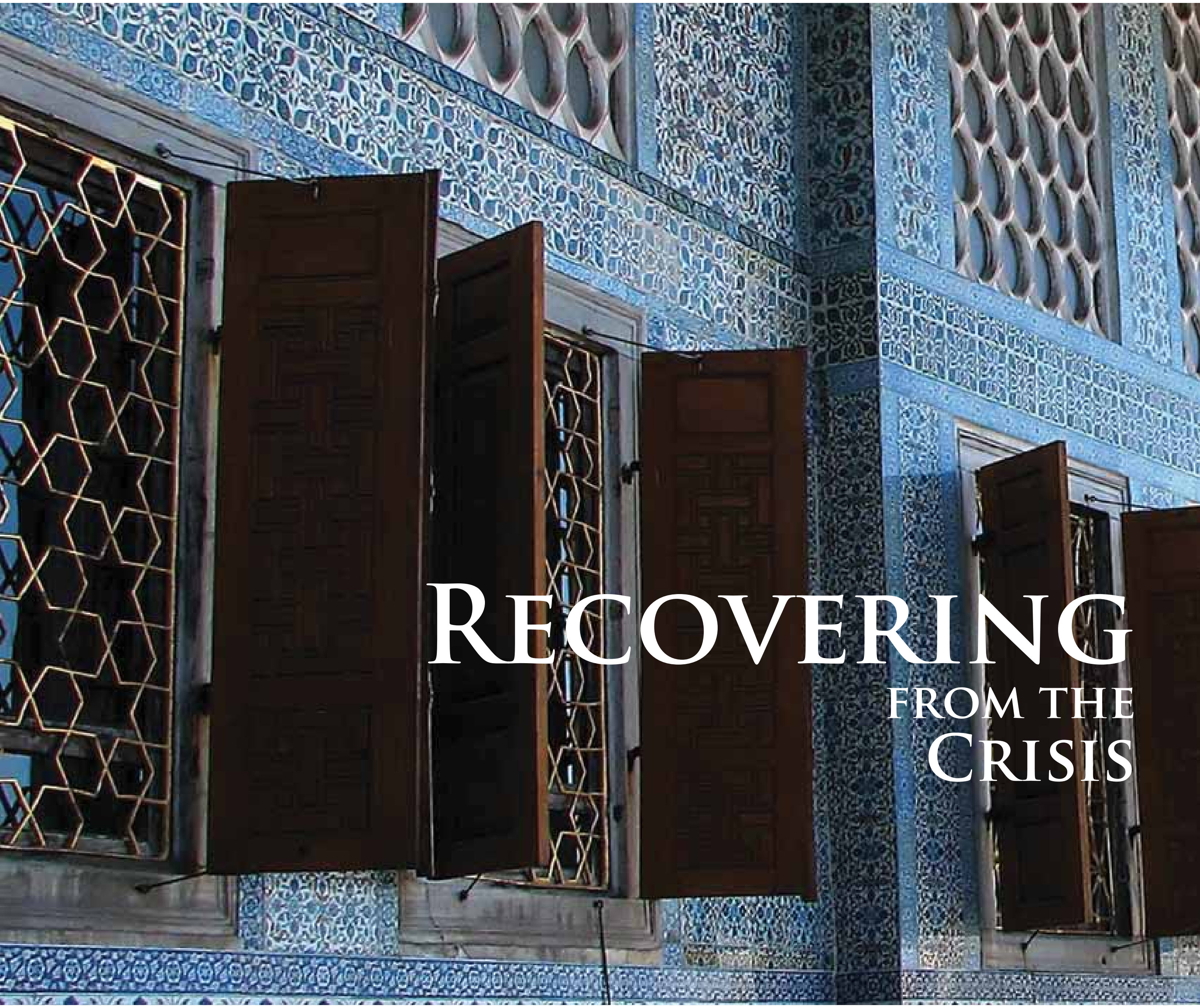
WORLD BANK **MIDDLE EAST AND NORTH AFRICA REGION – A REGIONAL ECONOMIC UPDATE**, APRIL 2010



Recovering from the Crisis

THE WORLD BANK

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The Middle East and North Africa Economic Update was prepared by Elena Ianchovichina (principal author) and a team comprising Lili Mottaghi, Kevin Carey, Nadia Spivak, Subika Farazi, and Ani Silwal. Country-specific data and information were provided by country economists and analysts working in the World Bank's Middle East and North Africa Region. The report was prepared under the guidance of Shamshad Akhtar (Vice President, Middle East and North Africa Region) and Ritva Reinikka (Acting Chief Economist, Middle East and North Africa Region). Valuable comments were provided by Roberto Rocha, Farrukh Iqbal and Mustapha Rouis.

For ease of analysis and exposition, the region is divided into three main groups: the GCC oil exporters, developing oil exporters and oil importers. The first group contains the Gulf Cooperation Council (GCC) countries, namely, Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and United Arab Emirates. The second group comprises the developing oil exporters such as Algeria, Islamic Republic of Iran, Iraq, Libya, Syrian Arab Republic, and Yemen. Oil importers include countries with GCC links (Djibouti, Jordan, and Lebanon) and those with EU links (Egypt, Morocco and Tunisia).

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CONTENTS

ABBREVIATIONS

Bbl	Barrels
BOP	Balance of Payments
Bps/bp	Basis points
CAB	Current Account Balance
CPI	Consumer Price Index
CDS	Credit Default Swaps
DECPG	Development Economics Prospects Group (World Bank)
DEV	Developing Countries
DFSF	Dubai Financial Support Fund
DW	Dubai World
EAP	East Asia and Pacific
ECA	Europe and Central Asia
EIU	Economist Intelligence Unit
EU	European Union
FDI	Foreign Direct Investment
GCC	Gulf Cooperation Council
G3	U.S., EU and Japan
GDP	Gross Domestic Product
HIY	High Income Countries
ILO	International Labor Organization
IMF	International Monetary Fund
LAC	Latin America and the Caribbean
MENA	Middle East and North Africa
MNSED	Middle East and North Africa Social and Economic Development Group (World Bank)
MSCI	Stock market index of 500 world stocks maintained by MSCI Inc
NPL	Non Performing Loans
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of Oil Exporting Countries
PPP	Purchasing Power Parity exchange rate
SA	South Asia
SAAR	Seasonally Adjusted Annual Rate
SME	Small Medium Enterprises
SSA	Sub-Saharan Africa
SWF	Sovereign Wealth Fund
UAE	United Arab Emirates
UK	United Kingdom
UNCTAD	United Nations Conference on Trade and Development
UNWTO	United Nations World Tourism Organization
U.S.	United States of America
WBG	West Bank and Gaza
WDI	World Development Indicators
WTO	World Trade Organization

SUMMARY

The Middle East and North Africa region is recovering from the financial crisis along with the global economy. Growth in 2010 is expected to be 4.4 percent region-wide, driven by domestic absorption as well as a positive contribution from external demand. The recovery from the crisis differs by country depending on initial conditions and the intensity of the impact via the three principal channels through which the global financial crisis affected MENA economies—the financial sector, the price of oil, and the balance of payments, reflecting the impact on trade, remittances and FDI flows.

The GCC countries are leading the regional recovery as oil prices have rebounded and the GCC financial sector is stabilizing. Growth in the GCC countries is projected at 4.4 percent in 2010—a remarkable comeback, given close to zero growth in 2009. These countries were hardest hit by the crisis because of a negative terms-of-trade shock associated with the drop in oil prices and a financial shock which destabilized overextended domestic banks and led to the bursting of a real estate bubble. Accumulated reserves and other assets enabled governments to respond quickly with monetary and fiscal stimuli, preventing a deeper deceleration in growth, and supporting the growth rebound.

The recovery in the GCC countries is expected to have a positive impact on other MENA countries, mainly through increased flows of remittances and FDI. The Dubai financial crisis is still unfolding, but the Dubai World debt restructuring offer has contributed to greater clarity about UAE's prospects. The restructuring package is partially funded through loans from Abu Dhabi to Dubai and its adverse impact on UAE banks is cushioned by the likelihood of increased support to these banks from Abu Dhabi and federal entities. These short-term measures are helping to contain the negative impact of these events on UAE growth. Ongoing large fiscal spending by Abu Dhabi is also expected to help the recovery and support the "service center approach" to integration and economic development. The question remains whether growth of the private sector will pick up when the public sector starts spending less, and the effects of the stimulus packages in UAE and Saudi Arabia wear off.

