risks. These efforts coincide with a reassessment of perceptions that have governed the massive flows from industrial to developing countries.

The reassessment reflects two developments. First, after declining sharply in 1991-93, short-term nominal yields in several industrial countries (and the United States in particular) have risen. This has, ceteris paribus, reduced the attractiveness of certain developing country instruments. Second, the Mexican crisis of December 1994 heightened perceptions of developing country risk, thereby slowing international diversification among investors in industrial countries. As a result, developing countries may well need to compete for private flows from more cautious investors--this at a time of growing pressures on aid budgets in most industrial countries.

4. Regional environment

Changes in the regional environment have an important impact on the region's economic outlook, both directly and in the manner the region is viewed by trading partners and domestic and foreign investors.

a. Peace process

The region is closer than ever to resolving the long-standing Arab-Israeli conflict. This conflict has adversely affected economic development in certain countries of the region: 2/ First, by contributing to what is the largest military outlay among developing

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1/ Net capital inflows to developing countries rose from an annual average of US$10 billion over 1983-89 to US$125 billion in 1994. While foreign direct investment--which rose from US$12 billion to US$56 billion over this period--represented an important component of this increase, the rise in portfolio investment--from US$1 billion to US$62 billion--was even more striking. However, these aggregate figures mask the regional diversity in the composition of flows. For example, the surge in portfolio flows has been much more marked in Latin America than in Asia, where foreign direct investment has been the largest component of capital inflows.

2/ Details are contained in El-Naggar and El-Erian (1993).

country regions, 1/ it has accentuated macroeconomic imbalances and diverted resources from productive investments in infrastructure and in the social sectors. Second, by aggravating perceptions of sociopolitical risks, it has discouraged investment in certain countries. Third, it has inhibited efficient regional projects for electricity, water management, and tourism.

Not surprisingly, the potential establishment of a comprehensive, just and durable peace in the Middle East is expected to result in a significant "economic peace dividend," provided it is accompanied by sound economic policies. Insights into the quantitative importance of this dividend is provided by a recent study which, based on an econometric approach using panel data procedures, demonstrates that military spending cuts will lead to substantial gains in per capita growth, through both direct and indirect channels. 2/ Specifically, a reduction in military expenditure can contribute to higher capital formation and, more generally, to less severe resource misallocation. The econometric results suggest the impact will be large but will materialize with some lag.

This impact will be compounded by the beneficial effect of efficient welfare-enhancing regional projects, particularly in infrastructure. Water management is identified most frequently for potential gains from regional integration, and discussions among the various parties on ways to develop and manage the limited and rapidly depleting water resources have already begun. 3/ Likewise, potential growth and development opportunities would clearly be enhanced for all MENA countries if there were a regional approach to sharing energy resources and developing an efficient energy distribution system. Transport is another area where a coordinated approach to the development of a regional network would be advantageous for all parties. Tourism is frequently identified as a potential growth sector in many countries of the region, and larger tourist inflows would benefit not only from a more integrated transport system, but also from a regional approach to the promotion of this sector. 4/

b. *Closer integration with the EU*

The EU's recently launched "Mediterranean Basin Initiative" aims, in the economic field, at the gradual creation of a "Euro-Mediterranean Economic Area." While this is to be developed further in the Barcelona Conference in November, it is likely to emphasize the private sector as the engine of growth and the establishment of a free trade area--initially between the EU and individual MENA countries and subsequently between the EU and MENA as a region. 5/

1/ This result emerges regardless of the aggregation methodology used. See, for example, Hewitt (1992) and Knight, Loayza, and Villanueva (1995).

2/ Knight, Loayza, and Villanueva (1995).

3/ See Shahar, Fishelson, and Hirsch (1989) for a discussion of a possible Middle East water plan in the context of a peace initiative. See also Kally (1989).

4/ For a discussion of the potential gains to MENA countries from a regional approach to the development of the energy and transportation network, see Ben-Shahar, et al (1989).

5/ Agreements on free trade areas have already been reached in the cases of Israel and Tunisia. Negotiations are underway for Algeria, Egypt, Jordan and Morocco.

The establishment of the envisaged Euro-Mediterranean Economic Area will involve transitional costs for countries in the region, particularly as their economic structure adjusts to a higher degree of foreign competition. To alleviate these costs, the EU Council will provide ECU 4.7 billion of grant assistance in 1996-99; a similar amount (in loans) is to be forthcoming from the European Investment bank. Accordingly, some US$12.5 billion will be available, to be disbursed on the basis of each recipient country's progress in implementing economic reforms. The welfare gains associated with this initiative would materialize from improved efficiency as a result of growing competition, 1/ somewhat better (albeit not dramatically better given existing preferential arrangements) access to EU markets, and positive externalities for domestic and foreign investment flows associated with the "policy credibility" aspect resulting from greater integration with the EU.

1/ For details, see Rutherford, Rustrom and Tarr (1993).

V. Addressing Policy Challenges

The paper's backward-looking analysis of the MENA economy suggests that, with notable country exceptions, the broad policy response has been insufficient to exploit fully the region's considerable potential. Looking forward, the economic challenge is compounded by the subdued outlook for the external environment. In this context, this chapter presents an overview of the status of various countries' policy initiatives. This overview is followed by a review of the eight policy issues facing most, if not all, the economies in the region. Detailed specification, prioritization, and sequencing of the policy measures is left to individual country analyses, which are beyond the scope of this paper.

