32994

MIDDLE EAST AND NORTH AFRICA REGION

2005 Economic Developments and Prospects

OIL BOOMS AND REVENUE MANAGEMENT

THE WORLD BANK

Middle East and North Africa

Economic Developments and Prospects 2005

Oil booms and revenue management

Middle East and North Africa Region
Office of the Chief Economist

TABLE OF CONTENTS

FOREWORD i

ACKNOWLEDGEMENTS ii

ABBREVIATIONS AND ACRONYMS iii

OVERVIEW v

CHAPTER 1: RECENT ECONOMIC OUTCOMES IN MENA

1.1 Introduction 1
1.2 Recent Growth and Employment Developments 3
1.2.1 Regional growth outcomes 3
1.2.2 Labor market developments 6
1.2.3 Sources of higher growth 7
1.3 External Sector 10
1.3.1 Export growth 10
1.3.2 Import growth 12
1.3.3 Capital flows 14
1.4 The Conflict and Reconstruction in Iraq 15
1.4.1 Economic and political developments in Iraq 16
1.4.2 Reform challenges ahead 17
1.4.3 Impacts on the MENA region 18
1.4.4 Potential regional impact of Iraq's reconstruction and reintegration 20
1.5 Recent Changes to Interregional Ties 21
1.6 Near Term Outlook, Risks and Policy Challenges 25

CHAPTER 2: OIL BOOMS AND REVENUE MANAGEMENT

2.1 Introduction 27
2.2 Overview of Oil Developments 28
2.3 Expenditure Patterns Under Present Shock 31
2.3.1 Recent fiscal developments 31
2.3.2 External positions 33
2.4 Comparison to Prior Oil Boom Spending Patterns 33
2.5 Transmission Channels of Oil Boom to Non-Oil Economies 37
2.6 Oil Management and Structural Reform 39

CHAPTER 3: STRUCTURAL REFORM FOR LONG TERM GROWTH

3.1 Introduction 42
3.2 Long Term Prospects for Economic Growth 43
3.3 Increasing Outward Orientation 44
3.3.1 Status of outward orientation in MENA 44
3.3.2 Developments in trade reform 48
3.3.3 Quantifying the progress with trade reform 51
3.4 Improving the Investment Climate for Private Sector Development 54
3.4.1 Status of private sector development in MENA 54
3.4.2 Developments in structural reform for private sector development 57
3.4.3 Quantifying the progress with business regulatory reform 61
3.5 Enhancing Governance 66
3.5.1 Status of governance challenges 66
3.5.2 Progress in governance reform 67
3.6 Structural Reform in Summary 70

STATISTICAL ANNEXES

Annex Tables 71
Constructing the Structural Reform Indices 77

BIBLIOGRAPHY 82

BOXES

Box 1.1 Recent developments in West Bank and Gaza 15
Box 2.1 Behind the recent oil price rise 30
Box 2.2 Oil stabilization funds in MENA 32
Box 2.3 UAE's diversification into non-oil activities 40
Box 3.1 Measuring structural reform 50
Box 3.2 Regional leaders in tariff reform 52
Box 3.3 Regional leaders in reform of the business environment 65

FIGURES

Figure 1.1 Average yearly output growth, 1990-2004 3
Figure 1.2 Unemployment in MENA, 2000 and 2004 6
Figure 1.3 Employment growth versus output growth 7
Figure 1.4 Contribution to regional growth rate increase, 1990s versus 2003-2004 8
Figure 1.5 Merchandise export volume growth, 1990-2004 10
Figure 1.6 Oil and non-oil export growth 11
Figure 1.7 Real effective exchange rate 12

Figure 1.8 External balances as a percent of GDP, 1990-2004 13
Figure 1.9 Portfolio equity and FDI inflows........ 14
Figure 1.10 Inward FDI performance index 19
Figure 1.11 Stock market performance in MENA, 2003-2004 23
Figure 1.12 Tourism in MENA 24
Figure 1.13 MENA export destinations........ 24
Figure 1.14 Intra-regional exports in MENA, 2000 and 2003........ 24
Figure 2.1 MENA oil production and oil export revenues 28
Figure 2.2 Oil prices, 1960-2004........ 29
Figure 2.3 Oil revenue paths during the 1973, 1979 and 1999 booms 29
Figure 2.4 Fiscal balances in MENA, 1990s versus 2003-2004........ 31
Figure 2.5 Oil windfall revenue management among MENA oil exporters........ 34
Figure 2.6 Saving and spending breakdown of the net change in oil export revenues relative to base year 36
Figure 2.7 MENA non-oil economies tourism receipts........ 38
Figure 2.8 MENA non-oil economies oil balance 38
Figure 2.9 Allocation of resources toward Algeria's Economic Recovery Program........ 41
Figure 3.1 Non-oil exports as a proportion of GDP, 1990 and 2003........ 45
Figure 3.2a FDI inflows as a share of GDP, 2003........ 47
Figure 3.2b FDI as a share of GDP, 2002-2003 47
Figure 3.3 Unweighted average tariffs in MENA versus the world, 2000 and 2004........ 49
Figure 3.4 Private sector contribution to GDP, early 2000s........ 54
Figure 3.5 Minimum capital required to start a business, 2004........ 56
Figure 3.6 Contract enforcement procedures, 2004........ 57
Figure 3.7 Procedures and minimum capital to start a business in MENA versus the world 60
Figure 3.8 Private sector access to credit: MENA versus the world 60
Figure 3.9 *Index of Quality of Administration*, by region........ 66
Figure 3.10 *Index of Public Accountability*, by region 67

TABLES

Overview Table 1
Summary: global developments and MENA GDP growth vii
Overview Table 2
Progress with structural reform, 2000-2004........ x
Table 1.1 MENA growth performance, 1990-2004 4
Table 1.2 MENA growth performance in international perspective, 1990-2004........ 6
Table 1.3 Sources of growth across the MENA region, 1990s and 2000s........ 9
Table 1.4 MENA oil exporters transactions in US financial assets, 2000-2004 22
Table 2.1 MENA oil exporters: total stock of external debt 37
Box Table 2.1 UAE's diversification into non-energy trade 40
Table 3.1 Export diversification and competitiveness, 2003........ 46

Table 3.2 Overall trade restrictiveness index (OTRI) for MENA and other developing countries 49
Table 3.3 Structural reform progress: trade reform 51
Table 3.4 Public sector employment in MENA 55
Table 3.5 Structural reform progress: business regulatory and financial sector reform 62
Table 3.6 Business regulatory and financial sector reform: progress along individual areas of the business environment 63
Table 3.7 Structural reform progress: governance reform 68

ANNEX TABLES

Annex Table 1 Oil markets and transmission channels for growth in MENA, 1990-2006........ 71
Annex Table 2 Oil exporters: the fiscal dimension........ 72
Annex Table 3 MENA external accounts, 1990-2006........ 73
Annex Table 4 MENA fiscal balances, 1990-2006 74
Annex Table 5 MENA external debt and aid flows, 1990-2003........ 75
Annex Table 6 MENA inflation, 1990-2006 76

FOREWARD

MENA ECONOMIC DEVELOPMENTS AND PROSPECTS 2005

The Middle East and North Africa (MENA) region remains in the spotlight of international attention. Rising oil prices, war and reconstruction in Iraq, the Israeli-Palestinian conflict, and the global economic aftermath of September 11 are only a few of the developments to heighten world interest in the region and to the economic and social issues it faces. Keeping abreast of regional developments and challenges is important not only to the region, but to the rest of the world.

The MENA region, despite many economic and social features that bind its economies, is remarkably diverse, and economic developments and outcomes differ significantly among its countries. Over the 1990s, for example, economic growth rates ranged from less than 2 percent a year on average in Algeria to more than 10 percent a year in Lebanon. In part, the diversity of economic outcomes in MENA is a reflection of natural resource endowments, with a few economies in the region subject to enormous swings in growth resulting from commodity price shocks. In part, it reflects the particular challenges of conflict and stability, which exert a tremendous impact on economic performance. In part, these differing economic trends reflect the very divergent paths countries in the region have taken regarding economic liberalization and integration.

The first in a series of annual reports, the 2005 MENA Economic Developments and Prospects report sheds light on the recent key economic developments in the region and the forces underlying the region's diverse economic outcomes. It analyzes the region's short-term growth prospects given global forecasts and current structural features of the economies, as well as the region's prospects for longer-term growth based upon progress in implementing comprehensive structural reforms. With economic headlines increasingly devoted to the rise in oil prices and what this implies for the MENA region, this first issue devotes particular attention to this theme, analyzing the impact of the oil price shock on the MENA region in terms of its relative size, its transmission channels throughout the broader region, and the manner in which windfall revenues have been managed.

With subsequent issues, the MENA Economic Developments and Prospects report aims to provide a venue for regularly monitoring major economic trends in the region, providing a snapshot of progress on key structural reforms needed for longer-term growth and highlighting specific issues affecting regional development. It is hoped that with each year, the report can deepen the understanding of the region's development progress, prospects, and challenges.

ACKNOWLEDGEMENTS

This report was the work of the Office of the Chief Economist of the Middle East and North Africa Region (MNA), with contributions from the World Bank's Development Prospects Group (DECPG). The core team responsible for the preparation of the report comprised Jennifer Keller (Task Team Leader) and Paul Dyer of the MNA Chief Economist's Office, and Elliot Riordan, Annette De Kleine, and Shane Streifel of DECPG, under the management of Hans Timmer. The report was prepared under the guidance of Mustapha Nabli (Chief Economist, MNA).

The team would like to acknowledge the cooperation and contributions received from Dr. Hoda Sabry, Mr. Ezzat Abd El Hamid, Dr. Omneya Hemly of the Egyptian Center for Economic Studies, Mr. Rafi Kourouian of the Cairo Foreign Press Association, Mr. Omneya Ramadan of the Economic Research Forum in Cairo, Mses. Elisabetta Cucchi and Valerie Herzberg of the European Investment Bank, Messrs. Jose Leando, Arno Baeker, Gerhard Krause, Bertin Martens, Bernarde Philippe and Ms. Michaela Dodini of the European Commission, Mr. Mouloud Hedir, Mr. Hamid Dahmani, and Messrs. Mahbrouk Aib and Sid Ali Zahaf of Sonatrach.

Essential contributions were provided by Carlos Silva-Jauregui, Sherine Al-Shawarby, Carmen Niethammer, Sergei Shatalov, Paloma Anos Casero, Ganesh Seshan, Paul Brenton, John Wetter, Markus Kostner, Zoubida Allaoua, Leila Zlaoui, and Sarosh Sattar. Messrs. Milan Brahmbahtt, Luis Serven, and Richard Newfarmer were peer reviewers, whose careful review and subsequent contributions substantially improved this report. The team would like to acknowledge the support of Shaha Riza, Lara Saade, Ingrid Ivins, Nawal Merabet, Dina El Naggar, Manuela Chiapparino, and Omar Lassel in coordinating and assisting in the valuable consultations which took place during the drafting of this report. Important administrative assistance was provided by Krisztina Mazo.

ABBREVIATIONS AND ACRONYMS

Bbl	Barrels
Bn	Billion
CIDCM	Center for International Development and Conflict Management
COMTRADE	Commodity Trade Statistics database (United Nations)
CPIA	Country Policy and Institutional Assessment
DECPG	Development Prospects Group (World Bank)
EAP	East Asia and the Pacific
ECA	Europe and Central Asia
EEC	European Economic Community (European Union)
EU	European Union
FDI	Foreign direct investment
FRH	Freedom House
GATT	General Agreement on Tariffs and Trade
GCC	Gulf Cooperation Council
GDP	Gross domestic product
GNFS	Goods and non-factor services
GNI	Gross national income
IFPI	Inward FDI Performance Index
ILO	International Labor Office
IMF	International Monetary Fund
ISIC	International standard industrial classification
LAC	Latin America and the Caribbean
LMIC	Lower middle income economies
MENA	Middle East and North Africa
MFA	Multifibre Agreement
Mn	Million
MNA	Middle East and North Africa region (World Bank department)
MUV	Manufacturer unit value
NTB	Non-tariff barriers
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of Petroleum Exporting Countries
PAFTA	Pan-Arab Free Trade Area
PSPE	Public Sector Pay and Employment database (OECD)
QIZ	Qualifying industrial zone
RPLA	Resource poor and labor abundant
RRLA	Resource rich and labor abundant
RRLI	Resource rich and labor importing
SAS	South Asia
SITC	Standard Industry Trade Classification
SOE	State-owned enterprise
SSA	Sub-Saharan Africa

TRAINS	Trade Analysis and Information System
UAE	United Arab Emirates
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
WDI	*World Development Indicators*
WITS	World Integrated Trade Solution Database
WTI	West Texas intermediate
WTO	World Trade Organization

OVERVIEW

The Middle East and North Africa (MENA[1]) region has experienced exceptional growth over the last two years. Over 2003 and 2004, economic growth in MENA averaged more than 5.6 percent a year, the strongest growth in a decade, and up strongly from the 3.6 percent average yearly growth over the 1990s. On a per capita basis, the MENA region's 3.5 percent average growth over the last two years was the region's strongest growth performance since the mid-1970s (Table 1).

Accompanying this strong growth performance, unemployment – a critical development challenge affecting virtually every economy in the region – has declined with the rise in oil prices over 2000-2004. Unemployment is estimated to have fallen from about 14.9 percent of the labor force in 2000 to 13.4 percent currently, the result of a 37 percent increase in the rate of employment creation over the 1990s. In many respects, the MENA region is in the midst of an economic boom.

However, there are caveats to the region's growth acceleration. For one, it has not been especially broad based. Comparing growth over the 1990s with growth over the last two years, 97 percent of the regional growth upturn was driven by just four countries – Saudi Arabia, the Islamic Republic of Iran, Algeria and the United Arab Emirates. In fact, nearly half of the region actually experienced growth downturns relative to the 1990s.

Moreover, MENA's recent positive economic developments have been driven largely by external events – in particular, dramatically rising oil prices. The escalation in oil prices and increased production from the major MENA hydrocarbons producers boosted oil export revenues more than 75 percent between 2001 to 2004, providing the region a strong impetus to growth through acceleration of domestic spending, particularly via government consumption and investment. In all, the region's increase in government spending and investment accounts for almost two-thirds of the increase in growth experienced from the 1990s.

And importantly, on a per capita basis, the MENA region's growth over the last two years continues to lag that of other regions, a reflection of both the firming of GDP growth rates across developing regions and the MENA region's high population growth. At the regional level, per capita growth in East Asia and the Pacific, South Asia, and Europe and Central Asia all significantly outpaced MENA's per capita GDP performance in both 2003 and 2004. And, with two year averages of 4.6 percent and 4.0 percent, respectively, during 2003-2004, the sub-

[1] The MENA region, as defined in this report, includes Algeria, Bahrain, Djibouti, Egypt, the Islamic Republic of Iran, Iraq, Jordan, Kuwait, Lebanon, Libya, Morocco, Oman, Qatar, Saudi Arabia, Syria, Tunisia, the United Arab Emirates, West Bank and Gaza, and the Republic of Yemen. Iraq, Libya, Qatar and West Bank and Gaza are not included in regional trends or forecasts due to a lack of data availability (although references to individual indicators may occur where data availability permits). Lebanon is included in growth, per capita and per laborer growth, and unemployment analyses only, unless otherwise indicated. In the few cases where Djibouti data exists, this data is presented but has not entered into regional aggregates.

regional groupings of Latin America and the Caribbean (excluding Brazil) and Sub-Saharan Africa (excluding South Africa) have also outpaced MENA's average per capita growth of 3.5 percent for the same period.

The MENA region has experienced two major economic shocks in recent years. One has been skyrocketing oil prices and the resultant revenue boon. The second has been the conflict in Iraq and its subsequent reconstruction and reintegration. For Iraq itself, the changes since 2003 have been extraordinary. While the formal war ceased quickly and democratic national elections were held in early 2005, the incidence of violence and sabotage attacks continue, severely disrupting trade and investment flows and the Iraqi reconstruction effort. Answering the critical need for re-energizing the reconstruction and improving economic conditions, in order to counter widespread poverty and high unemployment, will depend on progress on the security front.

For the broader region, negative spillover effects of the conflict have been limited, in part because Iraq had been, to a large degree, economically isolated from the rest of the region. Countries with strong economic ties to Iraq – Jordan and Syria – were the most affected, primarily by way of higher energy import bills and trade disruptions. The potentially large indirect effects on the broader region – substantially reduced foreign direct investment, portfolio inflows and tourism because of increased risk perceptions – appear to have been limited. In terms of Iraq's reconstruction, however, many countries in the MENA region are poised to reap numerous potential economic dividends, including trade and business activity related to the reconstruction and reintegration effort.

An increasing and potentially important development in the region has been an apparent strengthening of intra-regional economic ties, strongly heightened after 2001 and evidenced through trade and financial flows and tourism. With a temporary pullback from US financial markets, MENA investors have increasingly sought returns in markets closer to home, which has supported a sharp rise in regional real estate and equity prices. Over 2004 alone, Middle East equity markets rose by more than 60 percent, the strongest performance in the world. Intra-regional tourism has also advanced sharply, partly as a response to the imposition of travel restrictions in the US and in parts of Europe. Tourist arrivals from within the region rose from only 22.4 percent of total tourists in 1999 to 40.8 percent in 2002. And intra-regional trade, while still largely unexploited, has ticked up from 6.8 percent of total exports in 2000 to 8.0 percent in 2003.

The strong upturn in oil prices and the rapid accumulation of financial assets by MENA oil producers in many ways evokes memories of the oil price booms of the 1970s and 1980s. And with those memories emerge questions of what the fall-out of this current oil boom will be – particularly whether the way the revenues have been managed has changed from past booms and whether the current windfall revenues will slow the reform process.

Overview Table 1
Summary: Global developments and MENA GDP growth

growth, or as specified otherwise	Averages 1990-2000	2002	2003	Estimate 2004	Projections 2005	2006
World trade /1	6.6	3.7	5.6	10.3	7.7	7.7
Industrial country imports	6.7	2.4	3.2	7.6	6.1	6.8
Euro Area	6.1	0.7	2.0	5.8	6.1	7.1
United States	9.3	3.4	4.4	9.9	5.0	6.4
Oil prices ($/bbl) average /2	19.1	24.9	28.9	38.0	40.0	36.0
Non-oil commodity prices /3	-1.4	5.1	10.2	17.5	4.7	-5.2
MUV index /4	-0.3	-1.3	7.5	7.0	3.0	2.8
U.S. dollar LIBOR (6-month)	5.6	1.8	1.2	1.6	3.5	4.6
World GDP /5	2.7	1.7	2.5	3.8	3.1	3.1
Industrial countries	2.5	1.3	1.8	3.1	2.3	2.5
Developing countries	3.2	3.4	5.3	6.6	5.7	5.2
MENA /6	3.6	2.9	6.1	5.2	4.9	4.3
Resource-poor, labor-abundant	4.0	3.0	4.0	4.2	4.4	5.0
Resource-rich, labor-abundant	3.4	6.1	6.3	6.0	5.7	4.8
Resource-rich, labor-importing	3.5	0.5	7.2	5.2	4.8	3.6
Memo: per capita GDP						
Developing countries	1.6	2.1	4.0	5.3	4.4	4.0
MENA	1.4	0.7	4.0	3.1	2.9	2.3
Resource-poor, labor-abundant	2.0	1.0	2.2	2.4	2.6	3.2
Resource-rich, labor-abundant	1.2	4.1	4.4	4.1	3.7	2.9
Resource-rich, labor-importing	0.5	-2.9	3.7	1.7	1.3	0.1

Source: World Bank, Global Development Finance-2005
Notes: /1 World imports of goods and non-factor services in 1995 dollars. /2 World Bank average oil price (WTI, Brent, Dubai).
/3 World Bank index of non-oil commodities. /4 Manufactures unit value in US dollar terms. /5 GDP in constant 1995 dollars.
/6 MENA geographic region, comprised of: Resource-poor, labor-abundant countries (Egypt, Jordan, Morocco and Tunisia); Resource-rich, labor-abundant countries (Algeria, Iran, Syria and Yemen) and Resource-rich, labor-importing countries (Bahrain, Kuwait, Oman, Saudi Arabia and the United Arab Emirates).

Although fiscal expenditures have risen sharply with rising oil revenues (supporting the exceptional growth upturn), there is evidence—given generally large fiscal and external surpluses—of the adoption of a more prudent spending stance by oil exporters compared to previous boom periods. Comparing net changes in oil export revenues with net changes in the current account balance gives a clearer indication of how much of the windfall revenue has been saved and of how much has been spent. During the current boom, roughly 25 percent of the additional export revenue has been spent. This compares with nearly 60 percent during the 1973 boom.

In addition to relatively smaller spending advances, there has been a draw-down of external debt obligations across the board during the current oil revenue boom, as well as a significant accumulation of foreign exchange reserves, which can provide a buffer for the external account, should oil revenues unexpectedly decline rapidly. The reserve build-up can also help to partially insulate MENA's oil exporters from the short-run disturbances of Dutch disease. To date, non-oil export growth has been healthy, even outpacing oil export growth over the last three years. The beneficial impacts from the US dollar depreciation (to which many oil exporter currencies are pegged) have aided the competitiveness of the non-oil export sector.

In part, the more prudent spending stance reflects the fact that the initial positions of the oil producers have substantially changed. The overhang from spending in earlier booms has in many ways guided current spending. In part, the greater prudence reflects a change of thinking over past decades in terms of economic direction. In virtually every oil-producing economy in the region, significant challenges in employment creation have emerged. With this challenge has come the widespread recognition that oil exporters need to move to alternative sources of growth and job creation. At least notionally, all of the oil producing economies espouse reform. At the same time, oil continues to provide a powerful buffer to addressing fundamental economic reforms, partly evidenced by the current build-up in temporary public employment schemes.

In looking forward, shifts in external factors are again likely to predominate the shaping of the short-term growth profile for MENA. Oil prices are expected to ease moderately by 2006—affecting prospects for the oil-dominant MENA economies, countered in part as European growth conditions improve and support stronger recovery among the diversified economies of the region. Oil prices are viewed to ease only moderately from $38/bbl in 2004 to $36/bbl by 2006[2] as the current strength in demand begins to unwind with a maturing global expansion. But prospects for continued gains during 2005 have risen, with global oils prices approaching $40/bbl in the interim. Recovery in Europe should eventually be abetted by diminishing inflation, boosting real incomes and domestic spending—though the current strength of the Euro remains an impediment to exports. And assuming that a generally favorable outturn to the current uncertain situation in Iraq transpires over the period, the outlook for MENA is one of continued solid growth, amounting to 4.9 percent and 4.3 percent in 2005 and 2006, respectively.

Despite the enhanced growth prospects (relative to the last decade), current forecasted growth rates remain insufficient for fundamentally addressing the large development challenge in MENA with regard to employment creation. Close to 100 million[3] new jobs will be needed over the next 20 years to keep pace with new labor force entrants and absorb the current unemployed. This means that the number of jobs in the region needs to double during that period, which will require real economic growth rates averaging 6 to 7 percent a year for a sustained period of time. This is close to double the region's rate of economic growth over the 1990s and still a quarter higher than the exceptional growth rate of the past year.[4]

For the region to be able to meet this extraordinary challenge, it will need to transition to an economic model that enables it to substantially develop its employment-creating growth potential. At its foundation, this structural transition will require three fundamental and interrelated realignments: (1) *from closed to more open economies,* to create more competitive industries, benefit from international best practice, and gain access to new technology; (2) *from public sector dominated to private sector led economies,* providing the basis for improved efficiency and

[2] World Bank average price, which gives equal weighting to WTI, Brent and Dubai crude oil prices.
[3] Includes Iraq, Libya, Qatar and West Bank and Gaza.
[4] Required economic growth calculated assuming an optimistic elasticity of employment growth to economic growth of 0.6 – the same employment elasticity exhibited by several the high-performing East Asian economies during the height of their employment generation.

expansion of employment; and (3) *from oil dominated to more diversified economies,* to reduce the region's dependence on volatile sources of growth, maintain fiscal stability, and preserve important social expenditures. Achieving this realignment requires interrelated policy actions on several fronts, including improved governance, particularly with regard to strengthening inclusiveness and accountability, as well as enhancing the inclusion of female labor in the private sector to increase the flexibility of the labor force and make better use of the region's talents.[5]

The impact of such an integrated realignment is potentially very large, with conservative estimates of the increase to output growth per worker from actions on all fronts of between 2.5 and 3.5 percent per year[6]. This is an enormous potential boost to output per worker. Over the 1990s, output growth per worker in the region averaged less than 1.0 percent per year. The importance of the region's success with this transition can thus hardly be overstated. Examining the region's efforts on the structural reform front, then, is paramount to understanding the region's longer term economic prospects.

In evaluating the recent progress in various aspects of reform, the region has, by and large, not kept pace with worldwide progress. Trade reform stands apart as an area in which the region has exhibited notable progress. Motivated in part within the context of regional and bilateral trade agreements, several MENA countries have made considerable progress in reducing tariffs and dismantling non-tariff barriers to trade. On average, simple tariffs in the region declined from an average of 22 percent in 2000 to slightly more than 15 percent by 2004, a 30 percent decline in the tariff rate – well above the 19 percent decline observed in the developing world. As a result, the MENA region ranks in the 71st percentile worldwide in terms of improving its world standing with regard to import tariffs (Table 2).

However, in other areas of reform, the region has lost considerable ground compared with the progress taking place worldwide. MENA's progress on reforming the business environment has been the weakest in the world, and on average, the MENA countries rank in the bottom third of the world in terms of improvements across a range of business regulatory and financial sector reforms. The pace of reform in politically difficult areas, such as reform of the judiciary for improved contract enforcement, has been especially weak.

[5] World Bank 2003c.
[6] World Bank 2003e.

Overview Table 2: Progress with structural reform, 2000-2004[a]

Country	*Trade Reform* Current status	*Trade Reform* Reform progress	*Business and Regulatory Reform* Current status	*Business and Regulatory Reform* Reform progress	*Governance Reform* Current status	*Governance Reform* Reform progress
Algeria	5	66	26	54	32	61
Bahrain	65	34	..	..	42	30
Djibouti	..	..	..	..	30	17
Egypt	60	100	29	11	28	24
Iran, Islamic Republic	4	76	63	37	36	14
Jordan	20	86	57	43	44	61
Kuwait	..	..	77	16	42	14
Lebanon	81	87	33	9	32	1
Libya	..	..	..	..	3	10
Morocco	1	49	62	62	40	42
Oman	..	..	60	58	37	56
Qatar	..	..	..	..	31	57
Saudi Arabia	76	88	52	47	26	35
Syrian Arab Republic	..	..	17	2	21	..
Tunisia	1	49	79	74	35	6
United Arab Emirates	..	..	32	4	36	3
West Bank and Gaza	..	..	..	..	23	..
Yemen, Republic	..	..	42	24	24	79
MENA	**35**	**71**	**48**	**34**	**30**	**32**
Sub Saharan Africa	29	21	27	36	34	47
East Asia Pacific	55	49	47	40	41	49
Europe Central Asia	72	64	52	61	51	54
Latin America	49	56	39	45	56	46
OECD	93	67	89	73	88	65
South Asia	25	43	49	48	35	55
LMIC (excluding MENA)	***38***	***63***	***44***	***47***	***45***	***47***
World	***50***	***50***	***50***	***50***	***49***	***50***

Notes: /a Periods of analysis may vary, depending upon indicator. For each indicator, current status reflects the country's current placement in a worldwide ordering (distribution) of countries based on that (composite) indicator, with 100 reflecting the country with "best" policies, and 0 reflecting the country with the most burdensome/restrictive policies. Reform progress reflects the improvement in a country's rank between 2000 and 2004 (or period available), with 100 reflecting the country which exhibited the greatest improvement in rank and 0 reflecting the country which exhibited the greatest deterioration. LMIC = Lower middle income economies, defined as countries with gross national income per capita between US$765 and $3,035 in 2003.

Of greater concern is the lack of progress that has been made in improving governance in the region. Although it has many facets, governance can broadly be separated into two broad areas: the *quality of public administration* – the efficiency of the bureaucracy, the strength of the rule of law and protection of property rights, and the control of corruption and quality of regulations; and, *public sector accountability* – how well citizens can access government information and hold their political leaders accountable. Although the region can point to a few successes in improving the quality of public administration since 2000, in the area of public sector accountability, the region's progress has been the poorest in the world. Despite the fact that the region ranks at the bottom in terms of public sector accountability and has the longest reform path to travel (on

average, ranking in the 27th percentile worldwide), virtually no country improved its worldwide standing in this area, and most countries showed a marked deterioration relative to the progress occurring worldwide. As a result, the MENA region on average ranked in the 27th percentile worldwide in terms of progress in improving public sector accountability, and in the 32nd percentile worldwide in terms of improving overall governance.

Although each area of structural reform is important in its own right, the lack of progress in governance reform, and in particular public sector accountability reform, is of concern because of what it implies for the success of a broader economic reform effort. International experience with structural reform suggests that where reforms have been successful, there have been strong coalitions for change. But the ability for coalitions to press for reforms depends on access to information to formulate choices, the ability to mobilize, and the ability to contest policies that are poor, all areas of governance in which the region ranks poorly worldwide and demonstrates limited progress.

The region's weak progress with business regulatory reform is evidence of current governance limitations. MENA has demonstrated some success with implementing the broader, top-down reforms, including tariff reform, which has been relatively easier to execute especially within the framework of international trade agreements. However, progress in improving the business environment has been weaker than all other regions, in part because it has required a much deeper level of economic reform. In areas like contract enforcement, which requires the profoundly difficult task of reforming the judiciary, the MENA region has demonstrated the greatest difficulties in implementing reform. Addressing fundamental governance weaknesses will be a critical success factor for achieving the second generation of policy reform.

CHAPTER 1

RECENT ECONOMIC OUTCOMES IN MENA

1.1 Introduction

The Middle East and North Africa (MENA[7]) region has experienced exceptional growth over the last two years. Over 2003 and 2004, economic growth in MENA averaged 5.6 percent a year, the strongest growth in a decade. On a per capita basis, the MENA region's 3.5 percent average growth over the last two years was the region's highest recorded performance since the mid-1970s. Stellar output gains were driven by the oil exporters of the region, in which GDP advanced 6.8 percent and 5.5 percent respectively in 2003 and 2004. For example, output in Saudi Arabia grew 7.2 percent and 5 percent in these years, while growth in Kuwait skyrocketed to 9.9 percent and 6.8 percent respectively.

Accompanying this strong growth performance, unemployment – a critical development challenge affecting virtually every economy in the region – has declined with the rise in oil prices over 2000-2004. Unemployment is estimated to have fallen from about 14.9 percent of the labor force in 2000 to 13.4 percent currently, the result of a 37 percent increase in the rate of employment creation over the 1990s.

But while the region's recent growth has been strong, the basis for the growth acceleration has been largely exogenous. Underpinning the region's growth advance has been a sharp rise in oil prices and an increase in crude oil production, which has provided substantial revenue gains for the region's oil exporting economies and supported dramatic increases in government consumption and investment spending. In all, heightened government consumption and increased investment outlays, primarily emanating from the public sector, have accounted for two-thirds of the observed increase in growth in the region since the 1990s. Heightened spending has likewise filtered down to strong advances in private consumption.

A potentially large, negative impact on the broader region from the conflict in Iraq was largely avoided, with an initial downturn in economic activity by and large limited to countries bordering and maintaining strong economic ties with Iraq. On the other hand, the subsequent reconstruction effort in Iraq is likely to present potentially large economic gains for the region through trade and business activity related to the reconstruction and reintegration effort.

---

[7] The MENA region as defined in this report includes Algeria, Bahrain, Djibouti Egypt, the Islamic Republic of Iran, Iraq, Jordan, Kuwait, Lebanon, Libya, Morocco, Oman, Qatar, Saudi Arabia, Syria, Tunisia, the United Arab Emirates, West Bank and Gaza, and the Republic of Yemen. Iraq, Libya, Qatar and West Bank and Gaza are not included in any regional trends or forecasts due to lack of data availability (although references to individual indicators may occur where data availability permits). Lebanon is included in growth, per capita and per laborer growth, and unemployment analyses only, unless otherwise indicated. In the few cases where Djibouti data exists, this data is presented but has not entered into regional aggregates.

An important economic development among the MENA economies has been an apparent strengthening of regional ties and a greater "inward" focus. Partly in response to global security concerns, MENA financial and other revenue flows have been increasingly directed at home. One consequence of this internal focus has been the vibrant rallies in regional equity and financial markets, on the order of 60 percent growth over 2004, which have additionally benefited from higher oil revenues creating expansionary government budgets and ambitious public investment plans.