Growth of developing oil exporters is expected to accelerate to 4.2 percent in 2010 from 2.2 percent in 2009. Developing oil exporters felt the impact of the crisis, and now the recovery, largely through the oil price channel, due to the limited integration of their banking sectors into global financial markets and the importance of oil in their export baskets. The sustainability of their recovery therefore hinges on the evolution in the global demand for oil and oil prices. Iran and Iraq are especially vulnerable to oil price volatility. At present, further upward pressure on oil prices is not expected due to ample spare capacity and little or no growth in oil demand in the G3. Temporary spikes, however, cannot be ruled out in response to unanticipated shocks over the course of 2010–11. Recognizing their vulnerabilities, most countries in this group have launched stimulus packages, but the extent to which they have been able to respond has varied depending on their fiscal space, accumulated reserves, and access to external financing.

The oil importers felt the impact of the crisis through the secondary effects of the crisis on trade, remittances, and FDI flows, so their recovery will depend crucially on the recovery in key markets, especially the EU and the GCC countries. The feeble recovery expected in the euro zone will drag down growth in the near term, particularly the growth of those with strong links to EU markets. Growth of oil importers is expected to decelerate to 4.5 percent in 2010 from the moderate, yet respectable pace of 4.8 percent in 2009, when key non-oil sectors, such as services, remained relatively resilient. Trade is recovering, with export revenue of oil importers expected to grow by 7.7 percent in 2010, after contracting by 13 percent in 2009. Remittance flows are expected to grow by 1.3 percent in 2010, albeit this pace is much slower than the one observed during the pre-crisis years. The crisis has not led to reform reversals, and reforms have broadly remained on track, while in some cases countries have steamed ahead with reforms started prior to the crisis. Examples of the latter include the financial sector reform in Egypt and trade liberalization and economic integration in Tunisia. Fiscal policy is expected to continue to be expansionary, as countries use various measures to stimulate demand, and in some cases the private sector. Expansionary fiscal policy will have an adverse effect on fiscal balances. For some oil importers, including Lebanon, Jordan and Egypt, the fiscal space is limited and the fiscal situation may become a long-term growth issue, hence the need for these countries to trim fiscal deficits in the coming years.

High unemployment has been a problem in MENA for years, and the crisis has dimmed prospects for improvements in the near term. While the impact of the crisis on official unemployment rates has been negligible in most MENA countries, participation rates which were already low compared to other countries prior to the crisis, have declined as discouraged workers dropped out of the labor force and decided not to seek work in the official labor market. In addition, aggregate labor statistics hide the negative impact on some sectors. Workers in the manufacturing sectors have been especially vulnerable during this crisis, although job losses in these sectors were offset to some extent by the job creation in the non-tradable goods and services industries.

The World Bank Group responded actively to the economic downturn in the MENA region. In Iraq, where the fall in oil prices severely affected public finances, the World Bank provided financial support through a development policy loan, working closely with the IMF. In oil importing countries, such as Egypt, Jordan, Morocco and Tunisia, the World Bank has provided technical support through diagnostics work as well as financial support through several development policy operations focusing on financial sector, public sector reforms and trade integration. These operations also aim to build crisis resilience for the future. In the GCC countries, the short-term response of the World Bank Group was to step up economic and financial monitoring. IFC's Global Trade Finance Program has helped businesses, especially small ones, access trade finance, while its Global Trade Liquidity Program has helped infuse liquidity into the trade finance market. IFC has also helped banks across the MENA region by sharing views and solutions on how to successfully navigate the crisis, structure robust risk management systems, and train key bank staff on risk management.

Ample oil and gas resources, a youthful and growing workforce, and a growing momentum to look for ways to diversify their economies imply that the growth potential of the region is high. Looking beyond the next couple of years, however, MENA countries continue to face formidable longer term challenges. Standards of living in the region have stagnated as income growth has not been sufficient given MENA's high population growth. High unemployment rates, particularly youth unemployment, low labor force participation, especially for females, and informality have translated into one of the world's lowest formal employment rates. Private investment rates have not increased commensurately with greater market and private sector orientation in most countries in the region. Among key long term growth challenges are access to finance, which is very low in MENA, competitiveness, and the non-competitive business environment facing enterprises in MENA.

Ensuring access to finance without compromising financial stability will be a major challenge in MENA, although issues related to weak regulatory systems, corporate governance and overdependence on the banking system also loom large. The slowdown of credit growth as a result of the crisis has added urgency to the access agenda because the credit tightening expected in the post-crisis period affects disproportionately the underserved segments, typically high risk households and firms. Addressing the stability agenda will be equally challenging. The pre-conditions for effective market discipline are weaker in MENA than in developed countries due to weaker institutions and less sophisticated market players. In addition, the generous support programs in response to the crisis may have further weakened financial institutions. The severity of the financial crisis and the uncertainty about how the financial system will evolve has sparked interest in regional and domestic financial markets. Pursuing financial integration in MENA might be a good strategy given the mix of countries, which include both capital exporters (the GCC countries) and capital importers (oil importing countries), as this would facilitate trade integration.

Key problems of the business environment in MENA include policy and regulatory uncertainty and discretion in implementing reforms which prevent a level playing field for all firms and encourage the pursuit of privileged access. These problems, coupled with barriers to entry and exit, have created an environment of stagnation. Addressing these issues will require applying rules and regulations consistently and without discrimination among firms and introducing reforms that promote business dynamism, private investment, and innovation.

I. THE IMPACT OF THE CRISIS DIFFERED AMONG MENA COUNTRIES, AND SO DOES THEIR RECOVERY

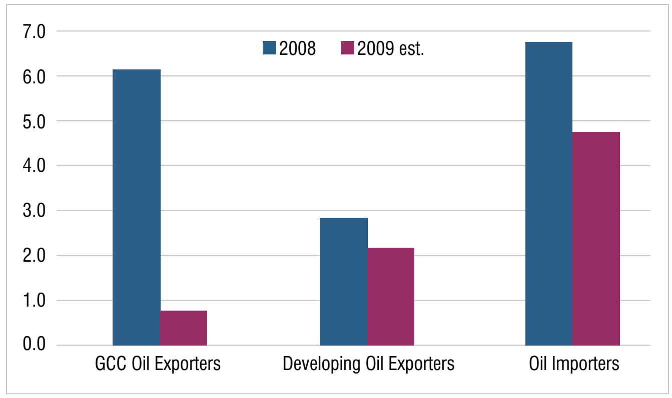
ONE CRISIS, DIFFERENT IMPACTS AND CHANNELS OF TRANSMISSION

The global financial crisis of 2008 resulted in the worst global recession since World War II, and had a direct, negative impact in MENA through the decline in oil prices and turmoil in international financial markets. MENA was also hit by the secondary effects of the crisis on trade, remittances, and FDI. Countercyclical policies and financial sector support measures are expected to have limited the decline in output in 2009 by encouraging consumption and investment activity (Table 1). In addition, a significant adjustment in imports is expected to have occurred between 2008 and 2009 due to compression in investment, private expenditure, and a decline in imports of intermediate inputs used in the production of exports.

The impacts of the crisis on the GCC oil exporters, developing oil exporters and oil importing countries differed substantially (Figure 1)—a fact obscured by the aggregate statistics, which show a much smaller deceleration in regional growth than the declines observed in most other middle-income regions (Figure 2). Among these three groups, the GCC oil exporters were hardest hit because the crisis affected them directly through two channels (i) a negative terms-of-trade shock associated with the drop in oil prices (Figure 3), and (ii) a financial shock which destabilized overextended domestic banks and led to the bursting of a real estate bubble. Growth plummeted for this group of countries from just above 6 percent in 2008 to an estimated 0.8 percent in 2009. Ample fiscal space, reserves and repatriated funds enabled governments to respond quickly with monetary and fiscal stimuli and prevent a deeper deceleration in growth.

Figure 1. Real GDP growth rates

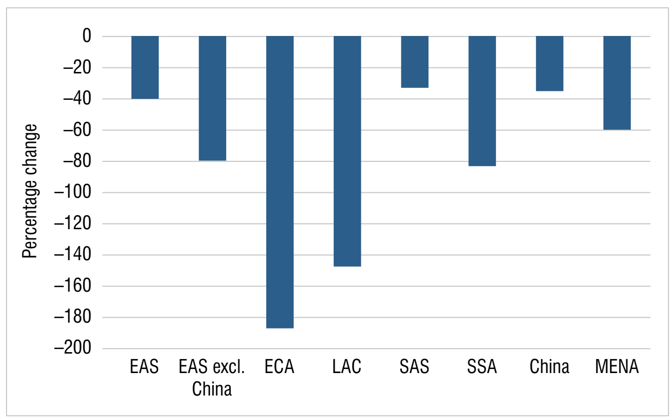
(percent)



Source: National agencies and World Bank staff estimates for 2009.