1. Background

Several countries (including Egypt, Israel, Jordan, Mauritania, Morocco, and Tunisia) implemented more or less sustained macroeconomic policy reforms in recent years, focusing on fiscal adjustment supported by a tight monetary policy. In these countries, except Israel, the adjustment was supported by International Monetary Fund arrangements for at least two years during 1989-94. 1/

These countries made headway in reducing their budget deficits, bringing down their inflation rates, and improving their external performance (in terms of growth and diversification of exports, size of current account deficits, and level of foreign exchange reserves). The improved economic performance was aided by progress in implementing structural reforms, particularly in the case of Israel, Jordan, Morocco and Tunisia. 2/

More recently, adjustment efforts and structural reforms were also intensified in the oil-exporting economies. Initially, these countries focused on expenditure reduction in the face of lower oil revenues and a reduced flow of investment income. More recently, efforts have also been made to enhance non-oil revenues, as illustrated by the measures introduced in the 1995 Saudi Arabian budget. In addition, several countries (including Algeria, Kuwait, the Islamic Republic of Iran, Oman, and Saudi Arabia) have elucidated medium-term programs with a defined path for further deficit reduction, structural reform measures, and human development policies--all this in a general framework emphasizing the role of the private sector in production and investment (Box 2).

A number of other countries (such as Djibouti, Iraq, Libya, Somalia, Sudan, Syria, and Yemen) are yet to put in place sufficiently comprehensive adjustment and reform programs, although some (including Djibouti, Sudan and Yemen) have initiated important policy efforts. Given the nature of the countries' economic difficulties, these efforts aim, in the first instance, at reducing unsustainable domestic financial imbalances pending the full effectiveness of structural reform measures. In the case of Lebanon, policy makers face the twin challenge of reconstruction and stabilization.

1/ See El-Erian (1993) for the relationship between the Fund and Arab countries.

2/ For detailed analyses of the adjustment experience of Morocco, see Nsouli et al (1995), and of Tunisia, see Nsouli and others (1993).

Box 2

Saudi Arabia—Sixth Development Plan

Saudi Arabia's Sixth Development Plan (1995-2000) targets the elimination of the budget deficit, continued restructuring and diversification of the Saudi Arabian economy in the context of increased private sector participation, and the development of human resources.

The budget deficit is to be eliminated by the year 2000 through increases in non-oil revenues and containment of expenditures. Revenues are to be mobilized mainly through higher fees and charges for publicly supplied goods and services (including utilities) and reduced subsidies. Such an approach would also improve resource allocation in the Kingdom, thus facilitating efficient economic diversification.

To expand the private sector, the Plan calls for privatizing a range of commercial activities currently undertaken by the Government and for identifying new investment opportunities for the private sector. Foreign direct investment is to be emphasized and domestic capital markets further developed to mobilize private investment.

For human resource development, the Plan targets a shift in education and training priorities to meet the expanding demand for skilled manpower in the private sector and to employ efficiently the growing number of nationals entering the labor force. Expenditures are to be shifted toward expanding the capacity of technical and vocational training, as well as higher education institutions.

2. Remaining policy challenges

Since MENA countries differ in the progress they have made in recent years in addressing macroeconomic imbalances and implementing comprehensive structural reforms, their starting point and the nature of the remaining policy challenge vary from country to country (Box 3). Nevertheless, the region faces a demanding economic and financial policy agenda, with different priorities depending on the circumstances of individual countries.

Even countries that have made significant progress in recent years recognize that the adjustment and reform process is continuous. The process places a premium on four aspects: maintaining the momentum of a comprehensive approach, sequencing major policy initiatives appropriately, undertaking the necessary adjustments in a timely manner especially in response to unanticipated exogenous developments, and establishing and maintaining the required institutional backing and human capabilities.

Box 3

Israel–Some Economic Characteristics

Israel's current economic situation differs from most other countries in the region.

- ***Its economic structure is the most akin to that of an industrial country. Moreover, a distinguishing feature of its industrial sector is the preponderance of high-tech industries.***

- ***Its economy is highly integrated in the world economy. This integration has deepened in recent years as a result of free trade agreements with the United States and the EU. It is presently engaged in a program of unilateral tariff reduction with "third" countries in the Far East, Latin America, and Eastern Europe.***

- ***Israel passed in 1992 a Domestic Deficit Reduction Law requiring the progressive elimination of the budget deficit. In compliance with this law, and notwithstanding the absorption of over 700,000 immigrants from the former U.S.S.R. since 1989, Israel's overall budget deficit was reduced to 2 percent of GDP in 1994. This was done in the context of significant tax reforms accompanied by financial sector liberalization.***

- ***Since December 1991, Israel has followed a "diagonal" exchange rate policy in terms of which the central rate of the currency is depreciated at a preannounced rate and a band of plus or minus 7 percent is maintained around the central rate. This exchange rate system is complemented by specific annual inflation targets. These policies have contributed to a reduction in inflation from around 20 percent following the 1985 Stabilization Plan to its present level of less than 10 percent.***

Most of the required reform measures involve short-term costs. While this is unfortunate, it is virtually unavoidable, given the resource reallocation requirements. Therefore the focus must be on minimizing these costs through proper planning and sequencing of policies, offsetting the costs by the gains entailed by the adjustment and reform effort, and protecting the most vulnerable segments of the population.

With these factors in mind--and at the cost of unavoidable overgeneralization in a paper covering such a large number of countries--MENA's policy agenda may be thought of as consisting of eight key items:

- intensifying measures to privatize and deregulate economic activity;

- reforming public finances;

- improving the functioning of labor markets;

- strengthening human resources;

- enhancing domestic and foreign investments;

- improving financial intermediation;

- liberalizing external trade and payments; and

- ensuring a supportive macroeconomic (fiscal/monetary/exchange rate) policy mix.

Privatization and deregulation policies enhance the MENA economy's supply responsiveness. First, such policies can improve the operational efficiency of public enterprises, contributing to the productivity of the overall economy and strengthening its ability to compete in international markets; they will also limit the drain on government budgets. Second, given the potential availability of substantial domestic and external investible resources, these policies can help upgrade the region's capital stock. Third, given the legacy of government dominance in many countries in the region, they are the authorities' most potent policy instruments to signal to the private sector their commitment to private sector led growth. Fourth, more realistic pricing of goods and services (including critical resources such as water) can enhance efficiency.