In the short run, external factors are again likely to predominate the shaping of the MENA regional growth profile. Oil prices are expected to ease only moderately. This will affect prospects for the oil-dominant MENA economies somewhat adversely, but this development will be countered in part as European growth conditions improve and support stronger recovery among the diversified economies of the region. Oil prices are expected to ease from $38/bbl in 2004 to $36/bbl by 2006[8] as current strength in demand gradually unwinds with a maturing global expansion. But recent oil market developments suggest that 2005 is likely to see continued firm prices, averaging some $40/bbl in the interim. Assuming that a generally favorable outturn to the current uncertain situation in Iraq transpires over the period, the outlook for MENA is one of further solid growth. Following an advance of 5.2 percent in regional output during 2004, GDP growth is anticipated to register 4.9 percent and 4.3 percent in 2005 and 2006, respectively.

Nevertheless, to meet the region's pressing development challenge of creating sufficient employment opportunities for a burgeoning, youthful labor force, the region will require still higher growth, which depends on implementing broad-based structural reforms to generate sustainable growth opportunities outside of oil.

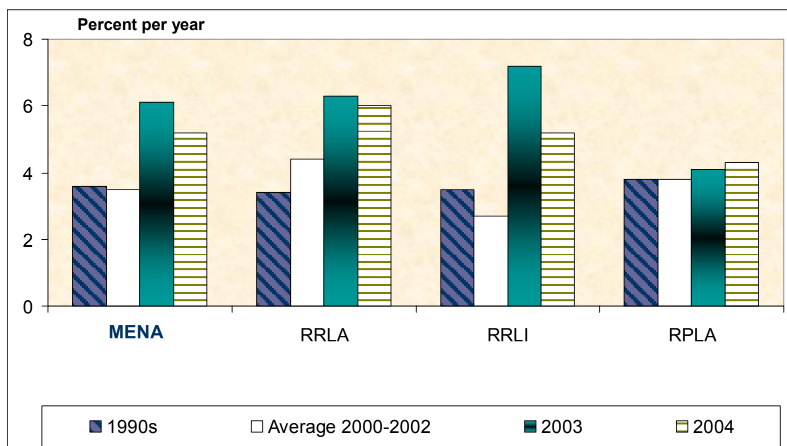
The rest of chapter is organized as follows: Section 1.2 summarizes the recent economic growth and labor market outcomes in the MENA region. Section 1.3 examines the sources behind the region's recent growth upturn, highlighting the importance of government consumption and investment in the region's growth outcomes. Section 1.4 discusses major economic developments in Iraq since the start of the conflict two years ago, as well as the impact of the conflict in Iraq on the broader region and the potential impact of Iraq's reconstruction and reintegration. In section 1.5, an examination of the strengthening of intraregional ties is developed, including its impact on tourism and financial flows in the region. Section 1.6 concludes the chapter with a discussion of near-term prospects, highlighting risks and medium-term challenges.

[8] World Bank average price, which gives equal weighting to WTI, Brent and Dubai crude oil prices.

1.2 Recent Growth and Employment Developments

1.2.1 Regional growth outcomes

Figure 1.1: Average yearly output growth 1990-2004



Source: World Bank data.

Strong world demand for oil prompted a robust expansion in domestic output in the MENA region over the last two years, with GDP expanding by 6.1 percent and 5.2 percent in 2003 and 2004, respectively, the strongest two-year growth showing for the region in a decade. On a per capita basis, MENA's growth over 2003 and 2004, averaging 3.5 percent a year, was the region's highest recorded performance since the mid-1970s.

Developments in the energy sector haven been at the foundation of this expansion, a fact reflected in exceptional growth rates among a fairly narrow set of oil exporters (Figure and Table 1.1). Output among the resource rich labor abundant economies (RRLA)[9] grew by an average 6.1 percent a year over 2003 and 2004, building upon strong growth averaging 4.6 percent a year between 2000-2002 on the back of sharp upturns in Algeria and the Islamic Republic of Iran, and considerably up from growth averaging 3.4 percent a year over the 1990s. Output among the resource rich labor importing economies (RRLI)[10] increased by an average of 6.2 percent a year over 2003-2004, up significantly from growth averaging less than 1.0 percent a year between 2000-2002, based upon strong outcomes in Saudi Arabia, the United Arab Emirates and Kuwait, and up considerably from growth over the 1990s (averaging 3.5 percent a year).

[9] Resource rich labor abundant economies include Algeria, the Islamic Republic of Iran, Iraq, Syria, and the Republic of Yemen. Because of data limitations, Iraq is not included in the regional analysis.
[10] Resource rich labor importing economies include Bahrain, Libya, Kuwait, Oman, Qatar, Saudi Arabia, and United Arab Emirates. Because of data limitations, Libya and Qatar are not included in the analysis.

Table 1.1
MENA growth performance (1990-2004)

	Average **1990-2000**	**2002**	**2003**	Estimate **2004**
Growth of real GDP (%)				
MENA Geographic Region	**3.6**	**2.9**	**6.1**	**5.2**
Resource Poor Labor Abundant*	**4.0**	**3.0**	**4.0**	**4.2**
Egypt, Arab Republic	4.3	3.2	3.2	4.3
Jordan	5.1	5.0	3.2	5.5
Morocco	2.2	3.2	5.2	3.3
Tunisia	4.7	1.7	5.6	5.2
Lebanon	7.1	2.2	2.7	3.8
Djibouti	-1.0	0.6	1.8	..
Resource Rich Labor Abundant	**3.4**	**6.1**	**6.3**	**6.0**
Algeria	1.7	4.1	6.8	5.9
Iran	4.0	7.4	6.6	6.5
Syrian Arab Republic	5.1	3.2	2.5	3.6
Yemen	5.8	3.6	3.8	2.0
Resource Rich Labor Importing	**3.5**	**0.5**	**7.2**	**5.2**
Bahrain	5.5	5.1	6.8	5.6
Kuwait	7.6	-0.4	9.9	6.8
Oman	4.6	0.0	3.9	1.5
Saudi Arabia	2.7	0.1	7.2	5.0
United Arab Emirates	4.0	1.8	7.0	5.7
Population (millions)				
MENA Geographic Region	**240.5**	**277.9**	**283.7**	**289.6**
Resource poor, labor abundant	100.6	115.1	117.2	119.4
Resource rich, labor abundant	115.1	131.9	134.4	137.1
Resource rich, labor importing	24.8	30.9	32.0	33.2
MENA growth rate (%)	**2.2**	**2.1**	**2.1**	**2.1**
Labor force (millions)				
MENA Geographic Region	**80.0**	**99.6**	**102.9**	**106.4**
Resource poor, labor abundant	36.7	45.1	46.3	47.7
Resource rich, labor abundant	34.7	43.8	45.5	47.2
Resource rich, labor importing	8.6	10.7	11.1	11.5
MENA growth rate (%)	3.0	3.3	3.4	3.4
Growth of GDP per capita (%)				
MENA Geographic Region	**1.4**	**0.7**	**4.0**	**3.1**
Resource poor, labor abundant	2.0	1.0	2.2	2.4
Resource rich, labor abundant	1.2	4.1	4.4	4.1
Resource rich, labor importing	0.5	-2.9	3.7	1.7
Growth of GDP per labor force (%)				
MENA Geographic Region	**0.7**	**-0.5**	**2.6**	**1.8**
Resource poor, labor abundant	1.2	0.2	1.2	1.4
Resource rich, labor abundant	0.3	2.1	2.3	2.1
Resource rich, labor importing	1.0	-2.9	3.6	1.6

Source: World Bank. Note: Although Djibouti growth data presented, Djibouti is not included in regional or subregional (resource rich labor abundant) growth aggregates.

Though oil exporters have been the drivers behind MENA's growth acceleration, the pace of growth among resource poor labor abundant economies (RPLA)[11] in the region has also improved, having benefited from a recovery in agriculture, stronger growth in worker remittances and tourism, and a modest fillip to intra-regional trade. While performance has been partially hampered by weakness in European export markets, growth among the RPLA economies climbed slightly averaging 4.1 percent a year over 2003-2004, up from an average 3.6 percent growth over 2000-2002. Jordan has been a net economic beneficiary of developments in neighboring Iraq. Increases in transit trade and the establishment of local reconstruction and diplomatic operational headquarters there have underpinned economic activity to a 5.5 percent gain during 2004. Lebanon, as well, which experienced depressed economic activity prior to the war in Iraq, saw a recovery in growth over 2004 to 3.8 percent. Egypt has enjoyed increased tourism revenues and Suez Canal transit fees, which among other factors served to raise growth by a full point to 4.3 percent in 2004. Morocco and Tunisia, linked more tightly to Europe through trade in textiles, other light manufactures and tourism, have been harder hit by sluggish economic conditions in that market, resulting in the waning GDP growth during 2004.

Despite the historically strong MENA regional growth, on a per capita basis, economic growth over the last two years lags the strong growth experienced in other developing regions, a reflection of both the firming of GDP growth rates across developing regions and the MENA region's high population growth. A number of positive factors have driven a broad acceleration in per capita growth across developing country regions worldwide during the first half of the 2000s. A rise in south-south trade, the realization of gains from past advances in economic reforms, buoyant domestic and foreign investment activity, and a supportive external environment have all contributed to global economic gains for developing nations. As a result, at the regional level, per capita growth in East Asia and the Pacific, South Asia and Europe and Central Asia have all significantly outpaced MENA's per capita GDP performance in both 2003 and 2004. And, with two year averages of 4.6 percent and 4.0 percent, respectively, during 2003-2004, the sub-regional groupings of Latin America and the Caribbean (excluding Brazil) and Sub-Saharan Africa (excluding South Africa) have also outpaced MENA's average per capita growth of 3.5 percent for the same period (Table 1.2).

[11] Resource poor labor abundant economies include Egypt, Djibouti, Jordan, Lebanon, Morocco and Tunisia. Regional average does not include Djibouti.

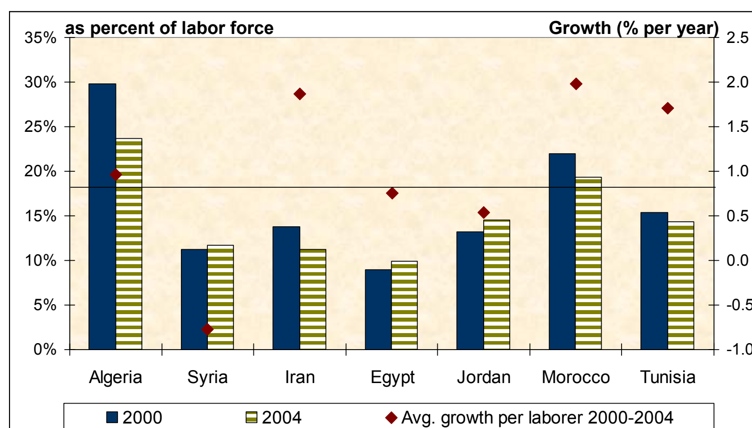
Table 1.2
MENA growth performance in international perspective (1990-2004)

growth of per capita GDP (%)	Averages 1990-2000	2002	2003	Estimate 2004
MENA Geographic Region	**1.4**	**0.7**	**4.0**	**3.1**
Resource poor, labor abundant	2.0	1.0	2.2	2.4
Resource rich, labor abundant	1.2	4.1	4.4	4.1
Resource rich, labor importing	0.5	-2.9	3.7	1.7
Developing countries	1.6	2.1	4.0	5.3
excluding China and India	0.4	0.8	2.6	4.4
East Asia and Pacific	6.4	6.0	7.0	7.3
excluding China	**3.0**	**3.1**	**3.9**	**4.6**
South Asia	3.3	2.9	6.1	4.9
excluding India	2.3	2.4	3.5	3.7
Latin America and Caribbean	1.6	-2.3	0.3	4.2
excluding Brazil	**3.8**	**-2.4**	**3.1**	**6.1**
Europe and Central Asia	-1.6	4.6	5.9	6.8
excluding Russia	0.3	4.6	5.1	6.6
Sub-Saharan Africa	-0.3	0.8	1.4	1.9
excluding South Africa	2.9	2.0	4.0	4.0
Memo items:				
High-income countries	**1.8**	**0.8**	**1.3**	**2.6**
North America	2.0	1.1	2.1	3.4
European Union (15)	1.8	0.8	0.6	1.8
East Asian NIEs	3.1	0.8	1.2	6.8
Source: World Bank				

1.2.2 Labor market developments

Concurrent with MENA's growth upturn has been a reduction in unemployment among several countries in the region. Among resource rich and labor abundant economies, unemployment, which averaged some 17 percent of the labor force in 2000, has declined by almost 3 percentage points to 14.3 percent. This was driven by significant declines in unemployment in Algeria (from almost 30 percent to 23.7 percent) and the Islamic Republic of Iran (from close to 14 percent to 11.2 percent).

Figure 1.2 Unemployment in MENA
2000 and 2004*

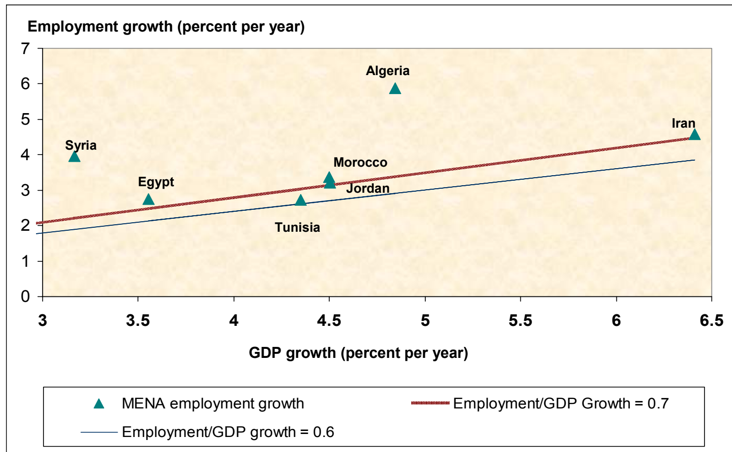


Source: World Bank data.
Note: *\ or most recent year available post 2000.

Several resource poor economies, including Morocco

and Tunisia, have also seen a decline in the level of unemployment in the last four years. Overall, regional unemployment is estimated to have declined from 14.9 percent of the labor force in 2000 to 13.4 percent. Region wide, more than 12 million jobs were created over the last four years[12], a 37 percent increase over the average yearly job creation over the 1990s.

Figure 1.3: Employment growth versus output growth



Source: World Bank data.

Despite this good news, the degree to which the current reduction in unemployment is permanent is questionable. A large number of temporary jobs have been created under Algeria's Economic Recovery Program. More generally, the region exhibits artificially high employment creation relative to the recent growth upturn (with the elasticity of employment growth with respect to output growth averaging almost 0.9, well above international averages for longer time horizons). Over a sustained period, this level of employment creation relative to growth is not likely. Though the employment/output relationship varies from country to country, the elevated pace of employment creation in the region, relative to its output growth, suggests that the strong unemployment decline has been achieved, for at least a few countries, only temporarily.

Furthermore, based on the World Bank's analysis of the employment situation in the MENA region in 2003[13], the number of new jobs that need to be created over the next 20 years to keep pace with labor force entrants and absorb the current unemployed implies real economic growth rates averaging 6 to 7 percent a year for a sustained period of time. In the last year alone, growth has moderated to 5.2 percent, suggesting that the fundamental problem facing the region in terms of job creation remains unchanged with the recent surge in growth.

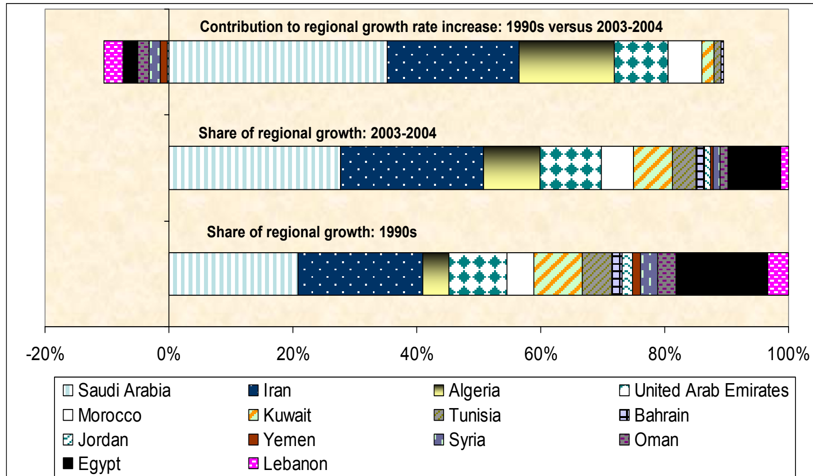
1.2.3 Sources of higher growth

Although, in aggregate, MENA has improved its economic performance, the region's strong growth recovery has been driven predominantly by oil, reflected in a narrow set of countries accounting for most of the region's upturn in growth that has occurred between the 1990s and the 2003-2004 period. Over the 1990s, growth averaged 3.6 percent a year for the region[14]. Over the last two years, that growth has risen to a regional average of 5.6 percent a year. The exceptional growth advances in Saudi Arabia, the Islamic Republic of Iran, Algeria, and the United Arab

[12] Does not include Iraq.
[13] World Bank 2003d.
[14] Does not include Djibouti, Iraq, Libya, West Bank and Gaza or Qatar.

Emirates account for more than 97 percent of the increase in regional growth that has taken place, although they represent only 63 percent of current regional output. At the same time, almost half of the region has actually experienced a decline in average growth over the last two years from 1990s averages (Figure 1.4).

Figure 1.4
Contribution to regional growth rate increase: 1990s versus 2003-2004



The factors underpinning growth in the region have also changed substantially since the 1990s, with growth over the last two years fueled increasingly by government consumption and investment. Prior to the recent run-up in oil prices, during the 1990s, the MENA region found support for 3.6 percent annual GDP growth from a more balanced set of factors. Domestic demand accounted for 79 percent of growth, led by personal consumption spending, which was the key driving force for growth (providing 1.6 points of overall growth, or some 43 percent). Government spending and domestic investment together provided another 1.3 percentage points to overall growth (or 36 percent of overall growth), reflecting cyclical influences stemming from the oil markets, as well as domestic conditions. Net exports, meanwhile, accounted for about 21 percent of growth, contributing 0.8 percentage points to overall growth (Table 1.3).

Over the last two years, however, rising oil prices and increased production have provided oil producers substantially elevated revenues with which to fuel domestic demand, particularly through investment. Rising global demand pushed oil prices from an average of $26/bbl in 2002 to $38/bbl in 2004[15], a 50 percent increase in the span of two years. A ramp-up in oil production accentuated an increase in hydrocarbon revenues—crude oil and products, as well as natural gas and derivatives—to 80 percent between 2002 and 2004.

The rapid increase in government revenues has helped to support robust investment spending[16] (mainly from the public sector), which grew by an average of 7.3 percent per year over 2003-2004, up from an average of 3.0 percent growth per year over the 1990s. Aided by strong investment drives in the Islamic Republic of Iran (which has increased its real capital spending by two-thirds in the span of four years), Algeria (largely the result of higher public investment associated with the government's Economic Recovery Program), and Saudi Arabia, investment spending provided an impetus of 1.7 percentage points to average yearly growth over 2003 and

[15] World Bank average price, which gives equal weighting to WTI, Brent and Dubai crude oil prices.
[16] Investment spending includes both fixed capital expenditure as well as any build-up of stocks.

2004 (more than doubling its contribution of 0.8 percentage points over the 1990s). Government consumption has provided another 0.9 percentage points to growth, almost doubling its contribution of 0.5 percentage points over the 1990s. In total, the increase in government spending and investment account for almost two-thirds of the increase in growth experienced from the 1990s.

Table 1.3: Sources of growth across the MENA region, 1990s and 2000s[1]
(Components of economic growth)

	1990-2000	2001-2002	2003-2004	Contribution to growth increase 2003-2004 versus 1990-2000[2]
MENA Region	***3.6***	***2.8***	***5.6***	***100%***
Private Consumption	1.6	1.9	2.2	32.0
Government Consumption	0.5	0.3	0.9	18.2
Investment	0.8	1.7	1.7	46.0
Foreign Balance	0.8	-1.1	0.8	3.8
Exports	1.8	-0.1	2.7	44.1
Imports	1.1	1.0	1.9	40.4
Resource Rich Labor Abundant	**3.4**	**4.6**	**6.1**	**42.0**
Private Consumption	1.2	3.6	2.9	
Government Consumption	0.5	0.3	0.4	
Investment	0.1	3.0	2.3	
Foreign Balance	1.6	-2.3	0.5	
Exports	0.8	-0.1	1.6	
Imports	-0.8	2.2	1.0	
Resource Rich Labor Importing	**3.5**	**1.0**	**6.2**	**55.8**
Private Consumption	0.7	0.7	1.4	
Government Consumption	0.7	0.4	1.5	
Investment	1.6	1.7	1.9	
Foreign Balance	0.6	-1.7	1.4	
Exports	4.1	-1.1	4.2	
Imports	3.6	0.6	2.8	
Resource Poor Labor Abundant	**4.0**	**3.6**	**4.1**	**2.0**
Private Consumption	2.9	2.0	2.6	
Government Consumption	0.5	0.4	0.5	
Investment	0.8	0.8	0.7	
Foreign Balance	-0.2	0.4	0.3	
Exports	1.1	0.9	1.6	
Imports	1.3	0.4	1.3	

Notes: 1\ A component's contribution to GDP growth during a particular period is formulated by calculating the share of total demand from component multiplied by the growth rate during that period. 2\ Proportion of increase in average yearly growth between 1990-2000 and 2003-2004, due to increase in component.

The boost in oil revenues has also indirectly increased demand by increasing transfers served to boost consumer spending, particularly among oil producers. Among both groups of resource rich economies, the contribution to growth from private consumption has more than doubled from the 1990s. Resource rich labor abundant economies have seen private consumption add 2.9 percentage points to growth (up from 1.2 percentage points over the 1990s), while resource rich

labor importing economies have seen a nearly equivalent rise, from 0.7 percentage points to 1.4 percentage points. In resource poor countries, in contrast, the contribution from private consumption has declined slightly from that of the 1990s.

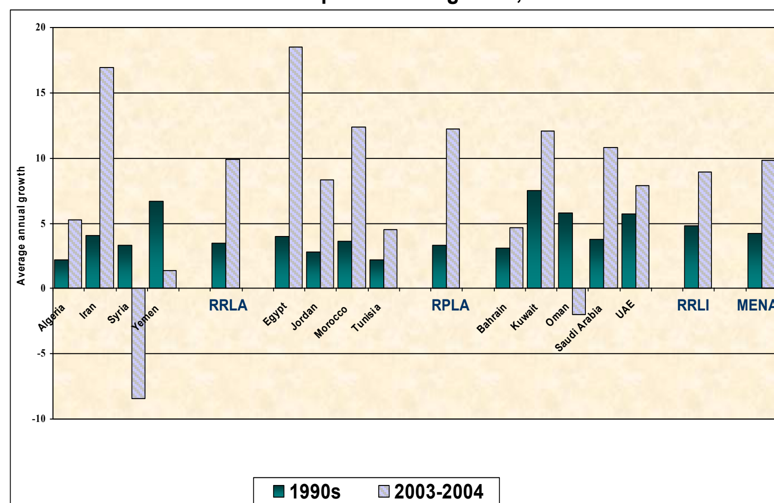
Although exports have advanced substantially, the net foreign balance has not provided an extra push to growth relative to the 1990s, as export growth has largely been offset by a significant upsurge in imports, especially in the resource rich and labor abundant economies (discussed below).

1.3 External Sector

1.3.1 Export growth

Merchandise export volume growth (oil and non-oil) posted strong gains of 13.6 percent and 6.1 percent in 2003 and 2004, respectively—more than double the average of 3.5 percent growth achieved during the 1991-2000 period. The acceleration was relatively broad-based across the MENA region, although a few countries have experienced notable drops in export volumes. Particularly strong advances emanated from the resource poor economies, with dynamic merchandise export volume growth in both Egypt and Morocco. Among resource rich and labor abundant economies, particularly robust export volume growth occurred in the Islamic Republic of Iran, the result of the strong performance both in oil and non-oil exports. Export volume declines experienced in Syria resulted from both reduced oil production stemming from dwindling oil reserves and large declines in non-oil exports, a consequence of the end of the Oil for Food program with Iraq and disturbances in the trade flows there. The Republic of Yemen, as well, has experienced a leveling off of oil production, raising concerns about a faster depletion of reserves than originally expected.

Figure 1.5
Merchandise export volume growth, 1990-2004



Supported by strong growth both in merchandise exports and non-factor services, real exports of goods and non-factor services rose by 9.2 percent over 2003 and 5.9 percent over 2004, up strongly from the average growth of 3.6 percent a year over the 1991-2000 period. Among resource poor economies, rising oil prices have actually benefited factor service export growth, boosting remittances and trade in services. While remittance inflows have not risen as much as

during past oil price increases, inflows to resource poor labor abundant economies rose a percentage point to 6.7 percent of GDP in 2004, up from 5.6 percent of GDP in 2002. The demand for RPLA exports, particularly of services (tourism) has also increased, with tourism revenues posting a gain of a near 1.0 percentage point rise to 6.3 percent of GDP in 2004, compared to 5.6 percent of GDP in 2002. Egypt and Jordan, in particular, have benefited from the rise in intra-regional tourism and have seen gains in remittance inflows.

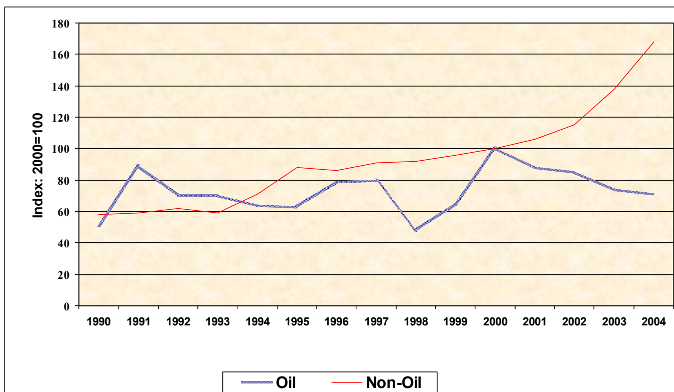
Oil exports remain a dominant share of merchandise exports for the region, accounting for 80 percent of merchandise exports among oil economies, and 72 percent for MENA countries as a whole. At the same time, recent non-oil export growth has been healthy, even outpacing oil export growth for all regional sub-groupings. With particularly strong advances from the Islamic Republic of Iran, Egypt and Oman, non-oil exports in current $US grew by an average of 22 percent a year between 2001-2004, relative to oil-export growth averaging 21 percent (and relative to non-oil export growth averaging only 4 percent over the 1995-2000 period).

Figure 1.6

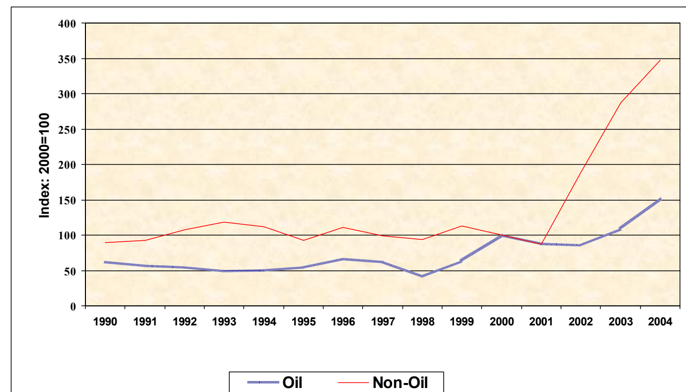
Oil and non-oil export growth

(Current $US)

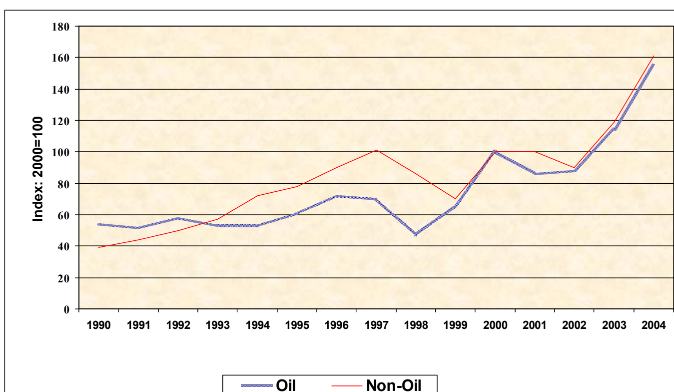
Resource poor and labor abundant economies



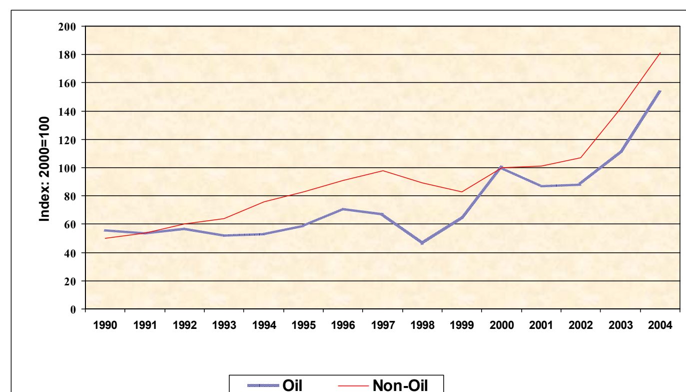
Resource rich and labor abundant economies



Resource rich and labor importing economies

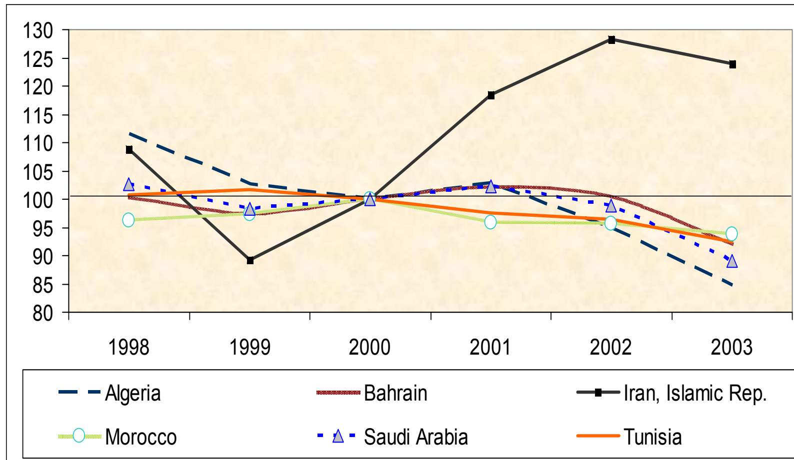


MENA: Total



The classic “Dutch disease”, where the non-oil export sector gets crowded out by the oil and non-traded goods sectors, does not appear to have materialized to date, judging by estimates of pre- and post-boom non-oil growth. Aiding the competitiveness of the non-oil export sector has been the relatively successful management of exchange rates in the region (Figure 1.7). GCC economies benefited from the peg to the US dollar, realizing substantial depreciation in their currencies as the dollar depreciated against other currencies. Outside of oil producers, the nominal devaluation of Morocco’s dirham in 2001 partly corrected the real appreciation of the currency since the 1990s. Since the devaluation, the dirham has continued to depreciate in real effective terms. Since 2001, Tunisia’s monetary policy has allowed the dinar to depreciate, although depreciation slowed in 2004. Egypt’s decision to float the pound in 2003 has also had positive results. In the Islamic Republic of Iran, despite significant progress with exchange rate management through the unification of the exchange rate and the shift to a managed float, the rial has appreciated in real terms, only partially corrected by a small nominal depreciation in 2003. Although the Islamic Republic of Iran has shown resilient non-oil export growth in the last several years, maintaining competitiveness for the development of stronger non-oil exports will require better management of the exchange rate.

Figure 1.7: Real effective exchange rate
1998-2003



Source: World Development Indicators.

1.3.2 Import growth

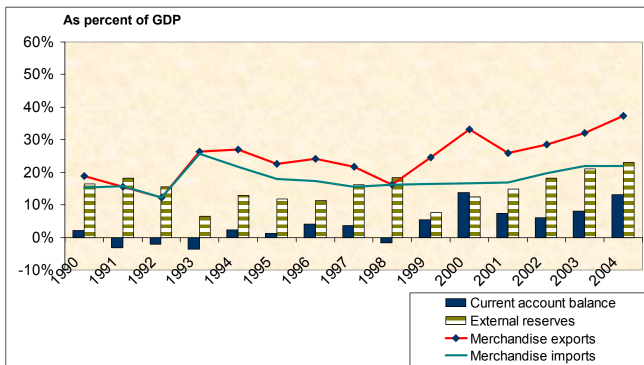
The region’s recent strong export growth has largely been offset by a significant upsurge in imports, especially in the resource rich and labor abundant economies. The Islamic Republic of Iran, which actually reduced imports by an average of 8 percent a year between 1990-2000, experienced growth of imports of goods and non-factor services averaging over 6 percent a year over 2003 and 2004, concurrent with rising domestic demand and following trade liberalization reform. In Algeria, the modest declines in imports achieved under the 1990s (averaging 2 percent a year) have been replaced by import growth averaging 3.7 percent a year over the last two years, mainly driven by increased demand for manufactured goods imports. As a result, the growth in the net foreign balance accounts for less than 5 percent of the increase in the region’s average growth that has occurred since the 1990s (Table 1.3).