Figure 2. Decline in growth rates between 2007 and 2009

(% changes)



Source: World Bank data.

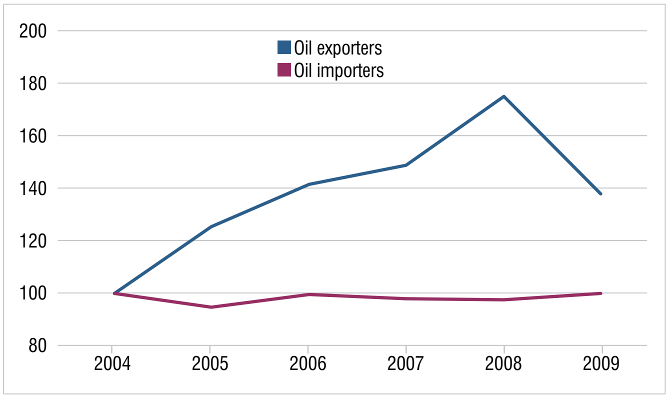
Table 1. Sources of growth in MENA by demand component

Contribution to Growth	GDP growth, %	Private Consumption	Government Consumption	Gross Domestic Investment	Exports of Goods and Services	Imports of Goods and Services
2007	5.6	4.4	2.5	4.3	2.2	–7.8
2008	5.4	3.3	2.2	2.8	2.7	–5.5
2009f	2.2	1.5	2.0	0.7	–1.0	–1.0
2010f	4.4	2.6	1.9	1.8	1.4	–3.3

Source: Staff calculations based on World Bank projections. Data for 2009 and 2010 are forecasts.

Figure 3. Terms of trade change

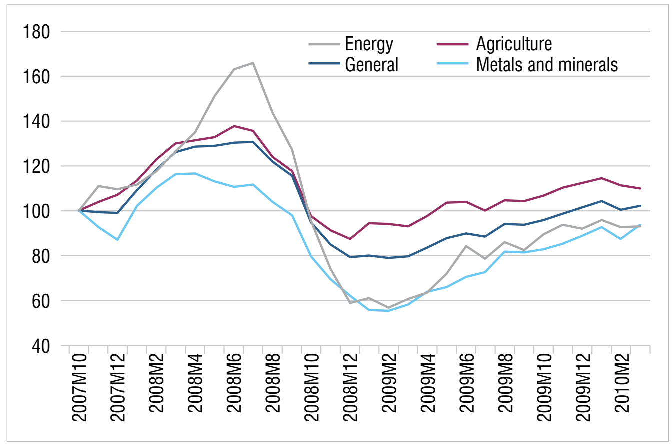
(Index, 2004 = 100)



Source: EIU; Simple averages.

Figure 4. Trends in key commodity prices

(Index, 2007M10 = 100)



Source: Bloomberg.

Due to the limited integration of their banking sectors into global financial markets, developing oil exporters felt the impact of the crisis mostly through the negative oil price shock. Growth declined only slightly from 2.9 percent in 2008 to 2.2 percent in 2009. Although typically these countries pursue pro-cyclical fiscal policies, during this crisis some governments responded with counter-cyclical measures, but the extent to which they were able to do so depended on their fiscal space, accumulated reserves and access to external financing. Strong non-oil GDP growth—at nearly 5 percent in 2009, helped soften the decline in overall growth.

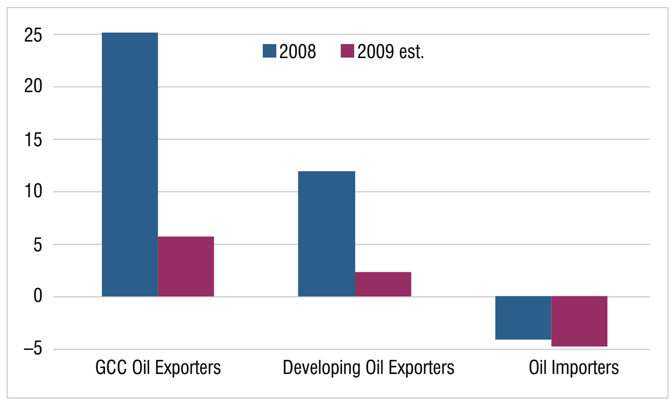
Oil importing MNA countries were hurt mostly by the secondary effects of the crisis on trade, remittances and FDI. Growth, which was high before the crisis, decelerated from close to 7 percent in 2008, to a moderate pace of 4.8 percent in 2009. Key non-oil export sectors such as services remained relatively resilient, while the decline in oil and other commodity prices (Figure 4) limited the deterioration of their external balances (Figure 5). Stimulus packages in Egypt, Morocco, Tunisia, and Jordan also helped soften the deceleration in growth.

THE GCC COUNTRIES WERE HIT HARD, BUT USED AMPLE RESERVES TO RESPOND FAST

As oil prices halved between 2008 and 2009, and GCC oil exporters cut production in order to support oil prices in the face of weakened global demand, there was a dramatic negative shock to their output growth (Figure 1), current and

Figure 5. Current account balances

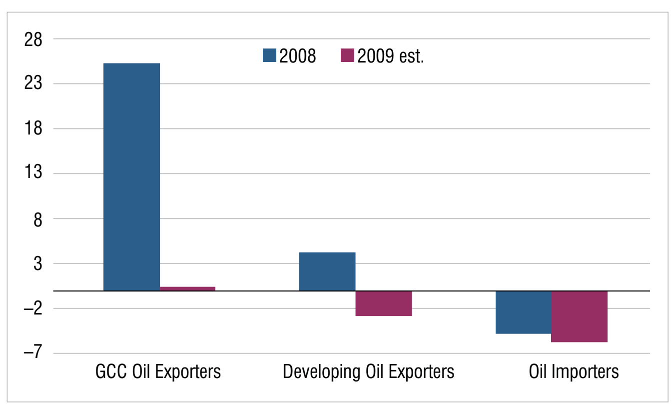
(% of GDP)



Source: National agencies and World Bank staff estimates for 2009.

Figure 6. Fiscal balances deteriorated as a result of the crisis

(% of GDP)



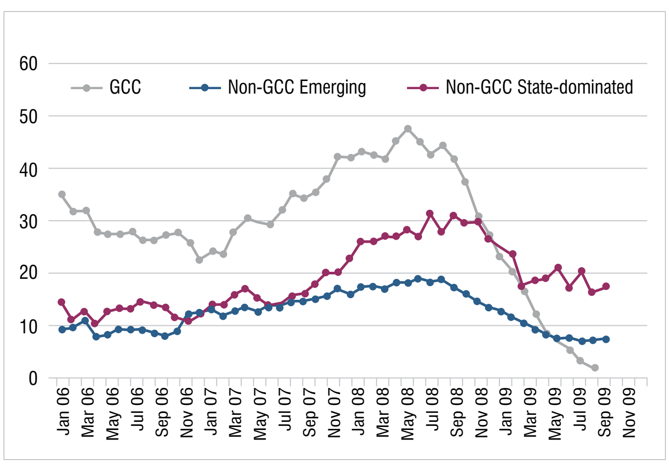
Source: World Bank, MNSED. Data for 2009 are forecasts.

fiscal accounts (Figure 5 and Figure 6). Although in most cases countries' current accounts remained in surplus, the external positions of GCC oil exporters deteriorated markedly, reflecting the fall in oil prices and production (Figure 5). Fiscal balances deteriorated too (Figure 6) reflecting the negative shock to oil revenue and the increase in government spending in response to the crisis.

The health of the banking sector in the GCC countries deteriorated substantially, as credit had expanded at very high rates,[1] banks had become overextended as indicated by high loan-to-deposit ratios and reliance on foreign borrowing, and exposed to real estate lending.[2] Sudden funding problems emerged as a result of the freezing of international wholesale debt markets,[3] while the collapse of the real estate market threatened the solvency of several GCC banks. As a result, credit growth plummeted between September 2008 and September 2009 (Figure 7), while many projects at different stages of planning and implementation were placed on hold by the end of 2009.[4] Stock market capitalization fell down considerably and volatility increased. Syndicated lending, an important part of portfolio flows to the GCC countries, declined dramatically between 2007 and 2009, as a result of the damage to banks' balance sheets and the tightening of credit standards. GCC Sovereign Wealth Funds (SWF) sustained losses estimated by market analysts at between 20–30 percent in 2008.[5]

All GCC governments responded quickly with policies that had many common elements with the support measures introduced in the US, EU and Eastern Europe, and intended to ensure financial sector stability. These policies included monetary easing, liquidity support from central banks or government guarantees on deposits and debt, capital injections and asset purchases. Saudi Arabia and UAE used fiscal stimulus packages to enhance economic prospects in the near term, but also to support reform and long-term growth. The government of Saudi Arabia spent half of the funds pledged on its $400 billion five-year investment program since the beginning of the financial crisis. This spending was the largest as a share of GDP of any G-20 countries, and is frequently cited as the country's G-20 stimulus contribution to the global recovery because of its high import content. Foreign exchange reserves accumulated during the oil boom enabled these governments to implement both financial sector support measures and countercyclical fiscal policies (Figure 8).[6]

Figure 7. Credit growth in MENA (YoY, in percent)



Source: IMF, International Financial Statistics. Non-GCC state-dominated economies refer to the developing oil exporters, while non-GCC emerging economies include the MENA oil importers.