The experience of other countries (industrial and developing) suggests that the region's largely ad hoc approach to privatization shall give way to a more systematic approach. This implies the formulation of multi-year programs which, in addition to dealing with small enterprises, also extend the policy effort to large corporations, for example in the utilities, airline, finance, and telecommunication sectors (Box 4). The design of these programs must identify the potential sources of financing, including tapping external markets. Finally, the programs need to be closely linked to social safety net/labor retraining measures to minimize associated welfare costs.

Reform of public finances is of utmost importance in most MENA countries in order to strengthen domestic savings and reduce the economies' vulnerability to exogenous shocks. On the revenue side, efforts need to focus on improving elasticity and the efficiency of the tax system. In several countries of the region, this involves a reorientation away from trade taxes and in favor of broad-based domestic consumption taxes (Box 5). In the oil economies, changes in the structure of revenue would need to reduce dependence on oil revenues. Finally, new tax measures need to be accompanied by improvements in administrative efficiency and tax enforcement.

On the expenditure side, improving the quality of public expenditure programs will enhance their contribution to economic growth. Such a strategy implies significant reductions in unproductive outlays, including defense spending, and rationalization and better targeting of subsidizes. Such efforts need to be accompanied by civil service reform aimed not only at reducing the government's wage bill but also at improving the efficiency of government operations. For some countries in the GCC, civil service reform entails reducing the role of the Government as the predominant supplier of jobs in the economy and removing wage distortions that bias employment in favor of the public sector. In contrast, for other countries (such as Egypt, the Islamic Republic of Iran and Syria), a reduction in numbers would need to be accompanied by *upward* adjustments in the salary packages of the remaining civil servants. Moreover, most countries in the region would benefit from a rationalization of government departments and agencies.

Box 4

Morocco—Privatization

Following a program of public enterprise restructuring starting in 1981, the Moroccan parliament enacted a privatization law that came into effect in 1990. The law listed 112 enterprises to be privatized, accounting for 40 percent of the state's portfolio, including major commercial banks, financial holdings, large industrial enterprises, and a number of hotels. Based on the law, the regulatory and administrative framework for privatization was subsequently put in place. Actual sales of enterprises started in 1993, and the pace gathered momentum during 1994-95. In early 1995, the Parliament amended the privatization law to include two large refineries and extended the period during which privatization was authorized from end-1995 to end-1998.

By mid-1995, 34 enterprises had been privatized, including a large commercial bank, the state's biggest financial holding company, and various smaller enterprises and hotels, yielding about DH 5.3 billion in total budget receipts (US$0.6 billion or 1.9 percent of the 1994 GDP). The methods of privatization varied, and included tenders, direct negotiations, and sales through the stock market. In a number of cases, a small part of the company's shares was sold to its employees at discounted prices. Sales to "core" investors were conducted on the basis of competitive tenders or direct negotiations; buyers typically had to commit to a number of obligations concerning investments and to a minimum duration of involvement. The privatization program contributed to the development of the stock market and attracted foreign equity investment. Furthermore, employment generally increased in the privatized firms.

The Government is now preparing a second phase that would extend privatization to hitherto excluded sectors. In addition, it is opening to private sector activity certain services that were previously in the exclusive domain of the state or the municipalities, such as electricity generation and management of urban water and energy distribution.

These factors can improve the overall efficiency of the economy by limiting the cost to the private sector of dealing with the bureaucracy. Indeed, several surveys of private investment decisions suggest that the now infamous bureaucratic structure of several Middle Eastern economies acts as a major disincentive to investment activities--especially foreign. Once again, it is critical that the civil reform be sequenced properly with social safety net/retraining measures to limit the cost of unemployment.

Reform of the labor markets is the other essential component to limiting unemployment and, more generally, to improving the employment creation potential of certain MENA countries. First, the cost of private employment should be reduced by eliminating various direct and indirect surcharges. Second, the hiring and firing process should be more flexible. Indeed, international experience indicates that constraints on firing (such as obtaining government approval for layoffs) can be a disincentive to hiring and increase informal market activity, which in some cases does not provide labor with minimum safeguards. Third, government employment guarantees should be replaced by a transparent system of closed-end unemployment schemes. Moreover, in some countries where wide-scale privatization and public-sector reform is needed, labor retraining schemes should be emphasized.

Box 5

Egypt—Fiscal Adjustment

Egypt undertook a significant fiscal correction as part of the adjustment and reform program launched in early 1991. The fiscal correction aimed at reducing fiscal deficits and improving the structure of the budget.

After averaging 16.5 percent of GDP annually between 1985/86 and 1990/91, the overall deficit was cut to 5 percent of GDP in 1991/92 and reduced further to under 2 percent of GDP in 1994/95. The primary budget surplus amounted to 8 percent of GDP in that year.

A number of structural fiscal reforms were implemented to ensure the sustainability of the fiscal adjustment. Tax reforms focused on addressing low elasticity, inefficiency, and heavy reliance of the tax system on external trade through the introduction of a broad-based domestic sales tax, the unification of income tax schedules, and the implementation of trade reform. Expenditure reform centered on streamlining the extensive system of general food and non-food subsidies. In addition, current transfers to public economic authorities were eliminated through improved efficiency, rationalization of their operations, and self-generation of revenues.

The *human resource* base of countries in the region must be strengthened through improved education systems. There is a particular need to intensify efforts to educate the female population. As illustrated by the experience of other developing countries, improved female education opportunities can also reduce population growth. Recent studies also support measures aimed at recasting the educational emphasis by shifting limited resources from the tertiary sector to the primary and secondary sectors, and in some countries, adjusting the balance in favor of vocational training as opposed to academic studies.

The four measures just cited can contribute to *enhancing domestic and foreign direct and portfolio investment* (Box 6). In several countries, additional steps are needed to facilitate investment procedures at the local level and to reduce barriers to entry for foreign investors. Determined actions in these areas, along with a stable macroeconomic environment, promise greater returns than the current approach based largely on incentives, concessions, and "offset programs." 1/ Indeed, the current approach entails for certain countries in the region significant fiscal costs without clear additional investment; it can also obfuscate the pricing of contracts.

