MIDDLE EAST AND NORTH AFRICA REGION

2006 Economic Developments and Prospects

FINANCIAL MARKETS IN A NEW AGE OF OIL

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MENA ECONOMIC DEVELOPMENTS AND PROSPECTS 2006

2005 was a year of major developments in the Middle East and North Africa (MENA) region. A few events made international headlines during 2005: oil prices hitting record levels, the continuing turmoil in Iraq, building tensions regarding the nuclear policy of the Islamic Republic of Iran, the aftermath of political upheaval in Lebanon, and the uncertain political situation and aid implications in the West Bank and Gaza. But many of the developments that have not made headlines—the deteriorating impact of high oil prices on nonoil producers in the region, increasing moves by oil producers to channel windfalls into longer-term assets, and progress with structural reforms—have been just as important in determining the direction of the economies in the MENA region.

With oil prices continuing their soaring advances, the efficiency with which the region channels its oil-related resources into the real economy will depend critically upon the region's financial sectors. It is thus particularly opportune to examine the state of the region's financial systems and to understand how they contribute to growth, promote efficiency, and enhance productivity: through corporate governance, through savings mobilization, and through their ability to protect against systemic shocks.

This is the second volume in a new series of annual reports on the MENA region. Its aim is to shed light on recent key economic developments in the region and the forces underlying the region's economic outcomes. It analyzes the region's medium-term growth prospects, given global forecasts, and (building on last year's issue) the report continues to chart the region's progress in implementing comprehensive structural reforms for longer-term growth. Also, in this second issue, the important topic of MENA's financial markets is highlighted to understand how financial systems are poised to meet some of the region's development objectives. As always, it is hoped that the report deepens the understanding of the region's development progress, prospects, and challenges.

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Abbreviations and Acronyms

ATM	Automated teller machine
bl	Barrel
bn	Billion
bpd	Barrels per day
CAR	Capital adequacy ratio
DECPG	Development Prospects Group (World Bank)
EU	European Union
FDI	Foreign direct investment
FSDI	Financial Sector Development Indicators (a World Bank database)
FTA	Free trade agreement
GCC	Cooperation Council for the Arab States of the Gulf (formerly named and still commonly called the "Gulf Cooperation Council")
GDP	Gross domestic product
ICA	Investment Climate Assessment (a World Bank report)
IFS	International Financial Statistics (an International Monetary Fund database)
IMF	International Monetary Fund
IPO	Initial public offering
LIBOR	London interbank offered rate
LMIC	Low- and middle-income economies
LPG	Liquified petroleum gas
MEDP	MENA Economic Developments and Prospects (a World Bank report)
MENA	Middle East and North Africa
MFA	Multifiber Agreement
MFN	Most favored nation
mn	Million
MUV	Manufacturers' unit value
NPL	Nonperforming loan
NTB	Nontariff barrier
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries

QIZ	Qualifying industrial zone
RPLA	Resource-poor, labor-abundant
RRLA	Resource-rich, labor-abundant
RRLI	Resource-rich, labor-importing
TRAINS	Trade Analysis and Information System
UAE	The United Arab Emirates
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNWTO	World Tourism Organization
WITS	World Integrated Trade Solution (software)
WTI	West Texas Intermediate
WTO	World Trade Organization

All dollar amounts are U.S. dollars unless otherwise indicated.

Overview

For the third year in a row, the Middle East and North Africa region[1] (MENA) enjoyed a spectacular year of growth, buoyed by record-high growth rates among the region's oil exporters. As oil prices continued their upward climb, the MENA region grew by an average of 6.0 percent over 2005, up from 5.6 percent over 2004, and compared with average growth of only 3.7 percent over the late 1990s. On an annual basis, MENA's average economic growth over the past three years, at 6.2 percent a year, has been the highest three-year growth period for the region since the late 1970s.

MENA's regional growth upturn has not been universally shared, however, and resource-poor economies[2] are increasingly feeling the adverse impact of higher oil prices. In earlier periods, MENA's nonoil economies also benefited from rising oil prices through a range of transmission mechanisms from the oil producers, including labor remittances and aid. Many transmission channels remain and have thrived during the current oil boom, including intraregional tourism and portfolio equity flows, but the overall magnitude of these channels is significantly diminished relative to prior booms. Moreover, with rising energy use, MENA's resource-poor countries are increasingly experiencing the negative consequences of higher oil prices on the external and fiscal fronts, in the form of higher oil import bills and energy subsidies.

Growth patterns among oil producers,[3] on the other hand, have been increasingly harmonized, reflecting a trend toward common development strategies. Compared with previous oil booms, the region's oil producers are increasingly demonstrating impressive fiscal restraint. They are building up liquidity through external reserves, oil stabilization funds, and paying down debt. They are also pursuing common strategies for diversification of the oil wealth into foreign assets, as a way to transform the finite oil wealth into longer-term revenue streams. They have worked almost in unison to develop trade ties and to encourage greater foreign participation in their economies. With increased prudence, the volatile growth outcomes among oil producers that characterized the 1970s and 1980s have been increasingly supplanted by a common growth effect.

Although oil prices dominate the region's external landscape, MENA has experienced other important

[1] The Middle East and North Africa region comprises Algeria, Bahrain, Djibouti, the Arab Republic of Egypt, the Islamic Republic of Iran, Iraq, Jordan, Kuwait, Lebanon, Libya, Morocco, Oman, Qatar, Saudi Arabia, Syria, Tunisia, the United Arab Emirates, the West Bank and Gaza, and the Republic of Yemen.

[2] Resource-poor economies include Djibouti, Egypt, Jordan, Lebanon, Morocco, Tunisia, and the West Bank and Gaza.

[3] Dominant oil producers in the region include Algeria, Bahrain, the Islamic Republic of Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, Syria, the United Arab Emirates, and the Republic of Yemen.

developments on the trade front. Resource-poor economies have dealt with the expiration of the Multifiber Agreement in 2005, which had allowed privileged access to European markets for the Arab Republic of Egypt, Morocco, and Tunisia in textile and clothing products. Textile exports in Tunisia and Morocco have been hard hit, while Egypt has managed to maintain textile exports to date, in part by cushioning the impact with a December 2004 agreement on qualifying industrial zones between Egypt, Israel, and the United States.

On the fiscal front, the sharp rise in oil prices has spotlighted the MENA region's heavy subsidization of oil prices within the domestic market. While oil-importing economies are particularly affected, the reliance on energy subsidies pervades the region, with large fiscal implications. Several resource-poor countries have implemented short-term adjustments to oil prices, but the concerns of potential poverty impacts have held back more ambitious reforms. Among oil exporters, windfall revenues have delayed the perceived urgency for reform.

Over the medium term, general conditions for maintaining a solid pace for growth appear promising. Global oil prices are now anticipated to hold above $50 per barrel through 2008, which will provide for a moderating, yet still substantial, flow of oil revenues to MENA exporters. Should prudent budgetary policies prevail, prospects for the oil-dominant economies are upbeat, with growth easing from 6.7 percent in 2005 to 5.0 percent by 2008. For the diversified economies, the anticipated recovery in European demand will be a key external factor for growth during 2006–2008, as will the easing of oil prices, which should allow some of the costs of subsidies to be recaptured; also, growth among resource-poor economies is viewed to pick up above 5.5 percent. Overall, on a base set of assumptions, including continued moderate progress in domestic reforms, the MENA region's growth is viewed to ease modestly in 2006 to 5.6 percent and to establish a 5.2 percent pace over 2007–2008, reflecting an acceleration for the diversified economies, contrasted with some slowing for oil exporters.

The oil shock MENA is experiencing has had important financial spillovers. Over the past few years, the region has seen an upsurge in financial activity as abundant liquidity has fed a rapid rise in credit growth, surging stock markets, and a booming real estate sector. Oil economies have been the primary recipients, but a financial market upswing has also reached some of the region's resource-poor countries through increased cross-border investment, remittance flows, and tourism.

Many of the recent regional financial sector developments are positive. Strong credit growth and declining nonperforming loans have improved bank profitability and asset quality. Rising equity capital has increased the breadth and depth of investment opportunities to investors. In addition, many countries in the region have utilized their strengthened positions to address long-needed financial sector reforms, including public sector bank restructuring and privatization, licensing private financial entities, improving bank supervision, and upgrading prudential regulations.

However, several of the recent financial sector developments have increased exposure of some MENA economies to negative shocks. Banks have rapidly expanded financing for equity markets. Although the recent stock market gains have been built in part on impressive corporate profitability, stocks have also been increasingly speculative. Bank exposure to equity markets, through both lending and substantial income from brokerage fees, leaves bank income and asset quality vulnerable because of recent market corrections. Banks have also increased exposure to the booming real estate sector, which may be vulnerable to contagion effects from the recent equity market weaknesses and may also face slowdown with growing oversupply.

However, a more troubling aspect about MENA's financial markets is the seeming disconnect between the financial sector and the real private economy, despite the appearance of a relatively deep financial sector by macroeconomic indicators. Although regional banks have abundant liquidity, outside of the Gulf, few private businesses have access to bank finance. Even in countries with relatively high rates of lending to the private sector, credit remains concentrated among a select minority, and investment climate surveys suggest an average of more than 75 percent of private business investment in MENA is financed internally through retained earnings. As a result, few of the assets accumulating to the region are channeled toward productive investment. Moreover, key elements of a well-functioning financial sector that could help boost sustainable and efficient growth, including bond and equity markets and contractual savings instruments, remain largely undeveloped outside of the Gulf.

Overview Table 1: Global developments and MENA GDP growth

Growth, or as otherwise specified	2004	2005	2006	2007	2008
World trade[a]	12.0	9.0	8.5	7.0	7.0
High-income imports	8.9	6.6	6.7	6.2	6.2
Euro Area	6.3	4.3	5.8	5.3	5.4
United States	10.7	6.2	5.0	3.8	3.8
Oil prices ($/bl)[b]	37.7	53.4	59.0	56.0	53.0
Nonoil commodity prices[c]	17.3	13.4	5.4	–3.1	–5.9
MUV index[d]	6.9	0.0	2.4	2.6	0.8
US dollar LIBOR[e] (%)	1.7	3.6	5.2	5.3	5.2
World GDP[f]	3.8	3.3	3.3	3.2	3.2
High-income countries	3.2	2.8	2.9	2.7	2.8
Euro Area	1.9	1.4	2.1	1.7	1.9
Developing countries	6.9	6.3	6.0	5.7	5.6
MENA[g]	5.6	6.0	5.6	5.2	5.2
Resource-poor	4.8	4.0	5.4	5.4	5.7
Resource-rich	5.9	6.7	5.5	5.2	5.0
Resource-rich, labor-abundant	4.7	5.5	5.3	5.1	4.8
Resource-rich, labor-importing	6.5	7.2	5.8	5.3	5.0

Source: World Bank 2006c.

[a] Goods and services (2000 US$).
[b] World Bank average oil price = equal weights of Brent, West Texas Intermediate (WTI), and Dubai crude oil prices.
[c] World Bank index of nonoil commodity prices in nominal US$ terms.
[d] Index of manufacturers' unit value, G-5 countries (France, Germany, Japan, the United Kingdom, and the United States).
[e] London Interbank Offered Rate.
[f] Real GDP in 2000 US$.
[g] MENA geographic region comprising resource-poor, labor-abundant countries (Djibouti, Egypt, Jordan, Lebanon, Morocco, and Tunisia); resource-rich, labor-abundant countries (Algeria, the Islamic Republic of Iran, Iraq, the Syrian Arab Republic, and the Republic of Yemen); and resource-rich, labor-importing countries (Bahrain, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates).

A few critical facts lie at the heart of the structural disconnect between the relatively plentiful financial resources found across MENA and the scarcity of external financing for businesses. Public sector ownership has significantly impacted the direction of credit in MENA, as well as the operating efficiency and the ability of the banking sector to conduct robust risk analysis. Bank regulatory frameworks, with limited market forms of oversight and discipline, have led to adverse credit allocation. Access to banking facilities remains comparatively limited across the region and in many cases is restricted to public sector banking networks, concentrating credit provision upon a relatively privileged minority. Underdeveloped contractual savings and capital markets remove a source of competition for banks and an alternate avenue for firm finance. Governance structures undermine formal financial relationships across much of MENA. In addition, commercial-finance relationships are further undermined by a wealth of problems in MENA's business climate.

The region's recent strong liquidity creates a window for the governments of the MENA region to either accelerate or postpone the complicated process of reform, both within the financial sector and in the economy in general. With the large windfall revenues accruing to oil producers since 2002, a natural question emerges as to what impact oil is having on the reform process. To date, the large budget surpluses appear to have delayed the imperative for reform of the oil subsidy system in resource-rich economies. Oil producers have also exhibited weaker reform progress over the past several years than have the region's resource-poor economies along two major structural reform fronts: improving the business climate and liberalizing trade.

However, the more subdued progress made by oil exporters in these areas of reform in large part reflects lack of improvements among the economies of the GCC (Cooperation Council for the Arab States of the Gulf, formerly named and still commonly called the Gulf Cooperation Council), which

have traditionally maintained more open and business-friendly trade and investment policies. More important, as a group, the oil economies have demonstrated long-awaited progress in governance, an area in which the group demonstrates a significant deficit relative to the rest of the world. Specifically, notable progress has taken place over the past five years in enhancing public sector accountability mechanisms, which augers well for continuing reform success. Although oil economies continue to rank in the bottom 20th percentile relative to the rest of the world with regard to measures of public sector accountability (including political and civil liberties, freedom of information, and so forth[4]), over the past five years, oil economies have made greater progress in improving public sector accountability than have all other regions of the world, ranking (on average) in the 65th percentile worldwide with regard to improving public accountability.

Worldwide, successful reform efforts have depended critically upon the support and participation of those in society whom reforms will impact. The governance improvements in MENA, with regard to enhancing the accountability of governments and granting greater voice in development to MENA's people, are important not only to take into account the needs and values of those who are affected by reforms but also to ensure that in the transition to a new development model, the economic outcomes are socially acceptable among those who have benefited from the old systems. The MENA region continues to have the greatest gap with the rest of the world with regard to accountable and inclusive governance structures, ranking (on average) in the bottom quintile worldwide. It is thus an important development that both resource-rich and resource-poor economies in MENA are making a start at these vital changes.

With diminishing positive links to the oil economies (and increasing negative impacts from higher oil prices), the resource-poor economies in the MENA region have maintained a solid pace of reform, generally exceeding other regions of the world across all areas of reform. In both trade reform and business and regulatory reform, the resource-poor economies have made (on average) stronger progress over the past five years than have all other regions of the world. Largely in connection with recent bilateral and multilateral trade agreements and led by deep tariff reductions undertaken in Egypt, resource-poor economies ranked (on average) in the 71st percentile with regard to tariff reform over the past five years. With regard to reform of the business climate, the steps taken by resource-poor economies placed them (on average) in the top 63rd percentile. Nonetheless, much stronger progress can take place, particularly with regard to trade liberalization. The resource-poor economies as a group continue to maintain some of the highest tariffs in the world, ranking in the bottom 25th percentile worldwide with regard to low tariff protection.

In the area of governance, resource-poor economies have also demonstrated significant progress. In the area of improving public sector accountability, resource-poor countries ranked (on average) in the 62nd percentile with regard to reform progress, second only to the gains made by the MENA region's resource-rich economies. In improving the quality of public sector administration, the group ranked in the 82nd percentile with regard to reform—the strongest progress worldwide, led by strong achievements in Egypt, Morocco, and Tunisia.

Along with across-the-board policy reform, MENA economies continue to look to selective industrial policies designed to enhance specific sector competitiveness and growth to complement more broad-based structural reform. Although the views on industrial policy are changing and a variety of economic justifications can be made for their use, MENA's own unsuccessful history with industrial policies (and the difficulty in transitioning out of them) should serve as a cautious reminder that the most effective policies for promoting growth rely on strategies to create a neutral and internationally competitive business environment.

[4] See appendix B for a description and the methodology behind governance indexes.

Overview Table 2: Structural reform progress in MENA, 2000–2005

Country/region	Trade policy		Business climate		Governance: quality of public administration		Governance: public sector accountability	
	Current status	Reform progress	Current status	Reform progress	Current status	Reform progress	Current status	Reform progress
Algeria	44	71	13	38	38	91	29	91
Bahrain	..	62	..	..	77	26	23	91
Djibouti	..	51	..	..	..	..	..	..
Egypt, Arab Rep. of	43	100	11	36	43	92	25	84
Iran, Islamic Rep. of	22	74	57	44	16	19	21	4
Iraq	..	..	66	..	..	..	..	..
Jordan	47	86	58	89	66	67	34	60
Kuwait	53	65	59	7	58	24	31	65
Lebanon	61	80	37	31	..	..	..	..
Libya	..	27	..	..	11	64	0	42
Morocco	38	52	61	54	73	83	33	81
Oman	71	11	78	15	61	75	16	81
Qatar	..	..	..	..	60	89	13	74
Saudi Arabia	39	77	80	26	57	77	5	69
Syrian Arab Rep.	18	43	30	5	15	67	7	74
Tunisia	51	57	83	93	74	87	22	22
United Arab Emirates	..	..	43	14	59	6	17	41
Yemen, Rep. of	62	82	35	57	28	71	20	89
MENA	**46**	**63**	**51**	**42**	**49**	**63**	**20**	**64**
Resource-poor	48	71	50	63	64	82	28	62
Resource-rich	44	57	51	23	44	55	17	65
Resource-rich, labor abundant	36	67	40	36	24	62	19	64
Resource-rich, labor importing	54	48	65	15	55	52	15	66
East Asia and Pacific	56	37	61	47	43	45	41	48
Europe and Central Asia	51	69	48	64	47	46	52	51
Latin America and the Caribbean	57	50	40	51	46	50	57	43
High-income OECD	70	64	84	50	89	47	91	49
South Asia	41	48	48	41	48	53	39	31
Sub-Saharan Africa	34	27	27	43	34	53	37	55
World	50	50	50	50	50	50	50	50

Source: World Bank Staff estimates from country data.

Note: For each index, current status reflects a country's current (2005) placement in a worldwide ordering of countries based on a variety of relevant indicators, expressed as a cumulative frequency distribution, with 100 reflecting the country with the "best" policies (worldwide) and 0 representing the country with the "worst" policies (worldwide). Reform progress reflects the improvement in a country's rank between 2000 and 2005 (2003 and 2005 for business and regulatory reform) in a worldwide ordering of countries based on the changes in a variety of relevant indicators, expressed as a cumulative frequency distribution, with 100 reflecting the country with the greatest improvement in rank (worldwide) and 0 reflecting the country with the greatest deterioration in rank (worldwide).

1

Recent Economic Outcomes and Short-Term Development Prospects in MENA

1.1 Introduction

The Middle East and North Africa region[5] (MENA) enjoyed another exceptionally strong year of economic expansion, buoyed by the record-high growth rates among the region's oil exporters. As oil prices continued their upward climb, the MENA region grew by an average of 6.0 percent over 2005, up from 5.6 percent over 2004, and compared with average growth of only 3.7 percent over the late 1990s. On an annual basis, MENA's average economic growth over the past three years, at 6.2 percent a year, has been the highest three-year growth period for the region since the late 1970s.

MENA's regional growth upturn has not been universally shared, however, and resource-poor economies are increasingly feeling the adverse impact of higher oil prices. In earlier periods, MENA's nonoil economies also benefited from rising oil prices through a range of transmission mechanisms from the oil producers, including aid and labor remittances. Many transmission channels remain and have thrived during the current oil boom (including intraregional tourism and portfolio equity flows), but the overall magnitude of these channels is significantly diminished relative to prior booms. Moreover, the positive benefits from these transmission channels have been increasingly overshadowed by the detrimental external and fiscal consequences of higher oil import bills and surging oil subsidies.

Economic growth patterns among oil producers have been increasingly harmonized, reflecting a trend toward common development strategies. Compared with actions during previous oil booms, the region's oil producers are increasingly demonstrating impressive fiscal restraint. They are building up liquidity through external reserves, oil stabilization funds, and paying down debt. They are also pursuing common strategies for diversification of the oil wealth into foreign assets as a way to transform the finite oil wealth into longer-term revenue streams. With this increased prudence, the volatile growth outcomes among oil producers that characterized the 1970s and 1980s have been increasingly supplanted by a common growth effect.

Although oil prices dominate the region's external landscape, MENA has experienced other important developments on the trade front. Resource-poor economies[6] have dealt with the expiration of the Multifiber Agreement (MFA) in 2005, which

[5] The Middle East and North Africa region comprises resource-poor, labor-abundant economies (Djibouti, the Arab Republic of Egypt, Jordan, Lebanon, Morocco, and Tunisia); resource-rich, labor-abundant economies (Algeria, the Islamic Republic of Iran, Iraq, Syria, and the Republic of Yemen); and resource-rich, labor-importing economies (Bahrain, Kuwait, Libya, Qatar, Oman, Saudi Arabia, and the United Arab Emirates).

[6] See previous note for description of MENA country groupings.

had allowed privileged access to European markets for the Arab Republic of Egypt, Morocco, and Tunisia in textile and clothing products. Textile exports in Morocco and Tunisia have been hard hit, while Egypt has managed to maintain textile exports to date, in part by cushioning the impact with a December 2004 agreement on qualifying industrial zones (QIZs) between Egypt, Israel, and the United States.

On the fiscal front, the sharp rise in oil prices has spotlighted the MENA region's heavy subsidization of oil prices within the domestic market. Although oil-importing economies are particularly affected, the reliance on energy subsidies pervades the region, with large implications for fiscal positions. Several resource-poor countries in the region have implemented short-term adjustments to oil prices, although the concerns of potential poverty impacts have held back more ambitious reforms. Among oil producers, windfall revenues have delayed the perceived urgency for reform.

Over the medium term, two major elements are likely to shape the outlook for the broader MENA region: Developments in critical nonoil export markets for MENA will carry substantial influence on the outlook for the region's diversified economies, largely within the resource-poor, labor-abundant group. At the same time, the dynamics of the oil market are anticipated to change as global demand and supply conditions evolve over the next years.

General conditions for maintaining a solid pace for growth over the next years appear promising. Global oil prices are now anticipated to hold above $50 per barrel through 2008, which will provide for a moderating, yet still substantial, flow of oil revenues to MENA exporters. Should prudent budgetary policies prevail, prospects for the oil-dominant economies are upbeat, with growth easing from 6.7 percent in 2005 to 5.0 percent by 2008. For the diversified economies, the anticipated recovery in European demand will be a key external factor for growth during 2006–2008, as will the easing of oil prices, which should allow some of the costs of subsidies to be recaptured. On a base set of assumptions, including continued moderate progress in domestic reforms, the MENA region's growth is viewed to ease modestly in 2006 to 5.5 percent and to establish a 5.2 percent pace during 2007–2008. Overall growth reflects a pickup for the diversified economies above 5.5 percent, contrasted with a slowing for oil exporters toward the 5.0 percent mark.

1.2 Recent Economic Developments

1.2.1 Regional growth outcomes buoyant

The Middle East and North Africa region experienced another stellar year of economic growth, as oil prices continued their upward climb over 2005. Growth in the region averaged 6.0 percent over 2005 (figure 1.1). Over the past three years, gross domestic product (GDP) in the region[7] has grown by an average of 6.2 percent a year, the highest three-year average growth rate for the region in nearly three decades.

Above all, MENA's recent growth upturn reflects the spectacular events in the oil market, where continuing tight supply and volatility in response to external conditions have resulted in surging oil prices over the past three years. Combined with production increases, rising oil prices have fueled extraordinary economic growth among oil producers,[8] which together grew 6.7 percent over 2005 and accounted for 84 percent of regional growth last year.[9] Most impressive has been the economic expansion among the region's resource-rich, labor-importing (RRLI) economies, which grew by more than 7 percent during the year (table 1.1). Most of the group has benefited from OPEC[10] production increases, including Saudi Arabia, which expanded by 6.5 percent (more than a percentage point gain over growth in 2004, and behind 2003, the highest rate of economic growth experienced by the economy in 15 years). Other OPEC producers, including Kuwait, Libya, Qatar, and the United Arab Emirates (UAE), all realized economic growth rates in excess of 8 percent last year, driven by across-the-board increases in the components of domestic demand (private and government consumption, as well as investment).

MENA's resource-rich, labor-abundant (RRLA) economies (excluding Iraq) also reaped the benefits of higher oil prices, supported by expansionary fis-

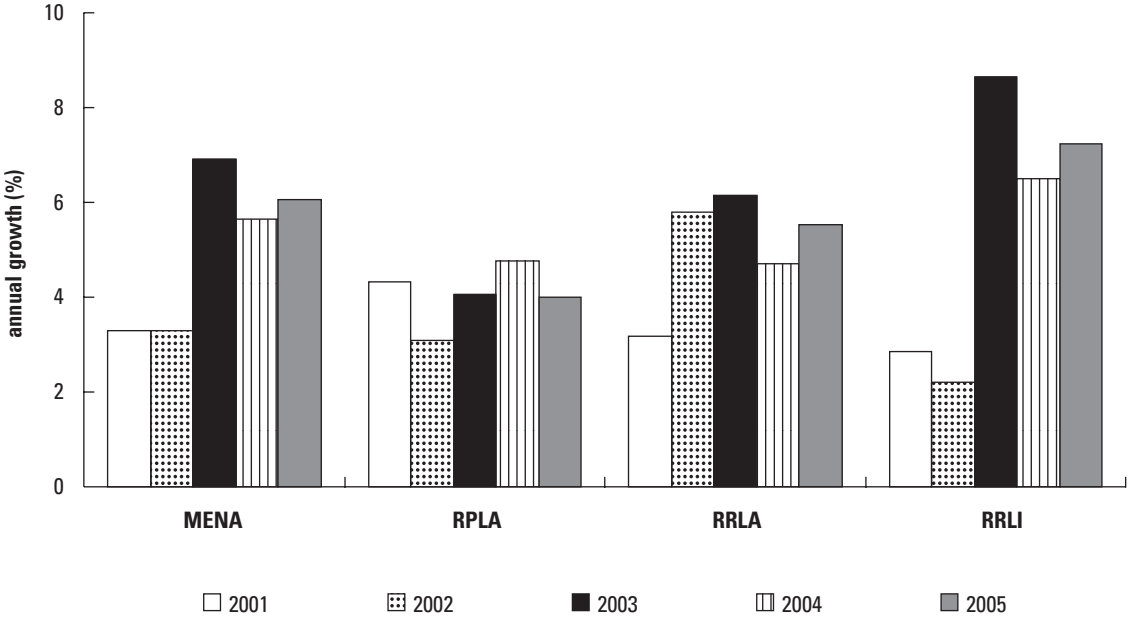
[7] Not including Iraq.

[8] Includes resource-rich, labor-importing economies (Bahrain, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates) and resource-rich, labor-abundant economies (Algeria, the Islamic Republic of Iran, Syria, and the Republic of Yemen), but does not include Iraq.

[9] As a comparison, the oil producers accounted for less than 70 percent of growth during the late 1990s.

[10] OPEC members include Algeria, Indonesia, the Islamic Republic of Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, the United Arab Emirates, and República Bolivariana de Venezuela.

Figure 1.1: Economic growth in MENA, 2000–2005



Source: World Bank staff estimates.

Notes: RPLA = resource-poor, labor-abundant; RRLA = resource-rich, labor-abundant; RRLI = resource-rich, labor-importing.

cal policy (particularly in the Islamic Republic of Iran and the Republic of Yemen). The Islamic Republic of Iran's economy grew by 5.9 percent last year, more than a percentage point gain over last year, while Algeria saw economic growth above 5 percent for the third year in a row. Although higher oil prices have only partially offset the effects of the substantial drop in oil exports (stemming from both production declines and loss of oil reexports from Iraq), the Syrian Arab Republic also managed stronger growth over 2005 because of sizable expansion of nonoil exports to Iraq. Overall, resource-poor, labor-abundant (RPLA) economies recorded robust growth over 2005 of 5.5 percent (up from 4.7 percent last year), driven by strong growth in government spending and improvements in the resource balance.

But the boon to oil producers did not fully translate to resource-poor economies in the region. Growth among resource-poor economies averaged 4.0 percent over the year (down from 4.8 percent in 2004), chiefly reflecting the sharp growth contractions in Morocco and Lebanon and slower growth in Tunisia. Stagnating European demand and a severe drought contributed to a reduction in Morocco's economic growth of almost two-thirds from 2004 (and the lowest annual growth rate for the country in five years), as well as to a drop in growth in Tunisia. Diminished investor confidence and shaken security following the February 2005 assassination of former prime minister Hariri, meanwhile, resulted in Lebanon's economic growth collapsing to 1.0 percent over 2005, down from more than 6.0 percent growth the previous year. Elsewhere, resource-poor countries fared better, including Egypt, where the economic revival has been driven by both manufacturing exports and strong growth of services, including tourism and Suez Canal receipts. Jordan has also posted strong growth, reflecting the rapid expansion of private spending and investment financed by surging capital inflows.

Following a strong economic rebound recorded in 2004, growth in Iraq averaged a sluggish 2.6 percent over 2005, with the country unable to capitalize on soaring oil prices. The sabotage of oilfield installations has thwarted Iraq's ability to increase oil export revenues, and continuing attacks on power and transportation facilities have seriously detracted from developing the nonoil sector of the economy, worth about 33 percent of GDP. The continued lack of security, with regard to both sectarian violence and insurgent activity, has stalled Iraqi reconstruction and remains the fundamental threat to a sustained economic recovery (see box 1.1).

Table 1.1: MENA growth performance, 1995–2005

Country/country grouping	Average 1995–1999	Average 2000–2002	2003	2004	2005
MENA region (excl. Iraq)[a]	3.7	3.3	6.9	5.6	6.0
MENA region (incl. Iraq)[a]	..	3.0	5.6	6.3	6.0
Resource-poor, labor-abundant[a]	4.7	3.7	4.1	4.8	4.0
Djibouti	–0.5	2.3	3.2	3.0	3.2
Egypt, Arab Republic of	5.6	3.3	3.1	4.2	4.9
Jordan	3.2	5.5	4.1	7.7	7.2
Lebanon	1.9	3.5	4.9	6.3	1.0
Morocco	3.6	4.7	5.5	4.2	1.5
Tunisia	5.6	3.5	5.6	5.8	5.0
West Bank and Gaza	..	–12.5	6.2	6.2	6.3
Resource-rich, labor-abundant (excl. Iraq)	3.4	4.5	6.1	4.7	5.5
RRLA economies (incl. Iraq)	..	3.1	1.2	7.2	5.3
Algeria	3.2	3.3	6.8	5.2	5.5
Iran, Islamic Republic of	3.5	5.3	6.7	4.8	5.9
Iraq	..	–7.2	–41.4	46.5	2.6
Syrian Arab Republic	2.4	3.3	2.5	3.6	4.0
Yemen, Republic of	5.5	4.2	3.1	2.6	3.8
Resource-rich, labor-importing	3.3	2.5	8.6	6.5	7.2
Bahrain	4.3	4.9	7.2	5.4	6.9
Kuwait	1.9	2.9	13.4	6.2	8.5
Libya	1.6	3.3	9.1	9.3	8.5
Oman	3.4	4.6	1.4	3.1	4.1
Qatar	11.8	5.9	5.9	9.9	8.8
Saudi Arabia	2.7	0.3	7.7	5.2	6.5
United Arab Emirates	5.2	6.0	11.3	8.5	8.0
Population (millions)					
MENA geographic region	281.4	304.7	317.4	323.5	330.2
Resource-poor, labor-abundant	106.2	114.1	118.1	120.0	122.1
Resource-rich, labor-abundant	143.0	154.5	160.9	163.8	167.1
Resource-rich, labor-importing	32.2	36.2	38.4	39.7	40.9
Labor force (millions)					
MENA geographic region	94.8	107.5	114.7	118.4	122.4
Resource-poor, labor-abundant	39.4	44.1	46.7	48.0	49.4
Resource-rich, labor-abundant	44.7	50.9	54.5	56.4	58.4
Resource-rich, labor-importing	10.6	12.4	13.5	14.0	14.6
Growth of GDP per capita (%)					
MENA geographic region[b]	1.7	1.3	4.9	3.8	4.0
Resource-poor, labor-abundant	2.8	1.9	2.3	3.0	2.2
Resource-rich, labor-abundant	1.5	2.6	4.3	3.1	3.7
Resource-rich, labor-importing	0.4	–0.5	5.3	3.3	3.9
Growth of GDP per laborer (%)					
MENA geographic region[b]	0.4	–0.2	3.4	2.1	2.5
Resource-poor, labor-abundant	1.8	0.2	1.2	1.9	1.1
Resource-rich, labor-abundant	–0.1	0.6	2.3	0.9	1.7
Resource-rich, labor-importing	–0.5	–1.5	4.3	2.2	2.9

Source: World Bank staff estimates from country data.

[a] West Bank and Gaza not included in regional or subregional totals.
[b] Does not include Iraq.

Box 1.1

Recent economic developments in Iraq

Economic growth in Iraq over 2005 continued to be hindered by an uncertain security situation and administrative weaknesses. High oil prices have benefited Iraq's fiscal stance, and have partially compensated for weak oil exports and production. Yet many Iraqis perceive little improvement in living standards due to insecurity, few well-paid jobs outside the public sector, rising inflation, and a continued lack of basic services. Terrorism and crime claim hundreds of victims daily; and sectarian strife continues unabated. Iraq's per capita income is estimated at US$1,200—a significant rise from the low of 2003, but still less than a third of the 1980 level. Iraq's medium term outlook depends on the restoration of security, successful political transition, recovery in the oil sector, strong world oil prices, and strong fiscal discipline.

Macroeconomic performance: Real economic growth was lackluster over 2005, averaging 2.6 percent, and growth is anticipated to improve only modestly over 2006. Inflation remains high, averaging 50 percent (as of May), fueled by high security costs, supply bottlenecks, lack of storage facilities, and rapidly rising public spending. Despite building healthy levels of foreign exchange reserves, dollarization is high, and capital flight continues to be widespread.

Oil sector developments: Crude oil accounts for two-thirds of GDP, and generates over 98 percent of exports and over 96 percent of government's own revenues, but the country was unable to capitalize fully from high oil prices over 2005. The Northern pipeline is paralyzed by attacks, while in the South dilapidated infrastructure is a major bottleneck for oil exports. Output declines are exacerbated by executive staff turnover and administrative bottlenecks at the Ministry of Oil. On the positive side, oil production and exports have been on a rising trend since a deep trough in end-2005.

Fiscal developments: Despite a large oil revenue windfall, Iraq's fiscal stance is subject to risk. Budgetary revenue projections depend on both continuing high oil prices and strong oil exports. Non-oil revenues remain negligible. On the spending side, Iraq's public subsidies remain a significant budgetary burden (equivalent to over half of GDP), with the costliest and most deleterious subsidy for fuel (equivalent to about a quarter of Iraq's GDP in 2005). The Iraqi government has begun to gradually increase fuel prices (price hikes took place in December 2005), but even after these increases, official fuel prices are three to five times below border and black market prices, and fuel smuggling out of Iraq is widespread. Spending pressures are significant, fueled by high inflation. Spending on public sector salaries is high at 14 percent of GDP. The number of public sector employees has doubled in the past two years, and they now account for a third of the total labor force.

Poverty developments: Poverty is widespread in Iraq, with an estimated 10 percent of families living in absolute poverty and a further 10-12 percent at high risk of sliding into this category. Although poverty data is weak, social indicators suggest that Iraq may be further away from the Millennium Development Goals (MDGs) than it was 25 years ago. The Public Distribution System (PDS), which distributed food rations to all citizens of Iraq, is increasingly unreliable, while other formal safety nets reach only 15 percent of households. In December 2005, the government launched a new social safety net, targeting one million poor families in Iraq. This initiative has been very successful, with the government receiving close to 450,000 applications. This safety net mitigates the impact of fuel price rises on the poor, and will gradually replace the PDS.

1.2.2 Regional unemployment declines

MENA economies have had some of the highest levels of unemployment in the world. In 2000, unemployment in the region was conservatively estimated at around 15 percent of the labor force, but in a few countries, including Algeria, Morocco, and Djibouti, more than 20 percent of workers were without jobs, with disproportionate impact on the region's stock of younger, better educated workers.[11]

Although unemployment remains critically high in a few countries, including Iraq, Djibouti, and the West Bank and Gaza, the recent growth upturn in MENA has been accompanied by significant declines in unemployment. Outside of Iraq, unemployment, by official statistics, is estimated to have declined from 15 percent of the labor force in 2000 to about 12.2 percent of the labor force currently (figure 1.2).[12]

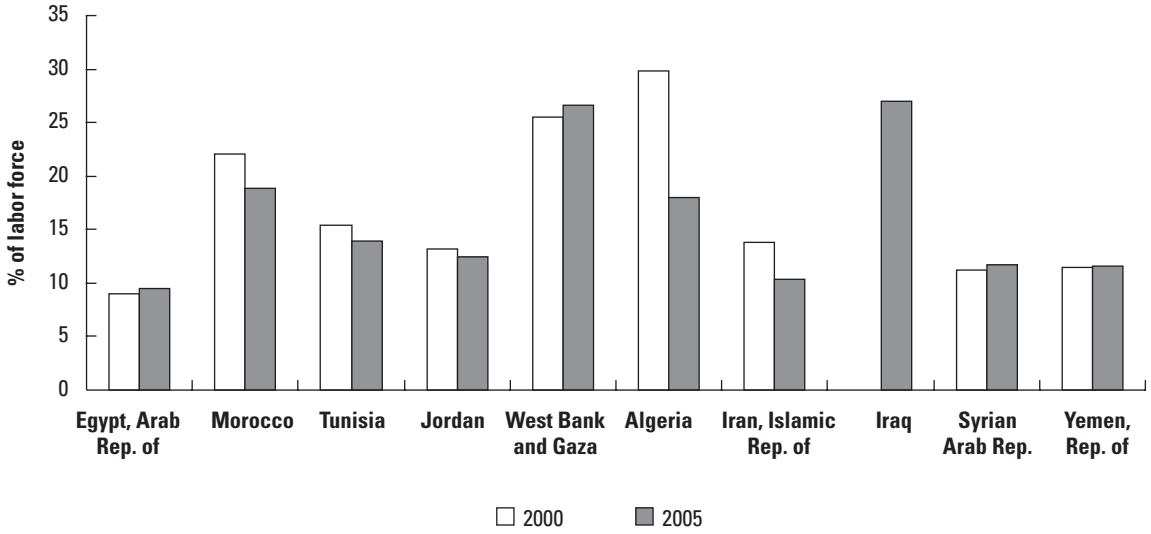
A large part of this decline stems from the major reduction in unemployment that has taken place in Algeria. According to the National Statistics Office, unemployment was estimated to have declined from 29.8 percent of the labor force in 2000 to 15.0 percent in 2005, by almost any comparison, a titanic reduction in unemployment in just a few short years. However, based on the economic growth and job creation relationships observed worldwide, the sustainability of the region's recent job creation is questionable. Every country in MENA (aside from Jordan) has exhibited declines in unemployment greater than what would be expected given their average annual rates of growth of GDP per laborer (which, in a sense, determine the envelope of improved labor market outcomes).

To better understand the importance of the growth of GDP per laborer in improving labor market outcomes, it is useful to refer to the simple accounting framework below. Creating employment for those who want to work is equivalent to increasing the ratio of employed persons to the total labor force (c). Increasing productivity (the basis for wage growth, at least over the long term) is equivalent to increasing output per employed person (b). The sum of these two objectives results in growth in output per laborer (a). The higher is real output per laborer growth, in turn, the greater is the scope for the economy to either reduce unemployment or increase productivity (and wages), or both. In short,

[11] In Egypt, for example, while those with a secondary education make up only slightly more than 40 percent of the labor force, they account for 80 percent of the unemployed. In Algeria, while those with a secondary education account for only 20 percent of the labor force, they comprise almost 40 percent of the unemployed.

[12] Including Iraq, current unemployment is estimated to average 13 percent of the labor force.

Figure 1.2: Official unemployment rates, 2000 and 2005



Source: World Bank staff estimates.

Note: 2005 data reflects most recent data available.

output per laborer growth provides a snapshot of the labor market outcomes that will arise.[13] Strong growth per laborer will allow for both unemployment reductions and wage increases.

$$Growth\ \frac{\text{output}}{\text{labor force}} = growth\ \frac{\text{output}}{\text{employment}} + growth\ \frac{\text{employment}}{\text{labor force}}$$

(a) (b) (c)

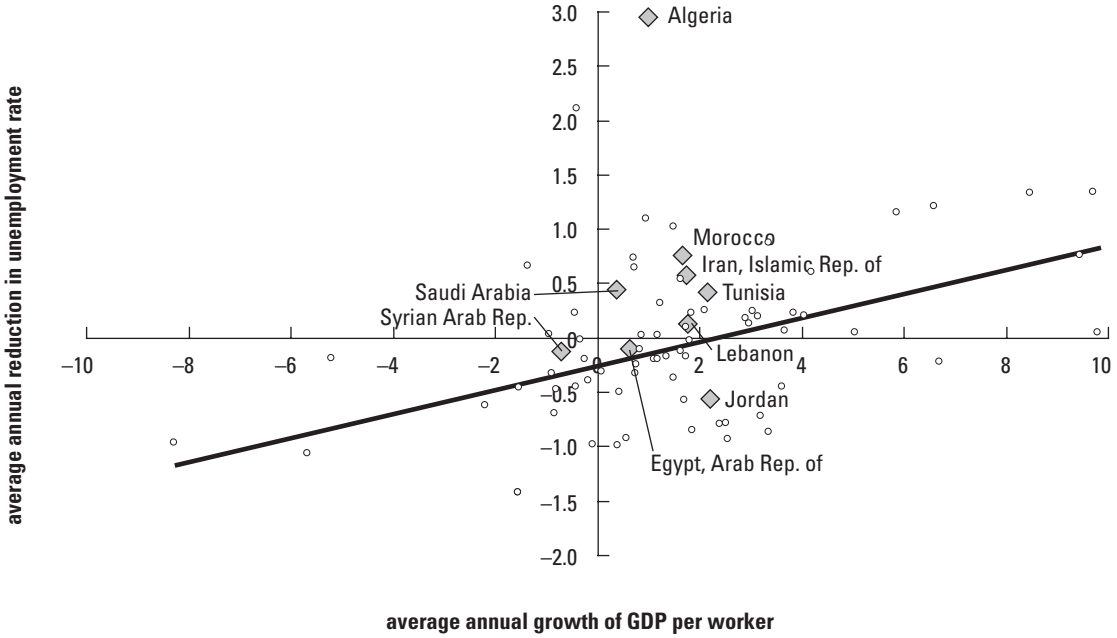
Although MENA economies have experienced strong economic growth with the oil boom, MENA's recent unemployment reductions have been substantially greater than other countries worldwide (figure 1.3). In the last five years, every country in MENA but Jordan has experienced declines in the unemployment rate greater than would have been expected, given their growth of output per laborer. This is particularly the case in Algeria, Morocco, Saudi Arabia, and Iran. MENA's high rate of unemployment reduction is all the more suspicious for countries in which the oil sector dominates, given the low employment creation capacity in the sector. In Algeria, a large number of jobs have been created under the first Economic Recovery Program, but jobs were primarily temporary jobs in the construction and agriculture sectors. Thus, although the reduction in unemployment in the region is welcome news, it is less clear whether it reflects sustainable job growth that will remain for the longer term.

1.2.3 Per capita growth less robust

MENA's recent economic expansion has been undermined by continuing rapid population growth, particularly among the resource-rich, labor-importing economies, where 2005's growth rate of 7.2 percent amounted to only 3.9 percent on a per capita basis. Overall, MENA's per capita growth over the past two years (averaging 3.9 percent a year), while a marked improvement over the 1990s, remains off the pace of developing countries as a group (overall, and excluding China and India), and well behind the growth in other middle-income regional subgroupings (table 1.2).

[13] Nabli and Keller 2006.

Figure 1.3: MENA's GDP per worker/unemployment reduction relationship 2000-2005, relative to world



Source: World Bank staff estimates.

Note: Trend line (based on worldwide observations): Average annual reduction in unemployment rate = 0.26 + (0.11 × average annual growth of GDP per worker). Adj. R^2 = 0.21.

Table 1.2: GDP growth per capita in an international perspective, 1995–2005

Growth of GDP per capita	Averages 1995–1999	2003	2004	Estimate 2005
MENA geographic region (excl. Iraq)	**1.7**	**4.9**	**3.8**	**4.0**
MENA geographic region (incl. Iraq)	..	3.4	4.3	3.8
Resource-poor, labor-abundant	2.8	2.3	3.0	2.2
Resource-rich, labor-abundant (excl. Iraq)	1.5	4.3	3.1	3.7
RRLA economies (incl. Iraq)	..	–0.8	5.3	3.2
Resource-rich, labor-importing	0.4	5.3	3.3	3.9
Developing countries	**2.1**	**4.2**	**5.5**	**4.7**
Excluding transition economies	2.5	3.9	5.4	4.7
Excluding China and India	0.8	2.6	4.6	3.4
Low-income countries	**3.5**	**5.3**	**4.7**	**4.8**
Latin America and the Caribbean	2.5	–0.1	2.8	1.5
South Asia	4.1	6.2	5.1	5.4
Excluding India	1.9	3.3	4.1	4.8
Sub-Saharan Africa	1.8	2.1	3.3	3.0
Middle-income countries	**2.3**	**4.3**	**5.9**	**4.9**
East Asia and Pacific	5.9	7.8	7.9	7.4
Excluding China	1.3	4.3	4.9	3.0
Europe and Central Asia	1.5	5.9	7.0	5.2
Latin America and the Caribbean	0.9	0.6	4.1	3.1
South Asia	3.6	4.8	4.2	3.5
High-income countries	**2.0**	**1.3**	**2.6**	**1.9**
World	**1.6**	**1.4**	**2.7**	**2.0**

Source: World Bank staff estimates.

[a] Does not include Libya.

1.2.4 Oil market developments shape regional outcomes

For the third straight year, crude oil prices rose sharply over 2005, from an average of $38 a barrel over 2004 to more than $53 over 2005, an increase of more than 40 percent year-on-year (figure 1.4).[14] Oil price developments over the past three years reflect a continuing tight market, with exceptionally large demand growth (particularly emanating from China), especially for refined products, driving prices upward. Over 2005, oil markets also experienced significant volatility in response to external conditions: the year saw prices spike in August following Hurricane Katrina, subsequently weaken with a mild U.S. winter, and spike again following a natural gas dispute between the Russian Federation and Ukraine.

Strong gains for region's resource-rich economies

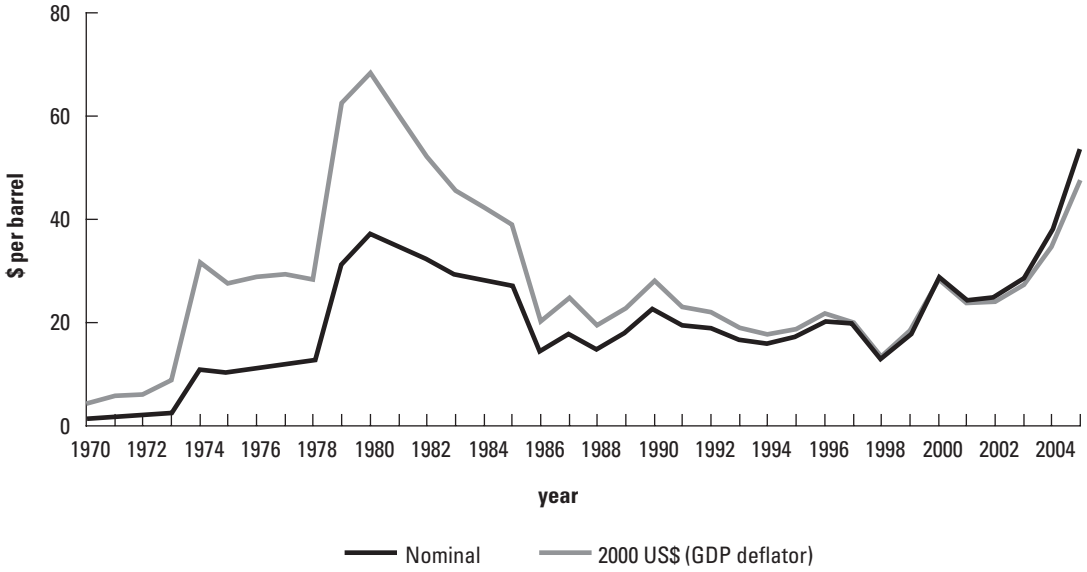
As the demand for oil has expanded, additional supply has been accommodated primarily through OPEC producers, to the benefit of several MENA economies (figure 1.5). Over the past three years, Saudi Arabia has increased output from an average of 7.4 million (mn) to 9.2mn barrels per day (an increase significantly higher than the total increase of OPEC production quotas).[15] Strong production drives also took place in Kuwait (with crude production up 33 percent in the past three years), Qatar (up 24 percent), and the UAE (up 23 percent). Non-OPEC oil producers in the region,[16] on the other hand, have generally not been able to capitalize on higher oil prices with increased production, partly reflecting depleting reserves and in part because of a shortage of refinery capacity. In fact, in

[14] Average of West Texas Intermediate (WTI), Brent, and Dubai crude oil prices per barrel.