Even among resource poor economies, real import growth increased moderately from the 1990s (from an average of 3.7 percent a year over the 1990s to 4.1 percent a year between 2002 and 2004). This increase has been driven by strong import upturns in Morocco and Jordan, the result of dynamism in demand and rising oil import bills, and despite import reductions in Egypt due to currency depreciation and associated shortage of foreign exchange.

With strong real growth of exports of goods and non-factor services, and despite the acceleration in the real growth of imports, MENA's current account has moved from an average net balance between 1990-2000 to a surplus averaging more than 12 percent of GDP over 2003-2004, a reflection of the dramatic rise in oil prices. For RRLA economies, the current account surplus reached 13 percent of GDP by 2004, and in RRLI economies, almost 22 percent. External positions also improved for the RPLA economies. Particularly strong gains in Egypt were partly the result of the upturn in tourism receipts (up 19 percent since 2002), but also came from Suez Canal receipts (up 44 percent), which have soared with rising oil prices as it becomes a more cost-effective transit route for exporters than circumnavigating Africa.

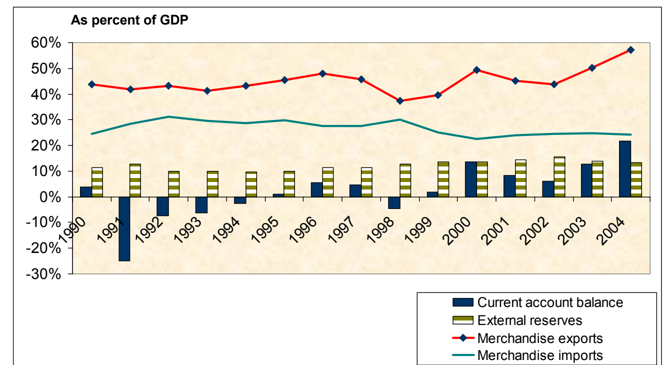
Figure 1.8
External balances as a percent of GDP, 1990-2004

Resource rich and labor abundant economies



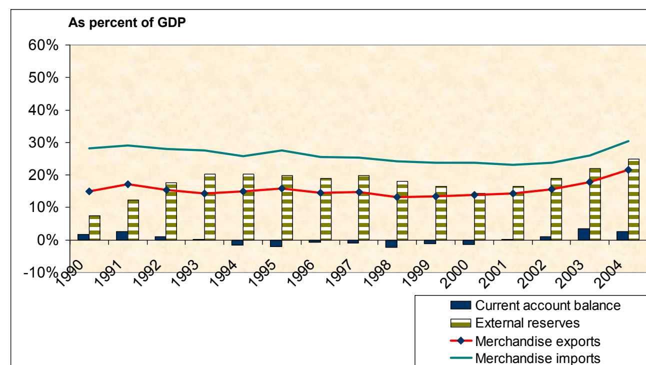
Source: World Bank data.
Note: Algeria, Iran, Syria and Yemen.

Resource rich and labor importing economies



Source: World Bank data.
Note: Bahrain, Kuwait, Oman, Saudi Arabia, and United Arab Emirates.

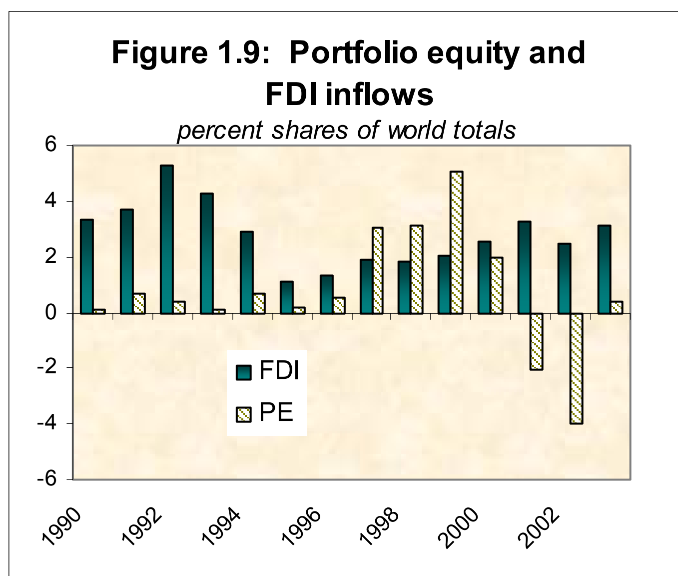
Resource poor and labor abundant economies



Source: World Bank data.
Note: Egypt, Jordan, Morocco, and Tunisia.

1.3.3 Capital flows

Private capital inflows to the MENA region remain subdued when compared with the strong capital inflows occurring worldwide. MENA's portfolio equity flows were visibly impacted by events following September 11, turning down markedly over 2001 and 2002 before posting a moderate recovery in 2003. Net portfolio equity flows for developing economies in MENA[17] shifted from an average inflow of $365 million over 1998-2000 to an average net outflow of $175 million over 2001 and 2002, recovering to net inflows again of about $100 million in 2003. As a share of total portfolio equity flows to developing countries, the proportion captured by MENA economies was significantly reduced, averaging about 0.4 percent of world equity flows in 2003, compared with 3.4 percent of total over 1998-2000 (Figure 1.9).



Net FDI inflows, in comparison, have remained largely stable, reflecting the longer-term nature of the investments. Although the share of world FDI toward developing economies captured by the MENA region has weakened compared with its performance during the early 1990s, the region has exhibited a slight improvement in recent years. In 2003, MENA captured approximately 3.1 percent of all FDI directed to developing countries, up from less than 2 percent over 1998-1999.

[17] Algeria, Egypt, the Islamic Republic of Iran, Jordan, Lebanon, Morocco, Oman, Syria, Tunisia, and the Republic of Yemen.

Box 1.1:
Recent developments in the West Bank and Gaza[1]

After a steep decline in 2001 and 2002, the Palestinian economy stabilized in 2003 and 2004. In the first two years of the *Intifada*, Palestinian real GDP per capita shrunk by almost 40 percent. This trend was halted in 2003, with a return of mild positive growth. Real GDP per capita increased by one percentage point, but real Gross Disposable Income (GDI) – which includes remittances from abroad and foreign assistance – increased by over 11 percent per capita. This rebound resulted from a lull in violence and less intense curfews / closures than in 2002, an increase in labor flows to Israel, and a resumption of revenue transfers by the Government of Israel (along with the return of US$178 million in withheld revenues). Almost 100,000 jobs were created, albeit many of them of poor quality[2].

In 2004, the fragile recovery of the previous year continued in the West Bank, but stalled in Gaza, with extended operations accompanied by segmentation of the Gaza Strip and stiff restrictions on movements of goods and people across the borders with Israel and Egypt. This led to a sharp reduction in the volume of Gaza's exports, as well as a temporary curtailment of humanitarian assistance. Worker access to the Erez Industrial Estate and to Israel from Gaza declined to a daily average of less than 1,000 in the second and third quarters (compared with 6,000 the previous year); at the same time, an additional 8,900 jobs have been lost within Gaza – resulting in a 6 percent increase in the unemployment rate in Gaza to 35 percent. In the West Bank, employment increased slightly, with unemployment averaging 23 percent in 2004, an improvement of 5 percentage points from 2002.

Negative economic outcomes since the beginning of the *Intifada* have had a particularly severe impact on social welfare. In 2004, just under half the Palestinian population (and nearly two-thirds in Gaza) were living below the official poverty line of US$2.20 a day. Those living in severe poverty (below US$1.50 per day) were estimated at 16 percent. Despite the crisis, the Palestinian Authority has continued to deliver basic social services and provide humanitarian assistance. However, the maintenance of these services is dependent upon external aid. High by international standards (around US$300 per person per year for the last four years), aid inflows alone cannot rapidly revive the Palestinian economy, which is essential to sustaining the momentum of a renewed peace process. This revival will only come about if there is a drastic improvement in the security environment, a dismantling of the various post-September 28, 2000 restrictions on the movement of Palestinian people and goods, and dynamic progress on Palestinian governance reform and institution-building.

[1] Because of data limitations, the West Bank and Gaza were not included in the general regional analysis of trends and prospects.
[2] More than half were classified as self-employed or unpaid family labor.

1.4 The Conflict and Reconstruction in Iraq

The conflict and reconstruction in Iraq represents one of the fundamental economic shocks to the MENA region. Aside from direct effects within Iraq itself, the conflict had spillover effects in the broader region. The initial negative shock from the conflict was limited to only a few economies with strong ties to Iraq, largely because Iraq had been for the most part economically isolated from the rest of the region. In terms of Iraq's reconstruction, however, many countries in the MENA region are poised to reap numerous potential economic dividends, including trade and business activity related to the reconstruction and reintegration effort.

1.4.1 Economic and political developments in Iraq

In June 2004, power was handed over from the Coalition Provisional Authority to the Interim Iraqi Government. Democratic national elections were held successfully in January 2005, despite widespread violence. And in March 2005 the Transitional National Assembly convened for the first time. The Transitional Assembly will draft Iraq's permanent constitution, which will be presented to the Iraqi people in a general referendum, leading to a constitutionally-elected government by end 2005.

While formal war ceased fairly quickly, the incidence of violence and sabotage attacks was increasing since late 2003, and has not abated yet. Violence has stifled a faster recovery and reconstruction. The Iraqi economy imploded during the 2003 invasion, with nominal GDP hitting a low of US$12 billion. In 2004, GDP recovered to an estimated US$21 billion, and income per capita rose to about US$780. Almost all growth has been in the oil sector, which accounts for over 75 percent of GDP and over 97 percent of exports and budget receipts. Oil production and exports in 2004 reached 2 and 1.5 m/bbl per day respectively, below the planned levels due to sabotage and the dilapidated state of facilities. Thanks to strong oil prices, however, oil revenues have nonetheless managed to exceed projections. Non-oil sectors witnessed an initial surge of activity in 2003 and early 2004, but have slowed down sharply since then. Access to basic services remains inadequate for large sections of population. Rising violence has severely disrupted trade and investment flows, with contractors' security outlays at 20-40 percent of total cost of works.

Early progress was made on the policy and institutional side, with a particular focus on opening up the Iraqi economy. Most reforms undertaken in 2003-2004 were concerned with legislation and institutional changes: a new law establishing an independent Central Bank; trade liberalization; new laws on public finance, audit and procurement; liberal banking, bankruptcy, and company laws; and the establishment of inter-ministerial commissions on reconstruction, privatization, oil, and economic reform. The independence of the Central Bank under the 2004 law has been upheld, with no new lending to the Government. The introduction of New Iraqi Dinar in early 2004 was a success. In line with the Central Bank policy toward securing exchange rate stability, the exchange rate has remained steady at NID1460 per US$1. The influx of oil revenue allowed the Central Bank to rebuild foreign exchange reserves to 3.7 months of merchandise imports by end-2004.

The Government's fiscal and monetary policies have been broadly anti-inflationary, contributing to initial macroeconomic stabilization. The strong fiscal stance was anchored by the Development Fund for Iraq, which receives oil and other revenues accruing to the Iraqi state. The Fund was established under UN Security Council Resolution No. 1483 and is managed by the Ministry of Finance. Its operational autonomy helps to achieve revenue smoothing and to protect the budgetary sphere from the volatility of oil revenues. A rapid buildup of government spending, however, has reignited inflation, which exceeded 30 percent in 2004. Iraq maintains a nationwide food rationing system, and an extensive system of subsidies on other sensitive goods and services (fuel, electricity, utilities, urban services). This represents a massive burden on the central

budget. These spending commitments will be extremely hard to sustain should the oil prices weaken.

1.4.2 Reform challenges ahead

Iraq faces high unemployment, widespread poverty, and narrow and weak social protection systems. The employment situation remains precarious, with more than 2 million unemployed – close to 30 percent of total workforce. Unemployment among young men is twice as high, while women's labor participation is low even by the MENA standards. A systematic poverty assessment has yet to be launched, but available data suggest that absolute poverty can be as high as 10-11 percent, with another 10-15 percent of population being close to the absolute poverty threshold[18].

The volatile security situation further strains Iraq's safety nets. The number of widows, orphans, and war disabled grows by the day, while the social exclusion of large vulnerable groups threatens the fragile democracy and the reconstruction process. Formal safety nets cover less than 5 percent of the population and face an imminent financial crisis. Lack of access to jobs and social services brings hardship to large sections of the population.

The most critical condition in re-energizing the Iraqi reconstruction is to reverse violence and insecurity, by building up and strengthening: (a) internal security and police, to deliver basic law and order; and (b) a participatory and representative form of government, to shift grievances away from violent conflict and toward political representation and contest. Iraq is making progress in both areas, with the enlargement of the national security forces and the national elections that led to democratically-formed government. The other critical need is demobilization. Providing sufficient civilian jobs and incomes, education and training, and social and economic opportunities for ex-combatants is essential.

Assuming that the process of reversing the violence gains credibility and the basic functions of representative government are restored, Iraq's economic and social challenges are likely to be shaped by three main goals: (a) creating an increasing number of productive and high-quality jobs; (b) restoring and expanding essential services (schools, hospitals, power, water and sanitation) that are available to citizens throughout the country and are accountable and responsive to citizens' needs; and (c) ensuring that the poor and vulnerable have equitable access to social safety nets. All three objectives need to be simultaneously met to ensure that an increasing majority of citizens share in a vision of a just and prosperous Iraq and to permit the Government to undertake an ambitious reform program.

---

[18] Using an international poverty line of $1 per capita per day.

1.4.3 Impacts on the MENA Region

Since Iraq did not participate much in the regional economy as a result of conflicts with its neighbors and international sanctions, direct negative economic spillovers from the conflict were limited to a few countries with strong economic ties, primarily Jordan, and to a lesser extent Syria. Both Jordan and Syria were provided Iraqi oil at sub-market rates[19]. Prior to the war, Jordan was 100 percent dependent on Iraq for its oil—50 percent of which it had received as a grant and the remainder at discount in return for Jordanian food and medicine. The loss of the Iraqi oil grant in March 2003, in combination with the surge in oil prices, resulted in a large upswing in the cost of Jordanian energy imports. With the loss of Iraqi oil, Saudi Arabia, Kuwait and the UAE have become suppliers to Jordan, part of this supply provided in grant but not nearly on as favorable terms as existed with Iraq. This has put pressure on the Jordanian government to reform its oil subsidy policies and has led to the planned elimination of a number of fuel subsidies by end-2006.

Both Jordan and Syria experienced disruptions to trade flows, beginning before the military intervention itself as tensions were building up. Jordan's exports of goods to Iraq declined by 28 percent and its imports from Iraq slumped 50 percent in 2003[20]. As a share of its total exports, Jordanian exports to Iraq dropped to 13.65 percent in 2003 from 20.2 percent in 2002. Syria experienced a similar sharp drop in exports to Iraq with the end of the Oil for Food program, and over 2003 merchandise exports decreased by 8 percent. But the war also led to trade opportunities. In Lebanon, the conflict and post-war rebuilding translated into early gains in trade with Iraq, with Lebanese exports in 2003 up 71 percent from the previous year, chiefly the result of strong advances in manufactured exports and car shipments.

Moreover, the potentially large indirect effects on the region – substantially reduced foreign direct investment, portfolio inflows and tourism because of increased risk perceptions – appear to have been limited. To be sure, the region experienced a net outflow of portfolio investment and a sharp drop in tourism, but much of this trend found its roots following September 11, 2001. Jordan's financial flows were undoubtedly the most greatly disrupted, with a decline in portfolio equity flows and FDI inflows during 2002. FDI inflows shrank to 0.3 percent of GDP in 2002 from 1.1 percent in 2001. Portfolio equity flows dropped about 50 percent, from 0.6 percent to 0.4 percent of GDP over the same period. International financial markets clearly turned away from Jordan in 2002 because of mounting uncertainties. Outside of Jordan, however, the region has not suffered dramatic downturns in financial flows directly as a result of the conflict.

In tourism, however, the Iraq conflict has had clear impact on countries neighboring Iraq. While in North Africa, the fall in tourism following September 11, 2001 had largely been reversed by 2003, with arrivals surging 4.5 percent, in contrast, the Middle East saw a notable slowing in arrivals in 2003, easing to 3 percent growth in the wake of a robust 15 percent gain during 2002.

[19] Although Syria is a net oil producer, it received oil at subsidized rates from Iraq which it re-exported at a profit.
[20] UN Comtrade data.

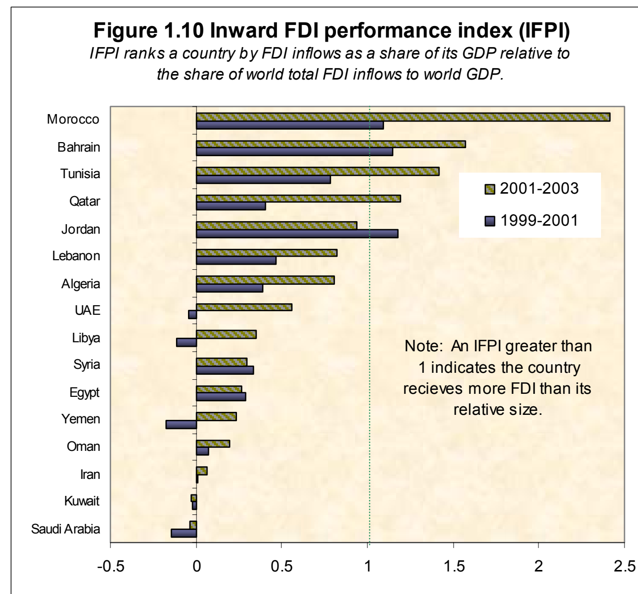
This was most apparent in Bahrain, Jordan, and Saudi Arabia, which posted substantial declines in tourist arrivals.

The Iraq conflict did not appear to have a strong influence on security spending throughout the region, despite the potential instability over 2003 and 2004. Statistics released by the International Institute of Strategic Studies put 2003 military expenditure in the Middle East and North Africa up just 4 percent from 2002, with expenditure currently accounting for 6 percent of GDP.[21] The evidence is supported by a lack of major procurement deals in the defense sector emanating from the region.

Most importantly, the negative economic impacts leading up to the war in Iraq had largely faded by 2004. Indeed, the MENA region posted stellar advances in tourism, with arrivals up nearly 24 percent for the Middle East and 17 percent in North Africa—both outstripping the 12 percent global rebound in the industry. Investment flows had staged a recovery in 2003 in the region, including Jordan[22], suggesting that uncertainty in the lead-up to conflict in Iraq and its influence on investor sentiment carried stronger effects on flows than did the war itself. Net portfolio inflows staged a strong recovery in 2004, as equity markets in the region posed double-digit gains. For most MENA countries, there has also been a relative upgrading—given world flows and the size of its economy—in the ability to attract capital flows, using UNCTAD's Inward FDI Performance Index (IFPI)[23] as a gauge. Reflecting the strengthening of inflows in 2003, contrasting the IFPIs during 1999-2001 with those for 2001-2003 suggests that the relative performance of most MENA countries improved. For countries directly bordering Iraq, however, the index deteriorated (Jordan, Kuwait, Syria), became less negative (Saudi Arabia), or rose only modestly (Islamic Republic of Iran). Among these, Jordan stands out—with an index above one during 1999-2001 and consequently falling abruptly during the latter period. IFPI rose for all other MENA countries not directly bordering Iraq, with the exception of Egypt (Figure 1.10).

Figure 1.10 Inward FDI performance index (IFPI)

IFPI ranks a country by FDI inflows as a share of its GDP relative to the share of world total FDI inflows to world GDP.



[21] MEES 2004a.

[22] FDI inflows rose sharply to a 3.8 percent share of GDP in 2003, and portfolio inflows returned to 0.6 percent of GDP by 2003. This strong rebound reflects the anticipation of growing business opportunities linked to Iraq's reconstruction, Jordan's locational benefits for foreign investors and the degree to which foreign business expect Jordan to reap gains as Iraq recovers.

[23] The Inward FDI Performance Index (IFPI) is calculated as: FDI inflow to a given country as a share of GDP, relative to world FDI as a proportion of world GDP. Hence, an index value greater than one indicates the country draws more FDI inflows relative to its size contrasted with the rest of the world. See World Investment Report, www.unctad.org.

1.4.4 Potential regional impact of Iraq's reconstruction and reintegration

It is difficult to overstate the scope of Iraqi reconstruction demands. The economic infrastructure has suffered the consequences of a long-standing war footing, if not active military engagement. The economy has been hindered by decades of corruption and economic mismanagement and burdened by over a decade of international sanctions. Growth is dominated by the oil sector, which has been largely run to the ground over the years. This coupled with the recent fighting and continued sabotage by the insurgency has led to large infrastructure requirements to maintain and expand capacity. With the potential for peace and stability, and as a new institutional framework and leadership for the country are established, there is opportunity for economic reform and a potentially rapid expansion of growth. Two scenarios of a low case and high case of the rise in Iraq's oil production over three years (for 2005 through 2008, from the base of 2004) indicate that cumulative oil export revenues could rise roughly in the range of between $20 billion to $50 billion over the three year period, providing a significant resource base for the reconstruction effort.[24]

As the Iraqi security situation improves and paves the way for much greater progress on the reconstruction front, positive economic spillovers are likely to extend throughout the region. Jordan, in particular, is likely to see a rise in Iraqi-related business activity. Iraqi and foreign firms are already establishing bases in Jordan due to security concerns in Iraq and are shifting some production activities to the country. This has generated strong gains in Jordan's re-exports and contributed to a rise in construction and housing demand. Jordan's re-exports grew sharply, by 48 percent in 2002 and by 20 percent in 2003. Jordan is also likely to benefit from rebounding trade. During the first quarter of 2004, *freight revenues* rose 40 percent, reflecting increasing trade and transport activity with Iraq, and exports to Iraq doubled in the first three quarters of 2004. Lebanon, as well, has witnessed a surge in freight volumes, increasing over the first six months of 2004 by 42 percent compared to the first six months of 2003, concurrent with an eight-fold increase in exports to Iraq.

The GCC countries—especially Kuwait and Saudi Arabia—are likely to benefit from a dramatically improved security situation and a rise in business activity in Iraq. Construction supply firms in Saudi Arabia should benefit from the reconstruction effort. Similarly, opportunities for increased regional banking should benefit Bahrain, in particular, which is likely to have a role in financing some of the reconstruction projects in Iraq. Significantly increased transit trade would also come to benefit Dubai in the United Arab Emirates.

Iraq's return to international markets could also sustain an expansion in trade with its proximate neighbors and further abroad, particularly as Iraq expands its oil production and achieves higher effective demand. Prior to the imposition of UN sanctions on Iraq in 1990, Kuwait exported 3.5 percent of its total goods trade to Iraq, and Saudi Arabia exported 0.6 percent of its total trade to Iraq. These ratios applied to Kuwait and Saudi Arabia's 2003 total exports represent over $660

[24] This assumes oil production rises from the 2004 level of 2 million bbl/day to a range of 2.8 million bbl/day to 3.5 million bbl/day, and applying the Bank's oil price forecast

million and $495 million, respectively—in turn equivalent to 1.6 percent and 0.3 percent of Kuwait and Saudi Arabia's 2003 GDP, respectively. These figures may offer a rough idea of the room for expansion in trade between Iraq and its neighbors. One initial indication that this process is beginning is the mid-December 2004 agreement on cooperation on a range of gas and oil supply and development projects between Iraq and Kuwait[25]. On the potential downside, should the reconstruction effort grind to a halt, the realization of prospective benefits will be delayed indefinitely and Jordan, in particular, will face adjustments due to a corresponding loss in some of its external demand.

1.5 Recent Changes to Intra-Regional Ties

An important development in the MENA region has been the increased strengthening of intra-regional ties, strongly heightened after 2001 and evidenced through financial flows and tourism, and to a lesser extent intra-regional trade flows. Investment flows originating from MENA largely backed-out of US assets over 2001-2003, in part as managers of burgeoning international reserve positions for the key MENA oil exporters sought returns in alternate markets and currencies.

[25] MEES 2004b.

Table 1.3: MENA oil exporters[/1] transactions in US financial assets (2000-2004)

Millions dollars	2000	2001	2002	2003	Jan-September 2004
Total US government securities	3,959	2,016	-1,921	-5,283	13,912
Treasury bonds and notes	3,482	865	-3,880	-6,913	1,659
US government agencies and GSEs	477	1,151	1,959	1,630	12,253
Total US private securities	10,754	2,975	-1,005	2,609	5,739
US corporate bonds	1,565	1,186	304	2,106	228
US corporate equities	9,189	1,789	-1,309	503	5,511
Total long term securities	14,713	4,991	-2,926	-2,674	19,651
Commercial and Banking Flows [/3]					*June 2004*
Net position with US non-banks ($mn)	1,740	1,664	3,096	2,138	1,128
Claims reported by US firms	1,104	985	897	1,046	1,207
Liabilities of US firms	2,844	2,649	3,993	3,184	2,335
Net flows with US non-banks[/4]	833	-76	1,432	-958	-1,010
Change in claims by US firms	-544	-119	-88	149	161
Change in liabilities by US firms	289	-195	1,344	-809	-849
					Sept 2004
Net position with US banks ($mn)	14,312	10,112	8,406	15,712	20,774
Claims reported by US banks	10,627	9,222	10,487	8,845	8,311
Liabilities of US banks	24,939	19,334	18,893	24,557	29,055
Net flows in banking	7,249	-4,200	-1,706	7,306	5,032
Change in claims by US banks	-4,875	-1,405	1,265	-1,642	-534
Change in liabilities by US banks	2,374	-5,605	-441	5,664	4,498
Net position with firms and banks	16,052	11,776	11,502	17,850	21,872
Net commercial and banking flows	8,082	-4,276	-274	6,348	4,022
Total flows in US assets	**22,795**	**715**	**-3,200**	**3,674**	**23,673**

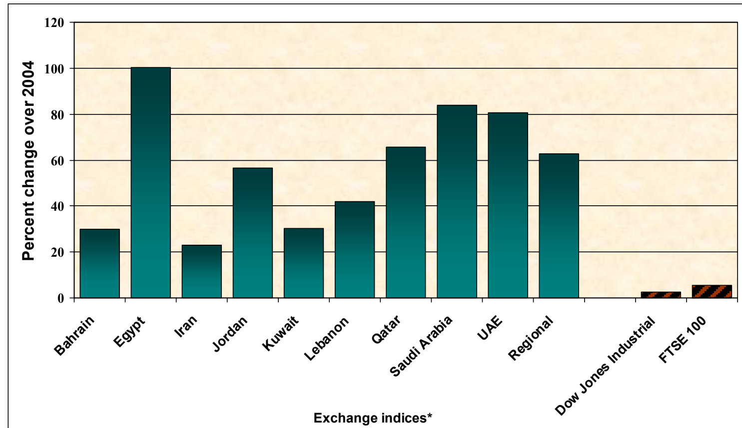
Source: US Treasury

Notes: /1 Comprised of Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.
/2 Positive sign connotes net foreign purchases or inflows to US; negative sign , sales or outflow from US.
/3 Positions (stocks) of claims and liabilities reported by US non-banking firms and commercial banks are stated at end year; the net position of MENA oil exporters with US firms and banks is calculated as US liabilities less US claims.
/4 Net flows represent the change in claims and liabilities reported by US entities; signs reflect the yearly change from the perspective of MENA investors (US liabilities minus US claims). Hence, they are not equivalent to balance of payments accounting methods.

The largest overall shift in financial flows was the apparent withdrawal by the major oil exporters of the region from investment in US assets between 2001 and 2003 (Table 1.3). Prior to 2001, the MENA oil exporters were investing between $18 billion and $25 billion per year in a mix of US government securities (Treasuries and US Agency bonds) and US corporate securities (bonds and equities), while channeling substantial funds through the US commercial banking system, as well as with US non-banking, commercial concerns. However, 2001 saw a net withdrawal of some $4.3 billion in commercial and banking flows, followed in 2002 and 2003 by substantial sales of

US long-term securities. Between 2001 and 2004, the proportion of deposits held in dollars declined from 75 percent in the third quarter of 2001 to 61.5 percent.[26]

Figure 1. 11
Stock market performance in MENA: 2003-2004



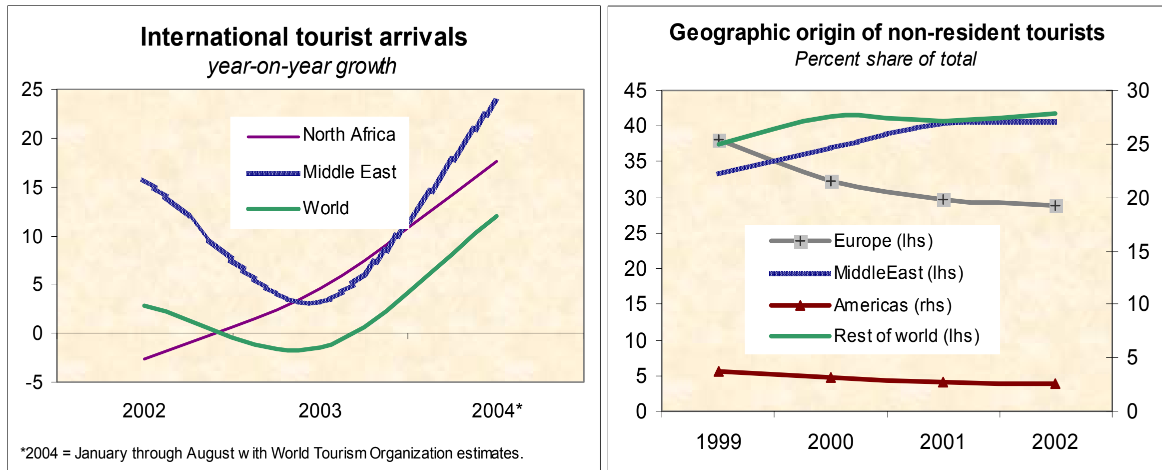
* Bahrain BSE, Egypt Hermes, Iran Tepix, Jordan ASE, Kuwait KSE, Lebanon BSI, Qatar DSM, Saudi Arabia TASI, United Arab Emirates NBAD, and the regional Shuaa Arab index.

While some of these assets may have been shifted to other parts of the world, the MENA region also appears to be a strong net beneficiary, experiencing a sharp rise in real estate and equity prices. Over 2004, Middle East markets rose by more than 60 percent, with strongest performance in Egypt and Saudi Arabia (Figure 1.11). Steeply rising markets have presented a lucrative opportunity for Gulf investors to diversify portfolios closer to home, creating a virtuous circle and fueling much of the stock market rise. Gulf investment in the Jordanian stock market, for example, now represents over 20 percent of the total. Gulf investors also have been active in the Cairo Stock Exchange where the devaluation of the pound has made Egyptian stocks cheaper to acquire[27].

This inward focus of the region has been echoed in the tourism sector, where along with the increased hesitancy of foreigners to travel to the MENA region there has been a similar reluctance of MENA citizens to travel abroad (Figure 1.12). Driven in part by a backlash to the imposition of restrictions in the US and in parts of Europe on the travel of Muslims (stemming back to the aftereffects of September 11), there has been a strong expansion in intra-Arab tourism, with tourist arrivals from within the region rising from 22.4 percent of total tourists in 1999 to 40.8 percent in 2002. This has greatly buffered the sharp declines in tourists from Europe, which fell nearly 10 percentage points, from 38 percent of total tourists into the region in 1999 to 29 percent in 2002, and from the US, from which arrivals fell from a far lower initial share of 3.7 percent of total tourists in 1999 to 2.5 percent in 2002.