1/ Under the offset programs in operation in several GCC countries, foreign firms awarded government contracts are required to invest a certain portion of the contract value in joint-ventures with locally-owned firms.

Box 6

Jordan—Improvements in Investment Environment

As part of its macroeconomic adjustment and structural reform program, Jordan has implemented several measures to strengthen private investment. This recently accelerated effort includes improvements in investment legislation, the rationalization of the income tax law, and the liberalization of the exchange and payments system.

The new Investment Law allows for equal treatment of all investors, eliminates the need for cabinet approval for foreign investment, specifies clearly the sectors open to 100 percent foreign ownership, provides firm guarantees against nationalization and expropriation, specifies the sectors eligible for tax incentives, eliminating discretionary judgement, opens the financial market to all foreign investors, and provides for third-party dispute settlement consistent with international practice.

This new law is to be complemented by another law governing the operations of the Amman Financial Market (AFM). The latter aims to improve and restructure the operations of the AFM, increase the number of instruments traded, and establish transparent rules and uniform treatment for all foreign investors.

Amendments to the Income Tax Law were also passed by Parliament. Elements under the amendment to the Corporate Income Tax Law include: (i) the reduction of the number of tax rates and of the maximum tax rates of corporate income taxes; (ii) the rationalization of corporate income tax rates, treating all sectors equally; (iii) the simplification of exemptions; and (iv) a withholding tax of 10 percent on distributed profits, encouraging capital accumulation.

Consistent with its private-sector and outward-oriented growth strategy, Jordan has also taken steps to further liberalize its exchange and payments system, eliminating restrictions on current account transactions. Furthermore, a draft law on the Regulation of Foreign Exchange Transactions submitted for parliamentary approval guarantees complete current account convertibility for residents and nonresidents, and capital account convertibility for nonresidents, including lifting all restrictions on the repatriation of profits and dividends for foreign investors. It also allows residents to engage in a number of capital account transactions and to take out any funds originally brought into Jordan through the banking system.

The *strengthening of the financial intermediation system* will enhance financial savings and channel resources to the most productive sectors (Box 7). It will also ensure that larger inflows of foreign investment do not destabilize the domestic financial system. Such strengthening has three key elements. First, exposing financial institutions to a sufficient degree of competition involves for some countries privatizing large public-sector banks (e.g., Algeria, Egypt, and Tunisia), and for others facilitating the entry of foreign financial institutions (e.g., in the GCC). Second, removing remaining controls on rates of return, charges for loans, and credit allocation in the context of further progress toward indirect monetary control will facilitate financing a wider range of productive activities in a transparent and nondistortionary manner. Third, improving the prudential regulatory and supervisory regimes in line with international standards, will reduce the risks of costly financial problems and enable institutions in the region to compete in international markets on a more firm footing.

Box 7

Tunisia—Financial Sector Reform

In the context of a comprehensive economic adjustment and reform program, Tunisia has since 1987 liberalized the banking system, strengthened the position of financial institutions, and promoted the development of the financial sector. Bank-specific credit ceilings have been replaced by indirect instruments of credit control, the elimination of the requirement for prior authorization of loans, the partial deregulation of interest rates and the simplification of their structure, and the creation of an interbank money market.

Central bank intervention in the money market has become the main instrument of monetary policy. Since 1994, interest rates have been liberalized (with only small exceptions), and the mandatory acquisition of public debt instruments abolished. The new banking law provides for the creation of investment banks and a gradual introduction of universal banking. To reinforce the financial position of the banking system, prudential regulations were upgraded, banking supervision improved, and the capital base of several institutions strengthened.

Other efforts support the development of financial markets. Certificates of deposit, commercial paper, investment certificates, and treasury bills have been introduced and the creation of investment funds has been encouraged. Also, in March 1994, an interbank foreign exchange market was established. With large participation by the banks, 80 percent of all foreign exchange transactions now take place outside the Central Bank.

To support rapidly increasing equity activities, the reform of November 1994 separates the activities of the stock exchange, which has become a private entity, from the supervisory functions, which are entrusted to a new independent institution. The volume of transactions on the stock market rose from D 162 million in 1993 to D 531 million in 1994, and the volume of stocks traded increased from 4 to 15 million during the same period. Capitalization rose to 15.8 percent of GDP in 1994 as compared with 6.8 percent of GDP in 1993.

The largely bank-based financial systems of MENA countries need to be broadened and those markets internationalized. Equity markets could play an important role in mobilizing resources--from domestic, regional, and international sources--and allocating them to productive investments in support of growth and development. The need to exploit this potential is especially important now because of pressures on aid flows and increased international competition for private capital. To this end, conditions need to be established for clear property rights, more effective settlement and custody systems, greater transparency of trading conditions and a more level playing field among financial instruments, and appropriate capital and dividend repatriation.

The *liberalization of the external trade and payments regime* complements domestic deregulation and enhances welfare-improving competition. It also reduces the cost of production, encourages the inflow of productivity-enhancing foreign capital and technology, and leads to a rapid growth of exports (particularly of the non-oil sector). It removes distortions that undermine economies' ability to respond to unanticipated changes in internal prices and demand. Finally, it reduces costs to consumers.

To this end, trade reforms should aim to reduce tariffs and simplify the tariff structure. 1/ These efforts need to be accompanied by reducing non-tariff barriers, eliminating remaining state trading monopolies, and harmonizing the institutional structure with that in most other market economies.

Such efforts are indispensable to the region's attempt to promote non-oil exports and benefit from the globalization and integration of markets. They are also consistent with membership of the World Trade Organization and certain countries' on-going efforts to increase their economic integration with the EU, as discussed in the previous chapter. It is widely accepted that credible membership in the multilateral trading system can enhance the effectiveness of countries' liberalization policies.

Once again, owing to the potential dislocation of trade reforms on certain firms, these efforts should be closely calibrated with the strengthening of the social safety net. Moreover, given the fiscal costs, trade reform must also be considered integral to budgetary-tax and expenditure reform.