[15] International Energy Agency (IEA).

[16] Bahrain, Oman, Syria, and the Republic of Yemen.

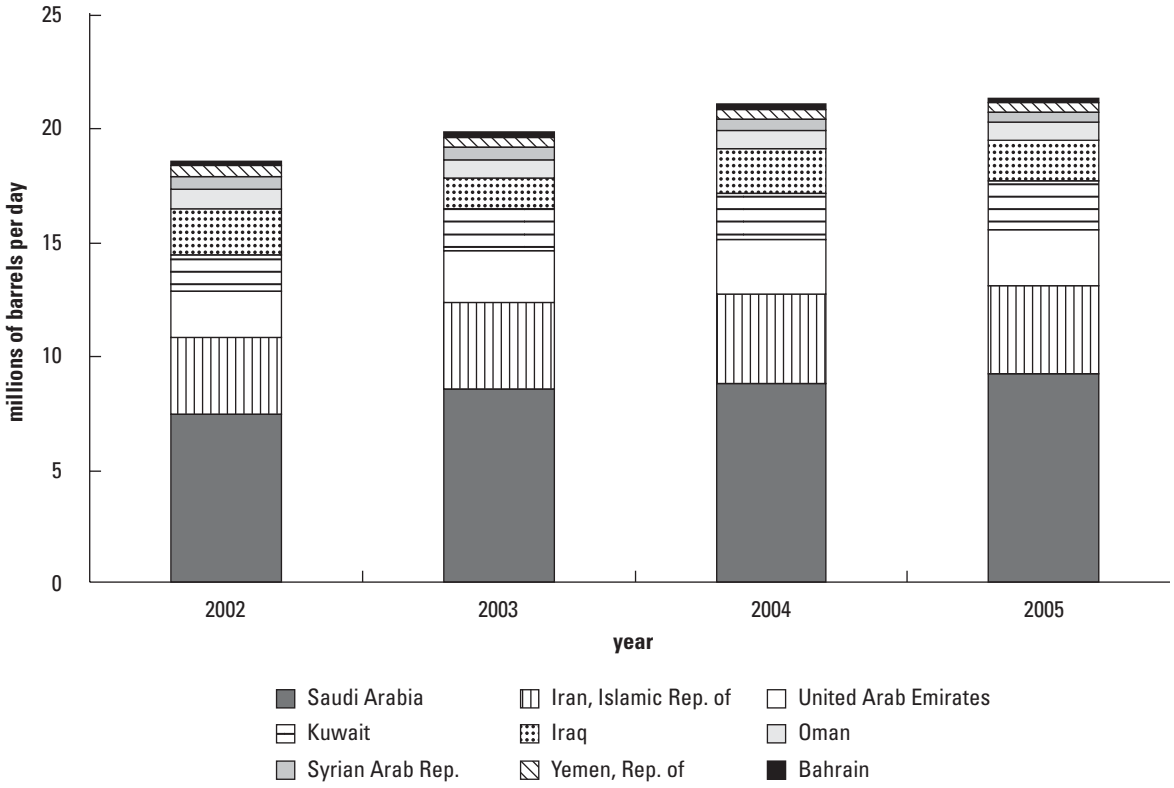
Figure 1.4: Oil prices, 1970–2005



Source: World Bank staff estimates

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

Figure 1.5: Crude oil production among select MENA producers



Source: World Bank staff estimates.

Bahrain, Syria, and the Republic of Yemen, oil production in 2005 was 10–15 percent lower than production over 2002.

With climbing oil prices and increased production, oil producers have seen substantial increases in the dollar value of oil exports, and consequently in oil export revenues accruing to governments. Government revenues from oil have more than doubled in the past three years, from $154 billion in 2002 to $365 billion in 2005,[17] and with an accumulated gain in revenues of $350 billion since 2002. Saudi Arabia has particularly benefited, realizing a tripling in government revenues from oil in the past three years (figure 1.6).

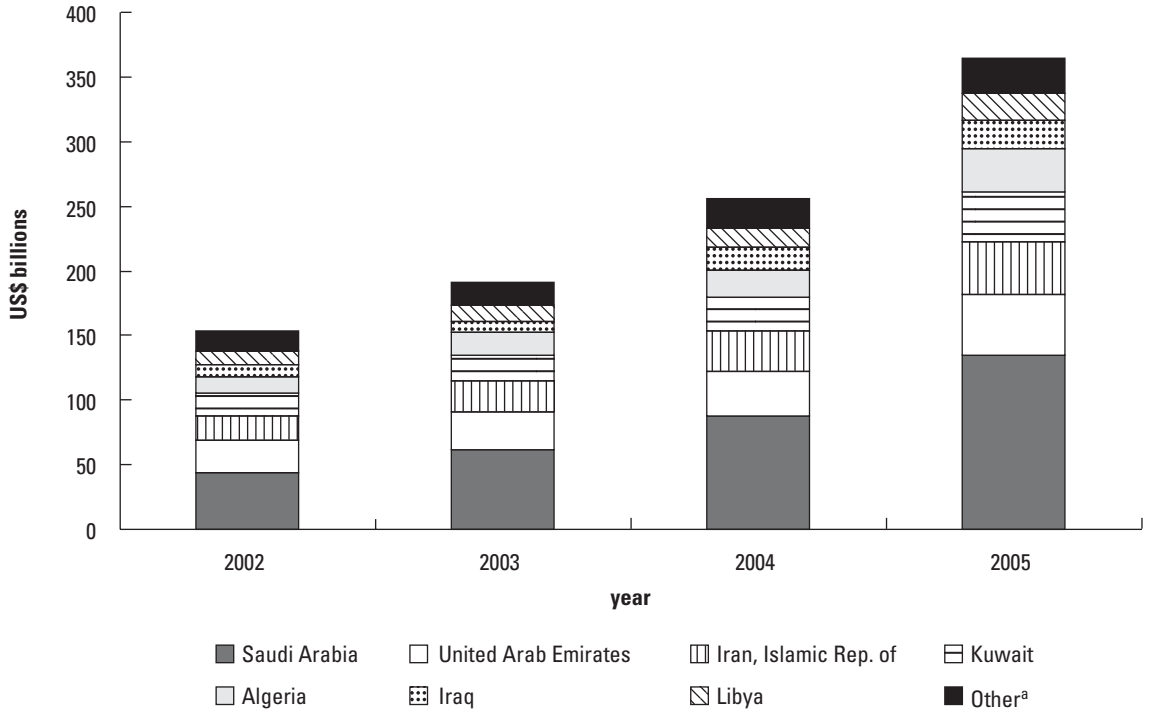
Higher import bills for resource-poor economies

But higher oil prices and increased consumption have meant sharply rising oil import bills for the net oil-importing economies in the region, with Jordan, Lebanon, and Morocco posting the largest increases. In Lebanon, oil and oil derivative import volumes grew by 9 percent over 2005, and since 1999 by more than 25 percent a year (in comparison, manufactured imports have only grown by an average of 4 percent a year). The impact has been most severe in Jordan, which was relying heavily on cheap oil from Iraq in the context of the oil-for-food program.[18] With oil imports growing significantly more rapidly than GDP, the oil-trade-deficit-to-GDP ratio jumped from only 2 percent in 2000 to almost 19 percent by 2005 (figure 1.7).

[17] Not including Syria or Libya.

[18] After the first Gulf war, Jordan imported most of its fuel products from Iraq under the food-for-oil program: around half of the imports took place in the form of a grant (3 percent of GDP in 2002), while the other half was sold at preferential below-market prices negotiated each year between the respective governments. The government then sold the oil at preferential prices to the Jordan Petroleum Refinery Company.

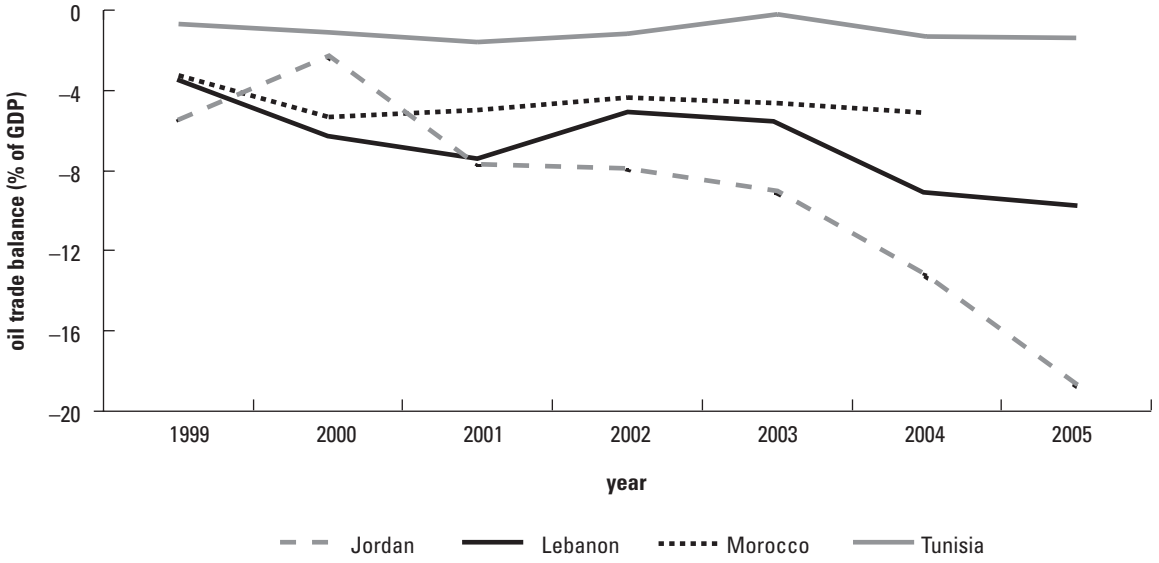
Figure 1.6: Oil revenue growth among MENA oil producers, 2002–2005



Source: World Bank staff estimates.

[a] Other oil producers include Bahrain, Oman, Qatar, and the Republic of Yemen.

Figure 1.7: Oil trade balance among select resource-poor economies



Source: UNCTAD.

Note: Oil trade balance represents exports minus imports of petroleum, refined petroleum, and natural gas products as a percentage of GDP.

1.2.5 Reliance on oil subsidies becomes a fiscal challenge

The sharp rise in oil prices has also brought to the spotlight the MENA region's heavy subsidization of oil prices within the domestic market, a policy officially designed to protect poor households (figure 1.8). Although the resource-poor economies are particularly affected, the reliance on oil subsidies pervades the region, with large implications on fiscal positions.

Among oil importers, Jordan has been particularly impacted by these subsidies, because of not only rapidly rising oil prices but also the recent loss of the oil and gas arrangements with Iraq. At the end of 2004, oil subsidies represented 3.1 percent of GDP, and 11.3 percent of total current expenditures. A year later, they amounted to 5.8 percent of GDP and 19 percent of current expenditures, this despite the first round of reduction in oil subsidies in September 2005 (without this reduction, oil subsidies would have grown to an estimated 7.2 percent of GDP over 2005). In Lebanon, surging Treasury transfers to the public electricity company to cover these higher oil costs have resulted in government consumption spending increasing by more than 8 percent a year over the past two years (compared with spending reductions in the years before).

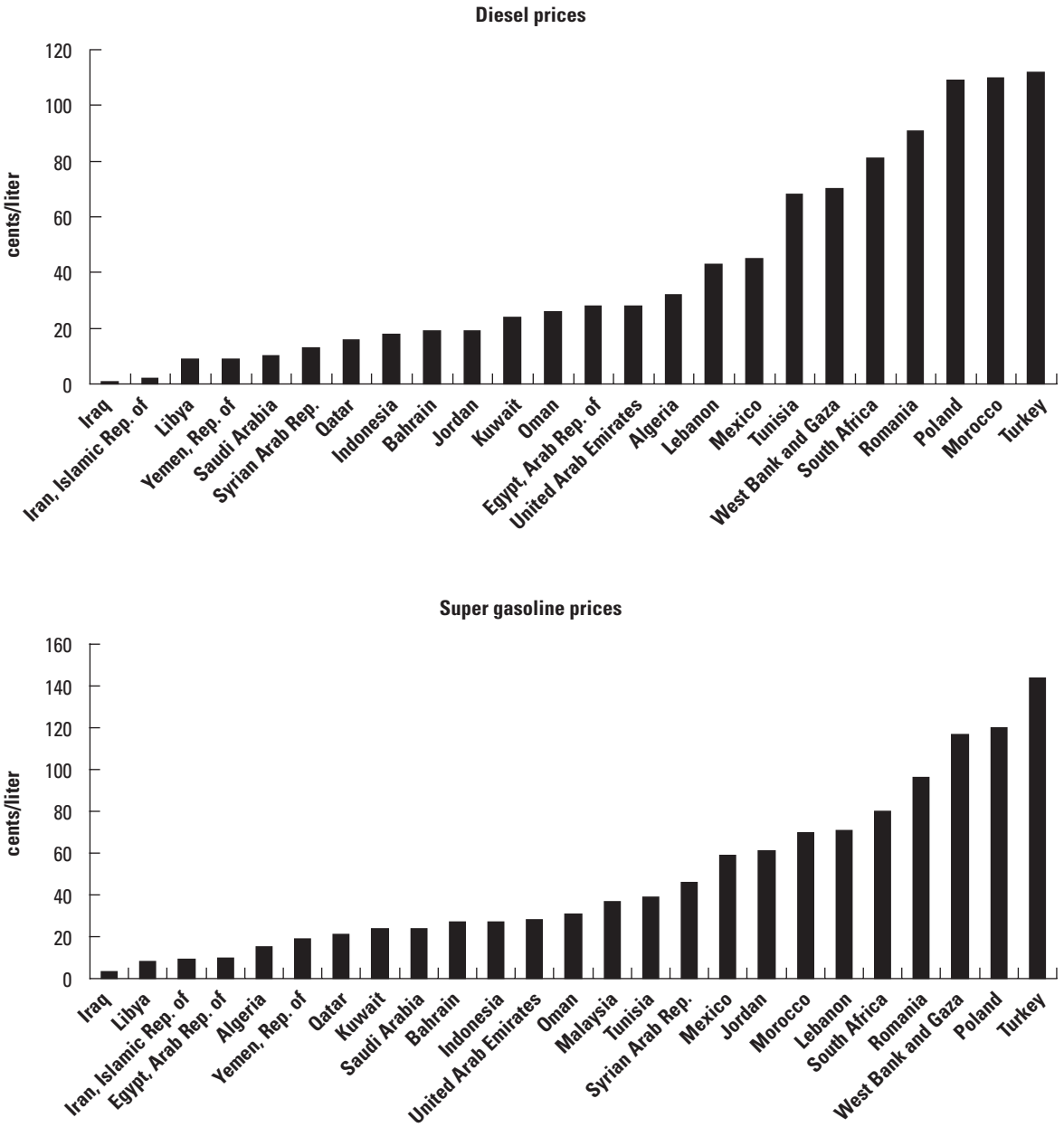
But the problem is not limited to the oil importers, and in fact, the degree of oil price subsidization is far greater in oil-producing economies. For the most part, resource-rich economies have been able to more than offset the negative impacts on the budget with strongly rising revenue streams. At the same time, these rising budget surpluses have provided limited incentive for reforming the energy subsidy systems. As a result, over the past several years, little if any progress has occurred in reducing these subsidies among the region's oil producers (discussed further in section 1.4.3).

1.2.6 Diverging relationship between oil prices and growth among nonoil economies

An important feature of the current growth environment in MENA is the substantially weaker overall ties between oil price movements and growth outcomes among the region's resource-poor economies. Twenty to thirty years ago, the economic growth outcomes in MENA's resource-poor economies were deeply linked to oil price movements because the resource-poor economies in the region received strong benefits from oil windfalls through vigorous transmission channels, especially labor remittances, official aid, and capital inflows.

Although there remain positive transmission channels from oil producers to the resource-poor economies and these channels have experienced a

Figure 1.8: Diesel and gasoline prices in MENA, 2005

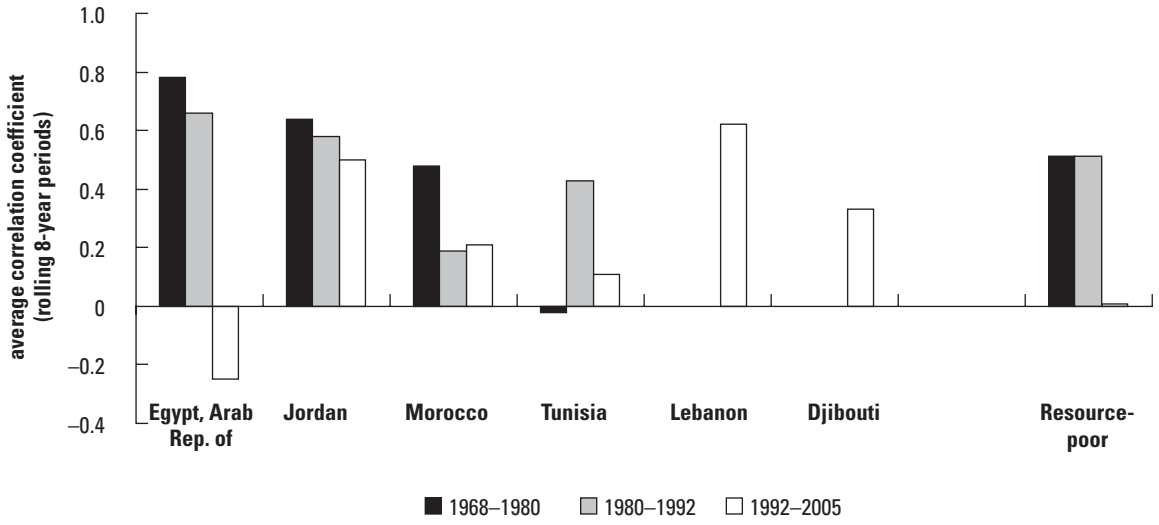


Source: GRZ.

boost under the current oil boom (particularly through rising portfolio equity inflows, foreign direct investment (FDI), and intraregional tourism), the relative size of combined transmission mechanisms from oil producers to resource-poor economies in the region has declined substantially over time. In addition, with rising energy use among resource-poor economies (relative to the past oil booms), the costs of higher oil prices (with regard to oil imports and oil import subsidies) have increased for nonoil economies. As a result, the correlation between economic growth and oil price movements has steadily declined among most of the resource-poor economies in the region (figure 1.9), and for the group has moved from an average of 0.5 over the 1970s and 1980s to almost zero over the past decade.

Egypt is most indicative of a changing growth environment. Over the late 1960s and 1970s, Egypt's

Figure 1.9: Correlation between real oil prices and economic growth among MENA's resource-poor economies



Source: World Bank staff estimates.

Notes: Average correlation coefficient reflects average of rolling eight-year period correlation coefficients between economic growth and oil price movements. Because the relationship between an oil price movement and a growth impact may have a time lag, each eight-year growth/oil price correlation reflects the best-fitting relationship (highest correlation) between oil price changes and growth, allowing for economic growth to lag up to two years. Regional averages weighted by GDP.

economic growth moved almost in lockstep with real oil price fluctuations (with a correlation of nearly 80 percent between real oil prices and growth), cemented through Egypt's own foreign exchange earnings from oil and oil-related revenues, as well as through the various transmission channels from the region's major oil producers (such as labor remittances, economic assistance, direct investment, and intraregional tourism). Over the past three decades, however, many of these transmission channels have weakened. Although at the peak of the 1980s oil boom, more than 20 percent of the Egyptian labor force was employed abroad (primarily in the Gulf), today only 7 percent of Egyptian laborers work in other Arab states,[19] as Gulf countries have increasingly replaced expatriate Arab with (less costly) South Asian laborers. Labor remittances as a percentage of GDP in Egypt have fallen from a high of almost 14 percent in 1979 to little more than 3 percent today. FDI inflows reached a peak of almost 7 percent of GDP in 1979, but averaged less than 1 percent of GDP by 2003 (but recently have climbed to more than 4 percent in 2005).[20] Official aid, which reached more than 19 percent of GDP in 1975, accounts for less than 2 percent of GDP today. And at the same time, with rising energy consumption and a leveling off of production, Egypt's net oil exports have declined as a share of GDP from more than 20 percent in 1980 to about 3 percent currently (figure 1.10).

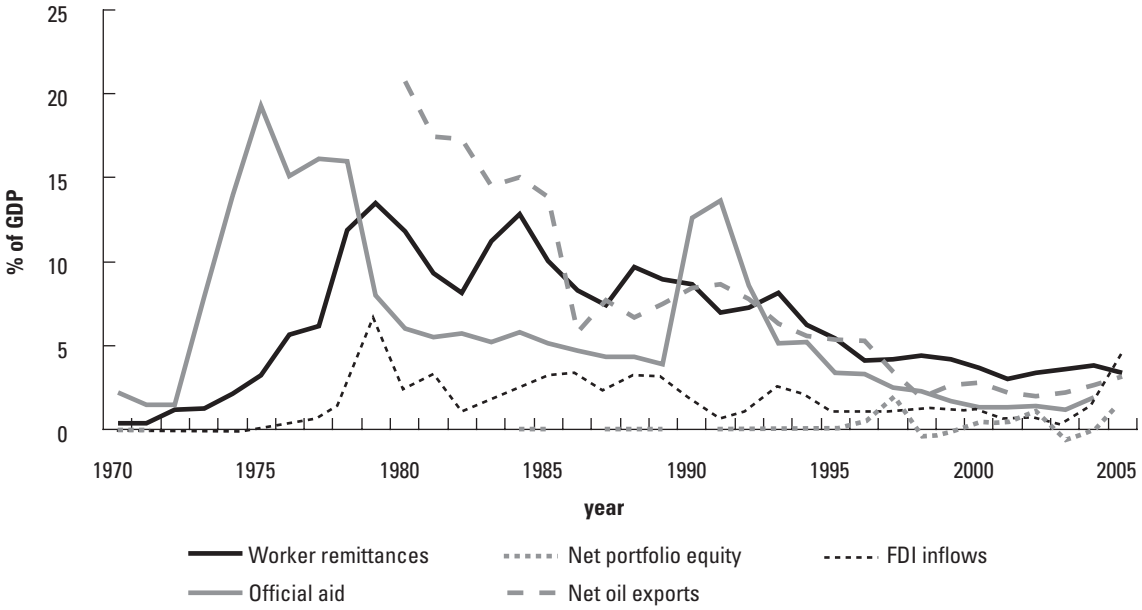
Even resource-poor economies that maintain strong ties with the oil-exporting economies are beginning to carry new costs with higher oil prices. Although regional oil wealth has spurred greater FDI and capital flows into Jordan, for example, and has resulted in higher tourist receipts, rising oil prices have also become increasingly taxing on both the fiscal and external fronts (figure 1.11). In the previous oil boom era, with significantly lower energy consumption, rising oil prices could be more easily accommodated. At the height of the 1980s oil boom, for example, oil imports in Jordan represented less than 10 percent of GDP, and oil subsidies absorbed about 3 percent of GDP.[21] That is little more than half of its relative costs today (oil imports representing 19 percent of GDP and oil subsidies 6 percent of GDP).

[19] Said 2004.

[20] Staff estimates from UNCTAD (FDI) and country (GDP) data.

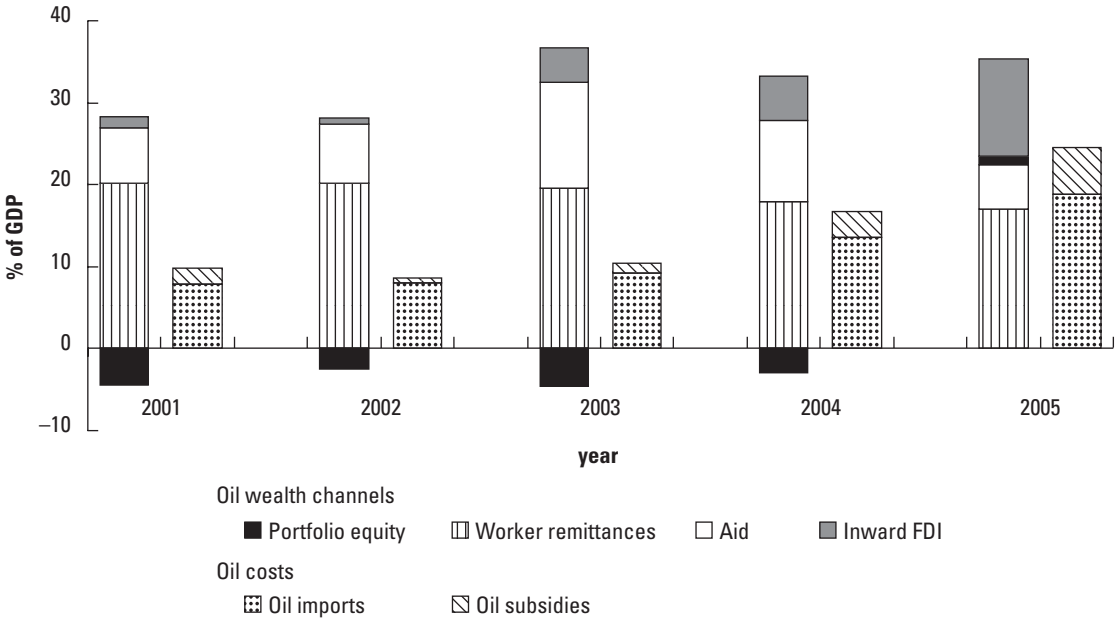
[21] Staff calculations from World Bank (1983).

Figure 1.10: Sources of oil-related wealth in Egypt, 1970–2005



Source: World Bank staff estimates.

Figure 1.11: Oil-related wealth and costs in Jordan, 2000–2005



Source: World Bank staff estimates.

Added to weakened transmission channels and higher costs, an additional element weakening the connection between oil price movements and growth among resource-poor economies has been the group's increasing progress with structural reform. Beginning in the 1980s and 1990s, many of the resource-poor economies adopted programs of macroeconomic stabilization and structural reform designed to restore macroeconomic balances and promote private sector–led development. Although the pace has varied, these reforms have resulted in more diversified economies than under the prior oil booms, with stronger nonoil export sectors to support growth. Between 1988 and 2005, for example, nonoil exports as a share of GDP more than doubled in Jordan, Morocco, and Tunisia. As outward orientation has strengthened, the dependence of resource-poor economies on oil price developments has weakened.

1.2.7 Strengthening correlation between oil price developments and growth in resource-rich economies

An equally important growth trend in the region has been the greater harmony among oil producers with regard to their growth outcomes. In the past, economic growth patterns among the major oil producers of the region varied widely, a reflection of diverging approaches and successes in utilizing windfall oil surpluses. Over the past decade, however, growth patterns among regional oil producers have moved progressively more in sync with oil price developments (and with each other), in part reflecting the pursuit of increasingly common development strategies (figure 1.12).

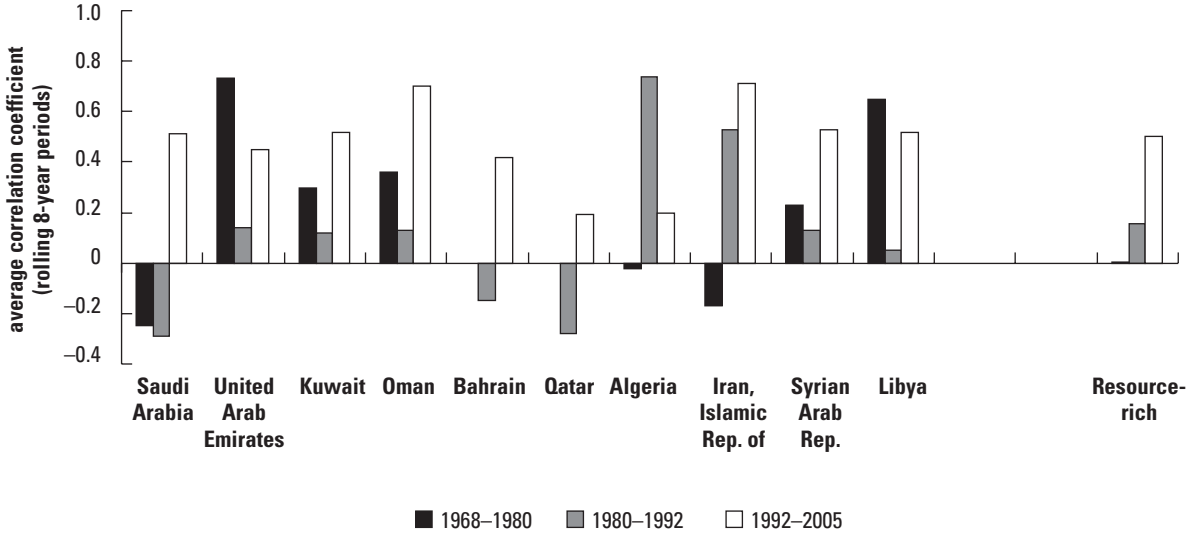
Unlike in past oil booms, MENA's oil exporters today are demonstrating significantly more fiscal restraint, building substantial external reserves, and pursuing common strategies for diversification of the oil wealth into foreign assets. With this increased prudence, the volatile growth outcomes among oil producers that characterized the 1970s and 1980s have been increasingly supplanted by a common growth effect. This is particularly evident when looking at the larger oil economies, which exhibited startling dissimilarity in growth outcomes in earlier periods (figure 1.13).

1.3 External Sector

1.3.1 Export growth robust throughout the region

Riding the wave of higher oil export values, MENA has achieved exceptional export growth since 2002, primarily among oil exporters, but broad-based

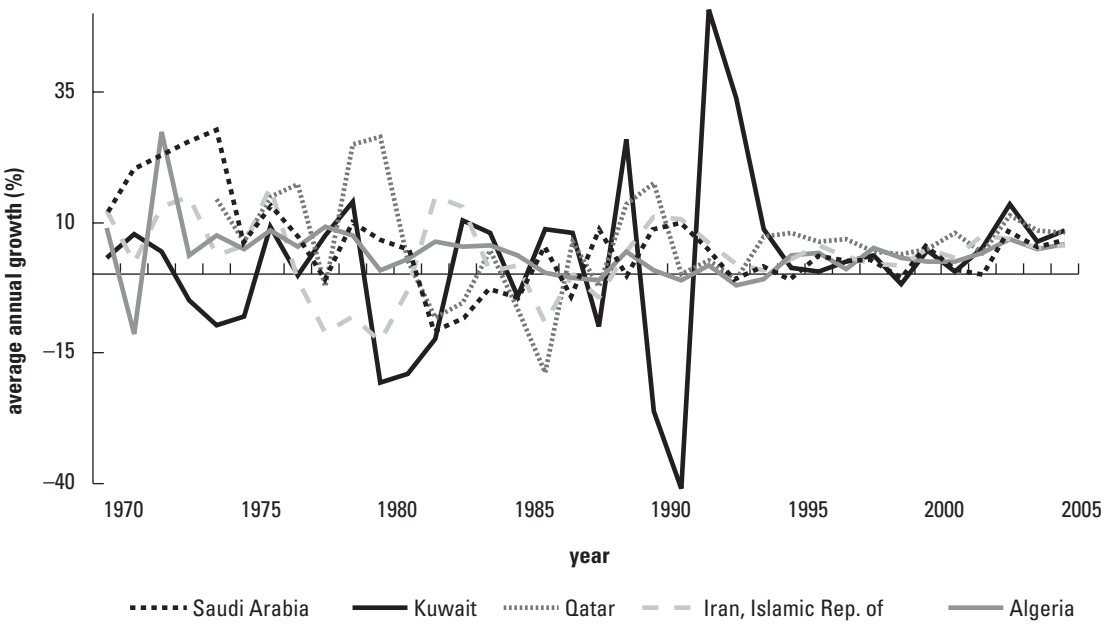
Figure 1.12: Correlation between real oil prices and economic growth among MENA's resource-rich economies



Source: World Bank staff estimates.

Notes: Average correlation coefficient reflects average of rolling eight-year period correlation coefficients between economic growth and oil price movements. Because the relationship between an oil price movement and a growth impact may have a time lag, each eight-year growth/oil price correlation reflects the best-fitting relationship (highest correlation) between oil price changes and growth, allowing for economic growth to lag up to two years. Regional averages weighted by GDP.

Figure 1.13: Economic growth among select MENA oil producers, 1970–2005



Source: World Bank staff estimates.

throughout the region. With oil exporters seeing a more than doubling of oil exports because of terms of trade movements (from about $186 billion in 2002 to $440 billion by 2005),[22] MENA economies have experienced a doubling or tripling of the average annual rate of growth of exports of goods and services over the past three years.

Not surprisingly, oil dominates the region's export landscape. More than three-quarters of the recent growth in exports of goods and services has come from oil exports among the region's dominant oil producers (figure 1.14). With the increase in the price of oil and production increases in several MENA countries, oil has grown to account for more than two-thirds of regional exports by 2005, up from only about half in 1998.[23]

But export growth has also been strong among the region's resource-poor economies, supported in part by strong growth in service exports (figure 1.15). Egypt's service exports increased by an average of 20 percent a year between 2002 and 2005 (compared with growth averaging about 4 percent a year between 1998 and 2002), the result of surging Suez Canal receipts and strong growth in tourism. Other RPLA economies also experienced an upswing in exports of services, primarily reflecting strong gains in tourism. International tourist receipts to both Morocco and Tunisia grew by 15 percent a year over the past two years,[24] resulting in exceptional service export growth. Even in Jordan, although tourism has been hit by regional political disturbances, service exports have expanded by an average of 14 percent a year (up from negative growth of 3 percent a year), on the strength of larger remittances and strong advances in transport and communication services destined for Iraq. Although Lebanon realized strong growth in tourism up to 2004, in 2005, in the face of the difficult security situation, tourism receipts—which account for about 5 percent of GDP—are estimated to have declined by some 11 percent, and overall service exports declined by 2.4 percent from 2004.

Oil producers have realized strong growth in energy-dependent exports

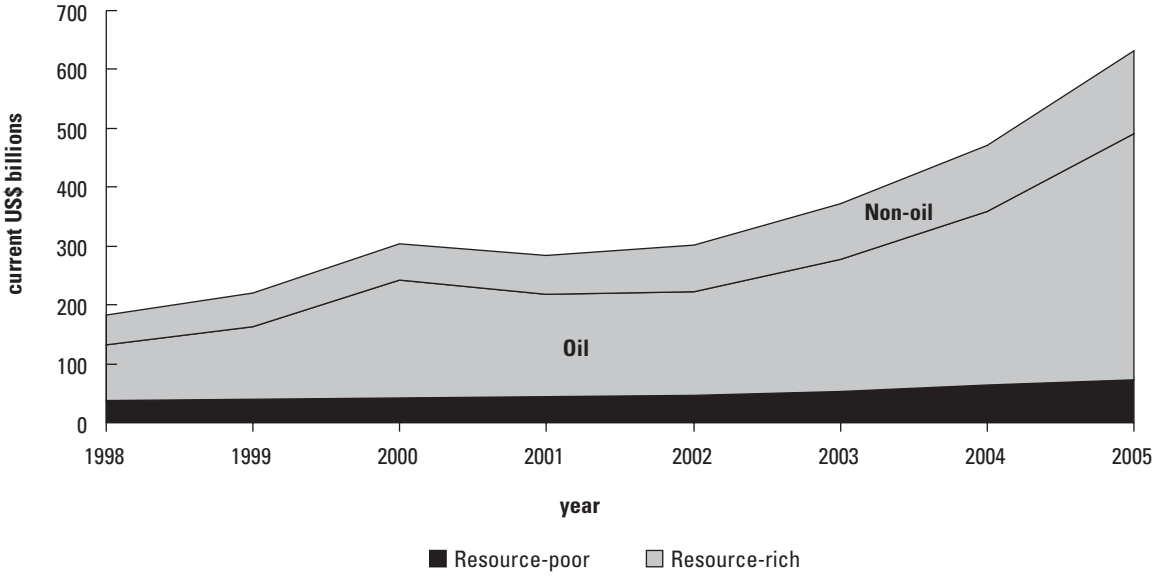
Regional oil producers have benefited not only from exceptional oil export growth but also from strong nonoil export growth, which between 2002 and 2004 averaged more than 16 percent a year. A strong impetus has been energy-dependent industries such as petrochemicals, which—as oil prices

[22] In current US$.

[23] Exports of goods and services, current US$.

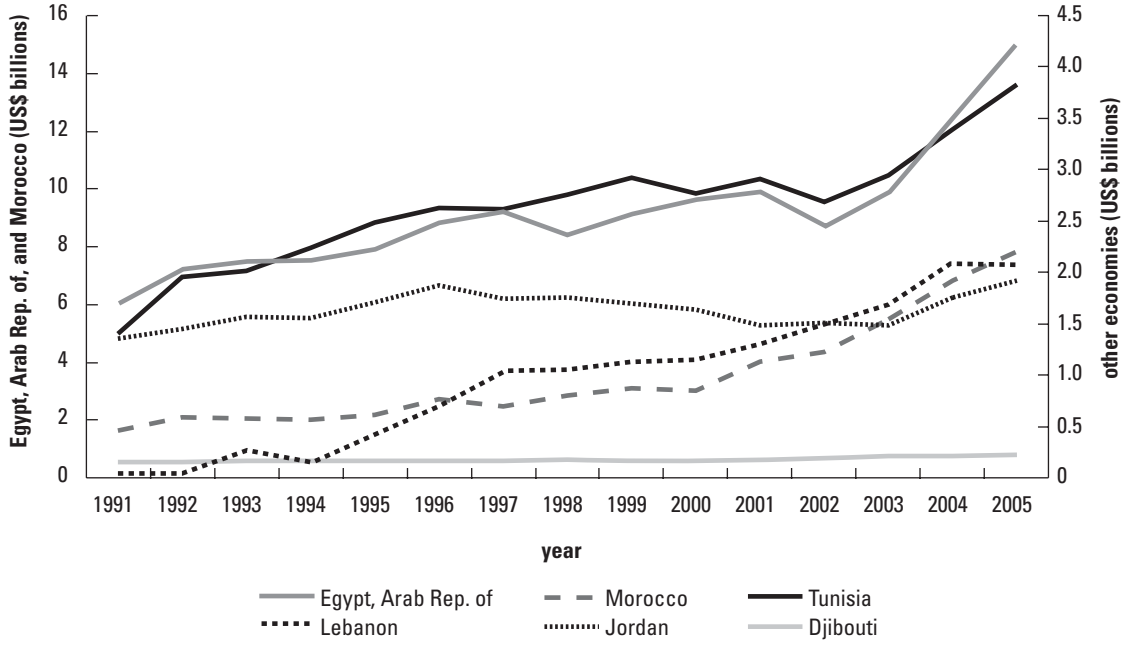
[24] UNWTO 2006.

Figure 1.14: Composition of MENA exports of goods and services, 1998–2005



Sources: World Bank staff estimates from UNCTAD data.

Figure 1.15: Growth of service exports among RPLA, 1991–2005



Source: World Bank staff estimates.

have risen—have become increasingly expensive for traditional centers of production to manufacture (see box 1.2). With a widening cost advantage in the industry, many countries have bolstered their petrochemical production facilities. As a result, over the past two years, 90 percent or more of the nonoil export growth in Kuwait, Qatar, and Saudi Arabia has come from petrochemicals (figure 1.16).

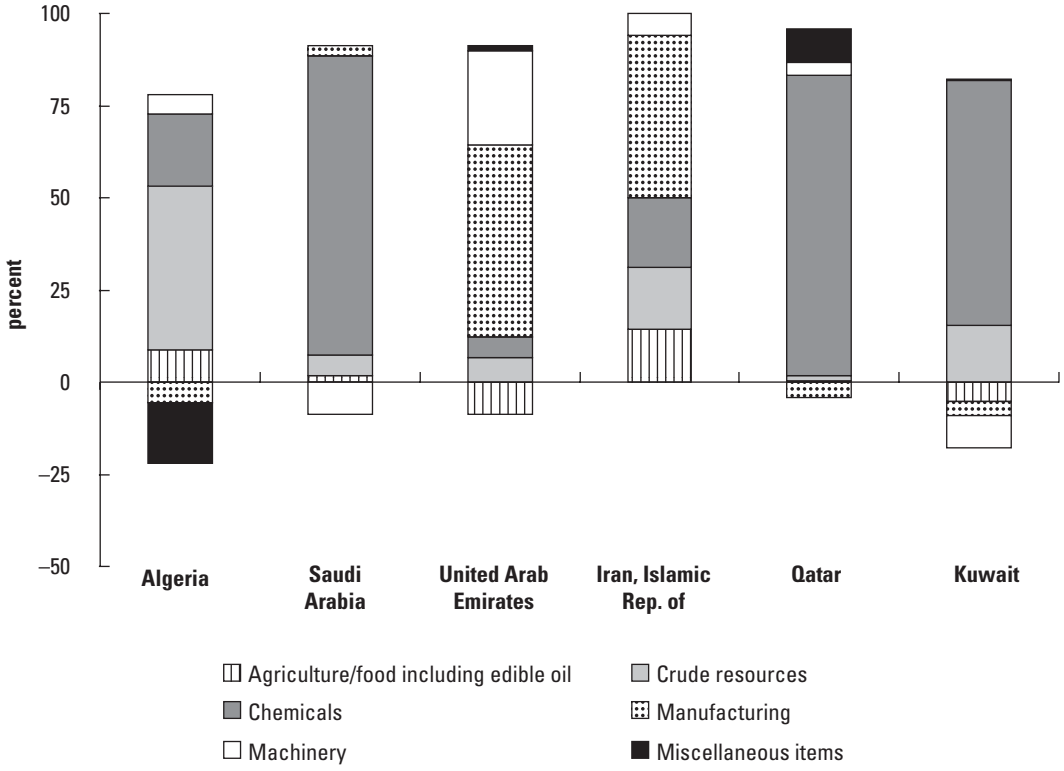
Nonoil export competitiveness has also benefited from a limited appreciation of the real effective exchange rate, despite the large export receipts accumulating to oil producers (figure 1.17). All of the GCC countries' currencies operate a fixed exchange rate regime pegged to the U.S. dollar, which has depreciated modestly against other major currencies over the past few years. As a result, the real effective exchange rate index among GCC countries depreciated by an average of 7 percent a year between 2002 and 2004. And although the Islamic Republic of Iran's currency appreciated substantially before its landmark exchange rate reform in 2002 (whereby the exchange rate was unified and a managed float system was adopted), it has since stabilized. Thus, the "Dutch disease," where the non-oil export sector gets crowded out by the oil and nontraded goods sectors, which characterized the oil booms of the 1970s, has not yet materialized with the current increase in oil prices and oil wealth.

1.3.2 Resource-poor economies face several new external challenges

Resource-poor economies, on the other hand, have seen a few unfavorable changes to the external landscape over the past few years. On the export side, the expiration of the World Trade Organization (WTO) Multifiber Agreement (MFA) on textile and clothing in January 2005 has impacted merchandise exports among several RPLA economies. The MFA had allowed privileged access to European markets for a few MENA economies (mostly from the resource-poor economies—Egypt, Morocco, and Tunisia—but also from the United Arab Emirates) in textile and clothing products. To date, Egypt has not experienced a major downturn in total textile exports, as evidenced by its woven apparel exports

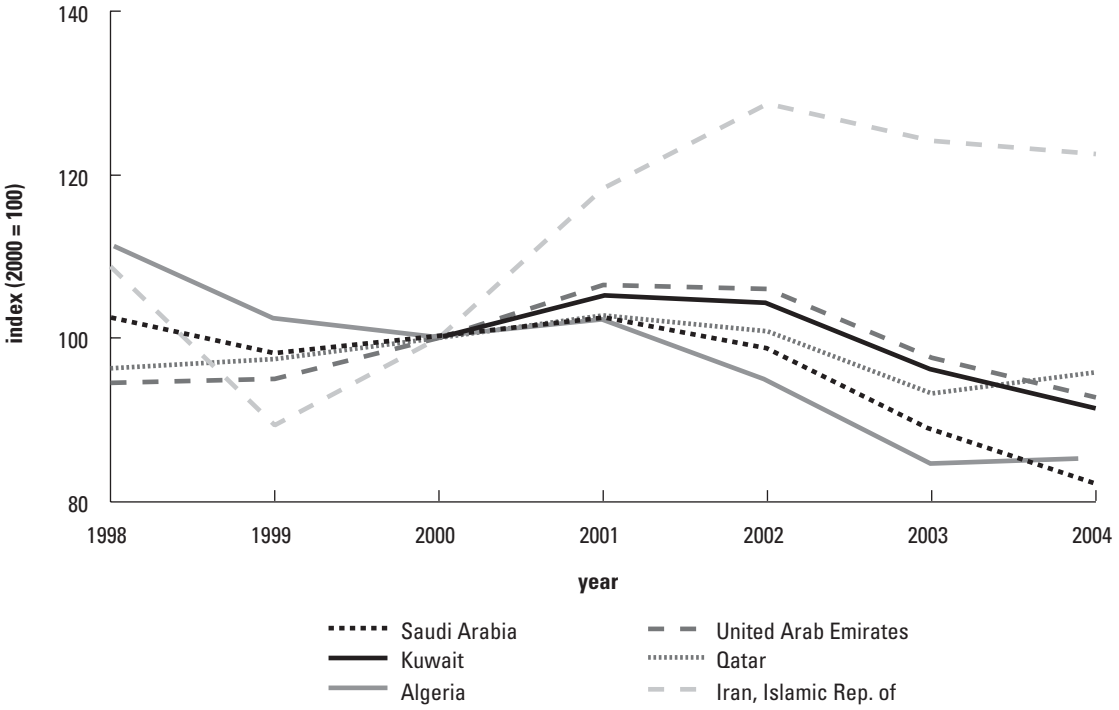
Figure 1.16: Nonoil export growth among select MENA oil exporters

(Proportion of total nonoil export growth, 2002–2004)



Source: World Bank staff estimates from UNCTAD data.

Figure 1.17: Real effective exchange rate, 1998–2004



Source: World Bank staff estimates.

increasing in value by 6 percent over 2005.[25] In part, the effects of the MFA expiration have been cushioned by the December 2004 agreement on qualifying industrial zones (QIZs) between Egypt, Israel, and the United States, providing tariff-free access for Egypt's apparel exports to the United States.[26] The Egyptian textile and apparel companies represent 77 percent of the 471 companies listed under the QIZ protocol.[27]

But other countries have already started to feel the pinch. Tunisian textile exports to Europe declined by 6 percent in 2005, and textile production in the country declined by an equivalent amount over the first six months of 2005 (see box 1.3). The weakening export market has affected jobs in the sector, which are down 9 percent from employment values in 2004. Thanks to a strong pickup in textile exports to the United States (42 percent year-on-year), however, Tunisian textile exports managed to remain a growing sector in 2005, albeit at a sluggish 1.5 percent pace. The impact on Morocco, however, has been sharper. Over the first six months of 2005, Morocco's clothing exports, representing 34 percent of merchandise exports, declined by some 13 percent from 2004 values, and of the export losses, more than 90 percent were in the textile export categories that were liberalized with the MFA removal. Partly as a result, both Morocco and Tunisia have experienced sharp downturns in merchandise export growth rates from 2004 (figure 1.18).

But far more challenging to the external landscape among resource-poor economies has been the impact of surging oil import bills. Since 2002, merchandise imports among the RPLA economies have increased by about 18 percent a year in dollar terms (figure 1.19), and from about 26 percent of GDP in 2002 to about 35 percent by 2005 (that compares with the resource-rich economies, in which as a share of GDP, merchandise imports have remained virtually unchanged since 2002, averaging between 24 and 25 percent). Primarily because of oil import bills, all of the RPLA economies, without exception, have seen a large upturn in the ratio of merchandise imports to GDP since 2002.

[25] www.egytex.com (2006).

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

[27] www.egytex.com (2006).