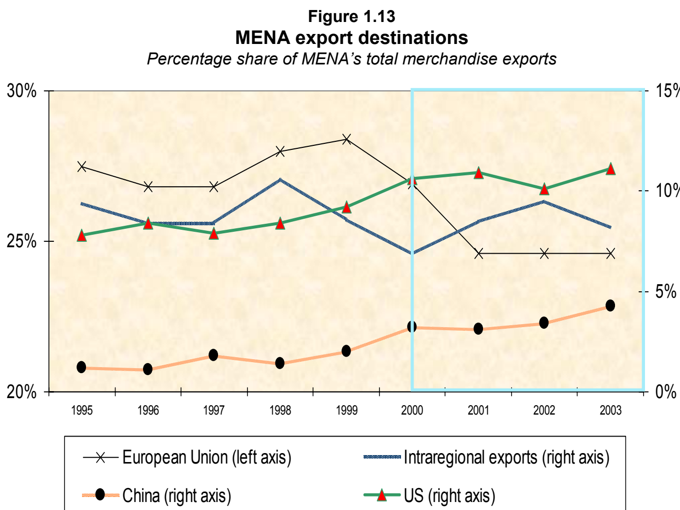
[26] Financial Times 2004.
[27] Oxford Analytica 2004.

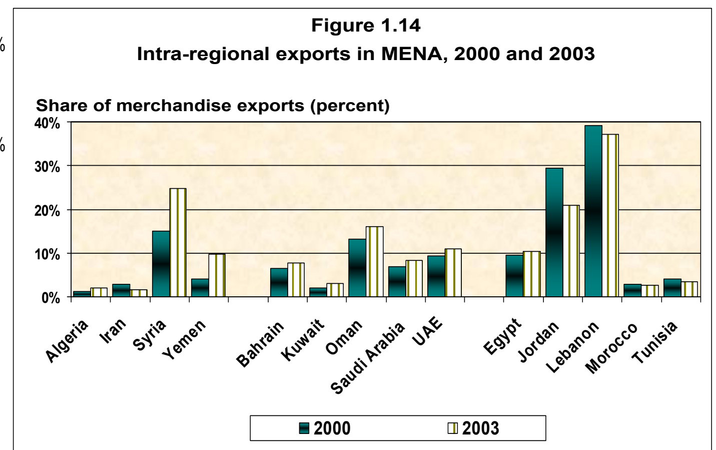
Figure 1.12: Tourism in MENA



Intra-regional trade, while largely unexploited, has gained some strength as well over the last few years. Merchandise exports directed to the region increased strongly between 2000 and 2002 (rising from 6.8 percent of total merchandise exports to 9.1 percent), as exports to Europe dropped sharply (Figure 1.13). While in 2003, the intra-regional share of exports had fallen back again (to 8.0 percent), this is primarily a reflection of sharply rising oil prices (with oil exports primarily directed outside the region and reflected in rising export shares to China).

At the country level, however, almost all of the MENA countries have exhibited a rise in the share of intra-regional exports since 2000 (Figure 1.14).





Figures Source: International Monetary Fund, Direction of Trade Statistics

1.6 Near-Term Outlook, Risks and Policy Challenges

Looking forward, MENA's growth is expected to moderate somewhat during 2005-2006. Industrial country output is expected to slow in response to higher interest rates, waning fiscal stimulus in the United States and Europe, and a maturation of the investment cycle (particularly in Japan and the United States). Higher global oil prices reduce disposable income available for other goods and services and are thus expected to slow global growth by between 0.2 percent and 0.5 percent over the period. The World Bank estimates that world GDP will slow from some 3.8 percent in 2004 to 3.1 percent over 2005-2006, while global demand for exports eases from 10.3 percent to 7.7 percent, respectively.

With the slower pace of world growth of output, global oil markets are expected to ease in the medium term but not immediately, given strong demand, capacity constraints, and OPEC's desire for higher prices. Oil prices are forecast to average $40/bbl in 2005, falling to $30/bbl later in the decade. As a result, the growth of government revenues and disposable incomes in resource rich MENA economies is expected to slow, and be reflected in slower consumption and investment demand. Under these conditions, GDP growth among the resource rich economies of the region is anticipated to ease from 5.5 percent in 2004, to 5.1 percent- and 4.1 percent in 2005 and 2006, respectively.

For resource poor, labor abundant countries, the direct impact of lower oil prices in the medium term may be moderately positive. However, the indirect effects flowing through regional linkages could temper these benefits. Of importance, economic conditions in Europe are seen to improve, with GDP growth firming toward a 2.5 percent pace. This follows a long period of sub par performance in growth (less than 1 percent during 2001-2002), reflected in stagnant domestic demand and little growth in imports.

The expiry of the WTO's Multifibre Agreement (MFA) in January 2005 will increase competition for dominant textile exporters Morocco, Tunisia, and Egypt[28], leading to potential export declines in that sector, with particular ramifications on female employment opportunities in a region where female unemployment is 50 percent higher than male unemployment[29]. Part of the negative impact of the MFA expiry may be mitigated with Egypt's agreement on qualifying industrial zones (QIZs) between the US, Egypt, and Israel, providing tariff free access for Egypt's apparel exports to the US[30]. Against this background of reduced textile exports but improved European export prospects, the resource poor, labor abundant economies are expected to enjoy modest improvement in export growth, leading to stronger gains in domestic demand over the near term. GDP is expected to turn up from 4.2 percent during 2004, toward 4.4 percent and 5.0 percent over 2005 to 2006, respectively.

---

[28] As well as the United Arab Emirates from the RRLI economies.

[29] ILO 2004.

[30] A similar agreement on QIZs between Jordan, Israel and the US buoyed textile exports dramatically, supporting the sector's 120 percent growth between 1999 and 2003, relative to 13 percent growth of overall exports.

Hence, growth for the MENA region, albeit below recent peak rates, is expected to be firm. Growth is projected to remain broadly stable in 2005 at 4.9 percent and to ease only moderately to 4.3 percent in 2006, still substantially above the regional average growth of the 1990s. Reflecting the importance of high oil revenues in the recent growth upturn, the slowdown will be concentrated among oil-exporting countries. Indeed, the resource poor, labor-abundant countries of the region are expected to see growth accelerate, reflecting improved export market growth and efforts to increase trade ties with the European Union.

Although the region's projected growth, averaging 4.6 percent in the next two years, is substantially stronger than the sluggish pace over the 1990s, this rate of growth will fall short of the rates needed to substantially improve the critical challenge of employment creation. With the labor force currently growing at 3.4 percent a year, the MENA region will require economic growth averaging between 6-7 percent a year, and for a sustained period of time to keep pace with labor market entrants.

Meeting this challenge will require broad-based structural reform to support alternative sources of growth outside of oil. While MENA's large and valuable oil reserves are clearly a strong point for the region, ensuring that oil revenues are well managed is a challenging task, both in terms of reducing vulnerability to oil price movements and ensuring that windfall revenues do not hinder the momentum of fundamental economic reforms for growth (addressed in Chapter 2).

Downside risks to the economic outlook center on a much more rapid decline in oil prices than anticipated, which would lead to a sharp fall-off in oil revenues. While a buffer of large reserve holdings and significant budget surpluses would ease the blow, a rapid decline would be a jolt to government spending programs in the resource rich economies of the region and could lead to challenging adjustments. The resulting reduced stimulus to the resource wealthy economies would translate into lower growth outturns. Correspondingly, significantly lower oil prices would ease the energy import burden for the region's resource poor economies, and, *ceteris paribus*, could lead to a rise in world demand. A further downside risk is the potential failure of the anticipated acceleration of growth in Europe to materialize, which would have a negative impact on the resource poor economies in particular as they seek to harness higher growth through their trade with European partners. A deterioration in investment sentiment also poses downside risks to growth, should this lead to a significant fall-off and/or outflow of funds from the region. Renewed interest in the region by investors of late—driven, for example, by the impact of high oil prices on the real economy, a downgrade of regional political risk, and the potential of Iraqi reconstruction—has supported the recent acceleration in regional growth.

Looking into the long term, assuming the path of oil prices is in line with the forecast, a significant down-side risk for regional resource abundant economies is failing to effectively utilize the current and projected oil revenues to contribute to diversification into non-energy sectors, which is key to supporting job creation in the region's resource abundant economies.

CHAPTER 2

OIL BOOMS AND REVENUE MANAGEMENT

2.1 Introduction

Much of the recent growth upturn in the MENA region has been the result of a tightening of the oil market and consequent rise in oil prices. In the past year, world oil prices have jumped by 30 percent to an average of $37.7/bbl. This has translated into a rise of 38 percent in oil export revenues for the MENA region.

The sudden rise in the price of oil over the last few years and the rapid accumulation of financial assets by MENA oil producers evokes memories of the oil price booms of the 1970s and 1980s. And with those memories emerge questions of what the fallout of this current oil boom will be – particularly whether the way the revenues have been managed has changed from past booms, and whether the current windfall revenues will slow the reform process.

Among oil exporting economies, there is evidence—given generally large fiscal and external surpluses—of the adoption of a more prudent spending stance compared to previous boom periods. For the labor abundant and labor importing groups, the net change in spending as a share of the net increase in revenues has averaged an estimated 18 percent and 27 percent, respectively, since the onset of the current boom in late-1999 through 2004. This compares to estimates of average spending of 76 percent and 47 percent for the RRLA and RRLI countries, respectively, from 1973 through 1978. Further, debt ratios have been reduced and international reserves have increased.

Although the rise in oil prices has primarily impacted MENA oil exporters, as in past booms, effects have spread throughout the MENA region through various channels, including increased tourism flows. Although there has been a strengthening of intra-regional links and a rise in both intra-regional tourism and capital flows to non-oil economies since 2000, compared with the booms of the 1970s, the transmission mechanisms for distributing the oil wealth to non-oil economies are far weaker, especially with regard to remittances and aid flows.

Rising oil prices have historically allowed the region to delay fundamental reforms. How the region utilizes the opportunity presented by enhanced oil revenues to advance structural reforms will ultimately determine the growth course along which the resource rich economies move.

In this chapter, the impact of the oil price shock on the MENA region is examined in terms of its relative size, its transmission channels throughout the broader region, and the manner in which windfall revenues have been managed. The chapter proceeds as follows. Section 2.2 reviews current oil developments, comparing the price rise and associated revenues with previous oil price booms. Section 2.3 discusses expenditure patterns during the present oil price boom, and section

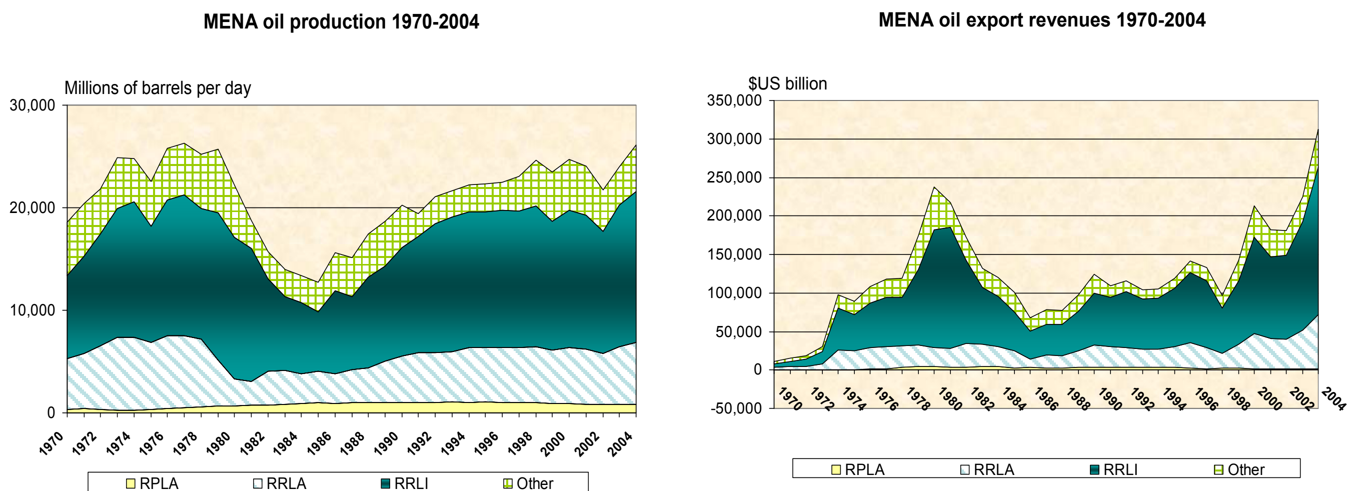
2.4 compares these patterns with prior oil booms. In section 2.5, the transmission channels to non-oil economies are discussed, while section 2.6 concludes the chapter by discussing key differences between oil exporters today and in prior periods, in particular with regard to initial conditions and the recognition of the need for structural reforms.

2.2 Overview of Oil Developments

World oil prices[31] averaged $31/bbl between 2002 and 2004 in constant dollars, about 50 percent higher than the $19.1/bbl average over the 1990s. Oil prices began their ascent over 2000, with the current dollar price increasing more than 50 percent over 1999 to $28.2/bbl, in part because OPEC producers sought higher prices for crude through production restraint. After dipping slightly in 2003-2004, prices jumped another 30 percent in 2004 to $37.7/bbl.

Several factors were behind the recent spike in prices, including unexpectedly large demand growth (particularly in China) and a number of supply constraints. This has translated into substantial windfalls for oil producers the world over. For the MENA oil producers, this dramatic rise in oil prices, combined with increases in production levels, has resulted in an increase in oil export revenues of 38 percent in the course of a single year, or close to $84 billion dollars (Figures 2.1a and 2.1b). Without a doubt, the oil price rise represents the single greatest economic shock to the region in the last three years.

Figure 2.1: MENA oil production and oil export revenues[32]



Source: World Bank data.

Source: World Bank data.

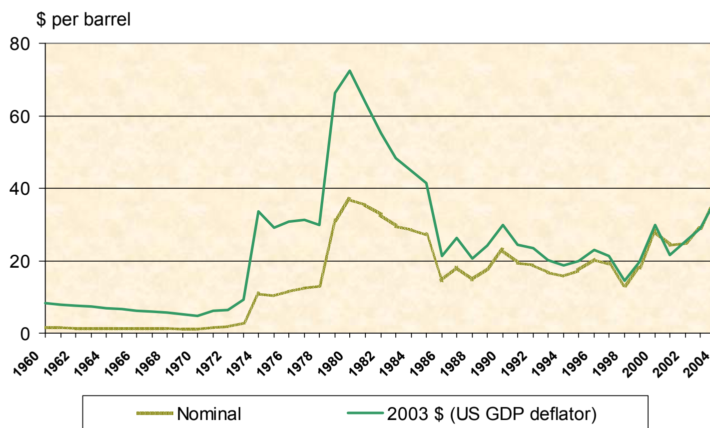
A strong boost in oil prices over the last five years and an accompanying increase in production have been the basis for exception growth advances in the MENA region. With this dramatic

[31] World Bank average price, which gives equal weighting to WTI, Brent and Dubai crude oil prices.

[32] Other includes Libya, Iraq and Qatar. RPLA oil exports emanate from Egypt.

upturn in growth come comparisons with the oil booms of the 1970s, booms that not only transformed the economies of MENA and spurred enormous advances in social indicators, but also preceded busts in oil prices that ushered in periods of economic stagnation. Despite the robust rise in prices, however, there are large differences between the current oil boom and the previous shocks of 1973 and 1979. To begin with, recent oil prices, when adjusted for inflation, have reached only a fraction of the prices arrived at in the early 1980s. Oil prices averaged about $37.7/bbl over 2004, about half of the average real price of 1980, and slightly lower than real prices in the late 1970s (Figure 2.2). In addition, the current boom has reflected a steady, upward trend in prices, rather than the dramatic surge in prices experienced in both 1973 and 1979.

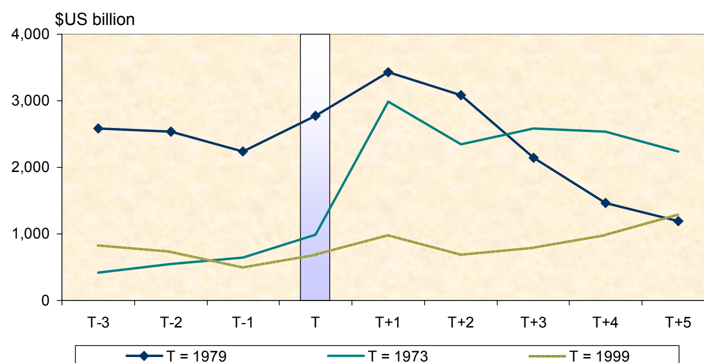
Figure 2.2: Oil prices 1960-2004



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

The size and nature of the oil price rise has been echoed in revenues. Current oil export revenues have not approached levels attained in either of the previous shocks. In the year prior to the onset of both the 1973 and the current boom, average per capita oil export revenues for the MENA oil exporters were roughly equivalent, at about $640 and $500, respectively (in constant 1995 US dollars). In 1974, oil revenues nearly quintupled (rose by 470 percent) to some $3,000 per capita. In contrast, the surge in revenues in the current boom resulted in a rise to only $900 per capita in 2000, just shy of a doubling (Figure 2.3).

Figure 2.3
Oil revenue paths during the 1973, 1979 and 1999 booms
Average oil export revenues per capita among MENA oil exporters (1995 $US)



Source: World Bank databases and staff estimates.

The most important feature of the current oil price boom, however, is the more positive feature that revenues have largely maintained a path of expansion and have risen (on average) in each year of the boom with the exception of 2001. This contrasts starkly with both prior booms. In the 1973 boom, after the initial fall-off in revenues to somewhat less lofty levels, revenues were flat (in per capita terms) if not declining marginally. In the 1979 boom, the short-lived—but spectacular—upswing in revenues was followed by a precipitous decline, ushering in a period of difficult economic adjustment for the region.

Box 2.1: Behind the recent oil price rise

Since the slump in prices following events of September 11th, oil prices (basis Brent) have nearly tripled to more than $55/bbl in mid-March 2005. Prices surged in 2004, mainly due to an unexpected demand shock, when world oil demand grew by 2.7 mb/d or 3.4 percent, the highest rate of growth since the 1970s. Much of this growth was in developing countries, with China's demand growing by 0.9 mb/d or 16 percent. Much of the growth in China was for diesel used in back-up generators for off-grid electricity. Nevertheless, there was relatively strong demand growth in all regions, driven by a record year of economic growth.

The rapid growth in demand required OPEC to raise production more rapidly than anticipated. In the fall of 2004, when oil prices first eclipsed $55/bbl, OPEC producers were near capacity for the first time in nearly 25 years. Refiners demanded light crudes to manufacture gasoline and gas oil—generating surplus heavy fuel oil. However, the spare crude oil production available for export was heavy, sour crude. This contributed to a large excess of heavy material in world markets causing prices for heavier crudes to trade at steep discounts to light crude oil.

In addition to much tighter physical markets, OPEC adopted a new policy following the slump in prices in 1998/99 of keeping commercial inventories low via production restraint in order to support higher prices. OPEC set a target of $22-$28/bbl for its basket of crudes. Since 2003, the basket price has been above this range, and OPEC formally abandoned the target in January 2005. A new band has not been set, but a new range or floor price is expected to be considerably above the previous band. The absence of a target has generated great uncertainty, as market participants do not know at what price level might provoke OPEC action.

Because of the uncertainty and tightening physical markets, oil futures rose substantially in 2004 and have surged in early 2005. Despite inventories and the market being in a more comfortable position than a year earlier, investors appear to expect that demand will outstrip supply. With limited spare capacity in production and refining, the market could be extremely vulnerable to a supply disruption all along the supply chain. Political problems in a number of producing countries (e.g., Iraq and Nigeria) add to the risk of disrupted supplies.

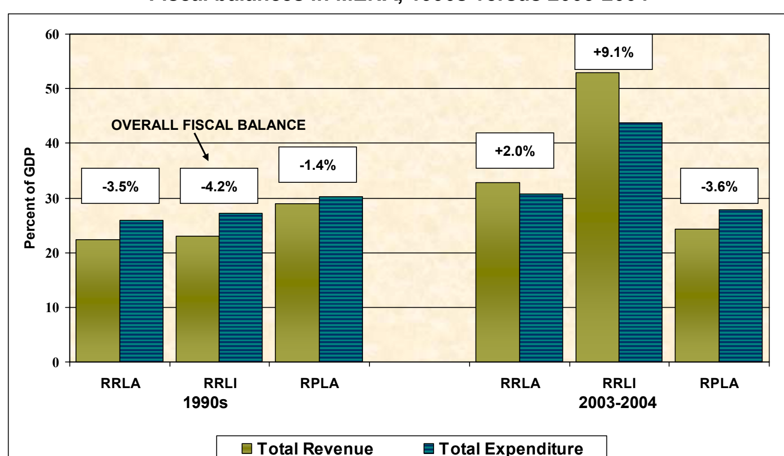
In a broader context, the boom in oil prices is part of larger boom in other commodity prices, including metals, coal, steel, iron ore, and other bulk commodities. The main driver has been exceptionally strong import demand from China. Following a lengthy period of low prices and underinvestment, resource commodities are in the midst of a sharp upturn of another cycle. It is uncertain how strong and lengthy the present cycle will endure, but the likelihood of an extended period of strong demand in China and other developing countries might result in higher prices and a more muted downturn during this cycle. In the case of oil, strong demand, capacity constraints, and OPEC's desire for higher prices will probably support a much higher level of prices going forward than was thought a few years ago. The current World Bank forecast has prices averaging $40/bbl in 2005, falling to $30/bbl later in the decade.

2.3 Expenditure Patterns under Present Shock

2.3.1 Recent fiscal developments

With the sharp upturn in oil prices, resource rich economies have benefited from a substantial rise in government revenues (Figure 2.4). Government revenues as a share of GDP increased to 32.8 percent for the resource rich and labor abundant economies over 2003-2004, and to 52.9 percent among the resource rich and labor importing economies, driven mainly by the dramatic increase in revenues from Saudi Arabia. Saudi revenues increased some 86 percent over the last four years alone, and as a share of GDP, revenues have almost tripled between the 1990s and 2003-2004, from 23.5 percent to 68.8 percent.

Figure 2.4
Fiscal balances in MENA, 1990s versus 2003-2004



Source: World Bank data.
Note: RRLA does not include Lebanon.

The strong growth of revenues has supported robust increases in expenditures. Among the RRLA economies, expenditures have risen from an average of 26 percent of GDP over the 1990s to 31 percent over the last two years, mainly toward current spending (Figure 2.4). Over the last three years alone, current spending rose by almost 5 percent of GDP, driven by strong spending pushes in the Islamic Republic of Iran and Algeria. Iran's increase in government spending accompanies the run-up to presidential elections, while Algeria's increased spending has been driven by large transfer payments and wages and salaries[33]. While capital spending as a percent of GDP has remained steady for the group, capital spending has increased over the last two years in Algeria, partly in response to reconstruction needs arising from a May 2003 earthquake. Among labor importing economies, meanwhile, expenditure increases have largely been limited to Saudi Arabia, directed toward a massive pay-down of debt and increased public welfare services and infrastructure spending, with the main beneficiaries being health and education.[34]

Despite an upturn in spending among the resource rich economies, a strong point of departure from prior oil booms has been the fact that fiscal accounts for the region have built into significant surplus, with the overall fiscal balance among oil exporters averaging 7.9 percent of

[33] Moreover, Algeria's spending increase does not fully reflect the large spending under the Economic Recovery Program (which is partially funded out of budget) and debt repayments (financed from the Oil Stabilization Fund, and outside the budget)
[34] MEED 2004c.

GDP in 2004, up from an average surplus of 3 percent of GDP over 2001 and 2002 and a deficit position averaging 3.5 percent of GDP over the 1990s. Despite the strong upturn in spending, compared with previous booms, the robust revenue increases have largely been saved, leading to a marked improvement in both fiscal and external balances.

Box 2.2: Oil stabilization funds in MENA

The importance of oil in the recent growth acceleration points to the systemic problem of high economic volatility in MENA, a result of being relatively undiversified and dependent on a few export markets or commodities which experience strong fluctuations in price. Oil prices, in particular, have led to sharp fluctuations in fiscal and external accounts. And, the ability of oil-exporting countries to effectively use oil revenues as a catalyst for stronger economic growth has been mixed.

Several MENA countries have employed the use of oil funds to both help manage the volatile and unpredictable nature of oil and natural gas revenues (which can lead to fiscal instability and can damage competitiveness in other tradable sectors) and to save for future generations. In the MENA region, the oldest fund is Kuwait's Fund for Future Generations which was established in 1976. It is reported to have accumulated around $65 billion at end-2003 (or the equivalent of over 155 percent of its 2003 GDP).[1] Funds in the Islamic Republic of Iran and Algeria have been created more recently, in 2000 and 2001, respectively, as well as in Qatar. The Islamic Republic of Iran's Oil Stabilization Fund was at $8.4 billion at the beginning of fiscal 2004, and Algeria's stabilization fund totaled $6.1 billion at end-2003. Oman's State General Reserve Fund was created in 1980 to save in anticipation of depleting oil reserves. The Fund's objectives have gone through several transformations, and it has often been used for budgetary purposes. Saudi Arabia, which does not have a fund, nevertheless is reported to have accumulated over $100 billion in foreign assets. The MENA region's funds are significantly less transparent than those in those in other regions. Consequently, it is not easy to assess their effectiveness.

Savings funds are designed to generate a store so that the benefits from depleting resource revenues can be extended to future generations. There is an inherent problem in calculating the long-run price which determines the portion to save for the future, and consequently price-setting rules have tended to change over time, opening the possibility for the reference price to be subject to political manipulation.

Stabilization funds have been developed to lower the impact of volatile resource revenues on the government and the economy, by smoothing expenditures flowing to the budget, i.e., saving during a revenue windfall and dissaving during a price slump. While resource revenues flowing to and from the budget might well be stabilized, the funds have no mechanism to limit government spending. The most critical period to restrain expenditure, and hence generate saving, is when prices and revenues are high, and without this restraint, the benefit of the fund may be limited. To smooth expenditures, therefore, requires additional fiscal policy decisions. During the current oil price cycle, MENA oil exporters have increased total expenditures by more than 13 percent of GDP (see Annex Table 2).

To further increase the effectiveness of these funds, all objectives, rules, management and operations should be transparent and shielded from political manipulation under law. Mechanisms should be in place to prevent misuse of funds. Independent auditing (financial and performance) and regular reporting of all operations (including inflows, outflows, and asset allocation) would further enhance public confidence and support of the overriding principles of saving.

For further information on oil revenue management, see Gelb et al 2003 and Gilbert 1995.

2.3.1 External balances

The other major point of departure with earlier periods has been external positions related to the boom. Boosted by both higher oil prices and volumes, hydrocarbon exports have surged by 75 percent from 2002 to 2004, leading to a sharp rise in the current account surplus and official reserves for resource rich economies. RRLI and RRLA economies are currently running current account surpluses averaging 13 percent of GDP among RRLA economies and more than 21 percent of GDP among RRLI countries in 2004 (see Figure 1.8 in prior chapter).

MENA oil exporters have significantly raised their reserves. Between 2000 and 2004, the RRLA countries increased their reserves-to-GDP ratio by 10.5 percentage points to 23 percent of GDP at end-2004, while RRLI countries have kept the ratio of reserve holdings to GDP largely stable. This strong accumulation in foreign exchange reserves during the current boom provides a substantial buffer for the external account, should oil revenues unexpectedly decline rapidly. In addition, the reserves build-up helps to keep the foreign exchange value of the domestic currency lower than it would otherwise be, helping to partially insulate MENA's oil exporters from the short run disturbances of Dutch disease.

2.4 Comparisons to Prior Oil Boom Spending Patterns

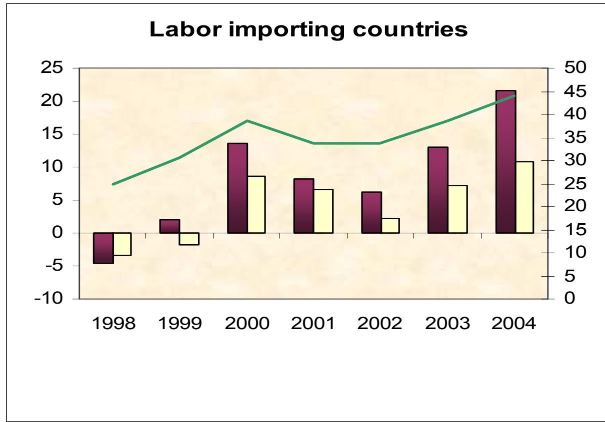
The build up of sizeable current account and fiscal surpluses by resource rich economies over the last few years contrasts sharply with performances during both 1973 and 1979 oil booms, where surpluses evaporated quickly following the shock. In the 1979 boom, a sudden huge spike in prices generated a sharp, if temporary, upswing in revenues that was quickly spent. The boost to external positions quickly dissipated and, despite the massive upswing in revenues, fiscal surpluses shrank in the case of the labor importing countries, or remained in deficit in the case of the resource rich labor-abundant countries. Similarly, during the 1973 oil boom, the large surpluses of oil revenues were also rapidly depleted by a ratcheting up of expenditures.

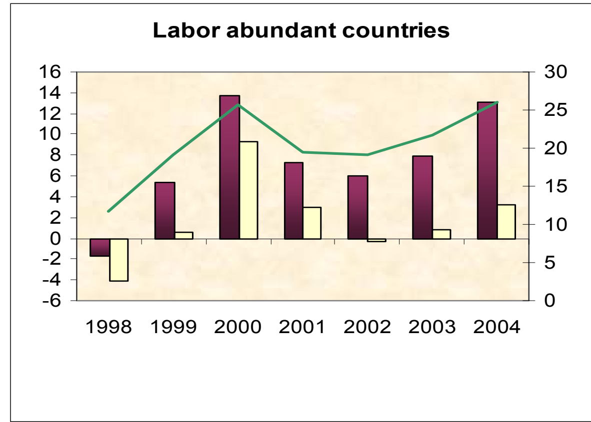
In the resource rich labor importing countries, current account surpluses equivalent to an average of 36 percent of GDP in 1980 evaporated within a few years and shifted to an average deficit of 2 percent of GDP in 1983. Their fiscal surpluses narrowed from 8 percent of GDP in 1980 (the first year of available data for the sub-region) to 0.8 percent in 1983. The current account of the RRLA countries posted a one-year 7.4 percent of GDP surplus in 1979 followed by deficits on the order of 2 percent and 3 percent of GDP in the subsequent two years. Economic disruption in the Islamic Republic of Iran, due to the 1979 Islamic Revolution and overthrow of the Shah, sparked a price shock and led to a rapid contraction in oil production. It explains the overall decline in export revenues for the RRLA countries during the 1979 boom period. On the fiscal side for the RRLA countries, given the large decline in oil production (particularly in Iran tied to the economic disruption of the Revolution), there was not a revenue boom per se. Given the compression in demand, due to various factors (revolution in Iran, high oil prices and production cuts, etc), the RRLA countries in aggregate experienced a large contraction in spending in 1979.

Subsequently, they did not witness the spending increases associated with large windfall oil revenues (Figure 2.5).