The seven measures discussed so far aim at enhancing the supply responsiveness of the economies--an essential component of a sustained growth and development strategy for the MENA region. International experience confirms that the effectiveness of such measures also depends on the prevailing macroeconomic environment. Thus there is a need for a consistent and supportive *fiscal/monetary/exchange rate policy mix.*

An appropriate mix requires careful calibration of these three policies to avoid crowding out private production, restrain inflationary pressure, and contribute to a strong and viable external position. Such a mix can be achieved through various configuration of policy measures. It is important in this regard that the measures be sustainable--that is, be part of strengthening the structure of the budgetary accounts (as discussed above in the case of the GCC) and a transparent and predictable system of exchange rate determination.

1/ Several MENA countries--particularly, non-oil ones--stand in stark contrast to other developing countries in Asia and Latin America when it comes to tariff levels and structure. The latter economies have tended to have maximum tariff rates of 20-25 percent at most and four or fewer bands; some have rates of below 10 percent.

VI. Summary and Conclusion

The MENA region possesses abundant human and natural resources, accounts for a large share of total world petroleum production and exports, and enjoys on average a reasonable standard of living by international standards. Countries of the region differ considerably in economic size, population, standards of living, public/private sector balance, natural resource endowments, external indebtedness, and trade and financial links with the rest of the world. At the same time, intra-regional interaction is small, being heavily weighted toward labor flows between certain countries, with rather limited trade in goods and capital market integration.

The review of developments in the MENA economy during 1989-94 provides a mixed picture. On the positive side, overall GDP has grown and domestic financial imbalances have been reduced, reflecting efforts to lower budget deficits and enhance private savings. Financial sectors have been reformed, as have exchange rate regimes in a number of countries. Foreign assets, while reduced by recent drawdowns, are still significant.

Nevertheless, with a rapidly growing population, the region's per capita income has stagnated. There has been insufficient progress in addressing unemployment and underemployment, thereby aggravating social problems. Domestic saving remains low and constitutes a constraint to higher investment. Meanwhile, the region's economy remains highly exposed to changes in its external environment. Thus, considerable fluctuations in the external terms of trade have been superimposed on a sharp deterioration.

As widely recognized by policy makers in the region, there is need to address two basic issues: Longstanding structural weaknesses that have inhibited the economy's growth responsiveness and diverted productive resources out of the region; and a poorly diversified economic and export base that has rendered most countries vulnerable to exogenous shocks.

Developments in the external environment will continue to affect significantly the economies of the region. While growth of the world economy is expected to remain fairly robust, the indications are that MENA countries face an uncertain overall environment, with significant downside risks. The sensitivity of the region to the subdued prospects for international prices of oil and food is relatively clear. The effects of the trade liberalization within the context of the Uruguay Round are more difficult to predict. It is clear, however, that policy changes are needed if potentially dynamic gains are to offset the static losses. Prospects for increased labor migration to Europe, as well as for intra-regional labor flows, are less favorable than in the past. Furthermore, recent developments in emerging capital market financing suggest that the countries of the region, which have not yet attracted significant capital inflows, may well have to compete in a more cautious investor climate.

To reduce the downside risks associated with the external environment and to strengthen their potential for achieving sustainable economic growth, the MENA countries will need to act rapidly to address their policy challenges. In view of these factors, it is not surprising that structural reform is on the top of the economic policy agenda of virtually all countries in the region.

With these factors in mind, MENA's policy challenge may be thought of as consisting of eight items:

- intensifying measures to privatize and deregulate economic activity;
- reforming public finances;
- improving the functioning of labor markets;
- strengthening human resources;
- enhancing domestic and foreign investments;
- improving financial intermediation;
- liberalizing external trade and payments;
- ensuring a supportive macroeconomic policy mix.

While such an agenda needs to be specified in greater detail at the individual country level, it is of relevance to most, if not all countries in the region. Its effective implementation would serve not only to increase MENA countries' economic growth and employment potential, but also to reduce their vulnerability to adverse exogenous shocks. In the implementation process, it is essential to address the short-term costs associated with resource reallocation. This involves proper planning and sequencing of policies and well-targeted social safety net provisions.

The policy challenges come at a time of renewed emphasis on integration efforts--within the region as well as with the EU. These efforts can help MENA economies to become internationally more competitive and exploit complimentarities. They can contribute to improved resource allocations, as well as boost investor confidence, but important qualifications must be kept in mind. First, regional integration efforts should support rather than substitute for multilateral trade liberalization. Second, integration schemes should be consistent and mutually reinforcing. Third, the rewards of integration will take some time to materialize and will materialize only if they are supported by appropriate domestic policy reforms.

For several countries in the MENA region--particularly the low-income economies--determined policy implementation needs to be accompanied by significant external assistance. Such assistance facilitates adjustment and reform provided it is available on a timely basis and on appropriately concessional terms.

With the combination of forceful domestic policies and external financial assistance to certain countries, MENA can look forward to reinvigorated growth and development. It would thus have a better opportunity to benefit from globalization and integration of the world economy while minimizing associated risks. Given the economic links in the region--through labor flows and, looking forward, more trade and private capital transactions--the beneficial impact of a generalized reform is substantial as individual country developments are augmented by welfare-enhancing region-wide effects. As a result, all countries in the region would be in a better position to exploit their considerable economic potential and meet the legitimate aspirations of their growing populations.

