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April 1, 1991

To: Members of the Executive Board

From: The Secretary

Subject: Joint Paper for the Gulf Crisis Financial Coordination Group (GCFCG)

There is attached for information a paper prepared by the staff of the Fund and the Bank at the request of the Gulf Crisis Financial Coordination Group on the "Coordination of Development Assistance in the Middle East Region." The paper is being made available to members of the GCFCG by the United States as chair of the Group and is being circulated to members of the Executive Board in the Bank for their information.

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COORDINATION OF DEVELOPMENT ASSISTANCE IN THE MIDDLE EAST REGION

Background

1. This discussion note has been prepared by the World Bank and IMF staff at the request of the Gulf Crisis Financial Coordination Group (GCFCG). At the March 11, 1991 meeting, participants agreed that the GCFCG had performed a highly useful function and should continue to follow up on existing commitments and disbursements of financial assistance to the three "frontline" countries (Egypt, Jordan and Turkey). Participants also had a preliminary exchange of views about how future financial assistance for reconstruction and development in the region might be coordinated. This note discusses organizational mechanisms for coordinating such financial assistance.

2. The note first briefly outlines the principal objectives of the economic programs that could be supported by a multilateral development assistance effort. It then discusses the principles that should guide the coordination of such assistance. Finally, possible mechanisms that satisfy these criteria are presented for discussion. The success of the economic program outlined here would obviously also depend on sufficient progress being made in parallel efforts to settle the political issues in the region, as well as to control military expenditures.

3. Financial assistance to countries in the Middle East region should, as in other cases, seek to facilitate, rather than substitute for, the sustained implementation of sound economic policies. In this regard, it is also important that, as earlier envisaged for the period after an initial phase, resources mobilized via the GCFCG or a successor group would be coordinated with the implementation of comprehensive adjustment policies, including those supported by or otherwise endorsed by the Bank and Fund.

Objectives

4. Countries in the region have been affected to varying degrees by recent events in the Middle East and face an array of economic challenges. For a few countries in the region, the most immediate task lies in emergency rehabilitation and physical reconstruction. Other countries in the region must respond to the continuing adverse impact of trade disruptions, loss of remittance and tourist receipts and, until recently, higher oil import bills--factors which, in some cases, compounded already serious financial imbalances and deep rooted structural problems. While the external environment has started to return toward pre-crisis conditions, there is a continuing need for economic recovery assistance, as well as financial support for the implementation of economic adjustment and restructuring programs.

5. However, these efforts need to be set in the context of a number of fundamental problems that have affected countries in the region for many years. The region is characterized by major disparities in resource endowments and income levels. While demographic trends are varied--and some countries have been labor scarce--in most countries, pressures from high population growth rates cause severe social strains, particularly in the rapidly growing urban areas. In the absence of improved economic performance,

unemployment is expected to increase in the labor-surplus countries, with the bulk of the unemployed concentrated in the large urban centers. Unfortunately, the Gulf crisis has the potential to result in further restrictions on labor mobility in the region as well as in acceleration of capital flight. Disparities could thus grow even wider than they are today.

6. A major cause of the economic problems in the region lies in the countries' own domestic economic policies, dirigiste orientation of institutions and administrative governance systems. Past policy failures have often been accompanied by inappropriate expenditure priorities and very high military expenditures. Large capital transfers alone would not be enough to transform these economies and could worsen the situation over the longer term by reducing the incentive for reforms. It is in the interest of both recipient and donor countries, therefore, that post-war aid be structured in a manner that promotes fundamental changes in economic management and leads to a gradual replacement of official assistance by private capital flows. Significant private investments, however, will only occur if a more hospitable business environment is created in the capital-poor countries.