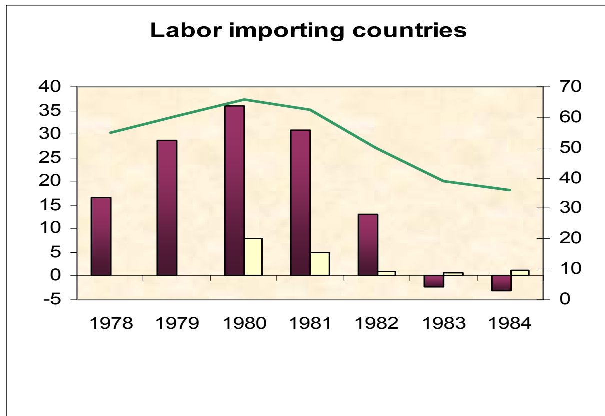
Figure 2.5 Oil windfall revenue management among MENA Oil exporters
percent share of GDP

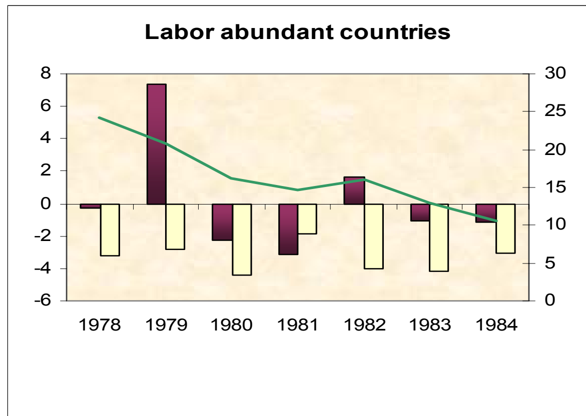
1999 boom



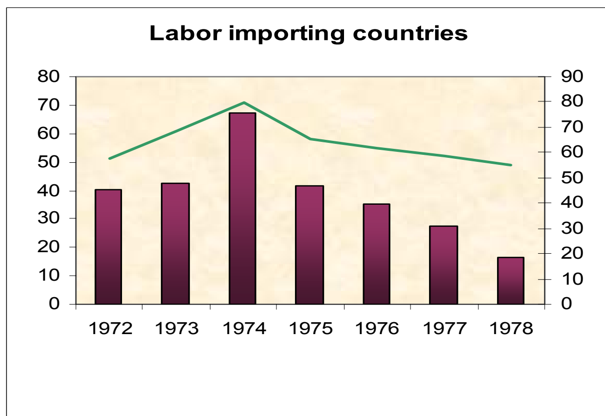


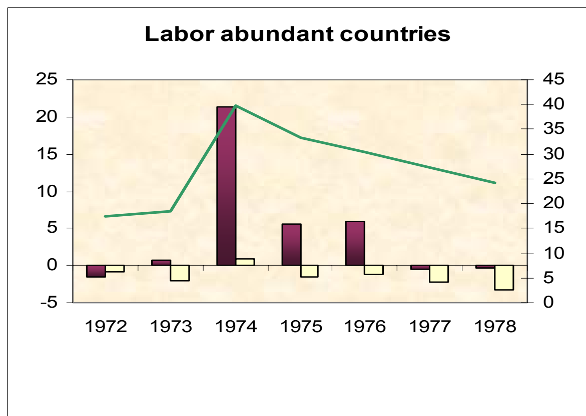
1979 boom*





1973 boom*





** Fiscal balance data for labor importing MENA countries not available until 1980.*

Current account balance (left)
Fiscal balance (left)
Oil export revenues (right axis)

The spending behavior during the 1973 boom was similar. In the case of the RRLI countries, despite a strong expansion in oil revenues, the large increase in the current account balance, from 42 percent of GDP in 1973 to nearly 70 percent in 1974, fully evaporated within a year. By 1976, the current account surplus declined to below the pre-shock level.[35] For the RRLA countries, the surge in the current account surplus to 20 percent of GDP was also short-lived, and the surplus shifted into deficit by 1977. Despite the high windfall revenues accrued during the boom, which extended from 1973 through about 1978, the RRLA countries posted a fiscal surplus of 1.0 percent of GDP in 1974, up from a deficit of 2.0 percent in 1973. This was followed by deficits of similar magnitude.

Comparing net changes in oil export revenues (relative to the base year, i.e., 1 year prior to the onset of the boom, or 1998, 1978 and 1972) with net changes in the current account balance gives a clearer indication of how much of the windfall revenue has been saved and of how much has been spent. During the current boom, roughly 25 percent of the additional export revenue has been spent. This compares with nearly 60 percent during the 1973 boom (Figure 2.6).

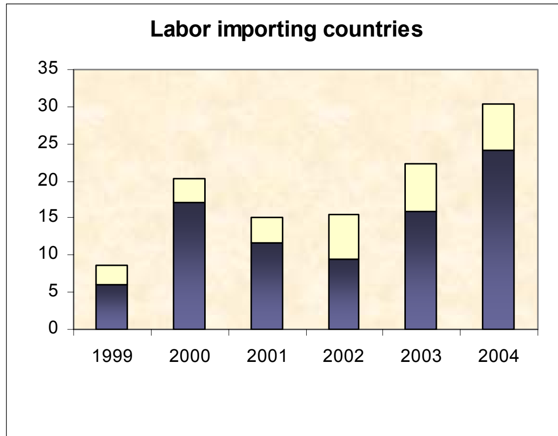
Thus, in many ways, MENA oil exporters are reacting to the current windfall revenues with a fair degree of prudence in comparison to previous booms. This is evidenced not only through relatively smaller spending advances associated with the oil windfalls, but also through a draw-down of external debt obligations across the board during the current oil revenue boom. Syria and Yemen, with the largest external debt obligations among the group (as a percentage share of GDP), have made substantial strides. They have reduced their external debt as a share of GDP by over 40 percentage points and over 35 percentage points, respectively, as of end-2002, compared with the ratios as of end-1998. Algeria and Oman have also made significant reductions in their debt-to-GDP ratios, of over 25 percentage points and over 22 percentage points, respectively, over the same time period.

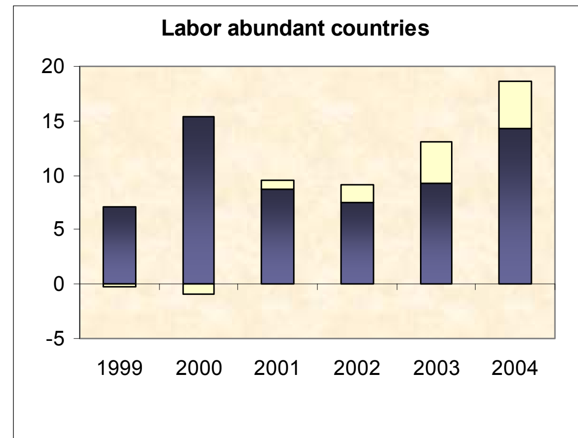
[35] Fiscal balances information is unavailable for RRLI countries until 1980.

Figure 2.6 Saving and spending breakdown of the net change in oil export revenues relative to base year.

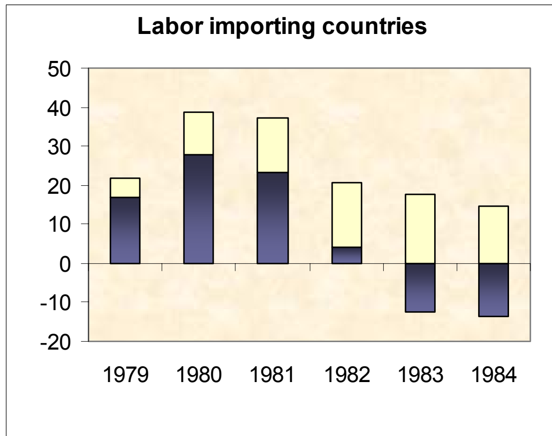
As percent share of GDP; Base year is one year prior to onset of boom (i.e., 1998, 1978 and 1972)

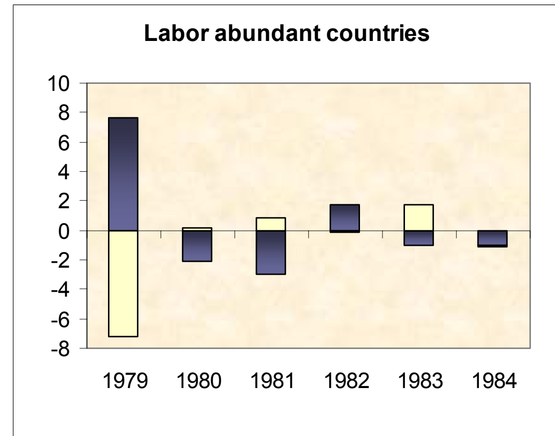
1999 boom



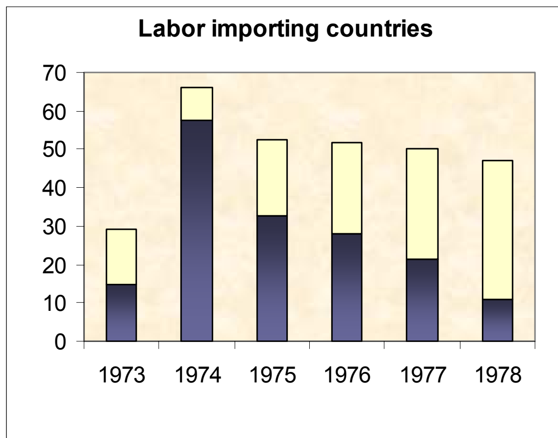


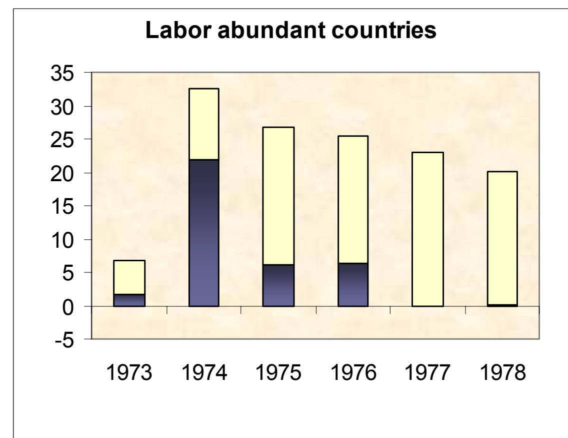
1979 boom





1973 boom





Net savings

Net spending

In part, this reflects the fact that the initial positions of the oil producers have substantially changed. The overhang from spending in earlier booms has in many ways guided current spending. During the two previous booms, the initial pre-boom debt-to-GDP ratios were not nearly as significant as they have since become, and in many cases debt-to-GDP ratios were at zero. Indeed, the oil booms (and/or discovery of significant oil reserves and a significant increase in exploitation) enabled a number of the countries to more easily access external financing and contract out debt. For example, the Republic of Yemen became a net exporter of oil first in the late-1980s, and Syria raised production significantly in the mid-1980s. Oman held no debt prior to the 1973 boom, but had accumulated nearly 20 percent, as a share of GDP, within a few years following the onset of the boom. The Islamic Republic of Iran also entered into the 1979 oil price boom debt free, but like Oman, held debt worth 7 percent of GDP within a few years of that boom. Syria significantly raised its external obligations during the two previous booms. And, Algeria raised its obligations during the 1973 boom, but succeeded in drawing down its external debt during the 1979 boom.

Table 2.1: MENA oil exporters: total stock of external debt*

(Percent share of GNI, increases in ratios are underlined)

	Pre-boom ratio			Difference in ratio 3 years after onset		
	1972	**1978**	**1998**	**1976**	**1982**	**2002**
Algeria	23.0	61.0	67.6	**12.1**	-20.8	-25.2
Syrian Arab Republic	13.1	20.9	153.7	**1.5**	**16.0**	-40.7
Iran, Islamic Republic	Na	0.0	13.9	Na	**6.6**	-5.9
Yemen, Republic	Na	Na	93.3	Na	Na	-35.9
Oman	0.0	24.1	46.0	**18.8**	-11.2	-22.6

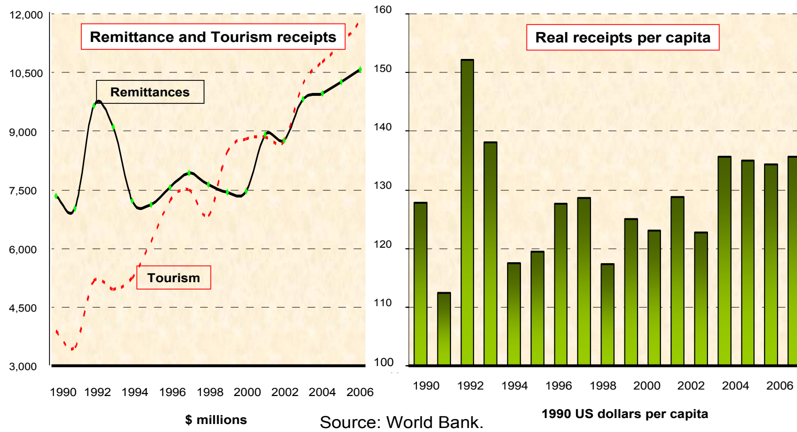
*Source: World Bank Debt Reporting System (DRS) database. *Data for Bahrain, Kuwait, Saudi Arabia and UAE not available.*

2.5 Transmission Channels of Oil Price Boom to Non-Oil Economies

As in past booms, the rise in oil prices has primarily impacted MENA oil exporters, but effects have spread throughout the MENA region through various channels. In the past, the accrual of oil revenues represented a key driving force for growth across the MENA region. Initially coming to benefit the hydrocarbon sectors of the oil dominant economies, the public sectors in these countries soon acted to intermediate growth impetus from the oil sector to the non-oil segments of the economy through increased current outlays, transfers and capital spending. In turn, a number of non-oil economies of MENA tended to benefit from three major sources. First, they received greater remittances from increased incomes of the expatriate labor force working in the major oil producers. Second, they received greater tourism flows, a result of increased incomes from citizens in oil producing economies. Finally, they took in flows of bilateral and multilateral aid from OPEC and Arab institutions. Moreover, intra-region investment flows, modest fillips to trade among MENA countries, and other elements (e.g. increased Suez Canal transit fees) served to spread the growth impetus more widely.

In the current oil price boom, there are some similarities with earlier periods. As noted in Chapter 1, there has been a strong expansion in intra-Arab tourism in the last years. This is partly in response to an increasing hesitancy to travel to Western destinations, but it is fortified by robust oil revenues among Gulf travelers (Figure 2.7).

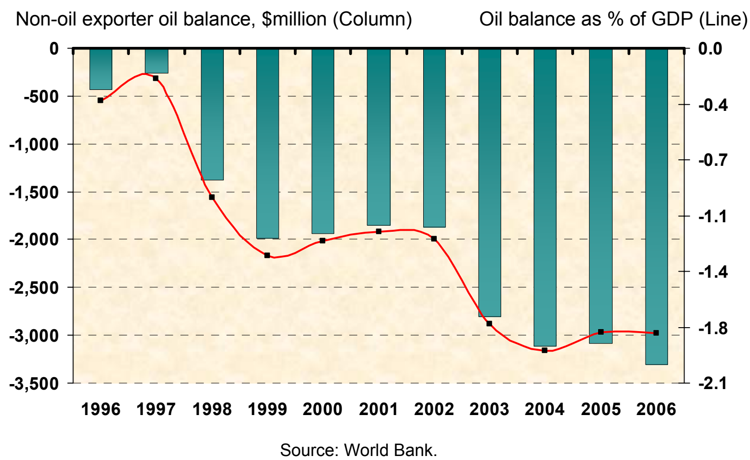
Figure 2.7
MENA non-oil economies tourism receipts



Source: World Bank.

At the same time, several important political and structural changes over the 1980s and 1990s have tended to alter the nature of the regional oil links. The modest increase in remittances to the non-oil countries reflects a desire on the part of the Gulf countries (GCC) to provide increased employment opportunities for citizens of their respective countries. This shift began in the 1980s and has continued through recent years. Also, beginning in the early 1990s, the expatriate labor force originating in the Levant, in Egypt, and to a degree, among the Maghreb countries, has given way to increased GCC importation of labor from South Asia and Southeast Asia. At present, the bulk of worker remittance receipts for the labor abundant countries in MENA now originate in Western Europe, where employment and wages have been stymied by a lack of economic growth over the last years. Thus, one traditional mechanism for transmission of growth impetus from the MENA oil-dominant economies to the non-oil economies of the region has diminished in importance. And when remittances (as well as tourism flows) are viewed in real per capita terms, the growth path following recovery in these flows during 2003 remains a sluggish 0.5 percent per year, offering less stimulus than in earlier episodes of high oil prices.

Figure 2.8
MENA non-oil economies oil balance



Source: World Bank.

Additionally, the boon to growth among MENA oil exporters from higher global oil prices has tended to exact a toll on external balances of the non-oil economies of the region. Due to the

recent escalation in oil prices, as well as medium-term changes in the volume of imports (and small-scale shipments) for the non-oil economies, a trend of deterioration in oil balances has worsened during 2004. Oil import bills increased 11 percent in 2004, widening the deficit to some $3.1 billion, or 1.9 percent of GDP for these countries, from a position of essential balance during 2003 (Figure 2.8).

2.6 Oil Management and Structural Reform

Oil producers in the region have exercised more prudence with windfall revenue management than in prior booms. This in part reflects a change of thinking over past decades in terms of economic direction. In virtually every oil-producing economy in the region, significant challenges in employment creation have emerged. With this challenge has come the widespread recognition that oil exporters need to move to alternative sources of growth and job creation by advancing structural reforms.

Traditionally, oil rents have been used to consolidate the role of the state—they have enabled centralization and preservation of the state's position. Now, at least notionally, all of the MENA oil exporters are in transition from large state-led economies to more private sector oriented economies in an effort to achieve greater efficiencies to improve economic welfare.

The region's great abundance of energy creates some limitations on profitable activities. To varying degrees for MENA oil exporting countries, particularly for the large exporters, their competitiveness in the production of oil limits diversification. That is, nothing else is as profitable. Despite these challenges, the MENA energy exporters can make advances by diversifying into service activities and by opening up their economies in order to gain access to larger markets. Services that have high locational benefits (enabling competitiveness) include tourism and transit facilities such as ports. By pursuing trade integration, countries can gain access to other markets and boost the returns to scale for producers, as well as boost consumer welfare by enabling access to cheaper products from abroad. Where absorptive capacity is higher—indicated by larger populations, greater ecological diversity, and arable land, such as in the Islamic Republic of Iran and Iraq—wage goods industries can be expanded, as larger populations allow producers to achieve required economies of scale to warrant the investments.

Box 2.3:
UAE's diversification into non-oil activities

Greater diversification enables an oil exporter to more readily mitigate some of the negative effects of oil price declines. The UAE has pursued a number of projects to reduce its dependence on oil, and since the 1990s, the Emirates have had marked success. As a share of total exports, non-oil exports have come to represent more than oil exports. They averaged 52 percent of total exports during the 1990s and into the early-2000s. This is up from an average of about 30 percent posted during the 1970s and 1980s. During the period from 1970-2004, non-oil exports as a share of GDP reached a low of 5.7 percent in 1975, but have subsequently risen to represent about 37 percent during the 1990s and early-2000.

UAE's diversification into non-energy trade
Percent (period averages)

	1970s	*1980s*	*1990s*	*2000-2004*
Share of total GNFS exports				
Non-oil exports	***31.9***	***29.5***	***52.4***	***52.3***
Oil exports	***68.1***	***70.5***	***47.6***	***47.7***
Share of GDP				
Non-oil exports	***29.4***	***17.5***	***36.6***	***36.7***
Oil exports	***62.7***	***41.7***	***33.2***	***33.5***

A third of the UAE's non-oil exports have a revealed comparative advantage (RCA) greater than 1 (indicating international competitiveness in the given export category). Although there is ample room for improvement to raise the ratio in the UAE, this is relatively high compared to other MENA oil exporters, such as Algeria, Kuwait and Saudi Arabia, where the share of non-oil exports with RCAs greater than 1 is estimated at zero (see Table 3.1 in following chapter).

The UAE has pursued diversification in a number of areas, including aviation, port facilities, tourism, finance and telecommunications. The Emirates have also increased integration through the pursuit of various trade and investment agreements within the region (GCC) and with the rest of the world (EC, US, China). In addition, they have established free trade zones, where foreign companies are allowed 100 percent ownership. In particular, the UAE's strong sea and air connectivity, supported by its free trade zones, make it the Gulf region's trade and transshipment hub. Air travel, freight turnover, and tourism revenues, in particular, have shown significant expansion over recent years.

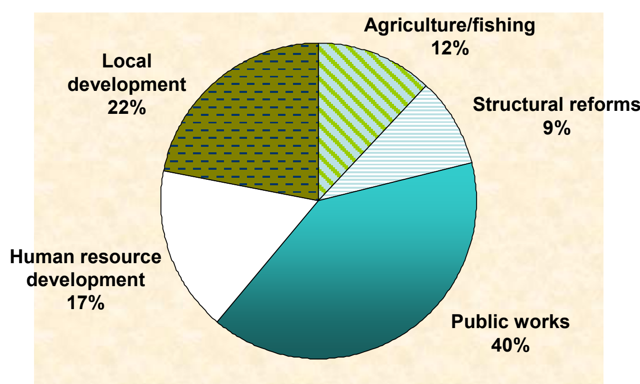
At least notionally, all of the oil producing economies espouse reform. Increasing integration with the rest of the world and within the region, as well as achieving greater diversification into non-energy economic activities, are being pursued to varying degrees to support the process of reducing the role of the state. Given recent high oil rents, money is available to finance adjustments engendered by the reform process.

However, oil also has provided breathing room for addressing many fundamental reforms. Saudi Arabia's windfall oil revenues have helped the country expand its subsidization to the private

sector to hire more Saudis.[36] The Saudi Human Resources Development Fund spent more than US$80 million to cover the costs of employing 10,000 Saudis in 2003, but only for a two-year period. The longer-term sustainability of these jobs is open to question.

An analysis of Algeria's expenditures between 2001 and 2004 under the Economic Recovery Program (ERP) reveals that only 9 percent was allocated to specific structural reforms, none of which actually came to fruition. A majority of expenditures went to public works (Figure 2.9). According to the National Statistics Office, unemployment in Algeria decreased, between 2001 and 2003, from 27.3 to 23.7 percent, largely owing to temporary employment related to the Economic Recovery Program, directed toward labor intensive housing, road and water projects to employ the growing jobless youth. The second ERP (2005-2008) is expected to create further temporary employment.

Figure 2.9
Allocation of resources towards Algeria's Economic Recovery Program



The question now is whether the current rise in oil prices will have a positive or negative impact on structural reform progress. As will be discussed in chapter 3, among oil producers, a few countries have made relatively strong progress with certain areas of reform. At the same time, however, there has been a distinct leveling off of reform momentum over the last two years in many oil-producing economies, concurrent with the dramatic upsurge in prices. The windfall revenues bestowed on oil exporters present a unique opportunity to make significant strides in structural reform, utilizing the vast oil resources to buffer many of the adjustment costs. How these resources are used will greatly determine the long-term growth prospects for the oil-producing economies.

[36] Middle East International 2004a.

CHAPTER 3

STRUCTURAL REFORM FOR LONG-TERM GROWTH

3.1 Introduction

Though oil prices have provided an enormous boost to MENA's growth over the last two years, the region's longer-term prospects depend on critical progress made in both consolidating macroeconomic stability for growth and transitioning to sustainably higher sources of growth and job creation. This progress depends upon the region's success in implementing broad-based economic structural reform.

Although MENA economies have improved their market orientation, in general they have not kept pace with worldwide progress. Reform has tended to be piecemeal and lacking in coherence. In general, the MENA countries have made substantial progress on reducing tariffs on trade, but tariff barriers in many MENA countries remain amongst the highest in the world.

In other areas of reform, the region has lost ground compared with the significant progress taking place worldwide. MENA's progress with reforming the business environment has been the weakest in the world. Even less progress has been made in improving governance in the region. Although the region can point to a few successes in improving the quality of public administration since 2000, in the area of public sector accountability, the region's progress has been the poorest in the world. Despite the fact that the region ranks at the bottom in terms of public accountability and has the longest reform path to travel, virtually no country improved its worldwide rank in this area, and virtually every county showed a marked deterioration relative to the progress occurring worldwide. As a result, the MENA region on average ranked in the 27th percentile worldwide in terms of progress in improving public sector accountability.

Although each area of structural reform is important in its own right, the lack of progress in this particular area of governance reform is of concern because of what it implies for a stronger reform effort in general. The international experience with structural reform suggests that where reforms have been successful, there have been strong coalitions for change. But the ability for coalitions to press for reforms depends on access to information to formulate choices, the ability to mobilize, and the ability to contest policies that are poor, all areas of governance in which the region ranks poorly worldwide and demonstrates limited progress. Moving the broader structural reform agenda forward will depend upon substantial improvements in this fundamental area.

3.2 Long-Term Prospects for Economic Growth

In 2003, the World Bank published four flagship reports – on trade and investment, governance, gender, and employment – which explored major development issues facing the region in the 21st century.[37] While MENA faces an extensive list of development challenges, these reports identify employment creation as the single most important development challenge over the coming decade. Close to 100 million new jobs will be needed over the next 20 years to keep pace with new labor force entrants and absorb the current unemployed. This means that the number of jobs in the region needs to double during that period, and this will require real economic growth rates averaging 6 to 7 percent a year for a sustained period of time – almost double the region's rate of economic growth over the 1990s, and even a third higher than the exceptional growth rate of the past year.[38]

The four reports shed light on what it would take for the region to be able to meet this extraordinary challenge, to be able to transition to an economic model that enables it to substantially develop its employment-creating growth potential. At its foundation, this structural transition will requires three fundamental and interrelated realignments: (1) *from closed to more open economies,* to create more competitive industries, benefit from international best practice, and gain access to new technology; (2) *from public sector-dominated to private sector-led economies,* providing the basis for improved efficiency and expansion of employment; and (3) *from oil-dominated to more diversified economies,* to reduce the region's dependence on volatile sources of growth, maintain fiscal stability, and preserve important social expenditures. Achieving this realignment requires interrelated policy actions on several fronts, including improved governance, particularly with regard to strengthening inclusiveness and accountability, as well as enhancing the inclusion of female labor in the private sector in order to increase the flexibility of the labor force and make better use of the region's talents.[39] The impact of such an integrated realignment is potentially very large. The four development reports put a conservative estimate of the increase to output growth per worker from actions on all fronts at between 2.5 and 3.5 percent per year[40]. This is an enormous potential boost to output per worker. Over the 1990s, output growth per worker in the region averaged less than 1 percent per year.

The importance of the region's success with this transition can thus hardly be overstated. The region's development is contingent upon the actions it takes on each of these fronts. Therefore, examining the region's efforts on the structural reform front is paramount to understanding the region's longer-term economic prospects.

---

[37] See World Bank 2003a, 2003b, 2003c, 2003d.
[38] Required economic growth calculated assuming an optimistic elasticity of employment growth to economic growth of 0.6 – the same employment elasticity exhibited by several the high-performing East Asian economies during the height of their employment generation.
[39] World Bank 2003c.
[40] World Bank 2003e.

Unlike monitoring economic outcomes such as growth rates, quantifying the progress in structural reform or measuring the precise contribution of a given policy action to a development objective is complex. Reforms often take time to result in measurable development outcomes. Moreover, each country has unique structural characteristics that affect development outcomes, so the same reforms may not lead to the same results. Each policy reform must thus be evaluated in conjunction with the state of other structural reforms.

Despite these difficulties, developing a set of measurable performance indicators in structural reform is essential for gauging growth prospects for the region as oil prices stabilize. Using a broad range of measures, structural reform progress indicators were constructed in three key areas of reform: trade orientation, business climate, and governance, based upon a country's change in worldwide rank with regard to a given structural feature. Utilizing these reform measures, we examined the region's progress in structural reform over the 2000-2004 period, relative to the progress taking place worldwide.

The chapter proceeds as follows: In section 3.3, the region's progress in the area of trade reform is examined, highlighting recent trade initiatives undertaken and measured progress in lowering import protection. In section 3.4, progress on the business regulatory environment is discussed. The section highlights recent efforts at liberalization and privatization, and measures progress in improving the business environment based primarily on measures from the World Bank's *Doing Business* indicators. In section 3.5, the region's progress with governance reform is discussed, both in terms of administration reform and in terms of improving public accountability. Section 3.6 concludes the chapter with a discussion of the region's overall progress with structural reform issues and priorities for the future.

3.3 Increasing Outward Orientation

One of the key elements for establishing new engines of growth and employment creation is an expansion of the region's outward orientation. A wealth of empirical literature indicates that economies with greater openness to international trade have higher rates of growth, as a result of both higher investment and sustained gains in factor efficiency.[41] Greater openness and trade are needed not only to achieve faster growth, but also to create more jobs and improve the knowledge, skills, and productivity of the work force.

3.3.1 Status of outward orientation in MENA

A recent World Bank report[42] highlights the degree to which the MENA region has missed opportunities for greater world integration. The growth of MENA's trade to GDP ratio has been lackluster, increasing by about half of the world's pace since the 1980s. The region's exports are dominated by oil, with only the small number of resource poor and labor abundant economies having fairly well-established non-oil export sectors (Figure 3.1). Few countries in the region have experienced the dynamic growth in non-oil exports that characterizes world trends. The

[41] Loayza and Soto 2003.
[42] World Bank 2003a.

entire MENA region, with a population close to 320 million, has fewer non-oil exports than Finland or Hungary, countries with populations of 5 and 10 million respectively[43]. The per capita volume of exports of the resource poor countries in the region is small relative to that of other countries. In Egypt, exports amount to just over $100 per capita. Morocco exports are about $260 per person. This compares with exports of over $570 per capita in Turkey, $1200 in Poland and more than $3400 in Hungary. There remains tremendous opportunity for growth. But at the same time, the costs of inaction and falling further behind are likely to rise as countries such as China, Russia and Ukraine provide more intense competition in the narrow product areas in which MENA non-oil exports are concentrated.

Figure 3.1 : Non-oil exports as a proportion of GDP, 1990 and 2003

Note: LMIC= average for all low and middle income economies, based on World Bank definition.

MENA's export structure remains highly compressed among a few export categories, and is highly vulnerable to trade shocks. The oil-exporting economies are particularly at risk. With the exceptions of Bahrain and UAE, the value of merchandise exports in the top four categories[44] among oil producers accounts for more than 90 percent of total merchandise exports – more than double the averages of comparator countries in other regions (Table 3.1). Even among diversified exporters, the region is characterized by a large share of exports concentrated around a few export

[43] Muller-Jentsch 2005
[44] At the 3-digit ISIC customs level (with approximately 35 merchandise export categories in total).

categories relative to international averages. This subjects the MENA region to greater potential export and output growth volatility as a result of commodity price or world demand shocks.

Table 3.1: Export diversification and competitiveness, 2003

	Proportion of exports from top 4 export categories	Share of non-oil exports in which RCA>1	Average RCA outside of oil sector[45]
MENA	**88.2**	**41%**	**2.5**
Algeria	98.5	0	0.1
Bahrain	80.9	71	3.4
Egypt, Arab Republic	46.7	65	2.1
Iran, Islamic Republic	92.6	29	0.5
Jordan	68.3	84	5.2
Kuwait	97.5	0	0.3
Lebanon	43.7	60	3.1
Libya	99.5	0	0.3
Morocco	56.4	74	4.7
Oman	94.8	3	0.3
Qatar	97.9	0	0.5
Saudi Arabia	96.8	0	0.6
Syrian Arab Republic	84.8	66	2.7
Tunisia	56.9	72	7.1
UAE	72.4	30	0.9
WBG	80.6	..	..
Yemen, Republic	96.7	15	1.2
Europe Central Asia	**32.8**	**72**	**1.9**
Czech Rep	28.8	80	1.5
Hungary	36.8	63	1.4
Poland	26.6	71	1.5
Turkey	40.7	72	3.1
Latin America Caribbean	**43.9**	**74**	**2.8**
Argentina	64.7	68	4.6
Brazil	41.2	70	3.4
Chile	66.8	88	8.0
Mexico	38.2	75	1.4
East Asia Pacific	**41.6**	**73**	**2.1**
China	39.2	78	2.1
Indonesia	35.4	61	1.7
Korea	41.7	68	2.7
Malaysia	59.9	65	1.7
Thailand	35.3	74	1.6

RCA = revealed comparative advantage.
Source: Staff estimates from COMTRADE TRAINS database.

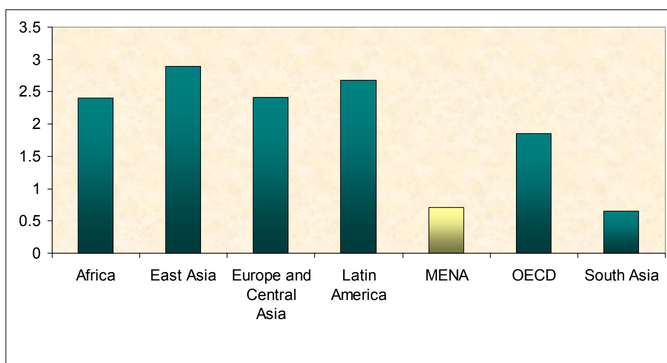
MENA exporters have not demonstrated comparative advantage outside of oil, as measured by the *revealed comparative advantage* (RCA) statistic (Table 3.1).[46] Only a handful of diversified

[45] Weighted by exports.
[46] Calculated at the product group level, the RCA measures a given country's exports of product *x* as a share of its total exports, relative to the world exports of product *x* as a share of total world exports. Where the RCA exceeds 1, the country in question can be said to have a comparative advantage in producing that product group, in that it can produce that good less expensively (relative to the other goods it produces) than the rest of the world, on average.

exporters, such as Jordan, Morocco and Tunisia, have developed non-oil export niches (with a high proportion of total exports in sectors with revealed comparative advantage, on par with the successful exporters in other regions). Oil exporters, by and large, have not found these alternative export niches, with non-oil exports scattered among product groups in which the economies do not demonstrate strong comparative advantage. A few exceptions exist, notably Bahrain and, to some extent, the UAE.

