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# **Annual Meeting of Arab Finance Ministers**

**April 2016**

**Manama, Bahrain**

## **Investment and Growth in the Arab World**

### **A Scoping Note**

**Prepared by Staff of the International Monetary Fund**

I N T E R N A T I O N A L   M O N E T A R Y   F U N D

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## EXECUTIVE SUMMARY<sup>1</sup>

Enhancing public and private investment, but also ensuring that this translates into higher growth and employment, have long been key policy challenges in Arab countries. Reflecting an improvement in policies and global conditions, investment rates in Arab countries have increased over the past couple of decades. In spite of this—and notwithstanding significant differences across the region—investment has on average been somewhat weaker than in peer countries and less effective at generating growth. Private investment, particularly foreign direct investment (FDI), has underperformed significantly. And while public capital spending has benefited from high oil prices in resource-rich countries, it has continued to lag in oil importers.

Addressing the investment challenge is paramount for promoting higher standards of living and creating jobs for young and rapidly growing populations. Doing so is even more urgent now that the environment is becoming less supportive. Both oil exporters and oil importers are exposed to lower medium-term growth prospects in trade partners and possible higher funding costs associated with the normalization of monetary policy in the U.S. In addition, lower oil prices will make it difficult for the public sector to continue to drive growth and job creation in oil exporters, highlighting the need for these countries to transition to more diversified, private-sector led growth models. Oil importers need to prepare for spillovers from fiscal adjustment and associated lower growth in their oil-exporting partners. Finally, conflicts throughout the region have also created their own set of investment and growth challenges for countries both directly and indirectly affected.

In this context, the onus will be on policymakers to implement sound macroeconomic policies and accelerate structural reforms to foster higher and more efficient private investment. Policy priorities will vary across the Arab world, but maintaining stable macroeconomic conditions will be key, particularly in the face of a more challenging external environment. Macroeconomic policies will also need to prevent crowding out of the private sector and excessive real exchange rate appreciation, encourage trade openness, and improve access to finance while preserving financial stability. Reforms to improve the business environment, including by refocusing the role of the government, are also required to bolster private sector dynamism, attract FDI, and foster diversification.

Ensuring adequate levels of public investment in a context of limited fiscal space and increasing their efficiency will also be important to unlock private sector growth. While many countries need to scale up infrastructure spending, the focus in GCC countries will be on ring-fencing critical investment outlays in the face of large fiscal adjustment needs. This will entail mobilizing additional nonhydrocarbon domestic resources and rebalancing government outlays away from subsidy and wage bills. Strengthening public investment management will be critical to boost growth dividends.

To help policymakers address these challenges, the IMF's Middle East and Central Asia Department (MCD) proposes stepping up analysis and policy dialogue in two critical areas: (i) policies and reforms to boost private investment; and (ii) options to generate fiscal space for public investment and reforms to enhance its efficiency. Building on the significant work already undertaken by the Fund in these areas, this enhanced focus would be reflected in MCD's regional surveillance as well as bilateral engagement. Other IMF departments could also support this policy agenda through technical assistance.

<sup>1</sup> This paper was prepared by Amina Lahreche, Stéphane Roudet (lead), and Mohammed Zaher, under the supervision of Daniela Gressani. It benefited from suggestions made by participants in the meeting of Arab deputy finance ministers that took place in Abu Dhabi on January 13, 2016. Research assistance was provided by Jonathan Manning. The paper also benefited from editorial support by Sara Salimi, Jean Vibar, and Diana Kargbo-Sical.

## INTRODUCTION

*Enhancing public and private investment, but also ensuring that this effectively translates into higher growth and employment, have long been significant policy challenges in Arab countries. This paper takes stock of the progress achieved in these areas, lays out key policy issues—particularly in light of less favorable global economic conditions—and identifies areas for deepening analytical and policy work.*

**1. Investment—both by private and public entities—is a key driver of growth and job creation.**<sup>2</sup> In the short term, both public and private investment can affect output and employment by increasing aggregate demand. Over time, private investment contributes to potential output and job creation by directly expanding the economy's productive capacity. It can also boost productivity through the introduction of new production techniques and processes—particularly in the case of FDI. Public investment also induces supply-side effects through several channels. Given its highly complementary nature, it is a catalyst for private sector development and productivity growth. As regards investment in infrastructure for instance, reliable transportation, energy, and communication infrastructures are indeed paramount for unlocking private sector investment. Investing in education and health is also vital for building human capital and enhancing competitiveness and productivity.

**2. In Arab countries,<sup>3</sup> promoting high-quality investment has long been a central policy challenge.** A large number of studies over the past couple of decades have stressed the insufficient level of private (both domestic and foreign) investment and the lack of public investment (for example, see Chauffour and others 1996, OECD 2006, and World Bank 2011, and, more recently, IMF 2014a and IMF 2015a) as key constraints on growth and job creation. Significant emphasis has also been placed on the quality of investment. For public investment, the focus has been on institutions and processes aimed at promoting government capital outlays with high growth and employment impact (IMF 1995, OECD 2010, and IMF 2014a), including by strengthening prioritization and implementation. As regards private investment, studies have highlighted the need to promote the effective allocation of capital, away from the hydrocarbon sector and energy-intensive industries (particularly for oil exporters) and toward sectors that promote sustainable growth and job creation.

<sup>2</sup> There is ample evidence on the positive impact of total investment on growth (Barro 1991; Barro and Lee 1993; and Aghion and others 2006), as well as private investment (Khan and Reinhart 1989) and public investment (Arslanalp and others 2010).

<sup>3</sup> Throughout the paper, and unless otherwise indicated, GCC refers to Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. Oil exporters excluding GCC refers to Algeria, Iraq, Libya, and Yemen. Oil importers refers to Comoros, Djibouti, Egypt, Jordan, Lebanon, Morocco, Mauritania, Somalia, Sudan, Syria, Tunisia, and the West Bank and Gaza. Comparators include Advanced Economies (AE), Emerging Markets and Developing Countries (EMDCs, excluding Arab World countries), Emerging Markets (EMs), and Low Income Developing Countries (LIDCs) as defined by the *World Economic Outlook*.

**3. How much progress has been made toward addressing this challenge?** Policymakers throughout the region have taken steps toward creating an environment more conducive to private sector development and economic diversification. There has also been an effort to increase public investment and advance reforms aimed at improving its impact on growth in some countries. Have these efforts been sufficient? One important question is whether private investment, including FDI, has been put on a trajectory that will generate enough jobs and foster higher standards of living. Another question is whether sufficient progress has been made toward closing infrastructure gaps and raising public investment efficiency and its contribution to long-term growth and employment.

**4. How will the transitions currently at play in the global economy affect investment policies in Arab countries?** Medium-term growth prospects in both advanced and emerging economies have been downgraded in recent years; China's expected slowdown as it rebalances its growth is creating larger-than-expected spillovers and commodity producers face the end of a long cycle of high commodity prices. Concerns over the macroeconomic outlook are also fueled by risks related to the normalization of U.S. monetary policy. Arab countries are exposed to all these developments. Moreover, the deepening and spreading of conflicts has created its own set of challenges for the countries both directly and indirectly affected. How will these developments affect investment in the region, and what challenges do they raise for policymakers?

**5. The purpose of this paper is to engage Arab finance ministers on these questions and on the role that IMF staff can play in helping address related policy issues.** The first few sections present stylized facts on investment, propose a diagnosis, and lay out key policy challenges for Arab countries. Recognizing that the nature of policy issues differs across groups of countries and even individual cases, the paper makes a distinction between the issues faced by oil importers and oil exporters—and GCC countries, in particular. The final section identifies areas that require further analysis and which could feature more prominently in MCD's work agenda.

## INVESTMENT IN THE ARAB WORLD: WHERE DO WE STAND?

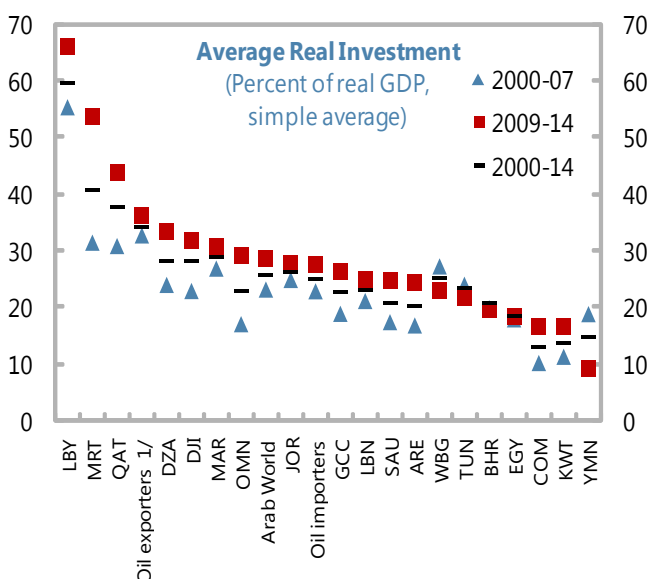
*Reflecting an improvement in policies, as well as in global conditions, investment rates in Arab countries have increased over the past couple of decades. In spite of this—and notwithstanding significant differences across the region—investment has been lower than in other EMDCs. Private investment, particularly FDI, has underperformed significantly. And while public capital spending benefited from high oil prices in resource-rich countries, oil importers have continued to lag in this area. Investment has also been less effective at generating growth.*

### Overall trends

**6. Reflecting an improvement in policies and in global conditions, investment rates in Arab countries have increased over the past couple of decades** (Figure 1). While progress has

been made on the policies and reforms aimed at fostering higher capital spending by both public and private entities (see below) over this period, investment also benefited strongly from more favorable global conditions. In particular, the significant rise in hydrocarbon prices that started in the early 2000s led to an expansion in public sector investment spending in resource-rich countries, reflecting the strong pro-cyclical nature of public capital expenditure. The spillovers from higher growth in oil-exporting countries—including ample bank liquidity in the region, on account of rising government deposits—set

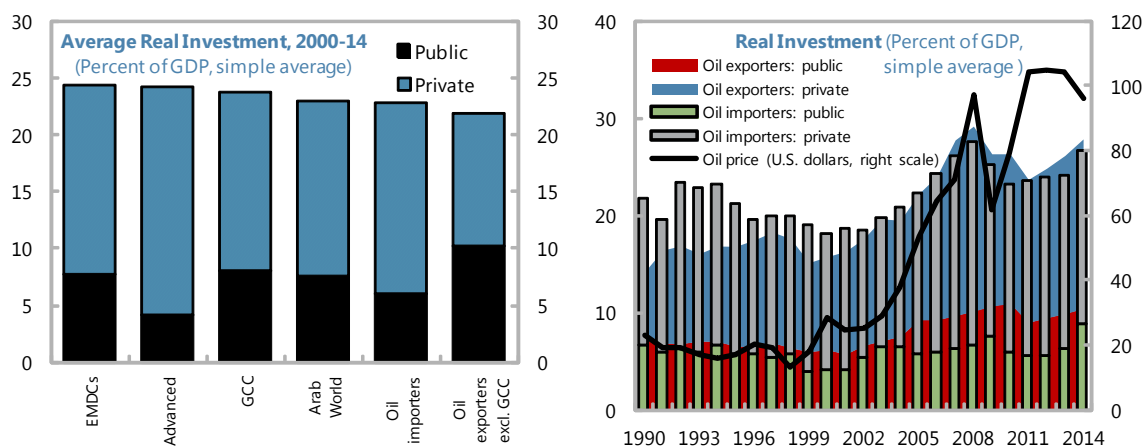
in motion a marked increase in private investment in both exporters and importers. Fast-paced global growth, low inflation, declining global interest rates, and expanding international trade also contributed. However, these trends were somewhat interrupted in the wake of the 2008-09 global financial crisis and the political turmoil in the region in the following few years—events from which many countries are still recovering.



Sources: IMF, *World Economic Outlook*; and IMF staff calculations.

1/ Excludes GCC.

**Figure 1. Real Investment Trends**



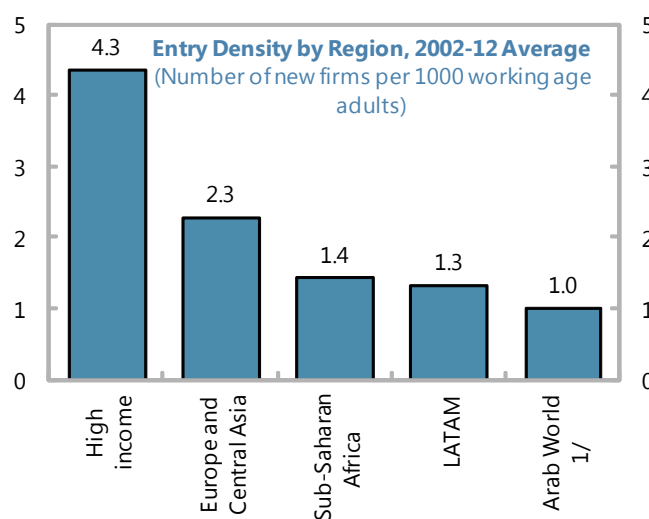
Sources: IMF, *World Economic Outlook*; and IMF staff calculations.

