# *Office Memorandum*

To: Members of the Executive Board May 25, 2011

From: The Acting Secretary

Subject: **Background Note by the Staff—Economic Transformation in MENA—Delivering on the Promise of Shared Prosperity**

Attached for the **information** of Executive Directors is a background note prepared by the staff at the request of the Group of Eight (G-8) on the economic transformation in MENA—delivering on the promise of shared prosperity, for the G-8 Summit to be held on May 26–27, 2011 in Deauville, France.

The note will be shortly posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (1)

FO/DIS/11/104

GROUP of EIGHT

G-8 Summit
May 27, 2011
Deauville, France

# Economic Transformation in MENA: Delivering on the Promise of Shared Prosperity

Prepared by Staff of the International Monetary Fund

INTERNATIONAL MONETARY FUND

## EXECUTIVE SUMMARY

The spark ignited by the death of Mohammed Bouazizi has irretrievably changed the future course of the countries in the Middle East and North Africa (MENA). But each country will change in its own way and at its own speed. Nor will they necessarily have a common political or economic model when they reach their destination.

The response to the recent popular protests in the MENA clearly entails a political dimension. But social and political stability will only be assured if the region creates 50–75 million jobs over the next decade for the people joining the labor force and to reduce unemployment, and if the economic model is seen as fair and inclusive.

Incremental changes in economic management will not deliver this outcome. A substantial increase in the pace of economic growth is needed, which calls for policies that support an enabling environment for the private sector. Change must also build on successes and achievements. In particular, the region's hard-won gains in macroeconomic stability need to be preserved during the coming period of structural transformation. To secure wide support among all stakeholders, growth strategies also need to deliver broadly shared gains to overcome skepticism grounded in past experiences where "reforms" were seen as imposed from above to benefit a privileged few.

The transformation should be led by the MENA countries themselves; they will determine its ultimate success. But the international community can greatly contribute to success by providing an ambitious and multifaceted program of support, encompassing incentives such as market access, labor mobility, credit guarantees, debt relief, and concessional lending. In the initial years, some countries will need external support to meet their financing requirements. In the current baseline scenario—that does not yet include the reform agendas that countries would develop—the external financing needs of the region's oil importers is projected to exceed US$160 billion during 2011-13, with a substantial part of these to be met from official sources.

The G8 can support this transformation through a long-term strategic partnership with the GCC and other interested MENA countries, underpinned by an institutional process of collaborative monitoring of this multiyear transformation. An action plan for such a strategic partnership could build on the following elements:

- In the immediate future, there is a need to restore confidence in the oil importing countries, which face surging global commodity prices and domestic pressures associated with the initial transition shocks. The International Monetary Fund (IMF) can play an important role by assessing the financing needs of these countries, proposing short-term financing strategies, and providing financial support as part of a broader international effort.
- In parallel, ministers of finance of the G8, GCC and other interested MENA countries could develop the objectives, elements, and implementation plan of a strategic G8-MENA partnership framework, with each party articulating its potential contribution. This overall framework could serve as a basis for country-level agreements, which set out each country's economic objectives and implementation strategy as well as the G8/GCC contribution, linked to the progress on the transformation agenda.
- The IMF, the World Bank and other multilateral and regional development banks could assist interested MENA countries in developing their economic strategy and translating it into a costed multi-year sector-by-sector development agenda, embedded in a medium-term macroeconomic framework. Support from the international community would be geared to help meet these development objectives and could be linked to progress on institutional and governance reforms in line with the elements and objectives of the strategic partnership.

## I. INTRODUCTION

**The social and economic transformation of MENA countries will be a multi-year agenda**. The path will not be easy, carrying risks and uncertainties throughout. The region's policymakers will need to revisit much of the existing framework of stifling economic regulations, state involvement in production and employment, a private sector based on privilege rather than competitiveness, generalized price subsidies instead of targeted social protection, and an educational system that no longer delivers on the expectations of students or their potential employers. An important challenge throughout this transformation will be to preserve macroeconomic stability while making steady progress toward social cohesion and ensuring that reform gains are broadly shared.

**This note was prepared at the request of the G8 for the Summit to be held in Deauville on May 26-27, 2011**. It identifies the economic features of MENA that may have contributed to the recent uprisings; assesses short- and medium-term economic challenges inhibiting inclusive growth; reflects on the role that the international community could play in support of the region; and proposes an action plan for a strategic partnership between the G8 and MENA.

**While the note covers the region as a whole, it is important to keep in mind the diversity within MENA**. Countries differ with respect to their social and economic characteristics, including their endowment with natural resources, but also with respect to their institutional development and the stage they have reached in the reform process. Regional trends provide context and background, but to take a reform agenda forward, the discussion needs to turn to the specifics of individual countries.

## II. BACKDROP: ECONOMIC PERFORMANCE BEFORE THE UPRISINGS

**Most MENA countries have successfully maintained macroeconomic stability over the past two decades, though fiscal deficits remained high in a number of oil importers** (Figure 1). Inflation was reduced to the low single digits by the end of the nineties, current account balances improved, and government debt was brought down relative to GDP. MENA oil importers also achieved a reduction in the external debt-to-GDP ratio. This provided the region with buffers to manage the challenges of the 2008 food and fuel price spike and the ensuing 2008/09 global financial crisis. At the same time, fiscal deficits for many MENA oil importers remained elevated, and oil exporters saw a steady deterioration of their non-oil overall fiscal balance since the late nineties.

**Despite its achievements in the area of macroeconomic stabilization, and notwithstanding a reform push in the eighties and nineties, MENA's growth performance has consistently lagged behind that of other emerging and developing countries** (Figure 2). Over the past three decades, MENA's real GDP growth averaged 3 percent, well below the 4½ percent average achieved by emerging and developing economies. The growth shortfall becomes even more apparent when looking at real per-capita GDP. Here, MENA averaged only ½ percent growth between 1980 and 2010, compared to 3 percent for emerging and developing economies. Encouragingly, growth accelerated since 2000, compared to the previous two decades, also reflecting the reform efforts, and annual employment growth averaged 2 percent between 2000 and 2007. But this was not enough: the region was not able to create sufficient jobs for a rapidly growing population—population growth was around 2½ percent—or raise the standard of living of the average citizen.