Box 1.2

Petrochemicals: building value into oil and natural gas production

The global economic downturn that began over the late 1990s and the slow subsequent recovery have limited demand for petrochemicals, and the recent strong price increases for oil and natural gas, the primary feedstock for petrochemicals, have severely limited profitability, particularly in traditional centers of production in Europe, Japan, and the United States. In response, there has been a shift in production from these traditional centers to locations in faster-growing, lower-cost developing regions. The focus has shifted largely to the Gulf region of MENA, where hydrocarbons are produced in excess of domestic demand and where costs associated with primary materials are extremely low.

The countries of the GCC and the Islamic Republic of Iran have taken strong steps to bolster their petrochemical production capabilities in recent years to take advantage of this shift in production and to build additional value into their oil and gas production. These countries now account for nearly 10 percent of global production in basic petrochemicals such as ethylene. By 2010, these countries are expected to provide nearly 50 percent of the world's annual new ethylene capacity and account for nearly 20 percent of total global capacity. Exports of liquid chemicals from the GCC and the Islamic Republic of Iran were 16.6 million tons in 2004 and reached 18.4 million tons in 2005. This amount is expected to rise to 32 million tons by 2007 and nearly 48 million tons in 2008, as planned petrochemical facilities come on stream.

Petrochemical investment projects in the GCC and the Islamic Republic of Iran

The Islamic Republic of Iran currently maintains about 9 percent of MENA ethylene production; however, the country is building major new facilities in Bandar Imam and Assalouyeh that are expected to be some of the largest petrochemical complexes in the world. By 2006, the country is expected to produce nearly 20 percent of the region's ethylene.

Saudi Arabia's petrochemical company SABIC has initiated construction on several petrochemical plants that will produce ethylene, ethylene glycol, polyethylene, and polypropylene products by 2008. The firm has also joined several international firms in expanding or building four additional facilities that will produce styrene and olefins, which will also come on line in 2008.

Other GCC countries are investing heavily in petrochemical enterprises. Kuwait is expanding its petrochemicals production with several new facilities that will be on line by 2007. Qatar is finishing a methanol plant this year and will add two ethylene crackers producing 2.7 million tons a year by 2011. UAE has added another ethylene cracker that will be running in 2009. Oman has announced plans for a petrochemicals complex, including two methanol plants, that will produce 2 million tons by 2008.

The petrochemicals industry has grown by 4 percent per year over the past two years. As MENA production facilities come on line, experts expect a drop in profitability as the industry responds to an initial oversupply of petrochemicals. However, in the longer term, the MENA region is poised to benefit greatly from a strengthened position in the petrochemicals industry as demand from China and India catches up with supply and as growth in the industry rebounds.

1.3.3 Current account positions diverge

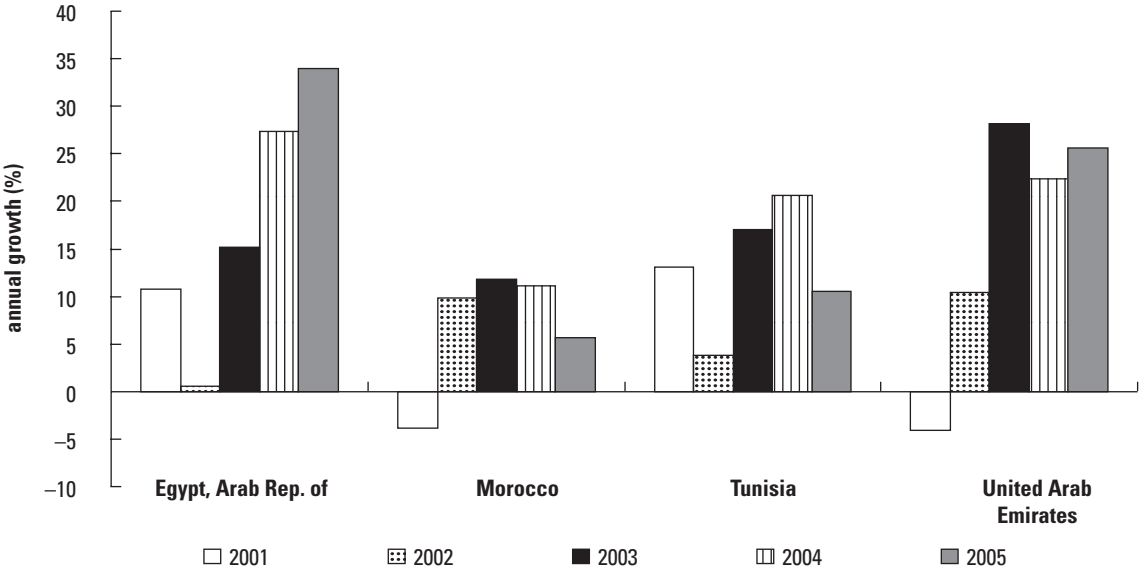
With conflicting external developments, the MENA region's current account positions have likewise diverged strongly between the resource-poor and resource-rich economies (figure 1.20). With rising oil import bills, resource-poor economies have seen widening current account deficits, which have become most evident in Jordan (where the current account moved from a surplus of about 5.6 percent of GDP to a deficit of almost 18 percent of GDP by 2005). Oil exporters, on the other hand, have built up sizable current account surpluses, from an average of only about 6 percent of GDP in 2002 to almost 23 percent of GDP by 2005. In the past year alone, the current account surplus has risen from about 15 percent to 22.7 percent of GDP.

Oil producers have substantially improved their external positions

Oil producers have also significantly increased their

Figure 1.18: Merchandise exports in MFA countries, 2001–2005

(Current US$)



Source: World Bank staff estimates.

Box 1.3

The Tunisian experience with the MFA removal

Production/employment: The textiles and clothing (T/C) industry is the largest contributor to the Tunisian economy, providing almost one-third of the manufacturing value added and about 5.7 percent of total GDP. The T/C sector constitutes one of the pillars of the Tunisian economy, employing approximately 204,460 people (or 46 percent of total industrial employment, with the largest female participation). The industry is also dominated by small and medium enterprises (with 10 to 100 employees). Only 25 firms have more than 500 employees. Since 1976, Tunisian products enjoyed duty-free access to European markets.

The T/C industry has been an export locomotive, generating some 50 percent of Tunisia's goods and services exports, with a high degree of geographic concentration. The majority (98 percent of value) of Tunisian T/C exports were destined for the European Union (EU), mostly to three countries (France, Germany, and Italy), and represented 45 percent of the total exports of the nation's manufacturing industries.

Recent developments: Over the first six months of 2005, the T/C industry production registered a loss of 4.9 percent relative to the same period in 2004. With the effective completion of the MFA removal, the Tunisian textile sector faced stiffer competition. The local textile industry remained fragmented and largely operating on a subcontractor basis. The threading and weaving firms were hardest hit. A slump in investment paralleled the trend in production. During the first quarter of 2005, 74 foreign firms/affiliates in the T/C industry closed their units in Tunisia (out of a total of 115 foreign firm closures). They were mostly small units (less than 100 employees) and subcontractors, heavily dependent on European *donneurs d'ordre*.

The loss of momentum has been particularly perceptible in the industry's traditional export markets, notably the EU, whereas textile exports to the United States increased during the first half of 2005. Compared with the first three quarters of 2004, Tunisia's exports to the EU in 2005 decreased by almost 6 percent (see table on next page). At the same time, Tunisia's exports to the United States during the first six months of 2005 increased by 42 percent relative to the same period in 2004.

(*Continues on the following page.*)

Box 1.3

The Tunisian experience with the MFA removal (continued)

EU Imports of Textiles and Clothing

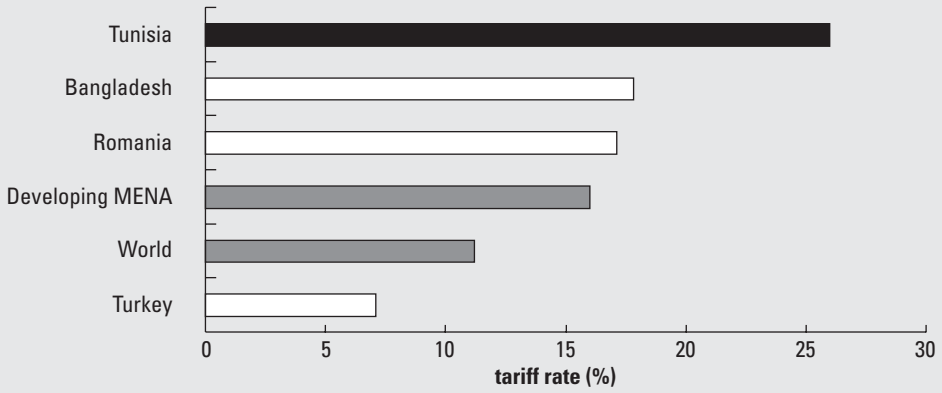
	January–September 2004		January–September 2005		
	Imports (EUR billion)	Share of EU's total imports (%)	Imports (EUR billion)	Share of EU's total imports (%)	Change in value (%)
World	52.6	100.0	54.5	100.0	+3.7
China	11.3	21.6	16.4	30.1	+44.8
Tunisia	2.2	4.1	2.0	3.7	–5.6

The expiration of the MFA in January 2005 and the consequent stiffer competition will compel Tunisia to surpass its simple role as a subcontractor by proposing a more complete offer to clients. Certain Tunisian suppliers find themselves at the head of true platforms composed of satellite subcontractors. The head of the network centralizes the entire scope of services (grading, cutting, grouping, packaging, dispatching) in such a manner as to present to the principal only a single representative. Such a development of services should permit Tunisia to move from the mass production of basics, which is the stronghold of Asian production enjoying a competitive advantage that Tunisia simply cannot rival. On the other hand, the development and promotion of national brands is difficult because of the financial weakness of the clothing sector and the small size of the domestic market.

Important competitiveness gains can derive from access to cheaper inputs. The industry most-favored-nation tariffs are still very high, at 26 percent (see figure below), which is above many competitors' tariffs, the world average, and those of the least-developed and medium-income MENA countries. Tariffs are high for apparel and also for the industry's main inputs, such as fabrics and fibers. Only access to cheap inputs from competitive textile producers would enable the Tunisian T/C industry to be competitive on the world market. As far as the European market is concerned, Tunisia should accelerate the process toward adoption of the Pan-European rules of origin.

Reduced labor costs could also help improve T/C competitiveness. In 2004, the T/C labor cost in Tunisia was about $2 an hour, lower than that of Morocco (at about $2.50), but higher than those of its competitors: Bulgaria ($1.30 an hour), Egypt ($0.90 an hour), and China (about $0.50 an hour).

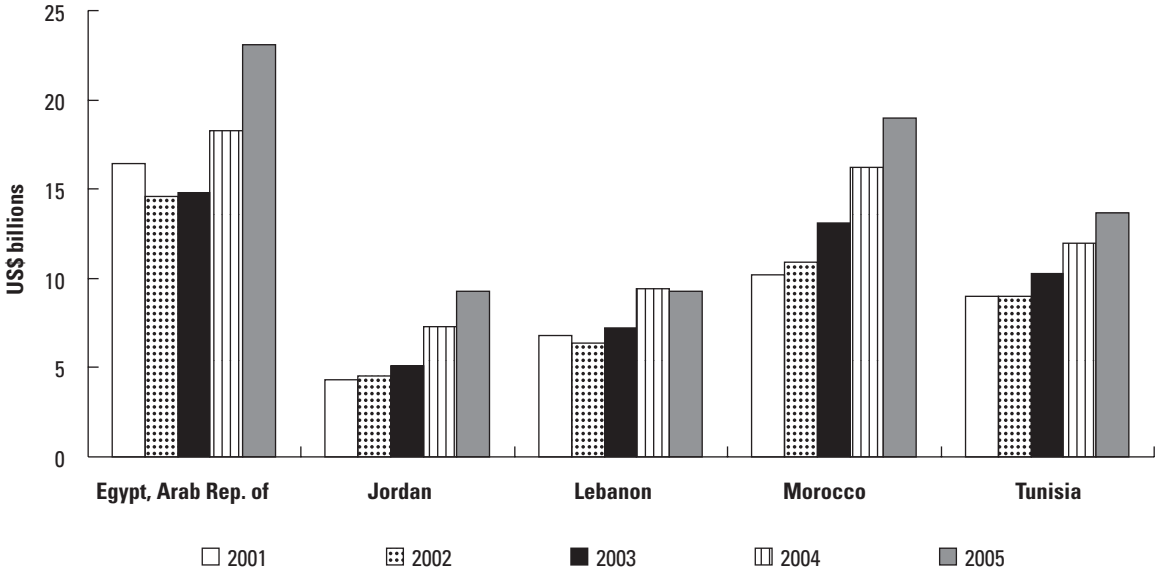
MFN tariff rates on textiles and clothing for selected countries, 2004



Source: WITS.

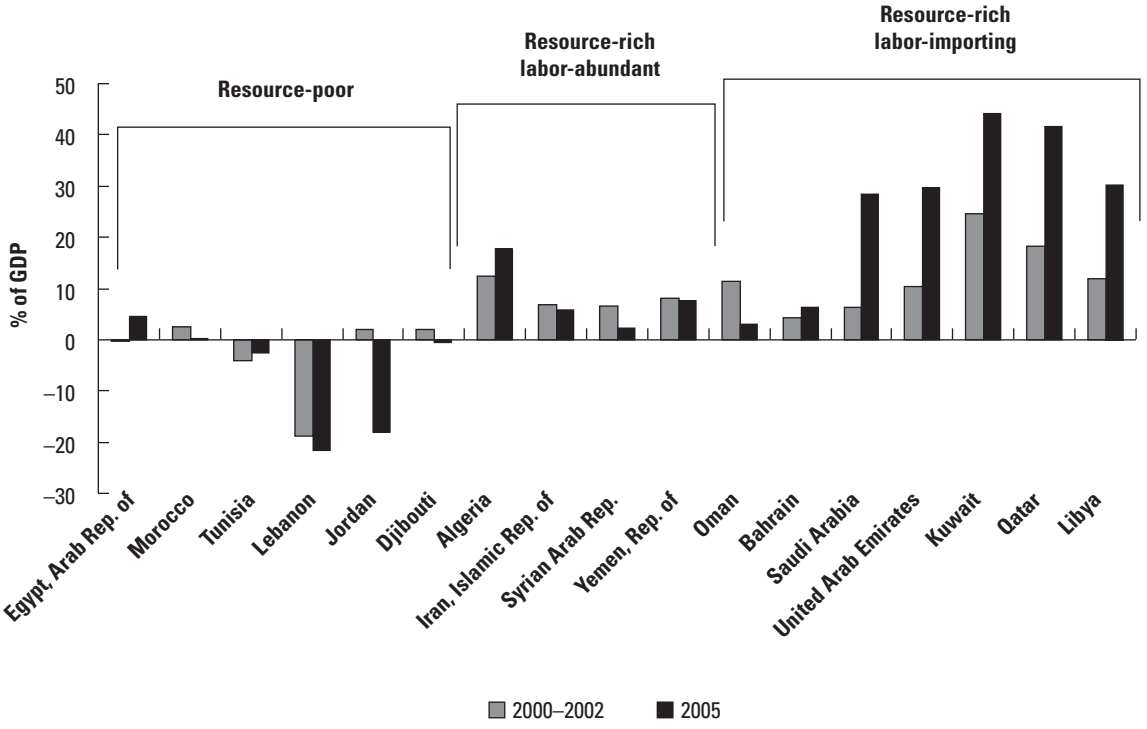
Note: Turkey data for 2003.

Figure 1.19: Merchandise import growth among RPLA economies, 2001–2005



Source: World Bank staff estimates.

Figure 1.20: Current account balance, early 2000s versus 2005



Source: World Bank staff estimates.

external reserves, providing a substantial buffer for the external accounts and partially insulating them from the exchange rate appreciation that marked earlier oil booms (table 1.3). In the past three years, external reserves among the oil exporters have risen from about $140 billion to more than $300 billion in 2005 (and from 12 percent of goods imports to almost 15 percent).

Oil stabilization funds have also been utilized for reserve building. Established to collect surplus hydrocarbons receipts, the funds are designed to lower the impact of volatile oil prices on government spending and on the economy. Oil producers in the region have set exceedingly conservative assumptions for the average price of oil for the purposes of their budgets (in 2005, for example, both Algeria and Qatar budgets called for an average price of oil over the year of only $19; Saudi Arabia's budgetary estimate was $25). As a result, with real oil prices substantially higher than budgeted assumptions, significant revenues have accumulated within the funds.

Not all of these surplus revenues have actually gone into the stabilization funds, however. In the Islamic Republic of Iran, for example, the fund was established in 2000 as part of the country's Third Five-Year Plan (Third Plan), conceived to absorb all foreign exchange earnings above the reference price (which between March 2000 and March 2005 has averaged between $12 a barrel and $19 a barrel). However, the unexpectedly robust rise in oil prices (averaging more than $35 over the period) resulted in both increases in the regular "oil share" of the budget and repeated withdrawals from the fund. As a result, while some $74 billion should have been accumulated in the fund between March 2000 and 2005 according to the original guidelines, instead the total deposits have amounted to a mere $29 billion.[28] Despite these drawdowns, the buildup in both oil stabilization fund assets and foreign reserves have provided oil producers in the region significant cushions against future oil price slides and sudden reversals in capital flows.

[28] Amuzegar 2005.

Table 1.3: External reserves, in months of imports

Country	2000	2001	2002	2003	2004	2005
MENA Total	11.4	12.0	11.7	12.7	13.2	13.7
Resource-poor	8.7	9.0	10.5	12.3	10.6	10.0
Djibouti	3.9	4.3	4.5	5.1	4.1	4.2
Egypt, Arab Rep. of	10.2	10.4	11.6	12.0	9.7	10.0
Jordan	10.1	8.9	11.0	12.7	9.0	7.1
Lebanon	16.9	12.2	15.5	23.5	18.0	18.7
Morocco	5.8	10.4	12.0	13.3	13.0	11.8
Tunisia	2.7	2.7	3.1	3.4	4.1	3.7
Resource-rich	12.5	13.2	12.1	12.9	14.0	14.8
Resource-rich, labor-abundant	11.7	14.5	15.1	15.8	15.9	18.5
Algeria	15.8	23.2	23.3	29.9	29.1	33.8
Iran, Islamic Rep. of	9.7	11.2	11.7	10.2	10.8	14.6
Syrian Arab Republic	8.9	9.1	9.9	11.1	8.1	5.4
Yemen, Republic of	12.9	15.5	15.8	15.0	15.9	14.2
Resource-rich, labor-importing	12.7	12.6	10.8	11.6	13.1	13.1
Bahrain	4.3	5.0	3.8	3.5	3.3	2.4
Kuwait	13.4	17.0	13.8	9.3	8.3	8.4
Libya	38.3	35.3	24.3	31.5	33.7	43.8
Oman	6.4	5.5	6.8	7.1	5.4	4.6
Qatar	3.4	3.4	3.9	6.4	8.4	8.9
Saudi Arabia	20.7	20.4	17.1	21.1	25.5	21.2
United Arab Emirates	5.4	5.1	4.9	4.0	4.1	4.5

Source: World Bank staff estimates from country sources.

1.3.4 Capital flows reflect increasing desire among resource-rich economies to diversify

The rising liquidity accruing to oil producers has brought forth a strong move toward overseas investment, particularly among Gulf economies, as part of an overall drive to diversify oil-dependent economies and transform finite oil reserves into longer-term revenue streams. A sizable portion of the oil windfall has returned to U.S. dollar holdings following a shift away from such assets following the events of September 11, 2001, but the Bank for International Settlements finds that MENA's financial outflows in the present boom have become more geographically dispersed and allocated across more asset classes,[29] thus diversifying their portfolios with the objective of spreading risk.

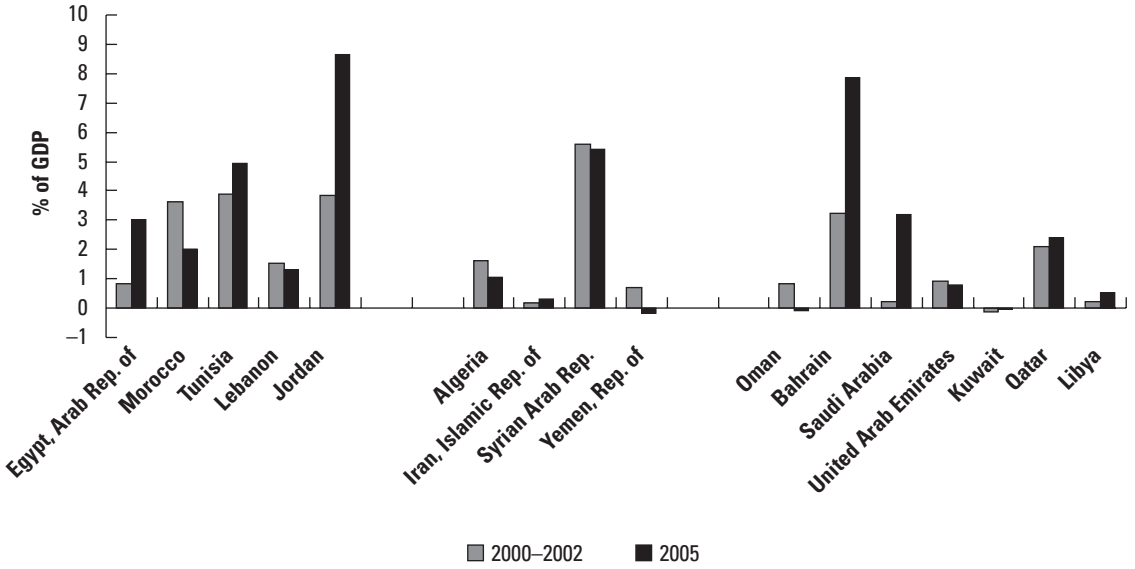
Some of these large surplus funds have been recycled through the region to direct investment projects in industry, finance, and commerce, particularly in both Egypt and the Mashreq.[30] GCC countries in particular are looking to build investment with large-scale flows, having been drawn at first into GCC equity and real estate. During 2003, share prices rose 70 percent across the region, and 2004 showed more spectacular returns—Saudi Arabia 80 percent, UAE 95 percent. But such opportunities are limited, and capital is now flowing into neighboring states, principally into industrial projects in Egypt, Jordan, and Syria (for example, cement, oil refineries). Inroads are also being made in the tourism infrastructure, as well as the financial sector and real estate (discussed in chapter 2). Though figures are largely anecdotal, direct and portfolio investment on the order of $5 billion to $10 billion appears to have been committed over the past year.

In addition to diversifying their assets geographically, many of the oil-producing economies of the GCC have substantially increased their exposure to foreign investment into their own economies. A strong drive is underway among GCC countries to capture greater foreign investment, and almost all of the economies have passed legislation to open up key sectors to foreign ownership, to encourage greater FDI (see chapter 3). Partly as a result, a few of the GCC countries, including Bahrain, Qatar, and Saudi Arabia have seen large increases over the past three years in inward FDI (figure 1.21).

[29] BIS 2005.

[30] MENA Mashreq countries include Iraq, Jordan, Lebanon, Syria, and West Bank and Gaza.

Figure 1.21: FDI inflows as a share of GDP, 2000–2005



Source: World Bank staff estimates from UNCTAD, 2005.

Note: 2005 or closest year available.

1.4 Fiscal Developments

1.4.1 Strong upturn in fiscal balances among oil producers

Record revenues from oil exports have swelled state coffers for the region's oil producers, who collectively have seen total revenues more than double over the past three years, from $202 billion in 2002 to $433 billion in 2005.[31] Over the past year alone, revenues as a percentage of GDP among oil producers rose from 40.5 percent to more than 45 percent.

In general, the phenomenal growth in government revenues has been met with fiscal restraint. Total expenditures as a percentage of GDP among resource-rich economies are below pre-oil-boom levels, although in current dollar terms they have increased by about 12 percent a year between 2002 and 2005 (slightly higher than over the period 2000–2002, when expenditure growth averaged 7.9 percent per year). Resource-rich, labor-importing economies in particular have shown fiscal prudence with this oil boom: expenditure growth has averaged only 10 percent a year, despite extraordinary spending outlays in Saudi Arabia to pay down public domestic debt (see box 1.4 on debt reduction among oil producers). Although there is evidence of higher spending on the horizon, including a strong expansion of infrastructure spending, the resource-rich, labor-importing economies have to date maintained unprecedented fiscal discretion.

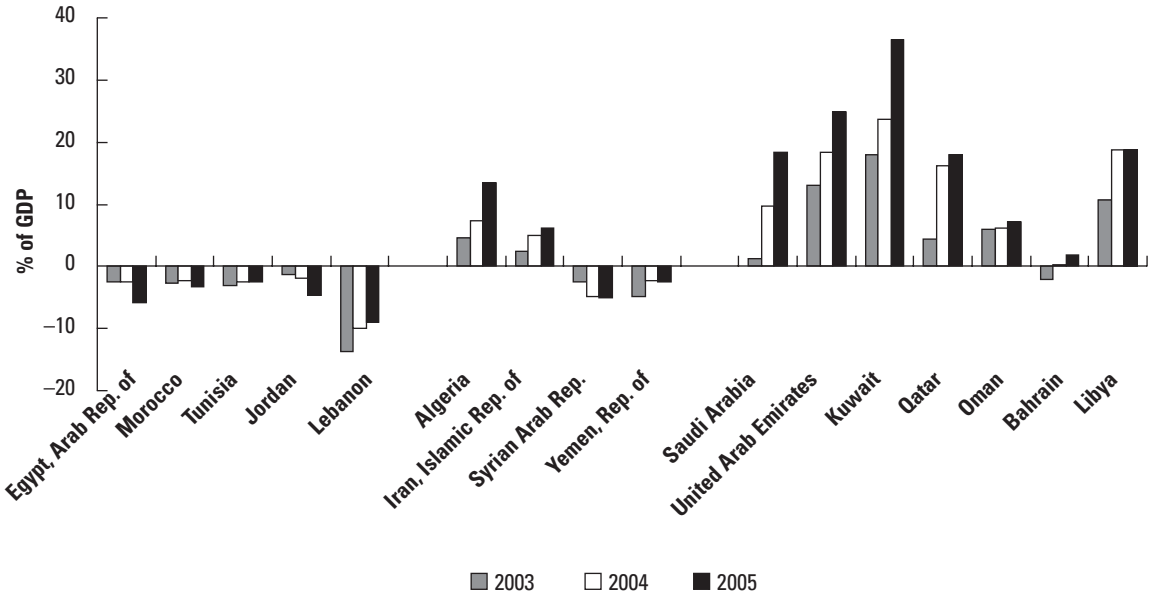
Spending advances have been more robust among the resource-rich, labor-abundant countries, with a tripling in the rate of growth of government spending in Algeria (a result of strong increases in the wage bill, but also reflecting significant payments toward external debt reduction) and a surge in the Islamic Republic of Iran's public spending, particularly in the run-up to presidential elections. With rapid revenue advances and only moderate spending increases, fiscal positions have improved sharply for MENA oil producers, who posted a fiscal surplus of 16 percent of GDP over 2005, up from 10 percent in 2004, and only 2 percent of GDP in 2002 (figure 1.22).

1.4.2 Deteriorating fiscal balances among resource-poor countries

But results have been sharply divided along resource allocation lines, with resource-poor economies remaining in fiscal deficit and with acute deteriorations in the fiscal deficits in Egypt, Jordan, and Morocco. A strong rise in public sector wages in Egypt, along with rising costs of energy subsidies through-

[31] Does not include Iraq.

Figure 1.22 Fiscal balances in MENA



Source: World Bank staff estimates.

out the region, resulted in total expenditures increasing by almost 13 percent over 2005 for RPLA economies as a group. Although Egypt actually cut current expenditures by almost 7 percent over 2004, current expenditures in 2005 rose by about 21 percent, reflecting a 50 percent increase in subsidies (primarily fuel) and a 27 percent increase in consumption expenditures (primarily wages and salaries, which rose 20 percent on the year). With revenue growth only modest, fiscal deficits among resource-poor economies have increased from slightly more than 3 percent of GDP in 2004 to almost 5 percent of GDP in 2005 (figure 1.22).

In the West Bank and Gaza, the fiscal worries are perhaps most challenging, given recent uncertainty about (primarily Western) donor aid payments, on which the Palestinian Authority strongly depends. Over 2005, the Palestinian Authority's budget deficit reached about $800 million, of which some $340 million was financed by donors in the form of direct budget support. With strong increases in both the public sector wage bill and social transfers, the Palestinian Authority's fiscal situation is increasingly unstable.

Box 1.4

Debt reduction among MENA's oil producers

Many of the oil producers have reacted to the windfall revenues with remarkable prudence, evidenced not only through relatively small spending advances, large surpluses, and the buildup of foreign assets but also through a drawdown of external and government debt obligations. On the external debt front, the most significant debt reduction has come from Algeria, where sizable surpluses in the balance of payments have allowed Algeria to initiate a process of early payoff of external debt. As a result, the external debt-to-GDP ratio has declined from 41 percent of GDP in 2001 to 16 percent of GDP by 2005, and by November 2005, Algeria's debt to the International Monetary Fund (IMF) was fully repaid.

Although countries in the GCC carry some external debt, the majority of debt is domestic, and a few countries have utilized the oil wealth to substantially draw down domestic debt obligations. Most notably, Saudi Arabia has initiated a massive debt repayment process, and in the span of just three years, it has reduced the stock of domestic debt from 97 percent of GDP to just 41 percent by 2005. Debt reductions have also occurred in Kuwait and Oman.

Stocks of external and domestic debt among MENA oil exporters

	Debt as a proportion of GDP				
Country (debt indicator)	**2001**	**2002**	**2003**	**2004**	**2005**
Algeria (external debt)	41	41	35	26	16
Iran, Islamic Republic of (external debt)	7	6	7	8	9
Syrian Arab Republic (external debt)	110	106	101	90	..
Yemen, Republic of (external debt)	53	51	48	42	33
Bahrain (govt. debt)	30	32	37	34	31
Kuwait (external debt)	32	32	27	23	17
Oman (govt. debt)	25	19	18	13	11
Qatar (govt. debt)	16	38	44	44	51
Saudi Arabia (govt. debt)	94	97	82	65	41
UAE (external debt)	27	27	24	..	..

Source: World Bank staff estimates.

Thus, unlike in the past oil booms, many of the region's oil economies seem to be viewing the recent oil wealth as a window of opportunity. Drawing down their debt obligations represents one of the several constructive actions undertaken by many oil economies to strengthen fiscal positions and enhance private sector confidence.

1.4.3 The special case of oil subsidies in MENA

Energy subsidies represent a special—and significant—expenditure item in many of the economies in MENA, and with the recent rise in oil prices, the impact on the budget has been particularly evident. Energy subsidy rates vary in the region. Estimates of energy subsidies as a percentage of GDP in a few MENA countries demonstrate diverging burdens for the region, ranging from 5.8 percent of GDP in Jordan to some 15.7 percent in the Islamic Republic of Iran, the highest in the region (outside of Iraq). Other recent estimates include 6.5 percent in the Republic of Yemen, 8.1 percent in Egypt, and 12 percent in Syria.

Aside from the enormous fiscal drain of these subsidies, with the exception of Jordan, energy subsidies in MENA are also regressive and untargeted. With energy consumption generally more modest among the poor, energy subsidies disproportionately benefit rich rather than poor households. In Egypt, individuals in the richest quintile receive more than two-and-a-half times the energy subsidy received by the poor, the disproportion being the greatest for gasoline, for which 93 percent of the benefits go to the richest quintile.[32] In addition, the artificially low prices result in energy inefficiency, excessive consumption, and environmental damage.

Price adjustments and other energy policies

Aware of the large fiscal impacts, authorities of a few economies in MENA have, with varying success, undertaken to mitigate the budget impact of subsidies and transfers by adjusting retail prices (see box 1.5 for details). However, with the exception of Jordan, the reforms to date have been timid, and in no country in the region are oil prices currently market-determined. Part of the hesitancy to undertake ambitious price reforms is explained by concerns about the poverty impact, as well as the fear of political backlash. In both Lebanon and the Republic of Yemen, efforts to reduce or offset these oil subsidies were met with riots. Governments have also worried about the inflationary impacts of rising oil prices to consumers.

But surging budget surpluses among oil producers have also seemed to contribute to a backing off from oil subsidy reform. In the Islamic Republic of Iran, the government asked parliament in October to approve a new pricing formula that would ration the availability of subsidized gasoline (the draft bill stipulated that car owners be provided with "smart cards," fixing the subsidized gasoline allowance and forcing drivers to pay full price when they exceed the ration). But parliament has backed off from implementing the scheme—a modest step in the right direction—until 2007 at the earliest. Energy subsidies will continue throughout 2006 according to the revised bill, which froze any adjustments to domestic prices of oil products, gasoline, electricity, water, and postal services for the budget period. In Saudi Arabia, meanwhile, the heavily subsidized domestic prices of gasoline and diesel have actually been lowered in early 2006 by nearly 30 percent, in an effort to soften the impact of the country's recent stock market declines. And equally telling, no other resource-rich economy has attempted to enact subsidy reform since the oil boom began.

While short-term adjustments have been limited, a few resource-poor economies are working to put into place longer-term measures. Both Morocco and Tunisia have recently taken steps to reduce consumption and dependence upon oil. The Tunisian government adopted an Energy Control Law in August 2004.[33] It also targets a 20 percent reduction in energy consumption by government administration, firms, and households; a greater use of natural gas; and the development of renewable energies. In that context, the Tunisian government launched in 2005 a public awareness campaign to reduce household energy consumption. It is also developing its use of both solar and wind energy. Likewise, the Moroccan government is considering the adoption of more long-term energy-saving measures, including a rolling work schedule to eliminate midday traffic, as well as the use of renewable energies.

In Egypt and Jordan, on the other hand, the issue is being approached by price reform. In Egypt, there is a general consensus to move from implicit to explicit and from direct to indirect cash subsidies and to strengthen the safety nets. In Jordan, the government voted for measures to allow a gradual reduction of the oil subsidies on diesel, fuel oil, liquefied petroleum gas (LPG), and kerosene and to liberalize the domestic market for petroleum products over three years. The first round of reductions in oil sub-

[32] World Bank 2005d.

[33] Law No. 2004-72 of August 2, 2004. The bill pertains to energy consumption and the use of renewable energies. It includes incentives and other promotional measures destined to boost the use of renewable energies in the country's private and public sectors.

Box 1.5

The experience with oil price adjustments in some MENA economies

In **Morocco,** oil products have been subsidized since 1995. Prices were indexed on the Rotterdam oil price up until 2000, but increasing oil prices pushed the Moroccan government to interrupt this indexation in September 2000, which has translated into the widening of the *Caisse de la Compensation* deficit. Prices were kept unchanged until 2004, when they were increased by between 2.9 and 3.5 percent, depending on the product. Further increases were introduced in May and August 2005 and in January 2006. As of May 2005, the energy bill was evaluated at Moroccan dirhams (DH) 7 billion (Ministry of Finance); however, the recent price adjustments will reduce it to DH 5 billion, equivalent to a 20 percent cutback.

The **Tunisian** government has controlled for the budget deficit by increasing retail oil prices several times. In 2004, prices were adjusted up by about 5 percent (in February and August), but the decision was offset by a 3 percent increase of the minimum wage to attenuate the burden on some 280,000 workers. More rises followed in February, June, and September 2005.

The government of **Jordan** made its first reforms of the oil and gas subsidies by raising the price of gasoline and fuel oil by 10.6 and 33.3 percent, respectively, on July 9, 2005. In September, the government announced additional increases, varying from 5 percent for gasoline to 20–22 percent for diesel and kerosene to Jordan dinars (JD) 0.25 for LPG cylinders. Prices are likely to further increase because the Jordanian government has embarked on long-term reform toward the removal of oil subsidies.

In **Egypt**, prices were adjusted upward in 2004, when the government introduced two new types of gasoline with higher octane levels at higher prices and increased the prices of diesel to Egyptian pounds (LE) 0.6 per liter (up by 50 percent), fuel oil to LE 300 per ton (up by 65 percent), and natural gas to LE 0.21 per cubic meter (up by 49 percent). This is a major step, given that there was no change in the nominal domestic price of any petroleum product between 1997 and 2004. While the price of LPG froze at its 1991 level (LE 2.5 per 12.5-kilogram cylinder), prices of gasoline were last adjusted in 1992 (LE 0.9 per liter for octane 80 and LE 1.0 per liter for octane 90), kerosene and diesel in 1993 (LE 0.4 per liter for kerosene and ordinary diesel), and natural gas and fuel oil in 1997 (LE 0.141 per cubic meter and LE 182 per ton, respectively). In addition, the depreciation of the exchange rate by 30 percent over 2003–2004 widened the gap between domestic and international prices of all energy products.

In the **Republic of Yemen**, the government has been trying to phase out subsidies on oil derivatives for at least seven years. A first rise in gasoline of 40 percent in 1998 led to riots and a death toll of 50. In July 2005, the government raised the price of diesel and oil—as well as kerosene and cooking gas—significantly: pump prices for diesel jumped from Yemeni rial (YRls) 17 per liter (8 U.S. cents per liter) to YRls 45 per liter, while those for oil almost doubled. These price hikes were combined this time with pro-poor supportive measures such as a sales tax cut, production and consumption taxes cancellation, and 200,000 additional individuals covered under the Social Care System. However, despite safety measures, riots led to 13 dead, and the government withdrew part of the price hike: new prices were cut by 20–30 percent, and oil prices remain at around half their market rate.

In **Lebanon**, the government imposed in May 2004 a price cap on gasoline and increased excise taxes to offset the rise in world oil prices. As in the Republic of Yemen, these price hikes resulted in riots, occurring in the southern suburb of Beirut and claiming five lives.

In the **Islamic Republic of Iran**, oil and gasoline prices are among the cheapest in the world, but gas subsidies have had the largest fiscal implications. Because of refining limitations, some 40 percent of the country's gas consumption is imported at market prices, and consumption has risen. In 2005, the government introduced a proposed rationing scheme for gasoline, in which each car owner would have a "smart card" allowing the purchase of a certain amount of gas at the subsidized rate, after which further fuel would have to be purchased at market prices. The scheme was intended to be implemented in 2006, but mixed reaction by the Majlis to the bill has resulted in freezing any adjustments to domestic oil prices, gasoline, or electricity. As a result, prices will remain unchanged until at least 2007.

sidies became effective in September 2005, and despite the continual rise in oil prices, subsidies for the last four months of the year increased by only 49 percent compared with the same period in 2004—in contrast, subsidies up to September increased by 139 percent over the same period in 2004.

The poverty impact of higher oil prices

Although energy subsides have contributed to significant deterioration of fiscal positions among resource-poor countries, many governments in the region have been hesitant to remove them, mainly because these subsidies have buffered the poor from the direct shock of higher oil prices. But rising oil prices may have poverty impacts beyond consumer budgets (for example, through growth itself). To the degree that higher growth benefits the poorest households, there may still be a poverty impact from the higher oil prices, even if it has not been directly passed on to consumers. A recent World Bank study estimated the impact of the recent increase in oil price on poverty through the growth channel,[34] and three resource-poor economies are found to be particularly affected: Djibouti, Jordan, and Lebanon. In Djibouti and Jordan, the impact was especially large, estimated as a 4.7 percent rise in the poverty headcount, and in Lebanon, the increase in the poverty headcount was estimated at approximately 2.6 percent (table 1.4).[35]

With growing recognition among MENA governments that to ensure fiscal sustainability, they must reevaluate present energy subsidy systems,

[34] The study considered a US$10 increase with respect to the average oil price in 2003 and a rise in the long-term oil price of about $5 a barrel in real terms. The study accounted for country-specific growth elasticities of poverty (World Bank 2005c).

[35] World Bank 2005c.

Table 1.4: Poverty impact of oil price rise: most severely affected countries

Country	Total growth[a] (%)	Poverty elasticity[b]	Poverty impact[c] (%)
Mauritania	4.08	–2.12	8.65
Moldova	3.22	–2.45	7.87
Belarus	2.13	–3.20	6.81
Kyrgyz Republic	1.83	–3.34	6.11
Uzbekistan	1.61	–3.63	5.84
Armenia	2.49	–2.22	5.53
Tajikistan	2.09	–2.56	5.35
Guyana	3.06	–1.73	5.28
Jordan	**1.93**	**–2.45**	**4.73**
Djibouti	**3.40**	**–1.39**	**4.72**
Ukraine	1.20	–3.34	4.02
Georgia	1.63	–2.33	3.80
Jamaica	1.63	–2.22	3.63
São Tomé and Principe	2.50	–1.39	3.48
Singapore	1.75	–1.82	3.18
Estonia	1.33	–2.33	3.10
Mongolia	1.83	–1.64	3.01
Macedonia, FYR	0.86	–3.48	2.98
Tonga	1.29	–2.22	2.88
Lithuania	0.95	–2.93	2.78
Guinea-Bissau	1.98	–1.39	2.75
Latvia	0.93	–2.93	2.73
Bulgaria	0.93	–2.93	2.71
Lebanon	**1.01**	**–2.56**	**2.58**
Pakistan	0.88	–2.81	2.47

Source: Herrera et al. 2005.

a. Total growth effect = sum of direct and indirect effects.
b. Poverty elasticity calculated according to Ravallian 2004.
c. Poverty impact = product of total growth effect multiplied by poverty elasticity.

there has been increasing interest in understanding the impact on the poor from reducing energy subsidies. To that end, poverty simulations undertaken in three MENA countries attempted to approach this question by analyzing the impact of setting all energy prices to import parity. In all cases, potential impact on the poor would be great without compensatory measures. In the Islamic Republic of Iran, such a policy would be equivalent to an across-the-board price increase of 308 percent on all energy products and would result in an increase in household expenditure of 33 percent for the urban poor and 47.6 percent for the rural poor. The estimated results for the Republic of Yemen were similar: price increases for oil products would correspond to (on average) a 104 percent increase, and the increase in expenditure would account for (on average) 14.4 percent of household budgets for the poorest households and 7.1 percent of household budgets for the richest. Most of the expenditure increase originates from LPG consumption, the major energy product of poor households in the Republic of Yemen. In Egypt, another approach to simulate the poverty impact of subsidy removal took into account other relevant effects, namely the welfare-enhancing effect of energy reform in the production sector and the likely quantity responses to the price increase. The study simulated a 50 percent reduction in overall energy subsidies without any compensation for potential losses through other social protection schemes and resulted in an estimated increase in the incidence of poverty of 4.5 percentage points, with most of the increase in poverty arising from the phasing out of LPG subsidies. In absolute numbers, the reduction of energy subsidies by half would increase poverty in Egypt by almost 3 million people.

But the simulations above only point to the potential increase in poverty without compensatory measures. With a large portion of energy subsidies currently benefiting the nonpoor, removing oil subsidies and directing some of these budgetary savings to the poor could eliminate these negative impacts on the poor. In Egypt, for example, it was shown that if only half of the savings from the subsidy reduction were used in a new, untargeted cash transfer program, the negative impact on the poor would be largely eliminated.[36] In addition, in the Islamic Republic of Iran, a seminal study of the oil subsidy scheme found that the wealth that would be freed up from the subsidy removal could be far better invested to create jobs while developing a well-targeted and efficient social safety net system that could replace the transitory transfer system.[37]

With the vast proportion of energy subsidies benefiting the nonpoor, removing energy subsidies and replacing them with programs that are better targeted to the poor could have a strong positive social impact. Moreover, although these subsidies emerged with the aim to protect the poor, they now represent an ever-growing fiscal burden, a burden that ironically may present its greatest risk to the poor with regard to preserving important social expenditures.

1.5 Near-Term Prospects

In the wake of quite strong performance over the past three years, two major elements are likely to shape the outlook for the broader MENA region over the period through 2008. First, the external environment for growth will be shifting over this period in line with the business cycle in the OECD countries, affecting global growth and trade patterns. Developments in critical nonoil export markets for MENA will carry substantial influence on the outlook for the region's diversified economies, largely within the resource-poor, labor-abundant group. At the same time, the dynamics of the oil market are anticipated to change as global demand and supply conditions evolve over the next years. In this context, OPEC policy will play an important role in establishing the price level that emerges and, consequently, the level of hydrocarbon revenues anticipated to accrue to regional oil exporters.

1.5.1 External environment for growth

In broad terms, the external environment for growth in the MENA region appears favorable (table 1.5). Long dormant, economic activity in the Euro Area is showing signs of increased vigor, with expectations that GDP growth and import demand will be picking up in 2006 and 2007 to the benefit of MENA exporters of manufactured goods, especially textiles, clothing, and similar products. At the same time, the balance of supply and demand forces suggests that global oil prices will remain at fairly high levels through 2008, continuing to rise into

[36] World Bank 2005d.

[37] World Bank 2003f.

Table 1.5: The external environment, 2004–2008

Growth, or as otherwise specified	2004	2005	2006	2007	2008
World trade[a]	12.0	9.0	8.5	7.0	7.0
High-income imports	8.9	6.6	6.7	6.2	6.2
Euro Area	6.3	4.3	5.8	5.3	5.4
United States	10.7	6.2	5.0	3.8	3.8
World GDP[b]	3.8	3.3	3.3	3.2	3.2
High-income countries	3.2	2.8	2.9	2.7	2.8
Euro Area	1.9	1.4	2.1	1.7	1.9
Developing countries	6.9	6.3	6.0	5.7	5.6
Oil prices ($/bl)[c]	37.7	53.4	59.0	56.0	53.0
Nonoil commodity prices[d]	17.3	13.4	5.4	–3.1	–5.9
MUV index[e]	6.9	0.0	2.4	2.6	0.8
US dollar LIBOR (%)	1.7	3.6	5.2	5.3	5.2

Source: World Bank 2006c.

Note: MUV = Manufacturers' unit value.
a. Goods and services (2000 US$).
b. Real GDP in 2000 US$.
c. World Bank average oil price = equal weights of Brent, WTI, and Dubai crude oil prices.
d. World Bank index of nonoil commodity prices in nominal US$ terms.
e. Index of manufacturers' unit value, G-5 countries (France, Germany, Japan, United Kingdom, and United States).

2006 (to $59 per barrel),[38] before easing to $53 per barrel by 2008. This pattern of global oil price (a base case, with substantial associated risks) would serve to sustain oil revenue flows to MENA exporters at high, albeit diminishing, levels. Together these factors point to a pickup in growth for those countries more dependent upon economic conditions in Europe and a moderate easing in activity for most oil exporters in the region—both as revenues scale back to a degree and as outlays (domestic and import spending) gradually adjust toward new equilibrium levels consistent with government policy.

For the MENA region, the tenor of the external environment offers clear opportunities for oil exporters to make use of continuing high revenue flows and for diversified economies to make the most of the revival in a key export market. These driving forces for growth come with challenges as well.

For oil-exporting economies, clear opportunities exist to place continuing high revenue streams into productive use in domestic spending because job growth will be essential to quell booming demographic pressures. Challenges facing policy makers include continuing cautious management of the financial windfall to avoid domestic overheating and inflationary consequences and, importantly, to avoid the tendency for high revenues to cloud the need for structural change.

For resource-poor, labor-abundant countries, growth in the European Union, sluggish since 2000, now shows signs of picking up and could offer stronger support for goods exports, tourism, and remittances over the next years.

On a base set of assumptions—continued moderate progress in domestic reforms—MENA growth is viewed to ease modestly in 2006 to 5.6 percent and to establish a 5.2 percent pace over 2007–2008. As shown in table 1.6, overall growth reflects a pickup for the diversified economies above 5.5 percent by 2008, contrasted with a slowing for oil exporters toward the 5 percent mark.

Oil-exporting countries

Among the *resource-rich, labor-importing economies*, the strong trend of recent growth is anticipated to ease from 7.2 percent to 5.8 percent in 2006 as additional gains in oil and gas production generally come up against capacity constraints, although efforts are being made to enhance capacity in the medium and long terms (see box 1.6). Though GDP measures of output fall in line with this development, much accrued hydrocarbon revenues remain to be expended though fiscal accounts and capital outlays. GDP growth in Kuwait, Qatar, Saudi Arabia, and the United Arab Emirates is anticipated to remain strong, while new oil production capacity in Oman should help to bolster growth there. For the group, hydrocarbon revenues

[38] World Bank average price gives equal weighting to Brent, WTI, and Dubai crudes.