Note: Oil exporters excl. GCC excludes IRQ. Oil importers excludes MRT, SOM, SDN, and WBG. Data for SYR to 2010.

**7. Despite their increase, investment rates in Arab countries have not yet reached those of their peers.** At about 23 percent of GDP, total real investment rates have, on average, lagged other EMDCs by about 2 percentage points over 2000–14. They have also been lower, on average, than in advanced economies in spite of a significant decline in public investment rates in these countries over the same period (IMF 2014b). This gap is, however, relatively small in comparison to the large intra-regional differences.

### Private investment

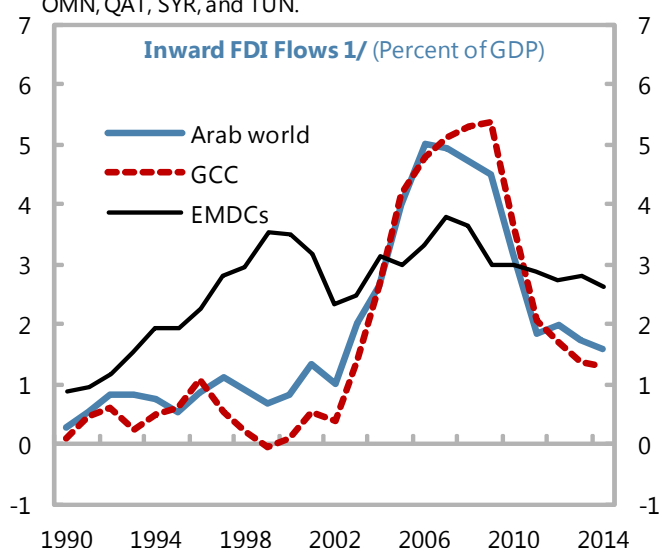
**8. Private investment, in particular, has been lower than in other EMDCs.** Relatively weak private investment rates have traditionally reflected high political and economic uncertainty as well as less conducive regulatory and institutional environments (World Bank 2011). They have been mirrored in a lack of dynamism of the domestic private sector. The firm entry density—a measure of enterprise creation dynamism—in Arab countries has been among the lowest in the world. The data exhibit wide variations in new entry of businesses across Arab countries—with GCC countries featuring an average twice as high as other Arab countries—but generally point to a difficult business environment for SMEs and a widespread informal sector, particularly in oil importers and non-GCC exporters.



Source: World Bank Entrepreneurship Database, 2013.

1/ Arab world includes ARE, DZA, IRQ, JOR, MAR, OMN, QAT, SYR, and TUN.

**9. FDI inflows have underperformed compared to other EMDCs.** Until the oil boom, FDI flows to the region were considerably smaller as a share of GDP than FDI flows to EMDCs. The pickup in the 2000s was largely driven by a surge in inflows to GCC countries, which stalled during the global financial crisis. In the rest of the Arab world, the global financial crisis, and

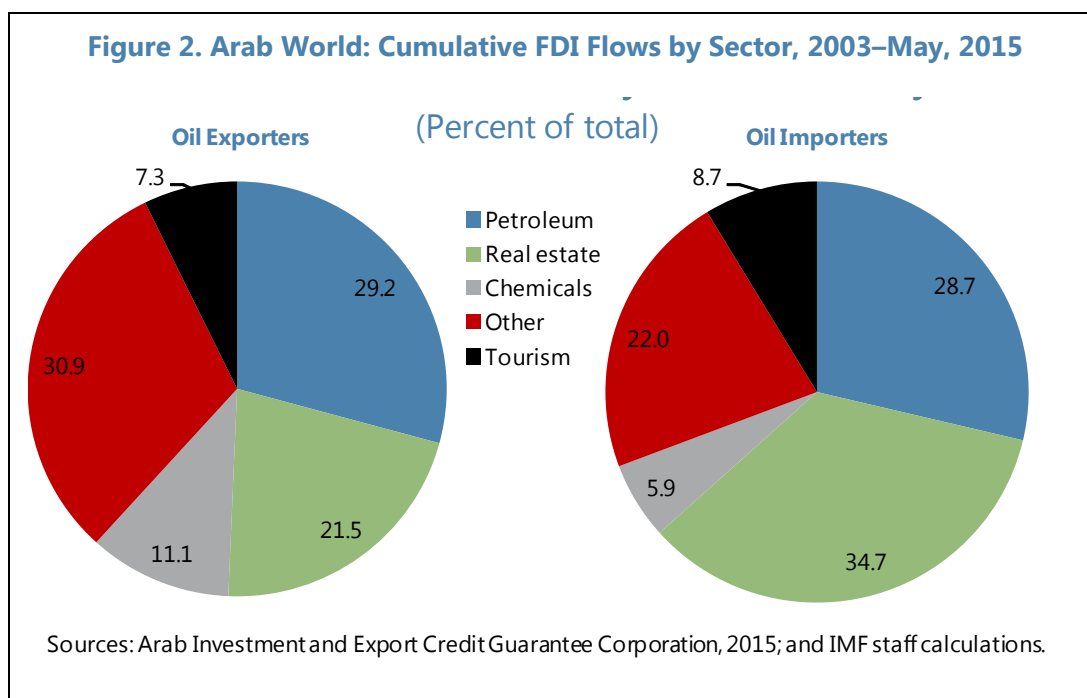


Sources: U.N. Conference on Trade and Development.

1/ Aggregates are sums of individual country data divided by sums of dollar-denominated GDP.

the Arab spring shortly thereafter, led to a retrenchment of FDI, which was more pronounced than in other EMDCs.

**10. Foreign direct investment has also been skewed toward specific countries and sectors.** GCC countries attracted almost half of the FDI inflows over the 2000s. And FDI has been highly concentrated in extractive industries—with lower impact on job creation given their highly capital-intensive nature—and the real estate sector (Figure 2), which does not traditionally bring significant productivity gains.



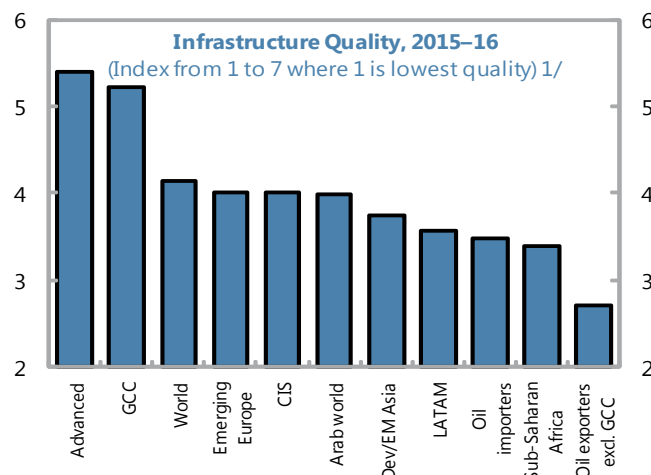
## Public investment

**11. While public investment rates have been, on average, similar to those of other EMDCs, this masks wide differences between oil importers and GCC countries.** The oil price boom of the 2000s supported a ramping up in public investment in oil exporters. Oil importers, in contrast, were constrained by limited fiscal spaces, which kept public investment rates at relatively low levels. While there was an increase in real public investment in these countries in the past few years, investment rates have remained much lower than in oil exporters.

## 12. As a result, public investment needs vary widely across the region.

- While GCC countries have invested massively in infrastructure, other parts of the Arab world appear to suffer from remaining gaps and need to scale up infrastructure investment. Arab

countries have, on average, a relatively high level of infrastructure endowment compared to other developing regions, but with large disparities between groups of countries. The region, taken as a whole, has good access to electricity, and generally high-quality paved road networks and water and sanitation systems (see Appendix I, Table 1). However, intra-regional differences in infrastructure endowments and quality are significant (Ianchovichina and others 2013): while considerable investment has positioned GCC countries well compared to other EMDCs, other countries in the region still face large infrastructure gaps—often reflecting high debt or fiscal deficits that limit fiscal space to enhance public spending. Closing these gaps would require a significant scaling-up in public investment.<sup>4, 5</sup> Long-term growth payoffs through crowding-in of private investment and other supply channels will be particularly large where capital is scarce—and hence presents high marginal returns.



Source: World Economic Forum, *World Competitiveness Report*.

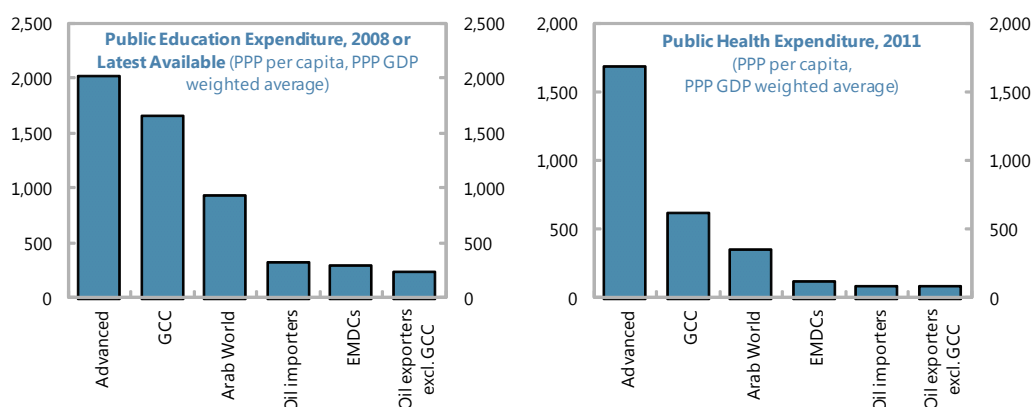
1/ Based on a survey to company executives: How would you assess general infrastructure (e.g., transport, telephony, and energy) in your country.

Note: Oil exporters excl. GCC excludes IRQ. Oil importers excludes COM, DJI, SOM, SDN, and WBG.

- The level and effectiveness of government spending on education and health have lagged (Figure 3). In general, Arab countries have spent less on education and health than advanced countries or EMDCs, although the group as a whole is marked by a large heterogeneity. To some extent, lower spending on health may reflect younger populations. However, somewhat lower education spending, even compared to EMDCs—against the backdrop of young and growing populations—points to the need to increase public investment in human capital to sustain

<sup>4</sup> Based on estimates of infrastructure gaps—defined as deviations of infrastructure capital stocks from levels warranted by the stage of economic development and other country characteristics such as the sectoral composition of output—IMF staff estimated investment gaps are some 6½ percent of GDP for non-GCC oil exporters and about 3 percent of GDP gap for oil importers (IMF 2014b).

<sup>5</sup> Additional investment may also be needed in the medium term to address other pressures, such as those stemming from the consequences of climate change.

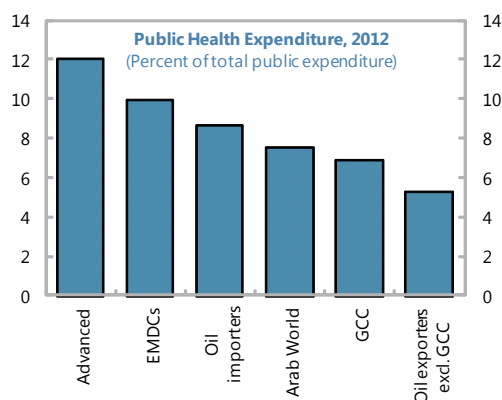
**Figure 3. Education and Health Spending Indicators**

Sources: UNESCO Institute for Statistics; U.N. Statistics Division; IMF, *World Economic Outlook*; and IMF staff calculations.

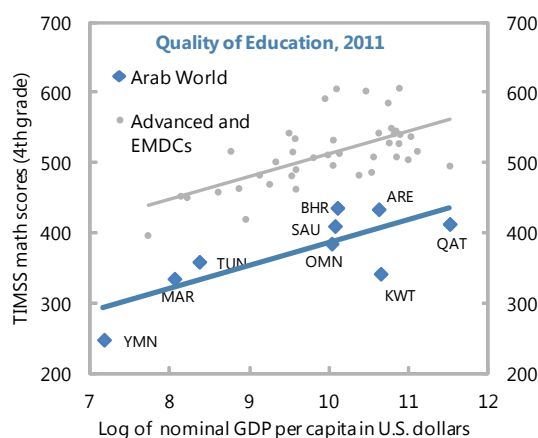
Note: GCC includes BHR (2012), KWT (2006), OMN (2009), QAT, and SAU. Oil exporters excl. GCC includes DZA and YMN. Oil importers includes COM, DJI (2010), EGY, LBN (2013), MAR (2013), MRT, SDN (2009), SYR (2007), and TUN (2012).

Sources: World Health Organization; and IMF staff calculations.