7. Country level programs will need to stress policy reforms to establish a sound macroeconomic environment and improve the efficiency of resource allocation and use within countries through private sector growth. Individual country programs also can be strengthened and supported by new efforts to nurture better regional economic cooperation. This will not be an easy task and objectives need to be realistic and focussed on steps that can begin to yield results in the near term. A first step might be consultations on policy and regulatory frameworks to promote capital and labor mobility and to reap efficiency gains through the economies of larger markets and increased competition. This could then lead to the exploration and development of common infrastructure projects. Such regional policy should be designed so that it becomes a step towards, and not a substitute for, greater integration with international markets. Initially, one of the benefits and justifications for the regional consultations may be mainly in building a common political consensus in support of the liberalization of economic policies on a region-wide basis. Such region-wide cooperation could produce, over time, substantial economic efficiency and welfare gains.

8. A sustainable approach would also require attraction of larger, market-based private capital flows for investment from both local and international sources. This again is something that will take time to emerge and will depend on improvements in the policy environment within individual countries as well as greater political stability in the region. These private flows would need to be supported by official assistance to finance government-sponsored activities in reconstruction and economic recovery, the development of physical and social infrastructure, environmental protection, and the setting up of social safety nets in individual countries.

9. The main focus of official support should thus be on fostering crucial domestic reforms in individual countries through financing of stabilization and adjustment program and priority development projects. The degree of regional and non-regional donor cooperation during the Middle East crisis has been exceptional. Such cooperation could provide a catalyst for renewed

efforts by the countries in the region to discuss common economic concerns and move towards region-wide economic liberalization. In addition, financing for regional projects and programs aimed at stimulating regional economic cooperation could play a significant role in the post-war efforts to create a lasting peace in the region. Success in limited and immediately feasible projects of common interest, supported by non-regional as well as regional donors and creditors on a multilateral basis, could prove to be a foundation for broader regional cooperation later.

10. Accordingly, future multilateral development assistance efforts should encompass the following four inter-related and complementary elements:

- (i) a reconstruction program that meets the urgent needs of a few countries as well as a development assistance program in support of the ongoing economic recovery programs in many others which are directed at mitigating the impact of the crisis. These programs, implemented within a comprehensive macroeconomic framework, should be designed in a manner that, at the same time, promotes the agenda for the long-term economic growth of the entire region;
- (ii) country-level policy and institutional reforms that would increase the productivity and growth of the countries in the region by: reducing and eliminating chronic internal and external imbalances as reflected in large fiscal deficits, excessive domestic liquidity and payments imbalances; improving the incentive environment and eliminating distortions; promoting outward orientation; reducing unnecessary regulations and controls; and, more generally, developing a business environment more conducive for private investment. Initially, this would require support for structural reforms and investment program that several countries are discussing with the Fund and the Bank, and initiation of similar programs in the other countries wishing to participate in the initiative. Over time, these reforms should be deepened and accompanied by further institutional changes as well as increased emphasis on human capital development and on efficient public administration and governance.
- (iii) region-wide infrastructure projects and networks to exploit obvious complementarities and foster regional cooperation. Such a program might, provided sufficient political support is forthcoming, incorporate regional or sub-regional projects, for example, for: joint exploitation of riparian waters; environment protection; networks of gas, petroleum and/or water pipelines; and research and training institutions; and
- (iv) broadly-based efforts to liberalize economic policies in the region in order to facilitate foreign investment, develop more flexible financial and labor markets, as well as facilitate

increased market-induced trade--both intra-regional and global--over the longer term.

11. An initiative based on the above outward-oriented and efficiency enhancing policies would require strong political leadership within the countries of the region, especially as these reforms may result in the social dislocation of some segments of the population in the short term. However, the success of such a program and its sustainability over the longer term would also depend heavily on support from the donor community--both regional and international. The donor/creditor countries and organizations from outside the region will need to provide new financing and facilitate debt relief, where necessary, to supplement internal resource generation and transfers within the region. Sustainable growth throughout the Middle East is of mutual interest to both capital-surplus and labor-surplus countries within the region as well as the rest of the world. Similarly, the integration of the region's economies internally and with the international economy is also highly desirable. Therefore, it is appropriate that official assistance within the region, including from existing regional institutions, be complemented with significant contributions by countries outside the region. Based on country needs, some of the official assistance would need to be on concessional terms, but it should not come at the expense of development programs in other regions. Two other areas of action by non-regional parties that are critical to the success of the program are to: (i) provide the countries in the region non-discriminatory access to markets outside the region; and (ii) facilitate transfer of technology and management skills to both the public and private sector entities.