Table 1.6: GDP growth for the MENA region

Growth, or as otherwise specified	2004	2005	2006	2007	2008
MENA	5.6	6.0	5.6	5.2	5.2
Resource-poor, labor-abundant	4.8	4.0	5.4	5.4	5.7
Egypt, Arab Republic of	4.2	4.9	5.5	5.8	6.0
Jordan	7.7	7..2	6.0	6.0	6.0
Lebanon	6.3	1.0	..	..	..
Morocco	4.2	1.5	5.0	4.0	4.5
Tunisia	5.8	5.0	5.5	5.5	6.0
Resource-rich, labor-abundant	4.7	5.5	5.3	5.1	4.8
Algeria	5.2	5.5	5.7	5.4	5.0
Iran, Islamic Republic of	4.8	5.9	5.5	5.3	5.0
Syrian Arab Republic	3.6	4.0	4.0	4.0	4.0
Yemen, Republic of	2.6	3.8	3.5	3.0	3.0
Resource-rich, labor-importing	6.5	7.2	5.8	5.3	5.0
Bahrain	5.4	6.9	7.0	6.8	6.5
Kuwait	6.2	8.5	6.2	5.0	4.0
Libya	9.3	8.5	..	..	..
Oman	3.1	4.1	6.0	5.5	5.0
Qatar	9.9	8.8	8.0	7.5	7.0
Saudi Arabia	5.2	6.5	5.1	4.8	4.5
United Arab Emirates	8.5	8.0	6.5	6.0	6.0
Memo item					
Oil exporters	5.9	6.7	5.5	5.2	5.0
Diversified exporters	4.8	4.0	5.4	5.4	5.7

Source: World Bank staff estimates.

are anticipated to remain at quite high levels despite the moderation in oil price, easing from $260 billion in 2005 toward $225 billion by 2008. The current account surplus is seen diminishing from about $185 billion to $80 billion as more of the windfall is expended on imports, and the overall fiscal position is seen to drop from the current surplus of 21 percent of GDP to a still-high 15 percent.

For the *resource-rich, labor-abundant countries*, economic activity will be driven by a combination of factors. In Algeria, increased oil and gas output, in several cases through massive new facilities, will serve as a driving force for growth. In contrast, a paradigm shift is underway in the Islamic Republic of Iran, in which large-scale increases in domestic subsidies and transfers underpin a revival of private consumption spending. In Syria and the Republic of Yemen, dwindling natural resources and (in the former country) increasing geopolitical tension and lack of market opening are likely to restrain growth potential. Still, advances in GDP are respectable, easing from 5.5 percent in 2005 toward 4.8 percent by 2008.

Resource-poor, labor-abundant countries

After suffering a slowdown in 2005 linked to poor export performance across the Maghreb[39] and devastating drought in Morocco, several of the RPLA economies are positioned to enjoy a revival of growth over 2006–2008. At the same time, fuel prices, if maintained at their current high levels, will continue to exert important pressure on the balance of payments (through the import bill) and on fiscal accounts (through oil subsidies). Part of this negative impact may be compensated for with higher capital and tourism inflows from the Gulf, and Jordan is well situated to garner economic spillovers from the continuing conflict in Iraq in the form of real estate, administrative, and other supporting work efforts. Also, Egypt's improving track record of reforms, together with revival of growth in European demand for goods and tourism services, holds the promise of accelerating GDP growth over the period to 2008.

[39] MENA Maghreb members include Algeria, Morocco, and Tunisia.

Box 1.6

Building greater oil production capacity in MENA

Rising oil prices and burgeoning demand have pushed MENA oil producers toward the limits of their upstream crude oil production in the past year. In August 2005, spare capacity among the six primary oil producers in the Gulf (the Islamic Republic of Iran, Iraq, Kuwait, Qatar, Saudi Arabia, and the United Arab Emirates) was estimated at 1.7 million barrels per day (bpd), the lowest spare capacity they have maintained since 2003. The lack of spare oil capacity has largely been shaped by the fact that OPEC countries, particularly Saudi Arabia, have boosted production to meet global demand. However, there are underlying concerns about future capabilities of the region to generate spare capacity because of limitations on manpower, equipment shortages, and, more important for the long term, aging oil reservoirs.

Supply shortages have triggered a renewed effort at exploration in the region. Kuwait most recently discovered new oil and gas deposits that could boost the country's reserves by some 10 percent. Algeria made 13 discoveries in 2004 and at least 6 in 2005. The country plans to increase production capabilities from a current 1.4 million bpd to 2 million bpd. UAE has agreed to add 200,000 bpd, increasing total production capacity to 2.7 million bpd. In an effort to develop greater upstream production to improve their spare capacity, most MENA producers are having to exploit heavy crudes. Heavy crude oils are sold at a discount rate because of the higher costs of refining them before they become end-use products. As spare capacity decreases, producers are more inclined to increase upstream production of heavy crudes, despite the price discounts. Saudi Arabia currently produces 11 million bpd of heavy crudes and is planning to produce 12.5 million bpd by 2009 by investing heavily in oil field developments. Kuwait has taken similar steps, launching a pilot heavy crudes scheme in 2005.

Regional oil producers are also attempting to develop new technology and extraction techniques to extend the life of aging reservoirs and boost production in existing wells. Oman, which has heavier crudes than its neighbors, has invested heavily in new techniques (such as steam and polymer injection) that will boost well production. Such investment is also key for the Islamic Republic of Iran and Iraq; however, the Islamic Republic of Iran's ability to import new oil production technology is limited by economic sanctions. Iraq's adoption of new technology is limited by the security environment. Currently, these countries are depending largely on the reinjection of gas and water into wells and (in Iraq) the reinjection of excess fuel oil. Although reinjection is a standard practice in many older wells, it can negatively affect the long-term health of a well if not managed properly.

On the downstream side of oil production, producers in the Gulf are investing heavily in refining. Recent global supply constraints are largely the result of a lack of global refining capacity, not a lack of crude oil production upstream. Refining capacity has been particularly hampered in developing nations, given the diverse product requirements caused by varying environmental standards and local resistance to the development of new refineries. To bolster global refining capacity and to help cover their own growing domestic needs, MENA oil producers are increasingly investing in refineries. Together, they are planning to add more than 4 million bpd of capacity in the next decade, and many of these refineries are being built primarily for export purposes.

Saudi Arabia is planning to double its total oil-refining capacity, both within the kingdom and abroad, to 6 million bpd by 2010. Proposed refineries in Saudi Arabia will add capacity of 400,000 bpd within the next three years. These refineries are designed specifically to produce high-end, cleaner fuels to meet the demands in the key export markets of Europe, Asia, and the United States. The Islamic Republic of Iran plans to raise its refining capacity to 2 million bpd in the near term. Currently, the country produces 1.64 million bpd, having increased that from 1.35 million bpd in 2000 by increasing refining efficiency. The country plans to build three refineries for medium crude in coming years; however, much of this increased capacity will be directed toward the domestic market because the Islamic Republic of Iran currently imports 132,000 bpd of gasoline. Kuwait plans to spend some $10 billion through 2011 to upgrade and increase its petroleum-refining capacity. Iraq also expects to bolster its refining capacity to 1 million bpd by the end of 2006 to meet domestic fuel needs. Cur-

Box 1.6

Building greater oil production capacity in MENA (continued)

rent refineries in Iraq, if operating at maximum capacity, can produce 750,000 bpd, but because of outdated technology, power outages, and sabotage, they are operating much below capacity.

Smaller oil producers have also taken steps to expand their refining capacities this year. The Republic of Yemen has announced the development of a private refinery in Ras Issa that will begin construction in mid-2006, a $450 million project (supported by the International Finance Corporation [IFC] of the World Bank Group) that will provide an additional 60,000 bpd. Its end products will primarily be targeted to the domestic market. Syria has also announced that it will move forward on increasing production at its two current facilities and on reconstructing a third. Syrian efforts are focused on maintaining a position in regional oil markets as its own upstream production slows.

Alleviating the supply situation in MENA countries in the long term will arguably require greater cooperation among industry producers, refiners, and associated contractors along the production train. Important to this is enhancing relationships between national oil companies and international firms, which would improve production and refining capacity and boost overall investment in the oil infrastructure of the region; however, the national oil companies in the region remain resistant to such suggestions, at least in the area of upstream production. Saudi Arabia has welcomed limited participation by internationals in its downstream sector, but upstream production continues to exclude international firms. The Kuwaiti government proposed a greater role for international firms in upstream production several years ago, but the proposal remains under intense political debate in the Kuwaiti Parliament. Of countries in the Gulf, only Qatar and the UAE have created significant roles in production for international firms. Algeria passed a law in 2005 that strips Sonatrach of its monopoly in oil distribution, storage, and refining, while allowing international firms more independence in taking on research and exploration contracts. However, it is too early to judge the true impact of this legislation on the role of Sonatrach and international firms in Algeria.

Following the subdued GDP outturns of 2005, activity is viewed to pick up quickly toward 5.4 percent and above as the situation in Morocco normalizes and export growth across the group enjoys a fillip.

1.5.2 Risks

A number of economic and geopolitical risks present tensions to the base outlook. Among these is the potential for much *lower* oil prices in the intermediate term should demand ease—or actually contract—in response to the much-heightened level of price. It appears that MENA exporters have budgeted oil prices in a conservative fashion, and adjustment to weaker revenues may present fewer problems than might be envisioned. More problematic is the potential for much *higher* oil prices in the intermediate term, should one or more of the currently heated geopolitical situations in the region give way to upward bidding on futures prices. In this case, the primary risk is to the health of the global economy and, in turn, for the potential of a sharp slump in oil prices in the aftermath. Finally, there is the risk of a reversion to difficult growth conditions in Europe, implying a volatile export market for the diversified economies of the region. If the removal of the Agreement on Textiles and Clothing results in complete domination of the textile-clothing market by large Asian producers, growth in the Maghreb could be quite adversely affected.

Although the external environment is a principal determining factor of regional growth over the medium term, MENA's longer-term growth prospects will be driven in large part by changes in the policy environment, which will determine the climate for growth of the private sector and the prospects for job creation. Gauging the region's recent progress with structural reform, then, can provide important insight into longer-term growth prospects (chapter 3).

2

Financial Sectors in a New Age of Oil

2.1 Introduction

MENA's oil shock has had important financial spillovers. Over the past few years, MENA has seen an upsurge in financial activity as abundant liquidity has fed a rapid rise in credit growth, surging stock markets, and a booming real estate sector. Oil economies have been the primary recipients, although a financial market upswing has also reached some of the region's resource-poor countries through increased cross-border investment, remittance flows, and tourism.

Increased liquidity has directly or indirectly fed a rapid rise in bank deposits and a simultaneous demand for credit from the real economy. Lending has accordingly expanded, improving access to finance for corporations, households, and consumers alike and facilitating some of the strongest growth in investment and consumption that MENA has seen for decades. In addition, many countries in the region have utilized their strengthened positions to address long-needed financial sector reforms, including public sector bank restructuring and privatization, licensing private financial entities, improving bank supervision, and upgrading prudential regulations.

Many authorities have looked to invest this oil windfall, building upon long-held ambitions to become regional hubs for finance, business, and tourism, and bank credit has flowed into a series of gargantuan real estate, tourist, and commercial ventures. Project finance has also boomed, with banks competing to supply long-term finance to a wave of new industrial and infrastructure initiatives, largely in the Gulf. In the process, bank profitability has reached record levels.

However, several of the recent financial sector developments have increased exposure of some MENA economies to negative shocks. Banks have rapidly expanded financing for equity markets. Although the recent stock market gains have been built in part on impressive corporate profitability, stocks have also been increasingly speculative. Bank exposure to equity markets, through both lending and substantial income from brokerage fees, leaves bank income and asset quality vulnerable because of recent market corrections. Banks have also increased exposure to the booming real

estate sector, which may be vulnerable to contagion effects from the recent equity market weaknesses and may also face slowdown with growing oversupply.

But a more troubling aspect of MENA's financial markets is the seeming disconnect between the financial sector and the real private economy, despite the appearance of a relatively deep financial sector by macroeconomic indicators. Although regional banks have abundant liquidity, few private businesses outside the Gulf have access to bank finance. Even in countries with relatively high rates of lending to the private sector, credit remains concentrated among a select minority, and investment climate surveys suggest that an average of more than 75 percent of private business investment in MENA is financed internally through retained earnings. As a result, few of the assets accruing to the region are channeled toward productive investment. Moreover, key elements of a well-functioning financial sector that could help boost sustainable and efficient growth, including bond and equity markets and contractual savings instruments, remain largely undeveloped outside the Gulf.

A few critical facts lie at the heart of the structural disconnect between the relatively plentiful financial resources found across MENA and the scarcity of external financing for businesses. Public sector ownership has significantly impacted the direction of credit in MENA, as well as the operating efficiency and the ability of the banking sector to conduct robust risk analysis. Bank regulatory frameworks, with limited market forms of oversight and discipline, have led to adverse credit allocation. Access to banking facilities remains comparatively limited across the region, and in many cases is restricted to public sector banking networks, concentrating credit provision upon a relatively privileged minority. Underdeveloped contractual savings and capital markets remove a source of competition for banks and an alternate avenue for firm finance. Governance structures undermine formal financial relationships across much of MENA, and commercial-finance relationships are further undermined by a wealth of problems in MENA's business climate.

Record oil receipts and strong economic growth present an important challenge for the financial systems of MENA to channel this liquidity into the real economy, boosting sustainable, efficient, and equitable growth. To do so, the region must address a range of underlying structural deficiencies that inhibit efficient and sound resource allocation.

2.2 Recent Upturn in Financial Activity in MENA

2.2.1 Windfall liquidity drives strong credit growth

Banks dominate MENA's financial systems,[40] and over the past three years, the exceptional increases in liquidity from oil and oil-related wealth in MENA have fed a rapid rise in bank deposits and a simultaneous demand for credit from the real economy. Between 2002 and 2005, deposits to the banking sector[41] rose in real terms by an average of 15 percent a year,[42] led by strong deposit growth among resource-rich economies (figure 2.1). Among resource-rich, labor-importing economies, bank deposits increased in current dollar terms by $95 billion (bn) between 2002 and 2005, or more than $30 billion a year, more than three times the pace established over the previous four years (about $10bn a year). Resource-rich, labor-abundant economies saw even greater deposit growth in banking institutions, with deposits growing by $45 billion over the past three years and with the average annual growth in deposits increasing almost fourfold relative to the 1998–2002 period. But the frenetic pace was not matched by resource-poor countries, despite the transmission of parts of the oil wealth through capital flows and remittances. Deposits in resource-poor countries grew by some $33 billion over the past three years (about $11bn a year), a pace down slightly from the four-year period before the start of the oil boom (about $12bn a year).

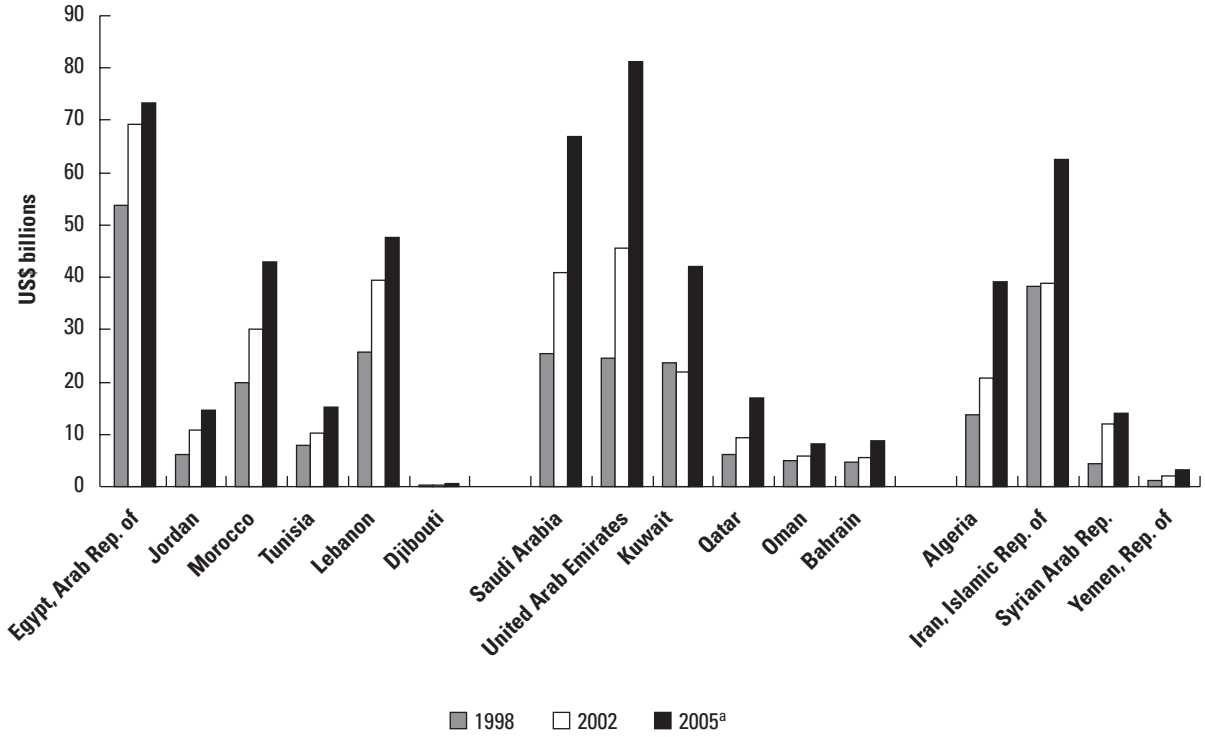
Rising liquidity in the banking sector and the increased demand for credit stemming from high-return investment opportunities have helped trigger substantial loan growth to private sectors. Bank credit to the private sector as a percentage of GDP has risen across most countries of the region, with the strongest loan growth occurring in the region's resource-rich economies. Between 2002 and 2005,

[40] See box 2.1 for a description of MENA's financial market development.

[41] Deposits include time, savings, and demand deposits. Does not include Libya.

[42] Total deposit growth, deflated by CPIs.

Figure 2.1: Bank deposits in MENA, 1998–2005



Source: IMF IFS.

a. 2005 or closest year available.

bank claims to the private sector rose from an average of 17.4 percent of GDP to 21.1 percent for resource-rich, labor-abundant economies and from 38.0 percent of GDP to 42.5 percent among resource-rich, labor-importing economies (figure 2.2). But the upturn in private sector credit has not been universal, and a large portion of the region—some 40 percent of its population—has not benefited from the liquidity or credit upturn.[43] Corresponding to the slower growth in deposits, private sector credit growth has been more subdued among the resource-poor economies in the region, and as a share of GDP, it has fallen slightly (from 59 percent to 57 percent), although a few countries, including Jordan and Morocco, have also seen strong gains in private sector lending. Corresponding to rising capital inflows and worker remittances, increased commercial bank deposits in Jordan have translated into private sector lending as a share of GDP increasing from an average of 73 percent in 2002 to almost 86 percent by 2005. Overall, credit to MENA's private sector as a share of regional GDP has risen from an average of 35 percent to 39 percent over the past three years.

A strong beneficiary of the credit upturn has been consumer lending, which in a few countries has been extended at startling rates. In Saudi Arabia, consumer lending grew by an average of 57 percent a year over 2004 and 2005 (compared with overall private sector credit growth of 39 percent) and now represents more than 40 percent of all loans.[44] In Jordan, consumer credit, including credit destined for stock markets, saw a 58 percent increase over 2005 (relative to a 30 percent increase in total credit to the private sector). Loans to finance investments into soaring stock markets almost certainly contributed to part of the dynamic consumer credit growth. While margin lending to stock investors is estimated to account for between 5 percent and 15 percent of total bank loans in the

[43] Measured by countries that either had an increase in the ratio of private credit to GDP between 2002 and 2005 or by countries whose average annual increase in bank deposits (in current terms) between 2002 and 2005 exceeded the average annual deposits over the previous four years.

[44] Economist Intelligence Unit (EIU), Saudi Arabia Country Report (May 19, 2006).

Box 2.1

A broad categorization of financial market development in MENA

In chapter 1, the developments within the MENA region are often discussed with regard to three broad country groupings, corresponding to countries with similar resource endowments: the resource-poor, labor-abundant economies (Djibouti, Egypt, Jordan, Lebanon, Morocco, Tunisia, and the West Bank and Gaza); the resource-rich, labor-importing economies (the six countries of the GCC—Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates—plus Libya); and the resource-rich, labor-abundant economies (Algeria, the Islamic Republic of Iran, Iraq, the Syrian Arab Republic, and the Republic of Yemen).

These categorizations are also useful in discussing the broadly similar characteristics of countries in the region with regard to financial sector size, ownership, access, and governance. The resource-rich, labor-importing economies are generally high-income states, and these countries have (on average) large financial markets, low levels of state ownership, and high foreign penetration. Governance is broadly effective, and access to credit is in line with income levels (Libya is a notable exception).

Resource-poor, labor-abundant economies, on the other hand, generally share a high level of financial market development relative to their income level and to the rest of the region. Levels of governance are better than those in transition markets and generally are ahead of their income peer group. The degree of state and foreign ownership within the banking sector varies widely, as does the concentration of banking systems. In addition, the financial systems of these emerging markets provide relatively limited access to finance, given their income level, and shareholder protection is particularly low.

Finally, the resource-rich, labor-abundant economies display a more state-led approach to financial sector development, in line with their approach to general economic management. Broadly categorized as lower-middle-income (the Republic of Yemen is an exception), their financial markets exhibit some depth, but considering their income levels, their banking systems are relatively small with regard to assets and private credit relative to GDP. The banking sectors are also highly concentrated and largely state-owned, and the quality of financial system governance is below that of the resource-rich, labor-importing Gulf economies or the resource-poor economies.

GCC (Cooperation Council for the Arab States of the Gulf), for example, the total proportion of bank credit exposed to stock markets is almost certainly higher, with widespread evidence that much of consumer, and even corporate, lending also flowed into stocks.

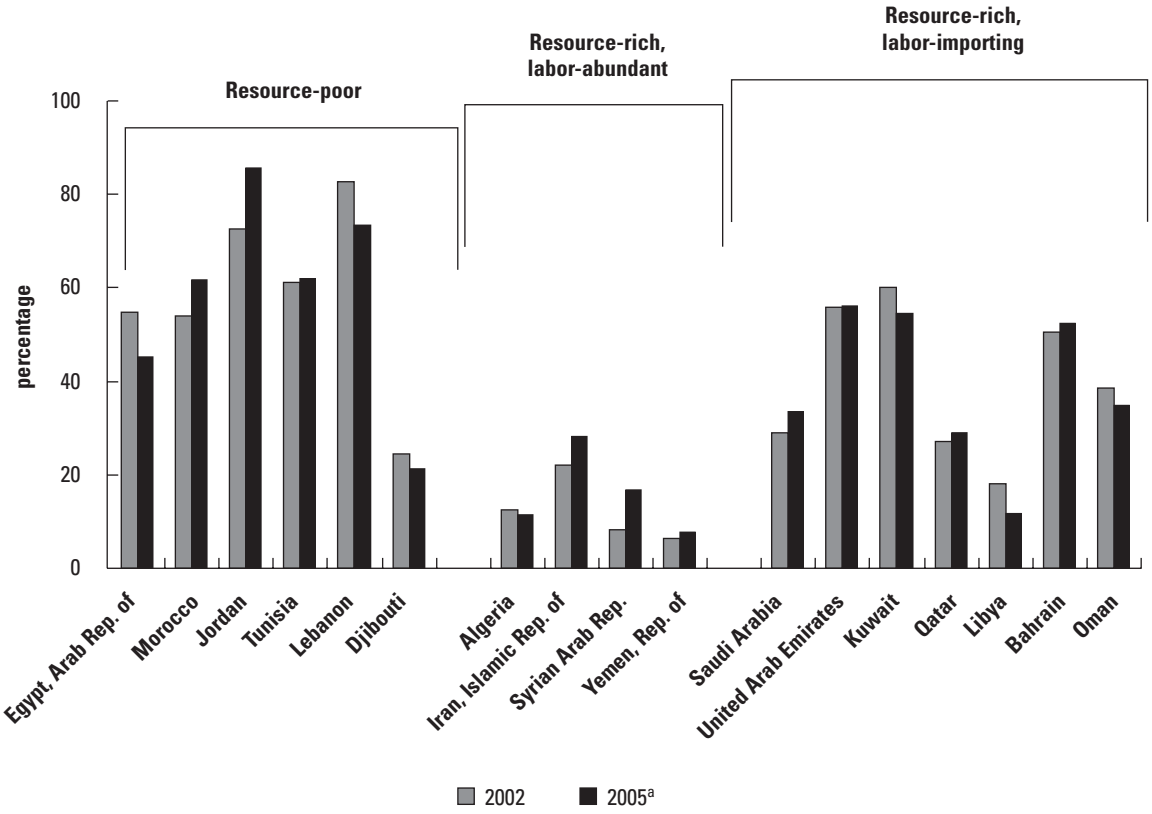
In addition, MENA's credit growth has supported real estate loans and sizable increases in corporate business. Corporate finance volumes in MENA are thought to have increased from US$11 billion in 2003 to almost US$19 billion in 2004,[45] with project finance among the GCC countries accounting for some three quarters. Over 2005, some $19 billion in project finance was extended among the GCC countries alone (a 34 percent increase over 2004), dominated by credit activity in the UAE (about $8bn over 2005, or some 6 percent of GDP, with a single project, Dolphin Energy's Dolphin Gas Project, accounting for almost 40 percent of the overall corporate finance extended by the UAE in 2005).[46] Corporate credit facilities in the GCC countries advanced strongly in several key sectors, including oil and gas and finance.

Mortgage lending has also been a beneficiary of the increased credit, particularly in high-target real estate segments such as Dubai. This has been partially supported by housing finance reform efforts throughout the region, although mortgage markets remain significantly underdeveloped (box 2.2). Particularly in the Gulf economies, the banking sector has increased credit and relaxed financing terms to the real estate sector, and loans of up to 95 percent of principal have become available, with maturities of 20 to 25 years. Across Bahrain, Oman, and Qatar, personal loans and construction lending have

[45] *The Banker* (August 2005).

[46] World Bank staff estimates from the *Middle East Economic Digest (MEED)* (March 24–30, 2006).

Figure 2.2: Private sector credit to GDP, 2002–2005



Sources: IMF IFS; World Bank country data.

Notes: Private sector credit to GDP reflects claims on the private sector by deposit money banks as a percentage of GDP.
a. 2005 or closest year available.

risen to 53 percent, 44 percent, and 37 percent of total lending, respectively. In the UAE, 13 percent of the banking sector's loan portfolio is dedicated solely to real estate and construction.[47]

2.2.2 Enhanced bank profitability in the Gulf

The surge in low-cost funding from deposits, increased lending (particularly to the consumer segment), and declining delinquency rates has translated into soaring profitability, particularly within the resource-rich, labor-importing economies. It is estimated that the top 100 Arab banks by size enjoyed a 36 percent increase in profits before tax to almost US$12 billion in 2004.[48] Of this total, US$9.6 billon can be accounted for by the GCC states alone, mostly by Saudi Arabia and the UAE. GCC countries enjoyed (on average) the highest return on average assets within MENA, at 2.4 percent. This compares well with other upper-middle-income countries, at 1.8 percent (on average) (figure 2.3).

Net interest margins have also increased, although for most countries they remain off the levels in upper-middle-income economies worldwide (figure 2.4). Strong credit growth and declining nonperforming loans over 2002 to 2005 contributed toward rising profitability. Lending deposit spreads have widened, thanks to the increase in higher-margin consumer lending and to the rise in low-cost demand deposits, and strong fee income has also been an increasingly important factor in many Gulf countries. As with credit growth, however, resource-poor economies have largely not benefited from rising bank profitability, with several countries (including Egypt and Tunisia) experiencing a rise in nonperforming loans as a proportion of total gross loans over the past few years.

[47] Capital Intelligence Group (CIG). "Personal loans" may include lending to family businesses.

[48] *The Banker* (November 2005).

Box 2.2

Housing finance in MENA

With an average growth rate of 2.1 percent a year over the past 15 years, MENA has one of the world's most rapidly expanding populations. Urban areas have been the main recipients of this population growth. Cities' share of the population in the region had grown from 48 percent in 1980 to close to 60 percent by 2000, and they are expected to account for nearly 70 percent of the region's populations by 2015 (this compares with an expected average of 54 percent in 2015 for all developing countries).

Despite the fundamental importance of housing in the economy, the stock of housing-related financial assets—largely mortgage loans—varies from less than 1 percent of GDP to nearly 11 percent.

Main issues in the MENA mortgage market

Formal housing finance in many MENA countries has historically been the prerogative of state-owned housing finance institutions whose presence in some countries has often deterred private sector lenders from offering housing finance products and has tended to constrain the development of the real estate sector for low- and middle-income households. Until the mid-1990s, in countries such as Algeria, Jordan, and Morocco, mortgages were mainly channeled through one public financial institution. The Islamic Republic of Iran and the Republic of Yemen continue to function under this model.

Moreover, the operations of these state-owned housing finance institutions have often imposed significant financial burdens and contingent liabilities on government finances. For instance, in past years, interest rate subsidies have been a main feature of housing finance policies in many MENA countries. Although well-designed subsidies can help to tap private savings and facilitate home ownership by lower-income groups, in particular, in practice they have frequently been poorly designed, not been well targeted to intended beneficiaries, and promoted financial market distortions.

The development of market-based housing finance in MENA has also been constrained by weaknesses in legal and judicial frameworks, affecting in particular the reliability of property titling and the ability of lenders to foreclose on delinquent borrowers. For example, in Algeria, because of the multiple layers and sources of laws and regulations, property rights are sometimes confusing and contradictory and, as a result, give rise to conflicting interpretations. This is the case, in particular, with the transfer of ownership for newly built or condominium units. In Egypt, the most serious obstacle is the property registration system. Today, few residential properties in Egypt are registered in the names of their current owners and occupants.

Reforms in the housing finance market

In recent years, several MENA countries have been taking concerted actions to reform their housing finance systems and pursue more market-based and sustainable alternatives through the development of formal mortgage finance markets.

At the core of such reforms are the opening of the housing finance systems to market competition, the leveling of the playing field among institutions in the primary market, and the development of mechanisms to provide long-term funds and to manage credit risk.

In ***Algeria***, until 1999, housing finance used to be entirely channeled through Caisse Nationale d'Epargne et de Prevoyance (CNEP), the savings and housing bank. CNEP was transformed into a public commercial bank and now provides only about half of all housing loans. Five other public banks share the remaining half. To provide banks with long-term refinancing, the Algerian authorities established the Société de Refinancement Hypothecaire (SRH) in 1997. As of 2005, loans refinanced by SRH stood for Algerian DA 8 billion. A year later, the Société de Garantie des Credits Immobiliers (SGCI) was established to provide banks with mortgage credit risk insurance.

In ***Morocco***, until 1998, the state-owned housing bank, Crédit Immobilier et Hôtelier (CIH), was the main player in bank mortgage financing, with more than 70 percent of all mortgage loans. Because of its financial problems, CIH had to restrict its activities. In addition, interest rate subsidies for mortgages provided through the state-owned housing bank were extended to the other banks, which rapidly be-

Box 2.2

Housing finance in MENA (continued)

gan to compete in the mortgage market. Overall, the mortgage finance market has expanded significantly; the outstanding mortgage amount grew from 3 percent of GDP in the mid-1990s to about 7 percent of GDP in 2004. More recently, the Moroccan authorities opted to create three mortgage guarantee funds whose development is currently underway. The objective of these funds is to facilitate access to bank financing for populations with modest or irregular incomes.

In ***Jordan***, the mortgage finance market was relatively small a decade ago. A government-supported housing bank was the main provider, supplying a modest number of loans at below-market rates—but at high government cost. Commercial banks were reluctant to enter the mortgage business mainly because the housing bank still retained competitive advantages from its government support. It was only when the state housing bank withdrew from the sector that banks started to enter the housing finance market. In addition, the Jordan Mortgage Refinance Company (JMRC) was established in 1996 to help primary lenders address the liquidity risks associated with long-term lending. Loans refinanced since JMRC's inception have exceeded Jordanian dinars (JD) 100 million, covering more than 9,000 housing loans. Today, more than 10 banks are competing actively in the sector, and the percentage of mortgage loans to GDP has increased from 2 percent in 1997 to 11 percent in 2004. Most recently, the United Arab Investors Company announced that it has signed an agreement with the Canada Mortgage and Housing Corporation to establish the first mortgage insurance company in Jordan, which will allow borrowers to finance houses with lower down payments, thereby increasing the number of borrowers in the market.

Emergence of secondary mortgage markets

Policy makers in MENA have recognized that the capital markets can provide both an attractive and potentially large source of long-term funding for housing and solutions to better allocate part of the risks. As described in the cases of Algeria and Jordan, some countries have pursued the creation of secondary mortgage institutions to help link primary mortgage markets to capital markets. The authorities in the ***West Bank and Gaza*** have also followed the same route. In the mid-1990s, the government was considering how it could best enhance the affordability of housing without having to resort to subsidy programs that could impose heavy financial burdens on the state. The concept of creating a financial intermediary working between retail lenders and capital markets was deemed the best alternative, with affordability being enhanced through the lengthening of the maturities of mortgage loans offered at market rates. The Palestine Mortgage and Housing Corporation (PMHC) was established in 1997 as the parent company of two separate but affiliated institutions: a liquidity facility company and a mortgage insurance facility. As of 2005, PMHC had extended approximately 500 residential mortgage loans totaling about $25 million and was preparing for a first bond issuance to move its operations closer to financial sustainability on a market basis.

Other countries such as ***Morocco*** have securitized mortgage loans without creating secondary mortgage institutions. For instance, the CIH has securitized Moroccan dirhams (DH) 1.5 billion in mortgage loans through a mutual fund run by a management and depository firm, Maghreb Titrisation.

Considering that the success of secondary mortgage markets is dependent on many factors (starting with a strong legal and regulatory framework, a liberalized financial sector, and a well-established primary market), it is not surprising that these markets have only recently begun to emerge in the MENA region.

For most countries in the region, the next challenge relates to further improving the accessibility of housing finance services to lower-middle-income households. This includes offering loans with fixed rates for a longer period and improving the various subsidy schemes, as well as developing systems to better manage credit risk and mobilize savings.

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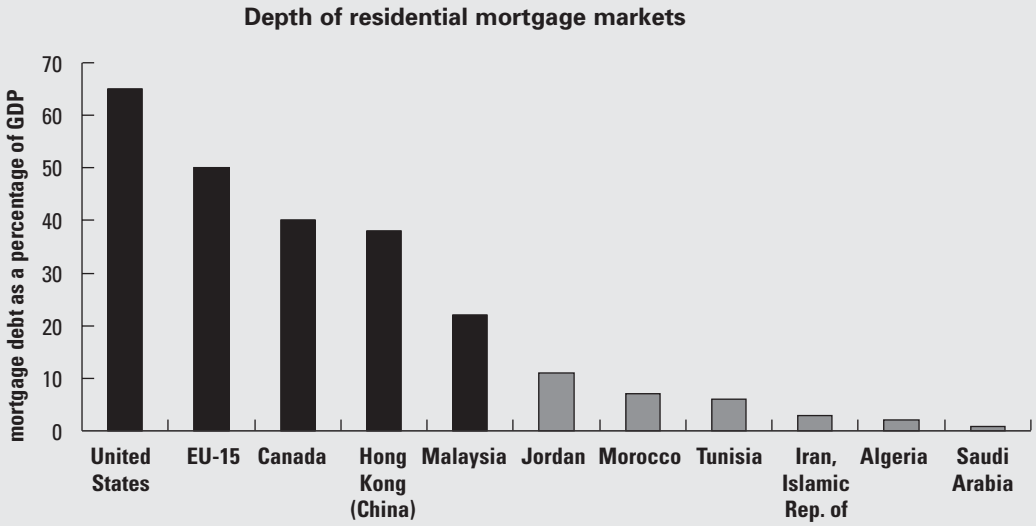
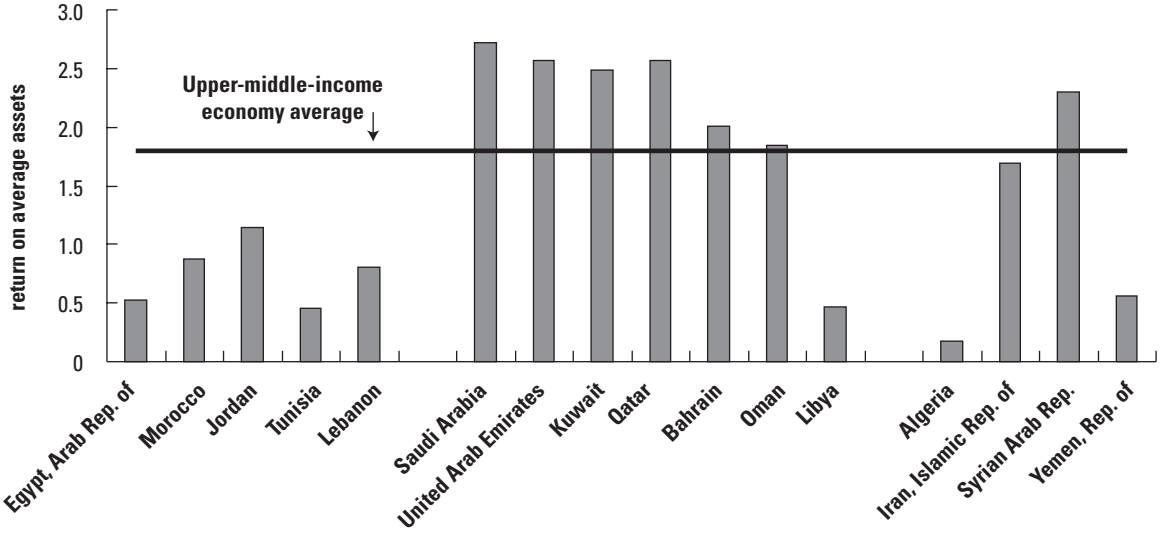
Box 2.2

Housing finance in MENA (continued)



Source: World Bank staff estimates.

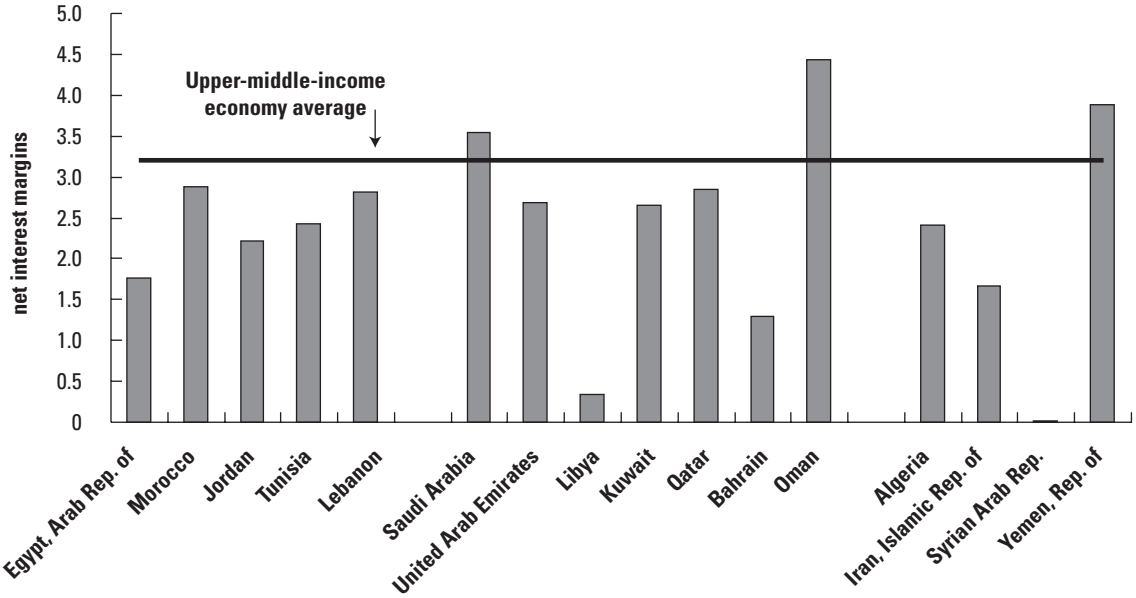
Figure 2.3: Return on average assets in MENA, 2004



Source: BANKSCOPE.

Note: Data for Lebanon, Algeria, Islamic Rep. of Iran, and Rep. of Yemen from 2003. Data for Djibouti from 2001.

Figure 2.4: Net interest margins, 2005



Source: BANKSCOPE.

Note: 2005 or closest year available.

2.2.3 Exposure to economic shocks heightened

At the same time that bank profitability has risen across the Gulf economies in particular, the acceleration in credit to the consumer and real estate segments has also increased the exposure of banking systems to economic shocks. Financing for equity initial public offerings (IPOs) has expanded rapidly in a number of countries, but substantial bank income is also derived from brokerage fees, raising the overall exposure to stock markets. In Saudi Arabia, for example, more than 70 percent of some banks' operating income stems from brokerage fees.[49]

Banks have also increased their exposure to the booming real estate sector (see box 2.3), both through lending and more directly, as some banks have actively sought to diversify their assets through the creation and syndication of funds invested in high-yield projects and property. The increasing exposure of MENA banks to these two high-return segments makes bank portfolios increasingly open to contagion effects. The real estate segment of bank assets may be vulnerable to recent sharp equity corrections as investors unwind leveraged positions. Real estate oversupply may also take its toll on profitability and loan quality, should the region experience an economic slowdown.

MENA's expansion in real estate has been particularly excessive across the Gulf. In Qatar, construction permits increased 23 percent year-on-year in 2004,[50] while the annual value of traded land permits in Bahrain rose by more than 70 percent between 2002 and 2004.[51] Kuwait has also enjoyed a rebound in activity, with annual building permits rising by 40 percent in 2002 and 2003.[52] In some cases, this has translated into increased housing and rental prices, and there is evidence of localized speculation emerging in some property markets, with undeveloped real estate lots trading hands on secondary markets.[53] Outside the Gulf, construction has accelerated in markets such as Jordan and the Islamic Republic of Iran. In the former, construction activity has grown because of the impact of re-

[49] Global Association of Risk Professionals (GARP).

[50] EIU.

[51] BMA 2005.

[52] EIU.

[53] MEED (January 27, 2006) and EIU (2005): UAE Country Profile.

Box 2.3

"The World" comes to Dubai: real estate in the Gulf

MENA's capacity to absorb the wave of new real estate development that has been commissioned in the past 12–18 months carries some risk for the banking system, which has substantially increased its financing toward this segment over recent years.

Entire new cities are being commissioned

From Saudi Arabia to Bahrain, entire cities have been commissioned by national governments, and vast swaths of coastline are set to be reclaimed and reengineered. King Abdullah City, currently the largest single project to be initiated, will cost US$26 billion, comprise 55 million square meters of greenfield land, and stretch 35 kilometers along Saudi Arabia's western coastline. Similar developments include the $15 billion Blue City in Oman, designed to accommodate 2 million tourists each year, along with 250,000 permanent residents; the New Town and Industrial Projects in Bahrain, costing more than $2.2 billion and being formed from reclaimed land; and Qatar's $5 billion Lusail development for 200,000 inhabitants.

With projects valued at some $200 billion, Dubai stands out among the Gulf states. The emirate has four headline projects, including the $9.5 billion Dubailand theme park, due for completion in 2010, as well as The World and Palm Islands developments. These two land reclamation projects, comprising literally hundreds of islands, will increase UAE's beachfront by more than 160 percent and are being developed by a variety of real estate consortiums for a mixture of exclusive residential, leisure, and commercial purposes. Topping the list comes the Burj Dubai, which, at half a mile high, will be the world's tallest building, comprising a hotel, luxury apartments, and the largest shopping mall in the world at 12 million square feet. Whether Gulf property markets can absorb this quantity of new and high-end development remains to be seen, and with a 1,001-meter building under consideration in Kuwait, there is a danger of "beggar thy neighbor" competitive development.

Tourism is recovering as Gulf airports link Europe and Asia

Hotel development and tourist infrastructure provide another important driver of real estate growth. The region has enjoyed a marked recovery in tourist and business activity, such that occupancy and average room rates recorded record growth in 2004 and 2005. The Gulf has been at the forefront of this trend, with average hotel occupancy rates reaching more than 70 percent, and new hotel projects continue apace, with most of the large developments inside and outside of the Gulf incorporating one or more new five-star hotels. Eighty new hotels are currently planned across the Arabian Peninsula by 2008, and over the long term, government projections are for continued and substantial growth, with 30,000 new rooms in Dubai by 2010 and a further 50,000 in Saudi Arabia by 2020.

The recovery in tourism has as much to do with a structural increase in international visitors to MENA as a cyclical recovery from recent political events. From 1995 to 2005, international arrivals into the region increased from 14 million to more than 38 million (a compound growth rate of more than 12 percent), and Emirates, the UAE's national carrier, has seen passenger numbers grow from 6 million in 2001 to 12 million by 2005. Such strong traffic growth has been central to the ambition of many Gulf states to become strategic transportation and business hubs connecting Europe and North America with the burgeoning markets of South and East Asia, and further airport capacity is set to come on stream. The Dubai International Airport expansion, costing $4 billion and projected to be completed in 2006, is expected to increase total annual passenger capacity from 25 million to 70 million. In Bahrain, current plans should take passenger capacity from 10 million to 45 million passengers, a tenfold increase from its actual flow of 4 million. To put these figures in perspective, Chicago's O'Hare Airport handled 75 million passengers in 2004, placing it as the second busiest airport in the world.

Sources: UAE Property Trends; MEED 2006; EIU 2005; Deloitte and Touche LLP 2005.

construction and the decision of many Iraqis to reside there, causing annual residential construction to double over 2000–2004.[54] The Islamic Republic of Iran's construction sector has also seen substantial growth, with private sector investment in urban construction rising by 170 percent between 1999 and 2003.[55]

The increase in bank exposure has prompted intervention on the part of some regulatory authorities. The Qatar Central Bank has limited bank mortgage lending to the lower of 150 percent of shareholder funds or 15 percent of total bank customer deposits,[56] while Saudi Arabia has limited the proportion of an individual's total salary that can be assigned for the repayment of debt. Loan to deposit ceilings were set at 87.5 percent and 80 percent in Oman and Kuwait, respectively, in 2004,[57] and share-dealing limits have been enforced, with the UAE's Central Bank imposing fines on four banks that had breached the 1:4 leverage ceiling on IPO financing in 2005.

While such action is extremely timely, regulators regionwide need to consider the wider implications of both a growth shock and a gradual deceleration in economic activity upon the financial health of the banking system. Recent profitability improvements in the Gulf are undoubtedly, in part, the result of one-time windfall gains, spurred both by the speculative excess on equity and real estate markets and by rising consumer lending. Although balance sheets appear robust enough to withstand some form of adjustment, the early consideration of vulnerabilities would be prudent.

2.2.4 Rising equity markets, with recent corrections

The region's windfall liquidity has also had important spillovers into MENA's equity markets, which by any measure performed impressively between 2002 and 2005. Against a backdrop of accelerating economic growth, expanding private credit, and growing corporate profitability, the region's equity markets rose almost fivefold between 2002 to the end of 2005 (and some markets, including Dubai and Egypt, rose more than tenfold over the period). These equity market gains have provided a valuable source of financing to private sector companies and an important route for state divestment of assets and wider public ownership. In tandem with capital gains, the markets greatly expanded with regard to liquidity, with average daily traded volumes rising from under US$1 billion per day to more than US$6 billion during 2005. This has proved advantageous for capital raising by both the private and public sectors, and there had been an increasing number of IPOs and rights issues across a variety of corporate sectors. Increased activity has also had advantageous effects with regard to widening domestic share ownership, as well as further liberalization of market access to foreign investors from both within the region and outside it.[58]

More than US$1 trillion was gained in market value between 2002 and late 2005. Of this, the Gulf countries saw the bulk of the gain in market capitalization, at more than US$934 billion, a rise of 675 percent (figure 2.5). In comparison, the rest of the region gained US$112 billion in market capitalization. Resource-rich, labor-abundant economies saw market capitalization rise by about 138 percent. Resource-poor economies also benefited, with equity markets that were some of the strongest targets of petrodollar recycling. It is estimated, for example, that by the end of 2005, 30 percent of investment in Egypt's stock markets emanated from the Gulf, while non-Jordanian investment made up more than 45 percent of Jordan's stock market capitalization.[59] Together, resource-poor economies saw market capitalization rise by more than 200 percent over the past three years.

With market capitalization to GDP rising from just more than 26 percent in 2002 to almost 110 percent in late 2005—and in some individual cases to almost 300 percent—clear signs emerged of excess in some markets (figure 2.6). IPOs, in particular, showed signs of increasing speculation. The 2004 IPO of a telecommunications company in Saudi Arabia attract-

[54] EIU.

[55] Private sector investment in construction projects has risen from Rls 22,069 in 1999 to Rls 59,765 billion in 2003 (EIU).