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Table 1. MENA Region: Population Characteristics

	Area (In 000s of sq.km)	Total population (In millions) 1994	Density (Population per sq.km.) 1/	Urban population (In percent o population) 1/	Population growth rate (In percent) 1/	Age dependency ratio (In percent) 1/	Number of children per woman 1/
Algeria	2,381.7	27.9	11.0	54.2	2.4	0.9	3.8
Bahrain	0.7	0.6	762.3	89.2	1.8	0.5	3.7
Djibouti	23.2	0.6	23.3	82.0	0.1	0.8	5.7
Egypt	1,001.5	57.4	55.3	44.4	2.2	0.8	3.8
Iran	1,648.0	62.8	37.7	57.9	1.0	0.9	4.9
Israel	20.8	5.4	238.6	90.5	2.7	0.7	2.8
Jordan	89.2	4.3	44.3	70.1	3.5	1.0	4.7
Kuwait	17.8	1.4	105.6	96.6	8.3	0.7	3.1
Lebanon	10.4	3.0	360.3	85.8	1.1	0.7	3.0
Libya	1,759.5	5.6	2.8	84.6	3.8	0.9	3.4
Mauritania	1,025.5	2.5	2.1	51.0	2.8	0.9	5.3
Morocco	446.6	26.7	56.8	47.5	2.2	0.7	3.6
Oman	212.5	2.1	9.0	12.3	5.1	1.0	7.1
Qatar	11.0	0.5	46.4	90.8	3.8	0.4	4.3
Saudi Arabia	2,149.7	18.1	7.8	79.0	3.6	0.8	6.3
Somalia	637.7	8.5	14.0	25.1	3.0	1.0	6.9
Sudan	2,505.8	27.2	10.4	23.8	2.7	0.9	5.7
Syria	185.2	13.9	71.4	51.5	3.5	1.0	5.8
Tunisia	163.6	8.7	51.7	56.3	1.7	0.7	3.1
United Arab Emirates	83.6	2.2	21.1	82.8	4.3	0.5	4.2
Yemen	528.0	14.7	23.7	31.7	3.1	1.0	7.5
MENA	14,902.0	294.1	50.7	51.2	3.0 2/	0.8 2/	4.7 2/
World	133,893.0	5,501.0 1/	24.3	44	1.7	...	...

Sources: World Bank, Social Indicators of Development 1995 and World Development Report 1995.

1/ Most recent estimate, 1993.
2/ Average.

Table 2. MENA Region: Income and Social Indicators

	Income					Health		Education				
	Nominal GDP (US$ billion) 1994	GDP per capita (US$) 1994	Real GDP growth (In percent) avg.1993–94	Real per capita GDP growth (In percent) avg.1993–94	Life expectancy (Years) 1/	Infant mortality (Per 1,000 live births 1/	Population per physician (Persons) 1/	Illiteracy (Percent of population age 15+ 1/	Primary enrollment (In percent of school age population) 1/	Secondary enrollment (In percent of school age population) 1/	Pupil–teacher ratio: primary schools 1/	Pupil–teacher ratio: secondary schools 1/
Algeria	42.2	1,512	−1.2	−3.6	67	52.8	2,322	43	99	60	27	17
Bahrain	4.7	8,437	5.4	3.5	72	17.6	799 2/	23	93	97	21	20
Djibouti	0.5	805	−2.8	−2.6	49	113.2	6,155	...	41	14	42	31
Egypt	45.5	793	1.4	−0.8	64	64.4	1,336	52	101	80	26	21
Iran	70.6	1,125	1.9	0.9	68	34.8	3,314	46	109	57	32	28
Israel	74.6	13,799	5.1	2.4	77	8.8	344	5 2/	94	85	16	...
Jordan	5.6	1,307	5.7	2.1	66	27.0	767	20	105	91	22	13
Kuwait	25.1	17,911	20.7	11.2	75	17.2	609	27	61	51	16	11
Lebanon	8.5	2,876	7.0	5.9	69	33.0	741	20	111	63	10 4/	12 3/
Libya	37.9	6,770	−3.8	−3.9	64	65.6	957	36	...	...	16 2/	12
Mauritania	1.4	546	4.5	−0.9	52	99.2	8,830	66	55	14	53	20
Morocco	31.5	1,182	5.4	2.2	64	65.6	4,710	51	69	28	28	15
Oman	10.8	5,152	6.0	−3.0	70	29.0	1,202	...	100	57	27	18
Qatar	7.9	16,455	0.7	−2.9	72	19.4	665	24 2/	95	82	7	7
Saudi Arabia	123.7	6,819	0.4	−3.1	70	27.8	708	38	78	46	14	12
Somalia	1.4	164	5.1	2.0	47	120.0	15,825 2/	76	104	10 2/	19 2/	19 2/
Sudan	6.6	242	6.6	3.6	53	76.6	9,964 2/	73	50	22	34	23
Syria	42.0	3,016	4.7	2.6	68	37.8	1,178	36	107	50	24	17
Tunisia	15.9	1,844	3.2	1.4	68	41.8	1,537	35	120	43	26	...
United Arab Emirates	37.0	16,923	−0.2	−3.4	74	18.2	1,095	...	118	69	17	14 2/
Yemen	18.7	1,272	5.9	1.3	51	117.0	5,561 2/	62	76	31	40 3/	21 3/
Middle East and North Africa	612.1	2,081	2.5	--	65	52.3	3,571	45	97	56	26	21
World	25,884.0	4,705	2.9		66	48.0 3/	5,860					

Sources: World Bank, Social Indicators of Development 1995 and World Development Report 1995.

1/ Most recent estimate, 1993.
2/ Latest single year, 1980–85.
3/ Latest single year, 1970–75.

Table 3. Openness Indicators and Per Capita Exports

	1989	1990	1991	1992	1993	1994	Average 1989–94
				Openness Indicators (Total trade as a percent of GDP)			
MENA	61	68	71	66	68	66	66
Developing countries	52	52	54	55	56	56	54
Sub–Saharan Africa	58	58	56	55	55	63	58
Asia	64	65	68	71	73	75	69
Western Hemisphere	28	27	28	29	27	26	27
Industrial countries	40	40	39	38	37	38	39
				Per Capita Exports (In U.S. dollars)			
MENA	543	686	655	671	668	658	647
Developing countries	224	245	255	277	297	316	269
Sub–Saharan Africa	96	99	93	90	86	85	91
Asia	183	192	212	239	267	289	231
Western Hemisphere	341	369	363	377	388	430	378
Industrial countries	3,811	4,150	4,230	4,447	4,313	4,703	4,276

Source: IMF, WEO.