**Consequently, many MENA countries suffer from some of the highest unemployment rates in the world**. Recorded overall unemployment has been fairly constant at 10-12 percent over the past two decades in Egypt, Jordan, Lebanon, Syria, and Tunisia, countries for which data are available. Unemployment in MENA is a structural problem, particularly among the young. Youth unemployment rates among are the highest in the world, ranging from 21 percent in Lebanon to 30 percent in Tunisia. Moreover— and in this respect MENA countries differ from most others—unemployment is a problem for individuals who hold advanced degrees, which suggests that the education system is not geared to providing graduates with the skills sought by the private sector. Also, governments with their relatively high salaries are seen as the employer of first resort, discouraging young people from seeking employment in the private sector, even though civil services are no longer expanding in most MENA countries.

**The record on per-capita growth and unemployment goes hand in hand with MENA being less open to trade and less attractive to foreign direct investment than other fast-growing emerging markets**. Outside of oil and gas, MENA's share in world exports has remained flat over recent decades, in contrast to emerging and developing economies which have more than doubled their market share since 1980. MENA oil importers' total exports in 2009 amounted to only 28 percent of GDP, compared to 56 percent for Asia Pacific excluding the three largest economies Japan, India, and China. Moreover, close to 60 percent of MENA exports are directed to Europe—reflecting proximity and long-standing linkages—which implies that MENA has not inserted itself into the global economy and has not been benefiting from the high growth rates achieved in other emerging markets. MENA exports have also been mainly concentrated in primary and consumer goods, and less so in high value-added, high-technology, intermediate, and capital goods, which have seen the fastest growth in recent years.

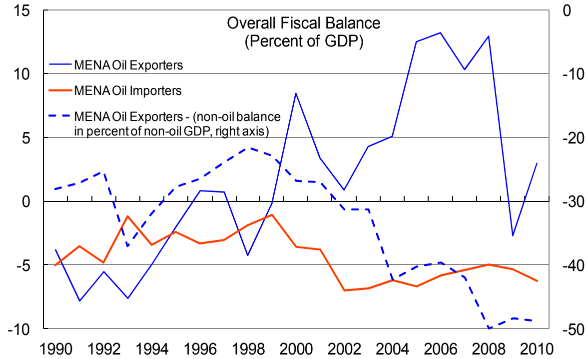
**In sum, MENA has not reaped the full benefits of globalization**. Over time, the gains from market-oriented reforms were seen to be increasingly captured by a privileged few and growing disparities became progressively uglier.

## III. Opportunity for an Inclusive Growth Agenda

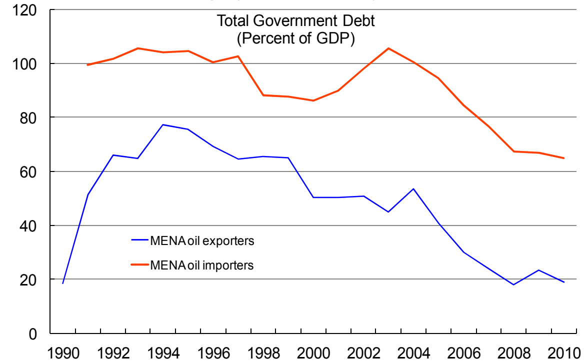
**For a political transformation to generate a prosperous future for the region, it must be accompanied with a multi-year agenda of social and economic transformation**. The path will not be easy; it will have risks and uncertainties all the way. The immediate challenge is to maintain social cohesion and macroeconomic stability in the oil importers. Beyond the short term, demands for access to economic opportunities, and employment call for an ambitious economic agenda. Each country must identify its policies, but all will need to promote broad growth participation; establish an enabling environment for the private sector to achieve higher growth; and foster accountable institutions.

# Figure 1. MENA: Macroeconomic Developments

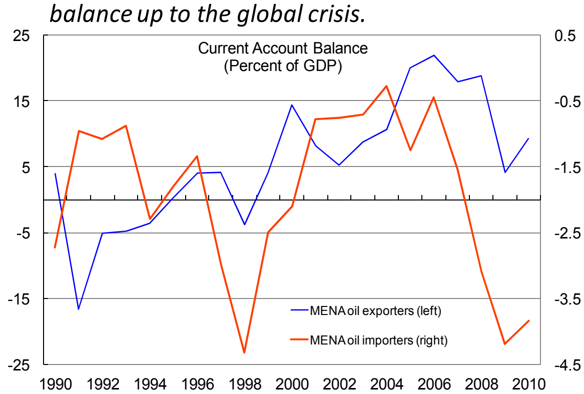
*Some improvements in fiscal balances, but vulnerabilities remain.*