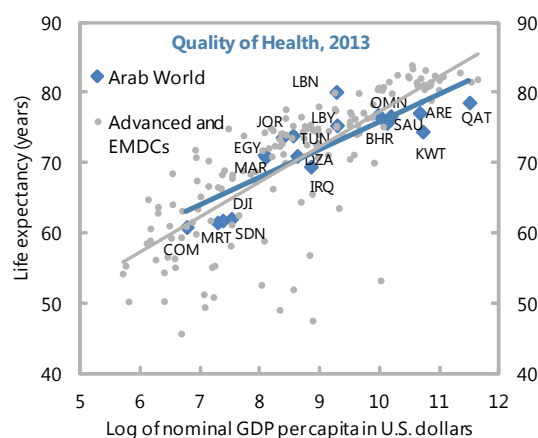
Note: Oil importers excludes WBG.



Sources: World Health Organization; and IMF staff calculations.



Sources: International Study Center, *Trends In International Mathematics and Science Study (TIMSS)*; IMF, *World Economic Outlook*; and IMF staff calculations.

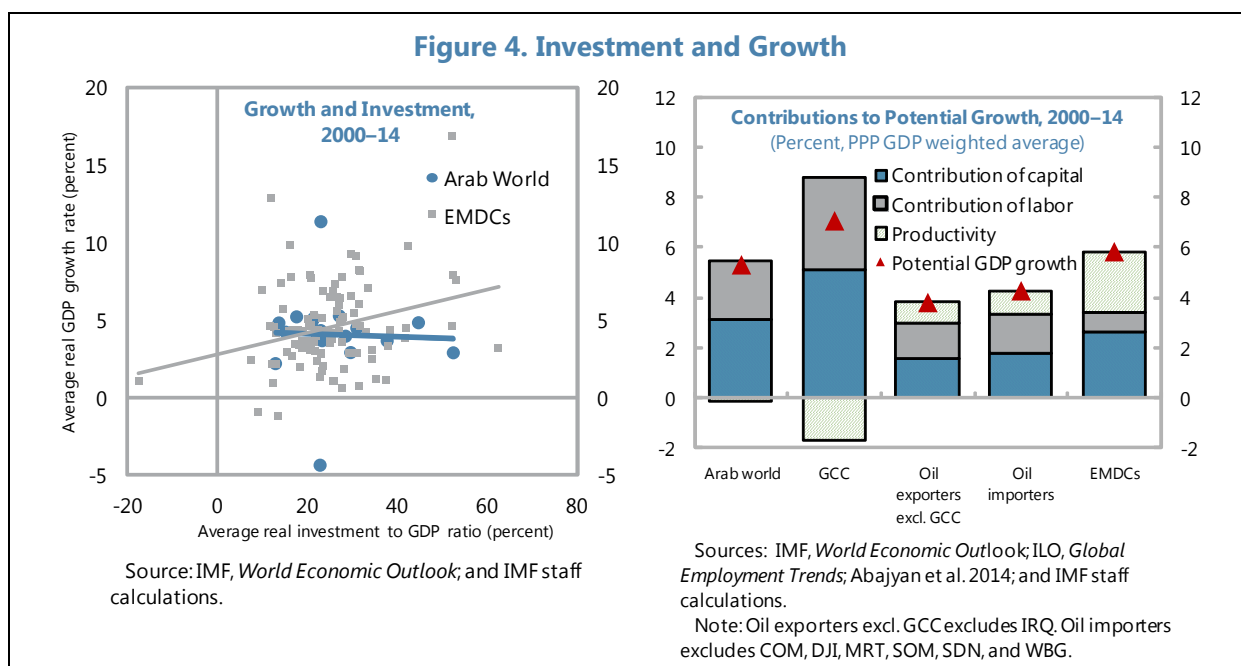


Sources: World Bank, *World Development Indicators*; IMF, *World Economic Outlook*; and IMF staff calculations.

growth. Some indicators also point to weaknesses in the quality of education and health systems in Arab countries compared to countries with the same income levels (IMF 2014; see also Appendix I, Table 2). Notwithstanding significant differences across Arab countries, the region has lagged the rest of the world in building a knowledge-based economy. To cope with the region's challenges, Arab countries need to encourage a better-educated workforce that can embrace innovation and research capabilities and expand information and communication technologies (World Bank 2013).

## Investment and growth

**13. Investment in Arab countries appears to have been less effective in generating growth than in other EMDCs.** The increase in investment rates over the past couple of decades has been concomitant with an improvement in the growth performance throughout the region. However, the correlation between real GDP growth and investment during 2000–14 has been weaker than in other parts of the world (Figure 4). This was also reflected in the relatively low contribution of total factor productivity to potential growth during this period, which weighted on overall growth performance despite sizable investment efforts, particularly in GCC countries. Low total factor productivity (TFP) growth has been a long-standing impediment to growth in the Arab world (Bisat and others 1997). Further analysis of the relationship between investment and growth, including of the sectoral distribution of private investment, would be useful in clarifying the underlying causes of low TFP growth.

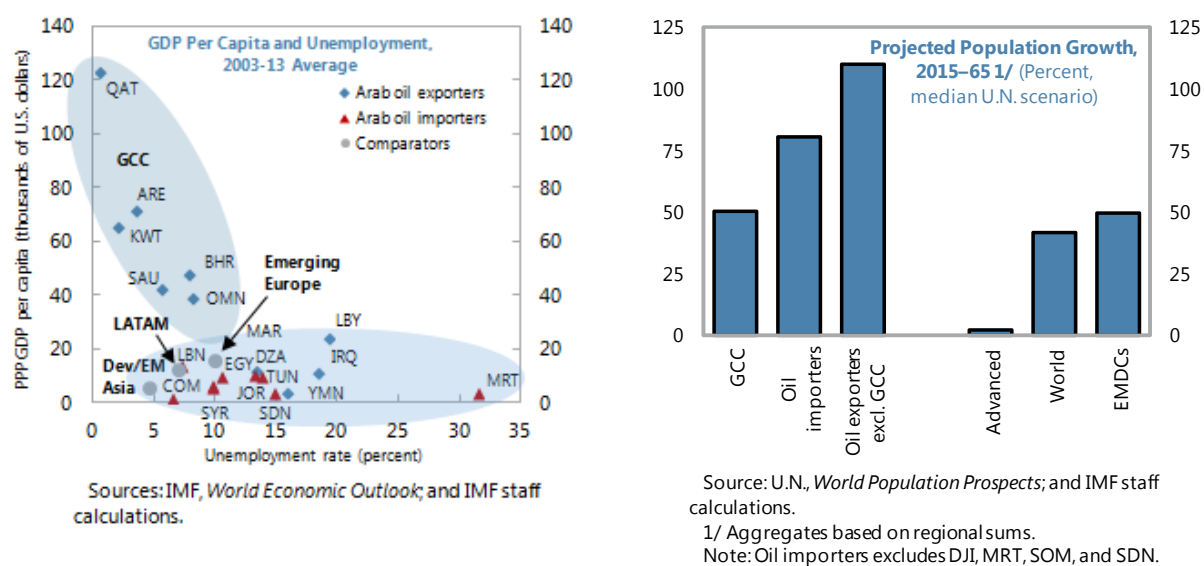


## KEY CHALLENGES AHEAD

*Enhancing investment and strengthening its impact on growth and employment will remain a high-priority objective for Arab countries' policymakers in the years ahead. This is indeed paramount to promote higher standards of living and provide jobs to young and rapidly growing populations. Addressing the investment challenge is even more urgent and difficult now that Arab countries face a less supportive external environment.*

**14. Arab countries need to achieve higher sustainable and inclusive growth.** In most countries outside of the GCC, standards of living have been lagging compared to other EMDCs; closing this per-capita-income level gap will require significantly higher growth for several decades (Figure 5). In oil-exporting countries, even where living standards are already relatively high, the challenge is to diversify economies away from capital-intensive energy sectors and promote sustainable non-oil private sector development. Higher growth is also necessary to create jobs throughout the region.<sup>6</sup> Arab countries already have large cohorts of unemployed young people and are facing a large expansion in labor force in coming years. This demographic profile presents potential opportunities but also demands that policymakers make headways toward boosting private sector growth and human capital development.

**Figure 5. Standard of Living and Employment Challenges**



<sup>6</sup> In the Arab Countries in Transition (ACTs) alone, an annual average growth rate of well above 6 percent would be necessary to bring unemployment halfway to the average of emerging markets (of about 8½ percent) in five years (see Finger and others 2014).

**15. Addressing these growth and employment challenges will require expeditiously boosting the level and efficiency of investment.** Notwithstanding some improvement in fostering higher investment over the past 15 years, the level of private investment has remained lower than in other EMDCs. More importantly, the volume of (nonhydrocarbon) private investment and productivity gains have, by and large, remained insufficient to address the current and prospective unemployment challenge and to raise standards of living sustainably. With the exception of selected oil exporters, levels of public investment have also been lower than in other EMDCs. Yet more effective and, in some cases, scaled up public investment is critical for encouraging private investment, raising human capital, and fostering higher medium-term growth.

**16. Progress on these fronts has become more pressing—but also increasingly challenging—in the current global environment.**

- *Both oil exporters and oil importers* are likely to face less supportive external conditions in the years ahead. Notwithstanding the ongoing cyclical recovery in trade partners, medium-term growth prospects in these countries have become more modest. Advanced economies' potential growth is seen as durably weaker (IMF 2015b); and there are doubts about the prospects in China and other large EMs. The associated dampening in external demand growth will shift the available drivers of growth toward domestic consumption and investment, and heighten the need for enhanced competitiveness to preserve strong export growth. At the same time, the U.S. is poised to raise interest rates amid a still ongoing recovery. This will entail raising financing costs in many Arab countries, particularly where exchange rates are linked to the U.S. dollar.
- *In oil exporters*, lower oil prices have enhanced the need for fiscal consolidation. In these circumstances, it will become increasingly difficult for the public sector to drive growth and provide jobs, highlighting the need to accelerate reforms that support the role of private investment as the engine of growth. Protecting essential public investment programs and strengthening their efficiency to avoid compromising medium-term growth will also be a challenge in the face of significant fiscal adjustment needs and rigid current spending.
- The windfall from lower oil prices offers *oil importers* some relief in the short term, including the opportunity to spend part of it on growth-enhancing capital expenditures. However, the projected slower growth in their oil-exporting partners (IMF 2015a)—as they cannot maintain current levels of government outlays—will eventually affect importers through lower trade, remittance, and financial flows. In this environment, the need for reforms to boost competitiveness and make the region an attractive investment destination will become even more acute.

## POLICY AND REFORM PRIORITIES<sup>7</sup>

*With countries in the region facing a less favorable global environment, the onus will be on policymakers to implement sound policies and accelerate reforms to promote effective investment.*

*Raising the contribution of private investment to growth will require maintaining stable macroeconomic conditions, preventing crowding out of the private sector, avoiding excessive real exchange rate appreciation, encouraging trade openness, and promoting the development of financial sectors while preserving financial stability.*

*Reforms to improve the business environment, including by refocusing the role of the government, are also essential for bolstering private sector dynamism, attracting FDI, and fostering diversification.*

*Ensuring adequate levels of public investment in spite of limited (or decreasing) fiscal space will also be important for encouraging private-sector led growth. This calls for mobilizing additional nonhydrocarbon domestic resources and rebalancing government outlays away from subsidy and wage bills. In addition, strengthening public investment management frameworks will be critical for boosting growth payoffs and saving financial resources.*

*Many of these issues are also relevant for countries directly or indirectly affected by conflicts, although the latter also face a specific set of challenges. These are discussed in Box 1.*

### A. Encouraging Effective Private Investment

#### 17. A significant leap in private investment and productivity growth will require macroeconomic policies and structural reforms to make further progress on:

- *Reducing uncertainty.* Firms are concerned about policy implementation risks and tend to hold back investment in the face of uncertainty. This calls for predictable policies and regulatory frameworks, as well as efforts to maintain a stable macroeconomic environment.
- *Lowering the cost of doing business.* Policy-related costs (high inflation and borrowing costs, red tape, distortive tax systems, and compliance costs) can be substantial and reduce investment incentives. Excessive regulations for example can also encourage the expansion of the informal sector at the expense of productivity and efficiency. Addressing these, both through sound macroeconomic policies and structural reforms, will help enhance competitiveness.

<sup>7</sup> The analysis of policy challenges to raise the contribution of investment to growth is based on a regional approach. It also builds on the key country-specific policy recommendations made in the context of recent Article IV consultations or reviews of IMF-supported economic and financial programs (see Appendix II).