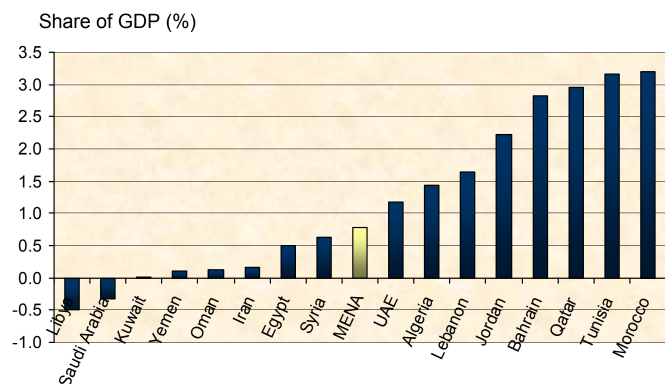
The region's low level of integration is also reflected in the ratio of net FDI inflows to GDP (Figures 3.2a and b), which averages only a third of the average level achieved worldwide, this despite moderate increases over the last few years (noted in chapter 1). This weak exposure to foreign investment denies the region of potential efficiency gains from advanced management skills and technology.

Figure 3.2a: FDI inflows as a share of GDP 2003*



•Or closest year available.
Source: World Development Indicators.

Figure 3.2b: FDI as a share of GDP, 2002-2003



Source: UNCTAD and WDI

The World Bank's recent trade report [47] provides a comprehensive assessment of the obstacles to MENA's greater integration into the world economy. Among them, protection remains high relative to countries elsewhere in the world. In addition, non-tariff barrier (NTB) coverage is still widespread. While the Gulf economies and Lebanon are relatively open, the majority of countries maintain protective import structures, primarily through tariffs. In addition, behind-the-border constraints to trade are considerable. Transport, logistics, and communication costs are high, raising the cost of trade. Exchange rate management has also played a role in discouraging non-oil exports, with currency overvaluation hurting competitiveness. Finally, the overall business climate has played a role in hindering investment in potential export-oriented industries (discussed in section 3.4).

[47] World Bank 2003a.

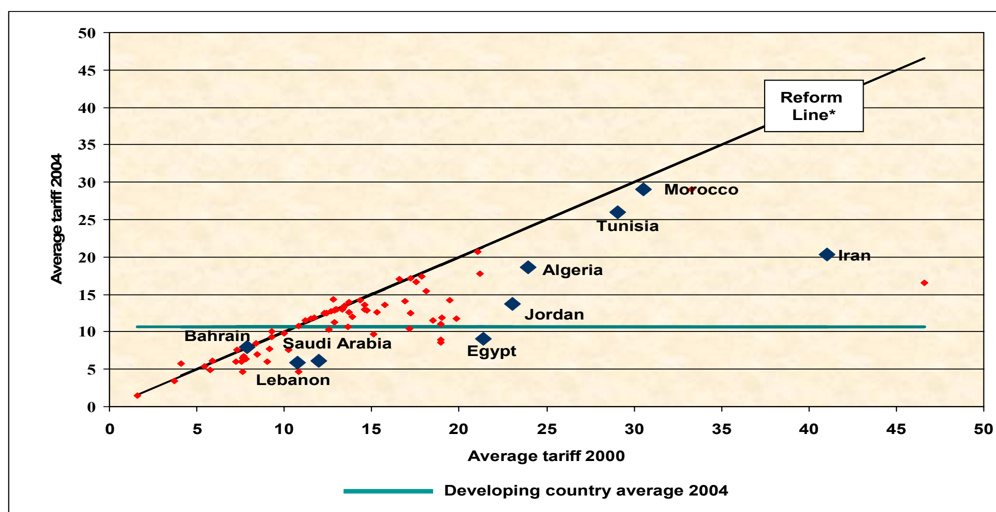
3.3.2 Developments in trade reform

In the last several years, bilateral and regional trade accords have proliferated in MENA, utilized as the primary vehicle for pursing expanded trade. Starting in the mid 1990s, the region sought to strengthen trade ties with Europe through Euromed and eventually EU Association Agreements on preferential trade (currently in force in Jordan, Egypt, Algeria, Lebanon, West Bank and Gaza, Tunisia, and Morocco, with an agreement signed by Syria in 2004). The region has also aimed to heighten regional trade through various agreements, including the Pan-Arab Free Trade Agreement (PAFTA), the Agadir Agreement (signed by Morocco, Jordan, Tunisia, and Egypt in 2004), and the GCC's customs union implementation in 2003 pursuant to a long-standing unified economic agreement. In addition, several countries have signed bilateral free trade agreements with the United States, including Jordan in 2000, Morocco in 2003, and Bahrain in 2004 (the first among the GCC). Other GCC countries are due to start talks with the United States this year, including Oman and the UAE.

Motivated in part in the context of these agreements, several MENA countries have made notable progress in trade and tariff reform. Since 2000, there has also been progress in several countries with dismantling of non-tariff barriers to trade (including Egypt, the Islamic Republic of Iran, Morocco, and Tunisia). Observable declines in simple and weighted average tariffs have occurred in Algeria, Egypt, the Islamic Republic of Iran, Jordan, Lebanon, Morocco, Tunisia, and Saudi Arabia. The most significant tariff reforms occurred in Egypt and Iran. Following the swearing in of a new cabinet in July 2004, Egypt reduced the number of tariff bands, annulled import fees and surcharges incompatible with the GATT, and instituted strong tariff rate cuts on most imports, resulting in a decline in average tariffs from 21 percent to 9.1 percent between 2000 and 2004. In Iran, strong tariff reform efforts resulted in simple average tariffs declining from over 40 percent to about 20 percent between 2000 and 2004. Overall, simple tariffs in the region declined from an average of 22 percent to slightly more than 15 percent, a 30 percent decline in the tariff rate and well above the 19 percent decline observed in the developing world. However, once the key reformers, Egypt and Iran, are excluded then average MENA tariffs fell by little more than the world average reduction, given the maintenance of a relatively high absolute level of tariffs in a number of MENA countries.

The differential progress across countries in tariff reform is evident in Figure 3.3, which compares the average tariffs worldwide in 2004 with those in 2000. By design, the diagonal line separates reformers, those that had lower tariffs in 2004 and lie below the line, from the non-reformers, those that had the same or higher tariffs in 2004 and lie on or above the line. From this figure, it is clear that most, but not all, MENA countries have reduced tariffs since 2000. Nevertheless, a number of MENA countries continue to have extremely high average tariffs relative to other developing countries. The horizontal line, at just under 11 percent in 2004, shows the current average tariff for developing countries as a group. Five of the nine MENA countries for which tariff data is available for both periods continue to maintain average duties above this level.

Figure 3.3
Unweighted average tariffs in MENA versus the world
2000 and 2004



Source: TRAINS database. Note: * Countries below and to the right of the line can be considered "reformers" in that they lowered the average unweighted tariff.

In addition to tariffs, non-tariff barriers are an important feature of trade policy in MENA. Table 3.2 presents a measure of trade policy that provides for a more consistent comparison of tariffs across countries and incorporates the impact of core NTBs (such as quotas, import prohibitions, variable levies and anti-dumping duties). This overall trade restrictiveness index (OTRI) suggests that, in a number of MENA countries, trade policy is highly restrictive and that NTBs are an important element in constraining imports. High tariff countries tend to apply restrictive NTBs. One should note, however, that the value of the index for Egypt does not reflect recent tariff reforms. With the exception of the Gulf countries, the restrictiveness of trade policy in MENA countries is typically twice as high when NTBs are taken into account than when only tariffs are considered. Countries that are reducing tariffs need to focus on reducing the impact of NTBs. Often these barriers are highly pernicious. They are not transparent or predictable, and therefore strongly suppress trade and investment. Finally, this index reinforces that certain MENA countries, Morocco, Algeria and Tunisia in particular, have trade policies that are among the most restrictive in the world today.

Table 3.2
Overall trade restrictiveness index (OTRI) for MENA and other developing countries, 2001

Country	OTRI-tariff	OTRI-w/NTB
Algeria	16.3	46.5
Bahrain	8.2	8.8
Egypt	44.0	67.8
Jordan	12.7	24.4
Lebanon	5.5	14.2
Morocco	25.4	50.9
Oman	10.1	15.6
Saudi Arabia	6.7	10.8
Tunisia	24.9	36.7
Chile	6.8	11.5
Czech Rep.	4.0	5.0
Estonia	1.1	2.3
Hungary	6.1	11.3
India	30.0	39.9
Kenya	13.7	14.4
Poland	10.8	15.2
Romania	11.9	15.8
South Africa	7.2	8.9
Australia	4.7	11.6
Average for all OTRI countries	***10.7***	***18.1***

Box 3.1: Measuring structural reform

Structural reforms entail measures that, broadly speaking, change the institutional framework and constraints governing market behavior and outcomes.[1] Measuring reform is a complex process. A wealth of literature on measuring structural reform provides a broad range of policy and outcome-based measures, several of which we have utilized in our analysis of reform in MENA.

Even with a set of structural reform indicators assembled, there is still the issue of how to measure reform progress. A variety of approaches to measuring change exist, each with their own merits and limitations. Our measure of structural reform progress was based on the concept of ranking. To the extent that we believe there are measurable structural features of the economy important for growth, countries can be *ranked*. Be it the average level of tariffs that prevail on imports, or the minimum capital requirements for setting up a business, there are inherently "better" values and "worse" values, and as such, there is an order in which we can place countries to describe where they stand with regard to these important structural features. This ranking is convenient, as it provides a straightforward and natural signpost for evaluating reform progress. If we are interested in the progress a country is making relative to other countries with regard to a certain structural reform feature, an obvious milestone would be to determine if the country has changed its rank.

With that thinking in mind, for each indicator, structural reform progress was estimated as the change in each country's rank between periods, expressed as a point in the relative cumulative frequency distribution (100 being the highest value, representing the greatest change in rank over the period). Composite indices of structural reform were also constructed, to measure the progress in the broader areas of governance reform (both in public administration and in public accountability), and business regulation (in five areas of regulation, financial development, and legal frameworks). Each composite index was constructed by taking the average of the relative cumulative frequencies for underlying indicators, expressed itself as a relative frequency for ease in interpretation. Thus, a composite index score of 100 can be interpreted as having made the strongest progress in terms of change of rank across a broader set of structural reform measures.

An alternative proxy for structural reform progress could be evaluated as the value change in the indicator itself (either in absolute terms, or relative to its starting value), but we have chosen the rank-change methodology for a number of reasons. To begin, for each indicator, the methodology chosen will minimize the influence of extreme values. For example, it minimizes the penalty that is applied to "good" countries in which the possibilities to improve an indicator's value is limited. Countries in which there is no minimum capital requirement to start a business, for example, can make no further progress in this area of reform. In a world in which the majority of countries are reducing minimum capital requirements, these top-ranked countries would be judged to be moving the least in this area of reform under a simple value-change approach, and they would be ranked as the poorest performers worldwide. Under our methodology, however, these countries would be more accurately judged as having exhibited no change in rank, placing them worldwide somewhere between countries that have moved up in rank and countries that have moved down in rank.

Secondly, this methodology has the advantage of allowing aggregation across variables which have different measurement units and distributions. Certain reforms are more difficult to achieve than others, and important information is lost by simply averaging across underlying indicators the unit or percentage change in values. Under the methodology adopted, since reform (measured through any indicator) is evaluated relative to a worldwide distribution, this important information is preserved, and it is thus possible to aggregate across different variables.

[1] IMF 2004b.

3.3.3 Quantifying the progress with trade reform

Judging trade reform is complex, and inherently there will be limitations with any methodology chosen. Many trade policy actions – such as signing onto regional trade agreements – cannot be compared across countries in any quantifiable way. Other indicators of trade reform which can be compared across countries (such as the Overall Trade Restrictiveness Index) are only just becoming available (thus it is not possible to evaluate progress).

Despite these difficulties, it is possible to get a sense of the MENA region's relative progress with trade reform (relative to world progress) using the single trade policy indicator for which widespread and reliable information is available: unweighted average tariffs. There are clearly limitations from attributing too much to a single indicator, but it sheds light on at least one important element of trade policy relative to the world. Using the methodology described in Box 3.1, Table 3.3 presents where MENA countries currently stand in a worldwide ordering of countries based on their simple average tariffs, along with their tariff reform progress over the last four years.[48] Both are expressed as cumulative frequency distributions, with higher values indicative of better current tariff policy (lower tariffs) or stronger tariff reform progress.

Table 3.3: Structural reform progress: trade reform

Country	***Current trade policy****	***Reform Progress*****
Algeria	5	66
Bahrain	65	34
Egypt, Arab Republic	60	100
Iran, Islamic Republic	4	76
Jordan	20	86
Lebanon	81	87
Morocco	1	49
Saudi Arabia	76	88
Tunisia	1	49
MENA	**35**	**71**
Sub-Saharan Africa	*29*	*21*
East Asia and the Pacific	*55*	*49*
Europe and Central Asia	*72*	*64*
Latin America and Caribbean	*49*	*56*
OECD	*93*	*67*
South Asia	*25*	*43*
LMIC (excluding MENA)	***38***	***63***
World	***50***	***50***

Notes: *Current trade policy reflects country's current placement in a worldwide ordering of countries based on their simple average tariff, expressed as a cumulative frequency distribution, with 100 reflecting the country with lowest average tariff (worldwide) and 0 reflecting the country with the highest average tariff (worldwide). ** Reform progress reflects the improvement in a country's rank between 2000 and 2004 in a worldwide ordering of countries based on the simple average tariff, expressed as a cumulative frequency distribution, with 100 reflecting the country which exhibited the greatest improvement in rank and 0 reflecting the country which exhibited the greatest deterioration. LMIC = Lower middle income economies, defined as countries with gross national income per capita between US$765 and $3,035 in 2003.

[48] Reflecting their improvement in country's rank between 2000 and 2004 in a worldwide ordering of countries based on the simple average tariff.

Based on this reform index, two-thirds of MENA countries were ranked above the 50th percentile[49] in terms of progress with tariff reform, relative to the world, and more than half ranked above the 75th percentile. Progress has been especially strong in a few countries, including Egypt (ranked in the 100th percentile, having improved its worldwide ranking by the greatest number of places, a result of the significant tariff reform undertaken in late 2004), Jordan (86th percentile), Lebanon (87th percentile) and Saudi Arabia (88th percentile). On average, MENA economies rank in the 71st percentile with regard to tariff reform, higher than the average progress exhibited in every other region of the world.

At the same time, it must be noted that in a worldwide ordering of countries based on their prevailing simple average tariff, MENA remains among the most trade-restrictive regions of the world (reflected in the current trade policy in the region ranking, on average, in the bottom 35 percent of countries worldwide, only higher than Sub-Saharan Africa and South Asia). Countries like Algeria, which made modest reductions in tariff rates over the last four years, still rank in the bottom 5 percent of countries in terms of tariff protection. Even Jordan, which made strong progress in tariff reform over the last four years, remains in the bottom 20 percent of countries worldwide in terms of its tariff protection. Thus, despite relatively strong progress, much work remains to be done.

Box 3.2: Regional leaders in tariff reform

Between 2000 and 2004, Egypt and Saudi Arabia made the strongest progress region-wide in terms of tariff reform. At the beginning of this decade, Egypt's tariff policy was among the most restrictive in the world, and the country ranked in the bottom 10 percent of all countries in terms of its simple average tariff on imports. Undertaking broad-based trade reform in the summer and fall of 2004, Egypt has reduced its simple average tariff from 21percent to about 9 percent. Where in 2000, Egypt ranked 80th of 87 countries in terms of the average tariff rate, by 2004, it ranked 35th. This progress puts Egypt at the top of the list in terms of improving its worldwide rank in relation to average tariffs.

Saudi Arabia, on the other hand, entered the decade with more moderate tariff protection. Average tariffs have been reduced from about 12 percent in 2000 to about 6 percent in 2004. In 2000, Saudi Arabia ranked in the middle of countries worldwide in terms of the average tariff rate (39th out of 87 countries), but the reduction in the average tariff to 6 percent places the country 21st in a worldwide ranking of average tariffs. This improvement of 18 places puts Saudi Arabia in the 88th percentile worldwide in terms of tariff reform progress over the period.

Even with the region's relatively strong progress, a fundamental question remains how the region's trade policy will impact its actual trade outcomes. The region's reliance on regional trade accords does not, for example, guarantee that trade will be expanded. What matters is the design and implementation of these agreements. The most important ingredient for success is low trade barriers with all trade partners. In addition, agreements that minimize excluded products expand the scope for positive impacts. As we have seen above, many countries in the region

[49] While the distribution functions differ from indicator to indicator, in general, ranking above the 50th percentile in a reform indicator suggests that the country's ranking has improved in a worldwide ordering of countries based on the indicator in question.

maintain high external trade barriers. This calls into question the likelihood that a number of the regional agreements will be beneficial. The maintenance of high external tariff barriers leads to a highly distorted set of incentives which constrains the trade expanding impact of these agreements.

Given proximity, the EU markets hold the greatest potential as a driver for export growth for MENA countries. However, agreements with the EU have not yet had a significant positive impact on the MENA partners (and as noted in Chapter 1, the share of MENA exports to Europe has sharply declined since 1998). In part, this reflects the design of these agreements. These economic relationships are limited by lack of coverage (agriculture and services are effectively excluded), by lack of depth (such that technical barriers to trade remain due to differences in regulatory requirements and the need to duplicate testing), and by rules (with restrictive rules of origin limiting the degree of effective market access).

Lack of liberalization of services is a crucial issue and could be a powerful mechanism for stimulating trade and growth in the region. Services account for a substantial proportion of GDP in MENA countries, so improvements in efficiency, through trade and competition, could have profound effects. Equally important, a range of services are used as inputs for the production of other goods and services and are often crucial in supporting trade. Lower priced and better quality services can have broad, economy-wide effects by raising productivity across a wide range of activities. In the context of trade and growth, key services are the so-called backbone services of transport, telecommunications, and financial services. Transport and telecommunications are critical in linking the poor to markets, both domestic and international, and financial services are key to helping the poor adjust away from existing activities to new activities to exploit the opportunities made available by trade.

There is one key difference that distinguishes services from goods liberalization, in terms of their impact on growth. Services liberalization often implies a larger scale of activity in the domestic economy. This provides greater scope for the growth enhancing characteristics that are present in many service sectors, such as learning by doing and knowledge generation, raising product variety, and product quality[50]. This larger scale of activity arises because, for many services, the simultaneity of production and consumption entails that a local presence is necessary to supply the market. This requires factors of production to move to the consuming country. Further, many barriers in service sectors constrain entry to the market, not just to foreign entrants but also to new domestic providers. Hence, the liberalization of services sectors can result in more competition from both foreign and new domestic firms, which implies a larger scale of activity. It is worth noting that since services are often labor intensive, this greater scale of activity can play an important role in absorbing workers released as trade protection of import-competing goods is reduced and in attacking general unemployment.

Regional integration within the Arab Mediterranean is currently governed by the PAFTA (Pan Arab Free Trade Area) process, which aims to have removed import barriers and other barriers to

[50] Mattoo et al 1999.

trade by 2008. However, the agreement is confined to trade in goods. Services and investment are excluded. As such, and given the limited scope for trade in goods between Arab countries in the Mediterranean that many authors have stressed, the aggregate economic impact of the PAFTA will be slight. Indeed, economic modeling of the impact of intra-regional integration confined to trade in goods suggests that it would be small for Tunisia and could be negative for Egypt[51]. This is not to suggest that there are no potential gains from removing border barriers to intra-regional trade in goods, but these gains will be small relative to the liberalization of trade in services and the removal of regulatory barriers to trade. Attaining the full benefits from removing border barriers is dependent upon regulatory reform and liberalization of services.

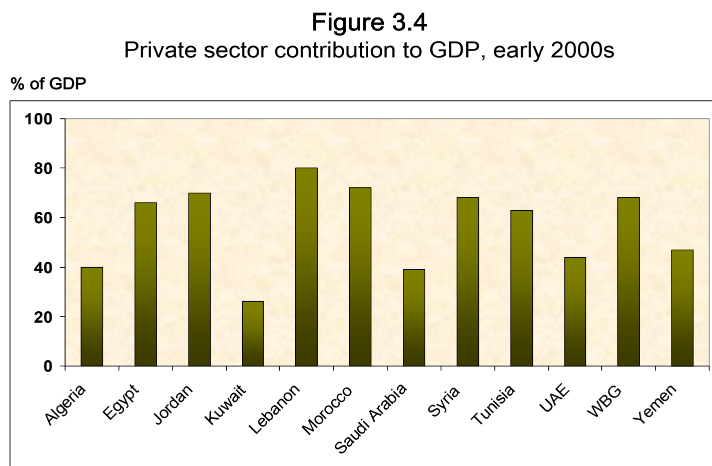
3.4 Improving the Investment Climate for Private Sector Development

While a number of countries in the region have low tariffs, recent research suggests that openness to trade tends to have little impact on growth in economies that are excessively regulated.[52] The impact of tariff liberalization will be constrained if the regulatory environment dissuades investment. Meeting the development challenges in MENA requires sustainable, productivity-driven economic development and job growth. The international experience overwhelmingly suggests that the most important engine for rapid and sustainable economic growth is a dynamic and competitive private sector, free from excessive regulation.

3.4.1 Status of private sector development in MENA

The formal private sector remains underdeveloped in MENA, still emerging from the culture of decades of state-led growth and industrialization. On average, the private sector accounts for less than 50 percent of GDP in the region. Private sector activity is concentrated in a small number of large firms that have benefited from protective policies, along with a number of micro-enterprises that account for much of employment but have little access to formal finance, markets, or government support programs.[53]

Figure 3.4
Private sector contribution to GDP, early 2000s



Sources: Assaf and Benhassine, 2003; Country sources.

[51] Hoekman and Messerlin 2002.
[52] See Bolaky and Freund 2004
[53] World Bank 2004a.

While most of the governments in MENA agree that the private sector needs to become the primary engine of job growth, the public sector remains a major source of job creation. The public sector is estimated to account for almost a third of employment in the region, compared with 27 percent worldwide, and 18 percent worldwide excluding China.[54] Public sector employment ranges from a low of 10 percent of employment in Morocco to a high of 93 percent in Kuwait, and averages more than 70 among the GCC[55] (Table 3.4). Public sector wages and salaries as a share of total expenditure are substantially higher than in the rest of the world.

Table 3.4: Public sector employment in MENA

	Public sector as a share of total employment, 2000*	Public sector wages and salaries as a share of current expenditure, 2004
MENA	**29.0**	**37.9**
Algeria	29	31.1
Bahrain	28	63.7
Egypt	29	29.2
Iran, Islamic Republic	28	37.8
Jordan	44	27.5
Kuwait	93	40.5
Libya	66	
Morocco	10	50.8
Saudi Arabia	79	
Tunisia	22	62.9
East Asia Pacific	**33.8**	
China	36.0	
Korea	4.5	16.3
Philippines	5.2	
Latin America and Caribbean	**12.6**	
Brazil	11.5	25.1
Colombia	8.4	14.5
Ecuador	13.8	44.6
Guatemala	14.9	
Mexico	16.4	19.2
OECD	**13.5**	
Canada	17.5	8.2
Germany	12.3	
Japan	7.7	
Spain	15.2	
United Kingdom	18.9	
United States	14.6	7.8
World	***27.0***	
Excluding China	18.2	

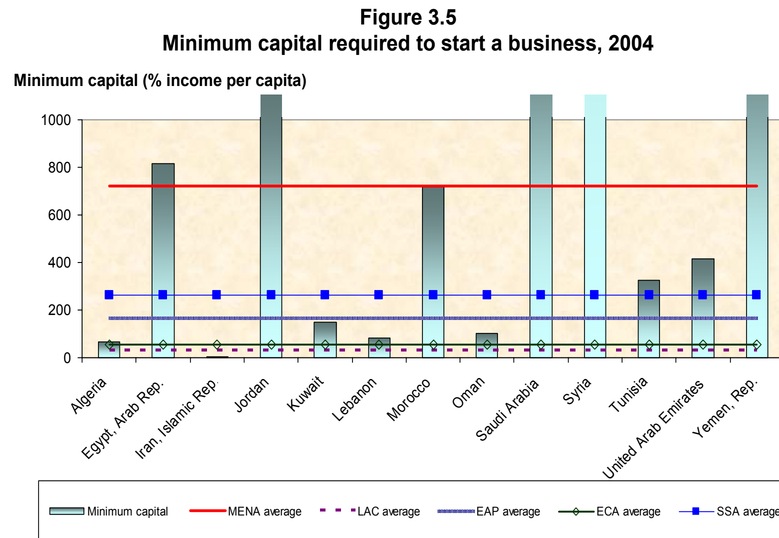
Note: *: or closest available year.
Sources: *Wages and salaries*: staff estimates from World Bank; unified survey submissions; International Monetary Fund, 2004a. *Public sector employment:* OECD PSPE; Hammouya 1999; Gardner 2003; country sources. World average for public sector employment based on countries shown.

Creating a climate in which the private sector sees opportunity and will invest and create jobs depends on several factors: (i) a stable macroeconomic environment where investment decisions

[54] Staff estimates.
[55] Public sector employment in Kuwait and the GCC is among nationals.

can be made with relatively low levels of uncertainty; (ii) basic protection of property rights and an adequate legal and regulatory framework; and (iii) a regulatory environment that does not deter investment with unnecessarily cumbersome procedures and costs. While there are large differences in the levels of national regulation, the region as a whole suffers from overly complex, time consuming, and costly business regulations and licensing requirements, impeding the entry of more private sector businesses. These costs to businesses especially deter the development of the small business sector, which cannot afford to hire intermediaries to deal with the complexity of administrative procedures.

Figure 3.5
Minimum capital required to start a business, 2004



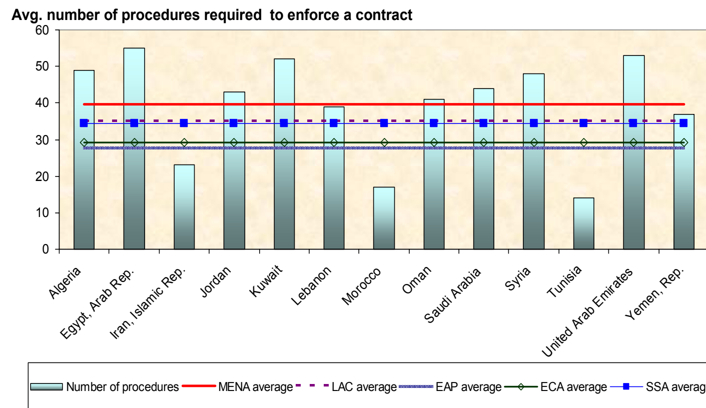
Sources: Doing Business Indicators, World Bank.
Notes: MENA=Middle East and North Africa; ECA=Europe and Central Asia; SSA=Sub-Saharan Africa; LAC=Latin America and the Caribbean; EAP=East Asia and the Pacific.

Several areas of government regulation stand out as particularly burdensome for the region. The minimum capital required to start a business is exceedingly high in the MENA region, almost five times as high as the world average and well above any other region of the world (Figure 3.5). The minimum capital requirement is a measure of the amount that an entrepreneur needs to deposit in a bank account to obtain a company registration number. In Jordan, Saudi Arabia, Syria, and Yemen, this amount averages more than ten times the country's average income per capita (with Syria requiring 50 times the average income per capita). Such high minimum capital requirements all but block entry into the business sector.

These high costs are all the more burdensome considering the underdeveloped state of the banking and financial sectors. While the economies in the GCC, Jordan, and Lebanon have fairly sophisticated financial sectors, with high bank and non-bank financial sector development and generally good regulation and banking supervision, much of the region's private sector still has limited access to market finance. Banks dominate the financial system, but in general they play a limited role in financial intermediation. Much of the banking sector remains primarily in government hands and is inextricably linked to state-owned enterprises (SOEs), subject to government intervention in its lending and credit allocation policies to SOEs. This intervention has led to a crowding out of the private sector where it is permitted to operate, especially in Algeria, Libya, Syria and Yemen. Lending remains predominantly short-term and trade-related, with relatively little being directed to either long-term investments or to households.

Contract enforcement mechanisms are also particularly taxing for businesses in the MENA region. On average, MENA businesses must go through a total of 40 procedures to enforce a contract, about a third higher than the world average and higher than in any other region of the world (Figure 3.6). In Kuwait, Egypt, and the United Arab Emirates, the process is especially long, requiring more than 50 different procedures to enforce a contract. Not surprisingly, as a result, the MENA region ranks high in terms of the number of days required to enforce a contract, averaging 426 days, about 50 percent higher than in East Asia, and almost 60 percent higher than in the OECD.

Figure 3.6
Contract enforcement procedures, 2004



Sources: Doing Business Indicators, World Bank.
Notes: MENA=Middle East and North Africa; ECA=Europe and Central Asia; SSA=Sub-Saharan Africa; LAC=Latin America and the Caribbean; EAP=East Asia and the Pacific

3.4.2 Developments in structural reform for private sector development

MENA's progress with improving the business environment has been uneven. On the one hand, there have been increasing actions to liberalize sectors of the economy for competition, allowing foreign investment in certain sectors, and privatization. However, these actions have not translated to strong changes in the business environment outside of a handful of countries.

The Gulf can point to considerable strides in liberalization, which has aided the development of a few key service industries. By and large, the Gulf has converted to private power. In Saudi Arabia, the banking sector has been opened up to competition with the passage of a new capital markets law, and new FDI guidelines have opened up the number of sectors to foreign investment.[56] In Kuwait, a new law on foreign investment permits 100 percent foreign ownership of companies. Kuwait has also opened up most economic sectors to foreign investment, including banking, real estate, and insurance.[57] Several countries have adopted laws permitting foreign freehold ownership of property. Competition in mobile communications has been introduced everywhere except Qatar and the UAE.[58]

On the back of this liberalization push, several Gulf economies have been able to diversify outside of oil into several service industries. Bahrain established itself as the premier financial entrepot in the region, and its Financial Harbour, which opened in March 2004, will deepen its specialization as a capital and retail financial market hub. Dubai, in the United Arab Emirates, has become a tourist hub in the region and is also aiming for the financial hub distinction, developing

[56] *The Banker* 2004.
[57] UNESCWA 2004.
[58] An agreement to be signed in June 2005 will open competition to mobile provision in Oman.

the Dubai International Financial Centre. The UAE now has free trade zones in each emirate and has experienced a five-fold increase in international construction contract orders since 2002, driven by a construction frenzy in the Dubai real estate market.[59]

Outside of the Gulf, two countries that have been especially successful in implementing business regulation reform are Morocco and Tunisia. As part of continuing industrial modernization efforts under the *Mise a niveau* program, new measures to create a more favorable investment climate and encourage private sector growth have yielded some strong results in both countries. By cutting the number of procedures for starting a business from 11 to 5, Morocco moved from the bottom half of economies worldwide to the top 10 percent between 2003 and 2004. Its privatization progress has been strong, with more than 40 companies wholly or partially privatized in the oil refining, road transport, telecommunications, and banking sectors. The largest of these is the privatization of Maroc Telecom. Morocco has made efficient use of public-private contracts in several sectors,[60] and it is continuing to liberalize, most recently in the audiovisual communications sector and air transport sectors. Liberalization in the former sector may reinforce the process of democratization, while the latter may stimulate tourism activities and help secure the target of attracting 10 million tourists by 2010. Other achievements include strengthening of property rights and the passage of a new Labor Code by the Moroccan Parliament in 2003, after years of discussion. Serious improvements in the business environment were also made in Tunisia, and recent developments include important reform in the legal framework for asset recovery and bankruptcy.

Elsewhere, however, progress in improving the business environment has been more uneven. Although Jordan has maintained steady progress with its privatization program (completing some 60 privatization transactions by mid-2004 and netting proceeds of $1,214 million),[61] its overall progress in various areas of business regulatory reform has been mixed. It has managed to significantly reduce the time and procedures associated with starting a business, and it has reduced the regulation for firing workers, in both areas ranking above the 50th percentile in terms of improving its worldwide standing. But it has failed to move forward in other areas of the business environment, including improving access to credit and contract enforcement, relative to worldwide progress.

Egypt's structural reform program stalled between 2000 and 2003, and it has made little progress in improving the business environment to date. Recently, the reform momentum has regained strength, beginning in 2003 with the decision to float the pound. The announcement of deeper and more comprehensive reforms in 2004, including the long-waited reforms in the banking sector, is a welcome development.[62]

---

[59] MEED 2004b.

[60] The program contracts have allowed enterprises to restructure their activities and improve governance, with the Government committed to making the procurement process more transparent, and to supply the required infrastructure.

[61] MEED 2004a.