Principles for the Design of Institutional Mechanisms

12. These considerations suggest a number of basic principles that might guide the design of specific arrangements to coordinate future development assistance in the Middle East, which are discussed below. In addition, given the need to move rapidly, attention at this time should perhaps be focussed on approaches that could quickly mobilize resources to meet urgent reconstruction needs and to support economic reform programs while fostering regional policy coordination. This would suggest building on the positive experience with the GCFEG and the use of existing multilateral institutions and coordination mechanisms in the immediate future--including, importantly, existing regional institutions--while leaving options open for possible development of more formal mechanisms over time.

13. First, renewed emphasis on domestic economic policy and institutional reforms in an appropriate policy context within the recipient countries, including efforts to promote private investment in the productive sectors, is crucial for establishing the basic enabling environment and sound economic framework. There have been substantial official transfers within and to the region in the past. All too often, they have either reinforced or failed to mitigate shortcomings in domestic economic policies within the recipient

countries. While some welfare-oriented transfers are needed and appropriate, the central focus of future assistance should be to support the crucial policy and institutional reforms. Efficiency and performance criteria should guide resource allocation and use decisions. To the extent feasible, official assistance should be linked to the creation of productive assets, associated institutional reforms and human resource development. The disbursement of public funds should be linked to the use of transparent and competitive procurement procedures, with suppliers from countries from within and outside the region participating.

14. Second, the official assistance, whether within the region or from the outside, would be most effective when coordinated in a multilateral context. The use of assistance in a multilateral context, as far as possible, is desirable to foster the needed domestic reforms, to stimulate regional cooperation and to visibly demonstrate the willingness of the international community to jointly tackle the fundamental problems in the region.

15. Third, there is the need to retain considerable flexibility to accommodate: (a) changes over time in membership of participating countries both donors and recipients; (b) major differences in the creditworthiness and financial needs of individual recipients; and (c) individual donor preferences on the magnitude and terms of official assistance to be made available to different recipient countries. Due to the diversity of international relations, attitudes, and starting economic environment, the initiative might start initially with a core group of countries committed to common objectives. There should be scope for flexibility and expansion over time in the focus of such aid coordination efforts beyond the initial core group. Countries have very different needs and will clearly not move ahead with adjustment programs and other developmental efforts at the same pace. More importantly, it is likely to be extremely difficult, if not impossible, to define a target group of participants rigidly at the outset. While criteria such as geographic proximity, shared resources, common language and culture may play a role, mutuality of interests and willingness to create an economic environment that will allow effective use of the resources are likely to be the most important considerations. Similarly, the resource mobilization mechanisms would need to recognize that the recipient countries have diverse financial requirements. The forms and terms on which assistance is extended to them should be based on their economic and financial needs. Finally, differences in donor country circumstances and preferences in terms of the size and conditions of official assistance to be made available to the individual recipient countries would have to be accommodated.

16. Fourth, considering the central importance of countries' own efforts in undertaking far reaching domestic reforms, it would be important that priority in allocation of the official assistance be given to support such policy reform programs, which would generally be expected to be developed in cooperation with the Fund and the World Bank (in addition to meeting the criteria outlined in para. 13).

17. Fifth, regional economic cooperation and policy harmonization must remain the responsibility of countries in the region. The non-regional donors and institutions could only support such efforts. Accordingly, appropriate arrangements would be needed to provide for enhanced dialogue on an ongoing basis between countries in the region and between them and the broader international community.