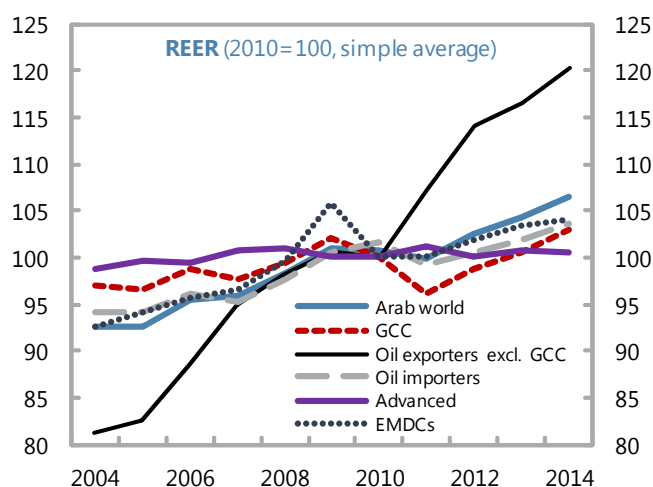
- *Fostering competition.* Further reforms to promote level playing fields and competition will encourage firms to improve efficiency, spurring both innovation and productivity gains.
- *Encouraging market-based prices and better resource allocation.* Price distortions can lead to a suboptimal allocation of resources. This calls for reforms aimed at promoting market-based prices, including the exchange rate. More generally, reforms should promote institutions that help channel resources to the most productive uses.

**18. One challenge will be to maintain stable macroeconomic and financial conditions in the face of a less favorable global economic environment.** Overall macroeconomic conditions have improved in Arab countries over the past decade, reflecting both a favorable global environment and a strengthening of macroeconomic policies (Appendix I, Figure 1). The improvement has been evidenced by declining and more stable inflation—also allowing for lower and more predictable costs of financing for investors—and more steady growth performance. Although public debt remains high in a number of oil importers, most of these countries have strengthened their fiscal frameworks. Overall, Arab countries have bolstered their external positions, with some of them able to increase reserve covers. Many oil exporters, in particular, have been able to build up comfortable buffers. Preserving or building on these gains will be more challenging in light of the headwinds from weaker external demand growth, lower oil prices, and higher funding costs.

**19. Particular attention will need to be given to the following areas** (see also Appendix II):

- *Avoiding the crowding out of private investment.* In some Arab countries, large government financing needs, combined with limited financial sector development, have pushed domestic banks to take on significant government exposure, curtailing private sector credit. This underscores the need for both fiscal consolidation and financial sector deepening to create enabling conditions for private sector investment. The crowding out has, thus far, been experienced mainly by oil importers. Looking ahead, however, wider fiscal deficits, combined with an increased reliance on domestic financing in oil exporters, calls for vigilance in these countries as well. Similarly, governments will need to ensure that mounting fiscal pressures do not lead to payment delays, which can be costly for private sector firms and constrain investment. Crowding out of the private sector can also take place during the procurement of public investment projects. Ensuring a level playing field, especially between state-owned enterprises and private sector firms, is important in this respect.

- Maintaining external price competitiveness.* A widespread preference for relatively fixed exchange rate regimes, in a climate of unfavorable inflation differentials and U.S. dollar appreciation, has led to significant real appreciation of currencies and competitiveness erosion. In some cases, a higher degree of exchange rate flexibility would help firms cope with competitiveness pressures, especially in a less favorable external environment, and encourage FDI and domestic private investment. In any case, structural reforms to enhance competitiveness over time are also of the essence.



Sources: IMF, *World Economic Outlook*; and IMF staff calculations.

Note: Oil importers excludes SOM.

- Preserving financial stability.* Adequate financing for investment requires healthy and well developed banks, credit institutions, and financial markets. While financial sectors have generally been sound in the region, lower oil prices warrant some caution, particularly in oil exporters, which face significant fiscal adjustment, drawdowns on government deposits in the banking system, and a slowdown in growth (IMF 2015b). Risks include lower liquidity and deterioration in asset quality. Increasing supervisory oversight, strengthening prudential and crisis management frameworks, and reducing bank vulnerabilities, are key to mitigate these risks and uphold the financial sector's ability to finance private investment.

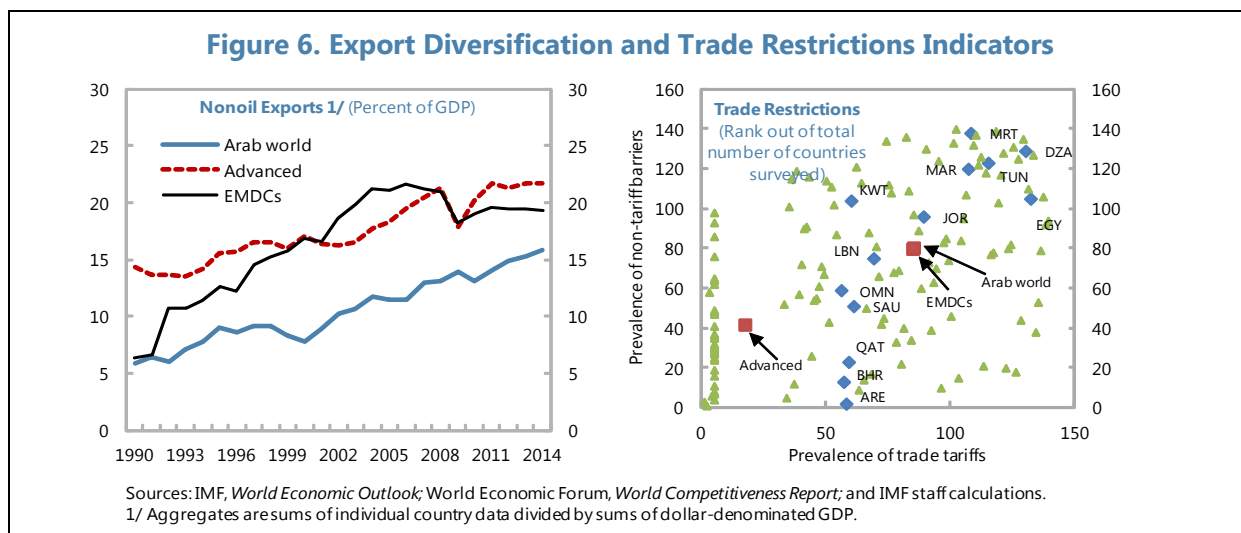
**20. Ongoing efforts to encourage financial sector development are important to improve access to finance and capital allocation.**

Limited access to finance remains a significant constraint to investment in the region (see below). In many Arab countries, limited financial infrastructure, instruments and non-bank financial institutions indeed contribute to higher costs of capital. Ongoing reforms aimed at improving access to finance by strengthening credit environment, promoting financial inclusion, for example by expanding Islamic finance, and developing domestic government debt markets and sources of finance for the corporate sector are critical to alleviate these constraints. Deeper and more developed financial sectors are also needed to channel savings toward the most profitable investment projects.

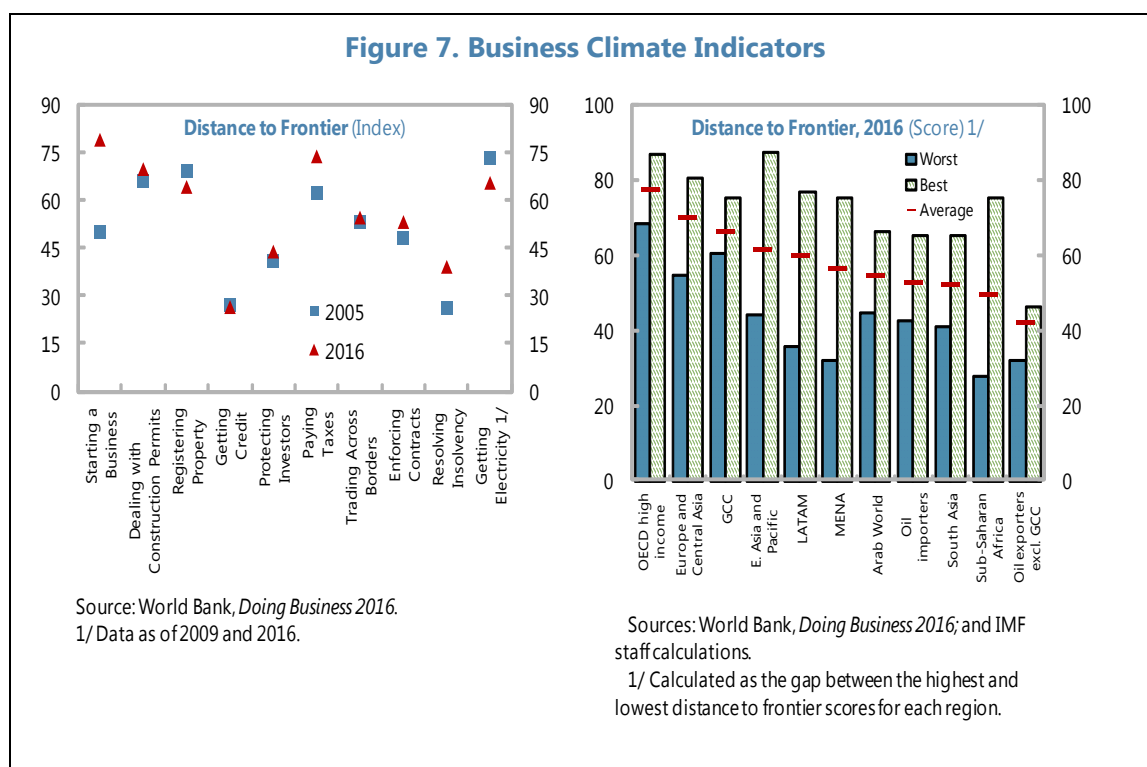
**21. Further reducing trade restrictions would also encourage investment and growth.**

Facilitating cross-border trade enhances access to external markets and to imported inputs by domestic firms. Significant tariff reforms have been implemented across the region over the past two decades. In spite of this, and notwithstanding significant disparities across countries, trade restrictions (tariff and non-tariff) have remained significant (Figure 6), particularly outside of the

GCC. This, as well as the limited complementarity and lower value added content of exports in the region, has led to limited integration into global value chains, weak export diversification, and low intra-regional trade. For example, at slightly above 10 percent, trade between Arab countries only accounts for a small fraction of total trade by countries in the region—this compares to some 65 and 25 percent for EU and ASEAN countries, respectively. Efforts to facilitate cross-border trade would help boost investment, notably FDI. In addition, with the development of large regional trade blocks globally, attention is needed to avoid marginalization of those countries that remain outside.

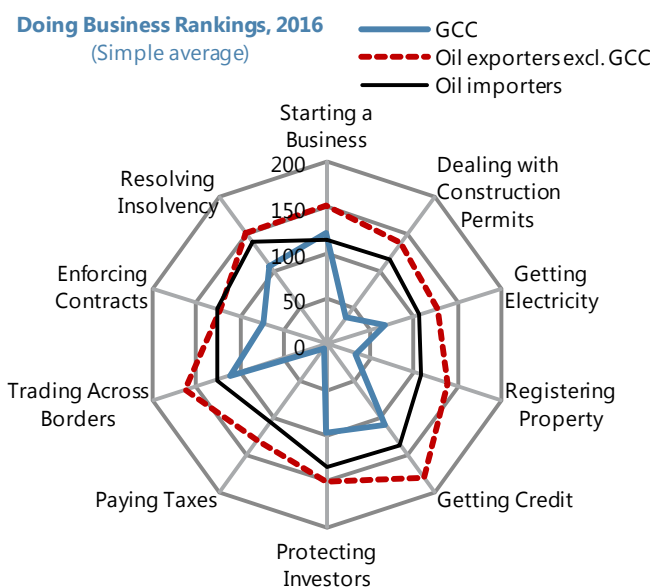


**22. Structural reforms to improve the business climate are also needed to support private investment.** Reforms over the past decade have led to some improvements in business climate indicators in Arab countries (Figure 7). Nonetheless, enterprises across the Arab world face more costly regulatory processes, difficulty in accessing credit, weaker investor and property rights protection, and less effective insolvency procedures than their counterparts in other regions. Accessing the information needed to comply with regulations is also reportedly challenging, resulting in an uneven playing field (World Bank 2012). Governance indicators (Kaufmann and others 2009 and World Bank 2014) also point to significant room for improvement in other areas, such as voice and accountability, political stability and government effectiveness, regulatory quality, rule of law, and anti-corruption measures. Labor market efficiency and education quality are also a concern in many Arab countries. Finally, while both domestic and foreign investment would benefit from reforms in these areas, foreign investors also take into account their ability to take substantial stakes in projects or companies, as well as to repatriate profits. Lifting restrictions on foreign ownership and capital flows can therefore have a significant impact on FDI.



## 23. The focus of structural reforms will differ across the various groups of countries.

- GCC countries generally rank highly in business environment indicators, as they benefit from relatively stronger institutions and infrastructure, abundant supply of foreign labor, and enjoy more stable macroeconomic environments. However, the same indicators point to further room for progress in other dimensions, including enforcing contracts, protecting investors, and the ease of business registration. In addition, reducing the influence of the government on the economy (for example, through state-owned enterprises) would help reduce barriers to entry for new private firms and increase competitive pressures. Continued reforms to improve labor market efficiency and the capacity of education systems to provide graduates with the skills that match the demands of the economy, particularly the private sector, will also be important. A key challenge going forward will also be to change incentives for GCC nationals



Source: World Bank, *Doing Business* 2016.

to work in the private sector (IMF 2015b), by, for example, adjusting salary differentials and signaling early on that reliance on the public sector to provide jobs is not sustainable.