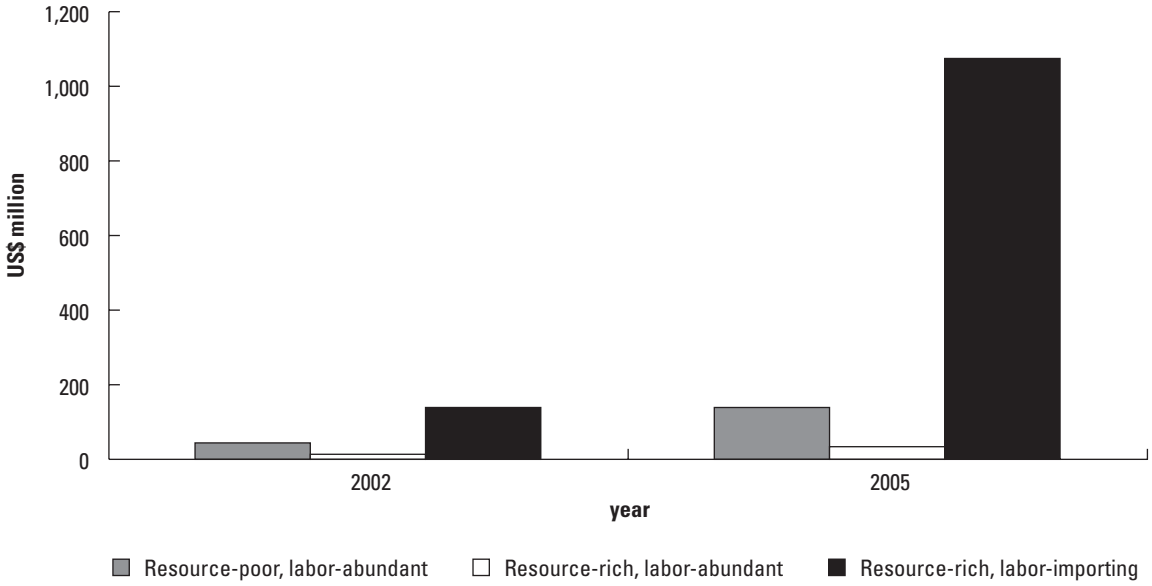
[56] Qatar Central Bank, *Annual Report 2004*.

[57] Because several Kuwaiti banks had already lent more than 100 percent of their deposit base, exposure had to be reduced by the July 2005 deadline (*The Banker* [November 2005] and the Oman Central Bank, *Annual Report 2004*).

[58] See box 2.4, "GCC capital markets' regional integration through competitiveness."

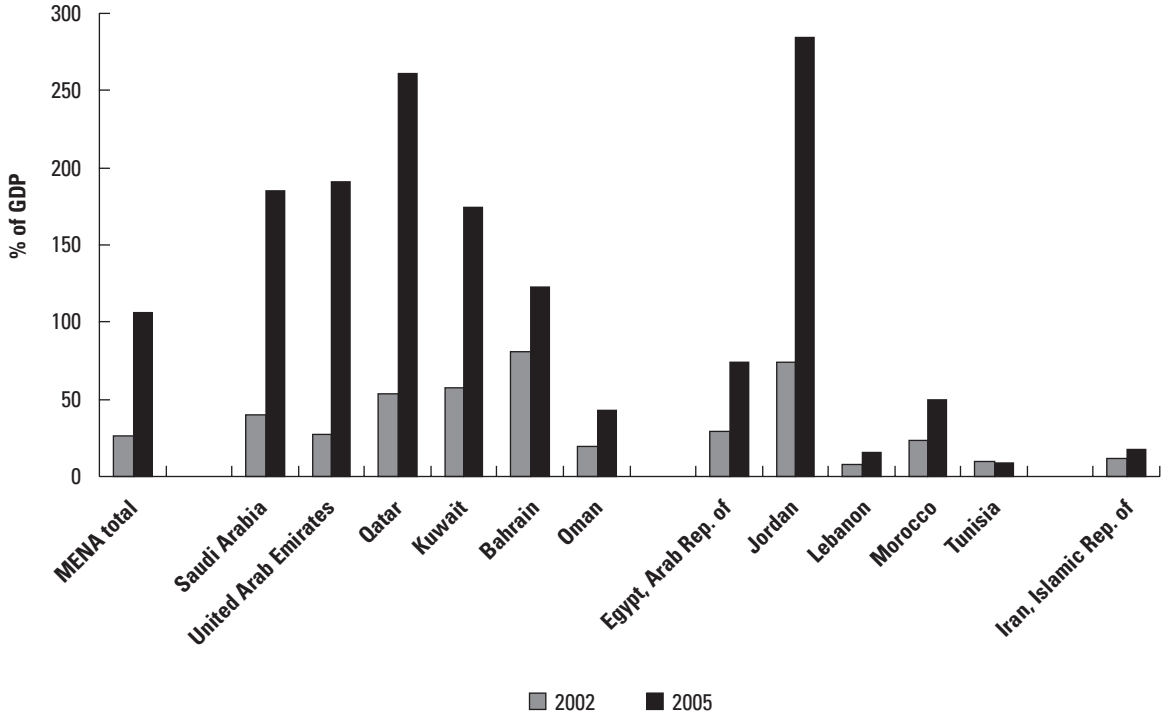
[59] Oxford Analytica (February 8, 2006).

Figure 2.5: Market capitalization in MENA, 2002–2005



Source: AMF 2005.

Figure 2.6: Market capitalization to GDP in MENA, 2005 versus 2002



Source: World Bank WDI.

ed Saudi riyals (SRls) 50 billion for an issue valued at only SRls 200 million, while the 2005 sale of a petrochemical company in the UAE was more than 800 times oversubscribed, attracting more than US$100 billion (or more than 100 percent of the country's GDP), for an issue valued at US$135 million.[60] Such speculative excess around new stock offerings was an early warning sign of "overheating" in many of MENA's equity markets, which, on certain valuation criteria, looked stretched relative to past history.

In early 2006, MENA equity markets fell sharply in a few countries, particularly in Qatar, Saudi Arabia, and the United Arab Emirates. Since the start of 2006, Saudi and Qatari stock indexes have fallen by more than 30 percent, while the major Dubai index has plummeted to half its value (figure 2.7).

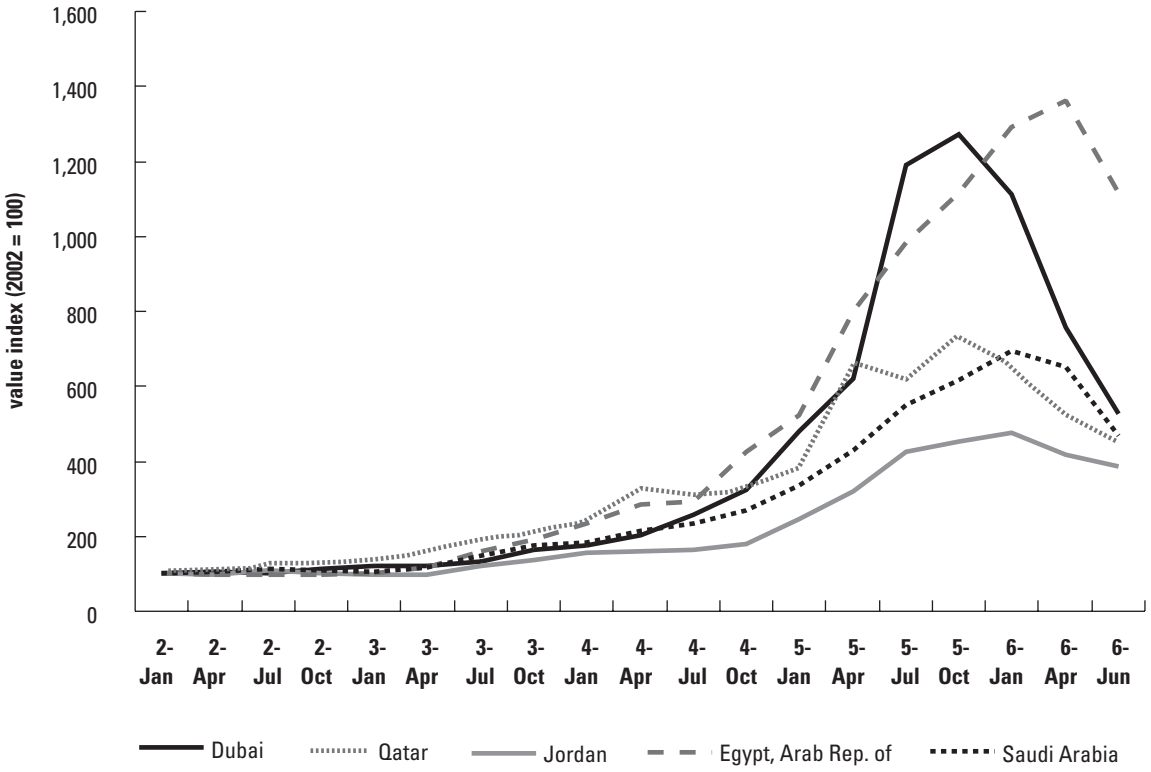
This is not to say that MENA's extraordinary stock market gains over 2002–2005 were built entirely on speculation. Earnings growth also accelerated at an impressive pace, and growing corporate profitability has been a strong source of valuation support for the markets. Earnings per share in Saudi Arabia have been consistently strong for the recent years, rising 30 percent in 2002, 87 percent in 2003, and almost 60 percent in 2004.[61] In Qatar, the net income of the constituents of the Doha stock exchange rose by 59 percent in 2004, led by industry and the insurance sector at 104 percent and 81 percent, respectively, and Kuwait's corporate sector enjoyed a 74 percent rise in net income over the first half of 2005, compared with the prior year.[62] However, most markets saw valuation measures increase quite steeply relative to their historic multiples and those of major developed markets in Germany, the United Kingdom, and the United States (table 2.1).

[60] Ittihad Etisalat in Saudi Arabia (Tadawul Stock Exchange, *Annual Report 2004*) and Aabar Petroleum in Abu Dhabi (*The Banker* [September 2005]).

[61] Average EPS growth, weighted by market capitalization of the 15 largest listed companies (*The Banker* [August 2005]).

[62] Qatar (Doha Stock Exchange, *Annual Report 2004*) and Kuwait (GCC Market Review, August 2005).

Figure 2.7: MENA equity markets, 2002–2006



Source: Bloomberg.

Notes: Egypt, Arab Rep. of = Egypt CSE Case 30 Index; UAE = Dubai Financial Mkt. Index; Saudi Arabia = Tadawul All Share Index; Jordan = Amman SE General Index; Qatar = DSM 20 Index.

Table 2.1: Market ratios of MENA stock markets, 2003–2005

	Price-to-earnings ratio		Price-to-book ratio		Dividend yield (%)	
Country	**2003**	**2005**	**2002**	**2005**	**2005**	**2005**
Bahrain	31	16	1.4	2.0	3.6	3.3
Egypt, Arab Republic of	12	43	2.1	8.7	4.9	1.2
Jordan	22	39	1.9	4.4	2.4	1.2
Morocco	25	22	1.7	2.4	4.7	4.2
Oman	9	11	1.5	2.9	8.8	3.1
Saudi Arabia	29	47	3.7	9.6	1.9	1.3
UAE (Abu Dhabi)	18	34	3.2	6.7	3.1	1.0
Germany (DAX)	..	16	..	1.8	..	2.1
United Kingdom (FTSE 100)	..	15	..	2.4	..	3.9
United States (S&P 500)	..	21	..	2.8	..	1.8
United States (NASDAQ)	..	35	..	2.5	..	0.6

Sources: AMF, Bloomberg, and IFCG (for Morocco). Historic figures throughout: MENA figures as at 06/05 and 02/06 for Germany, the United Kingdom, and the United States.

It is still too early to determine the full potential impact of these recent market corrections on the real economy. The banking sector is likely to experience some losses, and a decrease in trading activity will diminish profitability. Similarly, many individuals will have suffered substantial losses, often smaller investors who may have the least financial capacity to absorb them. Contagion effects appear to be working through to other regional equity markets, with Gulf investors unwinding intraregional investments. These pullouts may come from markets that have demonstrated relative stability and stand within historic valuation parameters. There may also be some danger of contagion to other asset classes such as real estate, as investors liquidate holdings to pay for equity-market-related losses.

On the negative side, even after the recent market corrections, many equity markets still appear considerably overvalued, should earnings growth ease to a more sustainable pace. On the positive side, with oil prices still high, the region's financial markets remain flush with liquidity to create shareholder value and drive demand for equity investments, and there is reason to believe that confidence in markets may be rebuilt.

2.3 Disconnect between Financial Sectors and the Real Private Economy in MENA

MENA has had something of a mixed record with financial sector developments since the oil boom. Increased liquidity, credit, and equity market gains have provided an important new source of finance to private sector companies. Bank profitability has improved with the surge in low-cost funding from deposits, increased lending, and declining delinquency rates. But for the most part, these positive developments have benefited only about 60 percent of the region (by population). And the increasing interests of MENA banks in the booming but volatile equity and real estate markets have heightened the exposure of MENA's dominant financial market segment to economic shock.

But a more troubling aspect of MENA's financial markets is the seeming disconnect between the financial sector and the real private economy, despite the appearance of a relatively deep financial sector by macroeconomic indicators. Although many of MENA's banks are flush with liquidity, they play a limited role in financial intermediation and economic development throughout most of the

region. Credit remains concentrated among a select minority, and few private businesses can access finance. As a result, little of the region's recent and dramatic increase in assets over the past few years have been accessed by the domestic economy to channel toward productive investment.

2.3.1 Macroeconomic indicators demonstrate a relatively deep financial sector across MENA

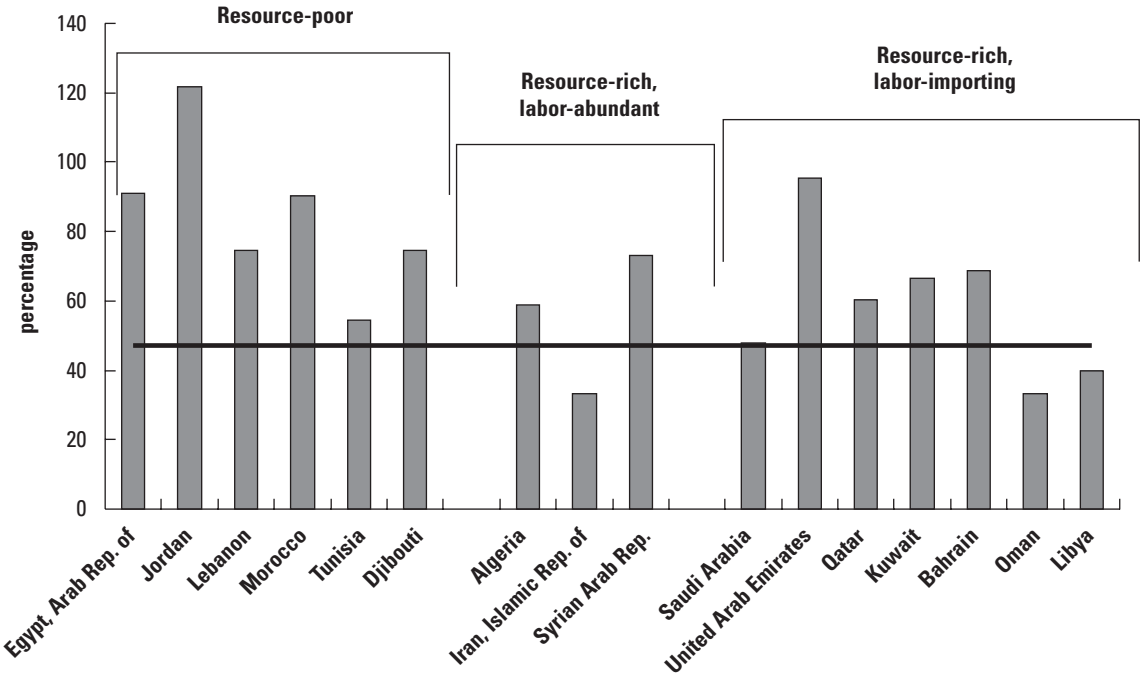
Several indicators would point to a relatively high degree of financial intermediation in MENA. The ratio of broad money (or M2) to GDP, which generally provides a useful indication of the overall degree of financial intermediation in MENA,[63] stands at more than 60 percent for the region as a whole and has remained largely constant since 1999. This is well ahead of the 47 percent recorded by middle-income countries (MIC average), but below the 84 percent of GDP in high-income countries (figure 2.8). At the same time, there is wide variation across the region, with resource-poor countries having significantly higher ratios of broad money to GDP than resource-rich economies.

Bank assets to GDP are also high, averaging 75 percent, and ahead of the average for middle- and low-income countries. Even excluding Lebanon, with its extraordinarily high level of bank assets, the region records an average of more than 50 percent of GDP.

Indeed, turning to the provision of credit by deposit money banks to the private sector, MENA's ratio of private credit to GDP averages more than 39 percent (figure 2.9), higher than the average for middle-income countries (37.5 percent), although only a fraction of the 112 percent average recorded among high-income nations. Most resource-poor economies in MENA, and several Gulf states, including Bahrain, Kuwait, and the UAE, have ratios of 50 percent and over. And as recalled in section 3.2, private credit has increased markedly in a number of countries, including Jordan and Morocco; many of the Gulf economies; and, off an extremely low base, Syria and the Islamic Republic of Iran.

[63] Care must be taken with M2:GDP because the ratio may decrease as the financial system develops and individuals invest in longer-term or less-liquid financial instruments that are not included in M2.

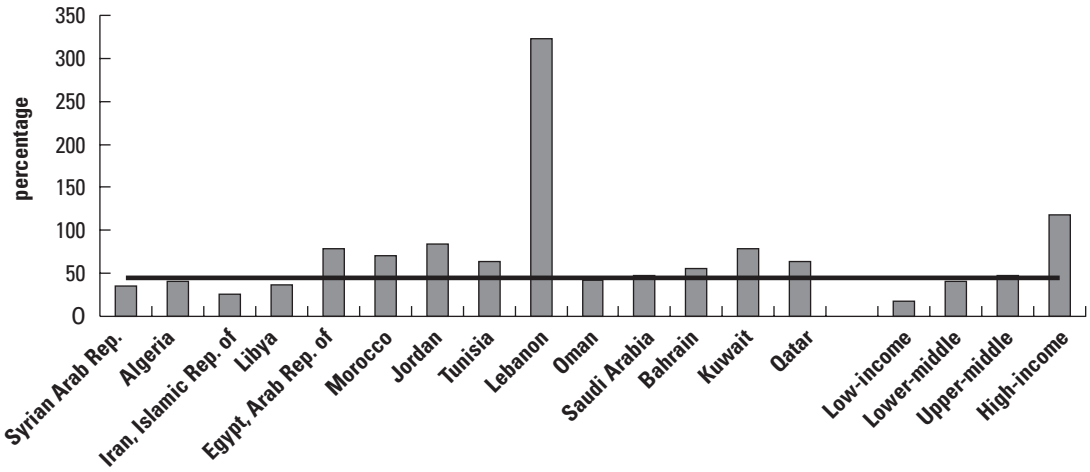
Figure 2.8: M2 to GDP in MENA



Source: World Bank FSDI.

Note: Results plotted against middle-income economy average.

Figure 2.9: Bank assets to GDP in MENA



Source: World Bank FSDI.

Note: Results plotted against average for all middle-income economies.

2.3.2 Financial sector has limited links to real private economy

Barring a few exceptions, most countries in MENA enjoy a reasonably high level of financial intermediation, deep bank assets, and robust onward lending to the private sector. Given the strong observed linkages between finance and development, this would suggest a supportive environment for new investment, economic growth, and employment generation at the firm level.

However, World Bank Investment Climate Assessments (ICAs) undertaken within the region provide strong evidence to the contrary. A low proportion of firms access finance, and many businesses report that one of the major impediments to growth is both access to, and the cost of, finance: firms from Algeria, Morocco, and Saudi Arabia all highlight finance as a major constraint to their operations.[64] Indeed, evidence suggests that firms in the MENA region have less recourse to bank finance than in any other region of the world, with 75 percent of funding for investment being sourced from retained earnings and only 12 percent from the banking sector (figure 2.10).

The phenomenon is widespread across the region. In the case of the resource-rich, labor-abundant economies, where aggregate private credit is relatively low and much economic activity is still conducted through the public sector, this may be less surprising: The survey of Algerian companies records a mere 16 percent of investment financing from banks and almost three-quarters of all financing from retained profits.[65] In Syria, the level of bank finance is even lower, with less than 5 percent of working capital or investment financing being secured from the banking sector.[66]

However, low penetration of bank finance to enterprises is also recorded in resource-poor, labor-abundant economies such as Egypt and Morocco, as well as the Gulf economies of Oman and Saudi Arabia. In Egypt and Morocco, with private credit representing a high 48 percent and 56 percent of GDP, respectively, banks and financial institutions provide a mere 20 percent or less of new investment finance.[67] More than 80 percent of new investments by Egyptian firms were sourced from retained profits, and less than 10 percent from the banking sector, while under 20 percent of all firms have some form of loan from a financial institution. A similar picture emerges in Saudi Arabia, where internal funds account for 70–80 percent of financing for working capital and new investment, against 10–15 percent from bank finance. Indeed, less than 40 percent of all Saudi Arabian firms report having an

[64] World Bank Investment Climate Assessments: 29 percent of firms in Algeria (World Bank 2003h), 80 percent in Morocco (World Bank 2005f), and 40 percent in Saudi Arabia (World Bank 2006d).

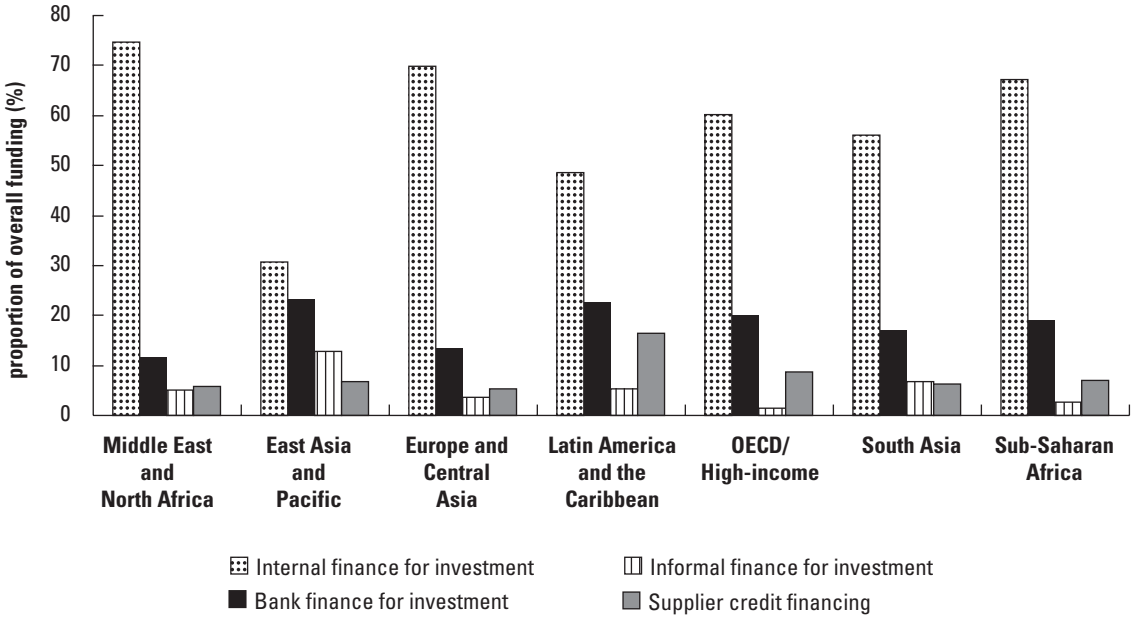
[65] World Bank 2003h.

[66] World Bank 2005g.

[67] World Bank 2005h (Egypt), World Bank 2005f (Morocco).

Figure 2.10: Sources of finance for investment

(MENA versus other regions)



Source: World Bank Investment Climate Assessments, various years.

overdraft facility, and slightly more than 20 percent a loan from a bank.[68]

This disconnect between a relatively deep financial sector and the level of firm finance is particularly apparent in the case of smaller companies, where access to bank credit is rarer still. In the case of Algeria, small firms source only 7 percent of working capital and 13 percent of investment financing from the banking sector, as against 13 percent and 29 percent, respectively, for larger firms. Furthermore, only 23 percent of smaller companies have an overdraft facility, compared with 69 percent for larger companies. Egyptian companies report a similar divide: of the 17 percent of firms utilizing the formal credit market, this comprised only 13 percent of small companies, compared with 36 percent of larger companies. And in Oman, small businesses represent a mere 2–5 percent of most banks' lending portfolios, contributing to a low rate of new business formation in the country.

The ICAs also reveal stringent conditions under which loans are made by banks, principally the extremely high level of collateral required. As a region, more than 80 percent of all loans require collateral to be put up by the company, and the average level of collateral represents 151 percent of the loan (figure 2.11). This places MENA toward the highest end of regional comparisons, with some countries recording average collateral requirements of more than 200 percent of loan value. A similar disparity in conditionality applied by the size of company, with smaller Syrian companies being required to pledge collateral worth 230 percent of the loan as against 160 percent and 182 percent for large and medium firms, respectively.

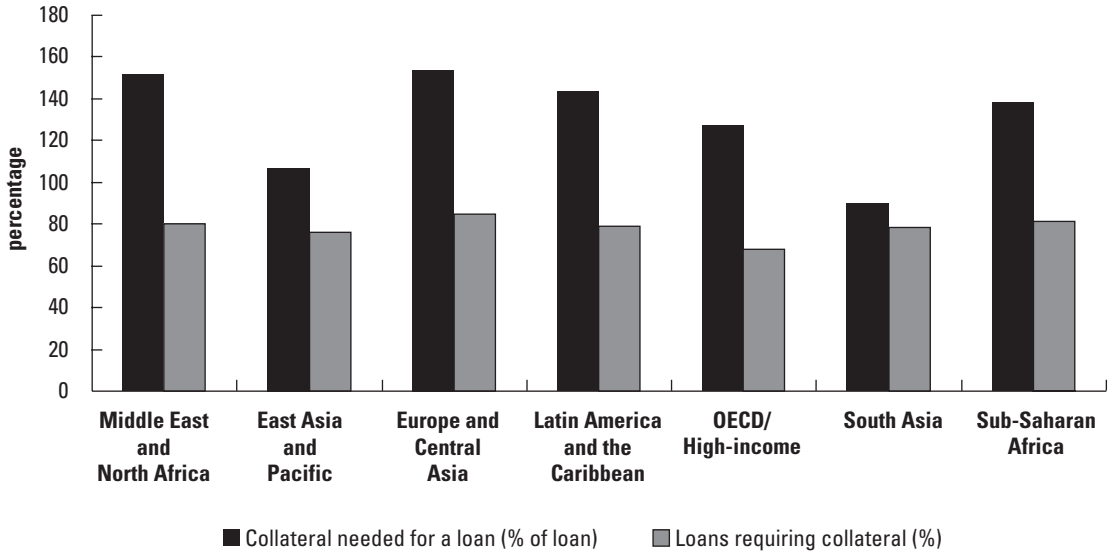
Banking sector demonstrates a marked aversion to lending

A close examination of MENA's banking sector suggests that such low levels of corporate lending are not a function of limited capacity. Indeed, the relative share of loans to total assets fell across MENA from 46 percent in 1998 to 41 percent in 2004 (figure 2.12).[69] Gulf economies exhibit the highest proportion of total assets dedicated to lending at 54 percent, unchanged since 1998. By contrast, Egypt, Jordan, Morocco, and Tunisia all saw a

[68] World Bank 2006d.

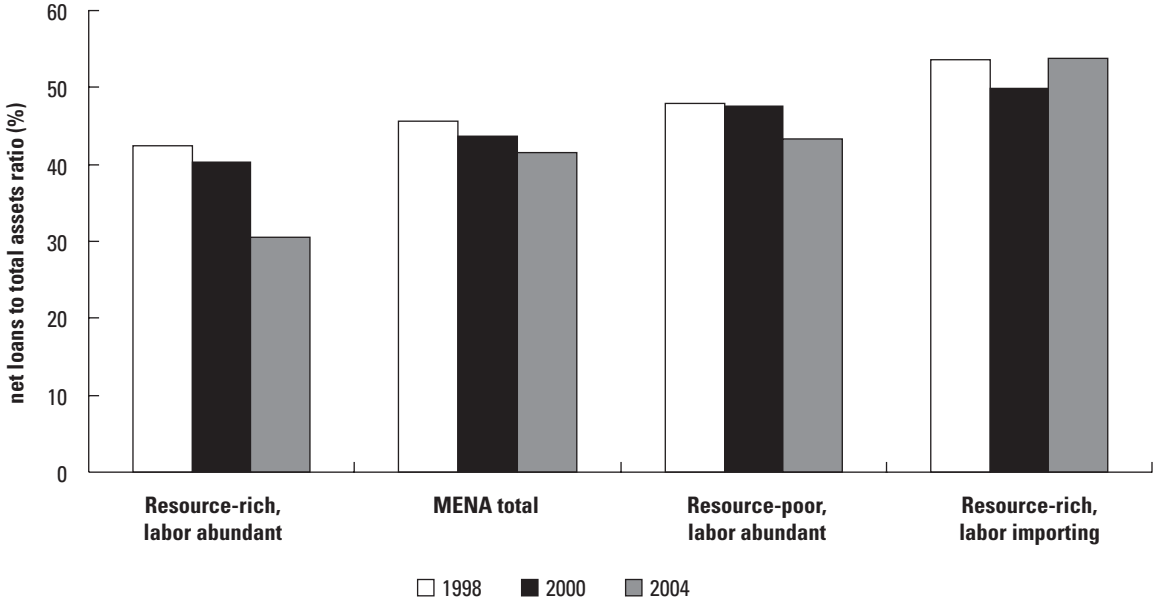
[69] "Loans" is measured net of provisioning.

Figure 2.11: Collateral requirements in MENA



Source: World Bank Investment Climate Assessments, various years.

Figure 2.12: Lending to assets in MENA



Source: World Bank Investment Climate Assessments, various years.

significant expansion in the banking sector's asset base relative to GDP such that, with the exception of Tunisia, the proportion of loans to total assets fell over the period to an average of 43 percent by 2004.[70] Lebanon also saw a decrease in loans to total assets, with the ratio for four leading banks standing below 20 percent by 2004.[71] Among the resource-rich, labor-abundant economies (except the Islamic Republic of Iran), all saw a substantial fall in the ratio between 1998 and 2004, with the subregional average falling from 43 percent to 31 percent.

In place of lending, the region's banking systems exhibit a bias toward liquid assets, with cash, deposits with the central bank and other financial institutions, and holdings of government debt forming a large proportion of the sector's asset base, particularly among resource-rich, labor-abundant economies. Thus, although the oil boom has translated into widespread gains in liquidity for MENA, several factors have acted to undermine access to credit by the wider corporate market and the majority of consumers, in spite of a seemingly deep financial sector.

2.4 Factors Inhibiting the Growth-Finance Nexus in MENA

In the long term, the degree to which the financial intermediation of oil-related flows will enhance economic efficiency, per capita GDP growth, and stability across MENA will depend upon whether assets have been, and will continue to be, channeled toward productive investment.

Ample empirical evidence exists on the positive and robust relationship between finance and growth. Countries with well-developed financial systems tend to grow faster, and financial intermediaries can impact long-term equilibrium growth rates through a variety of mechanisms, including mobilizing savings, collecting and analyzing information, screening potential entrepreneurs, allocating investment to highest-return projects, exerting corporate control, sharing risk, providing liquidity, and overcoming asymmetric information problems that typically exist in financial markets.[72]

The channels by which the financial sector can enhance growth include improving resource allocation, enhancing the efficiency of investment, accelerating the pace of total factor productivity growth and technological change, and hence contributing to long-term economic growth.[73] Another important channel linking financial development to economic growth is the role of well-functioning financial intermediaries in improving borrowing firms' access to external sources of funding, hence easing their financing constraints and promoting their investment and growth.

But in MENA, six critical factors lie at the heart of the structural disconnect between the relatively plentiful financial resources found across the region and the scarcity of external financing for enterprises: (a) high levels of public sector ownership significantly impact the direction of credit, operating efficiency, and the ability of the banking sector to conduct robust risk analysis; (b) regulatory frameworks, with limited market forms of oversight and discipline, have created adverse outcomes for credit allocation; (c) banking access remains comparatively limited across the region and in many cases is restricted to public sector banking networks, concentrating credit provision upon a relatively privileged minority; (d) contractual savings and capital markets remain underdeveloped, removing a source of competition for the banks and an alternate avenue for firm finance; (e) governance structures undermine formal financial relationships across much of MENA; and (f) a host of problems with the business climate further undermine commercial-finance relationships.

2.4.1 Public sector ownership of banking in MENA

Because the banking system is the primary conduit for savings and investment in the MENA region, the ownership of the banking sector is a matter of

[70] Tunisia alone saw a high and growing proportion of assets dedicated to lending, at 75 percent (*BANKSCOPE*).

[71] CIG 2004.

[72] For a detailed discussion of the role of the financial system in economic growth, see Levine (1997).

[73] Levine, Loayza, and Beck (2000a) find evidence of strong links between financial sector development and both real per capita GDP growth and total factor productivity growth. Wurgler (2000) shows that countries with well-developed financial systems improve the allocation of capital—by increasing investment in their growing industries and decreasing investment in declining ones—more than those countries with underdeveloped financial systems. Neusser and Kugler (1998) establish a positive link between financial depth and technical progress in the manufacturing sector (as measured by manufacturing total factor productivity) in a number of OECD countries.

considerable importance to efficient financial intermediation and the fostering of long-term economic growth.

State ownership in MENA remains high, at 42 percent of bank assets, double that in middle-income countries and six times that in high-income countries (figure 2.13). In Algeria, Libya, and the Islamic Republic of Iran, 89–100 percent of banking assets is majority-controlled by the state, while at the other end of the spectrum lie the Gulf states of Bahrain and Oman, which have no direct majority state ownership in any bank. Egypt, Morocco, Qatar, Tunisia, and the UAE stand between these extremes, with state control of 35–65 percent. Yet these figures understate the often substantial (though minority) stakes that MENA governments have in the banking sectors: the Omani government owns 40 percent of the nation's leading bank, and the Saudi Arabian state also has substantial minority positions in five banks.[74]

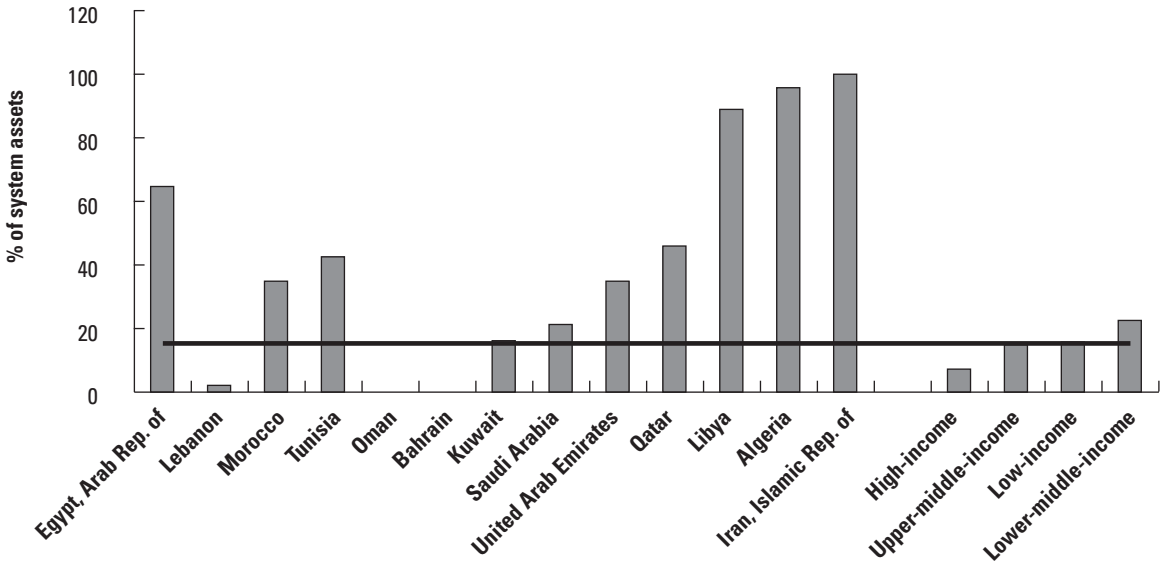
The impact of state ownership appears to have been felt in three key respects: first, high credit provision to the public sector; second, a weak credit culture and endemic inefficiencies; and third, low profitability and high nonperforming loans.

Skewed credit provision across MENA

Even after a decline in exposure to the public sector witnessed in recent years, MENA's banks continue to extend significant credit to the state. At an average of 18 percent of GDP, claims on the public sector by deposit money banks in MENA stand ahead of all comparable income groups (in absolute terms). Even after adjusting for the relative share of public credit in total bank credit, MENA stands with a high exposure to the state. At more than 30 percent of total credit, MENA's banking system extends a far higher proportion to the public sector than the 7 percent found in high-income countries or the 20–25 percent across middle-income countries (figure 2.14). Many of the countries with the greatest relative exposure to the public sector also exhibit the highest share of majority state ownership of banking assets (such as Algeria, Egypt, Libya, Qatar, and Syria). The clear implication is that state-directed lending to the public sector is a significant driver of resource allocation in many countries, a finding echoed in many ICA reports.

[74] It is also worth noting the ownership of leading banks or financial conglomerates by individuals closely tied to the ruling family.

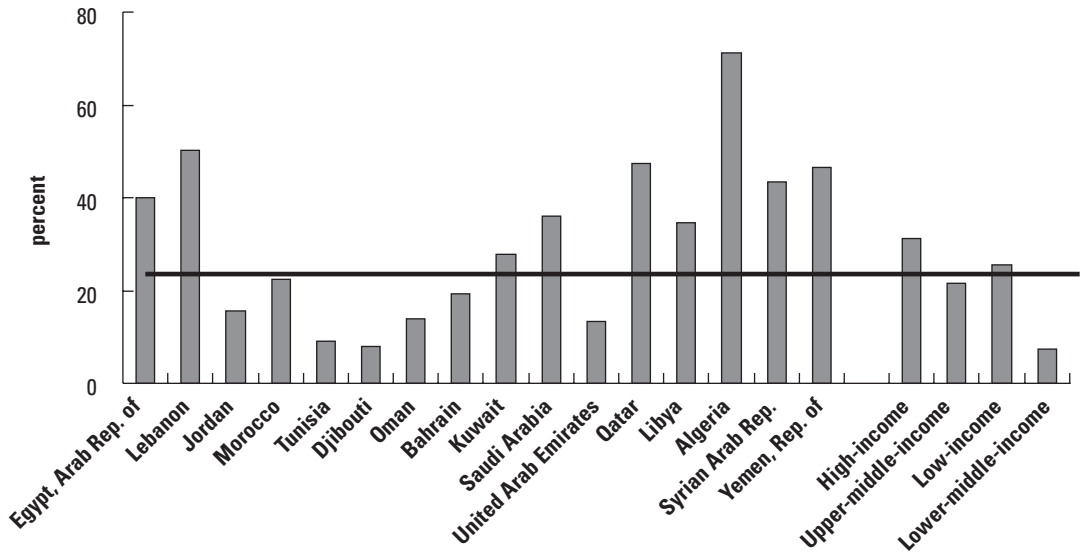
Figure 2.13: State ownership of bank assets



Source: World Bank FSDI.

Note: Results plotted against average for all middle-income economies.

Figure 2.14: Credit to the public sector as a percentage of total bank credit



Source: World Bank FSDI.

Note: Results plotted against average for all middle-income economies.

Weak credit culture

A more intangible effect of high state ownership is the impact of state control on banking practices and risk assessment. A culture of risk aversion and centralized credit allocation appears to be a common theme across MENA's state-controlled banks and is manifested in a lack of qualified credit officers who are capable of assessing business risk. In many countries in MENA, public banks exhibit classic characteristics of unwieldy bureaucracy, poor management, and overcentralization of decision making, inhibiting lending to enterprises and efficient resource allocation. In Algeria, for example, state-owned banks—the only ones with a large enough network to service small and medium enterprises, the bulk of the enterprise sector in Algeria—are bureaucratic, not business-friendly, and they lack modern information and payments systems. They also have little incentive to take responsibilities or manage risk—partly because of bureaucratic human resources management, as well as explicit constraints imposed by their state shareholder. Decision processes in the public banks are also complex and highly centralized.[75] In Egypt, the aversion to risk is disproportionate among branch managers and credit officers, because of fear that the default of any borrower can lead to suspicion of corruption and expose them to the risk of criminal charges for misuse of public assets—similarly for administration officials.[76]

Such a credit culture has a number of consequences for the banking sector: First, weak credit skills create a bias toward lending to larger and more mature companies with sufficient collateral at the expense of smaller companies, thereby starving a dynamic segment of the economy of capital. Second, poor credit decisions or state-directed lending to ailing public enterprises is likely to result in a high level of reoccurring nonperforming loans (NPLs), destroying capital and necessitating the periodic recapitalization of the banking system. Third, operating costs are likely to be higher, diluting profitability and the sector's long-term health.

Higher costs and lagging asset quality

Analysis of MENA's banking system according to capital adequacy, asset quality, and operating costs would confirm many of these expectations, with state-dominated banking systems largely exhibiting ratios inferior to those predominantly controlled by

[75] World Bank 2003h.

[76] World Bank 2005d.

the private sector.[77] Poor asset quality has been a hindrance to strengthening balance sheets across MENA, and a gap has appeared between the stronger capital adequacy ratios (CARs) exhibited by the largely private sector–controlled Gulf banks and the less robust figures presented elsewhere. CARs average about 14 percent among resource-poor economies, while resource-rich, labor-importing GCC economies have average CARs of some 19 percent. The Gulf has been successful in reducing NPLs over 2002–2005 from more than 9 percent to 3 percent in Saudi Arabia and from 8 percent to 5 percent in Kuwait (figure 2.15). In contrast, resource-poor economies have relatively high levels of NPLs, which have actually increased over recent years. In a few cases, the increase appears to be the result of a delayed recognition of prior NPLs, although this is far from a universal phenomenon.

Patterns of ownership are beginning to change

Although state ownership of bank assets and the share of the public sector in total credit remain high, recent years have seen an encouraging trend toward state bank privatizations and the selective opening of domestic banking systems to foreign entrants. Increased profitability, greater integration into the global economy, and the prospect of monetary union in the GCC by 2010 have helped drive a wave of cross-border investment in the Gulf. Merger and acquisition activity has also accelerated outside of the Gulf, and governments are proving more amenable to the entry of foreign banks.

In the resource-rich, labor-abundant countries, a notable feature has been the issuance of new licenses for private sector banks. In 2004 and 2005, the Syrian authorities issued a total of six new bank licenses, and four new private banks have come into operation in the Islamic Republic of Iran since a law was passed in 2001 (with two more licenses issued in 2005).[78] In Algeria, some 15 private banks were issued licenses between 1998 and 2003, although the six state-owned banks continue to control the overwhelming majority of bank assets.

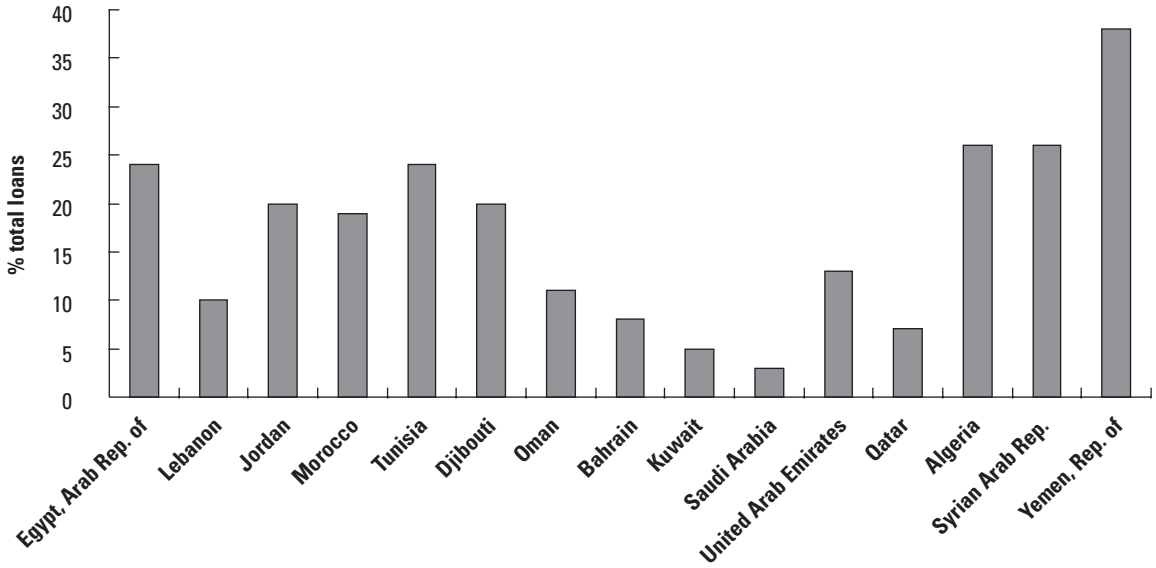
Privatization and the divestment of residual stakes held by state banks have also been prevalent in Egypt, reducing the total number of banks from 57 at the end of 2004 to 46 by late 2005.[79] Tunisia has also privatized two banks since 2002, while Moroc-

[77] The high operational efficiency, strong capital adequacy ratio, and low NPLs of the state-dominated Qatari banking system is an important reminder that this correlation is by no means automatic, but rather dependent upon the overriding managerial and institutional culture that pervades the system.

[78] *The Banker* (November 2005 for Syria and August 2005 for the Islamic Republic of Iran).

[79] World Bank 2003g.

Figure 2.15: Nonperforming loans



Source: World Bank FSDI.

Box 2.4

GCC capital markets' integration through competitiveness

How will the capital markets in the Gulf Cooperation Council (GCC) region continue to evolve? The rules of the game have apparently been changing. The private sector has been taking over the public sector as the driving force of the regional integration of GCC capital markets. As such, competitiveness appears to be more effective than harmonization for expediting capital market integration in the GCC. The initiatives that were launched almost simultaneously by Bahrain, Dubai, and Qatar for becoming regional financial centers illustrate this shift.

Harmonization or compatibility underlies government-backed market integration across the countries in the GCC region. With the exception of Saudi Arabia, the generally small economies of the GCC have had to urge their capital market policy makers to seek cross-border expansion and diversification of supply and demand bases. GCC stock exchanges as national flagship institutions sought the benefits of a substantially larger market in a cooperative manner. Cooperative attempts took the form of cross-listing, trading system networking, and a common settlements system; however, none of them has yet been successful, typically because of delays in technology development, cross-jurisdictional legal problems, disagreements over governance, and difficulties in creating continuing contractual commitments.

Instead, competitiveness has begun integrating GCC capital markets by attracting investors and issuers across borders to particular stock exchanges. Lowering cross-border information costs, coupled with regulatory liberalization in the GCC region, has allowed exchanges to compete for investors and issuers on a regional basis. The average investor and issuer are now able to cross borders in search of return, liquidity, reliability, integrity, variety, and transparency at an affordable cost. Information technology and regulatory liberalization have also enabled intermediaries to operate in all the national markets, while placing most of their people and headquarters in a single country. As a result, trading liquidity or financial assets (or both) converge on a particular market or markets. Furthermore, given the sheer size and the uniqueness of the Saudi market, GCC capital market integration through competitiveness may result in the region ending up with more than one financial center, each with its own unique focus.

The GCC capital markets have been structurally mutating in favor of market integration through competitiveness. Investment companies, in contrast to operating companies, have been becoming increasingly dominant among companies listed on the GCC stock exchanges. On top of the traditionally oil and gas–centric economy in the GCC countries, excess liquidity resulting from the recent oil price hike has made financial services one of the industries most in demand in the region. Meanwhile, intermediaries have become increasingly polarized between regional wholesale and local retail institutions. Regional wholesale investment banks have emerged to cover the entire GCC region and some non-GCC Arab countries, providing a broad scope of investment banking services. The separation of wholesale and retail functions in the financial industry normally helps to make a wider range of financial products available to end investors. On the demand side, affluent investors have been "massively" joining high-net-worth investors or ultra-high-net-worth investors in capital market activity. They are generally sensitive to delivery costs of financial services. Mobilizing them and integrating their investment behavior are likely to lead to regional market integration.