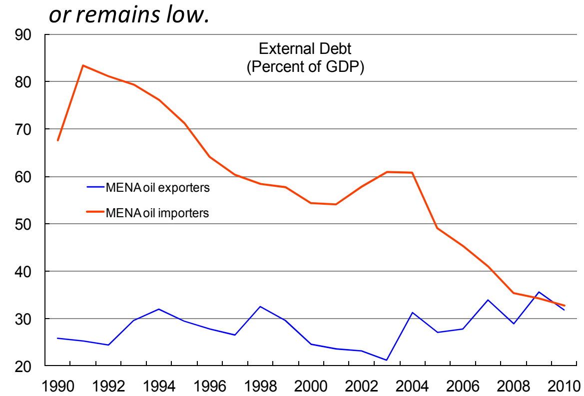

*Government debt has declined, but remains high for the oil importers.*



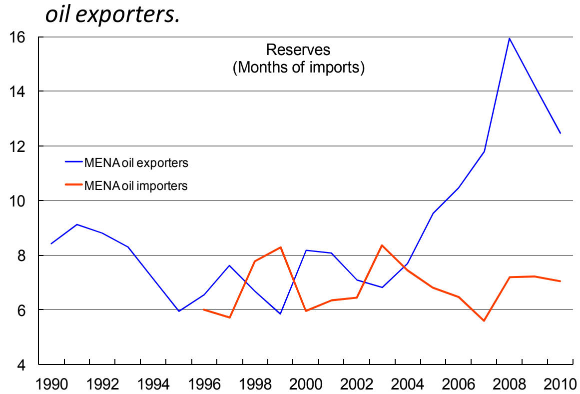

*Improvements occured in the current account balance up to the global crisis.*



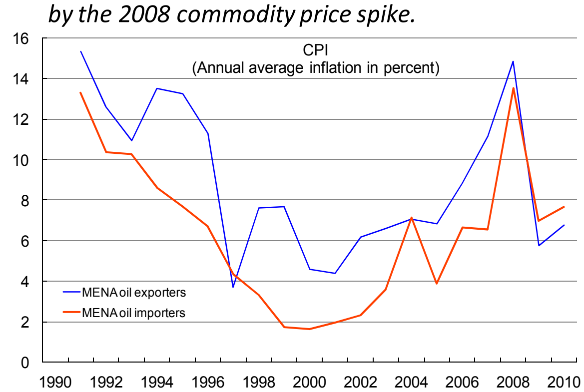

*External debt has also been reduced or remains low.*




*There was rapid reserve accumulation by oil exporters.*



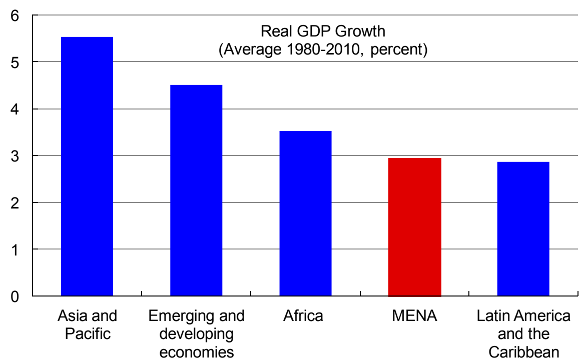

*Successful disinflation was interrupted by the 2008 commodity price spike.*




Sources: National authorities; and staff calculations.

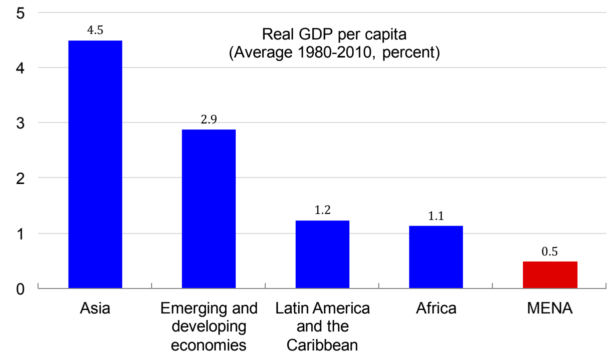
# Figure 2. MENA: Growth and Employment

*Headline growth only moderate compared to peers.*



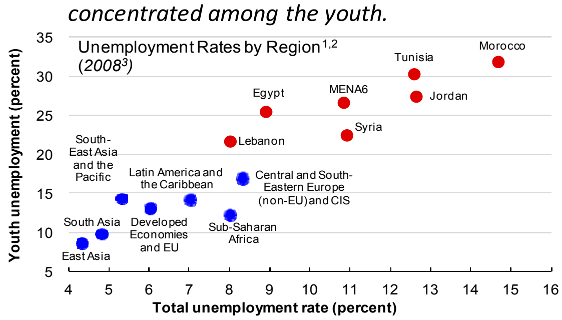

Sources: National authorities; and staff calculations.

*Per-capita growth falls far behind all other regions.*




Sources: National authorities; and staff calculations.

*Unemployment is high and concentrated among the youth.*

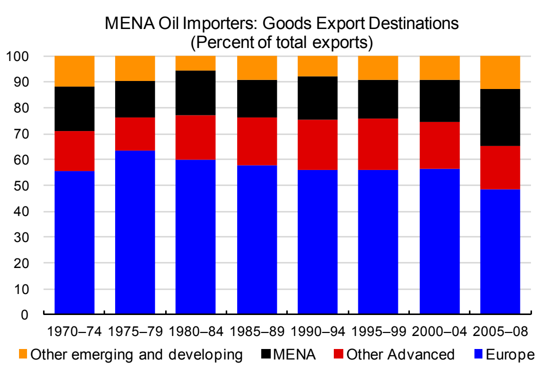



Sources: International Labor Organization; national authorities; IMF, *World Economic Outlook*; and staff estimates.
[1]MENA6 countries are Egypt, Jordan, Lebanon, Syria, Morocco, and Tunisia.
[2]Total and youth unemployment rates for Morocco reflect data from Urban Labor Force Survey.
[3]Or most recent earlier year for which data are available.

*MENA has not benefited from globalization.*

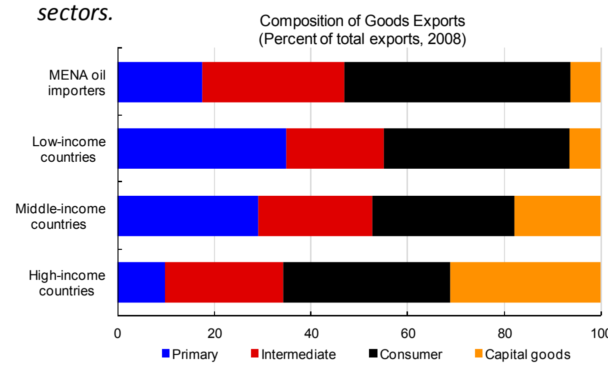

Sources: National authorities; and staff calculations.

*Oil importers trade mainly with Europe.*




Source: IMF, *Direction of Trade Statistics*.

*Exports are mainly concentrated in low value-added sectors.*




Sources: Comtrade, United Nations.