- *Oil-importing countries and other oil exporters* face challenges along several dimensions. Voice and accountability, government effectiveness, adherence to the rule of law, and efforts to combat corruption are areas where scores continue to lag. Competitiveness indicators also point to difficulties regarding rigid labor markets, inadequate workforce skills, and regulatory environments less conducive to innovation. Access to credit continues to be a constraint, in addition to burdensome and complex procedures to start businesses, resolve insolvencies, enforce contracts, and the lack of adequate investors' right protection. This points to the need to refocus the role of the government toward enabling private sector development and developing multipronged business climate reform strategies that address weaknesses in a comprehensive way.

### **Box 1. The Special Case of Conflict and Post-Conflict Countries**

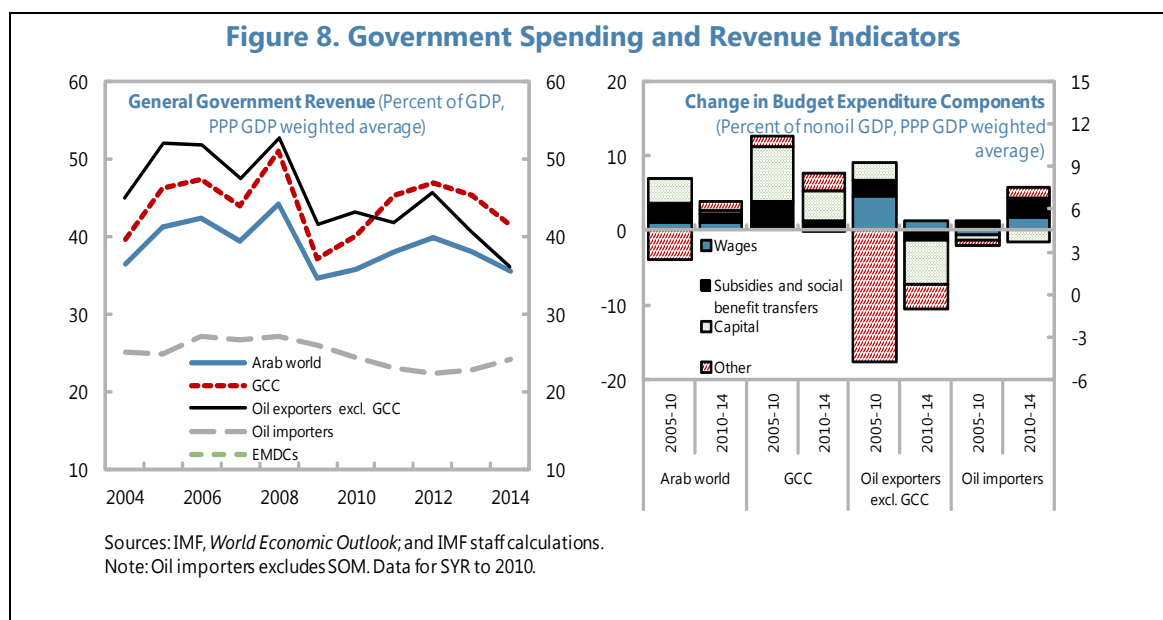
**Countries affected by conflicts face a specific set of challenges.** Conflicts, both internal and interstate, have spread to a growing number of Arab countries in the past decade, with violence having increased substantially in Syria, Iraq, Libya, and Yemen. Notwithstanding the heavy death toll and dramatic humanitarian impact of conflicts, direct consequences have also included widespread damage to infrastructure, large-scale displacement of populations, weakened institutions and rule of law, major losses in investor confidence, sharp contractions in activity in affected areas, depletions of policy buffers, and macroeconomic instability. Conflicts have had significant repercussions not only on the countries themselves, but also on neighbors. Lebanon and Jordan in particular, have faced massive inflows of refugees. Hosting refugees, in turn, has created additional needs for infrastructure and public services, particularly health and education.

**The challenge for policymakers is to balance the need for urgent spending with the need to maintain macroeconomic stability and to prepare for recovery and reconstruction.**

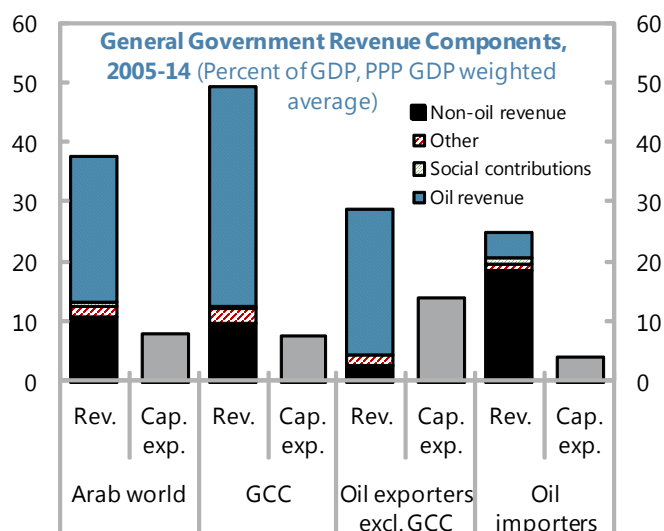
- In the case of full-scale conflicts, the immediate priority for policymakers is to prevent a social and economic collapse. This entails a difficult balancing act. On the one hand, country authorities need to satisfy urgent spending needs in order to maintain basic public services, safeguard infrastructure, and encourage economic activity. However, this often has to be done in the face of large revenue and international reserve shortfalls. On the other hand, avoiding an economic collapse requires maintaining macroeconomic stability.
- As the violence abates and the political situation allows, the authorities' attention will need to shift toward recovery and reconstruction. The priority will then be to restore key public services, social safety nets, and infrastructure. In light of the large-scale investments this will entail, the authorities will also need to rebuild institutions that can transparently and effectively identify priorities and implement reconstruction projects. Effective procurement systems, for example, will also be vital for generating critical donor assistance. This will need to be done while preserving—or, in most cases, re-establishing—macroeconomic stability and rebuilding policy buffers. Creating an environment conducive for the private sector will also be important in light of its potential role in the reconstruction effort. Juggling these multiple priorities in a context of low capacity and minimal resources will require massive external assistance, both in terms of financing and technical advice.

## B. Making the Most of Public Investment

**24. In an environment of constrained fiscal space, achieving the desired level of public investment requires raising additional domestic resources and reallocating government outlays away from current spending.**



- In many *oil importers*, high public debt levels have imposed significant constraints on the ability of governments to scale up public capital spending, including on human development, and close remaining infrastructure gaps. In these circumstances, reallocating spending from unproductive uses toward investment is critical. A number of countries have already started reforming fuel subsidies to the benefit of capital expenditure and higher health and education spending; lower oil prices offer a unique opportunity to accelerate reforms in this direction. Other untargeted subsidies are also good candidates for streamlining and reallocation. Steps to reform public employment and compensation frameworks may also be needed when there is a need to address large wage bills. There is



Sources: IMF, *Regional Economic Outlook: Middle East and Central Asia*; and IMF staff calculations.

Note: Oil exporters excl. GCC excludes DZA. Oil importers excludes SOM. Data for SYR to 2010.

also room to mobilize additional domestic resources for public investment in a number of countries (Figure 8). While tax rates remain relatively modest in many Arab countries compared to peer countries, the combination of large informal sectors, numerous tax exemptions, and weak tax administration are keeping tax revenues below their potential. To increase tax yields in a fair way (Jewell and others 2015), options include streamlining exemptions, simplifying tax systems, and improving tax administration. Raising existing tax rates or introducing new taxes may also be necessary in countries where tax burdens are not already a deterrent to investment and job creation.

- Fiscal space is also becoming more limited in *oil-exporting countries* as they face large medium-term consolidation needs. In GCC countries, large accumulated savings and low public debt will act as buffers in the short term and help smooth the adjustment process. They will also allow these countries to tap debt markets at favorable terms, thereby providing space for gradual adjustment. Yet over time, fiscal adjustment will be necessary as countries adapt to durably lower oil prices. In this context, it will be important to balance the need for consolidation with the need to maintain sufficiently high growth in the short term—this may call for preserving a certain level of public capital spending.<sup>8</sup> In addition, to preserve medium-term growth prospects and attract private investment, GCC countries will need to maintain a level of capital and current expenditure sufficient to sustain already well-developed public infrastructures, and to ensure adequate allocations for health, education, and other growth-enhancing expenditure. Doing so, while preserving savings for future generations, will require significant revenue and expenditure reforms. Options include raising nonhydrocarbon revenues and addressing large subsidy and wage bills.

**25. Ongoing efforts to alleviate financing constraints, particularly for oil importers and non-GCC oil exporters, need to be sustained.** As noted above, GCC countries are not expected to face difficulties in financing their investment projects through drawdown of buffers and borrowing via traditional syndicated loans, bond issuance, or Sukuk, which have become an increasingly popular financing option. However, notwithstanding increased support by international financing institutions,<sup>9</sup> lower income countries have continued to face significant external financing constraints (IMF 2014a). Efforts have been made in recent years to scale up financing for Arab countries, including through the Deauville initiative. The World Bank and other partners are looking into options to use grants and guarantees from donors to provide concessional funding for specific projects (for example, to assist with the support of refugees) in countries that would not normally be eligible to those financing terms and raise the pool of resources for public investment in infrastructure, health, and education. Over time, these

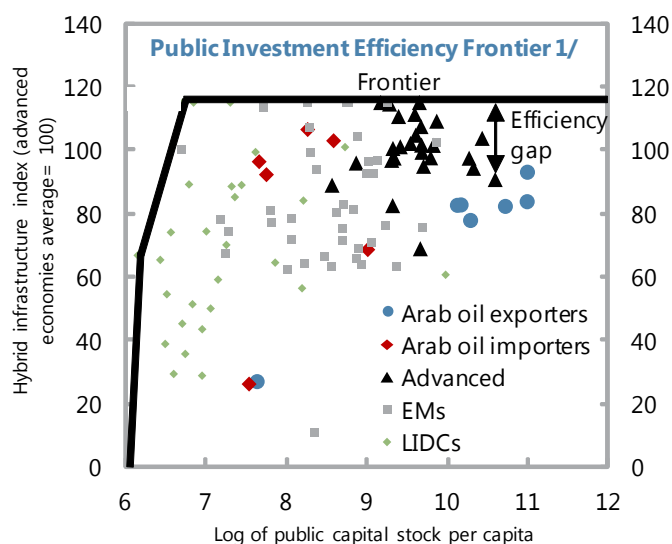
<sup>8</sup> IMF 2014a for instance points to large fiscal multipliers for government capital spending. This suggests that preserving investment projects could help limit the impact of fiscal consolidation on output and employment.

<sup>9</sup> For example through the Arab Financing Facility (a joint project between the Islamic Development Banks and its partners), increased engagement by the World Bank, and other donors (for example through the Deauville Partnership).

countries will also need to develop domestic capital markets that will help provide increasing access to public investment financing.

**26. Enhancing the impact of public investment on growth while safeguarding financial resources also calls for stronger public investment management frameworks.** There is

growing empirical evidence that more efficient public investment—such as public investment that effectively leads to higher quality public infrastructure—leads to a stronger relationship between investment and growth.<sup>10</sup> Efficient public investment, in turn, requires public investment management frameworks that can: (i) plan sustainable levels of investment—including factoring in maintenance and other recurrent costs from a higher domestic capital stock; (ii) evaluate and select the projects with highest impact, particularly when resources are limited or bottlenecks prevent efficiency; and (iii) implement projects on time and in a cost-effective way, including through sound procurement and monitoring systems (IMF 2015c). Arab countries, as per many other EMDCs, have ample scope for increased investment efficiency through reforms of public investment management frameworks.<sup>11</sup> These reforms should be cast within the broader public financial management reform agenda aimed at improving absorption capacity and the quality of government outlays.



Source: IMF staff calculations.

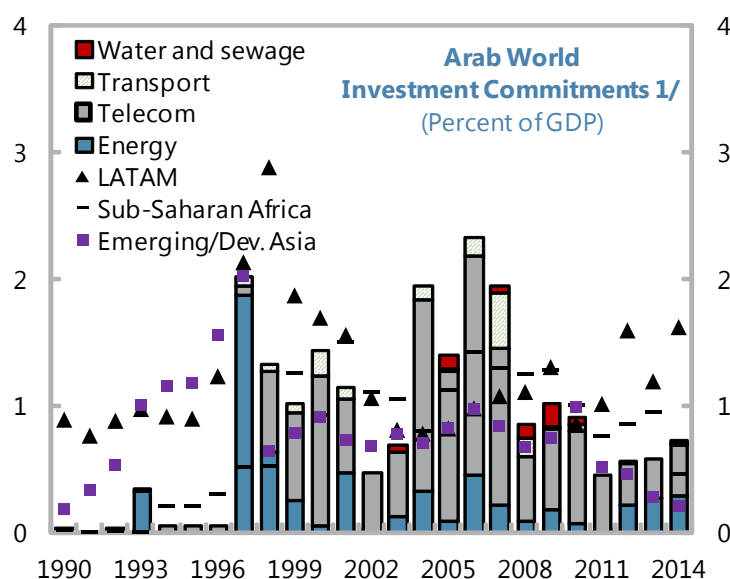
1/ The frontier is defined by the countries with the highest infrastructure quality and access (output indicator based on a hybrid index made of physical and survey-based measures) for a given level of public capital stock (input). The greater the distance from the frontier, the less efficient is public investment.