Yet it is still too early to determine which market has achieved capital market integration with its competitiveness. Relatively new markets like the Dubai and Doha markets have not experienced a full market cycle. They have yet to be tested for their sustainability and resilience in all aspects of market function. As mass affluent investors learn lessons, the competitiveness factors in the GCC region may further evolve. In addition, competitiveness factors leading to market integration are likely to differ between fund-flow activity (for example, trading and corporate finance) and fund-stock activity (for example, asset management). We have so far been seeing the cars only running simply straight ahead.

co has seen some consolidation and has announced its intention to sell public stakes in the banking sector. Finally, the Lebanese banking sector has clearly outgrown its borders, and banks have acquired positions across MENA in the past few years.

With a monetary union planned for 2010, the GCC financial markets are becoming increasingly integrated. Bahrain, Dubai, Qatar, and (as of May) Saudi Arabia[80] are all moving ahead with competing plans to become regional financial hubs, and considerable cross-border activity has been seen within the GCC (see box 2.4). Banks from across the region have opened branches and sought new licenses within each other's jurisdictions.

2.4.2 Regulatory frameworks and limited private monitoring

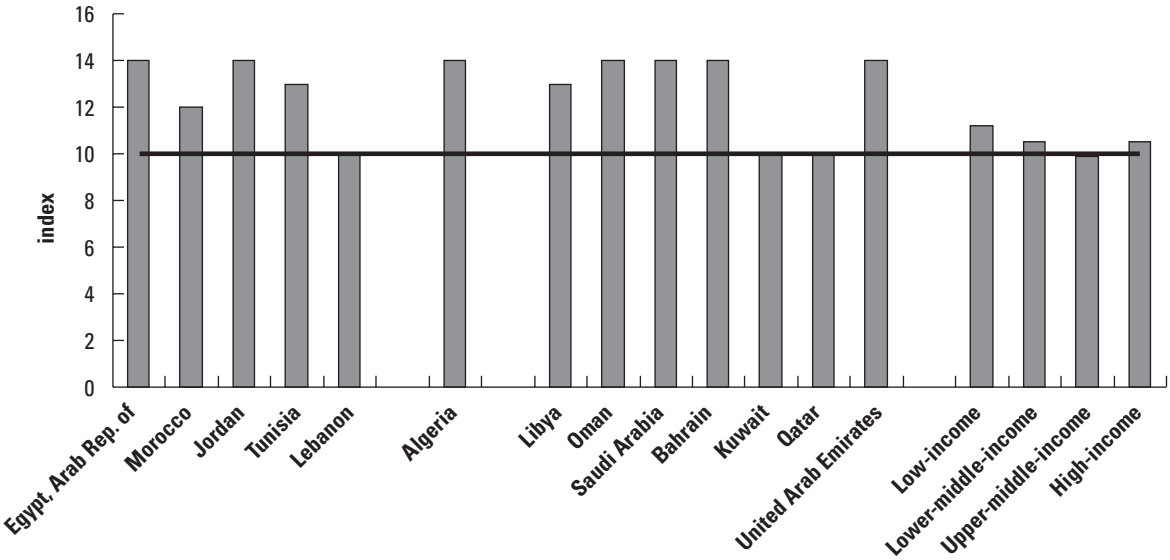
Another manner in which MENA's public sector exhibits substantial influence over the financial sector concerns official powers to regulate and supervise the banking industry. With regard to both official supervision and the restrictions placed upon bank activities, authorities exhibit significant control; however, this is not unambiguously positive for efficient outcomes. While regulatory regimes are designed to address the host of principal agent problems that the banking sector faces, recent evidence suggests that the institutional environment and ownership of bank assets can have a significant effect, both positive and negative, upon the manner in which supervision and regulation actually impact financial intermediation.[81]

MENA is characterized by extremely powerful "hands-on" supervisory authorities with wide-ranging powers to prevent and correct problems and regulate activities (figure 2.16). Supervisory officials have considerable powers to investigate and take action against banks suspected of fraud or negligence, including the power to intervene and restructure banks, remove management, and supersede shareholder rights where it is considered necessary. Only a few countries, including Kuwait, Lebanon, and Qatar, exhibit supervisory regimes with lesser powers of intervention than the average for middle-income economies worldwide.

[80] *Financial Times* (May 10, 2006).

[81] See Barth, Caprio, and Levine (2006).

Figure 2.16: Official bank supervisory powers in MENA



Source: World Bank 2003g.

Note: Official Supervisory Powers Index from 1 to 14, with higher values indicating greater official supervisory powers: the right to meet with external auditors to discuss their report without the approval of the bank, take legal action against external auditors for negligence, force a bank to change its internal organizational structure and order the bank's directors or management to constitute provisions to cover actual or potential losses. Results plotted against average for all middle-income economies.

MENA economies are also relatively restrictive with regard to the range of activities they allow to be conducted within the banking system, with few countries falling far below the average for all middle-income economies and a few countries maintaining relatively restrictive regimes, including Libya, Lebanon, and Tunisia (figure 2.17). Turning to market discipline and the degree to which private market forces monitor and enforce prudential standards upon the banking sector, MENA registers a strong degree of private monitoring, ahead of the high-income average and in line with countries such as Japan and the United States.

What kind of regulation may matter more than how much there is

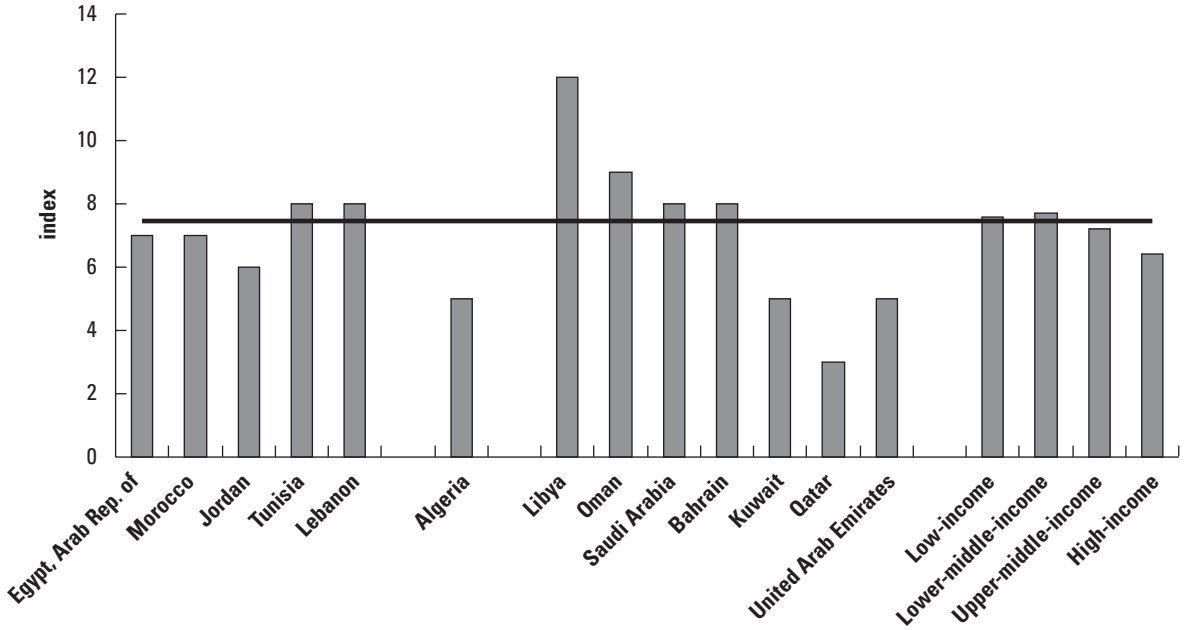
However, recent analysis of banks worldwide suggests a broad separation between those countries that rely less on official supervision and more on private sector monitoring to ensure efficiency and transparency in the banking sector and those countries that tend to have higher state ownership of the banking sector and tight supervisory and regulatory regimes with limited market monitoring. The latter were found to have banking systems that were at a relatively low level of development and exhibited a higher tendency toward inefficient resource allocation.[82] Looked at through this prism, the relatively high state ownership and tight supervisory and regulatory regimes across MENA may mean that many banking systems are at risk of performing poorly *because* of a combination of high supervisory powers and low private monitoring.

2.4.3 Limited bank access

As a whole, MENA also exhibits below-average access to banking facilities, in part because of poor physical access. In number of bank branches and automated teller machines (ATMs) per 100,000 people, MENA ranks ahead of low- and lower-middle-income countries, but still falls far short of high-income countries (figure 2.18). In addition, relative to GDP per capita,

[82] Barth, Caprio, and Levine 2006. The report finds an empirical relationship between tight regulation of bank activity, high state ownership, and poor bank performance and less stability. In addition, the authors find little relationship between the strength of capital requirements in a banking system and bank development, efficiency, governance, or corruption.

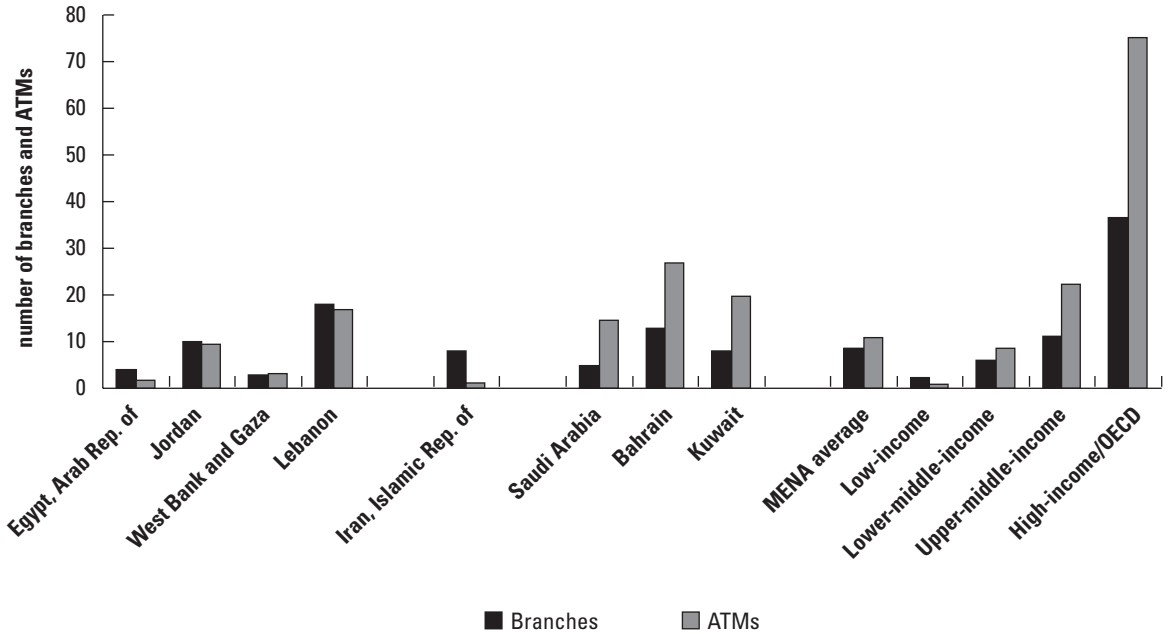
Figure 2.17: Restrictions on bank activities



Source: World Bank 2003g.

Note: Restriction on Bank Activities Index from 1 to 12, with higher values indicating greater restrictiveness: whether banks can engage in certain activities, such as securities, insurance, and real estate. Results plotted against average for all middle-income economies.

Figure 2.18: Financial access in MENA



Source: World Bank FSDI.

Note: Number of branches and ATMs per 100,000 persons.

average loans and deposits are large.[83] Both measures indicate that the banking sector may currently serve a relatively wealthy segment of the population. Given the importance of providing basic banking services to smaller firms and the poorer segments of the population, skewed access is an issue to address.

2.4.4 Underdeveloped capital markets

Deepening contractual savings markets and ensuring wider access to these instruments are of great importance to the development of financial markets and long-term economic growth. The creation of transparent and accessible instruments for insuring against risk can generate a valuable pool of long-term savings for investment. These can provide the building blocks for market liquidity and create new financing options for the corporate sector and the state, from venture capital to the securitization of mortgages. At the level of the household or individual, contractual savings provides a critical risk management tool, enabling savers to insure against death, disability, or retirement.[84]

At present, the contractual savings industry remains relatively underdeveloped in MENA, with asset accumulation overstated, and its performance is often marred by high state intervention. The failure to develop a substantial pool of contractual savings across MENA has inhibited the development of alternate capital markets and ensured a continued dependency upon bank finance. Insurance penetration—total written premiums (life and nonlife)—relative to GDP stands at 1.5 percent across MENA, just below the average of 1.7 percent for low-income countries and far below the 7.1 percent recorded by high-income countries.[85] Most resource-poor countries, such as Jordan, Lebanon, Morocco, and Tunisia, are ahead of the rest of the region with total written premiums worth 2–3 percent of GDP. On a per capita basis, insurance premiums average US$120 per capita in MENA, ahead of low- and lower-middle-income countries; however, the majority of written premiums comprises nonlife (casualty and property) insurance, at US$103 per capita.

[83] World Bank 2004a (Jordan, Lebanon, and Saudi Arabia).

[84] See Catalan, Impavido, and Musalem (2000) for discussion on contractual savings benefits for the real economy.

[85] In total written premiums (life and nonlife) for domestic business by registered insurers.

The more discretionary life insurance sector amounts to only US$17 per capita (figure 2.19).

At slightly more than 14 percent of GDP, accumulated state pension assets in MENA are significantly lower than the 43 percent recorded for G-10 countries.[86] However, some state schemes within the region appear large (at least on paper), such as Bahrain and Saudi Arabia with more than 50 percent of GDP in accumulated assets, Egypt at 45 percent, the Republic of Yemen at 34 percent, and Jordan at 23 percent. To put these figures in perspective, the United States and the United Kingdom have pension assets worth some 66 percent of GDP, while Japan stands at only 13 percent.[87]

However, current asset values can be hard to determine, because the true value of accumulated state assets in MENA is rarely well accounted for. For example, some 85 percent of the "surplus" assets of the Egyptian state pension fund is by law invested in government debt, creating a circular relationship in which the "virtual" reserves of the fund are swamped by the government's total implicit deficit to the system of 140 percent of GDP. So a seemingly large stock of assets can still fall short of pension liabilities. Excessively generous state retirement benefits, often extended to a small proportion of the population, have led to massive unfunded future liabilities in much of the region. Typically, state pensions in MENA are guaranteed at an average of 80 percent of earnings before retirement. As an example, because of differential tax treatment, a retiree in Egypt can earn more income following retirement than while working. Besides creating massive actuarial liabilities, these schemes also act as a strong disincentive to save outside the mandatory state structure. The final result is actuarial deficits as high as 50 percent in the Islamic Republic of Iran and 170 percent in Jordan.[88]

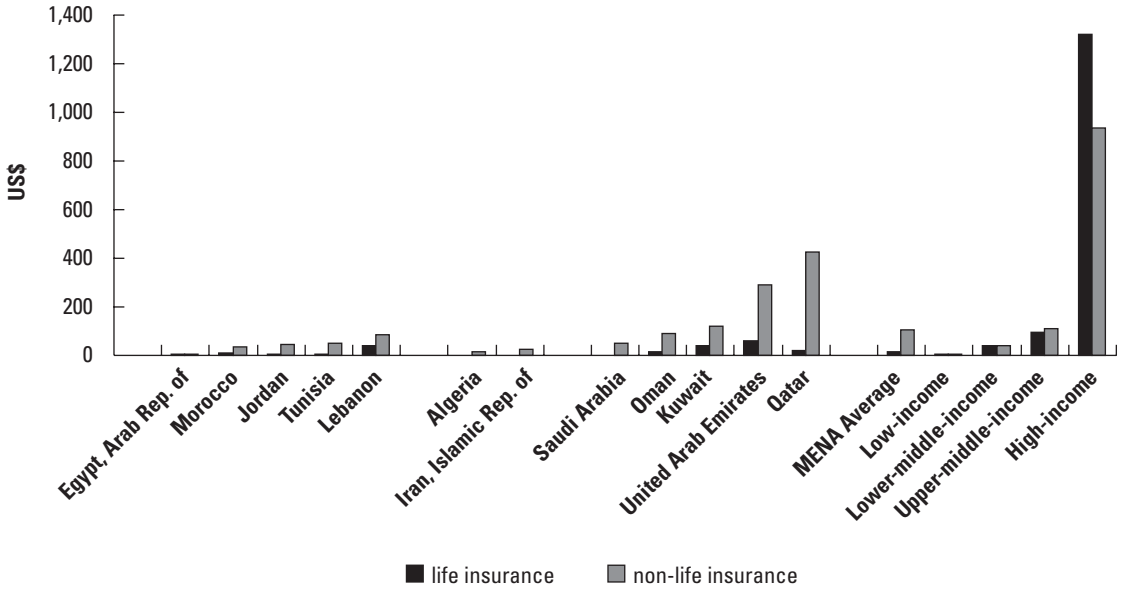
Even where pension and insurance assets have been accumulated, there is significant evidence of these funds being diverted away from the real economy toward state deficit financing. In Egypt, some 40 percent of insurance assets were placed on deposit at public sector banks, with a further 25 percent placed in government securities. In Lebanon and Libya, 50 percent and 64 percent, respectively, of pension fund assets are invested in government debt, while the supposedly independent public pension fund managers in Morocco saw the minimum

[86] MENA data from Robalino (2005); G-10 data from OECD (2005a).

[87] OECD 2005b.

[88] While many countries, including Egypt, Jordan, Morocco, and Lebanon, are in the process of addressing this issue, other countries, such as Algeria, Libya, and Syria, have yet to adequately tackle the problem (Robalino 2005).

Figure 2.19: Premiums per capita in MENA



Source: Swiss Re Sigma Study, "World Insurance in 2004."

required asset allocation in government securities increased from 80 percent to 88 percent.[89]

Equity markets remain concentrated in the GCC

As noted in section 2.2.4, equity markets in MENA enjoyed a spectacular run-up over 2002–2005; however, with the notable exception of the Islamic Republic of Iran, equity markets remain absent from most of the resource-rich, labor-abundant economies, and (with the obvious exception of Jordan) the majority of markets within the resource-poor, labor-abundant economies remain small relative to the size of their underlying economies. As a result, the Gulf states have come to represent a greater proportion of the region's total market capitalization, rising from 73 percent in 2002 to 86 percent by late 2005. Liquidity has become similarly concentrated, with the majority of markets outside of the Gulf trading less than US$10 million per day in 2005, compared with the US$4.6 billion average daily turnover in the Saudi market.

As markets became more liquid after 2002, many of MENA's largest companies raised equity capital for the first time, somewhat decreasing dependence upon the banking sector and increasing the breadth and depth of investment opportunities to investors; however, the scale of new listing must not be overstated. The shortage of new supply may have been, in fact, a large contributory reason for the dramatic increase in stock prices over the period. The total number of stocks in the GCC rose by only 50 between 2003 and 2005 and by 62 across all the emerging economies. In addition, the majority of new corporate listings were concentrated in the markets of Jordan and the UAE.

The partial privatization of state companies through equity offerings to nationals has been characteristic of many MENA markets in recent years: both Jordan in 2002 and Morocco in 2004 divested minority stakes in their respective state-owned telecommunication carriers (in the latter case, almost doubling the size of the equity market). In the Gulf, state utilities from Oman, Saudi Arabia, and the UAE were issued onto the market, which often had a catalytic effect, as in the case of Saudi Arabia, where the listing of the national telecommunications carrier increased the size of the market by more than 40 percent and encouraged a wider participation by Saudi Arabians in equity investment. However, public sector divestment has lagged behind potential supply, with substantial state ownership of assets prevalent across the region.

The increased competition between countries to develop regional financial centers has encouraged some loosening in the historically tight control on nonnational participation in the local equity markets. To the degree that this encourages mediating foreign flows of capital and new sources of research and evaluation, this should heighten the knowledge base of the market. However, despite recent changes in the Gulf, foreign investment in the markets remains very limited, and regulators will need to tackle not only legal restrictions on non-GCC participation but also corporate transparency and minority shareholder rights before there will be increased flows into the region. Even where non-GCC investors have had increased latitude to invest, actual participation has been limited: in Bahrain, non-GCC investors represented only 2 percent of traded stocks by value, while non-GCC ownership stood at around 7 percent in Oman.

The consequence of foreign ownership restrictions has been most obvious in the relative underrepresentation of the MENA region in global equity indexes. Taking the index weighting of the unrestricted S&P/IFC Emerging Markets General Index, it is clear that the region gained considerable representation by late 2005, in particular Saudi Arabia (with a weight of almost 12 percent), in line with established market heavyweights such as the Republic of Korea and Taiwan (China) and ahead of Brazil and the Russian Federation (table 2.2). However, within the S&P/IFC Investable Index, which takes into account the ability of foreign investors to actually participate in the market, the region's representation falls to 1.4 percent, comprising only Egypt and Morocco. It is illustrative to note that if the region had been ranked purely on market capitalization, it would have represented some 17.5 percent of the entire emerging market's universe toward the end of 2005.

Bond markets are almost nonexistent outside of GCC

In the long term, the creation of liquid bond markets would prove enormously beneficial to the majority of MENA's economic actors. The state can benefit from decreased dependence upon external debt and be provided with an additional tool to manage domestic liquidity. Corporations, both private and public, would have access to a new pool of

[89] Robalino 2005.

Table 2.2: MENA equity market representation in global indexes
(as of November 2005)

Country	IFCG market cap (US$bn)	Weight in IFCG composite	IFCI market cap (US$bn)	Weight in IFCI composite
Bahrain	8	0.3	..	..
Egypt, Arab Republic of	20	0.8	19	1.0
Jordan	21	0.8	..	..
Morocco	8	0.3	7	0.4
Oman	5	0.2	..	..
Saudi Arabia	304	11.9	..	..
Brazil	207	8.1	196	10.3
Korea, Republic of	390	15.3	369	19.5
Russian Federation	228	8.9	122	6.4
Taiwan (China)	287	11.2	283	15.0

Source: S&P/IFCG.

Note: IFCG = International Finance Corporation Global index; IFCI = International Finance Corporation Investable index.

long-term capital, particularly well suited to large infrastructure projects. Savers would also be provided with a range of new instruments, and this would be of particular use to the contractual savings industry, which requires assets to match long-term liabilities.

Largely absent from MENA's financial system until recently, secondary bond markets have begun to develop, particularly in the Gulf region. A combination of rising liquidity, substantial domestic investor appetite for longer-term assets, and local ambitions to launch regional financial hubs has helped create favorable momentum for the establishment of local infrastructure. Principally, this has meant the creation of tradable government securities, which has facilitated some local corporate issuance. Both public and private issuers have launched bonds that accord to the principles of Islamic finance, and these have met strong demand from local and international investors, who face a shortage of such instruments.

However, while an encouraging start has been made, outside of the Gulf and a few resource-poor economies, bond markets remain almost nonexistent. Even within the Gulf, the liquidity of secondary markets remains low, and actual trading is slight. The number of corporate issues is also small relative to the size of local economies.

Despite a preponderance of domestic debt financing in the Gulf, the region had not developed liquid secondary markets for government debt by the late 1990s. Instead, states historically used captive institutions (such as state banks and pension funds) to fulfill the majority of their financing needs. This inhibited the creation of a benchmark yield curve and restricted the corporate sector's financing options.

Recent years have seen some signs of change. Several borrowers have begun to construct market infrastructure and commenced issuance programs[90]; however, liquidity remains low in absolute terms and relative to the size of the local economy, resulting in constant excess demand for issuance and bonds that are tightly held, once issued.

This has created a limited market for corporate bonds

With the development of formal market mechanisms and an investor base eager to access fixed-income instruments, corporations have taken advantage of abundant domestic liquidity, and the number and sophistication of corporate issues have increased, particularly in the area of Islamic finance. A sample of corporate sector debt across MENA reveals increasing issuance over recent years, with the annual total rising from below 10 over 1999–2001 to 15 in 2002, 23 in 2004, and 41 in 2005.[91]

[90] In Kuwait and Oman, a limited market for domestic government debt has arisen, with the issuance of treasury and development bonds. In both cases, however, overall supply remains limited relative to demand, and greater liquidity will be needed before bonds are less tightly held by their buyers. Bahrain has issued more than 20 bonds locally, primarily Islamic, establishing a range of maturities that it issues according to a preannounced calendar; however, the overall size of issued instruments remains small relative to the size of the economy, and these also seldom trade. In Saudi Arabia, the process remains at a very early stage, with a government initiative to establish a market for public debt initiated only in 2005.

[91] All listed corporate debt is taken from Bloomberg and includes some international bond issues (1999–2005).

However, issuance has been concentrated within the Gulf economies and largely in only three countries: Bahrain, Kuwait, and the UAE (figure 2.20). By contrast, in Saudi Arabia (the GCC's largest economy), the corporate debt market remains very small, although it may begin to expand because of government initiatives concerning public debt and likely issues from leading state enterprises.[92]

2.4.5 Poor-quality governance can undermine financial intermediation

There is an established link between the effectiveness of the institutional environment and a well-functioning financial system; as a result, issues relating to the quality of public sector administration have important implications for the growth-finance link. In addition to fair and transparent legal systems, limited corruption and bureaucratic effectiveness are critical to effective financial intermediation and assuring proper financial sector regulation and supervision.

As will be discussed further in chapter 3, most of the resource-rich, labor-importing economies of the GCC register well across many dimensions relating to the quality of public sector administration, but there is variation among the group, and countries continue to fall short of best practices established among high-income OECD countries. In addition, the severely poor showing in overall quality of public sector administration by some countries, particularly among the resource-rich, labor-abundant group, raises fundamental questions as to how well their financial systems are currently operating. The governance deficiencies exhibited in a few countries suggests that development will be stunted unless these issues are addressed (see chapter 3).

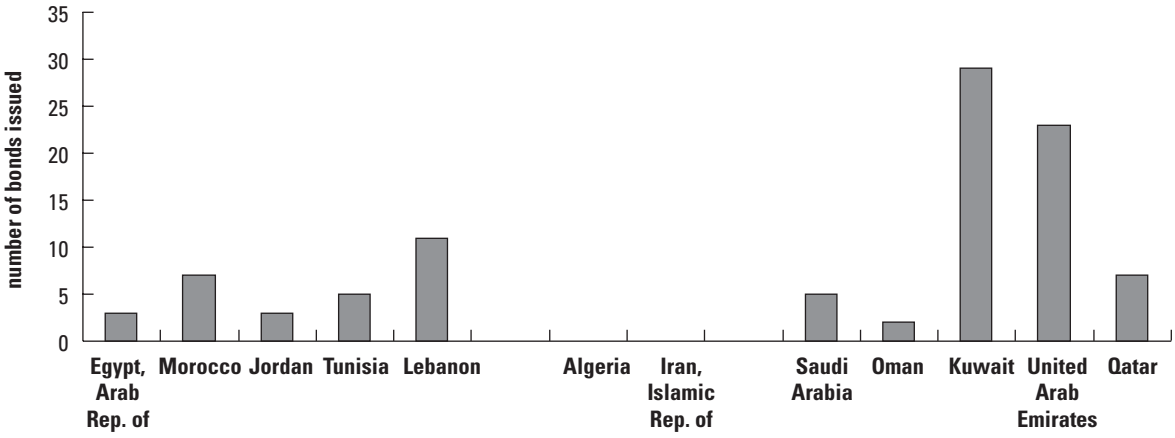
2.4.6 A business climate not conducive for lending

A range of issues related to the business climate impinge on a well-functioning relationship between the financial sector and the real economy. Deficiencies in MENA's business and regulatory structures have been strongly felt in contract enforcement and the availability and quality of financial information. The natural outcome has been a bias on the part of MENA's banks toward relationship banking, lending to larger companies with sufficient collateral, the public sector, or high-net-worth individuals. Regional surveys suggest that such conservatism is widespread in MENA. Moroccan banks appear to compete for business from a relatively small pool of large corporate borrowers, typically where there has been a long-term relationship of 10 years or more and the borrower can demonstrate significant collateral.[93] Elsewhere, the ability to secure loans di-

[92] SABIC and the Saudi Electricity Company are expected to issue in 2006: the first (a SRls 1 billion issue) is anticipated to be Islamic (*The Banker* [April 2005] and *Euromoney* [September 2005]).

[93] World Bank 2005f.

Figure 2.20: Bond issuance in MENA



Source: Bloomberg.

rectly against salaries has made the high end of the retail market an attractive proposition for banks. In Oman, the high profits and perceived lower risk of lending secured by salaries has lessened bank penetration into the smaller-company segment. Similarly, Saudi Arabian banks continue to compete fiercely in the retail segment to the detriment of the enterprise sector.

The low likelihood of collecting collateral in the face of default, as well as difficulties in valuing collateral or even registering it in the first place, have made MENA's banks reluctant to lend. In addition, a lack of reliable financial information plus shortages of sufficiently skilled credit officers have pushed many banks toward demanding very substantial collateral when loans are extended: in Syria and Morocco, collateral stands (on average) at 217 percent and 230 percent, respectively, of the value of the loan, while collateral represents a still-high 130 percent in Egypt.

Not only is the rule of law inadequate across much of the region, but so is the capacity of the judicial system and the specific design of collateral and bankruptcy laws. ICAs across MENA point to acute deficiencies in legal systems: in Morocco, one-third of surveyed firms cited the judicial system as a major constraint on growth, with almost a fifth mentioning corruption and administrative constraints (such as obtaining licenses and permits) as further obstacles.[94] In Algeria and Syria, the judicial system was repeatedly pinpointed as a major impediment to financial intermediation, with cost, lengthy procedures, insufficient staffing and expertise, and poor enforcement deterring enterprises from utilizing legal redress. Only 1 percent of Syrian firms surveyed had used the legal system to resolve business conflicts over the prior three years,[95] and 93 percent of cases involving smaller companies in Algeria had been settled privately, but only 2 percent through the judicial system.[96]

With regard to securing collateral in bankruptcy proceedings, ICA evidence and cross-regional surveys paint a similarly difficult picture. ICA evidence from Algeria and Syria suggests that collateral collection is not only time-consuming but also difficult to enforce, while repossession of immovable collateral in Egypt can take seven to eight years for court approval and making a public sale. World Bank *Doing Business* surveys support these country-specific findings, with contracts proving time-consuming to enforce, with numerous procedures and creditors, ending with a very low recovery rate on their loans. Not only does this lessen the likelihood of lending, but it can also seriously impede the development of important segments of the financial marketplace. One of these has been the leasing business across MENA, with an inability to collect upon collateral, a serious obstacle to establishing what, in many countries, is often a vital source of finance for smaller companies: Saudi Arabia's and Egypt's volume of leasing business relative to GDP stands at only 0.1 percent and 0.8 percent, respectively, as against 1.8 percent in North America and 3.4 percent in Asia.[97]

As important as enforcing collateral contracts in the event of bankruptcy is the ability to register property in the first place, and many companies face difficulties and high costs in doing so. Often land and other immovable assets prove to be the chief asset of smaller companies, and an inability to record title can lock companies out of the credit market.

Corruption is also cited in a number of ICAs as an impediment to financing. Many firms choose to opt out of the formal sector rather than surmount the repeated inspections, taxes, and administrative red tape that are required to operate a business, often negotiated with the help of "informal" payments. The impact of corruption upon financing is twofold: First, firms may prefer to self-finance or seek financial support through informal networks of friends and family, rather than deal with formal institutions. Second, where formal channels are used, a separate set of books may be presented to financiers, presenting difficulties of risk assessment. The ICA for Algeria notes that most firms underreport sales and have no certified balance sheets, self-selecting out of the formal credit market, while in Syria the typical business experiences around 25 inspections a year. Typically, more than half of these encounters involve some expectation of informal payment.[98]

Banks across the region cite poor quality of information and a lack of high-quality investment projects as a severe impediment to increased enterprise finance. Evidence from ICAs paints a picture

[94] World Bank 2005f.

[95] World Bank 2005g.

[96] World Bank 2003h.

[97] Data taken from *Euromoney*, *World Leasing Yearbook* (2001–2005).

[98] World Bank 2005g.

of poor transparency and limited disclosure by firms. In Morocco, fewer than 20 percent of firms have financial statements that have been certified by an external audit, and the banking sector notes a lack of creditworthy or viable investment projects.[99] In both Algeria and Syria, ICAs point to systematic underreporting of sales. In the latter, fewer than 35 percent of firms have audited financial statements, and many firms are reported to keep two sets of accounts.

2.4.7 Improving the impact of financial sectors on growth in MENA

Record oil receipts and strong economic growth present an important challenge for the financial systems of MENA: to channel this liquidity into the real economy, boosting sustainable, efficient, and equitable growth.

In some countries, particularly those of the GCC, the financial system is beginning to act as a more efficient conduit for savings: lending to the private sector is rising, capital markets have somewhat deepened, and national systems have become more integrated into the global financial system. With several states vying to become regional financial hubs, competitive pressures are likely to accelerate further market development and opening, with positive spillover effects for the wider economy.

At the other end of the spectrum lie several financial systems that, despite recent growth in lending to the private sector, are relatively underdeveloped in scale and sophistication, characterized by high operational costs, weak risk management practices, and poor asset quality. Largely isolated from outside influence and with sometimes nonexistent capital markets, the real economy remains dependent upon a fragile banking system that is inadequate for the task ahead. Not only has this impeded current growth, but it may also create future vulnerabilities when the present pace of economic growth subsides.

To meet the challenge of effectively intermediating the large oil-related flows and to build the financial infrastructure that can be an engine for growth and productivity improvements, the region must address a range of underlying structural deficiencies that inhibit efficient and sound resource allocation. In chapter 3, the recent progress with some of these reforms is evaluated.

[99] World Bank 2005f.

3

Structural Reform Progress for Long-Term Growth

3.1 Introduction

Although continuing high oil prices are expected to contribute to solid growth for oil producers in the medium term and an anticipated recovery in European demand should provide for stronger economic growth among the region's resource-poor, labor-abundant economies, longer-term growth prospects throughout the region depend upon the progress that is made in transitioning to sustainable sources of stronger economic growth and job creation through implementing broad-based structural reform.

Over the past three to five years, MENA has taken a number of steps to transition to more open, private sector–oriented economies with more efficient and accountable governments. With the large windfall revenues accruing to oil producers since 2002, a natural question emerges as to what impact oil is having on the reform process. As noted in chapter 1, the large budget surpluses accruing to oil producers appear to have delayed the imperative for reform of the oil subsidy system in resource-rich economies. Based on structural reform measurements, oil producers[100] have also exhibited weaker reform progress over the past several years than the region's resource-poor[101] economies have along two major structural reform fronts: improving the business climate and liberalizing trade.

However, the more subdued progress made by oil exporters in these areas of reform in large part reflects lack of improvements among GCC economies, which have traditionally maintained more open and business-friendly trade and investment policies. Perhaps more important, as a group, the oil economies have demonstrated long-awaited progress in governance, an area in which the group demonstrates significant deficit relative to the rest of the world. Specifically, notable progress has taken place over the past five years in enhancing public sector accountability mechanisms, which augers well for continuing reform success. Although oil economies continue to rank in the bottom 20th percentile relative to the rest of the world with regard to measures of public sector accountability (including political and civil liberties, freedom of information, and so forth),[102] over the past five years, oil economies have made greater progress in improving public sector accountability than have all other regions of the world, ranking (on average) in

[100] Resource-rich (oil) economies include (a) resource-rich, labor-importing economies Bahrain, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates and (b) resource-rich, labor-abundant economies Algeria, the Islamic Republic of Iran, Iraq, the Syrian Arab Republic, and the Republic of Yemen.

[101] Resource-poor economies include Djibouti, the Arab Republic of Egypt, Jordan, Lebanon, Morocco, Tunisia, and the West Bank and Gaza.

[102] See appendix B for a description of, and the methodology behind, governance indexes.

the 66th percentile worldwide with regard to improving public accountability.

Worldwide, successful reform efforts have depended critically upon the support and participation of those in society whom reforms will impact. The governance improvements in MENA, by enhancing the accountability of governments and granting greater voice in development to MENA's people, are important not only to take into account the needs and values of those who are affected by reforms but also to ensure that in the transition to a new development model, the economic outcomes are socially acceptable among those who have benefited from the old systems. The MENA region continues to have the greatest gap with the rest of the world with regard to accountable and inclusive governance structures, ranking (on average) in the bottom quintile worldwide. It is thus an important development that both resource-rich and resource-poor economies in MENA are making a start at these vital changes.

With diminishing positive links to the oil economies (and increasing negative impacts from higher oil prices), the resource-poor economies in the MENA region have maintained a solid pace of reform, generally exceeding other regions of the world across all areas of reform. Strong achievements have come in improving the business and regulatory environment (resource-poor economies rank (on average) in the 63rd percentile worldwide with regard to improving the business environment, higher than all other regions of the world but Europe and Central Asia). Trade reform (by reducing average tariffs) has also advanced strongly, largely in connection with recent bilateral and multilateral trade agreements. Led by deep tariff reductions undertaken in Egypt, progress among resource-poor economies outpaced (on average) all other regions of the world, with resource-poor countries ranking (on average) in the 71st percentile with regard to tariff reform. Nonetheless, much greater trade liberalization can take place. The resource-poor economies as a group continue to maintain some of the highest tariffs in the world, ranking in the bottom quartile worldwide with regard to low tariff protection.

Resource-poor economies also made strong advancements in the area of governance. Measures to improve public sector accountability resulted in resource-poor economies ranking (on average) in the 62nd percentile with regard to reform progress over the past five years, second only to the gains made by the region's resource-rich economies. In improving the quality of public sector administration, however, the group realized even stronger progress. With a number of efforts toward public sector modernization, civil service reform, and anticorruption legislation, resource-poor economies ranked (on average) in the 82nd percentile with regard to reform, the strongest progress worldwide, led by achievements in Egypt, Morocco, and Tunisia.

Along with across-the-board policy reform, MENA economies continue to look to selective industrial policies to complement more broad-based structural reform, including Morocco's recent "Emergence" program (designed to enhance specific sector competitiveness). Although the views on industrial policies are changing and a variety of economic justifications can be made for their use, MENA's own unsuccessful history with industrial policies (and the difficulty in transitioning out of them) should serve as a cautious reminder that the most effective policies for promoting growth rely on strategies to create a neutral and internationally competitive business environment.

3.2 Measuring Structural Reform

The World Bank Middle East and North Africa region's recent flagship reports on trade,[103] governance,[104] employment,[105] and gender[106] highlight an extensive list of development challenges facing MENA countries over the coming decades. Many of these challenges are well known, and they encompass a broad range of sectors and themes, from managing scarce water resources to reducing poverty to promoting gender equity. But one issue—employment creation—was identified as perhaps the single most important economic development challenge facing the region,[107] requiring three fundamental and interrelated realignments on the part of MENA economies: (a) *from closed to more open economies*, to create more competitive industries, to benefit from international best practices, and to gain access to new technology; (b) *from public sector–dominated to private sector–led economies*, to provide the basis for

[103] World Bank 2003a.
[104] World Bank 2003b.
[105] World Bank 2003d.
[106] World Bank 2003c.
[107] World Bank 2003e.

improved efficiency and expansion of employment; and (c) *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 these realignments require interrelated policy actions on several fronts, including improved governance, particularly with regard to strengthening inclusiveness and accountability.[108]

For the first MENA Economic Developments and Prospects report (MEDP), published in 2005, we attempted to better understand how the region is faring with this economic realignment by constructing a set of structural reform indicators that could allow us to see where the MENA region stood relative to the rest of the world in various areas of reform and—as important—that could allow us to monitor the progress that the region is making in this transition. For that report, structural reform indexes were constructed in three key areas of reform: ***trade orientation***, ***business climate***, and ***governance***. Incorporating a range of relevant indicators available at the time of the report's publication, composite indexes of reform were constructed in each reform area for 2000 and 2004 (the most recent available data at that time) to analyze the region's reform progress.

In this year's MEDP, we again aim to evaluate reform across these three broad areas both to understand where countries currently stand relative to one another and to monitor reform progress over time. In the meantime, across all three areas of reform, additional indicators have become available that strengthen our true understanding of the current reform status in each country. In the area of trade orientation, for example, new information has become available on behind-the-border constraints to trade and on the extent of nontariff barrier coverage. New indicators have also been added to our measurements of governance reform and business climate reform, particularly in the area of financial sector development, the theme of this year's MEDP.[109]

Utilizing these reform indicators, this chapter evaluates the recent progress that has been made by the region on the structural reform front. Because many economic reforms take time to result in measurable development outcomes, we also discuss the region's more recent efforts and emerging trends. The chapter proceeds as follows: In section 3.3, the region's progress with trade reform is examined, highlighting the trade initiatives undertaken and measuring progress in lowering trade barriers. In section 3.4, progress on improving the business climate is discussed, highlighting the region's recent efforts at liberalization and measuring progress in improving the business environment, based on a range of business climate indicators. In section 3.5, we highlight the region's progress with governance reform, both in improving the quality of administration and in improving government accountability.

3.3 Outward Orientation in MENA

3.3.1 Developments in trade reform

Much of the region's recent progress with structural reform has occurred in the area of trade policy, especially in connection with a recent proliferation of bilateral and regional trade agreements. The region entered the new millennium with high average tariffs (averaging 19 percent) and with pervasive use of nontariff barriers (NTBs), covering (on average) more than 14 percent of tariff lines (table 3.1). In addition, the MENA region had extensive behind-the-border constraints, including high transport, logistics, and communication costs, increasing the overall costs (and disincentives) to trade.

Since 2000, the MENA region has made significant strides in reducing obstacles to trade, partly in conjunction with bilateral and multilateral trade agreements. In many economies in the region (namely, Algeria, Egypt, Jordan, Lebanon, Morocco, Syria, Tunisia, and the West Bank and Gaza), tariffs have been reduced and nontariff barriers dismantled with the region's largest trading partner, the European Union (EU), as part of the EU Association Agreements. Other bilateral and regional agreements—including free trade agreements with the United States in Bahrain, Jordan, and Morocco; the Pan-Arab Free Trade Agreement; and the Agadir Agreement between Egypt, Jordan, Morocco, and Tunisia—have also helped the process of trade liberalization in the MENA region.

[108] World Bank 2005a.

[109] Because much of this new information is available only for 2005, it is not possible to evaluate progress with reform by utilizing the new information. As a result, the evaluation of the current status of structural reform (based on the widest set of indicators available in 2005) is not entirely comparable with our measures of structural reform progress (based on a more limited set of indicators available in both 2000 and 2005). (For a fuller description of the data and methodology behind the structural reform indicators, see appendix B.)

Table 3.1: Trade protection in MENA, 2000

Country/region[a]	Simple average tariff	Nontariff barrier coverage[b]
Algeria	24.0	7.4
Bahrain	7.9	7.7
Djibouti	31.0	..
Egypt, Arab Republic of	21.4	26.6
Iran, Islamic Republic of	41.1	39.1[c]
Jordan	23.1	0.1
Kuwait	3.6	..
Lebanon	10.7	22.3
Libya	17.0	..
Morocco	30.5	18.2
Oman	5.7	1.7
Saudi Arabia	12.0	1.9
Syrian Arab Republic	21.0	..
Tunisia	29.1	16.8
Yemen, Republic of	12.8	..
MENA	**19.4**	**14.2**
Resource-poor	24.3	16.8
Resource-rich	16.1	11.6
Resource-rich, labor-abundant	24.7	23.2
Resource-rich, labor-importing	9.2	3.8
ECA4	9.1	13.2
LAC4	14.5	10.5
EAP5	13.0	28.8

Source: United Nations Conference on Trade and Development (UNCTAD) staff estimates provided for this report.

Note: Data for 2000 or closest year available.
a. Regional average represents the simple averages of the data for the respective countries they represent.
b. Nontariff barrier coverage refers to the number of tariff lines that have at least one core nontariff barrier (quantitative restriction).
c. Number of tariff lines requiring license from Ministry of Industry (from World Bank 2001). The comparators are ECA4 (four countries in the Europe and Central Asia region—the Czech Republic, Hungary, Poland, and Turkey), LAC4 (four countries in the Latin America and the Caribbean region—Argentina, Brazil, Chile, and Mexico), and EAP5 (five countries in the East Asia and Pacific region—China, Indonesia, Malaysia, Republic of Korea, and Thailand).

Resource-poor economies, with higher initial levels of protection, have seen the greatest reduction in tariffs. Jordan significantly strengthened its trade reform program beginning in 2000 by cutting tariffs sharply and lowering other trade barriers; joining the World Trade Organization (WTO); and launching an economic-integration project with Israel, providing tariff-free access for clothes, jewelry, and other goods from joint Jordanian-Israeli factories into the United States. Jordan also completed a free trade agreement with the United States. Egypt undertook unprecedented tariff reform in the fall of 2004, reducing the number of tariff bands, annulling import fees and surcharges incompatible with the General Agreement on Tariffs and Trade, and instituting strong tariff rate cuts on most imports. Lebanon's implementation of the Association Agreement with the EU and negotiations to joining the WTO have also resulted in substantial trade liberalization efforts over the past few years.

A few of the resource-rich economies also undertook a series of trade liberalization measures. The Islamic Republic of Iran's trade reform strategy, adopted in its third five-year development plan (2000/2001–2004/2005), consisted of trade reform in two stages: in the first stage, emphasizing the elimination of export restrictions and replacing NTBs with tariffs, and in the second, rationalizing the tariff structure, reducing tariff bands, and lowering the average tariffs. Algeria, early in 2000, began a wave of trade reform measures, including abolishing remaining NTBs to trade, comprehensive tariff reform, signing an Association Agreement

with the EU, and beginning negotiations toward accession to the WTO.

Among the resource-rich, labor-importing economies, which had historically maintained more open trade, the GCC countries have worked almost in unison to develop trade ties and to encourage greater foreign participation in their economies. Almost all have taken further steps to cement greater ties with the West. All of the GCC economies have pursued free trade agreements (FTAs) or trade and investment framework agreements (TIFAs) with the United States. To date, Bahrain has an FTA, and similar agreements are being pursued or negotiated with Kuwait, Oman (signed, but not yet completed), Saudi Arabia, and the United Arab Emirates. TIFAs are in force in Bahrain, Kuwait, Qatar, Saudi Arabia, and the United Arab Emirates. The GCC economies have also worked to strengthen ties with emerging economies in Asia, particularly China and India. Most implemented further tariff reform (from already relatively low levels) with the introduction of the common external tariff among the GCC in 2003.

Progress over 2005

Over the past year, achievements have been made on the trade policy front by several of the resource-poor economies that had not yet undertaken deep reform. Under the EU Association Agreement, Tunisia's tariffs on imports originating in the EU were lowered, while imports from the 16 other members of the Greater Arab Free Trade Area have been admitted completely duty-free since January 2005. In addition, Tunisian customs carried out reforms to simplify import procedures, with special emphasis on documentation and the implementation of the WTO Agreement on Customs Valuation. Although technical import inspection procedures remain lengthy and complex, a start was made on reforming these procedures in 2005.

Morocco also made some progress over the year in deepening trade liberalization. Although the level and dispersion of multilateral tariffs remain high (the simple average tariff is 30 percent), over 2004, most-favored-nation (MFN) tariffs were reduced for goods freely traded with the EU—and in the context of the FTA with the EU—and further tariff reductions were applied in March 2005 on selected intermediate and consumption goods. Customs services have been streamlined, and implementation of the free-trade agreement with the United States began in January 2006. Morocco signed an important agreement with Turkey, which will allow it to take advantage of cheaper Turkish inputs in the production of its own textiles to European markets.[110]

Among resource-rich economies, in December, Saudi Arabia joined the WTO, following 12 years of negotiations. In meeting the WTO requirements, the kingdom undertook important steps in liberalizing its trade regime, particularly for import licensing, customs valuation and fees, standards and technical regulations, and revising its legislation for intellectual property rights and patent registration. With regard to specific markets, Saudi Arabia has agreed to revise the rules it applies to agricultural imports, including shelf-life restrictions and other nontariff measures that have long hindered the importation of agricultural goods to the kingdom. Almost all agricultural tariffs will be lowered to 15 percent or less. Membership in the WTO is expected help the Saudi Arabian economy diversify more rapidly, improve competitiveness, and create new employment opportunities. Oman, meanwhile, completed its negotiations to conclude its free trade agreement with the United States.

Among the resource-rich, labor-abundant economies, widespread smuggling of imported goods into the Republic of Yemen, combined with a desire to harmonize tariff rates with the GCC, prompted the Yemeni government to move strongly in lowering import tariff rates over 2005, reducing the number of bands from four to three, with the maximum rate still at 25 percent, but with two-thirds of the commodities attracting only a 5 percent tariff rate. After the recent changes, the unweighted tariff rate fell to 7 percent, the lowest average tariff outside the GCC in MENA.