DEVELOPING OIL EXPORTERS WERE AFFECTED BY THE DECLINE IN OIL PRICES

Developing oil exporters were hurt less than GCC oil exporters as they felt the impact of the crisis only through the oil channel (Figure 1). Furthermore, strong non-oil growth, estimated at nearly 5 percent in 2009, helped soften the decline in overall growth. Non-hydrocarbon growth was helped by a good harvest, which translated into high output growth in the agriculture sector, and an expansion of services and construction activity in response to increased public spending. Public spending in these countries is typically pro-cyclical, but in the current crisis, for example, Iran and Algeria, used monetary easing and fiscal stimulus to encourage economic activity.

1 Real credit growth averaged 23 percent a year during 2003–08, and led to increased bank leverage and almost doubling of the ratio of private sector credit to non-oil GDP (122 percent by end-2008). Excess credit measured as the cumulative deviation from trend credit as a share of non-oil GDP during the period 2005–08 was significant in all countries except Kuwait and Oman. This credit growth fueled a real estate bubble, and encouraged the use of leverage in the corporate sector (Source: IMF, 2010. *Impact of the Global Financial Crisis on the Gulf Cooperation Council Countries and Challenges Ahead*).

2 However, the banking sector in GCC countries had low exposure to toxic assets issued in the US and elsewhere.

3 Oil market developments had an indirect impact on banking and corporate liquidity and funding costs as speculative capital flows left the region and investor confidence plummeted.

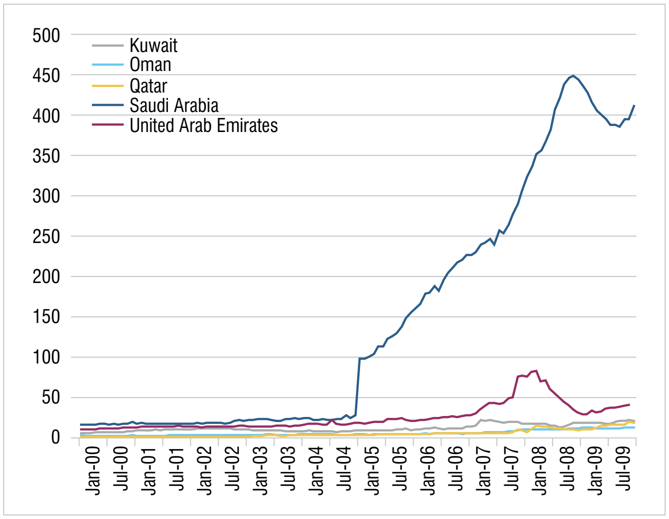
4 Nearly a quarter of an estimated $2.5 trillion of projects as of end-2008 were placed on hold by end-2009.

5 Source: IMF (2010) *Impact of the Global Financial Crisis on the Gulf Cooperation Council Countries and Challenges Ahead*.

6 It is difficult to compare reserves among GCC countries, given the role of SWFs in some countries. For instance, while Saudi Arabia accumulates its windfall oil revenue as reserves, other countries such as UAE uses SWFs instead.

Figure 8. International reserves

(US$ billion)



Source: IMF, International Financial Statistics.

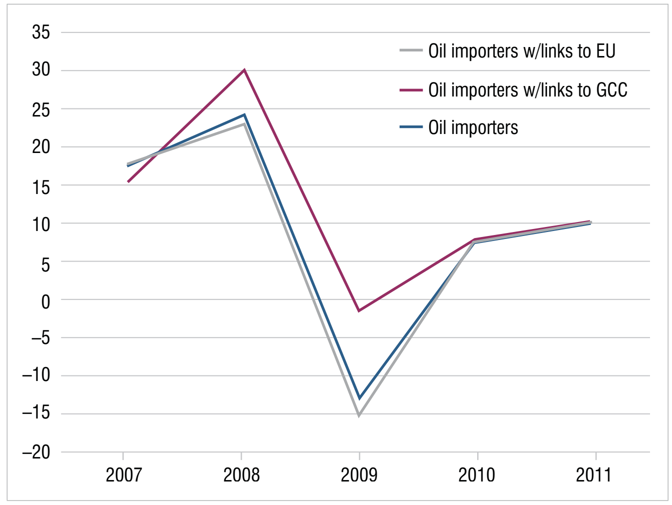
The financial sectors of developing oil exporters were not affected by the global financial crisis due to the underlying government guarantees and the fact that the banking sectors in these countries have remained isolated from global financial markets. Credit growth was much lower prior to the crisis in the developing oil exporters than in the GCC countries, and therefore these countries experienced only a moderate decline (Figure 7). However, the financial sectors of these countries, which are still state-dominated sectors, face chronic inefficiencies and persistently large NPL ratios, implying the need for recurrent recapitalizations by the State. During the current crisis, state banks maintained the pace of lending in Algeria and Libya. In the specific case of Algeria, banks were also instructed to increase SME lending by 20 percent per year.

SECONDARY EFFECTS THROUGH TRADE AND REMITTANCES AFFECTED OIL IMPORTERS

Growth of MENA's oil importing countries decelerated from 6.8 percent in 2008 to 4.8 percent in 2009, mostly because of the secondary effects of the crisis on trade and remittances, and in some cases because of its negative effect on FDI. The revenue from exports of goods and services declined by almost 13 percent in 2009 (Figure 9), while remittances were somewhat more resilient and contracted by 8.4 percent (Figure 10).

Figure 9. Growth in exports of goods and services

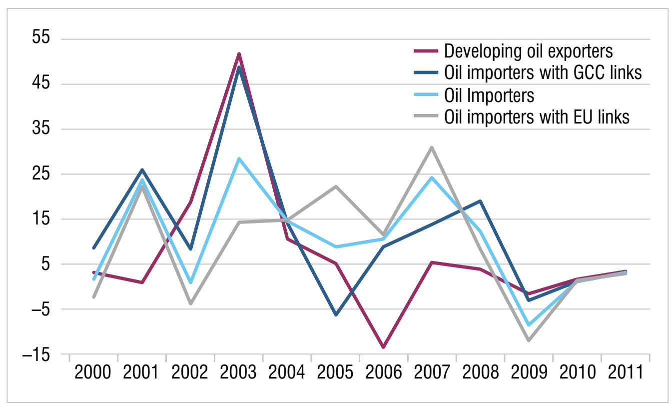
(% change in values)



Source: World Bank, DECPG; Staff estimates for 2009 and projections for 2010 and 2011.

Figure 10. Growth in remittances

(% change)



Source: World Bank, DECPG; Staff estimates for 2009 and projections for 2010 and 2011.

The financial sectors of these countries remained relatively unaffected by the developments in global financial markets as banks in oil importing countries were less overextended than those in the GCC countries. In the fall of 2009, the average loan-to-deposit ratio for this group of countries was slightly below 80 percent, compared to 100 percent in the GCC, although the variance was considerable with Morocco and Tunisia showing averages above 100 percent and Lebanon at 30 percent. In addition, with the exception of Jordan, these countries' relied much less on foreign borrowing than the GCC countries. Consequently, the deceleration in credit growth during the crisis was much more moderate than the one observed in the GCC countries, and was caused mostly by the slowdown in economic activity which led to a decline in demand for credit.

As the crisis unfolded only Jordan, Morocco and Tunisia had to introduce different types of financial support measures. For example, Tunisia and Morocco introduced liquidity support, while Jordan offered deposit guarantees, and monetary easing. In other oil importing countries, the policy responses focused on mitigating the impact on the real economy. Egypt and Tunisia passed fiscal stimulus packages geared toward job-creating infrastructure investments. Tunisia also introduced measures in support of SMEs and employment. Morocco implemented measures to help firms cope with the decline of external demand including guarantees of working capital loans, easing of regulation, and debt rescheduling facilities.