Note: Arab oil exporters includes ARE, BHR, KWT, OMN, QAT, SAU, and YMN. Arab oil importers includes EGY, JOR, LBN, MAR, MRT, and TUN.

<sup>10</sup> Gupta and others 2011, Gupta and others 2014, IMF 2014a, and Berg and others 2013.

<sup>11</sup> See also Dabla-Norris and Bal Gündüz 2012; Baunsgaard and others 2012 and Albino-War and others 2014. The frontier is built using different measures of infrastructure quality and access (physical, survey-based, and a synthetic indicator summarizing physical and survey-based indicators).

**27. Public-Private Partnerships (PPPs) could also help develop infrastructure and supply public services efficiently where resources and financing options are scarce.** Well-designed PPPs can generate significant efficiency gains in the design, construction, and operation of assets and services and can offer greater value for money than traditional investments. PPPs have been generally underutilized in Arab countries compared to other regions, and related investment commitments appear to have declined since the mid-2000s, indicating there may be room to increase the volume of infrastructure investment in partnership with the private sector (OECD 2014). However, since PPPs can also create significant fiscal risks, reaping their full benefits will require strong legal and institutional frameworks to help limit and manage associated fiscal risks.



Sources: World Bank, *Private Participation in Infrastructure*; and IMF staff calculations.

1/ Aggregates are sums of individual country data divided by sums of dollar-denominated GDP. Excludes GCC and LBY.

## INVESTMENT AND GROWTH: A PROPOSED WORK AGENDA

*In support of policymakers' efforts to address investment-related policy challenges, MCD staff proposes stepping up analysis and policy dialogue in two critical areas: (i) policies and reforms to boost private investment; and (ii) options to generate fiscal space for public investment and reforms to enhance its efficiency.*

**28. The IMF has done significant work on investment-related policy challenges.** At the multilateral level, a WEO chapter (IMF 2014a) and two IMF board papers (IMF 2015c and IMF 2015d) have highlighted the role of public investment in promoting growth and laid out the key principles for strengthening public investment efficiency. Recent MCD Regional Economic Outlooks (IMF 2014b and IMF 2015b) and an SDN (Albino-War and others 2014) have also explored these issues at the regional level. Work on private investment has focused on identifying impediments to private sector developments in oil importers (IMF 2014b) as well as conditions for economic diversification in oil exporters (Callen and others 2014 and IMF 2015e). Several investment-related policy issues have also been tackled in the context of MCD's work on

inclusive growth. The IMF continues to play a key role in addressing the financing constraints of Arab countries in transition by catalyzing financial support as part of the Deauville Initiative. At the bilateral level, policy dialogue on the investment and growth agenda has also taken place, both in the context of the Fund's surveillance and in programs.

**29. Building on this work, MCD staff proposes stepping up analysis and policy dialogue in Arab countries in the following key areas:**

***Encouraging private-sector driven investment and growth***

- *Investment and growth.* The note highlights the need to enhance the effectiveness of investment to generate growth. There is scope to deepen the diagnosis and analysis of linkages, both in the context of bilateral and regional work. This could be done for example by looking at the role of the sectoral composition of investment as well as efforts to promote innovation, drawing on successful international experiences. In this respect, the specific role of FDI could be further investigated.
- *Macroeconomic and financial policies.* Dialogue on policies for stability and growth is already taking place at the bilateral and regional levels. Staff proposes to deepen related analytical work, including by making more explicit the link between macroeconomic and financial policies, investment and diversification.
- *Business climate and other structural reforms.* The IMF has in recent years mobilized efforts to more systematically and effectively cover structural policies in surveillance.<sup>12</sup> Initiatives are underway to build expertise through training and guidance. Building on these efforts and other work described above, MCD staff proposes to leverage more systematically the structural and sectoral expertise of other partners—such as the World Bank, the EBRD, and the ILO—and enhance the focus on trade, business environment, and financial sector reforms in bilateral engagement with Arab countries.

***Creating fiscal space for public investment and enhancing its efficiency***

- *Multipronged strategies to generate fiscal space for investment.* Arab countries face the challenge of generating fiscal space to boost (or protect, in the case of oil exporters) public investment. Addressing this challenge requires combining reforms to reduce the weight of subsidy and wage bills and to mobilize additional non-oil domestic revenues. MCD staff proposes to deepen the analysis of these multipronged strategies, including their potential impact on private investment. This would include cross-country analysis in the context of MCD's Regional Economic Outlooks and/or ad-hoc analytical projects that could be used to underpin policy dialogue in regional forums. This would also mean greater focus in the

<sup>12</sup> The 2014 Triennial Surveillance Review called for IMF surveillance to analyze the economic implications of all macro-critical structural issues (IMF 2014c).

context of bilateral engagement to help country authorities identify options in these areas and develop medium-term fiscal frameworks.

- *Specific revenue and expenditure reforms.* As regards specific reforms for generating fiscal space, MCD has already done significant work on subsidies. This analytical work is now being taken forward through country-specific advice and strategies. Similarly, staff has done some regional analysis on fair taxation (Jewell and others 2015), which provides a good basis for discussions of revenue mobilizing options in bilateral engagement. The IMF's Fiscal Affairs Department's (FAD) technical assistance could also provide useful support in these areas. Public wage bills could be a good candidate for future regional policy work, drawing on expertise from FAD and other relevant institutions.
- *Financing and PPPs.* With many Arab countries facing financing constraints, IMF non-financial or financial arrangements have been instrumental in helping catalyze external support. Such Fund support will naturally continue. MCD also proposes additional work in the area of market development and financing strategies, including on the role of Islamic finance and other innovative financing instruments. It could also take a closer look at the actual and potential role of PPPs in the region and the reforms needed to implement them in the best conditions—ensuring they deliver value-for-money and limiting associated fiscal risk. Drawing on FAD's expertise in this area, this could be done first through cross-country analysis.
- *Strengthening public investment management systems.* Fundwide and regional work has highlighted significant room for improving public investment efficiency in Arab countries, with potentially large associated macroeconomic gains. There is scope to enhance the focus on public investment management reforms in MCD's bilateral work. This could be done building on broader Fund analysis and by more systematically drawing upon FAD's expertise in this area, including through technical assistance.

## ISSUES FOR DISCUSSION

- ❖ Do you agree with the proposed diagnosis and the key policy challenges identified in this paper?
- ❖ Do you see a need for stepping-up policy dialogue related to the investment, growth, and employment agenda?
- ❖ Do you agree with the three priority areas identified for enhanced policy dialogue—policies and reforms for boosting private investment; options for generating fiscal space for public investment and reforms for enhancing its efficiency; and support for the specific needs of conflict and post-conflict countries?

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## Annex I. Infrastructure Endowment and Human Capital Indicators

## Infrastructure Endowments, 2005–15

Sector	Dev. E. Asia and Pacific	Dev. Europe and Central Asia	Dev. LATAM	Arab World				S. Asia	Dev. Sub-Saharan Africa
				Total	Oil exporters	GCC	Oil importers		
Density of paved road network, 2005-08 average (km per 1,000 km <sup>2</sup> of arable land)	1,128	1,051	2,965	2,179	618	16,907	3,220	467	1,095
Telephone density, 2014 (fixed and mobile subscribers per 100 people)	100	113	111	124	112	192	95	75	71
Electricity generating capacity, 2005-08 average (millions of kWh per million people)	0.30	0.92	0.44	0.30	0.40	2.90	0.30	0.31	0.11
Access to electricity, 2012 (percent of population with access)	96	100	96	84	87	98	75	78	35
Improved water, 2015 (percent of population with access)	94	97	94	84	75	98	79	92	68
Improved sanitation, 2015 (Percent of population with access)	75	94	81	78	81	99	67	45	30

Sources: Ianchovichina et al., 2013; and World Bank, *World Development Indicators*.

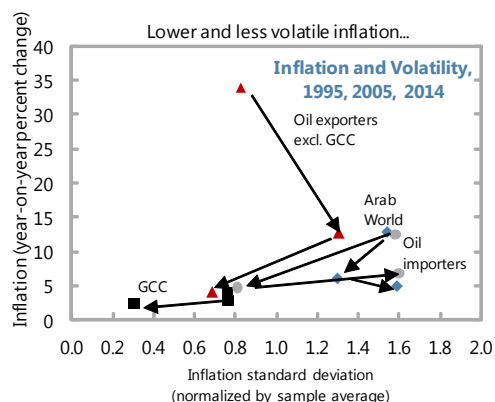
Human Capital Investment Outcomes, 2013  
(or latest available, unless otherwise indicated)

Sector	Dev. E. Asia and Pacific	Dev. Europe and Central Asia	Dev. LATAM	Arab World				S. Asia	Dev. Sub-Saharan Africa
				Total	Oil exporters excl. GCC	GCC	Oil importers		
Literacy rate (total in percent of people aged 15 and above)	95	98	92	83	77	94	79	67	60
Primary completion rate (total in percent of relevant age group) 1/	105	100	101	89	81	106	83	91	69
Tertiary school enrollment (percent)	30	55	38	27	20	34	26	21	9
Life expectancy at birth (years)	74	72	75	71	70	77	68	67	57
Infant mortality rate, 2014 (per 1,000 live births)	16	19	16	26	24	8	36	43	58
Incidence of TB (per 100,000 people)	117	67	48	76	54	18	113	186	282

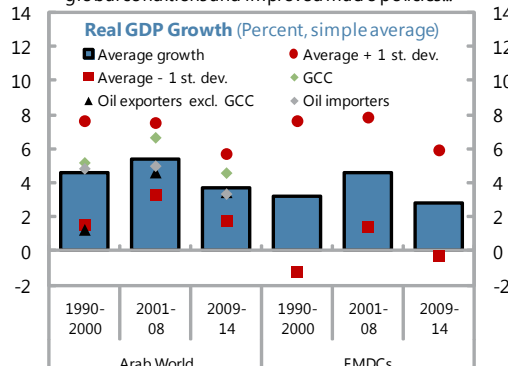
Source: World Bank, *World Development Indicators*.

1/ Number of new entrants into the last year of primary school (regardless of age) divided by the population of children at entrance age for the last year of primary school.

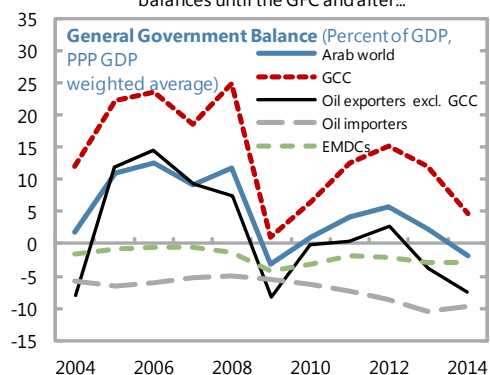
## Arab World: Macroeconomic Environment for Private Investment, 1990–2014 1/



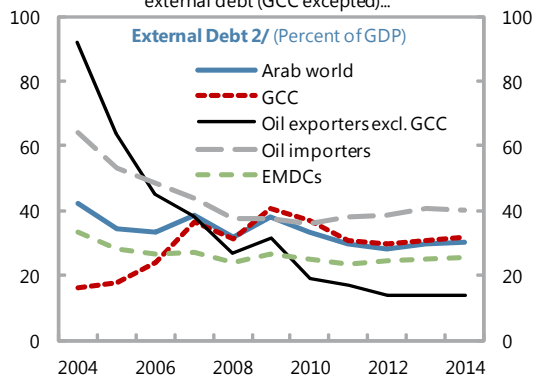
...and stable growth were brought by supportive global conditions and improved macro policies...



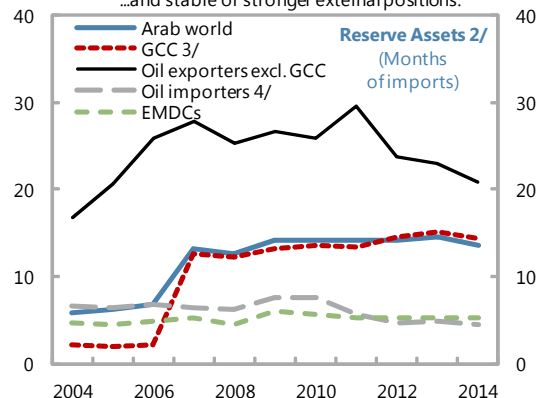
...leading to strong or stable fiscal balances until the GFC and after...



...with declining or stable external debt (GCC excepted)...



...and stable or stronger external positions.



Sources: IMF, *World Economic Outlook*; and IMF staff calculations.