Table 4. MENA Region: Direction of Trade

	1989	1990	1991	1992	1993	1994
EXPORTS						
			(In millions of U.S. dollars)			
World	123,090	161,191	158,412	163,174	156,639	164,644
MENA region	11,843	14,042	12,279	12,255	11,920	12,374
Of which:						
GCC	7,896	8,082	6,190	6,459	6,429	6,678
Rest of world	37,089	48,033	49,360	53,857	54,900	59,055
Of which:						
European Community	41,138	54,273	51,441	50,667	48,035	49,357
United States	15,219	19,026	19,727	20,269	17,452	17,949
Japan	17,801	25,816	25,606	26,125	24,332	25,909
			(In percent of total)			
World	100	100	100	100	100	100
MENA region	10	9	8	8	8	8
Of which:						
GCC	6	5	4	4	4	4
Rest of world	30	30	31	33	35	36
Of which:						
European Community	33	34	32	31	31	30
United States	12	12	12	12	11	11
Japan	14	16	16	16	16	16
IMPORTS						
			(In millions of U.S. dollars)			
Total	112,861	129,770	141,358	162,657	160,196	163,755
MENA region	7,925	9,236	9,895	11,590	12,273	12,777
Of which:						
GCC	5,908	6,999	6,434	7,460	7,900	7,928
Rest of world	34,940	38,228	38,346	42,894	42,985	46,263
Of which:						
European Community	48,605	58,298	63,319	71,969	70,221	73,227
United States	12,451	13,306	16,884	20,185	20,838	19,887
Japan	8,940	10,702	12,914	16,019	13,881	11,601
			(In percent of total)			
Total	100.0	100.0	100.0	100.0	100.0	100.0
MENA region	7.0	7.1	7.0	7.1	7.7	7.8
Of which:						
GCC	5.2	5.4	4.6	4.6	4.9	4.8
Rest of world	31.0	29.5	27.1	26.4	26.8	28.3
Of which:						
European Community	43.1	44.9	44.8	44.2	43.8	44.7
United States	11.0	10.3	11.9	12.4	13.0	12.1
Japan	7.9	8.2	9.1	9.8	8.7	7.1

Source: IMF, Direction of Trade.

Table 5. Real GDP and Per Capita GDP

(Annual changes, in percent)

	1989	1990	1991	1992	1993	1994	Average 1989–94
REAL GDP							
MENA	0.3	4.7	4.9	4.5	2.1	2.9	3.2
Oil exporters	0.8	6.0	5.3	5.3	1.6	1.3	3.4
remaining countries	−0.4	3.1	4.5	3.5	2.6	5.1	3.1
Developing countries	3.9	3.9	4.9	5.9	6.1	6.3	5.2
Sub–Sharan Africa	2.2	1.3	1.6	1.0	1.6	2.3	1.7
Asia	6.0	5.6	6.4	8.2	8.7	8.6	7.3
Western Hemisphere	1.6	0.6	3.5	2.7	3.2	4.6	2.7
Economies in transition	2.0	−3.9	−11.6	−15.3	−9.2	−9.4	−7.9
Industrial countries	3.3	2.4	0.8	1.5	1.2	3.0	2.0
REAL PER CAPITA GDP							
MENA	−1.4	3.1	3.5	−1.0	0.1	−0.1	0.7
Oil exporters	−2.4	5.3	5.0	−2.1	−0.2	−1.8	0.6
remaining countries	−0.2	0.4	1.6	0.6	0.4	2.2	0.8
Developing countries	0.6	2.2	3.1	3.6	4.3	4.3	3.0
Sub–Sharan Africa	−0.9	−1.3	−1.3	−1.9	−1.1	−0.7	−1.2
Asia	1.8	4.0	4.7	6.5	7.1	7.0	5.2
Western Hemisphere	−0.8	−1.4	1.5	0.7	1.3	2.6	0.7
Economies in transition	1.5	−4.5	−11.8	−15.6	−9.4	−9.5	−8.2
Industrial countries	2.5	1.6	0.0	0.8	0.6	2.4	1.3

Source: IMF, WEO.

Table 6. Consumer Prices

(Annual changes, in percent, weighted averages)

	1989	1990	1991	1992	1993	1994	Average 1989–94
MENA	13.4	13.0	18.1	17.4	15.2	17.9	15.8
Oil exporters	8.9	8.0	15.7	15.9	13.9	19.9	13.7
remaining countries	19.5	19.8	21.3	19.4	17.1	15.4	18.7
Developing countries	59.4	61.7	33.4	35.9	43.0	48.0	46.9
Sub–Sharan Africa	22.8	23.2	39.0	39.9	35.1	50.8	35.1
Asia	11.1	6.6	7.7	7.1	9.4	13.5	9.2
Western Hemisphere	337.4	440.8	128.8	152.6	212.3	225.8	249.6
Economies in transition	37.1	44.1	94.8	722.3	675.1	295.2	311.4
Industrial countries	4.4	5.0	4.5	3.3	3.0	2.4	3.8

Source: IMF, WEO.