Export revenue and remittances of oil importers with links to GCC markets declined a lot less than those with links to EU markets as the EU contracted by nearly 4 percent in real terms, whereas output in the Gulf expanded by almost 1 percent in 2009. Remittances contracted slightly more than export revenue for the oil importers with GCC links (Figure 9 and Figure 10), while FDI held up relatively well. Djibouti, however, remains vulnerable as current estimates suggest that its FDI levels might decline substantially due to cancellations and postponement of investment projects in 2008. Djibouti's economy depends heavily on activities in UAE as Dubai World is a large investor in port infrastructure and hotels, and manages the ports and free zones in the country. Growth decelerated in Lebanon too but the country grew at a much faster pace than other countries, helped by strength in certain sectors—tourism and real estate, and vibrant private investment.

Output growth of the oil importers with strong links to EU markets weakened in 2009 relative to 2008 as manufacturing activity contracted in response to cutbacks in European demand for goods and services. Export revenue declined by 15 percent while remittances contracted slightly less than that (Figure 10). Growth, however, remained moderate due to the strong expansion of agriculture and the improved performance of services. In Morocco, for instance, the expansion of the agriculture sector was remarkable due to a record output of cereals.

THE CRISIS HAS DIMMED PROSPECTS FOR IMPROVEMENT IN PERSISTENTLY HIGH UNEMPLOYMENT RATES IN THE SHORT RUN

High unemployment has been a problem in MENA for years, and the crisis has dimmed prospects for improvements in the near term. While the impact of the crisis on official unemployment rates has been negligible in most MENA countries, participation rates which were already low compared to other countries prior to the crisis, have declined as discouraged workers dropped out of the labor force and decided not to seek work in the official labor market. Workers in the manufacturing sectors have been especially vulnerable during this crisis. Firms in these sectors scaled down their activities, reduced working hours, and even shed jobs in order to adjust to the drop in external demand. The good news is that the job losses in these sectors were offset in most cases by the job creation in the non-tradable goods and services industries.

In the GCC countries, official labor market statistics do not reflect the full impact of the crisis on the labor market as these countries rely heavily on migrant workers. A large number of migrants have residence permits linked to employment contracts. When these workers are made redundant, they are more likely to return to their countries of origin, and therefore drop out of the labor force of the country of destination.[7] In addition, some GCC countries enacted laws restricting the termination of national workers, which helped secure their jobs in the short run, but disadvantaged expatriate workers. In Kuwait, for instance, despite receiving considerable attention in the media, just 1000 Kuwaitis have lost their jobs in 2009. This is not surprising given that most nationals hold government jobs or work in the private sector in positions that are much more secure than those of expatriate employees.

The crisis harmed the incomes of households dependent on remittances. According to estimates by the World Bank, in 2009 the decline of remittance flows to oil importers with strong links to EU markets was nearly as large as the decline of their export revenue, close to 12 percent (Figure 9 and Figure 10). Remittance flows to other developing MENA countries declined as well but the decline was much smaller than the one

7 By contrast, migrant workers in Europe can often remain and "sit out the crisis" in the country of destination.

registered in oil importing countries with link to EU markets (Figure 10).

The decline in growth is expected to result in a decline in the rate of poverty reduction in the region. According to recent estimates, because of the economic crisis, approximately 2.6 million more people are expected to fall into poverty in the region by 2011, with nearly half of those residing in Egypt.[8] Any weakening of the rate of poverty reduction is a cause for concern because, while absolute poverty in MENA is relatively low,[9] vulnerability is very high. In 2005, 17 percent of MENA's population lived on $2 a day PPP, and a sizeable share of the population lived on more than $2 a day PPP, but less than $2.5 a day PPP. In addition, more than a third of the region's workers are in vulnerable types of employment. These workers are less likely to have formal work arrangements, and are therefore more likely to lack benefits and rights associated with decent employment such as adequate social security and recourse to effective social dialogue mechanisms.

8 Source: Yemtsov and Iqbal (2009). Lack of high frequency data on household incomes and expenditures makes it difficult to assess the impact of the crisis on the poor. These estimates are based on a number of assumptions and past patterns of poverty and growth.

9 In 2005, 5 percent of the MENA population lived on less than $1.25a day.

II. THE RECOVERY UNDERWAY

MENA IS RECOVERING ALONG WITH THE GLOBAL ECONOMY

The region is expected to grow in the next couple of years at the same pace it did in the early 2000s. Real GDP growth is projected to reach 4.4% in 2010 driven by domestic absorption as well as a positive contribution from external demand (Table 1). Government consumption is expected to remain stable, reflecting governments' continued supportive policies. Most importantly, exports are expected to contribute positively to growth in 2010. Led by a strong rebound of economic activity in Emerging Asia, the global economy is recovering (Figure 11), helped by a combination of timely fiscal and monetary stimuli in many countries, notably China, and inventory restocking that began in the second half of 2009. Global growth rates are recovering in a V-shaped fashion, along two tracks which reflect the slower recovery path of advanced economies compared to that of developing countries (Figure 11).

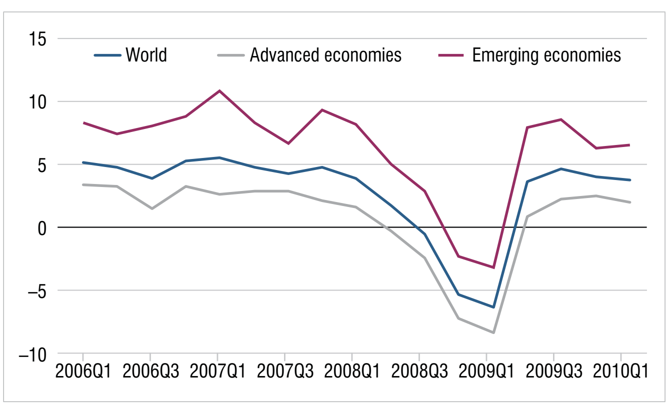
The severity of the recession and the relative weakness of the expected recovery suggest that significant spare capacity, high unemployment and weak inflationary pressures will continue to characterize the environment for both developed and developing economies. The rebound in advanced economies has been sluggish, jobless and credit-constrained. Whether this rebound turns into a sustained recovery depends on how the global economy adjusts to a new economic context in which the US and other deficit countries moderate their deficits as they start exporting more and importing less from the rest of the world, while surplus economies moderate their surpluses by encouraging domestic demand and investment (Figure 12). So far, major economies have simply shifted liabilities from the private to the public sector, postponing a needed adjustment, and the private sector in many developed economies remains highly indebted.

Global industrial production has responded strongly to changes in global growth, particularly to changes emanating from trade and investment during 2009. Industrial production in developing countries has recovered much faster than the rate observed in advanced economies, but as of February 2010 remains below its pre-crisis level in most countries except China, India and some fast growing Asian economies (Figure 13).

Global trade is rebounding too, driven by robust import demand from developing countries. Their imports grew in value terms by 64 percent in January 2010 compared to a year earlier, nearly twice the rate at which imports of developed countries recovered during the same period (Figure 14). Global exports are also recovering with the expansion of developing countries again surpassing that of high income economies (Figure 15). And, global trade volumes are expected to be back to pre-crisis

Figure 11. Two-track, V-shaped recovery

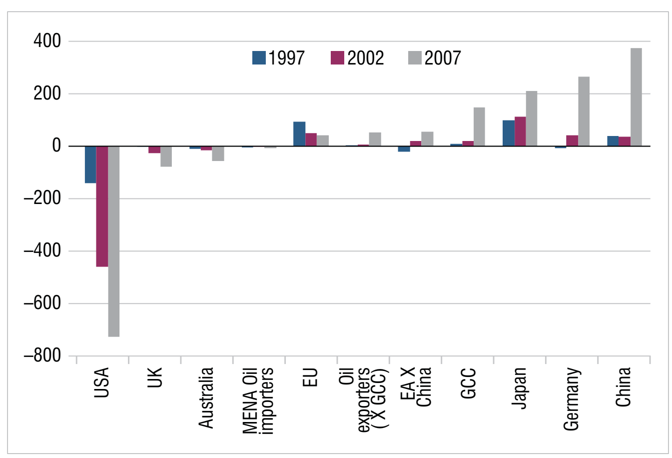
(real GDP, % change quarter-on-quarter)



Source: IMF

Figure 12. Current account surpluses and deficits

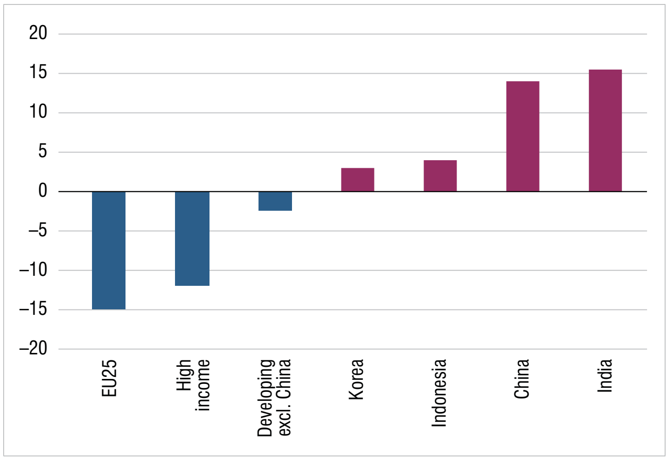
(US$ billions)



Source: World Bank, WDI.