[62] MEED 2004e

Progress among the resource rich labor abundant economies has also been mixed, with the continuing climb in oil prices seemingly diminishing the perceived urgency for reform over the last two years. The Islamic Republic of Iran, for example, had shown strong initial progress with its reform program. Both trade and financial sector reforms advanced, including the licensing of private banks, and the liberalization of FDI regulations through an improved Foreign Investment Law. However, progress has now slowed significantly, and the economy has yet to address other reforms aimed at improving the business environment, reducing labor market rigidities, and restructuring and privatizing public enterprises.[63] Only in recent months has there been the hint at renewed actions, with the door for private sector participation in key industries opened by an unprecedented ruling on liberalization provisions in Iran's constitution. This should allow for private ownership and operation in most major industries, including banking, insurance, power generation, water works, telecommunications, postal service, railways, airlines, and shipping. Excluded from the list, and still to be kept as state monopolies, are ownership and upstream management of the oil and gas sector and radio and television stations. This ruling would bring an end to the constitutionally-sanctioned monopoly in several key industries and economic activities.[64]

Deregulation legislation in Algeria opened nearly all economic sectors to private and foreign investment and competition, including banking, telecommunications, pharmaceuticals, transportation, and heavy industry, but excluding hydrocarbons. However, the structural reform agenda was subsequently paralyzed. Only 19 companies were privatized in 2003, out of 1,200 SOEs. In Libya, the enthusiasm for fundamental economic reform has also faded, with little being done after unification of the exchange rate in 2003.[65] Most recently, the Government has unveiled a promising program of economic reforms, including the abolition of state subsidies on electricity, fuel, and food, as well as fiscal and legislative reforms.[66] However, the optimism about these reforms being enacted is guarded. And in Syria, while economic reforms have been enacted in some areas, such as banking, this has been done in a piecemeal and limited way, and the economy still operates under considerable distortions.

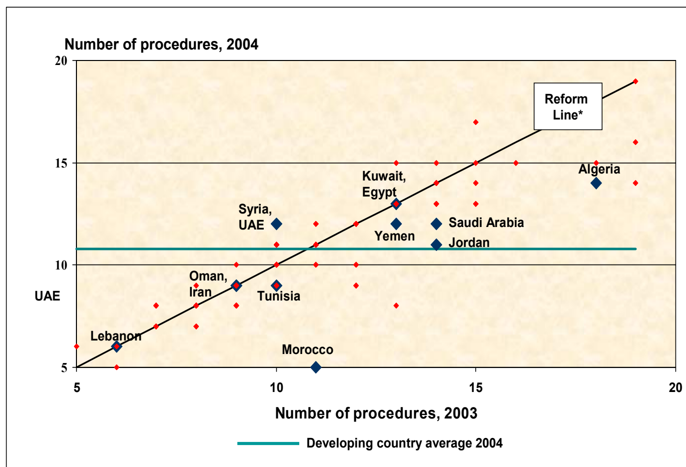
Looking at individual obstacles to private sector development, the region can point to only limited success in a few areas of reform, and more often the region has lost ground relative to progress made in other regions. In the area of business start-up, for example, regulations and costs associated with business start-up have, in general, been reduced in MENA, but the region has made less progress in reducing high minimum capital requirements (Figure 3.7), and two-thirds of MENA countries continue to have minimum capital requirements higher than the average for developing countries.

---

[63] IMF 2003.
[64] MEED 2004d.
[65] Middle East International 2004b.
[66] MEED 2004c.

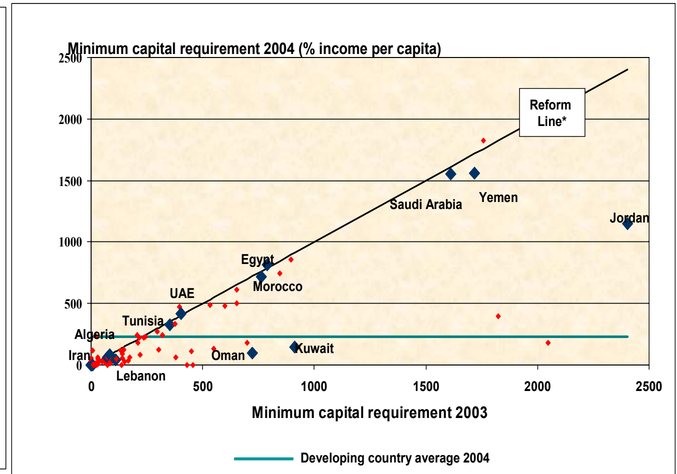
Figure 3.7: Procedures and minimum capital to start a business in MENA versus the world *2003 and 2004*

Number of procedures to start a business: MENA versus the World
2003 and 2004



Source: TRAINS database. Note: * Countries below and to the right of the line can be considered "reformers" in that they have reduced the number of procedures.

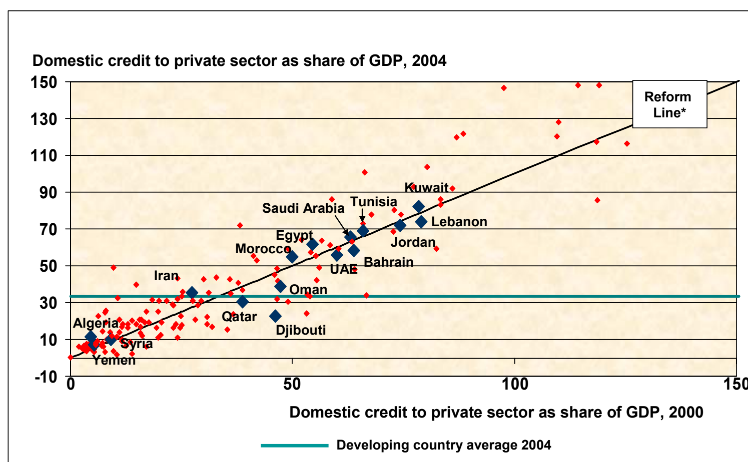
Minimum capital requirements in MENA versus the World
2003 and 2004



Source: TRAINS database. Notes: * Countries below and to the right of the line can be considered "reformers", in that they have reduced the given barrier. Syria (with minimum capital requirement above 5000% of income per capita not shown

Access to finance by the private sector remains a problem for many countries in the region. Over the 1998-2003 period, the rest of the world saw a rise in private sector credit amounting to almost 1.0 percent of GDP (from about 41 percent of GDP to 42 percent). In MENA, however, half of the countries experienced an actual decline in credit to the private sector. Libya, which ranks in the lower third of all countries in terms of private sector finance, saw a reduction in credit to the private sector as a share of GDP from 25 percent of GDP to 18 percent. Djibouti saw the greatest deterioration, with credit to the private sector shrinking from 46 percent to 22 percent. Syria, which ranks in the bottom quintile in terms of private sector finance, realized less than average improvement in credit ratios (from 9.2 percent to 10 percent). Some healthier progress was made in a few countries, including Algeria and Yemen (Algeria increased credit to the private sector from 4.6 percent to 11.9 percent, and Yemen from 5.4 percent to 6.9 percent), but both countries remain in the bottom quartile worldwide in terms of private sector finance.

Figure 3.8
Private sector access to credit: MENA versus the World
1999 and 2003



Note: Countries above and to the left of the reform line can be considered "reformers", in that they have increased the amount credit accessed by the private sector, as a proportion of GDP.

3.4.3 Quantifying the progress with business regulatory reform

The region's progress with structural reform in the area of improving the environment for private sector development was measured across five areas, corresponding to subjects covered in the World Bank's *Doing Business* database (supplemented with financial sector information from the World Bank's *World Development Indicators*). These key business regulatory and financial areas include: (i) starting a business, (ii) hiring and firing workers, (iii) private sector access to credit, (iv) enforcing contracts, and (v) closing a business. A composite index was constructed, averaging the progress across the five areas of business regulatory reform.

Based on this composite index, the MENA region's recent progress with reform lags the world in terms of improving the environment for business, especially given the low initial conditions of business development (Table 3.5). Currently, on average MENA economies place in the middle in a worldwide ordering of countries (averaging in the 48th percentile) based upon the range of indicators of regulatory costs of business. This is slightly higher than other lower middle income economies, which on average rank in the 44th percentile. However, based on ***progress*** over the last years, MENA has lost significant ground compared to world progress in reducing impediments to business development. On average, countries in the MENA region place in the 34th percentile worldwide in improving the business environment relative to other countries, compared with an average of 47th percentile among other lower middle income economies (and far below the average progress demonstrated in Europe and Central Asia and South Asia). In terms of improving their world standing across a range of indicators of obstacles to private sector development, the MENA region has made the least progress of any other region of the world.

A few countries can point to some success in improving their standing relative to other countries, including Tunisia and Morocco. Both have relatively fewer obstacles to business (Tunisia more so than Morocco), and both continued to make progress in improving the climate for private investment, especially through a reduction in the administrative hurdles for starting a business. On the other hand, several economies in MENA with the most cumbersome and costly regulatory procedures (including Lebanon, Egypt, Syria, the United Arab Emirates, and Yemen) have fallen short of world reform progress, and they have fallen in their world standing.

Table 3.5: Structural reform progress: business regulatory and financial sector reform

Country	***Current business environment****	***Reform Progress*****
Algeria	26	54
Egypt	29	11
Iran, Islamic Republic	63	37
Jordan	57	43
Kuwait	77	16
Lebanon	33	9
Morocco	62	62
Oman	60	58
Saudi Arabia	52	47
Syrian Arab Republic	17	2
Tunisia	79	74
United Arab Emirates	32	4
Yemen, Republic	42	24
MENA	**48**	**34**
Sub-Saharan Africa	*27*	*36*
East Asia and the Pacific	*47*	*40*
Europe and Central Asia	*52*	*61*
Latin America and Caribbean	*39*	*45*
OECD	*89*	*73*
South Asia	*49*	*48*
LMIC (excluding MENA)	***44***	***47***
World	***50***	***50***

Notes: *Current business environment reflects country's current placement in a worldwide ordering of countries based on a variety of business regulations, expressed as a cumulative frequency distribution, with 100 reflecting the country with easiest business regulations/best financial sector development, and 0 reflecting the country with the most burdensome business regulation/least developed financial sector. ** Reform progress reflects the improvement in a country's rank between 2000 and 2004, expressed as a cumulative frequency distribution, with 100 reflecting the country which exhibited the greatest improvement in rank and 0 reflecting the country which exhibited the greatest deterioration. LMIC = Lower middle income economies, defined as countries with gross national income per capita between US$765 and $3,035 in 2003.

The general deterioration in MENA's standing with regard to business regulatory reform is the result of declines in world ranking across every area of business regulatory reform. In the area of contract enforcement procedures, for example, MENA countries on average rank below other lower middle income economies. Furthermore, in 2004, they saw a deterioration in their world standing, and MENA countries average in the 27th percentile in terms of the change (improvement) to their world standing. No country – with the exception of Morocco and Oman – has kept pace with world improvements in contract enforcement procedures and costs. Though MENA's standing with regard to private sector access to credit and hiring and firing procedures is, on average, higher than the average for other lower middle income economies, in terms of *progress* over the last years the region fell slightly short of keeping pace with world improvements. Still less progress occurred in the area of procedures and costs for closing a business (Table 3.6)

Table 3.6: Business regulatory and financial sector reform:
progress along individual areas of the business environment

	Starting a Business		*Hiring and Firing*		*Enforcing Contracts*		*Access to Credit*		*Closing a Business*	
Country	**Current status**	**Reform progress**	**Current status**	**Reform progress**	**Current status**	**Reform progress**	**Current status**	**Reform progress**	**Current status**	**Reform progress**
Algeria	32	58	29	13	13	29	22	94	70	63
Djibouti							42	4		
Egypt	11	9	51	44	20	14	77	73	18	21
Iran, Islamic Republic	68	12	61	52	64	46	60	87	38	28
Jordan	24	85	59	66	60	5	81	32	39	49
Kuwait	46	40	100	91	37	1	83	30	57	22
Lebanon	41	15	42	30	10	46	85	44	23	23
Libya							33	9		
Morocco	70	95	2	4	80	64	71	60	62	46
Oman	67	71	68	81	44	54	61	27	38	34
Saudi Arabia	8	88	100	68	35	1	74	27	41	62
Syrian Arab Republic	15	1	66	23	3	10	19	44	42	49
Tunisia	65	91	4	29	97	40	80	47	84	94
United Arab Emirates	17	1	92	84	14	20	72	30	5	5
Yemen	3	62	84	46	63	21	12	65	67	3
MENA	**36**	**48**	**58**	**49**	**42**	**27**	**60**	**47**	**45**	**38**
Sub Saharan Africa	30	37	35	35	35	42	27	51	38	48
East Asia Pacific	49	56	54	48	44	42	56	44	27	37
Europe Central Asia	54	58	50	55	57	57	41	64	51	50
Latin America	42	49	47	72	37	42	46	34	44	45
OECD	82	57	71	53	83	72	89	54	80	68
South Asia	70	44	43	31	35	48	51	59	49	65
LMIC (excluding MENA)	***44***	***50***	***48***	***57***	***46***	***49***	***44***	***44***	***47***	***45***

Notes: *Current business environment reflects country's current placement in a worldwide ordering of countries based on a variety of business regulations, expressed as a cumulative frequency distribution, with 100 reflecting the country with easiest business regulations/best financial sector development, and 0 reflecting the country with the most burdensome business regulation/least developed financial sector. ** Reform progress reflects the improvement in a country's rank between 2000 and 2004, expressed as a cumulative frequency distribution, with 100 reflecting the country which exhibited the greatest improvement in rank and 0 reflecting the country which exhibited the greatest deterioration. LMIC = Lower middle income economies, defined as countries with gross national income per capita between US$765 and $3,035 in 2003.

MENA's employment challenge over the next two decades requires tremendous job creation, which itself relies on the development of a vibrant and dynamic private sector. Lack of progress in improving the climate for private investment is thus discouraging for the region's longer term employment prospects. It is worth noting that in two-thirds of the MENA countries with labor force growth rates exceeding 3 percent a year (not including the GCC)[67], the overall business environment is ranked below average, relative to the world (Algeria, Syria, Yemen, and Egypt).

A few countries may offer some guidance to others in the region. Regarding procedures to start a business and contract enforcement, Morocco and Tunisia appear to have substantially more favorable conditions than the average for developing countries as a whole. This suggests that there is much that other countries in the region could learn from these two countries when reforming their own business rules and regulations. Likewise, in the area of employment regulations it is the Gulf countries that have a climate that compares favorably with other developing countries. Identifying good or best practices within the region and relative to developing countries as a group could be a useful way to guide other MENA countries with methods for improving businsess conditions.

[67] Labor force growth rates over the next decade for the following countries are estimated at above 3 percent a year: Syria (4.1), Republic of Yemen (4.1), The Islamic Republic of Iran (3.8), Algeria (3.7), Jordan (3.6), Egypt (3.0). From World Bank staff estimates.

Box 3.3: Regional leaders in reform of the business environment

Between 2003-2004, Tunisia and Morocco made the strongest overall progress region-wide in terms of reform of the business environment, measured through the rise in country rank (relative to the world) across five separate areas of business regulation, financial sector development, and legal frameworks.

Tunisia's strongest progress came in two areas: improvement in procedures/costs of starting a business and improvement in procedures to close a business. Tunisia reduced the number of procedures for starting a business from 10 to 9, moving it up in worldwide rank from 53 to 42 (out of 133 countries), placing Tunisia in the 88th percentile in terms of rise in rank (with minimal improvement throughout most of the world). The days needed to start a business were reduced from 46 to 14, moving it up in worldwide rank from 67 to 14 (placing Tunisia n the 98th percentile in terms of rise in rank). The cost for setting up a business reduced from 16 percent of gross national income to 11 percent, moving it up in worldwide rank from 50 to 38 (placing it in the 93rd percentile worldwide in terms of rise in rank). Tunisia made only marginal progress in lowering the minimum capital required to start a business, and its worldwide rank fell from 104 out of 133 in 2003 (with minimum capital requirements equal to 352 percent of income per capita) to 114 in 2004 (with minimum capital requirements of 327 percent of income per capita). Overall, across the range of indicators for starting a business, Tunisia ranked in the 91st percentile in terms of progress in rank improvement. Further, Tunisia ranked in the 94th percentile in terms of improvement in rank in closing a business, through both strong progress in reducing the time (96th percentile in rise in rank) and cost (86th percentile in rise in rank). Currently, Tunisia ranks 20th worldwide for ease of closing a business in terms of time (out of 133 countries) relative to a rank of 48 worldwide in 2003. Overall, Tunisia's strong progress in two major areas of business regulatory reform (in the 91st and 94th percentile in areas of starting a business and closing a business, respectively) helped the country place in the 74th percentile worldwide in overall business regulatory reform, despite lack of progress in areas of improving contract enforcement (40th percentile), access to credit (47th percentile) or hiring and firing flexibility (29th percentile worldwide).

In Morocco, strong progress was made in the area of reducing cumbersome procedures and costs for business start-up. Between 2003 and 2004, the number of procedures to start a business declined from 11 to 5, moving Morocco up 64 places (in a ranking of 92 countries worldwide) and placing it in the 99th percentile in terms of the rise in rank. The time required for procedures was reduced from an average of 36 days to 11 (a reduction that placed Morocco in the 95th percentile in terms of its rise in world ranking). The cost associated with start up procedures declined from 19.1 percent of GNI per capita to 12.3 percent (95th percentile in change in world ranking), with only modest progress in reducing the minimum capital requirements for starting a business (still averaging 720 percent of GNI per capita, down from 762 percent). Overall, Morocco placed in the 95th percentile in terms of improving its world standing with regard to starting a business. It also made some progress in terms of business financing. Credit provided to the private sector increased between 1998 and 2003 from 50 percent to 55 percent of GDP, moving Morocco from 53rd place up to 49th place in a worldwide ranking of 164 countries (and placing Morocco in the 60th percentile worldwide in terms of its rise in rank). In the area of enforcing contracts, Morocco also improved its worldwide rank. In terms of time required for contract enforcement, Morocco ranked 43rd out of 118 countries in 2003. By 2004, it had moved up in rank to 28th. Likewise, it improved its worldwide ranking in procedures to enforce a contract, from a position of 22nd to 13th. While its ranking deteriorated in terms of the cost to enforce contracts (from 47 to 60), in all, Morocco ranked in the 64th percentile in terms of improvement in worldwide rank with regard to contract enforcement procedures and costs. Overall, the relatively stronger efforts in three areas (with deterioration in standing with regard to hiring and firing and closing a business) allowed Morocco to place in the 62nd percentile worldwide in terms of improving its world standing across a range of business regulatory and financial areas.

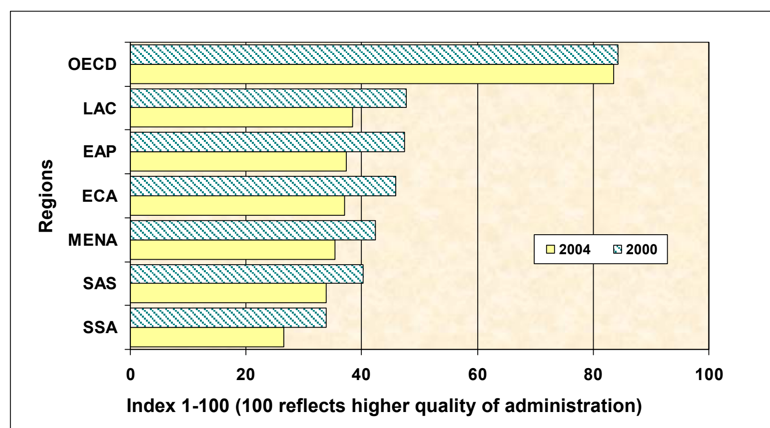
3.5 Enhancing Governance

Achieving the transition to more open, market-oriented economies requires fundamental changes in the role of government in some key areas of policymaking and considerable enhancement of its effectiveness in others. A broad governance agenda is central to reform efforts aimed at improving the business and investment climate, deepening trade integration, and increasing economic diversification.[68]

3.5.1 Status of governance challenges

The MENA region faces many of the traditional challenges to efficient public sector management, including reducing state intervention in production and employment and improving the quality of public sector administration. But the region's governance agenda goes well beyond the traditional sphere of administration.

Figure 3.9
***Index of Quality of Administration,* by region**



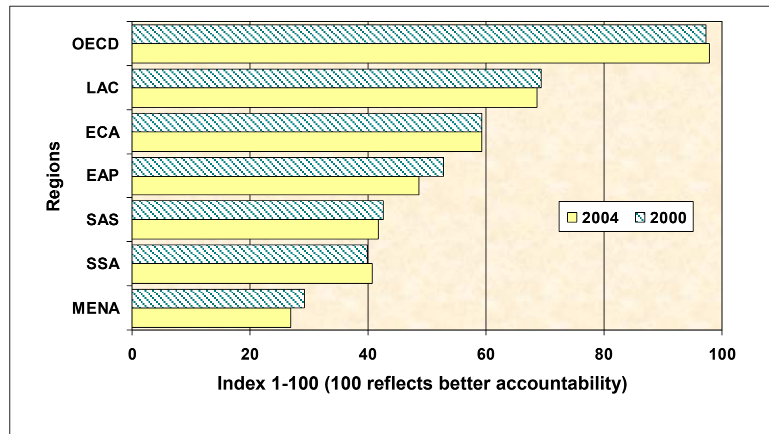
Source: See annex for methodology behind Quality of Administration Index.
Notes: MENA=Middle East and North Africa; EAP=East Asia and Pacific; ECA=Europe and Central Asia; OECD=Organization for Economic Cooperation and Development; SAS=South Asia; and SSA=Sub-Saharan Africa.

The World Bank's report on governance in the MENA region[69] highlights the major governance challenges. On the administrative side, MENA countries fall short of other countries at similar income levels (Figure 3.9). In areas such as the efficiency of the bureaucracy, the rule of law, the protection of property rights, the level of corruption, the quality of regulations, and the mechanisms of internal accountability, MENA countries have, individually and on average, lower levels of quality of administration in the public sector than would be expected for their incomes[70].

[68] World Bank 2003b.
[69] World Bank 2003b.
[70] World Bank 2003b.

But even more importantly, countries across the region exhibit a pattern of limited government accountability and inclusiveness, reflected in an index of public accountability (Figure 3.10). In the area of openness of political institutions and participation, respect of civil liberties, transparency of government, and freedom of the press, the MENA region falls far short of the rest of the world. Not a single country in MENA ranks above the world median for the quality of public accountability, whether adjusted for income or not.[71]

Figure 3.10
***Index of Public Accountability,* by region**



Source: See annex for methodology behind *Public Accountability Index*.
Notes: MENA=Middle East and North Africa; EAP=East Asia and Pacific; ECA=Europe and Central Asia; OECD=Organization for Economic Cooperation and Development; SAS=South Asia; and SSA=Sub-Saharan Africa.

3.5.2 Progress in governance reform

Several countries in the MENA region have embarked on reform of various areas of public administration. Jordan and Morocco, for example, both have ambitious civil service management reform programs, and many countries in the region have taken steps to improve public expenditure management.

MENA's progress in improving the quality of public administration was examined with the use of nine indicators, corresponding to the indicators underlying the World Bank's governance indicator of public administration quality[72]. A composite index was constructed, measuring each country's average progress in improving its worldwide ranking with regard to these public administration features[73].

Based on this indicator, a few countries could point to some progress in improving their worldwide standing with regard to public administration quality, including Algeria, Egypt, Jordan, Morocco, Oman, Qatar, Saudi Arabia, and Yemen, all of whom ranked above the 50th percentile in improving their worldwide rank of public administration quality. However, it is important to note that this improvement occurred more due to a worldwide deterioration in public

[71] World Bank 2003b.
[72] See Annex 2 for methodology behind structural reform indicators
[73] See Box 3.1 and Annex 2 for description of methodology underlying structural reform indicators.

administration quality than direct improvements from the MENA countries. Moreover, the average level of progress in MENA has been weak, with economies on average ranked in the 47th percentile with regard to public administration reform, below those of Sub-Saharan Africa (52nd), East Asia and the Pacific (54th), Europe and Central Asia (57th), and South Asia (65th), and below the average for lower middle income economies outside of MENA (Table 3.7).

Table 3.7: Structural reform progress: governance reform 2000 versus 2003/2004

	Quality of administration		***Public sector accountability***		***Overall governance***	
Country	***Current status***	***Reform progress***	***Current status***	***Reform progress***	***Current status***	***Reform progress***
Algeria	30	60	34	59	32	61
Bahrain	58	45	29	40	42	30
Djibouti	23	32	34	25	30	17
Egypt, Arab Republic	31	52	27	22	28	24
Iran, Islamic Republic	28	35	41	11	36	14
Iraq	7	..	11	..	9	..
Jordan	46	77	41	42	44	61
Kuwait	46	38	40	9	42	14
Lebanon	28	5	36	3	32	1
Libya	14	17	1	14	3	10
Morocco	44	62	37	32	40	42
Oman	52	85	26	28	37	56
Qatar	44	87	22	29	31	57
Saudi Arabia	43	58	14	31	26	35
Syrian Arab Republic	27	..	18	40	21	..
Tunisia	46	14	29	12	36	6
United Arab Emirates	49	7	26	12	36	3
West Bank Gaza	16	..	28	..	23	..
Yemen, Republic	27	85	24	47	24	79
MENA	**35**	**47**	**27**	**27**	**30**	**32**
Sub-Saharan Africa	*27*	*52*	*41*	*42*	*34*	*47*
East Asia and the Pacific	*30*	*54*	*51*	*41*	*41*	*49*
Europe and Central Asia	*38*	*57*	*60*	*52*	*51*	*54*
Latin America and Caribbean	*38*	*43*	*69*	*54*	*56*	*46*
OECD	*83*	*44*	*93*	*79*	*88*	*65*
South Asia	*32*	*65*	*37*	*39*	*35*	*55*
LMIC (excluding MENA)	***32***	***53***	***54***	***43***	***45***	***47***
World	***41***	***50***	***56***	***50***	***49***	***50***

Notes: *Current business environment reflects country's current placement in a worldwide ordering of countries based on a variety of business regulations, expressed as a cumulative frequency distribution, with 100 reflecting the country with easiest business regulations/best financial sector development, and 0 reflecting the country with the most burdensome business regulation/least developed financial sector. ** Reform progress reflects the improvement in a country's rank between 2000 and 2004, expressed as a cumulative frequency distribution, with 100 reflecting the country which exhibited the greatest improvement in rank and 0 reflecting the country which exhibited the greatest deterioration. LMIC = Lower middle income economies, defined as countries with gross national income per capita between US$765 and $3,035 in 2003.

Far more disturbing, however, is the lack of progress in the area of public accountability. Public accountability was measured with the use of twelve indicators corresponding to the measured used in constructing the World Bank's governance indicators for the MENA region.[74] Because many of the underlying indicators reflect 2003 information, the public accountability index may fail to reflect positive progress which took place over 2004. However, based on the most recent information, the region has made virtually no progress relative to the world, ranking in the 27th percentile with regard to improving the accountability of the public sector -- lower than every other region of the world by far, this despite the fact that the region has the least accountability public sectors in the world.

Overall, the region's progress with governance is in the bottom third of the world, far below the average of other lower middle income economies and behind the pace of every region of the world. Although each area of structural reform is important in its own right, the lack of progress in the area of governance – and particularly public sector accountability -- is of specific concern because of what it implies for a stronger reform effort in general. International experience with structural reform suggests that reforms are most successful when there have been coalitions for change – organizations or individuals who share a commitment to advancing reform. The driving force may be the private sector, pressing for changes to improve competitiveness. It may be trade unions, or non-governmental organizations. But coalitions of key stakeholders to reform are vital not only to advance reforms but also to sustain them.[75]

But underlying these coalitions for change, vital to a strong structural reform effort, groups need certain central rights. They need the ability to access to information to formulate choices, they need the ability to mobilize, and they need the ability to contest policies that are poor. These rights are limited in the MENA region. Government information is not accessible by the public. Freedom of the press is carefully monitored and circumscribed in most countries. There are restrictions on civil society. There are restrictions on freedom of association. And the ability to contest government policies is weak[76]. A critical element of moving the broader structural reform agenda forward will be addressing the public accountability governance challenge.

The region's recent lack of progress with structural reform is evidence of current governance limitations. MENA has had some progress with implementing broader, top-down reforms, including tariff reform, which have been relatively easier to execute especially within the framework of international trade agreements. However, progress in improving the business environment has been weaker than all other regions, in part because it has required a much deeper level of economic reform. It is little surprise that in areas like contract enforcement – requiring the profoundly difficult task of reform of the judiciary – the MENA region has had the most difficulty in implementing reforms.

[74] World Bank 2003b.
[75] For example, see World Bank 2004c.
[76] World Bank 2003b.

3.6 Structural Reform in Summary

The MENA region's long term growth prospects require a fundamental transition from closed to open economies, from public sector-managed to private sector-led economies, and from oil-dependent and volatile to diversified and stable economies. From the analysis of reform progress over the 2000-2004 period, the region's transition record is mixed, with relatively strong progress in only one sphere of reform.

By far, the region's greatest progress has come in the area of trade reform. Motivated in part by trade initiatives and free trade agreements, the region has been able to make strong progress in tariff reduction over the last few years, and two-thirds of the MENA economies have improved their world standing with regard to unweighted import tariffs.

In other key areas of reform, however, the region has lost significant ground. Few economies have addressed the myriad regulatory obstacles to business development, and the MENA region ranks below every other region of the world in terms of improving the business environment. Of even greater concern, the MENA region has made the least progress of all regions of the world in improving governance, with MENA economies, on average, in the bottom third worldwide in terms of governance reform. Despite the fact that the region ranks at the bottom in terms of public accountability and has the longest reform path to travel, virtually no country improved its worldwide rank in this area. As a result, the MENA region on average ranked in the 27th percentile worldwide in terms of progress in improving public sector accountability. The lack of progress in this particular area of governance reform is of concern because of what it implies for a stronger reform effort in general.

The region's inability to tackle some of the deeper and more complex reforms in the business regulatory and financial areas provides some persuasive evidence of the limitations of top-down reforms by decree. Improved governance is a critical success factor for achieving deeper and often more difficult reforms.

ANNEX 1: STATISTICAL TABLES

Table 1 Oil markets and the transmission channels for growth among MENA countries (1990-2006)						
	averages			Estimate	Projections	
growth rates, averages or as specified	**1990-2000**	**2002**	**2003**	**2004**	**2005**	**2006**
Global hydrocarbons market						
World oil demand (mb/d)	71.4	77.9	79.7	82.4	83.8	85.2
World oil price ($/bbl, WBavg)	19.1	24.9	28.9	37.7	40.0	36.0
MENA oil production (mb/d)	27.8	27.3	29.7	31.5	31.7	31.9
MENA hydrocarbon exports ($bn)	111.7	158.6	202.0	276.1	288.9	268.4
Oil-exporters current acct ($bn)	2.4	31.7	65.8	129.6	131.8	99.1
Current account %GDP	0.6	6.1	11.0	18.4	17.6	13.0
Worker remittance payments ($bn)	22.2	22.9	22.3	23.4	24.4	25.4
Oil-exporters fiscal balance ($bn)	-15.2	6.3	28.5	56.0	30.9	9.1
Fiscal balance (%GDP)	-3.7	1.2	4.8	7.9	4.1	1.2
Other exports, remittances and tourism						
OECD import demand (GNFS vol) ch%	6.7	2.4	3.2	7.6	6.1	6.8
European Union (15)	6.1	0.7	2.0	5.8	6.1	7.1
United States	9.3	3.4	4.4	9.9	5.0	6.4
MENA non-oil exports ($bn)	46.1	64.4	85.1	108.9	115.9	111.5
MENA worker remittance receipts ($bn)	11.0	12.6	12.9	13.2	13.6	13.6
MENA Tourism revenues ($bn)	8.9	13.7	15.2	16.5	17.7	19.0
Memo items:						
Growth of world oil demand (mb/d, %)	1.5	0.8	2.3	3.4	1.7	1.7
Growth of MENA oil production	2.0	-8.7	9.0	5.9	0.6	0.8
Oil price, (ch%)	2.1	2.4	15.9	30.5	6.1	-10.0
Growth of MENA hydrocarbons exports (%)	6.0	1.2	27.4	36.7	4.6	-7.1
MENA Hydrocarbon exports per-capita ($)	464.4	568.4	710.3	950.0	972.8	884.6
Real hydrocarbon exports per capita /1	408.4	445.6	546.9	715.5	716.5	638.7
Worker remittance receipts per capita	45.8	45.1	45.3	45.3	45.9	44.9
Tourism revenues per capita	36.9	49.2	53.6	56.8	59.7	62.7

Source: World Bank

Notes: /1 Converted to real terms using U.S. GDP deflator, base 1990.