3.3.2 Quantifying progress with trade reform

MENA's trade policy was evaluated in two ways: First, the trade policy status in 2005 was assessed

[110] One of the major constraints faced by textiles exporters in Morocco is the EU's restrictive rules of origin. For Moroccan clothing products to satisfy EU rules of origin and qualify for duty-free access in that market, they must be made from domestically produced fabrics, fabrics from EU countries, or fabrics from Tunisia or Algeria (countries that are considered as qualifying areas through full accumulation). These rules force suppliers to forgo cheaper inputs from third-country suppliers to qualify for duty-free entry to the EU. With its recent free trade agreement with Turkey, Morocco has positioned itself to exploit an accumulation of origin with that country—as part of the Pan-Euro-Mediterranean initiative—to reduce Morocco's costs and improve competitiveness.

based on current information on average tariffs, the prevalence of NTBs (with regard to percentage of tariff lines), and behind-the-border constraints to trade (including average time required for both exporting and importing goods). Second, the region's progress with trade policy reform was evaluated, based on the progress made with reducing average tariffs (the only trade policy indicator widely available in 2000, the initial period for comparison).

Based on these evaluations, MENA countries have demonstrated strong progress over the past five years in the area of trade reform, with continued progress by many countries to lower barriers to trade and to establish trade ties through regional and bilateral trade agreements. MENA countries rank (on average) in the 63rd percentile with regard to their progress in lowering import tariffs, only slightly behind developing countries of Europe and Central Asia and high-income OECD economies (table 3.2).

Particularly strong progress has occurred among the resource-poor economies of the region, led by deep tariff reform in Egypt. With average tariffs de-

Table 3.2: Structural reform progress: trade reform

Country/region	Current trade policy,[a] 2005	Trade policy reform progress,[b] 2000–2005
Algeria	43.6	70.7
Bahrain	—	62.0
Djibouti	—	51.1
Egypt, Arab Republic of	42.8	100.0
Iran, Islamic Republic of	22.3	73.9
Jordan	47.1	85.9
Kuwait	52.6	65.2
Lebanon	61.1	80.4
Libya	—	27.2
Morocco	38.4	52.2
Oman	70.8	10.9
Saudi Arabia	39.5	77.2
Syrian Arab Republic	18.4	43.5
Tunisia	50.9	56.5
Yemen, Republic of	61.7	81.5
MENA	**45.8**	**62.5**
Resource-poor	48.0	71.0
Resource-rich	44.1	56.9
Resource-rich, labor-abundant	36.5	67.4
Resource-rich, labor-importing	54.3	48.5
East Asia and Pacific	56.2	37.2
Europe and Central Asia	50.9	69.5
Latin America and the Caribbean	56.6	50.2
High-income OECD	70.2	64.4
South Asia	41.4	47.6
Sub-Saharan Africa	34.4	26.9
World	**50.0**	**50.0**

Sources: See appendix B.

Note: Regional averages reflect the simple average of the data for the countries included. — = Not available.
a. "Current trade policy" status reflects country's current placement in a worldwide ordering of countries, based on four major categories of trade policy indicators available in 2005, expressed as a cumulative frequency distribution, with "100" reflecting the country with the most-open trade policies (worldwide) and "0" representing the country with the most-closed trade policies (worldwide).
b. "Reform progress" reflects the improvement in a country's rank between 2000 and 2005 in a worldwide ordering of countries, based on the simple average tariff (the only trade policy indicator available for a large group of countries in 2000) expressed as a cumulative frequency distribution, with "100" reflecting the country that exhibited the greatest improvement in rank and "0" reflecting the country that exhibited the greatest deterioration. A larger sample of indicators was used to compute the current trade policy because some indicators have only been made available in 2005.

clining from around 21 percent to 9 percent, Egypt's progress in reducing import tariffs places it at the top of the worldwide ordering of countries with regard to tariff reductions.[111] But strong progress also occurred in Jordan and Lebanon, and the region's resource-poor economies as a group ranked in the 71st percentile with regard to reducing tariffs over the past five years, greater than any other region of the world.

Resource-rich economies exhibited weaker progress, but this partly reflects the lower average tariffs initially, with an average tariff level in 2000 of 16.1 percent, compared with more than 24.3 percent among resource-poor economies (see appendix table B1). Among resource-rich economies, relatively strong progress was made among the resource-rich, labor-abundant economies of Algeria, the Islamic Republic of Iran, Syria, and the Republic of Yemen, which as a group had higher average tariff protection initially (averaging 24.7 percent in 2000, relative to only 9.2 percent among the labor-importing economies). Average tariffs for the group fell from an average of 24.7 percent in 2000 to 16.9 percent in 2005, led by significant tariff reductions in the Islamic Republic of Iran (between 2000 and 2005, the Islamic Republic of Iran's average tariff fell from about 41 percent to around 22 percent). Oil-producing, labor-abundant economies ranked (on average) in the 67th percentile worldwide with regard to lowering tariffs.

Among the region's oil-producing, labor-importing economies of the GCC and Libya, though tariff reform has been more limited (the group ranked [on average] in the 49th percentile worldwide with regard to lowering tariffs), this partly reflects lower initial tariff protection. Still, relatively strong progress in lowering tariffs occurred in Saudi Arabia, where the simple average tariff declined from an average of 12 percent in 2000 to an average of 6 percent in 2005.

Although the region has made strong progress with tariff reform over the past five years, MENA's trade liberalization remains far from complete. The region continues to be one of the most trade-restrictive in the world, ranking (on average) in the bottom 46th percentile of countries worldwide with regard to trade regime openness, higher than only Sub-Saharan Africa and South Asia.

Much of this stems from the continuing high tariff protection (MENA countries rank [on average] in the bottom 38th percentile worldwide with regard to average tariffs)[112] that remains commonplace. About half the countries in the region—Algeria, Djibouti, the Islamic Republic of Iran, Jordan, Libya, Morocco, Syria, and Tunisia—maintain simple average tariffs in excess of 10 percent, the world average. This is especially true among resource-poor economies, where simple tariffs continue to average close to 20 percent, placing them in the bottom quartile worldwide with regard to tariff protection. In Tunisia, the simple average of the MFN tariffs applied in 2005 was more than 28 percent.[113] The heavy MFN tariff protection of the domestic market has changed only slightly in the course of the past 10 years. The average duty on agricultural products (WTO definition) is 67 percent, with a maximum rate of 150 percent; the average duty on nonagricultural products is 23 percent. MFN customs duties in the manufacturing sector average 30 percent, with rates extending up to 150 percent. The modal rate (that most frequently applied) is 43 percent, and products corresponding to only 15 percent of tariff lines are admitted duty-free.

But the region also suffers from proliferation of NTBs, as well as lengthy processes for both importing and exporting. Trade protection is most acute among the oil-exporting, labor-abundant economies, particularly because of high levels of protection in the Islamic Republic of Iran and Syria, with regard not only to tariff protection but also to cumbersome processes for both exporting and importing. Syria, for example, ranks in the bottom 15th percentile worldwide in both the time required to export as well as the time required to import. It requires (on average) some 63 days to complete the processes associated with importing and 49 days to complete the processes associated with exporting.[114] In addition, with tariffs that average close to 20 percent, it ranks in the bottom decile in tariff protection. The Islamic Republic of Iran, with

[111] Progress with tariff reform is measured by the change made by a country in its placement in a worldwide ordering of countries based on their simple average tariffs. Egypt, which moved from the bottom decile of countries worldwide in 2000 (based on simple average tariff) to almost the 50th percentile in 2005, improved its ranking by the greatest amount over the period (with regard to progress, it thus ranked in the 100th percentile with regard to tariff reform). (See appendix B for a further description of methodology.)

[112] See appendix table B2.

[113] Staff estimates from UNCTAD TRAINS database.

[114] World Bank 2006a.

average tariffs of 22 percent (despite significant tariff reduction), ranks in the bottom 5th percentile in tariff protection. It also faces lengthy processes to comply with import and export regulations, ranking in the bottom 20th percentile in the time needed to export and in the bottom 30th percentile in the time needed to import (table 3.3).

Even among the relatively open GCC economies (with regard to tariff barriers to trade), when accounting for behind-the-border constraints to trade (particularly prevalent in Saudi Arabia), the group ranks (on average) in only the 54th percentile worldwide, below the Latin America and the Caribbean region, the East Asia and the Pacific region, and high-income economies.

Thus, while MENA has made relatively strong progress with trade reform over the past several years, much work remains on the trade liberaliza-

Table 3.3: Current trade policy in MENA

(Based on simple average tariffs, NTB coverage, average time required for exporting, and average time required for importing)

Country/region	Average tariff	Tariff index	NTB coverage (% of tariff lines)	NTB index	Average time for exports (days)	Export time index	Average time for imports (days)	Import time index	Overall trade policy index (1–100)
Algeria	18.7	8	0.0	88	29	52	51	27	44
Bahrain	5.2	71	0.5	40	..	..	..	..	..
Djibouti	31.0	0	2.7	24	..	..	..	..	..
Egypt, Arab Rep. of	9.1	48	6.1	7	27	55	29	62	43
Iran, Islamic Rep. of	22.1	5	0.5	40	45	17	51	27	22
Jordan	13.1	21	0.3	51	28	54	28	63	47
Kuwait	3.6	92	2.1	26	30	50	39	44	53
Lebanon	5.4	71	0.2	53	22	67	34	54	61
Libya	17.0	14	2.2	26	..	..	..	..	..
Morocco	30.1	1	0.3	51	31	47	33	55	38
Oman	5.7	67	0.0	88	23	64	27	65	71
Qatar	5.0	74	1.0	32	..	..	..	..	..
Saudi Arabia	6.0	63	1.2	30	36	32	44	33	39
Syrian Arab Rep.	19.6	6	0.5	40	49	14	63	13	18
Tunisia	28.3	3	0.0	88	25	58	33	55	51
Yemen, Rep. of	7.0	58	0.0	88	33	43	31	59	62
MENA	**14.2**	**38**	**1.1**	**48**	**31.5**	**46**	**38.6**	**46**	**46**
Resource-poor	19.5	24	1.6	46	26.6	56	31.4	58	48
Resource-rich	11.0	46	0.8	50	35.0	39	43.7	38	44
RRLA	16.9	19	0.2	64	32.5	32	42.0	31	36
RRLI	7.0	64	1.2	40	29.7	49	36.7	47	54
East Asia abd Pacific	7.4	57	0.6	52	27.6	60	31.3	63	56
Europe and Central Asia	7.0	67	5.7	36	31.3	53	42.8	51	51
Latin America and the Caribbean	10.2	43	0.5	72	29.7	50	36.8	49	57
High-income OECD	3.7	90	9.2	18	12.0	86	13.4	88	70
South Asia	16.8	14	0.0	69	33.7	39	39.3	44	41
Sub-Saharan Africa	13.7	30	6.6	57	49.2	24	61.1	4	34
LMIC average	**10.4**	**47**	**2.3**	**52**	**28.5**	**55**	**33.8**	**56**	**53**
World	**10.0**	**50**	**2.7**	**50**	**32.2**	**50**	**40.4**	**50**	**50**

Sources: See appendix B.

Note: 2005 or closest year available. LMIC = Low- and middle-income economies. Regional averages reflect the simple average of the data for the countries included. For each index, a country's value represents the country's current placement in a worldwide ordering of countries, based on that trade characteristic expressed as a cumulative frequency distribution, with "100" reflecting the countries with the most-open/friendly trade policies and "0" reflecting the countries with the most-closed/burdensome trade policies.

tion front. Factoring in tariffs, NTBs, and trade procedures, the MENA region ranks ahead of only Sub-Saharan Africa and South Asia with regard to trade openness, and only one country in the region (Oman) ranks in the top third of countries worldwide with regard to trade facilitation. Many countries in the region have lowered tariffs in parallel with integration efforts with the EU, but the region needs to continue liberalization efforts on a multilateral basis to tap into the trade potential with non-EU countries.

3.4 Business Climate

3.4.1 Developments in business and regulatory reform

Just as MENA's trade policies will impact the development of competitive export-oriented businesses, MENA's policies and practices regulating business will impact the development of a productive, competitive private sector that can drive economic development and job growth. Thus, a critical focus of MENA's economic transition relates to creating a pro-competitive business environment, free of excessive regulation.

With diminishing links to oil economies, resource-poor economies in MENA have led the way in improving the regulatory environment for private investment. Both Morocco and Tunisia, as part of their industrial modernization efforts under the *mise à niveau* program, undertook various measures to create a more favorable investment climate. Major achievements in Morocco include strengthening the legal, regulatory, and supervisory framework of the financial sector, strengthening property rights, the passage of a new labor code, and—as part of its national privatization program—liberalization of many sectors of the economy, including air transport (significantly improving the potential for tourism) and telecommunications. Structural reforms in Tunisia have included significant progress in privatizing state enterprises, some strengthening of the banking sector, streamlining several business procedures, and reforming the legal framework for asset recovery and bankruptcy.

But a strong drive to attract business has also emerged from resource-rich, labor-importing countries, particularly through opening up to and capturing greater foreign investment. Bahrain passed an amended Commercial Law in 2003, streamlining the conditions for the operation of private enterprises and easing the restrictions on foreign ownership.[115] Under the new law, Bahrain has become one of the first countries in the GCC to abolish the sole agency Commercial Law. During 2003–2004, a number of key sectors (such as telecommunications, electricity generation, and petrochemicals) were opened to competition. The UAE has also established new laws on foreign ownership and has set its sights on several new industrial free trade zones targeted at attracting more foreign firms.[116] Plans to attract FDI to Qatar are leading to the creation of a "one-stop shop" for investors. A recent law allowing foreign ownership in prespecified sectors, with the approval of the finance minister in each case, is being proposed (with up to 100 percent ownership in selected sectors such as tourism, health, and education). Under the terms of Saudi Arabia's accession to the WTO, significant steps are also being taken toward removing the barriers to FDI. Among the sectors expected to witness foreign entry are insurance, banks and other financial intermediaries (banks can now set up branches, and existing banks can increase their foreign equity from 40 to 60 percent), and energy companies operating in the downstream and midstream sectors.

The Gulf economies have also moved aggressively over the past few years to establish themselves as regional and international hubs for a variety of services, including financial services, trading, tourism, and transport. Bahrain and Qatar have established themselves as regional financial hubs, and the Qatar Financial Center created a financial free zone for international banks and investment companies in 2005. But other services are also emerging: Kuwait is developing a technology free trade zone, and Qatar is positioning itself as a regional education and health services hub, most recently establishing Education City and Hamad Medical City.

Progress over 2005

Over 2005, continued progress has been made by several of the resource-poor economies to improve aspects of the business environment. Morocco's recent achievements included selling a second fixed-

[115] Under the existing rules, foreign ownership of commercial activities is permitted up to 100 percent of unlisted companies, up to 49 percent of public shareholding companies; furthermore, foreigners can buy property in certain designated areas of the country.

[116] EIU, UAE Country Report, February 2006.

line telephone license to a private company, consolidating financial reforms, and accelerating civil service reform with a successful program of 38,000 civil servants (8 percent of the total) voluntarily retiring. Tunisia's preparations for the implementation of a broad money-targeting framework are at an advanced stage and will lay the groundwork for more flexible exchange rate management in the future. With respect to the financial sector, the government pursued measures to strengthen financial stability. A new round of reforms is expected to be gradually implemented in preparation for the opening of the banking sector to foreign competition. The reforms involve tighter operating standards and a strategy to deal with nonperforming loans and bank restructuring.

Starting in July 2004, Egypt's privatization program was resurrected, and the speed was further accelerated over 2005. The government has sold stakes in a number of commercial banks and companies, the largest privatization thus far being the sale of a 20 percent stake in Telecom Egypt in December 2005, which brought in revenues of more than LE 5.1 billion (close to $900 million). The government announced in January that it is considering the sale of 45 companies, both minority stakes via public offerings and controlling stakes to corporate investors. This should result in continued strong FDI inflows for 2006.

Egypt also signed into law a new, more simplified income tax in 2005 that substantially cut the personal and corporate tax rates, resurrected the privatization program, and undertook several reforms in the financial sector, including restructuring the banking and nonbanking sectors—a program relying on both privatization and bank consolidation as two major pillars in the drive to strengthen the banking sector by reducing the number of institutions.

For Lebanon, in contrast, 2005 was a lost year for structural reforms, with government changes, practical inability to convene parliamentary sessions, boycott of cabinet meetings, and a very divisive political situation hindering the country from implementing significant structural reforms. A number of laws prepared in the fields of trade, competition, intellectual property rights, e-commerce, public procurement and auditing, public enterprises management, public debt management, public and private pensions, and capital markets are still pending in parliament. The budget law for 2005 was passed only by the end of the year. On the positive side, the establishment of a large taxpayer's office and the completed registration of private sector employees permitted the Ministry of Finance to raise its collection efficiency.

Among the resource-rich, labor-abundant economies, however, recent progress with structural reforms has been more mixed. Algeria strengthened performance contracts of public bank managers and shareholder oversight, initiated the privatization of a public bank, and made progress in modernizing the payments system. A new hydrocarbon law was adopted that further liberalizes investment in this sector. In the Islamic Republic of Iran, however, structural reforms slowed, with little government activity in pursuing the reform agenda before the June presidential elections, and a new government formed only in late August. Syria's reforms have been limited to date, but over the year several policy reforms have been initiated, including taking steps to liberalize the banking sector and modify taxation.

3.4.2 Quantifying progress with business and regulatory reform

As with trade policy, MENA's business climate was evaluated in two ways. First, the business climate in 2005 was evaluated based on current information on eight different areas important for doing business (ease of starting a business, ease of closing a business, access to finance, ease of hiring and firing, ease of contract enforcement, ease of dealing with pertinent licenses, ease of paying taxes, and ease of registering property). In each of these areas, a variety of information about the ease of doing business was utilized, often including average time, cost, and total number of procedures required for each business obligation (see appendix B for a fuller description). In addition to evaluating the current status of the business environment, the progress with reform of the business climate was evaluated, based upon progress made along four different fronts (the four areas for which information was available in both 2003 and 2005): starting a business, hiring and firing, access to credit, and enforcing contracts. From these data, an overall reform progress index was calculated, reflecting the average progress along all four fronts, expressed as a cumulative frequency distribution.

Based on the composite reform index, the MENA region's progress over the past five years in improving the environment for investment was be-

low the world average. MENA countries ranked (on average) in the 42nd percentile worldwide with regard to business and regulatory reform, about on par with the reform progress in South Asia and Sub-Saharan Africa, and well behind the progress made in Europe and Central Asia (table 3.4).

The greatest progress has occurred among MENA's resource-poor economies, averaging in the 63rd percentile worldwide, driven by strong achievements in Jordan (89th percentile) and Tunisia (93rd percentile), stemming from progress mainly in removing obstacles to starting a business but also in improving access to finance.

Much more limited progress occurred among the resource-rich economies, ranking (on average) in only the 23rd percentile with regard to reform, with the weakest progress among the resource-rich, labor-importing economies (15th percentile). In part, this reflects an overall friendlier business climate initially among the GCC economies. Resource-rich, labor-importing economies, as a group, rank (on average) in the 65th percentile with regard to all aspects of the business environment. Resource-rich, labor-importing economies, however, which rank the lowest in the region (and second-lowest in the world, behind Sub-Saharan Africa) with regard to a

Table 3.4: Structural reform progress: business and regulatory reform

Country/region	Current business environment,[a] 2005	Reform progress,[b] 2003–2005
Algeria	13.1	37.6
Egypt, Arab Republic of	11.1	35.9
Iran, Islamic Republic of	56.9	43.7
Iraq	66.0	..
Jordan	58.2	88.6
Kuwait	58.8	6.7
Lebanon	37.3	31.4
Morocco	60.8	54.4
Oman	77.8	15.1
Saudi Arabia	79.7	25.8
Syrian Arab Republic	30.1	5.0
Tunisia	83.0	92.5
United Arab Emirates	43.1	14.0
Yemen, Republic of	35.0	56.6
MENA	**50.7**	**41.5**
Resource-poor	50.1	62.8
Resource-rich	51.1	23.5
RRLA	40.1	35.8
RRLI	64.9	15.4
East Asia and Pacific	61.1	46.8
Europe and Central Asia	48.1	64.4
Latin America and the Caribbean	40.4	51.4
High-income OECD	83.5	50.3
South Asia	48.0	41.0
Sub-Saharan Africa	27.4	43.1
World	**50.0**	**50.0**

Sources: See appendix B.

Note: Regional averages reflect the simple average of the data for the countries included.

a. "Current business environment" reflects country's current placement in a worldwide ordering of countries, based on eight major categories of business environment indicators available for 2005, expressed as a cumulative frequency distribution, with "100" reflecting the country with the most-friendly business policies (worldwide) and "0" representing the country with the most-unfriendly business policies (worldwide).

b. "Reform progress" reflects the improvement in a country's rank between 2003 and 2005 in a worldwide ordering of countries, based on four major categories of business and regulatory policies available in 2003 and 2005, expressed as a cumulative frequency distribution, with "100" reflecting the country that exhibited the greatest improvement in rank and "0" reflecting the country that exhibited the greatest deterioration. A larger sample of indicators has been used to compute the current business environment because some indicators have only been made available in 2005.

conducive business environment, also managed relatively limited progress. RRLA economies ranked (on average) in the 36th percentile worldwide with regard to business reforms, with the strongest progress from the Republic of Yemen (primarily through improvements in hiring and firing, the result of a revision to the labor code facilitating the hiring of foreign labor by private investors).

Despite the progress made by a few MENA countries, there remain large impediments to conducting business in the region, evidenced in several key areas. Regionwide, starting a business remains exceptionally cumbersome, with MENA countries ranking (on average) in the bottom third of countries worldwide with respect to time, cost, and procedures necessary to start a business (table 3.5). Investors in resource-poor economies also face particular impediments with regard to labor laws, with RPLA economies ranking (on average) in the 41st percentile worldwide with regard to the ease of hiring and firing workers. Resource-rich, labor-abundant economies face obstacles in a number of

Table 3.5: Current business and regulatory environment in MENA

Country/region	Contract enforcement	Access to finance	Hiring/ firing	Starting a business	Closing a business	Dealing with licenses	Registering property	Paying taxes	Overall business climate
Algeria	16	13	35	30	73	34	11	3	13
Egypt, Arab Rep. of	24	51	13	26	14	3	14	46	11
Iran, Islamic Rep. of	64	63	28	65	34	3	39	74	57
Iraq	53	..	30	25	..	53	72	..	66
Jordan	63	75	59	23	45	60	34	92	58
Kuwait	38	79	84	43	68	37	49	..	59
Lebanon	9	82	71	36	20	39	45	73	37
Morocco	82	43	16	67	67	17	58	19	61
Oman	43	31	76	60	47	24	89	98	78
Saudi Arabia	39	80	84	5	45	78	99	97	80
Syrian Arab Rep.	5	22	42	13	48	48	48	74	30
Tunisia	97	64	34	74	87	41	55	58	83
United Arab Emirates	15	52	58	14	6	81	94	97	43
West Bank and Gaza	43	..	54	3	..	49	44	..	..
Yemen, Rep. of	63	4	65	3	63	77	74	28	35
MENA	**44**	**53**	**50**	**32**	**48**	**44**	**55**	**66**	**51**
Resource-poor	53	63	41	38	47	46	42	58	50
Resource-rich	37	40	56	29	48	43	64	71	51
RRLA	40	27	40	27	55	46	49	56	40
RRLI	34	80	75	31	42	39	83	97	65
East Asia and Pacific	41	53	71	61	35	63	62	73	61
Europe and Central Asia	59	51	42	56	49	38	56	42	48
Latin American and the Caribbean	38	58	46	42	45	52	52	25	40
OECD	84	90	56	77	85	78	68	71	84
South Asia	37	48	51	62	50	50	39	56	50
Sub-Saharan Africa	38	24	40	29	37	32	24	36	26
LMIC average	**49**	**58**	**52**	**51**	**46**	**50**	**55**	**50**	**53**
World	**50**	**50**	**50**	**50**	**50**	**50**	**50**	**50**	**50**

Sources: See appendix B.

Note: 2005 or closest year available. Regional averages reflect the simple average of the data for the countries included. For each column, a country's value represents the country's current placement in a worldwide ordering of countries, based on that business climate characteristic expressed as a cumulative frequency distribution, with "100" reflecting the countries with the most-friendly policies for doing business, and "0" reflecting the country with the most-cumbersome policies for doing business. OECD = High-income/OECD economies; LMIC = Low- and middle-income economies.

key areas. Of the eight key areas of doing business, in only two (closing a business and paying taxes) do the RPLA economies rank (on average) in the top half of countries worldwide. Impediments are particularly large with regard to contract enforcement, access to finance, and business entry requirements. In resource-rich, labor-importing economies, meanwhile, though generally more business-friendly (in a few areas, such as access to finance, registering property, and paying taxes, they average in the top quintile of countries, worldwide), there remain areas with especially burdensome regulations, including contract enforcement and the procedures for starting a business.

Industrial policy as a complement to market forces

Along with across-the-board reforms of the business environment, several MENA economies continue to utilize industrial policies (designed to promote specific industries or sectors) to complement more broad-based policies that promote market forces. In Morocco, for example, a new industrial strategy—"Emergence"—was adopted in 2005, designed to enhance specific sector competitiveness and employment creation and to improve the country's growth potential. The strategy focuses on the identification of specific sectors' weaknesses and strengths and upgrading the industrial sector through the modernization of its production processes and the consolidation of its competitive edge (see box 3.1).

Tunisia, in the midst of progress along certain structural reform fronts, continues to maintain a dual system of investment promotion and trade policy. Generous privileges are extended for investments in selected economic activities and for exporting, by supporting the creation of "offshore" firms, but the government still discourages foreign investment in protected service sectors. For more than 30 years, the strategy pursued by Tunisia has consisted of promoting exports, especially manufactured goods, while heavily protecting enterprises that supply the local market. This strategy has created a dualism within the economy between an export sector whose competitiveness depends largely on concessions (including tax exemptions, transport cost subsidies, facilitated customs procedures, and foreign exchange concessions) and a domestic sector that is still heavily protected (despite the opening up of bilateral trade in nonagricultural products under the Association Agreement with the EU).

The continued use of industrial policies throughout MENA comes at a time of renewed interest in their effectiveness. Although economists agree that market forces and private entrepreneurship need to be the driving forces behind growth and productivity enhancements, increasing analysis of late has focused on the complementary role to market forces that industrial policies can play.[117]

While a variety of economic justifications can be made for the use of selective industrial policies (including coordination problems and information externalities), several caveats for their use are warranted, particularly for MENA economies. MENA has a long history with industrial policy (from infant industry protection to state planning to widespread consumer subsidies), and although the limits of the region's protective interventions were realized as early as the 1980s, the transition out of these policies has been painstaking, in large part because it has involved the profoundly difficult task of cutting back economic rents that have been built over the years.

Moreover, the international history of industrial policy has demonstrated, if nothing else, the ability to "get it wrong." Well-motivated or not, worldwide experience with industrial policy has been remarkably divergent, with as many (or more) failures as successes and with significant unintended consequences (including rent seeking and corruption).

MENA's recent selective interventions to promote various industries appear on the surface, at least, to be intrinsically different from those in the past (aimed less at protecting domestic industries than at improving their chances for international competitiveness). And indeed, most countries maintain a mixture of both mainstream free-market measures and industrial policies. Nonetheless, given the region's difficulty with extracting itself from the legacy of past industrial policies, MENA should be cautious in looking to a new system of industrial policies to promote growth, but instead look to create a neutral and internationally competitive business environment.

3.5 Governance

Improving governance in the region is at the forefront of improvements in economic policy. Parallel to the economic reforms the region faces, it must

[117] See, for example, Rodrik (2004).

Box 3.1

Morocco's Emergence program

Morocco's Emergence program is aimed at overhauling the industrial apparatus while enhancing its competitiveness and carrying out voluntarist policies in favor of emerging sectors. The strategy takes into account changing regional and international environments. It encompasses a set of measures designed to improve the access of Morocco's domestic products to world markets and to the attraction of foreign investment. The industrial sector has been divided into three poles: the first, made of expanding activities, needs little public help; the second requires public support, given the tough competition it faces; and the third is composed of new global activities in which Morocco could position itself favorably. The latter two poles comprise eight subsectors: the aeronautical, agroprocessing, automotive, craft, electronic, offshoring, seafood, and textile industries.

Within the textile industries, in close partnership with the Association of the Textile and Garment Industries (AMITH), the government is aiming to restructure the competitiveness of the textile and clothing sectors. The two interrelated strategic goals of this plan are (a) to move the textile and garment industry from its present position as subcontractors for EU suppliers to full-service providers, working directly with the final buyers, and (b) to upgrade from the production of commodity garments to higher-value-added fashion garments. The main instruments of the plan include tariff and customs reforms; transport and logistics improvements; financial and fiscal incentives to boost new investments, establish export platforms, and help firms restructure their balance sheets; and education and training.

The vision of moving away from basic garment products and subcontracting is consistent with the global dynamics of retailing. This will provide some advantages to nearby suppliers of fashion goods and will require additional services. The focus of the plan is on skills development (including design, merchandising, and material sourcing). Trade and customs reforms and trade facilitation are also pertinent. The real test, however, is that of implementation because Morocco lags slightly behind most major competitors with regard to putting in place reforms to adjust to the Multifiber Agreement removal. A swift and effective implementation of the plan is crucial to the survival of the industry.

strengthen the incentives, mechanisms, and capacities for public institutions, both to improve economic policies and to forge the broad social consensus needed to successfully enact reform.

The governance challenges facing MENA are twofold: First, it faces the challenge of modernizing governance structures and operations for more efficient public sector management. It involves administrative reform of the public sector to enhance the efficiency of the bureaucracy, to improve mechanisms of internal accountability, and to reduce corruption. Second, the MENA region faces the more difficult challenge of increasing public sector accountability. This governance challenge requires improving transparency in governance mechanisms and enhancing contestability in government policies.

3.5.1 Developments in governance reform

Several important steps toward governance reform have been taken by MENA countries over the past several years. On the administrative side, there have been various achievements by both resource-poor economies and oil exporters. Jordan, Morocco, and the Republic of Yemen have each embarked on ambitious programs of civil service management reform, and in Egypt, civil service reform was advanced with the announcement of a new system of early retirement for public sector employees in December 2005. There has been additional progress by the region in attacking corruption, including in Algeria, Egypt, Jordan, and Libya, which recently enacted anticorruption legislation (although implementation is forthcoming).

In addition, several countries in the region have taken important steps in opening up the political space and allowing for greater accountability in public policy. Many of these steps have been taken by the GCC countries. In 2001, Bahrain became a constitutional monarchy with a bicameral parliament, granting full suffrage to all male and female

citizens, and creating an independent judiciary. Qatar's political environment has also undergone rapid changes, including introducing an electoral process in conjunction with the Municipal Council. In May 2003, Qatar also established a Human Rights Committee and became the first country in the Gulf to have a female holding a public office. In 2004, the government introduced new legislation granting more freedoms and permitting demonstrations, labor union formation, and public meetings. These steps toward allowing greater voice in development are an important element in moving further with the economic reform agenda, ensuring that in the transition to a new development model, the economic outcomes are socially acceptable. In Oman, a consultative parliament was established in 2003, enabling all eligible adults to vote.[118] Political rights have been extended to women, and starting in 2004, a number of other key appointments of women to ministerial and ambassadorial posts have occurred. Allowing greater information about domestic economic policies has also begun to enter the agenda. In 2005, the Omani government granted a license for private television and radio stations for the first time. Taken together, these steps provide greater incentives to regional governments to pursue sound and effective policies.

Elsewhere, a major achievement in enhancing public sector accountability has occurred with Morocco's recent adoption of the Law on Political Parties, which helps consolidate the credibility and efficiency of political parties and institutions. First, the law aims at enabling the political parties to take more responsibility and be more accountable to their constituencies. Second, it seeks a more efficient parliament, with two or three homogeneous groups becoming healthy coalitions. Third, the law includes provisions to ensure good governance inside political parties by allowing the judicial system to abolish parties that do not abide by internal regulations.

3.5.2 Quantifying progress with governance reform

Governance in the MENA region is evaluated based on the set of governance indicators established in the World Bank's 2003 report on governance in the MENA region.[119] From that report, two separate spheres of governance were examined: governance related to public accountability and governance related to the quality of public administration. For comparability, those governance indicators have been computed again, utilizing the methodology established, but with a minor adjustment to the underlying data and an adjustment to the computation methodology (see appendix B).

From these two governance spheres, we evaluated both the current status of governance in MENA (in quality of public administration and in public sector accountability) and the progress with governance over 2000–2005. Based on the composite reform indexes, the MENA region has made significant strides in the realm of governance over the past few years.

In the area of improving the quality of public administration, the MENA region ranked (on average) in the 63rd percentile worldwide, ahead of all other regions of the world. The strongest reform effort has occurred among resource-poor economies in the region, which ranked (on average) in the top quintile worldwide with regard to improving the quality of public administration, led by strong achievements in Egypt, Morocco, and Tunisia. But a few resource-rich economies also made strong gains, including Algeria, Oman, Qatar, Saudi Arabia, and the Republic of Yemen.

But perhaps even more important, the region has made strong progress in improving mechanisms for greater government accountability. Between 2000 and 2005, MENA countries ranked (on average) in the 64th percentile with regard to improving mechanisms for government accountability, stronger progress than in any other region of the world (table 3.6). The greatest improvement has emanated from the resource-rich, labor-importing economies, where a few countries (such as Bahrain, Oman, and Qatar) have taken significant steps to open up the political space for greater participation in public policy.

These essential reforms toward greater public sector accountability are particularly important for the successful implementation of other areas of the reform agenda. Worldwide successful reform efforts have depended critically upon the support and participation of those in society whom reforms will impact. The governance improvements in MENA, with regard to granting greater voice in development to MENA's people, are important not only to take into account the needs and values of those who are affected by reforms but also to ensure that in the transition to a new development model, the eco-

[118] Despite the parliamentary elections, however, the powers of the parliament are still limited.

[119] World Bank 2003b.

Table 3.6: Structural reform progress: governance reform

Country/region	Quality of administration, current status[a]	Reform progress,[b] 2000–2005	Public sector accountability, current status[a]	Reform progress,[b] 2000–2005
Algeria	37.6	91	29.1	91
Bahrain	76.6	26	22.7	91
Egypt, Arab Republic of	42.6	92	24.8	84
Iran, Islamic Republic of	16.3	19	20.6	4
Jordan	66.0	67	34.0	60
Kuwait	58.2	24	31.2	65
Libya	10.6	64	0.0	42
Morocco	73.0	83	32.6	81
Oman	61.0	75	15.6	81
Qatar	59.6	89	13.5	74
Saudi Arabia	57.4	77	5.0	69
Syrian Arab Republic	14.9	67	7.1	74
Tunisia	74.5	87	22.0	22
United Arab Emirates	58.9	6	17.0	41
Yemen, Republic of	28.4	71	19.9	89
MENA	**49.0**	**63**	**19.7**	**64**
Resource-poor	64.0	82	28.4	62
Resource-rich	43.6	55	16.5	65
Resource-rich, labor-abundant	24.3	62	19.1	64
Resource-rich, labor-importing	54.6	52	15.0	66
East Asia and Pacific	43.3	45	41.0	48
Europe and Central Asia	47.0	46	51.8	51
Latin America and the Caribbean	45.8	50	57.0	53
High-income OECD	89.2	47	91.2	49
South Asia	47.5	53	38.9	31
Sub-Saharan Africa	39.4	53	36.7	55
World	**50.0**	**50**	**50.0**	**50**

Sources: World Bank Staff estimates; see appendix B.

Note: Regional averages reflect unweighted average of countries included.

a. "Current status" reflects country's current placement in a worldwide ordering of countries, based on a variety of governance indicators expressed as a cumulative frequency distribution, with "100" reflecting the country with the most-efficient/accountable governance processes (worldwide) and "0" representing the country with the most-inefficient/unaccountable governance processes (worldwide).

b. "Reform progress" reflects the improvement in a country's rank between 2000 and 2005 in a worldwide ordering of countries, based on governance indicators expressed as a cumulative frequency distribution, with "100" reflecting the country that exhibited the greatest improvement in rank and "0" reflecting the country that exhibited the greatest deterioration.

nomic outcomes are socially acceptable among those who have benefited from the old systems.

At the same time, it must be emphasized that the MENA region continues to have the greatest gap with the rest of the world with regard to accountable and inclusive governance structures, ranking (on average) in the bottom quintile worldwide, by far the lowest average ranking worldwide. Moreover, there is almost no diversity in the region with regard to accountable governance structures. Every country in the region except one—Jordan—ranks in the bottom third with regard to public sector accountability (and Jordan is only marginally higher). Given this especially large gap in public sector accountability with the rest of the world, it is thus an important development that both resource-rich and resource-poor economies in MENA are making a start at these vital changes.

Appendix A: Statistical Tables

Appendix Table A1: Gross domestic product and prices: real GDP Growth, 1995–2005
(percentage per year)

Country	1995–2000	2000–2002	2003	2004	2005
MENA region (incl. Iraq)	..	3.0	5.6	6.3	6.0
MENA (excl. Iraq)	3.7	3.3	6.9	5.6	6.0
Resource-poor, labor-abundant	4.7	3.7	4.1	4.8	4.0
Djibouti	–0.5	2.3	3.2	3.0	3.2
Egypt, Arab Republic of	5.6	3.3	3.1	4.2	4.9
Jordan	3.2	5.5	4.1	7.7	7.2
Lebanon	1.9	3.5	4.9	6.3	1.0
Morocco	3.6	4.7	5.5	4.2	1.5
Tunisia	5.6	3.5	5.6	5.8	5.0
West Bank and Gaza	..	–12.5	6.2	6.2	6.3
Resource-rich, labor-abundant (incl. Iraq)	..	3.1	1.2	7.2	5.3
Resource-rich, labor-abundant (excl. Iraq)	3.4	4.5	6.1	4.7	5.5
Algeria	3.2	3.3	6.8	5.2	5.5
Iran, Islamic Republic of	3.5	5.3	6.7	4.8	5.9
Iraq	..	–7.2	–41.4	46.5	2.6
Syrian Arab Republic	2.4	3.3	2.5	3.6	4.0
Yemen, Republic of	5.5	4.2	3.1	2.6	3.8
Resource-rich, labor-importing	3.3	2.5	8.6	6.5	7.2
Bahrain	4.3	4.9	7.2	5.4	6.9
Kuwait	1.9	2.9	13.4	6.2	8.5
Libya	1.6	3.3	9.1	9.3	8.5
Oman	3.4	4.6	1.4	3.1	4.1
Qatar	11.8	5.9	5.9	9.9	8.8
Saudi Arabia	2.7	0.3	7.7	5.2	6.5
United Arab Emirates	5.2	6.0	11.3	8.5	8.0

Source: World Bank Staff estimates.

Note: The MENA region includes the resource-poor, labor-abundant (RPLA) economies of Djibouti, Arab Republic of Egypt, Jordan, Lebanon, Morocco, Tunisia, and the West Bank and Gaza; the resource-rich, labor-abundant (RRLA) economies of Algeria, the Islamic Republic of Iran, Iraq, the Syrian Arab Republic, and the Republic of Yemen; and the resource-rich, labor-importing (RRLI) economies of Bahrain, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. The West Bank and Gaza is not included in the regional or subregional aggregates.

Appendix Table A2: Gross domestic product and prices: GDP, 1995–2005

(constant US$ billions)

Country	Average 1995–2000	Average 2000–2002	2003	2004	2005
MENA region (incl. Iraq)	..	779.3	846.6	899.7	953.4
MENA (excl. Iraq)	660.2	755.1	833.5	880.5	933.8
Resource-poor, labor-abundant	156.4	184.9	199.0	208.5	216.8
Djibouti	0.5	0.6	0.6	0.6	0.6
Egypt, Arab Republic of	84.4	102.8	109.5	114.1	119.7
Jordan	7.6	8.9	9.8	10.5	11.3
Lebanon	16.0	17.2	18.6	19.8	20.0
Morocco	31.2	35.1	38.6	40.2	40.8
Tunisia	16.7	20.2	21.9	23.2	24.4
West Bank and Gaza	..	4.0	3.8	4.0	4.3
Resource-rich, labor-abundant (incl. Iraq)	..	208.6	218.3	234.0	246.4
Resource-rich, labor-abundant (excl. Iraq)	161.5	184.4	205.2	214.9	226.7
Algeria	48.8	55.1	61.0	64.1	67.7
Iran, Islamic Republic of	87.2	100.8	113.9	119.4	126.5
Iraq	..	24.1	13.1	19.2	19.7
Syrian Arab Republic	17.2	18.6	19.7	20.4	21.3
Yemen, Republic of	8.2	9.9	10.6	10.9	11.3
Resource-rich, labor-importing	342.3	385.8	429.3	457.2	490.2
Bahrain	7.0	8.4	9.4	9.9	10.6
Kuwait	34.7	37.8	44.4	47.2	51.2
Libya	33.3	35.7	40.2	43.9	47.6
Oman	18.1	21.0	22.0	22.7	23.6
Qatar	13.3	18.7	21.1	23.2	25.2
Saudi Arabia	174.7	189.2	204.2	214.9	229.0
United Arab Emirates	61.1	75.0	87.9	95.3	103.0

Source: World Bank staff estimates.

Note: The MENA region includes the resource-poor, labor-abundant (RPLA) economies of Djibouti, Arab Republic of Egypt, Jordan, Lebanon, Morocco, Tunisia, and the West Bank and Gaza; the resource-rich, labor-abundant (RRLA) economies of Algeria, the Islamic Republic of Iran, Iraq, the Syrian Arab Republic, and the Republic of Yemen; and the resource-rich, labor-importing (RRLI) economies of Bahrain, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. The West Bank and Gaza is not included in the regional or subregional aggregates.

Appendix Table A3: Gross domestic product and prices: real GDP per capita growth, 1995–2005

(percentage per year)

Country	1995–2000	2000–2002	2003	2004	2005
MENA region (incl. Iraq)	..	0.9	3.4	4.3	3.8
MENA (excl. Iraq)	1.7	1.3	4.9	3.8	4.0
Resource-poor, labor-abundant	2.8	1.9	2.3	3.0	2.2
Djibouti	–3.2	0.3	1.4	1.5	1.4
Egypt, Arab Republic of	3.7	1.5	1.3	2.4	3.0
Jordan	0.1	2.5	1.4	5.1	4.4
Lebanon	0.4	2.2	3.6	5.0	–0.3
Morocco	1.8	3.1	3.9	2.6	–0.1
Tunisia	4.2	2.1	4.4	4.6	3.8
West Bank and Gaza	..	–15.7	2.5	2.4	2.7
Resource-rich, labor-abundant (incl. Iraq)	..	0.8	–0.8	5.3	3.2
Resource-rich, labor-abundant (excl. Iraq)	1.5	2.6	4.3	3.1	3.7
Algeria	1.5	1.8	5.1	3.4	3.9
Iran, Islamic Republic of	1.9	3.8	5.4	4.0	4.6
Iraq	..	–10.3	–43.3	41.6	–0.8
Syrian Arab Republic	–0.2	0.8	0.1	1.3	1.6
Yemen, Republic of	2.6	1.1	0.0	–0.5	0.7
Resource-rich, labor-importing	0.4	–0.5	5.3	3.3	3.9
Bahrain	1.2	2.8	5.1	3.4	4.8
Kuwait	–2.0	–0.4	10.5	3.5	5.4
Libya	–0.4	1.3	6.9	7.1	6.3
Oman	0.9	1.9	–1.0	0.8	1.6
Qatar	8.5	3.7	3.6	7.6	6.5
Saudi Arabia	0.0	–2.4	4.6	2.1	3.6
United Arab Emirates	–0.9	–1.4	3.7	2.1	0.8

Source: World Bank Staff estimates.

Note: The MENA region includes the resource-poor, labor-abundant (RPLA) economies of Djibouti, Arab Republic of Egypt, Jordan, Lebanon, Morocco, Tunisia, and the West Bank and Gaza; the resource-rich, labor-abundant (RRLA) economies of Algeria, the Islamic Republic of Iran, Iraq, the Syrian Arab Republic, and the Republic of Yemen; and the resource-rich, labor-importing (RRLI) economies of Bahrain, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. The West Bank and Gaza is not included in the regional or subregional aggregates.

Appendix Table A4: Gross domestic product and prices: consumer prices, 1995–2005

(average annual change)

Country	Average 1995–2000	Average 2000–2002	2003	2004	2005
MENA region (incl. Iraq)	..	..	..	..	..
MENA (excl. Iraq)	5.2	2.8	4.5	5.1	6.1
Resource-poor, labor-abundant	3.3	2.3	4.4	5.6	5.6
Djibouti	2.5	1.2	2.0	3.1	3.0
Egypt, Arab Republic of	3.8	2.8	7.1	9.5	8.9
Jordan	2.8	1.8	1.6	3.4	3.5
Lebanon	4.1	0.7	3.9	4.7	1.3
Morocco	1.9	1.7	1.2	1.5	3.9
Tunisia	3.2	2.3	2.8	3.6	2.6
West Bank and Gaza	6.5	3.4	..	..	..
Resource-rich, labor-abundant (incl. Iraq)	..	9.9	11.7	12.6	14.0
Resource-rich, labor-abundant (excl. Iraq)	14.1	9.0	10.5	10.9	12.1
Algeria	6.3	2.8	2.6	3.6	3.5
Iran, Islamic Republic of	19.3	13.6	15.6	15.6	17.9
Iraq	..	17.8	34.0	31.7	32.8
Syrian Arab Republic	1.8	0.1	1.3	3.3	3.0
Yemen, Republic of	11.1	8.7	11.9	12.0	14.6
Resource-rich, labor-importing	0.5	–0.1	1.1	1.6	3.0
Bahrain	–0.2	–0.8	1.7	2.3	2.7
Kuwait	1.8	1.5	1.2	1.3	4.0
Libya	..	–9.3	–2.1	–3.4	3.4
Oman	–1.0	–0.6	0.2	0.8	1.9
Qatar	3.3	1.2	2.3	6.8	7.8
Saudi Arabia	–0.3	–0.3	0.6	0.3	1.1
United Arab Emirates	2.3	2.9	3.1	4.6	6.0

Source: World Bank Staff estimates.

Note: The MENA region includes the resource-poor, labor-abundant (RPLA) economies of Djibouti, Arab Republic of Egypt, Jordan, Lebanon, Morocco, Tunisia, and the West Bank and Gaza; the resource-rich, labor-abundant (RRLA) economies of Algeria, the Islamic Republic of Iran, Iraq, the Syrian Arab Republic, and the Republic of Yemen; and the resource-rich, labor-importing (RRLI) economies of Bahrain, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. The West Bank and Gaza is not included in the regional or subregional aggregates.

Appendix Table A5: Government finance: total expenditures, 1995–2005

(percentage of GDP)

Country	Average 1995–1999	Average 2000–2002	2003	2004	2005
MENA region (incl. Iraq)	..	..	..	31.9	30.6
MENA (excl. Iraq)	32.0	32.3	31.3	30.2	29.2
Resource-poor, labor-abundant	28.9	30.9	30.7	30.0	30.6
Djibouti	35.1	31.9	36.6	38.1	36.5
Egypt, Arab Republic of	26.8	29.9	30.1	29.3	29.4
Jordan	35.3	34.9	37.6	38.1	38.2
Lebanon	35.4	38.8	35.8	32.7	31.2
Morocco	29.3	30.8	30.0	29.8	33.1
Tunisia	29.0	27.8	27.0	26.5	26.5
West Bank and Gaza	..	..	41.1	42.3	49.7
Resource-rich, labor-abundant (incl. Iraq)	..	..	..	33.5	33.8
Resource-rich, labor-abundant (excl. Iraq)	27.0	27.2	27.7	27.6	29.4
Algeria	30.8	32.2	32.4	28.8	26.6
Iran, Islamic Republic of	25.2	24.1	24.2	25.3	29.2
Iraq[a]	..	..	..	98.3	78.9
Syrian Arab Republic	27.0	30.5	27.8	28.0	28.0
Yemen, Republic of	30.1	32.9	35.7	34.2	40.5
Resource-rich, labor-importing	36.8	35.6	33.6	31.7	28.6
Bahrain	31.0	31.1	33.4	31.1	30.6
Kuwait	48.1	40.2	38.6	36.9	30.7
Libya	..	38.8	44.2	40.8	40.8
Oman	39.7	37.4	39.7	39.9	40.1
Qatar	44.6	31.7	31.4	30.7	26.7
Saudi Arabia	33.8	35.5	33.3	32.1	29.6
United Arab Emirates	38.5	33.6	28.2	24.4	20.0

Source: World Bank Staff estimates

Note: The MENA region includes the resource-poor, labor-abundant (RPLA) economies of Djibouti, Arab Republic of Egypt, Jordan, Lebanon, Morocco, Tunisia, and the West Bank and Gaza; the resource-rich, labor-abundant (RRLA) economies of Algeria, the Islamic Republic of Iran, Iraq, the Syrian Arab Republic, and the Republic of Yemen; and the resource-rich, labor-importing (RRLI) economies of Bahrain, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. The West Bank and Gaza is not included in the regional or subregional aggregates.