Figure 13. Industrial production

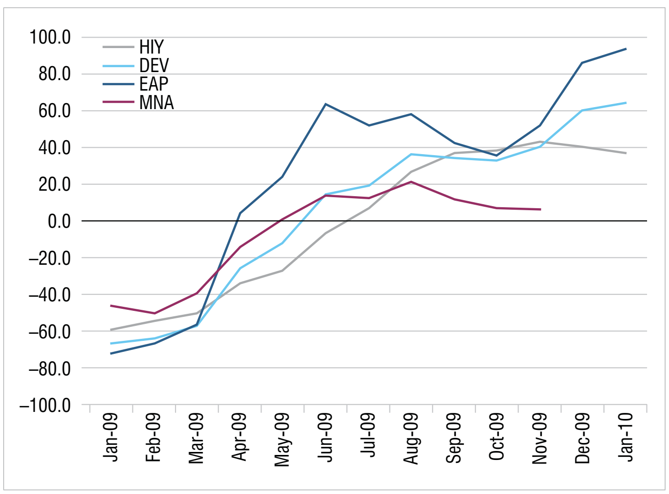
(percent difference from peak to February 2010)



Source: World Bank based on data from Datastream.

Figure 14. Import growth, seasonally adjusted annualized growth rate in values

(percent)



Source: DECPG.

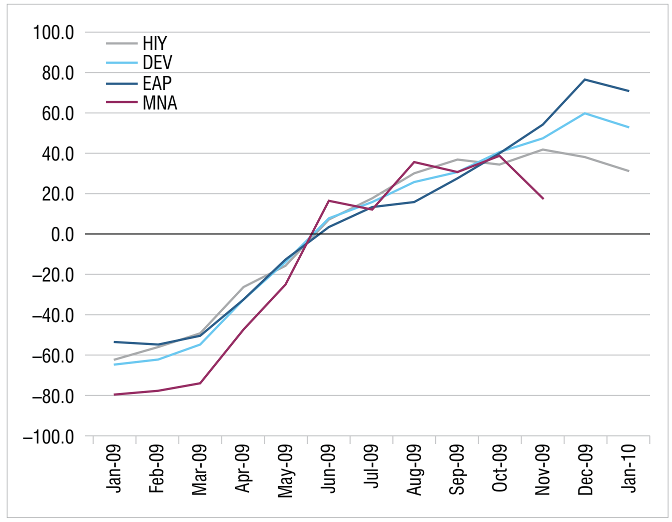
levels by end of 2010.[10] But, apart from energy exports, so far the recovery of MENA's trade has been weak relative to those of other developing countries, and even high income economies (Figure 14 and Figure 15).

GCC ECONOMIES ARE LEADING THE REGIONAL RECOVERY

GCC economies have started growing at moderate rates as oil demand picked up and the GCC financial sector is stabilizing. The rebound in global demand for oil, which lifted oil prices

Figure 15. Export growth, seasonally adjusted annualized growth rate in values

(percent)



Source: DECPG.

(Figure 4) despite large inventories of extracted and processed oil, has been good news for MENA oil exporters, including GCC countries. Global demand for oil started growing in the fourth quarter of 2009 after falling for five consecutive quarters. The strong rebound was due to the rapid recovery in emerging markets, most notably Asia, and improvements in global financial conditions. US demand for oil has started growing too. It was up 1.9 percent for the 4-week period ending April 2nd 2010 compared with the same period a year earlier, with gasoline demand up 1.7 percent. And, although oil prices are far below the levels reached during the oil-boom years, they have moved to levels in the range between $75 and $85 a barrel—a level that is comfortable for many oil exporters.[11]

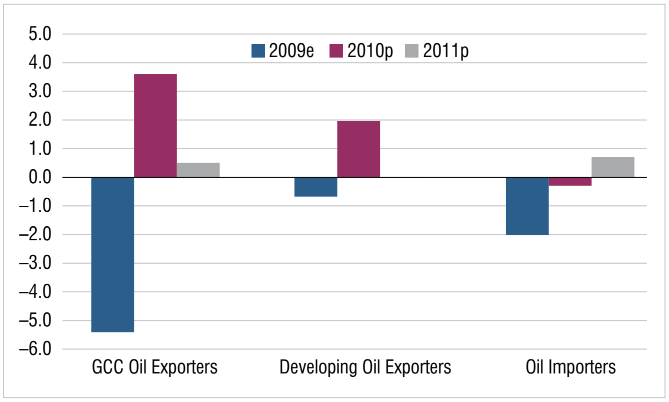
As a result of these positive developments, GCC oil exporters are expected to lead the regional recovery. In 2010, growth of GCC economies is projected to rise by 3.6 percentages points compared to a year earlier. This growth acceleration is faster than that expected for developing oil exporters, and in stark contrast to the slight deceleration anticipated for oil importers in 2010 (Figure 16). GCC countries were hit hard by the global crisis so a return to growth of 4.4 percent in 2010 and 4.9 percent in 2011 represents a remarkable comeback (Figure 17).

10 Source: WTO (2010).

11 The IMF estimates that the breakeven price—the price at which a country would achieve fiscal balance—is close to $57 per barrel for many MENA oil producers. Stark exceptions include Iraq and Iran with breakeven oil prices of $111 and $90 per barrel.

Figure 16. Expected growth rate changes relative to previous year

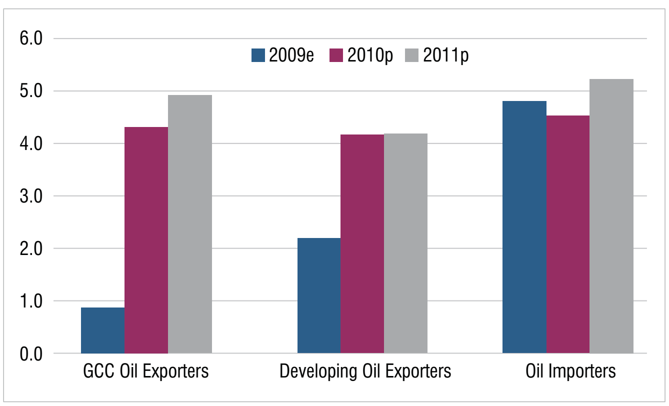
(percentage point change)



Source: Staff calculations based on data from national agencies and World Bank staff estimates for 2009 and projections for 2010 and 2011.

Figure 17. MENA annual growth outlook

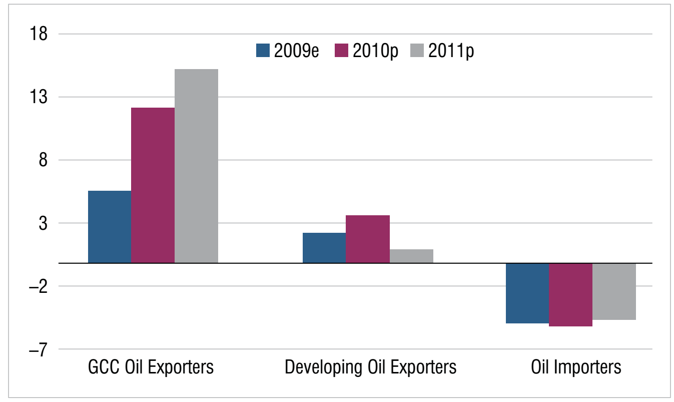
(percent)



Source: National agencies and World Bank staff estimates for 2009, and projections for 2010 and 2011.