**A broad regional strategy will likely address the following**:

- Overcoming high unemployment will require a substantial increase in the pace of economic growth. To absorb the unemployed and new entrants to the labor force, MENA emerging economies would require annual real GDP growth of more than 7½ percent—almost 3 percentage points higher than the average achieved in the past decade.[1]
- Achieving such growth rates will entail both additional investment and improved productivity. While some increases in public investment may be required, for instance to improve the quality of infrastructure and services in less developed rural areas, the key role will have to be played by the private sector, including by attracting foreign direct investment. Thus, government policies should support an enabling environment in which the private sector flourishes. In countries with limited fiscal space, public investment may require international support.
- Growth also needs to be more inclusive; governments need to create an environment that allows all segments of the population to contribute to and benefit from economic growth, not just a privileged few, while providing social protection for the most vulnerable.
- Underlying these goals is the need to build modern and transparent institutions to foster accountability and good governance.
- Last, but not least, preserving macroeconomic stability throughout the process is a prerequisite for the success of any inclusive growth agenda.

## A. Macroeconomic Stability

**Recent events will strain macroeconomic stability in the near term although the impact varies considerably from country to country, and oil exporters appear to be largely protected.** Most countries have been hit by a downturn in confidence that is affecting tourism and investment, and are relying on higher public spending to maintain social cohesion and support domestic demand. The average growth of the region's oil importers is expected to drop to 2 percent in 2011 from 4½ percent in 2010, while the average non-oil GDP growth of oil exporters is projected to stay at 3½ percent. Some oil importing countries are beginning to face external pressures. Likewise, nonperforming loans in the financial sectors are rising, and most of the region's stock markets have seen a downward correction. Finally, political uncertainty has caused financial markets to raise risk premiums, and hence sovereign borrowing costs, for most countries across the region.

**The surge in global food prices is weighing on the current account balances of oil importers and pushing up inflation.** In the case of the region's emerging markets, these effects are compounded by the sharp rise in oil prices. The price of wheat alone has nearly doubled since mid-2010, and oil prices are up by about 30 percent from last year's average. The extra cost of food and fuel imports alone will add US$15 billion (on average about 3 percent of GDP) to this year's combined import bill of Egypt,

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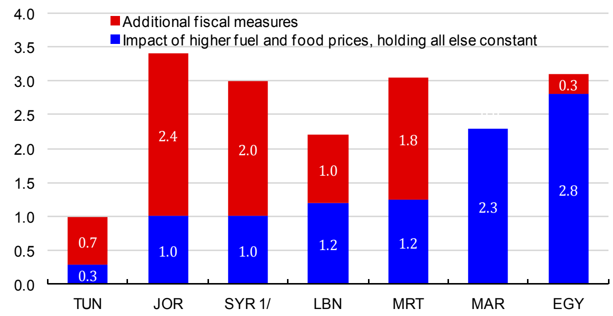
[1] MENA emerging economies are Egypt, Jordan, Lebanon, Morocco, Syria, and Tunisia. Assumes a constant employment elasticity.

New Fiscal Costs
(Percent of GDP)




Sources: National authorities; and IMF staff calculations and projections.
1/ Cost estimates for Syria does not include the additional measures announced since late March.

Jordan, Lebanon, Morocco, Tunisia, and Syria. At the same time, inflation has ticked up across the region, mainly reflecting commodity prices, and remains elevated in Egypt.

**Nearly all governments have made efforts to mitigate the domestic impact of higher food and fuel prices**. They have raised public spending (e. g., higher food and fuel subsidies and public sector wage and pension increases) and reduced certain tax rates, while providing other economic incentives such as promises to create civil service jobs. The cost of these new measures ranges from less than ½ percent of GDP for some MENA oil importers to 2½ percent in Jordan. As a result, the combined 2011 fiscal deficit of the region's emerging markets will likely reach 8 percent of GDP (over US$40 billion).

**With mostly limited fiscal space, MENA oil importers confront the immediate challenge of preserving macroeconomic stability while building social cohesion**. Additional spending in the short term is understandable and necessary to ensure social cohesion. Nonetheless, oil importers cannot afford to strain public finances, in order not to derail—over the medium-term— the pursuit of the new inclusive growth agenda. To this end, they will need to partially offset some of the additional cost of higher subsidies and other support measures through cuts elsewhere. In the same vein, they will also need to avoid introducing measures that would raise spending on a permanent basis. To preserve market confidence and prevent further escalation of the cost of funding, governments should detail credible plans for unwinding emergency measures.

**Balancing the demands for quick gains on the inclusive growth agenda and maintaining macroeconomic stability will remain a challenge for policymakers over the medium-term.** Until reforms start to bear fruit that are broadly shared, popular demands for additional spending together with investment needs associated with reform agendas will add to fiscal pressures. Oil exporters have enough resources to undertake investment and respond to such pressures. However, oil importers are more constrained by the need to safeguard external and fiscal sustainability that are the precondition for their longer-term job-creating growth agenda.

**In this context, developing a comprehensive medium-term sustainable fiscal framework is useful.** Such a framework can guide the annual budget planning process and allow for a transparent discussion between policymakers and the population as to how policy priorities and tradeoffs are reflected in the budget. In parallel, governments can explore options to increase the revenue take through tax policy reform that seeks to broaden the tax base and ensure an efficient, fair, and more equitable contribution to the funding of government activities from all parts of society.

**Similarly, there is scope for some central banks to enhance their monetary management frameworks.** At present, many countries in the region rely on the exchange rate as the nominal anchor—the GCC is mainly pegged to the U.S. dollar; oil importers follow the U.S. dollar, the euro, or a currency basket. While this reliance has yielded important stability gains, it also constrains the scope in which monetary policy can maintain price stability and support economic activity. Expanding the monetary policy toolkit would allow central banks to adopt a different nominal anchor, and let the exchange rate to adjust to external shocks and do its part in ensuring that countries maintain competitiveness, an issue particularly relevant for the oil importers seeking to raise medium-term growth.