1/ Oil importers excludes SOM. Data for IRQ from 2005. Data for SYR to 2010.

2/ Aggregates are sums of individual country data divided by sums of dollar-denominated GDP or sums of imports.

3/ SAU from 2007.

4/ MRT from 2006; excludes WBG.

Part I. Oil exporters (Algeria, Bahrain, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, UAE, Yemen).					
Country	Macroeconomic policies		Structural reforms		
	Fiscal	Monetary, FX, and financial (stability)	Public investment management	Business climate	Financial (development)
Algeria	Implement gradual but sustained fiscal consolidation while preserving growth-enhancing public investment. Key components: (1) contain wage bill; (2) implement subsidy reform; and (3) mobilize more nonhydrocarbon revenues (by broadening the tax base, raising certain tax rates, and improving tax administration).  Simplify the tax code; eliminate the tax on business turnover.  Adopt a fiscal rule to better manage hydrocarbon revenues	Adapt monetary policy to new environment of lower liquidity brought on by the oil price shock.  Bring overvalued exchange rate in line with its equilibrium value.  Implement reforms to preserve the stability of the banking sector in the face of lower oil prices.	Enhance the efficiency of public investment by improving the selection and budgeting process, as well as the implementation and ex-post evaluation of investment projects.	Streamline administrative procedures related to starting a business, conducting international trade, and paying taxes.  Strengthen anti-corruption efforts.  Eliminate or rationalizing the so-called 51/49 rule requiring majority Algerian ownership in all investments.	Improve access to finance by strengthening competition, enhancing creditors' rights, modernizing the bankruptcy framework, and improving debt enforcement procedures.  Increase sovereign debt issuance to help develop local debt markets.  Implement reforms to develop the foreign exchange market (spot and forward).

Annex II. Country-Specific IMF Policy Recommendations to Promote Efficient Investment in Arab Countries<sup>1</sup>

<sup>1</sup> The key country-specific policy recommendations are drawn from recent Article IV consultations or reviews of IMF-supported economic and financial programs

Country	Macroeconomic policies		Structural reforms		
	Fiscal	Monetary, FX, and financial (stability)	Public investment management	Business climate	Financial (development)
<b>Bahrain</b>	<p>Gradual fiscal adjustment to stabilize debt in the medium term should be a priority. Delaying the adjustment now would require a more costly adjustment later.</p> <p>Capital expenditures should be preserved to limit the impact of fiscal consolidation on growth.</p> <p>Fiscal consolidation should rest on retargeting subsidies to the lower-income segment of the population, and controlling growth of the wage bill and other current spending.</p> <p>In the longer term, the economy should diversify its sources of fiscal revenue, including by introducing a corporate income tax (CIT) and a value added tax (VAT).</p>	<p>In the context of Bahrain's fixed exchange rate regime, global interest rates and domestic liquidity conditions are supportive of growth.</p> <p>The financial sector is in good health, but continued vigilance is needed, including close monitoring of the retail Islamic banking segment.</p> <p>Enhance crisis preparedness plans with global developments in mind, adopting plans for emergency liquidity assistance for wholesale banks, and keeping wholesale banks in the list of systemically important financial institutions.</p>	<p>Private investment levels need to be increased, including through strategic infrastructure provision and removing bottlenecks in the King Fahd Causeway.</p> <p>The implementation of GCC-funded projects should be accelerated.</p>	<p>Improve Bahrain's competitiveness.</p> <p>Eliminate red tape.</p>	<p>Broadening corporate financing sources by continuing to develop the sovereign yield curve as market conditions permit.</p> <p>Enhance access to finance for SMEs; for instance, by extending the credit bureau to SMEs.</p>
<b>Iraq</b>	<p>Short term: adopt a cohesive macroeconomic framework under which there is no financing gap. This will require a reduction of the non-oil primary balance.</p> <p>Medium term: strengthen PFM to rebuild fiscal buffers and create fiscal space, and to raise capital spending to accommodate reconstruction needs, post-conflict.</p>	<p>Continue prudent management of international reserves (including DFI).<sup>2</sup></p> <p>Maintain commitment to the exchange rate peg as a key nominal anchor (has served Iraq well).</p> <p>Gradually liberalize foreign exchange market: (1) remove remaining restrictions on current international transactions; (2) abolish multiple currency practices whenever these arise; (3) accept obligations under Article VIII of the IMF's Article of Agreement</p> <p>Strengthen AML/CFT, and anti-corruption frameworks</p>	<p>Strengthen PIM (World Bank leading).</p>	<p>Improve the business environment by removing impediments to business startups, access to credit, enforcement of contracts, and resolution of insolvencies. Improve governance and rule of law.</p> <p>Amend the Investment Law to remove limitations on transfers of investment proceeds.</p> <p>Restructure (reform) SOEs</p> <p>Diversify the economy away from dependence on oil, and reduce the size of the informal sector.</p> <p>Promote private sector growth and job creation.</p>	<p>Accelerate the restructuring—and, if necessary recapitalization—of the two largest public banks Rasheed and Rafidain.</p> <p>Deepen financial sector reforms: (1) create a level playing field for private banks; (2) open up government business to private banks; and (3) proceed with enactment of a carefully-designed deposit insurance scheme.</p> <p>Improve relevant legislative and institutional frameworks to address AML/CFT concerns.</p>

<sup>2</sup>The Central Bank of Iraq has a long term objective to centralize the management of international reserves by moving reserves from abroad (the Federal Reserve Bank of New York, and other central banks) to Baghdad.

Country	Macroeconomic policies		Structural reforms		
	Fiscal	Monetary, FX, and financial (stability)	Public investment management	Business climate	Financial (development)
<b>Kuwait</b>	Staff advice focused on containing current spending and reducing rigidities in the budget, mainly subsidy and wage bills, to reduce fiscal risks, build buffers to ensure intergenerational equity, and support long term growth.  On the revenue side, staff advised simplifying the tax system and achieving neutrality by introducing a business profits tax on the net profits of all companies and individuals' earning business income (above an exempt threshold).	Follow policies to ensure financial stability. Establish a more formal macroprudential framework and a coordinating mechanism to assess incipient risks. Expand and refine macroprudential toolkit, strengthen early warning systems, and conduct macro stress tests of banks.	Strengthening budget framework, prioritizing and improving the efficiency of capital spending.	Diversifying the economy, developing the non-oil tradable sector and supporting employment of nationals in the private sector, improving the business climate, and supporting SME development.	Improving liquidity management framework and developing debt markets Modernizing restructuring resolution. Improving AML/CFT frameworks.
<b>Oman</b>	Staff advise for containment of current spending growth, including subsidies, public sector employment and wages, and defense. Fiscal adjustment will reduce fiscal risks, build buffers for intergenerational equity, and support long term growth.	Maintaining financial stability. Deregulation of interest rate ceiling on personal loans to increase efficiency in financial intermediation.	Modernizing the current budget system, integrating the dual budget, establishing a medium-term budget framework, and improving PFM system.	Further diversification of the economy, including via support to the SME sector. Enhancements to the quality of education, incentives for tradable production and private sector employment, including through privatization.  Further improvements on business environment: need to remove impediments to physical, legal and business infrastructure, including modernizing the Commercial Companies Law.	Further improvements to liquidity management framework and market development. Development of local debt market.

Country	Macroeconomic policies		Structural reforms		
	Fiscal	Monetary, FX, and financial (stability)	Public investment management	Business climate	Financial (development)
<b>Qatar</b>	<p>Gradual reduction in subsidies, as part of comprehensive strategy that includes a communications plan, additional savings in administrative expenses, broadening corporate income tax, introducing low-rate VAT.</p> <p>Necessary reforms include: (1) formulation of clear medium-term fiscal objectives to which binding annual budget is aligned; (2) enhanced communication on expectations about the future path of budget expenditures and taxation; (3) more transparency of fiscal accounts; (4) setting up of contingency plans to address potential risks related to low oil price; and (5) Sustained medium-term fiscal consolidation is appropriate, but Qatar's sizeable buffers afford adjustment that is gradual and measured so as to reduce any potential negative impacts on GDP growth.</p>	<p>Monitor risks of falling liquidity due to oil price drop and rapidly growing credit to some sectors and abroad. Enhance the early warning system, including improved availability of real estate statistics</p>	<p>Public investments have been receiving greater scrutiny and been subjected to a 10-year spending cap, but steps can be taken to deepen cost-benefit analysis and conduct ex-post assessment of public investment projects.</p>	<p>Simplifying business registration, improving contract enforcement, and enhancing education quality.</p> <p>Greater mobility for expatriates would increase productivity, reduce reputational risks, and make growth more inclusive.</p>	
<b>Saudi Arabia</b>	<p>Comprehensive energy price reform.</p> <p>Firm control of the public sector wage bill.</p> <p>Greater efficiency in public sector investment.</p> <p>Expansion of non-oil revenues, including by introducing a VAT and a land tax.</p> <p>Reforms to improve the efficiency of public spending including through setting the annual budget and expenditure priorities from the 5-year national development plan into the medium-term budget framework.</p>	<p>The current exchange rate peg remains appropriate but reforms that would support a move to a more flexible region, if appropriate in the future, include strengthening liquidity management, improving monetary transmission by developing money and debt markets, and improving data on foreign currency exposures of corporate.</p> <p>Formalizing the macroprudential policy framework to ensure coordination among key agencies</p> <p>Build on the existing use of macroprudential tools in a countercyclical manner.</p>	<p>Project selection, monitoring, and appraisal processes should be reviewed to ensure they are sufficiently robust.</p> <p>Review of existing projects conducted to check they are closely linked to, and efficiently meeting, developments goals with a view to making additional savings in the capital spending budget.</p>	<p>Reorienting public spending and strengthening the role of private sector competition to incentivize firms to focus on tradable rather than nontradable production.</p> <p>Improving the availability of finance and insurance for export-oriented firms could enable them to produce in the riskier tradables sector.</p>	<p>Improve financial inclusion of expatriate workers</p> <p>Improving SME access to finance</p> <p>Developing the domestic government debt market</p>

Country	Macroeconomic policies		Structural reforms		
	Fiscal	Monetary, FX, and financial (stability)	Public investment management	Business climate	Financial (development)
<b>U.A.E.</b>	<p>Gradual fiscal consolidation.</p> <p>Rationalization of spending (control of the public sector wage bill and reduction of energy subsidies and capital and other transfers).</p> <p>Preservation of government investments to support infrastructure.</p> <p>Mobilization of extra nonhydrocarbon revenues through new tax measures.</p> <p>Close oversight and continued strengthening of debt management frameworks.</p>	<p>Easing of liquidity management to support credit growth.</p> <p>Strengthening of the banking regulatory and supervisory frameworks.</p> <p>Continued strengthening of GRE balance sheets and active management of their upcoming debt repayments.</p>	<p>Gradual implementation of GRE megaprojects.</p>	<p>Further opening up of foreign direct investment.</p> <p>Improvement of selected areas of business environment.</p> <p>Creation of the right incentives for entrepreneurship.</p>	<p>Development of domestic debt markets.</p> <p>Easing access to finance for startups and SMEs.</p>
<b>Yemen</b> (as per discussions under ECF)	<p>Reorienting spending in favor of capital and development outlays.</p> <p>Facilitating private access to credit through fiscal consolidation.</p>	<p>Managing liquidity to maintain moderate inflation.</p> <p>Maintaining FX stability.</p> <p>Enhancing confidence in banks through supervisory and regulatory reforms.</p>	<p>Enhancing transparency and regulatory framework.</p> <p>Introducing PPP</p>	<p>Improving public service and delivery.</p> <p>Simplify operations of customs and tax assessment and dispute resolving processes.</p> <p>Strengthening property rights, dealing with red tape, and corruption.</p> <p>Rationalizing tax exemptions.</p> <p>Opening new sectors for private participation.</p>	<p>Developing banking services to support credit.</p>

## Part II. Oil importers (Comoros, Djibouti, Egypt, Jordan, Lebanon, Mauritania, Morocco, Sudan, Tunisia, West Bank and Gaza)