[a] Current expenditures.

Appendix Table A6: Government finance: current expenditures, 1995–2005

(percentage of GDP)

Country	Average 1995–1999	Average 2000–2002	2003	2004	2005
MENA region (incl. Iraq)	..	..	..	25.9	24.5
MENA (excl. Iraq)	25.4	25.8	24.1	23.9	22.6
Resource-poor, labor-abundant	23.1	25.0	25.1	24.7	25.5
Djibouti	30.8	28.6	29.9	30.3	28.4
Egypt, Arab Republic of	21.1	23.7	24.4	24.0	24.4
Jordan	28.0	28.5	28.7	28.3	31.2
Lebanon	28.3	35.9	32.8	29.5	28.9
Morocco	24.9	25.5	25.3	25.4	28.3
Tunisia	22.0	19.9	19.6	19.9	19.1
West Bank and Gaza	..	..	33.9	36.6	39.7
Resource-rich, labor-abundant (incl. Iraq)	..	..	..	25.8	26.2
Resource-rich, labor-abundant (excl. Iraq)	17.5	18.6	20.0	19.2	21.0
Algeria	23.1	22.9	22.6	19.0	15.1
Iran, Islamic Republic of	14.8	16.1	18.4	18.7	23.2
Iraq	..	..	..	98.3	78.9
Syrian Arab Republic	15.4	18.5	15.6	15.6	15.6
Yemen, Republic of	24.1	26.2	26.7	24.7	31.2
Resource-rich, labor-importing	31.6	30.0	27.1	26.5	23.0
Bahrain	25.6	24.9	26.3	25.3	25.5
Kuwait	42.5	36.3	33.8	32.2	26.5
Libya	..	21.5	14.7	..	..
Oman	32.2	29.5	29.4	28.9	27.2
Qatar	38.6	26.9	25.3	22.1	18.6
Saudi Arabia	29.6	31.0	28.5	28.1	25.0
United Arab Emirates	31.7	28.9	23.2	20.3	16.5

Source: World Bank Staff estimates.

Note: The MENA region includes the resource-poor, labor-abundant (RPLA) economies of Djibouti, Arab Republic of Egypt, Jordan, Lebanon, Morocco, Tunisia, and the West Bank and Gaza; the resource-rich, labor-abundant (RRLA) economies of Algeria, the Islamic Republic of Iran, Iraq, the Syrian Arab Republic, and the Republic of Yemen; and the resource-rich, labor-importing (RRLI) economies of Bahrain, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. The West Bank and Gaza is not included in the regional or subregional aggregates.

Appendix Table A7: Government finance: total revenues, 1995–2005

(percentage of GDP)

Country	Average 1995–1999	Average 2000–2002	2003	2004	2005
MENA region (incl. Iraq)	..	..	..	39.2	43.1
MENA (excl. Iraq)	29.2	34.6	34.3	37.8	41.6
Resource-poor, labor-abundant	25.0	26.9	27.0	26.8	25.7
Djibouti	31.5	29.6	34.3	35.9	34.3
Egypt, Arab Republic of	25.1	27.9	27.7	26.8	23.6
Jordan	33.3	32.5	36.3	36.2	33.6
Lebanon	16.8	20.5	22.1	22.8	22.1
Morocco	27.0	27.4	27.3	27.6	29.8
Tunisia	24.5	24.4	23.9	24.1	24.0
West Bank and Gaza	..	..	24.3	26.4	30.3
Resource-rich, labor-abundant (incl. Iraq)	..	..	..	37.3	42.0
Resource-rich, labor-abundant (excl. Iraq)	25.4	31.4	30.1	32.2	26.7
Algeria	30.8	36.7	37.0	36.2	40.1
Iran, Islamic Republic of	22.8	28.8	26.7	30.3	35.3
Iraq	..	..	..	93.6	96.3
Syrian Arab Republic	25.8	28.1	24.8	23.0	23.0
Yemen, Republic of	27.0	36.0	30.9	32.0	38.1
Resource-rich, labor-importing	33.9	40.0	39.9	45.2	49.7
Bahrain	26.6	33.4	31.4	31.4	32.5
Kuwait	57.7	67.1	56.6	60.5	67.1
Libya	..	46.6	54.8	59.5	59.5
Oman	39.4	45.7	45.6	46.0	47.2
Qatar	37.0	37.9	35.8	46.8	44.5
Saudi Arabia	28.6	33.3	34.5	41.8	48.0
United Arab Emirates	34.5	41.0	41.1	42.7	45.0

Source: World Bank Staff estimates.

Note: The MENA region includes the resource-poor, labor-abundant (RPLA) economies of Djibouti, Arab Republic of Egypt, Jordan, Lebanon, Morocco, Tunisia, and the West Bank and Gaza; the resource-rich, labor-abundant (RRLA) economies of Algeria, the Islamic Republic of Iran, Iraq, the Syrian Arab Republic, and the Republic of Yemen; and the resource-rich, labor-importing (RRLI) economies of Bahrain, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. The West Bank and Gaza is not included in the regional or subregional aggregates.

Appendix Table A8: Government finance: overall fiscal balance, 1995–2005

(percentage of GDP)

Country	Average 1995–1999	Average 2000–2002	2003	2004	2005
MENA region (incl. Iraq)	..	..	..	6.4	11.8
MENA (excl. Iraq)	–2.9	2.3	3.0	7.6	12.4
Resource-poor, labor-abundant	–3.9	–4.0	–3.7	–3.2	–4.9
Djibouti	–3.6	–2.2	–2.3	–2.1	–2.2
Egypt, Arab Republic of	–1.7	–2.0	–2.4	–2.4	–5.8
Jordan	–2.0	–2.4	–1.4	–1.9	–4.6
Lebanon	–18.6	–18.3	–13.7	–9.9	–9.1
Morocco	–2.3	–3.4	–2.7	–2.3	–3.3
Tunisia	–4.4	–3.4	–3.2	–2.5	–2.5
West Bank and Gaza	..	..	–16.8	–15.9	–19.4
Resource-rich, labor-abundant (incl. Iraq)	...	..	..	0.9	5.6
Resource-rich, labor-abundant (excl. Iraq)	–2.0	4.3	2.3	4.6	7.3
Algeria	–0.1	4.5	4.6	7.4	13.5
Iran, Islamic Republic of	–2.8	4.7	2.5	5.0	6.1
Iraq	..	..	..	–40.5	–10.9
Syrian Arab Republic	–1.3	–2.3	–3.1	–5.0	–5.0
Yemen, Republic of	–3.1	3.1	–4.8	–2.3	–2.4
Resource-rich, labor-importing	–2.9	4.4	6.3	13.4	21.0
Bahrain	–4.4	2.3	–2.0	0.3	1.9
Kuwait	9.6	26.9	8.0	23.6	36.5
Libya	..	7.8	10.6	18.7	18.7
Oman	–0.3	8.3	6.0	6.1	7.1
Qatar	–7.7	6.2	4.3	16.2	17.9
Saudi Arabia	–5.2	–2.2	1.2	9.6	8.4
United Arab Emirates	–4.0	7.4	13.0	18.3	24.9

Source: World Bank Staff estimates.

Note: The MENA region includes the resource-poor, labor-abundant (RPLA) economies of Djibouti, Arab Republic of Egypt, Jordan, Lebanon, Morocco, Tunisia, and the West Bank and Gaza; the resource-rich, labor-abundant (RRLA) economies of Algeria, the Islamic Republic of Iran, Iraq, the Syrian Arab Republic, and the Republic of Yemen; and the resource-rich, labor-importing (RRLI) economies of Bahrain, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. The West Bank and Gaza is not included in the regional or subregional aggregates.

Appendix Table A9: External sector: exports of goods and services, 1995–2005

(percentage of GDP)

Country	Average 1995–1999	Average 2000–2002	2003	2004	2005
MENA region (incl. Iraq)	..	..	..	49.1	..
MENA (excl. Iraq)	34.2	39.9	43.8	48.6	54.4
Resource-poor, labor-abundant	24.5	24.5	28.5	33.2	34.6
Djibouti	38.9	37.0	39.9	37.3	36.9
Egypt, Arab Republic of	18.1	17.0	21.7	29.2	31.1
Jordan	48.5	43.9	47.5	52.0	51.1
Lebanon	12.8	14.8	18.8	20.5	20.8
Morocco	28.0	32.7	32.5	33.1	35.0
Tunisia	42.8	45.7	43.9	46.4	47.2
West Bank and Gaza	..	..	..	..	..
Resource-rich, labor-abundant (incl. Iraq)	..	..	..	37.3	..
Resource-rich, labor-abundant (excl. Iraq)	23.6	32.0	31.8	34.4	37.7
Algeria	27.5	38.2	38.3	40.2	45.3
Iran, Islamic Republic of	19.0	27.4	28.2	31.8	34.1
Iraq	..	..	..	69.1	..
Syrian Arab Republic	39.9	37.5	32.0	28.7	29.2
Yemen, Republic of	38.2	39.4	39.0	38.1	43.1
Resource-rich, labor-importing	45.4	51.6	57.1	62.5	69.1
Bahrain	78.5	85.2	82.3	83.3	79.8
Kuwait	49.4	50.8	53.9	60.5	66.5
Libya	26.0	42.4	65.4	72.0	86.7
Oman	46.8	57.6	56.2	57.0	59.1
Qatar	47.1	65.0	62.3	71.5	73.2
Saudi Arabia	36.8	41.6	46.1	52.7	60.8
United Arab Emirates	77.7	72.8	79.1	81.9	84.9

Source: World Bank Staff estimates.

Note: The MENA region includes the resource-poor, labor-abundant (RPLA) economies of Djibouti, Arab Republic of Egypt, Jordan, Lebanon, Morocco, Tunisia, and the West Bank and Gaza; the resource-rich, labor-abundant (RRLA) economies of Algeria, the Islamic Republic of Iran, Iraq, the Syrian Arab Republic, and the Republic of Yemen; and the resource-rich, labor-importing (RRLI) economies of Bahrain, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. The West Bank and Gaza is not included in the regional or subregional aggregates.

Appendix Table A10: External sector: merchandise exports, 1995–2005

(current US$ billions)

Country	Average 1995–1999	Average 2000–2002	2003	2004	2005
MENA region (incl. Iraq)	..	272.8	337.1	436.7	600.0
MENA (excl. Iraq)	182.4	260.1	327.0	418.9	577.3
Resource-poor, labor-abundant	20.5	24.9	30.6	36.7	42.4
Djibouti	0.0	0.0	0.0	0.0	0.0
Egypt, Arab Republic of	4.9	6.9	8.2	10.5	14.0
Jordan	1.8	2.3	3.1	3.9	4.3
Lebanon	1.1	1.3	2.1	2.4	2.6
Morocco	7.1	7.5	8.8	9.7	10.3
Tunisia	5.6	6.4	8.0	9.7	10.7
West Bank and Gaza	..	0.5	0.4	0.5	0.6
Resource-rich, labor-abundant (incl. Iraq)	..	68.4	77.6	103.9	141.2
Resource-rich, labor-abundant (excl. Iraq)	36.5	55.7	67.6	86.1	118.5
Algeria	12.0	19.8	24.5	32.2	45.8
Iran, Islamic Republic of	18.7	26.9	33.8	44.4	61.0
Iraq	..	12.7	10.1	17.8	22.8
Syrian Arab Republic	3.8	5.4	5.4	4.9	5.3
Yemen, Republic of	2.1	3.6	3.9	4.7	6.4
Resource-rich, labor-importing	125.4	179.5	228.8	296.1	416.4
Bahrain	4.2	5.9	6.7	7.6	10.4
Kuwait	12.8	17.0	21.8	30.1	45.1
Libya	8.4	11.5	14.7	17.4	29.6
Oman	6.8	11.2	11.7	13.3	16.3
Qatar	4.8	11.4	13.6	19.4	24.9
Saudi Arabia	52.2	72.6	93.1	125.9	180.6
United Arab Emirates	36.4	49.9	67.3	82.3	109.5

Source: World Bank Staff estimates.

Note: The MENA region includes the resource-poor, labor-abundant (RPLA) economies of Djibouti, Arab Republic of Egypt, Jordan, Lebanon, Morocco, Tunisia, and the West Bank and Gaza; the resource-rich, labor-abundant (RRLA) economies of Algeria, the Islamic Republic of Iran, Iraq, the Syrian Arab Republic, and the Republic of Yemen; and the resource-rich, labor-importing (RRLI) economies of Bahrain, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. The West Bank and Gaza is not included in the regional or subregional aggregates.

Appendix Table A11: External sector: imports of goods and services, 1995–2005

(percentage of GDP)

Country	Average 1995–1999	Average 2000–2002	2003	2004	2005
MENA region (incl. Iraq)	..	..	..	37.9	..
MENA (excl. Iraq)	32.3	32.1	34.4	36.5	35.8
Resource-poor, labor-abundant	34.1	32.2	34.0	40.0	42.2
Djibouti	50.7	46.6	49.1	54.6	54.0
Egypt, Arab Republic of	25.6	22.3	23.6	29.6	31.3
Jordan	69.8	67.6	68.7	81.8	92.0
Lebanon	49.0	38.1	37.0	44.0	43.2
Morocco	32.3	36.9	36.4	39.3	43.9
Tunisia	45.5	49.9	47.6	49.3	50.2
West Bank and Gaza	..	..	..	..	..
Resource-rich, labor-abundant (incl. Iraq)	..	..	..	35.0	..
Resource-rich, labor-abundant (excl. Iraq)	20.8	23.7	27.6	29.8	29.0
Algeria	24.3	23.2	23.9	25.8	23.5
Iran, Islamic Republic of	15.4	21.2	27.6	30.1	28.8
Iraq	..	..	..	92.7	..
Syrian Arab Republic	38.4	32.1	31.5	37.6	50.3
Yemen, Republic of	47.4	38.6	42.5	37.8	36.9
Resource-rich, labor-importing	38.2	36.5	38.4	38.9	37.2
Bahrain	69.8	63.8	64.0	64.2	64.6
Kuwait	44.2	34.1	35.6	36.0	30.3
Libya	22.7	26.7	38.0	41.7	37.2
Oman	39.5	34.8	37.7	42.9	47.0
Qatar	50.1	35.0	33.7	26.7	26.7
Saudi Arabia	27.2	28.9	27.5	28.2	29.1
United Arab Emirates	72.3	60.0	65.1	65.3	57.6

Source: World Bank Staff estimates.

Note: The MENA region includes the resource-poor, labor-abundant (RPLA) economies of Djibouti, Arab Republic of Egypt, Jordan, Lebanon, Morocco, Tunisia, and the West Bank and Gaza; the resource-rich, labor-abundant (RRLA) economies of Algeria, the Islamic Republic of Iran, Iraq, the Syrian Arab Republic, and the Republic of Yemen; and the resource-rich, labor-importing (RRLI) economies of Bahrain, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. The West Bank and Gaza is not included in the regional or subregional aggregates.

Appendix Table A12: External sector: current account balance, 1995–2005

(percentage of GDP)

Country	Average 1995–1999	Average 2000–2002	2003	2004	2005
MENA region (incl. Iraq)	..	..	..	10.7	17.4
MENA (excl. Iraq)	0.2	6.9	7.8	11.9	18.3
Resource-poor, labor-abundant	–3.9	–1.8	0.1	–0.5	–1.7
Djibouti	1.5	2.0	6.6	–0.5	–0.5
Egypt, Arab Republic of	–0.9	–0.2	2.3	4.4	4.6
Jordan	–0.3	2.1	11.6	–0.2	–17.8
Lebanon	–29.2	–18.7	–19.4	–22.7	–21.6
Morocco	–0.9	2.5	3.6	2.2	0.1
Tunisia	–3.1	–4.0	–2.9	–2.0	–2.6
West Bank and Gaza	..	..	..	..	..
Resource-rich, labor-abundant (incl. Iraq)	..	..	..	2.1	7.3
Resource-rich, labor-abundant (excl. Iraq)	2.8	8.5	4.3	5.6	9.5
Algeria	0.4	12.5	13.0	13.1	17.8
Iran, Islamic Republic of	4.1	6.9	1.4	2.5	5.9
Iraq	..	..	..	–36.8	–14.4
Syrian Arab Republic	0.9	6.5	–2.2	2.3	2.2
Yemen, Republic of	2.9	8.1	–0.1	2.0	7.6
Resource-rich, labor-importing	0.9	10.3	13.2	20.3	29.7
Bahrain	–1.1	4.2	2.1	3.8	6.4
Kuwait	18.5	24.6	20.4	31.4	44.1
Libya	4.1	11.9	51.9	30.3	30.3
Oman	–6.2	11.5	6.6	3.3	3.1
Qatar	–18.6	18.2	23.9	38.3	41.5
Saudi Arabia	–2.7	6.3	13.1	20.6	28.3
United Arab Emirates	5.5	10.5	8.7	11.9	29.8

Source: World Bank Staff estimates.

Note: The MENA region includes the resource-poor, labor-abundant (RPLA) economies of Djibouti, Arab Republic of Egypt, Jordan, Lebanon, Morocco, Tunisia, and the West Bank and Gaza; the resource-rich, labor-abundant (RRLA) economies of Algeria, the Islamic Republic of Iran, Iraq, the Syrian Arab Republic, and the Republic of Yemen; and the resource-rich, labor-importing (RRLI) economies of Bahrain, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. The West Bank and Gaza is not included in the regional or subregional aggregates.

Appendix Table A13: External sector: external reserves, 1995–2005

(current US$ billions)

Country	Average 1995–1999	Average 2000–2002	2003	2004	2005
MENA region (incl. Iraq)	..	..	229.1	296.9	373.3
MENA (excl. Iraq)	..	167.3	227.9	289.0	364.0
Resource-poor, labor-abundant	..	36.4	51.8	56.1	62.3
Djibouti	0.1	0.1	0.1	0.1	0.1
Egypt, Arab Republic of	..	14.5	14.8	14.8	19.2
Jordan	2.1	3.6	5.4	5.5	5.5
Lebanon	9.1	7.9	14.0	14.1	14.6
Morocco	4.5	8.3	14.6	17.6	18.7
Tunisia	1.9	2.0	3.0	4.1	4.2
West Bank and Gaza	..	..	..	..	..
Resource-rich, labor-abundant (incl. Iraq)	..	..	67.6	93.8	126.3
Resource-rich, labor-abundant (excl. Iraq)	..	41.7	66.5	85.9	117.0
Algeria	5.4	18.0	33.2	43.5	57.4
Iran, Islamic Republic of	6.8	16.8	24.4	33.0	49.8
Iraq	..	..	1.1	7.9	9.3
Syrian Arab Republic	..	3.4	4.5	4.3	4.4
Yemen, Republic of	1.1	3.5	4.4	5.1	5.4
Resource-rich, labor-importing	35.1	89.2	109.6	147.0	184.6
Bahrain	1.3	1.6	1.5	1.7	1.7
Kuwait	1.0	8.8	7.7	8.4	9.5
Libya	6.6	14.1	18.9	24.6	39.5
Oman	2.2	2.7	3.6	3.6	4.1
Qatar	0.9	1.3	2.9	3.4	4.9
Saudi Arabia	14.0	46.2	59.8	86.8	101.9
United Arab Emirates	8.9	14.5	15.1	18.6	23.0

Source: World Bank Staff estimates.

Note: The MENA region includes the resource-poor, labor-abundant (RPLA) economies of Djibouti, Arab Republic of Egypt, Jordan, Lebanon, Morocco, Tunisia, and the West Bank and Gaza; the resource-rich, labor-abundant (RRLA) economies of Algeria, the Islamic Republic of Iran, Iraq, the Syrian Arab Republic, and the Republic of Yemen; and the resource-rich, labor-importing (RRLI) economies of Bahrain, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. The West Bank and Gaza is not included in the regional or subregional aggregates.

Appendix Table A14: External sector: external reserves, 1995–2005

(months of goods imports)

Country	Average 1995–1999	Average 2000–2002	2003	2004	2005
MENA region (incl. Iraq)	..	..	..	12.6	..
MENA (excl. Iraq)	..	11.7	12.7	13.2	13.7
Resource-poor, labor-abundant	..	9.4	12.3	10.6	10.0
Djibouti	4.6	4.3	5.1	4.1	4.2
Egypt, Arab Republic of	..	10.7	12.0	9.7	10.0
Jordan	6.3	10.0	12.7	9.0	7.1
Lebanon	15.7	14.8	23.5	18.0	18.7
Morocco	5.8	9.4	13.3	13.0	11.8
Tunisia	3.0	2.8	3.4	4.1	3.7
West Bank and Gaza	..	..	..	..	..
Resource-rich, labor-abundant (incl. Iraq)	..	..	..	13.3	..
Resource-rich, labor-abundant (excl. Iraq)	..	13.8	15.8	15.9	18.5
Algeria	7.5	20.8	29.9	29.1	33.8
Iran, Islamic Republic of	..	10.8	10.2	10.8	14.6
Iraq	..	..	..	4.8	..
Syrian Arab Republic	..	9.3	11.1	8.1	5.4
Yemen, Republic of	5.9	14.7	15.0	15.9	14.2
Resource-rich, labor-importing	5.3	12.0	11.6	13.1	13.1
Bahrain	4.4	4.4	3.5	3.3	2.4
Kuwait	1.8	14.7	9.3	8.3	8.4
Libya	13.6	32.6	31.5	33.7	43.8
Oman	5.9	6.2	7.1	5.4	4.6
Qatar	3.0	3.6	6.4	8.4	8.9
Saudi Arabia	6.4	19.4	21.2	25.5	21.2
United Arab Emirates	3.9	5.1	4.0	4.1	4.5

Source: World Bank Staff estimates.

Note: The MENA region includes the resource-poor, labor-abundant (RPLA) economies of Djibouti, Arab Republic of Egypt, Jordan, Lebanon, Morocco, Tunisia, and the West Bank and Gaza; the resource-rich, labor-abundant (RRLA) economies of Algeria, the Islamic Republic of Iran, Iraq, the Syrian Arab Republic, and the Republic of Yemen; and the resource-rich, labor-importing (RRLI) economies of Bahrain, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. The West Bank and Gaza is not included in the regional or subregional aggregates.

Appendix Table A15: External sector: real effective exchange rate index, 1995–2005

(2000 = 100)[a]

Country	Average 1995–1999	Average 2000–2002	2003	2004	2005
MENA region (incl. Iraq)	..	..	..	..	..
MENA (excl. Iraq)	87.8	105.5	103.0	101.1	..
Resource-poor, labor-abundant	85.2	97.3	85.9	80.4	78.0
Djibouti	..	..	..	..	..
Egypt, Arab Republic of	99.6	89.8	69.7	62.2	56.7
Jordan	89.2	101.2	91.9	88.4	94.3
Lebanon	20.7	98.0	96.1	93.7	94.9
Morocco	86.5	104.0	91.0	83.9	82.2
Tunisia	100.9	98.0	92.6	89.0	88.2
West Bank and Gaza	..	..	..	..	..
Resource-rich, labor-abundant (incl. Iraq)	..	..	..	..	..
Resource-rich, labor-abundant (excl. Iraq)	74.7	123.1	145.2	154.9	144.7
Algeria	102.1	99.2	84.7	85.0	85.5
Iran, Islamic Republic of	57.5	141.5	188.1	205.2	198.6
Iraq	..	..	..	..	..
Syrian Arab Republic	..	..	..	..	..
Yemen, Republic of	69.8	98.3	91.4	87.9	..
Resource-rich, labor-importing	93.3	102.0	93.1	87.5	..
Bahrain	95.7	100.9	92.0	86.9	..
Kuwait	..	103.2	96.0	91.0	..
Libya	..	..	..	..	..
Oman	96.3	100.4	87.1	78.8	..
Qatar	89.5	101.2	93.3	95.8	..
Saudi Arabia	97.3	100.4	89.1	82.3	..
United Arab Emirates	87.8	104.1	97.7	92.8	98.3

Source: World Bank Staff estimates.

Note: The MENA region includes the resource-poor, labor-abundant (RPLA) economies of Djibouti, Arab Republic of Egypt, Jordan, Lebanon, Morocco, Tunisia, and the West Bank and Gaza; the resource-rich, labor-abundant (RRLA) economies of Algeria, the Islamic Republic of Iran, Iraq, the Syrian Arab Republic, and the Republic of Yemen; and the resource-rich, labor-importing (RRLI) economies of Bahrain, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. The West Bank and Gaza is not included in the regional or subregional aggregates.

[a] Regional REER indexes weighted by total trade.

Appendix B: Structural Reform Indicators for 2006

B1 Trade Openness

In the 2005 MENA Economic Developments and Prospects report (MEDP), the index for trade policy was constructed using a single policy-based measure (because of data limitations): the average simple tariff on imports. In the 2006 MEDP, a larger range of trade openness and facilitation measures were available. For comparability, appendix table B1 presents the abbreviated trade policy index, reflecting the status of tariff policy in 2000 versus 2005 (or the closest years available). Appendix table B2 presents the "enhanced trade policy index," utilizing not only the (a) information on tariffs (above) from UNCTAD's TRAINS (TRade Analysis and INformation System) database but also information on (b) the average number of tariff lines subject to nontariff barriers (NTBs) from the World Trade Organization's (WTO's) statistical database; in addition, the trade reform index now includes information on behind-the-border constraints to trade captured through (c) the average time (in days) necessary to comply with all procedures required to export goods (from the World Bank's *Doing Business Indicators*) and (d) the average time (in days) necessary to comply with all procedures required to import goods (again from the World Bank's *Doing Business Indicators*).

A given country's value for the abbreviated trade policy index (utilizing only information on simple average tariffs) reflects where the economy is located in a normalized cumulative frequency distribution of worldwide tariffs—where a value of "100" indicates the economy that has the lowest average tariff rate worldwide, "0" indicates the economy that has the highest average tariffs, and (by design) the world average tariff index value is "50." The index is constructed for two periods of time: 2000 and 2005.

In constructing the enhanced trade policy index, in addition to the index on tariff policy mentioned above, indexes on trade policy were constructed in a similar manner across the other three areas of trade policy information (NTBs, average time to export goods, and average time to import goods) such that for each area, a country's policy value reflected where the economy was located in the normalized cumulative frequency distribution of that policy feature worldwide, where "100" indicated the economy that had the "best" policy (lowest NTBs, lowest time to export, lowest time to import), "0" indicated the economy that had the "worst" policy, and the world average value was "50."

The composite trade policy index (the "enhanced trade policy index") was constructed by averaging across all four subindexes (recalling that each subindex reflects where the economy is located in the worldwide distribution with regard to that policy feature) and expressing the final value as a normalized cumulative frequency distribution.

Thus, a score of "100" reflects the economy that had (on average) the best trade policies (relative to the world) across a range of trade policy measures, "0" reflects the economy that had (on average) the "worst" trade policies, and the world average value was "50." Regional averages for all of the structural reform indexes reflect the simple average of the countries in that regional grouping.

Finally, "trade reform progress" was estimated as the change in each country's rank according to the (abbreviated) trade policy index between 2000 and 2005, expressed as a point in the relative cumulative frequency distribution ("100" being the highest value, representing the greatest change in rank over the period).

Appendix Table B1: Abbreviated trade policy index, 2000 and 2005, and trade reform progress
(based on simple average tariffs)

Country/region	Average tariff, 2000	Abbreviated trade policy index, 2000	Average tariff, 2005	Abbreviated trade policy index, 2005	Trade reform index, 2000–2005
Algeria	24.0	7	18.7	8	71
Bahrain	7.9	73	5.2	71	62
Djibouti	31.0	3	31.0	0	51
Egypt, Arab Rep. of	21.4	9	9.1	48	100
Iran, Islamic Rep. of	41.1	1	22.1	5	74
Jordan	23.1	8	13.1	21	86
Kuwait	3.6	92	3.6	92	65
Lebanon	10.7	63	5.4	71	80
Libya	17.0	27	17.0	14	27
Morocco	30.5	4	30.1	1	52
Oman	5.7	85	5.7	67	11
Qatar	..	..	5.0	74	..
Saudi Arabia	12.0	57	6.0	63	77
Syrian Arab Republic	21.0	12	19.6	6	43
Tunisia	29.1	5	28.3	3	57
Yemen, Republic of	12.8	50	7.0	58	82
MENA	**19.3**	**33**	**14.2**	**38**	**63**
Resource-poor	24.3	15	19.5	24	71
Resource-rich	16.1	45	11.0	46	57
RRLA	24.7	17	16.9	19	67
RRLI	9.2	67	7.1	64	48
East Asia and Pacific	10.4	60	7.5	57	37
Europe and Central Asia	8.9	69	6.8	67	69
Latin America and the Caribbean	13.4	45	10.2	43	50
High-income OECD	3.2	93	3.7	90	64
South Asia	24.2	21	16.8	14	48
Sub-Saharan Africa	13.5	44	13.7	30	27
LMIC average	**15.0**	**43**	**10.4**	**47**	**56**
World	**13.3**	**50**	**10.0**	**50**	**50**

Source: World Bank Staff estimates.

Note: 2005 or closest years available.

Appendix Table B2: Enhanced trade policy index, 2005

(based on simple average tariffs, NTB coverage, average time required for exporting, and average time required for importing)

Country/region	Average tariff	Tariff index (1–100)	NTB coverage (% of tariff lines)	NTB index (1–100)	Average time for exports (days)	Export time index (1–100)	Average time for imports (days)	Import time index (1–100)	Enhanced trade policy index, 2005 (1–100)
Algeria	18.7	8	0.0	88	29	52	51	27	44
Bahrain	5.2	71	0.5	40	..	..	..	..	..
Djibouti	31.0	0	2.7	24	..	..	..	..	..
Egypt, Arab Rep. of	9.1	48	6.1	7	27	55	29	62	43
Iran, Islamic Rep. of	22.1	5	0.5	40	45	17	51	27	22
Jordan	13.1	21	0.3	51	28	54	28	63	47
Kuwait	3.6	92	2.1	26	30	50	39	44	53
Lebanon	5.4	71	0.2	53	22	67	34	54	61
Libya	17.0	14	2.2	26	..	..	..	..	..
Morocco	30.1	1	0.3	51	31	47	33	55	38
Oman	5.7	67	0.0	88	23	64	27	65	71
Qatar	5.0	74	1.0	32	..	..	..	..	..
Saudi Arabia	6.0	63	1.2	30	36	32	44	33	39
Syrian Arab Rep.	19.6	6	0.5	40	49	14	63	13	18
Tunisia	28.3	3	0.0	88	25	58	33	55	51
Yemen, Rep. of	7.0	58	0.0	88	33	43	31	59	62
MENA	**14.2**	**38**	**1.1**	**48**	**31.5**	**46**	**38.6**	**46**	**46**
Resource-poor	19.5	24	1.6	46	26.6	56	31.4	58	48
Resource-rich	11.0	46	0.8	50	35.0	39	43.7	38	44
RRLA	16.9	19	0.3	64	39.0	32	49.0	31	36
RRLI	9.3	58	0.9	46	28.6	52	34.0	52	54
East Asia and Pacific	7.5	57	0.6	52	27.6	60	31.3	63	56
Europe and Central Asia	6.8	67	3.7	36	31.3	53	42.8	51	51
Latin America and the Caribbean	10.2	43	0.4	72	29.7	50	36.8	49	57
High-income OECD	3.7	90	9.7	18	12.0	86	13.4	88	70
South Asia	16.8	14	0.2	69	33.7	39	39.3	44	41
Sub-Saharan Africa	13.7	30	1.8	57	49.2	24	61.1	24	34
LMIC average	**10.4**	**47**	**2.3**	**52**	**28.5**	**55**	**33.8**	**56**	**53**
World	**10.0**	**50**	**2.7**	**50**	**32.2**	**50**	**40.4**	**50**	**50**

Source: World Bank Staff estimates.

Note: All trade policy data for 2005 or closest year available.

B2 Business Environment

In the 2005 MEDP, the business environment was measured across a range of World Bank *Doing Business Indicators* of business regulations and procedures, supplemented with financial sector information from *World Development Indicators*. Composite indexes were developed across five separate areas of business regulations and financial and legal development; based on these, a "composite index of business reform" was developed.

In the 2006 MEDP, much of that information is retained, but where possible, additional information (including with regard to the financial sector) has been supplemented to enhance our evaluation of the business and regulatory environment.

The "abbreviated business climate index" is constructed utilizing information in four areas of the business regulatory environment and across two periods of time (generally 2003 and 2005)[120]:

(1) *Starting a business:* Comprising four separate components from the *Doing Business Indicators*: (a) the number of procedures for starting a business, (b) the time required to complete the procedures, (c) the cost for starting a business (in income per capita), and (d) the minimum capital required to start a business (in income per capita). Available for 2003 and 2005.

(2) *Hiring and firing*: Comprising two *Doing Business* indexes measuring the difficulty of hiring and the difficulty of firing. The difficulty-of-hiring index measures a variety of aspects of hiring, including (a) whether term contracts can be used only for temporary tasks; (b) the maximum duration of term contracts; (c) 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: (a) whether redundancy is grounds for dismissal; (b) whether the employer must notify the labor union or the labor ministry for firing one redundant worker; (c) whether the employer must notify the labor union or the labor ministry for group dismissals; (d) whether the employer needs approval from the labor union or the labor ministry for firing one redundant worker; (e) whether the employer needs approval from the labor union or the labor ministry for group dismissals; (f) whether the law mandates training or replacement before dismissal; (g) whether priority rules apply for dismissals; and (h) whether priority rules apply for reemployment. Available for 2003 and 2005.

(3) *Access to credit*: Comprising two separate measures of credit from the *World Development Indicators* database: (a) domestic credit provided by the banking sector as a share of GDP and (b) domestic credit provided to the private sector as a share of GDP. Available for 2002 and 2004.

(4) *Enforcing contracts:* Comprising three separate *Doing Business* components: (a) the average number of procedures required to enforce a contract, (b) the number of days required to enforce a contract, and (c) the average cost to enforce a contract (in country income per capita). Available for 2003 and 2005.

In addition to composite indexes for each area of business regulation and financial and legal infrastructure, an overall business environment index ("abbreviated business reform index") was computed as the average of the four area composite scores, expressed as a relative cumulative frequency, with a score of "100" reflecting the country that had (on average) the "best" policies across the four areas of the business environment measured.

For the 2006 MEDP, in addition to the four areas mentioned above, four new areas of information were incorporated into the business climate index:

(5) *Closing a business*: Comprising two *Doing Business* components: (a) the average time (in years) to close a business and (b) the cost (in percentage of estate).

(6) *Dealing with licenses*: Comprising three *Doing Business* components: (a) the average number of procedures to build a warehouse, (b) the average time (in days) spent during these procedures, and (c) the average cost (in income per capita) to comply with these procedures.

(7) *Registering property*: Comprising three *Doing Business* components: (a) the number of proce-

[120] One area of business and regulatory reform, the ease of closing a business, is not presented in the abbreviated reform index although it was originally available in the 2005 MEDP, because the information used to construct that index has been revised and historical information is no longer available. That area of reform is now only covered in the enhanced business reform index.

dures legally required to register property, (b) the time spent in completing the procedures (in days), and (c) the costs (as a percentage of property value) for these procedures, including fees, transfer taxes, stamp duties, and any other payments to the property registry, notaries, public agencies, or lawyers.

(8) *Paying taxes*: Comprising three *Doing Business* components: (a) the total number of taxes paid (number); (b) the time it takes to prepare, file, and pay (or withhold) the corporate income tax, the value added tax, and the social security contributions (in hours); and (c) the total amount of taxes payable by a business, except for labor taxes (as a percentage of gross profit).

In addition, the previous reform area, Access to Credit, was enhanced to include, in addition to the two components mentioned, information on two *Doing Business* components of access to credit: (a) the legal rights index, measuring the degree to which collateral and bankruptcy laws facilitate lending and (b) the credit information index, measuring the scope, access, and quality of credit information. Information available for 2005.

As with the trade policy index, the business and regulatory climate index (both the abbreviated and the enhanced versions) was constructed by initially evaluating each subindicator based on a worldwide cumulative frequency distribution of that area, with a maximum value of "100" (best policies), a minimum value of "0" (worst policies), and a worldwide mean of "50." The composite index for any area of the business climate (for example, the composite index for ease in closing a business) represents the average of the underlying distributions, expressed as a normalized cumulative frequency distribution with mean "50." Thus, a score of "100" reflects the economy that had (on average) the best policies for closing a business (relative to the world) across the range of measures of ease of closing a business, "0" reflects the economy that had (on average) the "worst" policies for closing a business, and the world average value was "50."

The composite business climate index (both the abbreviated and the enhanced versions) reflects the average of each composite subindex (the average of the composite indexes for closing a business, hiring and firing, and so forth), expressed as a normalized cumulative frequency distribution.

Finally, "business reform progress" was estimated in two steps: A composite progress index was calculated for each of the four subindexes used in constructing the abbreviated business reform index (enforcing contracts and so forth) by calculating the country's change in ranking worldwide according to that indicator and expressing it as a cumulative frequency distribution (where "100" reflects the country that made the strongest progress worldwide with regard to improving its worldwide ranking according to that index, and "0" reflects the country that made the weakest progress). The overall business reform progress index then represents the average of those four composite progress indexes, expressed again as a cumulative frequency distribution. Thus, "100" reflects the country that made the strongest progress along all areas of business and regulatory reform, while "0" reflects the country that made the weakest progress.

Appendix Table B3: Abbreviated business climate index, 2003 and 2005, and business reform progress
(based on five areas of business and regulatory reform)

	2003					2005					
Country/region	Contract enforce-ment	Access to finance	Hiring and firing	Starting a business	Abbreviated business climate index	Contract enforce-ment	Access to finance	Hiring and firing	Starting a business	Abbreviated business climate index	Business reform
Algeria	18	39	33	28	14	16	36	35	30	17	38
Bahrain	..	70	..	..	..	..	..	..	..	..	..
Egypt, Arab Rep. of	26	78	37	15	31	24	85	13	26	27	36
Iran, Islamic Rep. of	64	49	46	69	67	64	63	28	65	61	44
Iraq	54	..	..	..	..	53	..	30	25	25	..
Jordan	64	76	58	4	50	63	84	59	23	64	89
Kuwait	42	82	77	49	74	38	82	84	43	71	7
Lebanon	11	91	60	41	51	9	92	71	36	54	31
Libya	..	47	..	..	..	..	12	..	..	..	..
Morocco	82	73	32	34	61	82	79	16	67	69	54
Oman	48	58	59	68	65	43	58	76	60	66	15
Qatar	..	49	..	..	..	..	49	..	..	..	..
Saudi Arabia	42	71	85	5	52	39	77	84	5	52	26
Syrian Arab Rep.	6	26	56	18	13	5	..	42	13	8	5
Tunisia	97	75	34	59	80	97	81	34	74	85	93
United Arab Emirates	16	67	62	19	35	15	67	58	14	29	14
West Bank and Gaza	46	..	..	3	..	43	..	54	3	22	..
Yemen, Rep. of	65	2	56	2	16	63	7	65	3	24	57
MENA	**45**	**60**	**53**	**30**	**47**	**44**	**62**	**50**	**32**	**45**	**42**
Resource-poor	54	79	44	26	54	53	84	41	38	54	63
Resource-rich	39	51	59	32	42	37	48	56	29	39	23
RRLA	41	29	48	29	28	40	33	40	27	27	36
RRLI	37	66	70	35	56	34	67	75	31	54	15
East Asia and Pacific	41	54	69	63	60	41	60	71	61	61	47
Europe and Central Asia	57	35	46	51	46	59	47	42	56	53	64
Latin American and the Caribbean	38	50	47	41	39	38	52	46	42	40	51
OECD	84	88	56	78	86	84	87	56	77	79	50
South Asia	37	45	50	69	56	37	57	51	62	49	41
Sub-Saharan Africa	39	28	37	32	27	38	25	40	29	29	43
LMIC average	**51**	**51**	**51**	**45**	**49**	**51**	**56**	**49**	**48**	**51**	**53**
World	**50**	**50**	**50**	**50**	**50**	**50**	**50**	**50**	**50**	**50**	**50**

Source: World Bank Staff estimates.

Note: Access to finance reflects 2002 and 2004, respectively.
OECD = High-income/OECD region.

Appendix Table B4: Enhanced business climate index, 2005

(based on eight areas of business and regulatory reform)

Country/region	Contract enforcement	Access finance	Hiring and firing	Starting a business	Closing a business	Dealing with licenses	Registering property	Registering taxes	Enhanced business climate index
Algeria	16	13	35	30	73	34	11	3	13
Egypt, Arab Rep. of	24	51	13	26	14	3	14	46	11
Iran, Islamic Rep. of	64	63	28	65	34	3	39	74	57
Iraq	53	..	30	25	..	53	72	..	..
Jordan	63	75	59	23	45	60	34	92	58
Kuwait	38	79	84	43	68	37	49	..	59
Lebanon	9	82	71	36	20	39	45	73	37
Morocco	82	43	16	67	67	17	58	19	61
Oman	43	31	76	60	47	24	89	98	78
Saudi Arabia	39	80	84	5	45	78	99	97	80
Syrian Arab Rep.	5	22	42	13	48	48	48	74	30
Tunisia	97	64	34	74	87	41	55	58	83
United Arab Emirates	15	52	58	14	6	81	94	97	43
West Bank Gaza	43	..	54	3	..	49	44	..	..
Yemen, Rep. of	63	4	65	3	63	77	74	28	35
MENA	**44**	**53**	**50**	**32**	**48**	**44**	**55**	**66**	**51**
Resource-poor	53	63	41	38	47	46	42	58	50
Resource-rich	37	40	56	29	48	43	64	71	51
RRLA	40	27	40	27	55	46	49	56	40
RRLI	34	80	75	31	42	39	83	97	65
East Asia and Pacific	41	53	71	61	35	63	62	73	61
Europe and Central Asia	59	51	42	56	49	38	56	42	48
Latin America and the Caribbean	38	58	46	42	45	52	52	25	40
High-income OECD	84	90	56	77	85	78	68	71	84
South Asia	37	48	51	62	50	50	39	56	48
Sub-Saharan Africa	38	24	40	29	37	32	24	36	27
LMIC average	**51**	**59**	**48**	**48**	**49**	**47**	**53**	**46**	**50**
World	**50**	**50**	**50**	**50**	**50**	**50**	**50**	**50**	**50**

Source: World Bank Staff estimates.

Note: All business climate data for 2005 or closest year available. Access to finance indicator above differs from access to finance indicator utilized in constructing the abbreviated business climate index (in appendix table B3). Additional financial information was added, which gives a truer sense of a country's access to finance; however, some of this additional information was not available before 2005. Thus, to evaluate structural reform progress, an abbreviated version of the financial sector indicator was utilized. (See earlier discussion on construction of business environment indicators.)

B3 Governance and Public Sector Reforms

In the 2005 MEDP, governance indicators were developed based on the methodology presented in the World Bank's 2003 report on governance in the MENA region.[121] From that report, two separate spheres of governance were examined: governance related to public accountability and governance related to the quality of public administration. For comparability, those governance indicators have been computed again, utilizing the methodology established, but with a minor adjustment to the underlying data utilized and with an adjustment to the computation methodology (see discussion).

1) ***Index of public accountability (IPA):*** Comprises 11 measures:

   (a) Freedom House political rights measure
   (b) Freedom House civil liberties measure

[121] World Bank 2003b.

(c) Freedom House freedom-of-the-press ranking
(d) Center for International Development and Conflict Management (CIDCM) Polity IV database polity score
(e) CIDCM Polity IV database regulation of executive recruitment regulation
(f) CIDCM Polity IV database competitiveness of executive recruitment competition
(g) CIDCM Polity IV database openness of executive recruitment
(h) CIDCM Polity IV database regulation of participation
(i) CIDCM Polity IV database competitiveness of participation
(j) CIDCM Policy IV database executive constraints
(k) Political Risk Services index of democratic accountability

2) ***Index of quality of public administration (IQA):*** Comprises 7 measures:

(a) Political Risk Services index of corruption
(b) Political Risk Services index of bureaucratic quality
(c) Heritage Foundation index of property rights
(d) Heritage Foundation index of regulation
(e) World Bank *Doing Business* indicator of starting a business (number of procedures)
(f) World Bank *Doing Business* indicator of contract enforcement (average time)
(g) World Bank *Doing Business* indicator of closing a business (average time)

According to the methodology established in the 2003 Governance Report, principal component analysis (PCA) was performed on the 11 and 7 measures listed above to derive the two broad governance indicators; unlike in last year's MEDP, however, the methodology has been revised. The set of countries was reduced to 142 to remove countries with a large share of missing data in the subindicators. Although the PCA approach was retained, the weights applied to the normalized underlying variables were derived from the first principal component (see appendix box for a brief explanation of PCA). The same weights generated for 2000 are now used for 2005 to ensure consistency and comparability across time. In addition, the scale of the resulting index was adjusted such that a maximum score of "100" is given to a (hypothetical) country that is at the top in each underlying variable that supports a particular index, while the lowest score of "0" would be for a country that is at the bottom of each subindicator. Finally, these governance indexes were also used to determine a country's position relative to others, using percentile ranking. A country that is in the 90th percentile for a particular governance index in a selected year implies that it performed better than 90 percent of all other countries in that year.

Finally, as with the other structural reform areas, governance reform progress was estimated as the change in each country's rank according to the given governance reform index between 2000 and 2005, expressed as a point in the relative cumulative frequency distribution ("100" being the highest value, representing the greatest change in rank over the period).

Appendix Table B5: Governance indexes, 2000 and 2005, and governance reform progress

Country/region	Quality of administration, 2000	Quality of administration, 2005	Quality of administration, reform	Public sector accountability, 2000	Public sector accountability, 2005	Public sector accountability, reform
Algeria	26	38	91	22	29	91
Bahrain	80	77	26	16	23	91
Egypt, Arab Rep. of	29	43	92	19	25	84
Iran, Islamic Rep. of	23	16	19	35	21	4
Jordan	63	66	67	33	34	60
Kuwait	62	58	24	30	31	65
Libya	9	11	64	1	0	42
Morocco	66	73	83	28	33	81
Oman	56	61	75	11	16	81
Qatar	49	60	89	10	13	74
Saudi Arabia	52	57	77	3	5	69
Syrian Arab Republic	12	15	67	4	7	74
Tunisia	65	74	87	26	22	22
United Arab Emirates	74	59	6	18	17	41
Yemen, Republic of	24	28	71	13	20	89
MENA	46	49	63	18	20	64
Resource-poor	56	64	82	27	28	62
Resource-rich	42	44	55	15	17	65
RRLA	21	24	62	19	19	64
RRLI	55	55	52	12	15	66
East Asia and Pacific	44	43	45	43	41	48
Europe and Central Asia	47	47	46	51	52	51
Latin America and the Caribbean	46	46	50	58	57	53
High-income OECD	89	89	47	92	91	49
South Asia	47	48	53	47	39	31
Sub-Saharan Africa	35	34	53	35	37	55
World	50	50	50	50	50	50

Source: World Bank Staff estimates.

Note: Governance indexes reflect data for 2000 and 2005, or closest available years.

Appendix Box

Principal component analysis

Principal component analysis (PCA) is an aggregation technique designed to linearly transform a set of interrelated variables into a new set of uncorrelated principal components that account for all of the variance in the original variables. Each computed principal component is a linear combination of the underlying variables weighted to capture as much of the variance across observations in the variables as possible. There are as many principal components as there are explanatory variables. Each component is uncorrelated with the others, and each succeeding principal component accounts for as much of the variation in the explanatory variables as possible that was unaccounted for by the preceding principal components. PCA extracts from the data the true source of variation by giving more weight to those variables that vary most across countries (that is, the analysis gives more weight to underlying variables that have more useful information relative to other variables with less useful information). It should be noted that typically in PCA work, only the first one or two principal components are retained, because they generally explain most of the variance among all standardized linear combinations of the original data.

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