**In the initial years, some countries will need external support to meet their financing requirements**. In the current baseline scenario—that does not yet include the reform agendas that countries would develop—the external financing needs of the region's oil importers is projected to exceed US$160 billion during 2011-13, and their fiscal financing needs are about US$150 billion. Over the medium term, the financing requirements of a new growth agenda will likely be higher, and will be determined once countries develop their economic and social strategies. In the next 18 months, a greater part of these financing needs will need to be met from the international community because of more cautious market sentiments during the uncertain transition. Over the medium term, private financing will likely will resume its traditional role in light of the creditworthiness of these countries. At the same, such financing will be necessary to meet the scale of the new growth agenda.

**Financing Needs, Middle Income MENA Oil Importers 1/**
(in billions of U.S. dollars)

| | Est. | Projections | | | |
|---|---|---|---|---|---|
| | 2010 | 2011 | 2012 | 2013 | 2011-13 |
| Current account deficit | 21.9 | 27.9 | 25.5 | 23.6 | 77.1 |
| External amortization (BOP) | 22.9 | 26.6 | 29.7 | 32.6 | 88.8 |
| **External gross financing needs** | **44.7** | **54.5** | **55.2** | **56.1** | **165.8** |
| | | | | | |
| Budget deficit | 33.9 | 46.3 | 38.5 | 34.6 | 119.3 |
| External amortization (fiscal) | 8.0 | 7.8 | 8.8 | 8.3 | 24.9 |
| **Fiscal financing need 2/** | **41.9** | **54.0** | **47.3** | **42.9** | **144.2** |

Sources: National authorities; and IMF staff estimates and projections.

1/ Comprises Egypt, Jordan, Lebanon, Morocco, Syria, and Tunisia.
2/ Assuming full domestic rollover, zero external rollover.

## B. An Enabling Environment for Inclusive Growth and Job Creation

**A more open and enabling environment for the private sector is important both for faster growth and for greater acceptance of private sector-led growth among the population.** One reason for the recent uprisings was discontent with political and economic systems that were perceived to be rigged to benefit a privileged few, and to result in gains from reforms being largely captured by a small segment of the population. It will be important to ensure broad access to economic opportunities through fair, transparent, and competitive processes, backed up by a strong legal framework and an independent and efficient judicial system. To this end, policies could include:

- Revisiting the role of the public sector and providing space for a vibrant private sector;
- Improving further the business climate;
- Developing financial systems with a wider reach;
- Fostering trade integration; and
- Strengthening the functioning of labor markets.

**Egypt: Economic Outlook and Financing Needs**

**Short-term outlook**. The January revolution has raised the aspirations of Egypt's population at a time when the economy is taking a hit from domestic unrest in the short term, the ensuing uncertainty, and large global and regional shocks (e.g., the rise in commodity prices and the violence in Libya). The political shock triggered substantial capital outflows, which in addition to the decline in tourism revenue, remittances, and exports, have led to a loss of foreign exchange reserves of about US$15 billion in the four months to end-April. Real GDP has contracted in January-March 2011 yielding annual economic growth of 1-2 percent in FY2010/11. Already high unemployment—especially among the youth—could worsen further in this low-growth environment, and managing popular expectations and providing some short-term relief measures will be essential to maintain social cohesion in the short term. Looking ahead, growth is expected to recover gradually up to 4 percent in FY2011/12, as confidence improves during the post-electoral period. However, there is considerable uncertainty about the speed of the economic recovery, which hinges primarily on an orderly political transition.

**Egypt. Selected Economic Indicators 1/**

| | 2009/10 | 2010/11P | 2011/12P |
|---|---|---|---|
| **Real GDP** (annual percent change) | 5.1 | 1.5 | 4.0 |
| **CPI** (average annual percent change) | 11.7 | 10.7 | 10.5 |
| **Current account** (percent of GDP) | -2.0 | -3.5 | -3.1 |
| **Fiscal balance** (percent of GDP) | -8.1 | -9.9 | -11.3 |
| **Public debt** (percent of GDP) 3/ | 73.8 | 74.9 | 76.3 |
| **External debt** (percent of GDP) 3/ | 15.6 | 14.2 | 16.9 |

Sources. Egyptian authorities; and IMF staff estimates and projections.

1/ Fiscal year ending June 30.

2/ Official gross international reserve plus CBE's foreign deposits with commercial banks.

3/ Including the expected financing gap in 2011/12.

**Short-term financing needs**. Staff currently projects external and fiscal financing gaps of US$9-12 billion in FY2011/12, which would need to be filled with exceptional support from Egypt's multilateral and bilateral development partners, particularly given the limited scope for adjustment in the short term. Pressures on the balance of payments will ease only gradually with continued net capital outflows, and weak tax revenues and higher food and fuel subsidy costs will weigh on the budget. Financing the deficit will become increasingly difficult and costly following the sell-off by foreign Treasury bill holders, the downgrading of sovereign debt and a decline in banks' excess liquidity.

**Medium-term challenges**. A key medium-term challenge for Egypt is to accomplish more job-rich growth in the future. About 700,000 people enter Egypt's labor market every year. Absorbing them and reducing the number of the currently unemployed will require a more vibrant economy. Achieving this requires bold actions, many of which will have to be implemented by the government that will emerge from the general elections later this year. Key reform challenges include enhancing competition so that markets become more contestable for domestic and foreign investors; creating a business environment that attracts and retains private investment and supports small businesses; reforming labor markets; and reducing the fiscal deficit, including by reducing waste through general subsidies. Even if implemented, the growth dividend from these reforms will take time to materialize. In addition, higher public investment in infrastructure, human capital, and social protection—needed to ensure more inclusive growth—will involve additional fiscal costs. As a result, Egypt's fiscal deficit will only decline in the medium term, and it will be important to ensure that public debt returns to a declining trajectory. To avoid excessive reliance on the domestic borrowing and leave sufficient space for private sector credit growth, continued external financing will remain desirable for several more years, including from the private sector.