Country	Macroeconomic policies		Structural reforms		
	Fiscal	Monetary, FX, and financial (stability)	Public investment management	Investment climate	Financial (development)
<b>Comoros</b>	<p>Mobilize additional domestic revenue to increase fiscal space in support of development, including by freezing the granting of new tax exemptions and expanding the list of large tax payers.</p> <p>Ensure that all revenue and expenditure transactions on behalf of the government are captured in the budget and treasury accounts. Establish a single treasury account for the Union and the island governments</p>	<p>Continue to maintain the currency peg in the context of the monetary cooperation agreement with France.</p> <p>Continue strengthening banking supervision, including risk-based supervision.</p>	<p>Investments should focus on sectors with high growth potential (tourism, fisheries, agriculture) and on enhancing human development.</p> <p>Development strategy should be based on realistic macroeconomic assumptions.</p>	<p>Put in place measures to strengthen the business environment, especially in regard to ease of establishing a business and the enforcement of contracts.</p> <p>Strengthen the application of existing legislation with respect to relations between commercial banks and clients.</p> <p>Take urgent actions to improve the provision of electricity, which currently is an important impediment to doing business.</p> <p>Improve competition in the telecoms sector by allowing a license for a second operator.</p>	<p>Develop a viable plan to address difficulties in the postal bank.</p>
<b>Djibouti</b>	<p>Implement fiscal reform including: (1)simplifying the fiscal regime; (2) enhancing fiscal equity; (3) improving tax efficiency; and (4) and securing fiscal revenues</p> <p>Reinforce and multiply fiscal revenue sources in the wake of debt reimbursement after the implementation of big investment projects by:</p> <ul style="list-style-type: none"> <li>- Reducing tax exemptions for the free zone.</li> <li>- Abolishing both the current investment code and the domestic consumption tax on investment goods (and raw materials).</li> <li>- Raising the lump sum minimum tax from 1 percent to 1.5 percent.</li> <li>- Setting up a system of electronic tax filing and payment.</li> </ul>	<p>The currency board arrangement has served Djibouti well and should be maintained.</p> <p>Reserve buffers are sufficient but need further reinforcing.</p>	<p>The process of projects appraisal, selection, implementation, and valuation should be reinforced.</p> <p>Public capacity to manage the scaling-up of investment requires strengthening.</p> <p>Public debt management capacity requires strengthening.</p>	<p>Improving the business environment by reforming the judicial system to enhance contract enforcement and property rights protection.</p> <p>Lowering the cost of utilities and improving the quality of service delivery.</p> <p>Investing in human capital.</p>	<p>Enhance financial inclusion and development.</p> <p>Develop microfinance.</p> <p>Strengthen and develop the credit information system.</p> <p>Implementation of the credit guarantee fund for SMEs.</p> <p>The central bank's banking supervision capacity and commercial banks' risk management capacity require strengthening to enhance financial stability.</p>

Country	Macroeconomic policies		Structural reforms		
	Fiscal	Monetary, FX, and financial (stability)	Public investment management	Investment climate	Financial (development)
<b>Egypt</b>	Fiscal consolidation to: (1) support macroeconomic stability; (2) create fiscal space for public investment in a context of high public debt; and (3) stimulate private sector credit.  Specific measures: (1) continue energy subsidy reform; (2) implement the VAT; (3) contain the wage bill; and (4) prioritize investment spending.	Focus monetary policy on containing inflation.  A more flexible exchange rate policy focused on achieving a market-clearing rate and avoiding real appreciation would improve the availability of foreign exchange, strengthen competitiveness, support exports and tourism, and attract foreign direct investment.  Continue strengthening the regulatory and supervisory framework.	Improve the delivery of public services to enhance the efficiency of investment.  Carefully design and monitor projects to limit potential fiscal risks.  Prioritize projects contributing to long-term growth, job creation and export potential.	Improve the business climate (investment, bankruptcy, and corporate laws and regulations, as well as access to land).  Settle arrears to international oil companies to attract further investment in the hydrocarbon sector.	Develop the financial sector and enhance financial inclusion.  Enhance the secondary market for government securities.  Develop mobile payments.
<b>Jordan</b>	Pursue fiscal consolidation efforts, with a focus on equity-enhancing tax reform and the streamlining of non-priority current spending, while creating the fiscal space for a gradual increase in investment spending. These efforts will reduce the government's financing needs and help to boost private sector credit.	While monetary policy will remain anchored to the dollar, monetary policy decisions should be data-driven, taking into account U.S. rates and the risk premium, but also inflation, credit, and growth.  The financial sector's regulatory and supervisory frameworks should be strengthened further, including through amendments to align the CBJ and banking laws with best practice.	The new public investment framework (adopted in March 2015) should be fully implemented, including through the establishment of a public investment management unit at the MoF in charge of making sure that all projects are in line with the new standards set for design, prioritization, implementation, and monitoring.	Fully implement the one-stop shop for investors and the roadmap for enhancing the business climate designed with the WB to specifically improve the doing-business indicators.  Adopt the pending by-laws to the investment law, specifically those related to FDI.  Implement labor market reforms to address skill mismatches, reform public sector hiring practices and compensation, and increase women's labor force participation.  Improve the quality of public institutions by promoting transparency, accountability, and good governance.  Adopt a bankruptcy/insolvency law in line with best practices.	Fully license a credit bureau.  Adopt the secure lending law.  Transfer the supervision of the loss-making insurance sector to the central bank.

Country	Macroeconomic policies		Structural reforms		
	Fiscal	Monetary, FX, and financial (stability)	Public investment management	Investment climate	Financial (development)
<b>Lebanon</b>	<p>Restore primary fiscal surpluses, to place debt on a downward path and arrest an ever-growing interest burden.</p> <p>Increase public investment, by shifting the composition of spending, and increasing taxes in a fair manner.</p>	<p>The U.S. dollar peg continues to support investor confidence and serve the economy well; reserve buffers should be maintained.</p> <p>Reduce the institutional burden on the central bank, allowing more flexible interest rates and the development of financial markets.</p>	<p>Public investment is low by regional and historical standards, and can be accelerated most efficiently by executing the most productive projects from the existing pipeline of projects for which concessional financing has already been secured.</p> <p>Governance should be improved through more robust PFM.</p>	<p>Address Lebanon's chronic infrastructure deficit, with a particular focus on electricity reform.</p> <p>Passing the framework law for Public Private Partnerships (PPPs) could help mobilize private sector resources for infrastructure investment, though with due attention to possible fiscal risks</p>	<p>Reform of capital markets should continue. Building on ongoing progress, the authorities should facilitate the transformation of the Beirut Stock Exchange into a joint-stock company, to pave the way for privatization.</p>
<b>Mauritania</b>	<p>Fiscal consolidation to: (1) support macroeconomic stability in the context of persistently negative terms-of-trade shocks; (2) create fiscal space to maintain as much as possible the public investment envelope in a context of high public debt; and (3) bolster private sector in investment.</p> <p>Increase taxes on retail fuel prices and orient the windfall toward public investment.</p> <p>Specific measures: (i) revenue measures; (ii) improve tax administration; (iii) energy subsidy reform; (iii) contain the wage bill; (iv) prioritize investment spending; and (v) enhance investment efficiency.</p>	<p>Develop a monetary framework that focuses on containing inflation.</p> <p>A more flexible exchange rate policy (currently a soft peg vis-à-vis the U.S. dollar) will restrain real appreciation in the context of weaker fundamentals and support competitiveness and private sector development. Reforms in the FX market and elimination of direct sales will allow for a market-determined exchange rate and higher competition.</p> <p>Strengthen financial supervision to enhance the efficiency and resilience of the financial sector to shocks. Incorporate the public development bank into banking supervision.</p>	<p>Improve the efficiency of public investment.</p> <p>Establish a medium-term public investment strategy that identifies infrastructure and social gaps, and priorities and opportunities for private investment.</p> <p>Limit fiscal risks for investment projects executed by public institutions outside the central government.</p> <p>Enhance monitoring of financing of investment projects, including debt.</p> <p>Address shortcomings in the public procurement process to enhance accountability and governance.</p>	<p>Improve the business climate (investment, bankruptcy, and corporate laws and regulations, as well as access to land).</p> <p>Develop a framework for PPP to promote crowding in for private sector.</p>	<p>Develop the financial sector to more effectively channel savings in ways that promote economic diversification.</p> <p>Mobilize long-term credit for the private sector (collateral policy, savings maturity).</p> <p>Enhance financial inclusion by developing mobile payments and financial literacy.</p>

Country	Macroeconomic policies		Structural reforms		
	Fiscal	Monetary, FX, and financial (stability)	Public investment management	Investment climate	Financial (development)
<b>Morocco</b>	<p>Gradual fiscal adjustment to anchor public debt ratio-to-GDP in the medium term should be a priority.</p> <p>Broaden the tax revenue base.</p> <p>Reform food and butane subsidies to create additional fiscal space for public investment.</p> <p>Increase efficiency of public spending in education.</p>	<p>A more diversified Moroccan economy would benefit from more exchange rate flexibility and domestically-focused monetary policy.</p> <p>The adoption of a new central bank law would further strengthen the central bank's independence.</p> <p>Continue strengthening banking regulation and supervision. The central bank's resources for banking supervision should be expanded.</p>	<p>Greater efficiency in public sector investment.</p> <p>Allocate adequate competencies to regions and decentralized entities.</p> <p>Speed up payments to contractors and SMEs.</p>	<p>Reduce workforce skill mismatches</p> <p>Reform restrictive labor regulations.</p> <p>Reduce the inefficiency of government bureaucracy.</p> <p>Improve transparency and address corruption.</p> <p>Unlock the capacity for innovation.</p>	<p>Facilitate further SME access to finance.</p> <p>Improve oversight of the securities market.</p> <p>Continue to improve financial inclusion.</p>
<b>Sudan</b>	<p>Fiscal consolidation to restore macroeconomic stability and create space for social spending, including by reducing tax exemptions, improving tax administration, and gradually phasing out subsidies.</p>	<p>Tightening monetary policy to help lower inflation while strengthening the monetary policy framework; for instance, by expanding Shari'a compliant policy instruments.</p> <p>Greater flexibility in the official exchange rate to reduce the parallel market rate premium, improve the availability of foreign exchange, and eliminate distortions.</p> <p>Strengthening banking supervision, upgrading the regulatory framework, and restructuring weak banks.</p>	<p>Preparing a medium-term fiscal framework to help improve the planning and execution of government expenditure, including public investment.</p>	<p>Improving the business climate by simplifying licensing procedures and cross-border trade (including customs operations).</p> <p>Strengthening the judiciary and upgrading the AML-CFT framework.</p>	<p>Broadening access to financial services by simplifying procedures for opening accounts, developing and strengthening microcredit institutions, and setting up a credit registry system.</p>

Country	Macroeconomic policies		Structural reforms		
	Fiscal	Monetary, FX, and financial (stability)	Public investment management	Investment climate	Financial (development)
<b>Tunisia</b>	<p>Growth-friendly fiscal consolidation to: (1) support macroeconomic stability; and (2) create fiscal space for public investment by improving tax collection, containing the wage bill—including through civil service reform—and reducing energy subsidies.</p> <p>That would need to be accompanied with a reorientation of budget composition toward public investment.</p> <p>Specific measures on the tax front include rationalizing exemptions, tax deductions, and the number of tax rates, and ensuring a gradual convergence in onshore and offshore corporate taxation.</p>	<p>Maintaining a prudent monetary policy to keep inflation low.</p> <p>Increasing exchange rate flexibility through reduced CBT interventions in the FX market and through the introduction of FX auctions. This will help strengthen competitiveness, reduce the current currency overvaluation, and avoid further tightening dinar liquidity.</p>	<p>Improve absorption capacity of public investment, particularly in the interior regions, by revising land rights, improving projects prioritization, and applying decrees of new public procurement law.</p> <p>Improve the reallocation capacity of investment spending from one project to the other in order to maximize total capital spending.</p>	<p>Reforms of the business environment aim at ensuring an even playing field for all investors, improving the transparency of regulations, the effectiveness of institutions for public accountability, and removing stringent regulations.</p> <p>That requires an investment code, a flexible labor market reform, fair and simplified tax reform, and PPPs and bankruptcy laws.</p>	<p>Financial sector reforms aim at increasing credit access for the private sector, in particular domestic firms.</p> <p>Reforms are focused on restructuring public banks, upgrading the resolution and supervision framework, solving the NPLs through an AMC, and developing a secondary market.</p>
<b>West Bank and Gaza</b>	<p>Fiscal consolidation to: (1) close fiscal financing gaps and avoid arrears to the private sector; (2) ensure public debt sustainability; and (3) create fiscal space for public investment. Additionally, seek additional donor aid.</p> <p>Specific measures in the short run include: (1) containing the wage bill; (2) further reducing fuel subsidies; (3) increasing government fees; and (4) introducing a tax on dividends.</p> <p>In the medium term: (1) civil service and pension reforms; (2) improve efficiency of health spending (health referrals); (3) exercise better control over payment discipline in the electricity sector, and strengthen generation and distribution systems; (4) improve tax administration; and (5) further reduce tax exemptions.</p>	<p>Continue strengthening the regulatory and supervisory framework, including for shadow banking. Note that monetary policy in the WBG is influenced by the Bank of Israel, as the WBG does not issue its own currency and uses the new Israeli shekel extensively.</p>	<p>Prioritize projects under the National Development Plan 2014–16.</p> <p>Shift public spending away from consumption toward investment, particularly infrastructure.</p> <p>Strengthen PFM (improve accounting and reporting, including for arrears; introduce medium-term budgeting; and introduce organic budget law).</p> <p>Seek additional aid based on multiyear commitments.</p>	<p>Improve the business climate (enact secured transactions, competition and new companies laws; make progress with land registration)</p>	<p>Continue developing financial sector and enhancing financial inclusion, but watch for risks. Develop capital markets, including government securities, money markets, and insurance.</p>