Figure 18. Anticipated external accounts

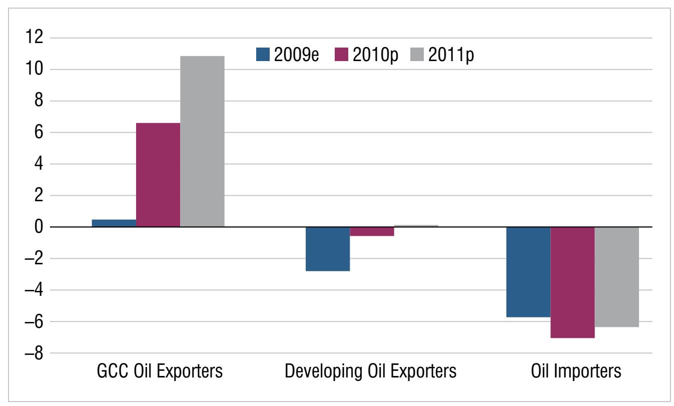
(percent of GDP)



Source: National agencies and World Bank staff estimates for 2009, and projections for 2010 and 2011.

Figure 19. Fiscal outlook

(percent of GDP)



Source: National agencies and World Bank staff estimates for 2009 and projections for 2010 and 2011.

The climb in oil prices and the firming of oil demand are expected to translate into an increase in oil revenue and an improvement in the GCC countries' external and fiscal balances (Figure 18 and Figure 19). This in turn will enable governments in GCC countries to continue implementing supportive policies. Such policies have helped domestic growth which in turn had an important stabilizing impact on other MENA countries by contributing to workers' remittances, foreign direct investment (FDI), and to a lesser extent, imports.[12]

The Dubai financial crisis is still unfolding (Box 1). The debt standstill announcement at the end of 2009 had a prominent impact on Dubai's credit risk as market participants could no longer assume an implicit sovereign guarantee. In the weeks following the announcement of the Dubai World's default, risk premiums in the MENA region deteriorated markedly (Figure 20), while CDS spreads widened (Figure 21). Stock markets dropped in the UAE, while those in the rest of the GCC experienced higher volatility (Figure 22).

So far the impact of the Dubai World debt crisis has not had a major negative impact on the region and the Dubai World debt restructuring offer has contributed to greater clarity about UAE's prospects. The offer—still subject to acceptance by creditors—consists of a sizable debt rollover, a swap of

12 Source: IMF (2010) *Impact of the Global Financial Crisis on the Gulf Cooperation Council Countries and Challenges Ahead.*

Box 1. The Dubai World debt restructuring: Recent Developments

As the funding needs of various Dubai government-related enterprises ("Dubai Inc.") became clear during 2009, the emirate's government has moved to a progressively more centralized approach to managing these needs. In July 2009, the Dubai Department of Finance established the Dubai Financial Support Fund (DFSF) to manage the proceeds of the government's new $20 billion bond facility, of which the first $10 billion had been bought by the UAE Central Bank. Enterprises seeking support were expected to show their alignment with Dubai's long-term growth strategy—leaving implicit the possibility that some restructuring could take place when this alignment was not present.

In November 2009, the Dubai Department of Finance announced that it was seeking an extension of at least 6 months on all near-term maturing debt of the DW holding company, including the $3.5 billion sukuk of its property subsidiary Nakheel which was due for redemption on December 14. In addition, a restructuring team from Deloitte was appointed to oversee DW. Separately, the Department of Finance announced that it had sold another $5 billion of the DFSF bond facility. On December 14, the government of Dubai announced a further $10 billion loan to DFSF from Abu Dhabi which was used to settle the Nakheel sukuk ($3.5 billion plus a contingent coupon payment) along with contractor debts. However, just $5 billion of the loan was new money, as the remainder was used to absorb the facility that had been provided by the two commercial banks.

After intensive behind-the-scenes negotiations, DW and Nakheel announced related but separate restructuring proposals to creditors in March 2010. The package has a face value of about $20 billion consisting of a $9 billion debt-to-equity conversion of DFSF debt in DW, $1.5 billion in new funds for DW to meet immediate commitments, $8 billion in new funds for Nakheel, and a $1.2 billion debt-to-equity conversion of DFSF debt in Nakheel. The Nakheel funds include redemption in full of sukuks due in 2010 and 2011, while bank creditors will be offered a rollover including accrued interest. Bank creditors at the DW holding company level will be offered new sukuks of either 5 or 8 years maturity. It is unclear how much accrued interest in existing debt will be reflected in the face value of the new securities. Nakheel trade creditors will be offered 40 percent cash and 60 percent tradable debt in settlement of bills.

With a fairly comprehensive restructuring offer on the table, the criteria governing the decision-making of the Dubai government are now somewhat clearer. Contrary to some expectations in December, the government is not prepared to de-emphasize the property business model, since Nakheel is receiving most of the new funds being committed to the DW conglomerate. Meeting Nakheel's sukuk obligations in full avoids potentially complex litigation and confines the scope of the overall restructuring to banks and bilateral creditors. In fact, there are indications that the government has for all practical purposes moved Nakheel out of DW and intends to have the DFSF run it directly.

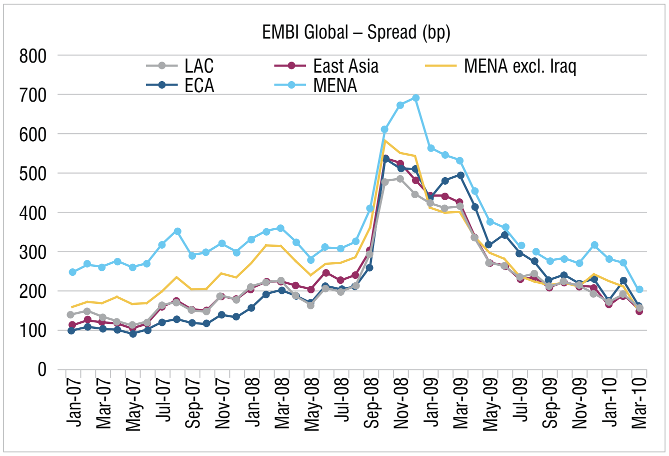
It appears that the government was focused on how the debt overhang had caused property-related economic activity to seize up. Under the proposed restructuring, trade creditors are receiving some funds immediately, and residential purchasers are being encouraged to consider properties close to completion. Although DW creditors may be dissatisfied with their differential treatment compared to Nakheel, their options are limited, especially as the government still has its own option of moving DW into a special decree tribunal which would aggregate and adjudicate on all creditor claims against it.

Although predictions of significant debt haircuts have been avoided, the restructuring does involve some losses and changes in maturity and asset composition for creditors. Once loan losses are crystallized, the UAE authorities will have to decide whether and how the domestic banking system will raise additional capital. As most UAE banks already have some public ownership, further government support seems inevitable.

Source: Compiled by World Bank, MNSED.

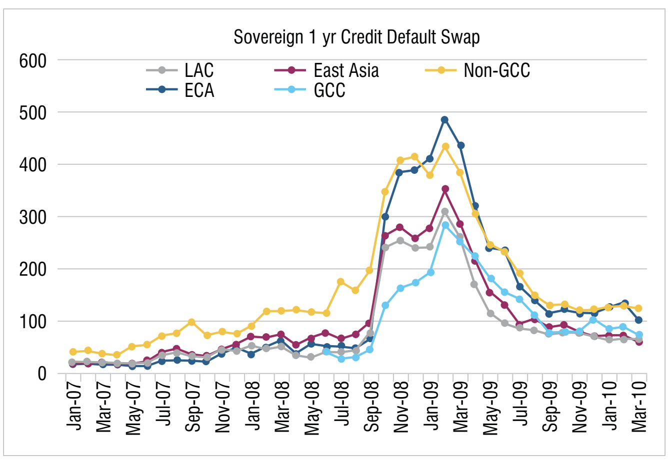
Figure 20. EMBI Global Spreads over US Treasuries

(bps)



Source: Datastream.