### Tunisia: Economic Outlook and Financing Needs

**Short-term outlook.** The uncertainties associated with the political transition, together with the impact of the conflict in Libya, are expected to lead to a significant decline in tourism, FDI, and remittances. With banks facing liquidity constraints, domestic investment could also decrease. The fiscal stimulus envisaged by the authorities—an economic and social support plan of about 2 percent of GDP and a large increase in subsidies and social transfers—would partially mitigate the impact on economic activity and help to address some pressing social demands. In a baseline scenario prepared by Fund staff in which tourism receipts would decline by 40 percent and FDI inflows by 20 percent through the year, real GDP growth is projected to slow to 1.3 percent in 2011, resulting in a rise in unemployment. The current account deficit would increase to 7.8 percent of GDP and, depending on the availability of external financing, international reserves (currently at US$8.3 billion, or 4 months of imports) could decline further. The fiscal deficit is expected to widen to 4.8 percent of GDP, but public debt would remain at a sustainable level of 43 percent of GDP. These projections are subject to significant downside risks: the political transition and a lasting crisis in Libya could weigh on tourism and FDI more than currently assumed, credit growth and investment could be durably hampered if the banking sector is not restructured, and the government may face capacity and financing constraints for implementing the envisaged fiscal stimulus, thus weakening the short-term growth outlook.[1]

**Tunisia. Selected Economic Indicators**

| | 2009 | 2010 | 2011P |
|---|---|---|---|
| **Real GDP** (annual percent change) | 3.1 | 3.7 | 1.3 |
| **CPI** (annual percent change) | 3.5 | 4.4 | 4.0 |
| **Current account** (percent of GDP) | -2.8 | -4.8 | -7.8 |
| **Fiscal balance** (percent of GDP) | -3.0 | -1.3 | -4.8 |
| **Public debt** (percent of GDP) | 42.9 | 40.4 | 42.8 |
| **External debt** (percent of GDP) | 48.1 | 48.7 | 49.9 |

Sources. Tunisian authorities; and IMF staff estimates and projections.

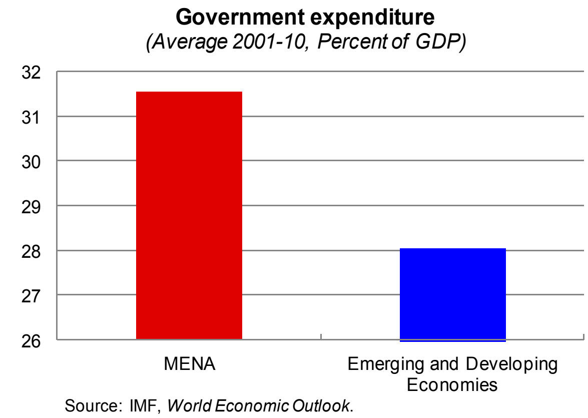
**Short-term financing needs.** In the short term, mobilizing additional external financing will be critical for implementing the envisaged fiscal stimulus without crowding out bank lending to the economy, and while maintaining an adequate level of foreign exchange reserves. Under the Fund staff baseline scenario, Tunisia's budgetary financing needs would reach US$3.7 billion in 2011, about 8 percent of GDP, and the external financing gap (after FDI and short-term capital flows) is expected to be US$4.4 billion in 2011, about 9.5 percent of GDP. External financing needs would become larger if downside risks were to materialize. Based on current indications, the government could receive about $2 billion of external financing in 2011, including US$1 billion from the World Bank and the African Development Bank. Given moderate needs for roll-over, debt relief has limited benefits and carries the risk of possibly restricting market access and increasing borrowing costs.

**Medium-term challenges**. Tunisia will need to create over one million jobs over the next decade to bring unemployment below 5 percent. This will require higher and more inclusive growth by capitalizing on its strengths and removing obstacles to private sector investment. It will entail continued sound macroeconomic policies to maintain a sustainable financial position, improved governance and transparency in the economy leading to a more efficient allocation of resources, reforms in the labor market and education system to improve job opportunities, and substantial investment in infrastructure to foster the development of impoverished in-land regions. This strategy will give rise to sustained external financing needs, which will need to be assessed more precisely as the authorities design their reform program in more detail.

[1] Preliminary estimates point to bank recapitalization needs of 2 percent of GDP at end-2010 to bring the provisioning of nonperforming loans to an adequate level.

**Revisiting the role of the public sector**

**The public sector in most MENA countries plays an important role in economic management**. Although the size of the central government in MENA is not much larger than in developing countries, the public sector—i.e., the government and the many large state-owned enterprises— is heavily involved in many private-sector economic activities and plays the role of the employer of first choice and last resort.[2] In contrast, public services are often provided by the private sector.




**Revisiting the role of the public sector will be key to the emergence of a vibrant private sector**. In particular, it will be important to reorient public spending towards social services (e.g., health and education) and infrastructure in less developed areas; reduce waste; and introduce a more commercial approach to public activities (e.g., competitive tendering and contracting out some services to the private sector).

**Further improving the business climate**

**There are many examples of successful reforms to improve the business climate and attract investment in the region**. A number of countries, including Egypt and Tunisia, have established "Smart Villages" or "Education Cities" where entrepreneurs find modern infrastructure and enjoy simplified regulation and low taxation. Others have established a base in services such as tourism and call-centers. In some cases, such improvements succeeded in attracting foreign direct investment from global companies, including those in high-tech sectors such as information technology and aeronautics. And all of these new businesses have created jobs, directly and indirectly.


**Nevertheless, MENA still lags behind most regions**, and there is a need to build on success stories and expand them in ways that benefit broad segments of the population. Areas where progress is most needed include streamlining the cumbersome and costly procedures for business

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[2] In most MENA countries, the public sector attracts many of the most qualified graduates, and also serves as a 'safety net' for those who cannot find jobs elsewhere, often at wages well above those for comparable private- sector jobs, thereby inflating public payrolls and wage bills.

startups, protecting investor rights, enhancing contract enforcement, and, more generally, strengthening transparency and governance (see below). Such reforms are key to unlocking the region's employment potential.