Table 7. Terms of Trade and Current Account Balance

	1989	1990	1991	1992	1993	1994	Average 1989–94
TERMS OF TRADE							
			(Annual percent changes)				
MENA	4.5	10.8	−9.2	−4.6	−4.8	−4.4	−1.3
Oil exporters	8.0	13.2	−12.6	−3.6	−5.2	−5.4	−0.9
remaining countries	−1.4	4.3	0.5	−6.3	−2.6	−1.5	−1.1
Developing countries	1.2	2.2	−3.1	−0.7	−1.1	−0.3	−0.3
Sub–Sharan Africa	−2.3	−5.7	−3.5	−5.7	−3.6	−3.4	−4.1
Asia	−0.5	−0.8	0.4	1.0	0.4	0.4	0.1
Western Hemisphere	1.1	−0.7	−4.3	−1.1	−2.6	2.7	−0.8
Economies in transition	3.4	0.1	−3.8	−1.8	−3.3	1.4	−0.6
Industrial countries	−0.9	−0.6	1.3	1.7	2.3	1.2	0.8
CURRENT ACCOUNT BALANCE							
			(In percent of GDP)				
MENA	−0.0	1.7	−11.6	−5.2	−4.5	−4.5	−4.0
Oil exporters	0.6	3.0	−16.6	−6.6	−4.5	−3.5	−4.6
remaining countries	−1.4	−0.9	−2.2	−2.5	−4.5	−5.8	−2.9
Developing countries	−0.3	−0.1	−2.1	−1.7	−2.1	−1.8	−1.3
Sub–Sharan Africa	−5.5	−6.4	−6.1	−6.8	−6.5	−5.6	−6.1
Asia	0.3	0.1	0.1	0.1	−0.7	−0.5	−0.1
Western Hemisphere	−0.6	−0.2	−1.6	−2.9	−3.3	−3.0	−1.9
Economies in transition	−0.1	−0.4	−0.5	−1.8	−1.4	−1.7	−1.0
Industrial countries	−0.7	−0.7	−0.2	−0.2	0.1	−0.1	−0.3

Source: IMF, WEO.

Table 8. Trade Volumes

(Annual percent change)

	1989	1990	1991	1992	1993	1994	Average 1989–94
EXPORTS							
MENA	10.3	10.1	−0.0	6.7	3.7	2.6	5.6
Oil exporters	11.6	12.8	1.4	7.4	3.7	−0.7	6.0
remaining countries	6.1	0.7	−5.2	4.2	4.0	15.2	4.2
Developing countries	7.8	6.2	7.1	9.6	9.0	10.4	8.4
Sub–Sharan Africa	2.8	2.7	−2.5	−3.6	2.6	−3.2	−0.2
Asia	9.5	7.8	12.8	12.3	11.0	13.4	11.1
Western Hemisphere	3.9	6.8	4.3	6.2	8.9	9.4	6.6
Economies in transition	−7.1	−16.4	−10.3	−12.1	8.0	2.5	−5.9
Industrial countries	7.2	5.4	2.8	4.2	1.5	8.6	4.9
IMPORTS							
MENA	1.2	6.0	7.3	7.1	−1.7	−3.3	2.8
Oil exporters	8.2	5.2	8.9	9.3	−5.1	−10.8	2.6
remaining countries	−8.9	7.3	4.5	3.3	4.6	9.5	3.4
Developing countries	7.1	8.1	10.5	12.6	10.4	8.7	9.6
Sub–Sharan Africa	−2.0	−0.9	−2.0	−5.0	−2.1	−9.8	−3.7
Asia	10.9	9.4	13.8	13.3	13.8	13.1	12.4
Western Hemisphere	2.0	8.4	17.6	21.4	9.8	13.7	12.1
Economies in transition	3.0	−7.6	−22.9	−15.7	3.9	6.0	−5.6
Industrial countries	7.6	4.7	2.1	4.3	1.5	10.5	5.1

Source: IMF, WEO.

Table 9. External Debt and Debt Service

	1989	1990	1991	1992	1993	1994	Average 1989–94
EXTERNAL DEBT							
				(As percent of GDP)			
MENA	44.7	41.6	40.5	38.2	41.0	40.7	41.1
Oil exporters	19.2	17.9	18.7	18.5	20.5	20.9	19.3
remaining countries	99.6	91.8	82.1	75.6	75.4	69.0	82.3
Developing countries	35.9	34.8	35.2	33.7	33.0	31.3	34.0
Sub–Sharan Africa	83.8	87.5	93.4	93.6	101.6	113.2	95.5
Asia	21.9	22.9	24.0	23.7	23.8	23.9	23.4
Western Hemisphere	43.6	39.6	40.0	38.5	36.5	32.6	38.5
Economies in transition	2.3	2.3	9.0	53.3	39.0	31.8	22.9
DEBT SERVICE							
				(As percent of exports of goods and services)			
MENA	14.3	14.5	15.2	12.7	12.2	19.3	14.7
Oil exporters	8.7	7.8	8.2	7.8	9.4	19.0	10.1
remaining countries	28.2	33.5	34.3	26.0	19.4	20.1	26.9
Developing countries	16.8	15.8	17.3	15.4	14.8	15.8	16.0
Sub–Sharan Africa	21.6	19.5	19.4	19.5	14.0	26.4	20.1
Asia	10.9	10.6	10.1	9.3	8.8	9.5	9.9
Western Hemisphere	32.7	28.6	43.1	38.5	40.7	35.7	36.6
Economies in transition	11.8	8.7	15.1	11.4	7.7	13.3	11.3

Source: IMF, WEO

Table 10. **MENA Countries: Summary Features of Exchange and Trade Systems as of December 1994**

	Algeria	Bahrain	Djibouti	Egypt	Islamic Rep. of Iran	Iraq	Israel	Jordan	Kuwait	Lebanon	Libyan Arab Jamahiriya	Mauritania	Morocco	Oman	Qatar	Saudi Arabia	Somalia	Sudan	Syrian Arab Republic	Tunisia	U.A.E.	Yemen
Exchange rate regimes																						
Pegged to a single currency			•			•								•					•			•
Pegged to a composite of currencies								•	•		•	•	•									
Limited flexibility with respect to single currency		•													•	•					•	
Managed floating	•			•			•											•		•		
Independently floating					•					•							•					
Payments arrears																	•	•	•			
Bilateral payments arrangements	•			•	•			•		•	•							•				
Payments restriction																						
For current transactions	•			•	•	•					•	•					•	•	•			•
For capital transactions	•			•	•	•	•	•			•	•	•				•	•	•	•		•
Cost related import surcharges																						
Import surcharges			•		•	•		•		•	•		•						•			•
Advance import deposits					•					•	•						•	•				•
Surrender or repatriation requirement for export proceeds	•			•	•	•	•	•			•	•	•				•	•	•	•		•

Source: International Monetary Fund, Annual Report on Exchange Arrangements and Exchange Restrictions, 1995 (forthcoming).