Possible Coordination Mechanisms

18. There is a wide variety of potential mechanisms for multilateral cooperation at the regional level. Based on the objectives of the initiative and the principles discussed above, as well as the need to act expeditiously to support the process of recovery and reform, a flexible and less institutional two-tier arrangement--at the regional and individual country levels--appears desirable at this time. Under this approach, an umbrella group consisting of participating donors (including regional institutions) and recipients, as well as international institutions, would be created. Similarly to the GCFCG itself or the Special Program of Assistance (for Africa), but, in either case, with the possible participation of recipient countries, this group would agree on the objectives, policies and procedures that donors should collectively support within the region. The chairmanship and representation--both in terms of seniority of officials and agency participation--would have to be decided at an early stage. This umbrella organization would also provide the vehicle for marshalling multi-year (e.g., 3-year) pledges of financial support for these purposes, based on aggregate estimates of what would be required by the target group of countries in a medium-term context. The resources pledged within this group would be made available to recipient countries as cofinancing of, or in parallel with, programs developed in cooperation with and supported by the multilateral institutions. Pledges could also involve commitments to a core multilateral fund that would be administered under the guidance of the umbrella group (see para. 20 below). There would also be need for a regular reporting system on aid commitments and for coordinating and monitoring program implementation by the recipient country and assuring that the agreed policies and approaches within the group of donors are followed. This could be accomplished by appointing the institution(s) providing the policy framework also as the secretariate to the umbrella group.

19. The second tier would consist of individual country aid consortia or consultative groups. The bulk of the bilateral and multilateral assistance would be channeled through these country level consortia within the policy framework and overall priorities agreed by the umbrella group. The individual country consortia would thus allow donor countries and regional and non-regional institutions to maintain the flexibility associated with their programs to individual countries, while providing a mechanism for coordinating and facilitating cofinancing arrangements with the multilateral institutions in support of economic reform programs and other development purposes. The

emphasis of these programs would vary reflecting the diverse country circumstances. In a few cases, the emphasis would need to be on support for reconstruction and rehabilitation programs, and for most others on stabilization, structural adjustment, and longer-term development. Chairmanship of the individual country consortia would normally be a matter for the recipient countries themselves to decide, in consultation with the principal donors and institutions.

20. In addition, a core multilateral fund could be established to finance domestic reform programs and projects and to support agreed region-wide initiatives. Such a core fund need not represent a large share of the total program of financial assistance and transfers to countries in the region. It could be funded in part by already committed regional resources (e.g., a portion of the recently announced \$15 billion program of the Gulf Coordination Committee). As with all of the resources mobilized through the SPA-like umbrella group, the resources of the core fund would be allocated on strict criteria and guidelines consistent with the objectives outlined above. There are alternate ways to set up such a fund--a new institution, a facility of one of the existing institutions, or a trust fund jointly governed by the donors. Some of the alternatives would require that administration be assigned to an existing competent institution. Should such a fund take time to set up, the economic programs in the recipient countries could (and should) nonetheless be supported by associating bilateral and other multilateral financing with the ongoing Fund and Bank programs in the countries. Specific lending operations of the core fund or cofinanced through the country consortia would need to be supervised and administered according to common and generally accepted procedures.

21. Consideration could also be given to the formation of a regional forum in which policy-makers from the participating countries in the region could exchange views on regional development priorities, draw upon the expertise of existing regional and international organizations, and reach agreements on economic goals and certain policies that have regional implications. As needed, sub-groups could be organized to handle special topics of common regional interest, e.g. water management. In addition, depending on the degree to which political factors might enter into the decisions of the umbrella group, it may be necessary to consider establishing parallel mechanisms for coordinating development assistance and for discussing political issues as, for example, is being done in the case of Central America.

22. Given strong political support, a two-tier approach along the preceding lines could be established quite rapidly. Other possible options that have been proposed for managing financial transfers and the policy dialogue include a Middle East Bank for Reconstruction and Development as well as a special World Bank subsidiary. Such approaches could lead to a more permanent institution specialized in the problems of the region, and could provide a capacity to leverage official contributions with borrowings from the financial

market. However, current conditions within and outside the region may not be conducive at this time to an early agreement on issues such as decision-making and financial structures, burden-sharing arrangements, operating procedures, etc. Also, there are important legal and policy issues related to the establishment of a World Bank subsidiary which could take considerable time to resolve. Nonetheless, since these proposals merit further study, it may be necessary to adopt a phased approach, treating the permanent institutional mechanisms as longer-term options and to focus at this time on how best to structure immediately feasible coordination mechanisms so that they can be strengthened and evolve, over time, as deemed necessary and desirable.

March 29, 1991