**Developing financial systems with a wider reach**

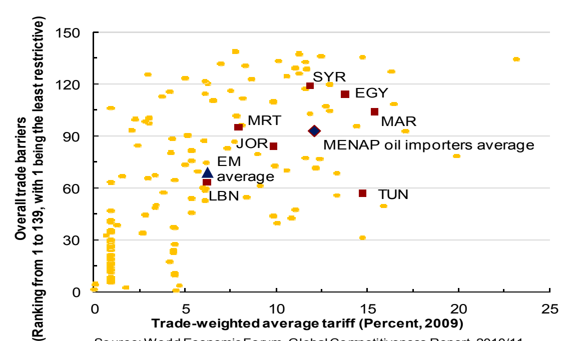
**Although MENA has made progress in financial sector reforms, in most countries these reforms failed to create a level playing field**. In particular, the region falls short in providing access to financial services for the population. Likewise, small and medium-sized enterprises receive substantially less financing from banks than in other regions. MENA banking systems have not produced the expected growth-enhancing benefits commensurate with their depth, signaling a "quality gap" with respect to the rest of the world.[3]

**The challenge will be to expand the reach of the financial sector**. Areas of action include strengthening the financial infrastructure (e.g., credit information and creditor rights); enhancing competition by removing barriers to entry and reducing regulatory tolerance toward large exposures and connected lending, reassessing the role of state banks; developing the nonbank financial system; and deepening local debt and equity markets to provide alternative sources of finance.

**Fostering trade integration**

**Despite recent liberalization, trade regimes in MENA remain more restrictive than those of its peers**. MENA countries have streamlined and lowered tariffs over the past two decades, often in the context of trade agreements with the European Union and the United States. However, tariffs remain high (averaging 12 percent), and several countries in the region rank at the higher end among 139 countries surveyed on a measure of overall trade restrictiveness.

**Trade Restrictions**



Source: World Economic Forum, Global Competitiveness Report, 2010/11.

**Greater integration with international markets could substantially boost output and labor demand**. Evidence suggests that bringing the region's openness to the level of Emerging Asia could increase annual per capita GDP growth by almost a full percentage point. For MENA countries, this will require further liberalizing, diversifying trade toward fast-growing emerging markets.

**Promoting regional integration would also improve the region's prospects for integrating them into the global supply chain.** To have a meaningful impact, regional integration should encompass trade in services consistent with GATS, liberalization of capital flows and investment,

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[3] See Section 3.3 of International Monetary Fund (2011), *Regional Economic Outlook—Middle East and Central Asia*, April 2011. For example, if Yemen's banking system were to deepen to the average of emerging and developing countries, annual per capita growth would increase by 1½ percentage points, while a non-MENA country with a similar initial depth—Armenia, for example, would increase growth by 2⅓ percentage points per year.

freedom of labor movement, freedom of establishment, and regulatory convergence, in areas such as competition policy, trade and investment regimes, public procurement, and sanitary measures.

**Strengthening the functioning of labor markets**

**MENA countries suffer from overly rigid labor market regulations.** According to the latest Global Competitiveness Report, the region ranks particularly poorly in labor market efficiency, with, for example, firing regulations in most MENA countries more restrictive than the average of emerging and developing countries. High costs of firing discourage firms from hiring in the first place. Thus, while they are intended to protect the worker, they in fact impede job creation in the formal sector and contribute to driving firms into the informal economy, where young people have limited opportunities for human capital development, and workers enjoy no rights or protection.

**Relaxing labor market regulations, while providing effective social protection, would help the private sector respond effectively to market signals.** Moreover, revising public sector hiring practices and compensation policies in a broader civil service reform framework would also help. To strengthen the link between compensation and productivity, adjustments in government pay scales will be needed within a framework of overall wage restraint.

**Enhancing skill formation and better aligning education curricula with market needs will help address youth unemployment.** In many countries, curricula can be better aligned with the needs of private-sector employers, including promoting writing skills, critical thinking, and problem solving. There are a number of recent initiatives to build private-public partnerships to enhance the quality and relevance of education but these need to be scaled up for impact. One such promising initiative is Injaz, a partnership between Ministries of Education and the private sector that enables business leaders to teach marketable skills to high school and college students, including basic business skills, teamwork, leadership skills, and entrepreneurial thinking.

## C. Providing Comprehensive and Well-Targeted Social Protection

**Recent fiscal policy measures highlight the urgent need to develop better-targeted social protection mechanisms**. MENA stands out compared to other regions for its heavy reliance on universal price subsidies as a social protection tool. Food and fuel subsidies amount to 8 percent of GDP in the region.[4] They appeal to governments because of they are easy to administer. But subsidies, when not targeted to the neediest, are costly, and may crowd out growth-enhancing public investments.[5]

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[4] According to estimates by the International Energy Agency, the MENA region accounted for almost two thirds of global petroleum price subsidies in 2009. Food subsidies are also widespread, with 17 out of 21 MENA countries currently providing them.

[5] For example, the poorest 40 percent of the population in Jordan receive less than a quarter of total spending on fuel subsidies. Food subsidies, as for example the “baladi” bread subsidy in Egypt, are more successful terms of targeting, but leakages to the better-off are still quite large.

**Over time, it will be important to design targeted and more cost-effective social safety nets to protect the vulnerable segments of the population**. Effective social safety interventions such as cash transfers and other forms of income support can be better targeted than standard commodity subsidies; typically about 50–75 percent of spending on well-designed cash transfers reaches the bottom 40 percent of the population. It will be important to build adequate infrastructure for safety nets (e.g., delivery and targeting mechanisms, beneficiary registry), to install price-indexed cash transfers, ideally with attached conditions that provide incentives for human capital investment and productivity, and to consolidate fragmented social safety nets into more effective programs. The ongoing fuel price subsidy reform in Iran may yield important lessons on designing a successful reform strategy.