Table 2
Oil exporters: the fiscal dimension

billions U.S. Dollars	1990-2000	2002	2003	2004	2005	2006
	averages			Estimate	Projections	
Current revenues	**96.1**	**218.0**	**260.9**	**329.2**	**337.7**	**319.6**
Tax (direct and indirect)	51.1	98.4	125.3	167.3	176.6	165.1
Non-tax	20.0	36.8	46.9	63.4	62.1	57.7
Other current revenues	25.0	82.8	88.8	98.4	99.0	96.9
Grants	0.4	0.0	0.0	0.0	0.0	0.0
Current revenues plus grants	96.5	218.0	260.9	329.2	337.7	319.6
Capital revenues	0.1	0.0	0.1	0.1	0.1	0.0
Total revenues	**96.6**	**218.0**	**261.1**	**329.2**	**337.7**	**319.7**
Current expenditures	**88.1**	**174.9**	**190.9**	**224.0**	**249.9**	**252.2**
Goods, services and wages	70.2	120.7	132.2	158.5	179.5	181.3
Domestic transfers and subsidies	15.2	50.3	55.4	62.2	66.1	67.3
Interest payments	2.5	3.8	3.3	3.3	4.3	3.7
Other current expenditures	0.2	0.1	0.0	0.0	0.0	0.0
Capital spending plus net lending	**23.7**	**36.8**	**41.7**	**49.3**	**56.9**	**58.4**
Total expenditures	**111.9**	**211.7**	**232.6**	**273.3**	**306.8**	**310.6**
Balances						
Current balance	8.4	43.1	70.0	105.2	87.7	67.4
Capital balance	-23.6	-36.8	-41.5	-49.2	-56.9	-58.3
Overall balance	**-15.2**	**6.3**	**28.5**	**56.0**	**30.9**	**9.1**
Percent of GDP						
Total revenues incl grants	23.3	41.7	43.7	46.6	45.1	41.9
Total expenditures incl NLD	27.0	40.5	38.9	38.7	41.0	40.7
Current balance	2.0	8.3	11.7	14.9	11.7	8.8
Capital balance	-5.7	-7.0	-6.9	-7.0	-7.6	-7.6
Overall balance	**-3.7**	**1.2**	**4.8**	**7.9**	**4.1**	**1.2**

Source: World Bank

Table 3
MENA external accounts (1990-2006)

U.S. dollars, growth rates, or as indicated	averages 1990-2000	2002	2003	Estimate 2004	Projections 2005	2006
MENA Geographic Region						
Export revenues (GNFS) $bn	**182.0**	**258.1**	**327.2**	**428.6**	**451.5**	**429.8**
Export volume growth (%)	**4.2**	**3.9**	**13.6**	**6.1**	**3.9**	**3.9**
Current account balance $bn	**1.6**	**33.4**	**71.3**	**133.5**	**134.3**	**101.4**
Resource-poor Labor abundant						
Export revenues (GNFS) $bn	**31.8**	**42.5**	**49.8**	**56.3**	**60.8**	**63.7**
Export volume growth (%)	**3.3**	**5.7**	**17.1**	**7.3**	**6.1**	**6.0**
Current account balance $bn	**-0.8**	**1.7**	**5.6**	**3.9**	**2.4**	**2.3**
Egypt						
Export revenues (GNFS) $bn	12.9	16.4	20.1	22.0	23.4	23.8
Export volume growth (%)	4.0	4.5	29.1	8.0	5.7	4.8
Current account balance $bn	0.5	0.6	3.7	3.3	3.5	3.0
Jordan						
Export revenues (GNFS) $bn	3.2	4.3	4.6	5.3	5.7	6.2
Export volume growth (%)	2.8	13.4	6.3	10.4	8.0	7.0
Current account balance $bn	-0.2	0.4	1.0	0.4	0.3	0.5
Morocco						
Export revenues (GNFS) $bn	8.5	12.2	14.2	16.6	18.6	20.1
Export volume growth (%)	3.6	9.0	16.9	7.8	6.8	7.6
Current account balance $bn	-0.4	1.5	1.6	1.2	-0.3	-0.4
Tunisia						
Export revenues (GNFS) $bn	7.2	9.5	11.0	12.4	13.0	13.6
Export volume growth (%)	2.2	-0.1	5.0	4.0	5.0	5.3
Current account balance $bn	-0.7	-0.7	-0.7	-1.0	-1.0	-0.8
Resource-rich Labor abundant						
Export revenues (GNFS) $bn	**40.9**	**63.2**	**82.4**	**109.7**	**114.6**	**108.3**
Export volume growth (%)	**3.5**	**14.3**	**14.9**	**4.9**	**3.7**	**3.8**
Current account balance $bn	**3.2**	**12.0**	**18.5**	**35.5**	**34.9**	**26.4**
Algeria						
Export revenues (GNFS) $bn	12.9	18.9	25.5	35.4	35.7	34.0
Export volume growth (%)	2.2	4.6	6.4	4.2	3.8	4.3
Current account balance $bn	1.7	6.0	9.8	16.6	13.9	10.9
Iran						
Export revenues (GNFS) $bn	20.7	32.3	45.5	59.6	63.1	59.4
Export volume growth (%)	4.1	22.9	28.5	5.4	3.7	3.7
Current account balance $bn	1.2	4.0	7.9	16.8	18.5	14.0
Syria						
Export revenues (GNFS) $bn	5.3	8.2	7.1	9.2	9.7	9.2
Export volume growth (%)	3.3	5.5	-21.8	5.0	3.0	2.6
Current account balance $bn	0.3	1.4	0.8	1.5	1.7	1.1
Yemen						
Export revenues (GNFS) $bn	2.1	3.8	4.3	5.6	6.0	5.6
Export volume growth (%)	6.7	6.0	0.3	2.4	5.0	3.7
Current account balance $bn	0.0	0.5	0.1	0.6	0.8	0.4
Resource-rich Labor importing						
Export revenues (GNFS) $bn	**109.2**	**152.4**	**195.0**	**262.6**	**276.1**	**257.8**
Export volume growth (%)	**4.8**	**-1.0**	**11.7**	**6.1**	**3.2**	**3.2**
Current account balance $bn	**-0.7**	**19.7**	**47.2**	**94.1**	**96.9**	**72.7**
Bahrain						
Export revenues (GNFS) $bn	4.6	7.0	7.8	10.4	11.5	11.4
Export volume growth (%)	3.1	12.5	1.0	8.3	7.9	7.2
Current account balance $bn	-0.4	-0.5	-0.1	0.9	1.3	1.1
Kuwait						
Export revenues (GNFS) $bn	12.3	17.0	22.9	31.3	32.9	30.6
Export volume growth (%)	7.5	-5.9	16.4	7.8	2.3	1.6
Current account balance $bn	2.2	4.3	7.6	13.7	13.9	10.7
Oman						
Export revenues (GNFS) $bn	6.9	11.6	15.3	19.4	17.9	16.4
Export volume growth (%)	5.8	-0.8	-7.8	3.8	4.2	5.8
Current account balance $bn	0.0	1.8	4.6	7.6	5.4	3.4
Saudi Arabia						
Export revenues (GNFS) $bn	55.2	77.7	100.7	136.4	144.3	134.6
Export volume growth (%)	3.8	4.4	15.3	6.2	2.8	2.9
Current account balance $bn	-7.3	11.9	29.7	56.8	60.6	48.0
United Arab Emirates						
Export revenues (GNFS) $bn	30.2	39.1	48.4	65.2	69.4	64.8
Export volume growth (%)	5.7	-10.6	10.4	5.3	3.3	3.1
Current account balance $bn	4.7	2.3	5.4	15.1	15.7	9.5

Source: World Bank

Table 4
MENA fiscal balances

Current U.S. dollars, and as a share or GDP	averages 1990-2000		2002	2003	Estimate 2004	Projections 2005	2006
MENA Geographic Region							
Total revenues, $ bn	130.2		253.1	299.9	368.4	379.1	363.0
Total expenditures, $ bn	147.2		257.2	276.9	318.4	353.8	359.2
Overall balance to GDP (%)	-3.2	2.6	-0.6	3.0	5.8	2.8	0.4
Resource-poor Labor abundant							
Total revenues, $ bn	33.6		35.1	38.8	39.1	41.4	43.3
Total expenditures, $ bn	35.3		45.5	44.3	45.2	46.9	48.7
Overall balance to GDP (%)	-1.5		-6.7	-3.4	-3.8	-3.3	-2.9
Egypt							
Total revenues, $ bn	19.9		17.6	17.1	15.8	16.9	18.7
Total expenditures, $ bn	21.0		27.0	22.2	20.7	21.6	22.2
Overall balance to GDP (%)	-1.4		-10.4	-6.2	-7.1	-6.3	-4.5
Jordan							
Total revenues, $ bn	2.1		3.2	3.7	3.6	3.6	3.9
Total expenditures, $ bn	2.2		3.3	3.8	3.8	4.0	4.2
Overall balance to GDP (%)	-1.0		-0.2	-0.8	-1.9	-3.6	-2.9
Morocco							
Total revenues, $ bn	8.3		9.0	12.0	13.1	13.8	13.2
Total expenditures, $ bn	8.1		9.4	11.5	13.0	13.2	13.6
Overall balance to GDP (%)	0.7		-1.1	1.1	0.2	1.0	-0.8
Tunisia							
Total revenues, $ bn	4.4		5.2	6.0	6.7	7.1	7.7
Total expenditures, $ bn	5.1		5.9	6.8	7.6	8.1	8.6
Overall balance to GDP (%)	-3.7		-3.1	-3.2	-3.4	-3.4	-3.1
Resource-rich Labor abundant							
Total revenues, $ bn	38.7		59.4	72.5	93.2	92.8	88.4
Total expenditures, $ bn	45.5		60.1	70.5	84.6	93.5	96.8
Overall balance to GDP (%)	-3.7		-0.3	0.9	3.2	-0.2	-2.9
Algeria							
Total revenues, $ bn	14.7		20.1	25.4	35.9	33.9	32.8
Total expenditures, $ bn	12.9		17.3	22.1	27.8	31.1	31.5
Overall balance to GDP (%)	3.8		5.0	5.2	10.7	3.6	1.6
Iran							
Total revenues, $ bn	20.1		30.5	38.2	48.2	49.9	46.8
Total expenditures, $ bn	27.6		33.2	38.5	46.3	51.9	54.7
Overall balance to GDP (%)	-6.1		-2.4	-0.2	1.2	-1.2	-4.7
Syria							
Total revenues, $ bn	3.3		5.6	5.3	5.1	5.4	5.7
Total expenditures, $ bn	3.4		6.2	6.0	6.2	6.6	7.0
Overall balance to GDP (%)	-1.1		-3.2	-3.1	-4.3	-4.2	-4.3
Yemen							
Total revenues, $ bn	1.6		3.2	3.6	4.0	3.7	3.0
Total expenditures, $ bn	1.8		3.3	3.9	4.2	4.0	3.6
Overall balance to GDP (%)	-5.3		-0.7	-3.0	-1.8	-2.3	-4.6
Resource-rich Labor importing							
Total revenues, $ bn	57.9		158.6	188.5	236.0	244.9	231.3
Total expenditures, $ bn	66.4		151.6	162.0	188.7	213.3	213.8
Overall balance to GDP (%)	-3.6		2.2	7.3	10.9	6.8	3.7
Bahrain							
Total revenues, $ bn	1.7		2.5	2.8	3.2	3.7	3.8
Total expenditures, $ bn	1.9		2.5	2.7	3.1	3.4	3.6
Overall balance to GDP (%)	-3.4		-0.2	2.3	2.0	2.5	1.5
Kuwait							
Total revenues, $ bn	9.9		23.0	27.4	34.0	35.0	32.7
Total expenditures, $ bn	15.1		15.6	17.2	21.7	25.2	27.1
Overall balance to GDP (%)	-35.2		21.2	24.4	23.7	17.5	9.7
Oman							
Total revenues, $ bn	3.9		4.7	6.2	7.9	7.3	6.6
Total expenditures, $ bn	4.9		4.9	5.4	6.2	7.0	7.1
Overall balance to GDP (%)	-8.0		-0.9	3.9	7.8	1.2	-1.7
Saudi Arabia							
Total revenues, $ bn	40.9		121.7	143.7	179.6	186.8	177.1
Total expenditures, $ bn	44.3		122.6	130.5	149.4	168.9	166.9
Overall balance to GDP (%)	-2.4		-0.5	6.2	11.9	6.6	3.7
United Arab Emirates							
Total revenues, $ bn	5.1		6.7	8.3	11.3	12.0	11.1
Total expenditures, $ bn	4.8		6.3	6.5	8.6	9.2	9.3
Overall balance to GDP (%)	0.4		0.6	2.3	2.7	2.8	1.8

Source: World Bank

Table 5
MENA external debt and aid flows

U.S. dollars, growth rates, or as indicated	averages 1990-2000	2000	2001	2002	2003
MENA Geographic Region					
External debt $bn	**174.9**	**180.7**	**178.4**	**189.0**	**188.1**
Grants and technical cooperation $bn	**4.2**	**3.1**	**2.9**	**3.2**	
Debt to GDP (%)	**20.1**	**32.0**	**31.1**	**33.0**	**33.6**
Resource-poor Labor abundant					
External debt $bn	**73.0**	**67.9**	**67.0**	**70.1**	
Grants and technical cooperation $bn	**3.5**	**2.5**	**2.4**	**2.6**	
Debt to GDP (%)	**67.0**	**42.2**	**41.6**	**44.8**	
Egypt					
External debt $bn	31.9	29.2	29.3	30.8	
Grants and technical cooperation $bn	2.4	1.4	1.4	1.4	
Debt to GDP (%)	58.6	29.1	29.5	34.2	
Jordan					
External debt $bn	7.9	7.4	7.5	8.1	
Grants and technical cooperation $bn	0.4	0.5	0.5	0.5	
Debt to GDP (%)	143.7	87.1	85.0	87.0	
Morocco					
External debt $bn	23.4	20.7	19.3	18.6	
Grants and technical cooperation $bn	0.5	0.4	0.4	0.4	
Debt to GDP (%)	78.5	63.8	58.4	52.6	
Tunisia					
External debt $bn	9.9	10.6	10.9	12.6	
Grants and technical cooperation $bn	0.2	0.1	0.2	0.2	
Debt to GDP (%)	62.1	57.4	57.1	63.0	
Resource-rich Labor abundant					
External debt $bn	**71.9**	**60.0**	**56.5**	**58.7**	
Grants and technical cooperation $bn	**0.7**	**0.6**	**0.5**	**0.6**	
Debt to GDP (%)	**49.1**	**32.9**	**28.2**	**29.4**	
Algeria					
External debt $bn	29.7	25.3	22.6	22.8	
Grants and technical cooperation $bn	0.2	0.1	0.1	0.2	
Debt to GDP (%)	65.7	49.8	42.5	42.5	
Iran					
External debt $bn	15.7	8.0	7.5	9.2	
Grants and technical cooperation $bn	0.2	0.1	0.1	0.1	
Debt to GDP (%)	20.1	7.9	6.2	8.0	
Syria					
External debt $bn	20.5	21.7	21.3	21.5	
Grants and technical cooperation $bn	0.2	0.1	0.1	0.1	
Debt to GNI (%)	158.5	125.7	116.5	113.0	
Yemen					
External debt $bn	6.0	5.1	5.1	5.3	
Grants and technical cooperation $bn	0.2	0.2	0.2	0.2	
Debt to GDP (%)	124.1	58.8	57.5	57.4	
Resource-rich Labor importing					
External debt $bn	**4.8**	**6.6**	**6.0**	**4.6**	
Grants and technical cooperation $bn	**0.0**	**0.0**	**0.0**	**0.0**	
Debt to GDP (%)	**0.0**	**0.0**	**0.0**	**0.0**	
Bahrain					
External debt $bn	0.0	0.0	0.0	0.0	
Grants and technical cooperation $bn	0.0	0.0	0.0	0.0	
Debt to GDP (%)	0.0	0.0	0.0	0.0	
Kuwait					
External debt $bn	0.0	0.0	0.0	0.0	
Grants and technical cooperation $bn	0.0	0.0	0.0	0.0	
Debt to GDP (%)	0.0	0.0	0.0	0.0	
Oman					
External debt $bn	4.8	6.6	6.0	4.6	
Grants and technical cooperation $bn	0.0	0.0	0.0	0.0	
Debt to GDP (%)	38.1	34.3	31.1	23.4	
Saudi Arabia					
External debt $bn	0.0	0.0	0.0	0.0	
Grants and technical cooperation $bn	0.0	0.0	0.0	0.0	
Debt to GDP (%)	0.0	0.0	0.0	0.0	
United Arab Emirates					
External debt $bn	0.0	0.0	0.0	0.0	
Grants and technical cooperation $bn	0.0	0.0	0.0	0.0	
Debt to GDP (%)	0.0	0.0	0.0	0.0	

Source: World Bank

Table 6
MENA inflation (1990-2006)

Private consumption deflator (%), regional/sub-regional rates are medians	averages 1990-2000	2002	2003	Estimate 2004	Projections 2005	2006
MENA Geographic Region	**3.3**	**3.2**	**3.6**	**3.6**	**3.5**	**4.1**
Resource-poor Labor abundant	**4.3**	**4.0**	**3.1**	**4.3**	**4.2**	**5.1**
Egypt	4.4	2.4	2.5	1.1	3.1	4.7
Jordan	4.9	4.1	-0.6	7.6	5.5	5.5
Morocco	2.5	4.6	7.9	3.6	3.0	4.1
Tunisia	4.3	3.9	3.7	5.0	5.2	5.5
Resource-rich Labor abundant	**2.8**	**3.8**	**8.7**	**4.1**	**3.7**	**3.5**
Algeria	-0.1	3.1	-4.0	5.1	4.2	4.5
Iran	3.3	5.2	6.1	5.0	5.5	4.0
Syria	2.2	-0.4	23.4	3.1	3.2	3.0
Yemen	4.0	4.6	11.2	2.2	2.5	2.0
Resource-rich Labor importing	**2.8**	**1.5**	**3.5**	**3.2**	**3.5**	**4.0**
Bahrain	2.8	3.2	3.5	3.2	3.5	4.0
Kuwait	3.7	0.4	3.6	6.0	5.5	5.0
Oman	-9.2	5.0	3.5	3.2	3.5	4.0
Saudi Arabia	-0.3	0.8	2.5	3.0	3.0	2.2
United Arab Emirates	4.4	1.5	4.0	6.0	6.5	5.0

Source: World Bank

ANNEX 2: CONSTRUCTING THE STRUCTURAL REFORM INDICES

At its core, structural reform involves changing the institutional framework and eliminating or reducing constraints that affect market behavior and outcomes. Measuring these changes is a complex process. A wealth of literature on measuring structural reform provides a broad range of outcome-based measures. However, such measures (e.g., of trade reform through trade/GDP ratios) are based on the incorrect assumption that improvements in values are due primarily to policy changes, when they may be affected by a wide variety of factors outside of the policy variable being considered. Policy instruments are thus generally preferable for an analysis of the institutional framework for growth. However the availability of these indicators is often sparse.

Our analysis of structural reform in the region is based primarily on policy instruments (instruments in the direct control of the government), although a few outcome-measurements were utilized to supplement our information base. Using a range of measures of policy changes, three indices of structural reform were composed, summarizing the broad reform progress made in the areas of trade openness, business environment, and governance reform over the past few years.

As explained in chapter 3, structural reform measures took values from 0 to 100, reflecting the country's reform progress in the world cumulative frequency distribution. Progress was measured as the change in the country's ranking worldwide over time, with the greatest positive change in rank (improvement in rank) associated with the cumulative frequency 100.

Where composite indicators were developed, an average of the cumulative frequencies was taken across underlying indicators. This two-stage process (computing the cumulative frequency for each underlying indicator, then averaging across underlying indicators, and expressing as a cumulative frequency) allowed for varying distributions among the underlying rank-progress indicators. An alternate method – simply averaging the change in rank across underlying indicators and expressing as a cumulative frequency – would implicitly and spuriously assume that the ability to move up in rank is equivalent for each structural reform measure. This is likely not to be the case. A unilateral decision to cut tariffs, for example, could result in a country dramatically moving up in worldwide rank over just one period. For other structural reform measures examined, such as the number of procedures required to start a business, because changes often require parliamentary approval, it is much less likely that a country could rise significantly in rank over a short period of time. Nonetheless, small improvements in rank may imply significant reform progress, which we want to fully reflect.

Trade Openness

The index for progress made in trade openness was constructed using a single policy based measure (due to data limitations). The trade reform index measured the change in country rank in a worldwide ranking of simple average tariffs in 2000 and 2004. Tariff information comes from UNCTAD's TRAINS database.

Business Environment

Progress in improving the business environment was measured through changes in country rank with regard to a range of World Bank *Doing Business Indicators*[77] of business regulation and procedures, supplemented by financial sector information from *World Development Indicators*. Composite indices were developed for five separate areas of business regulation and financial and legal development:

(1) *Starting a business:* Comprising four separate components from the *Doing Business* indicators– the number of procedures for starting a business, the time required to complete the procedures, the cost for starting a business (in terms of income per capita) and the minimum capital required to start a business (in terms of income per capita). Available for 2003 and 2004.

(2) *Hiring and firing*: Comprising two *Doing Business* indices measuring the difficulty of hiring and the difficulty of firing. The difficulty of hiring index measures a variety of aspects of hiring, including (i) whether term contracts can only be used for temporary tasks; (ii) the maximum duration of term contracts; (iii) the ratio of the mandated minimum wage (or apprentice wage, if available) to the average value-added per working population. The difficulty of firing index has eight components: (i) whether redundancy is not grounds for dismissal; (ii) whether the employer needs to notify the labor union or the labor ministry for firing one redundant worker; (iii) whether the employer needs to notify the labor union or the labor ministry for group dismissals; (iv) whether the employer needs approval from the labor union or the labor ministry for firing one redundant worker; (v) whether the employer needs approval from the labor union or the labor ministry for group dismissals; (vi) whether the law mandates training or replacement prior to dismissal; (vii) whether priority rules apply for dismissals; and (viii) whether priority rules apply for re-employment. Available for 2003 and 2004.

(3) *Access to credit:* Measured using the *World Development Indicators* measure of domestic credit provided to the private sector as a share of GDP. Available for 2000 and 2003.

---

[77] World Bank 2004a, 2005.

(4) *Enforcing contracts:* Comprising three separate *Doing Business* components – the average number of procedures required to enforce a contract, the number of days required to enforce a contract, and the average cost to enforce a contract, in terms of country income per capita. Available for 2003 and 2004.

(5) *Closing a business*: Comprising two *Doing Business* components – the average time (in years) to close a business and the cost (in terms of percent of estate). Available for 2003 and 2004.

In addition to composite indices for each area of business regulation and financial and legal infrastructure, an overall business environment index was computed as the average of the five area composite scores, expressed as a relative cumulative frequency. Thus, a score of 100 reflects that the country in question had the strongest average progress in terms of change of rank across all five business environment areas (with each business area receiving equal weight in the final score).

Governance and public sector reform

Our measurement of governance relies on the methodology developed in the World Bank's 2003 report on governance in the MENA region[78]. From that report, two separate spheres of governance were examined: governance related to public accountability and governance related to the quality of public administration. Using their methodology, two indicators of governance were developed:

1) ***Index of public accountability (IPA):*** Comprised of 12 separate measures:

   i. Freedom House political rights measure[79]
   ii. Freedom House civil liberties measure[80]
   iii. Freedom House freedom of the press ranking[81]
   iv. Center for International Development and Conflict Management (CIDCM) Polity IV database polity score[82]
   v. CIDCM Polity IV database regulation of executive recruitment
   vi. CIDCM Polity IV database competitiveness of executive recruitment

[78] World Bank 2003b.
[79] Freedom House 2001a, 2005; ratings for 2000 and 2004.
[80] Freedom House 2001a, 2005; ratings for 2000 and 2004.
[81] Freedom House 2001b, 2004; ratings for 2000 and 2003.
[82] Center for International Development and Conflict Management 2004; ratings for 2000 and 2003.

vii. CIDCM Polity IV database openness of executive recruitment
viii. CIDCM Polity IV database regulation of participation
ix. CIDCM Polity IV database competitiveness of participation
x. CIDCM Policy IV database executive constraints
xi. Political Risk Services (PRS) index of democratic accountability[83]
xii. World Bank Country Policy and Institutional Assessment (CPIA) indicator of transparency and accountability[84]

2) ***Index of quality of public administration (IQA):*** Comprised of 10 separate measures:
   i. Political Risk Services index of corruption
   ii. Political Risk Services index of bureaucratic quality.
   iii. World Bank CPIA property rights and rule bases governance assessment[85]
   iv. World Bank CPIA quality of budgetary and financial management assessment[86]
   v. World Bank CPIA efficiency of revenue mobilization assessment[87]
   vi. World Bank CPIA quality of public administration assessment[88]
   vii. Heritage Foundation index of property rights[89]
   viii. Heritage Foundation index of regulation
   ix. Heritage Foundation index of informal market activity
   x. Djankov and others 2000 (number of procedures)[90].

From the Governance Report, principal component analysis (PCA) was performed on the twelve and ten measures listed above to derive the two broad governance indicators.

Our measure of progress in these two broad areas of governance utilized the underlying indicators of these governance indices, but not the composite governance indices themselves[91]. Within each

[83] Political Risk Services 2004; ratings for 2000 and 2003.
[84] Ratings for 2000 and 2003.
[85] World Bank 2004e; ratings for 2000 and 2003.
[86] World Bank 2004e; ratings for 2000 and 2003.
[87] World Bank 2004e; ratings for 2000 and 2003.
[88] World Bank 2004e; ratings for 2000 and 2003.
[89] Heritage Foundation 2005.
[90] Djankov and others 2000.
[91] We utilized the underlying indicators rather than the composite to getter a fuller set of information on structural reform progress.

broad governance indicator, the change in rank was determined for each sub-indicator. A relative cumulative distribution of the change in rank was determined for each sub-indicator, with a mean of 50. The overall governance reform progress indicator was constructed by taking the average of the relative cumulative distributions for all countries in which at least half of the sub-indicators were present. Finally, the results were normalized for ease in interpretation, with mean of 50.

Our indicator of progress in reform of quality of the administration did not utilize the identical underlying indicators as the World Bank's quality of administration governance index, in that it did not include the Djankov[92] indicator, the reason being that this indicator was subsequently updated and is included as part of the *Doing Business*[93] indicators. The Djankov indicator was incorporated in the indicators of progress in structural reform of the business environment.

[92] Djankov and others 2000.
[93] World Bank 2004b.

BIBLIOGRAPHY

Bolaky, Bineswaree and Caroline Freund. 2004. "Trade, Regulations and Growth." World Bank Policy Research Working Paper 3255. The World Bank. Washington, D.C.

Center for International Development and Conflict Management. 2004. *Polity IV Project, Political Regime Characteristics and Transitions: 1800-2003*. University of Maryland, College Park. Available online at www.cidcm.umd.edu/inscr/polity/index.htm.

Djankov, Simeon, Rafael La Porta, Florencio Lopez de Silanes, and Andrei Shleifer. 2000. "The Regulation of Entry." NBER Working Paper. National Bureau of Economic Research. Cambridge, Massachusetts.

Financial Times. 2004. (December 6) "OPEC Sharply Reduces Dollar Exposure."

Freedom House. 2005. *Freedom in the World 2004*. Washington, D.C. Available online at www.freedomhouse.org.

Freedom House. 2004. *Freedom of the Press 2004.* Washington, D.C. Available online at www.freedomhouse.org.

Freedom House. 2001a. *Freedom in the World 2000-2001*. Washington, D.C. Available online at www.freedomhouse.org.

Freedom House. 2001b. *Press Freedom Survey 2000.* Washington, D.C. Available online at www.freedomhouse.org.

Gardner, Edward. 2003. "Creating Employment in the Middle East and North Africa". International Monetary Fund. Washington, D.C.

Gelb, Alan, Benn Eifert and Nils Borje Tallroth, 2002. "The Political Economy of Fiscal Policy and Economic Management in Oil Exporting Countries." Presentation to the IMF Conference on Fiscal Policy Formulation and Implementation in Oil-Producing Countries. June 5-6.

Gilbert, Christopher L. 1995. "International Commodity Control: Retrospect and Prospect." Policy Research Working Paper 1545. World Bank. Washington, D.C.

Hammouya, Messaoud. 1999. "Statistics on Public Sector Employment: Methodology, Structure and Trends." Sectoral Activities Program Working Paper 144. International Labor Organization. Geneva.

Heritage Foundation. 2005. *2005 Index of Economic Freedom*. Washington, D.C. Available online at www.heritage.org/research/features/index.

Hoekman, Bernard, and Patrick Messerlin. 2002. "Initial Conditions and Incentives for Arab Economic Integration: Can the European Community´s Success by Emulated?" World Bank Policy Research Paper 2921. World Bank. Washington, D.C.

ILO (International Labor Organization) 2004. "Global Employment Trends for Women 2004." Employment strategy paper. March. Geneva.

IMF (International Monetary Fund). 2004a. *Government Finance Statistics.* Washington, D.C.

IMF (International Monetary Fund). 2004b. *World Economic Outlook: Advancing Structural Reforms.* IMF World Economic and Financial Surveys. April. Washington, D.C.

IMF (International Monetary Fund). 2003. The Islamic Republic of Iran *Article IV* consultation. September. Washington, D.C.

Loayza, Norman and Raimundo Soto. 2003. "On the Measurement of Market-Oriented Reforms." Draft working paper. December.

Mattoo, Aaditya, Arvind Subramanian, and Randeep Rathindran. 1999. "Measuring Services Trade Liberalization and Its Impact on Economic Growth: An Illustration." World Bank Policy Research Working Paper 2655. World Bank. Washington, D.C.

MEED (Middle East Economic Digest) 2004a (June 25-July 1). Vol. 48, No. 26. London.

MEED (Middle East Economic Digest) 2004b (September 3-9). Vol. 48, No. 36. London.

MEED (Middle East Economic Digest). 2004c (November 12-18). Vol. 48, No. 46. London.

MEED (Middle East Economic Digest). 2004d (November 26 – December 2). Vol. 48, No. 48. London.

MEED (Middle East Economic Digest). 2004e (December 3-9). Vol. 44, No. 49. London.

MEES. (Middle East Economic Survey). 2004a. (December 6). Vol. 47, No. 49. Nicosia, Cyprus.

MEES (Middle East Economic Survey). 2004b. (December 20-27) Vol. 47, No. 51-52. Nicosia, Cyprus.

Middle East International. 2004a (September 10). No. 733. London.

Middle East International. 2004b (September 24).No. 734. London.

Muller-Jentsch. 2005. "Deeper Integration in Trade Services in the Euro-Mediterranean Region: Southern Dimensions of the European Neighborhood Policy." Draft working paper. The World Bank. Washington, D.C.

OECD (Organization for Economic Cooperation and Development). 2004 *Public Sector Pay and Employment database (PSPE)*. Available online at www.oecd.org.

Oxford Analytica. 2004 (May 12). "Structural Risks Dog Non-Oil Bourses."

Political Risk Services. 2004. *International Country Risk Guide*. PRS Group. New York. Available online at www.prsgroup.com.

The Banker. 2004 (August 2). "GCC Economies Are Booming." London.

UNESCWA (United Nations Economic and Social Commission for Western Asia). 2004. Survey of Economic and Social Developments in the ESCWA Region 2002-2003. United Nations. New York.

World Bank. 2005a. *Economic Growth in the 1990s: Learning from a Decade of Reform.* Washington, DC. World Bank. Washington, D.C.

World Bank, 2005b. *Doing Business Indicators.* World Bank. Washington, D.C. Available online at www.worldbank.org.

World Bank. 2004a. *Private Sector Brief*. MENA Region. World Bank. Washington, D.C.

World Bank. 2004b. *Doing Business Indicators*. World Bank. Washington, D.C. Available online at www.worldbank.org.

World Bank. 2004c. "PREM Notes". July 2004. World Bank Public Sector Group. World Bank. Washington, D.C.

World Bank. 2004d. *World Development Indicators.* August 2004 electronic version. World Bank. Washington, D.C.

World Bank. 2004e. *Country Policy and Institutional Assessment - 2003*. Washington, D.C.

World Bank. 2003a. *Trade, Investment, and Development in the Middle East and North Africa: Engaging with the World*. MENA Development Report. World Bank.Washington, D.C.

World Bank. 2003b. *Better Governance for Development in the Middle East and North Africa: Enhancing Inclusiveness and Accountability*. MENA Development Report. World Bank. Washington, D.C.

World Bank. 2003c. *Gender and Development in the Middle East and North Africa: Women in the Public Sphere*. MENA Development Report. World Bank. Washington, D.C.

World Bank. 2003d. *Unlocking the Employment Potential in the Middle East and North Africa: Toward a New Social Contract*. MENA Development Report. World Bank. Washington, D.C.

World Bank. 2003e. *Jobs, Growth, and Governance in the Middle East and North Africa: Unlocking the Potential for Prosperity.* World Bank. Washington, D.C.