**There is also scope to improve income support in the region**. In particular, the region needs to strengthen and modernize the existing social insurance programs and expand their coverage, and to introduce national unemployment insurance as an essential complement of any labor market reform.

## D. Building Effective and Transparent Institutions

**Building effective and transparent institutions is essential for good governance and ultimately for the success of reforms**. While some progress has been achieved over the past decades, promoting an environment for fair competition will require modernizing the legal and regulatory framework for property rights, for competition and anti-trust, and for bankruptcy mechanisms.

**Fiscal transparency is essential to enhancing public accountability and good governance.**[6] Strong fiscal institutions and timely and comprehensive dissemination of information on fiscal policy—from budgets to outcomes—allows citizens to hold their government accountable for policy choices. More transparent governments also benefit from improved access to international capital markets. Greater oversight by civil society and international markets further encourages governments to pursue sound economic policies and achieve greater financial stability. Strong fiscal institutions also include a fair, transparent, and effective tax system; effective public financial management systems at the various stages of the budget cycle to enforce fiscal discipline and good governance; and the elimination of bureaucratic intrusiveness and corruption.

**Strengthening the statistical system is key to good policy-making**. Regular publication of good-quality statistics is essential to provide investors with the background information relevant to their economic and financial decisions. Likewise, citizens need to know the state of play of economic developments so that they can manage their own affairs and to be informed partners in the policy dialogue with the government. A regional statistical institution (“Arab Stat”) could take the lead in promoting the production and dissemination of data at the country as well as regional level, and offer a framework to foster collaboration among national statistical agencies.

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[6] Fiscal transparency requires providing comprehensive and reliable information about past, present, and future activities of government; the availability of this information informs and improves the quality of economic policy decisions.

## IV. Support from the International Community

**The MENA countries themselves should lead this transformation, and they will determine its ultimate success**. However, the prospects for success will be much higher if the efforts of the region are accompanied by a multifaceted program of support from the international community. While parallels with the transformation of the Central and Eastern European transition countries need to be drawn with caution, there are important lessons from the constructive role played over by international partners in supporting institutional reform and policy development over more than a decade. In the MENA region, such supportive partnership may be even more needed as the region is still in the early stages of formulating a shared agenda for change and lacking a natural regional anchor that could drive this transformation.

**The success of such a partnership will require the international community to draw lessons from the shortcomings of previous approaches** that generated weak country ownership and resulted in skepticism amongst many stakeholders in the region. For the IMF, this means addressing important socio-economic dimensions that thus far have not been sufficiently brought to the fore in its policy advice, and to work with other stakeholders to build broader support within the region.

**Critical aspects that the G8 may want to consider are:**

- **The scale and scope of support should measure up to the needs of the transformation**. In the economic sphere, this could range from financial support to helping countries build accountable institutions, to providing market access (including in agriculture as needed), to easing labor mobility arrangements. The European Union's recent initiative for an ambitious partnership for democracy and shared prosperity with Southern Mediterranean contains some of these elements.
- **The support should be tailored to each country's objectives and pace of reform**. Given that changes are taking place at different speeds in different countries, the international community could tailor incentives to national objectives, including in the political sphere. Countries that go further and faster with reforms could benefit from greater support.
- **The support should be embedded in a framework of joint partnership with the region**. The commitment to good governance and equitable economic reform must be shared. For that, it will be important to build a partnership with the region and its institutions, jointly define the elements of such partnership, and develop a process of collaborative monitoring of this multiyear transformation. The participation of the regional donors and institutions will also be key for domestic and regional ownership. In this regard, the Gulf Cooperation Countries have already initiated discussions within the region.
- **Leveraging the participation of the private sector will contribute to success**. As countries move to less dominant role of the state in economic activity and given the scale of investments required to realize the potential of the region, increased reliance on the private sector for both financing and expertise, including through public-private partnerships, will be key to achieving the inclusive growth objective.

**An action plan for such a strategic partnership could build on the following elements:**

- **As a first step, ministers of finance of the G8, GCC and other interested MENA countries could jointly develop a strategic G8-MENA partnership framework**, with clear objectives, elements, and implementation plan. As part of this framework, the G8/GCC could articulate the elements of their contribution to the partnership, (e.g., economic incentives such as market access, labor mobility, concessional lending, credit guarantees, debt relief, or incentives in other areas).
- **This overall framework could serve as a basis for country-level agreements**, which set out each country's economic objectives and implementation strategy as well as the G8/GCC contribution, linked to the progress on the transformation agenda.
- **These agreements could be underpinned by costed multi-year sector-by-sector development agenda, embedded in medium-term macroeconomic frameworks** prepared in collaboration with the IMF, the World Bank, and other multilateral and regional development banks. Support from the international community would be geared to help meet these development objectives and could be linked to progress on institutional and governance reforms in line with the elements and objectives of the strategic partnership.
- **There is also the immediate need to help the oil-importing countries restore confidence** in the face of surging global commodity prices and domestic pressures associated with the initial transition shocks. The IMF can play an important role by assessing the financing needs of these countries, proposing short-term financing strategies, and providing financial support as part of a broader international effort.

**Potential Role of the IMF**

**During the 2011 IMF/World Bank Spring Meetings, the Managing Director announced that the IMF was fully committed to helping its member countries from the MENA region** to secure their goals of sustainable and inclusive growth, economic stability, job creation and improved living standards. By way of illustration, should MENA oil importers request similar financing relative to their membership quotas as in recent Fund-supported programs, an overall amount of about US$35 billion could be made available.

- The IMF has already started assessing the immediate financing needs of MENA oil-importing countries, and stands ready to provide finance support as part of a broader international effort.
- The IMF is also committed to assist MENA countries in developing medium-term macroeconomic frameworks and assessing their financing needs in close collaboration with the World Bank and other multilateral and regional banks.
- Beyond the provision of technical, policy, and financing support, the IMF will draw lessons on how the focus and scope of its work needs to be adapted to reflect the new realities of the region. This applies to the IMF's policy advice and to the way it provides technical assistance.