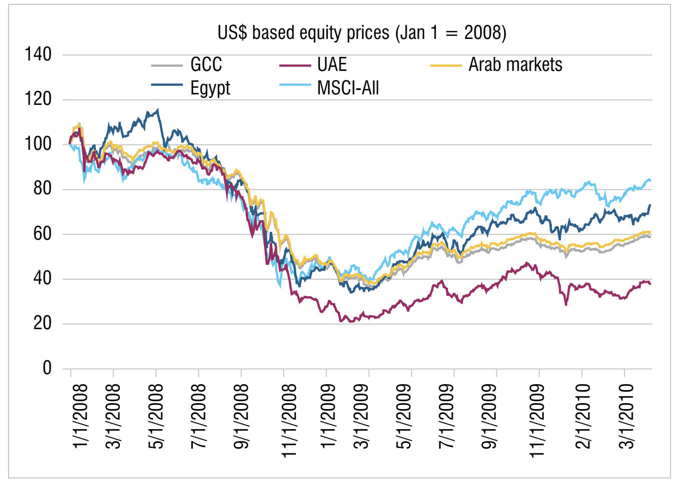
Figure 21. Credit Default Swaps



Source: Datastream.

existing Dubai government debt in Dubai World for equity, and a substantial cash infusion to the property developer Nakheel to redeem Islamic bonds and restart frozen trade credit. The restructuring package is partially funded through loans from Abu Dhabi to Dubai and its adverse impact on UAE banks is cushioned by the likelihood of increased support to these banks from Abu Dhabi and federal entities. These short-term measures are helping to contain the negative impact of these events on UAE growth. Risk premiums have declined in the region as a whole, and excluding Iraq, are comparable to those in other emerging markets (Figure 20). CDS spreads have also declined in the GCC (Figure 21). However, it will take some time for the Government of Dubai to develop a strategy

Figure 22. Equity price indexes



Source: Thompson/Datastream and World Bank, Development Prospects Group.

to restructure its corporate sector. Furthermore, lack of high-frequency financial information and news complicates the analysis. Equity markets reflect this uncertainty and remain depressed in UAE, while the recovery in other parts of MENA has stalled (Figure 22).

The GCC banking sector has remained relatively resilient, but the GCC credit growth slowdown has been steep, and the trend has not reversed according to most recent data (Figure 7). Bank profitability declined, but banks continued to be profitable in 2008 and the first half of 2009 and most recent available financial sector indicators also remained generally strong.[13] Islamic banks in GCC were less affected in the months following the global financial crisis, but mid-year 2009 results indicate slightly larger declines in profitability for Islamic banks in some countries due to second-round effect of the crisis on the real economy and real estate.

The outlook for bank performance, and banks' ability and willingness to extend credit remains uncertain, and so does the outlook for growth. Ongoing large fiscal spending by Abu Dhabi is expected to help the recovery and support the "service center approach" to integration and economic development. The question remains whether growth of the private sector, which is smaller in the GCC oil exporting countries than in the non-GCC MENA countries, will pick up when the public

13 Source: IMF (2010) *Impact of the Global Financial Crisis on the Gulf Cooperation Council Countries and Challenges Ahead.*

sector starts spending less and the effects of the stimulus packages in UAE and Saudi Arabia wear off.

THE RECOVERY OF DEVELOPING OIL EXPORTERS HINGES ON DEVELOPMENTS IN THE OIL MARKETS

Growth of developing oil exporters is expected to accelerate largely due to the strong rebound of oil prices and demand for oil in emerging markets, and more recently in the US. Developing oil exporters are expected to grow by 4.2 percent in 2010, and maintain this pace of growth into 2011. The sustainability of this recovery, however, hinges on the evolution of global demand for oil and oil prices, as this group of countries rely on exports of oil and fuel products even more than the GCC countries (Table 2), and Iran and Iraq are especially vulnerable to oil price volatility. Only Syria may be less vulnerable to developments in oil markets as oil exports represent 75 percent of its total exports, compared to 91 percent for this group of countries (Table 2).

Global oil demand is expected[14] to increase by 1.7 percent in 2010 and most of this increase is expected to come from non-OECD Asia—notably China and India, where rising per capita incomes will boost consumption. In contrast, demand growth in the G3 (North America, Europe and Japan) is expected to be restrained. Oil demand in OECD countries has been falling since 2005 and little or no growth is expected in 2010. Due to reduction in production in an effort to maintain prices at around $75 a barrel, OPEC spare capacity increased to around 6.5 million barrels a day or roughly 5 years of demand growth.[15] Most analysts therefore do not expect the upward pressure on real oil prices to persist in the near term. Temporary spikes, however, cannot be ruled out in response to further dollar weakness over the course of 2010–11, or security issues threatening access to oil.

The state-dominated financial sectors of the non-GCC oil exporters were not affected by the crisis, but face high NPL rates and efficiency issues that will need to be addressed. Some of the developing oil exporters—notably Syria will benefit from a strong recovery in the GCC countries as their exports to GCC countries represent a substantial share in their total exports. Developing oil exporters which rely on remittances from the Gulf, notably Yemen, will also benefit from a strong recovery in the GCC countries.

14 Source: Samba Financial Group: "2010 Oil Market Outlook and Implications for GCC Economies."

15 Source: GEP 2010.

Table 2 Export shares in total exports

	Primary goods	Fuels	Manufacturing
GCC oil exporters	**0.03**	**0.85**	**0.11**
Kuwait	0.01	0.93	0.06
Oman	0.06	0.83	0.11
Saudi Arabia	0.01	0.90	0.09
United Arab Emirates	0.07	0.76	0.18
Developing oil exporters	**0.05**	**0.91**	**0.04**
Algeria	0.01	0.97	0.02
Iran, Islamic Rep.	0.05	0.86	0.09
Iraq	0.01	0.99	0.00
Libya*	0.01	0.95	0.05
Syrian Arab Republic	0.17	0.75	0.08
Yemen	0.05	0.92	0.03
Oil importers	**0.23**	**0.12**	**0.65**
Egypt, Arab Rep.	0.21	0.44	0.35
Jordan	0.18	0.01	0.81
Lebanon	0.32	0.02	0.66
Morocco	0.31	0.03	0.66
Tunisia	0.11	0.10	0.79

Source: World Bank, PRMED.
Data are averages in the 2000s up to 2005; Data for Libya are for the 1990s

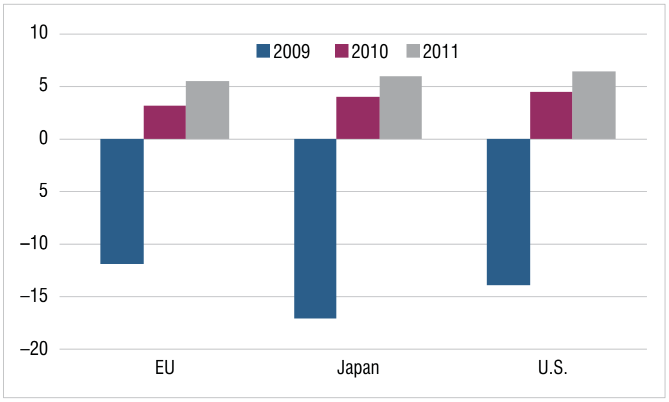
THE RECOVERY IN THE EU AND GCC COUNTRIES WILL BE CRUCIAL TO THE RECOVERY OF OIL IMPORTERS

Oil importers weathered the crisis better than the GCC oil exporters, but the feeble recovery expected in the euro zone will drag down their growth in the near term, especially the growth of those with strong links to EU markets. Growth of MENA oil importers is expected to decelerate slightly relative to 2009 (Figure 16), averaging 4.5 percent in 2010 and 5.2 percent in 2011 (Figure 17).

Exports of services have been more resilient than merchandise exports and are likely to remain a bright spot for oil importers in the short to medium term. The importance of tourism in oil importing countries has grown substantially over the past decade, with the share of tourism revenue in GDP climbing from 4.4 percent in the period 1996–1999 to 6.5 percent in 2007. The region has made significant investments in the tourism

Figure 23. Annual import growth

(percent change in values)



Source: World Bank, DECPG. Staff estimates for 2009 and projections for 2010 and 2011.

sector in the past few years, and with tighter constraints on private spending in EU markets, demand for tourism services in the Middle East and North Africa might increase as it offers quality services at attractive prices.

Growth of oil importers with strong links to the EU is expected to be lower than growth of oil importers with links to the GCC markets as the outlook for growth in the EU is the weakest among advanced economies, and much lower than the expected growth in the GCC economies. Output growth in the Euro Area is expected to be 1 percent in 2010, compared to 4.3 in the GCC countries, 2.5 percent in the US and 1.3 percent in Japan. Import growth in the EU is also expected to trail growth in Japan and the US (Figure 23).

Recent concerns in the EU market include issues related to fiscal sustainability in several member countries, in particular Greece, Ireland, Spain and Portugal, which are expected to further constrain growth in the near term. In the UK, growth will be driven by recovery of net exports and inventory, and is expected to remain below trend as households limit spending in light of large debt overhang, tightened lending standards, and anticipation of tax hikes.

A strong economic recovery in the GCC states will affect oil importers mostly through remittances and FDI. The impact of developments in GCC markets on the balance sheets of banks and other financial firms in oil importers has so far been limited, and is likely to remain limited assuming that the debt restructuring process remains contained. The impact through trade is also likely to be limited since exports from oil importers to the GCC oil exporters are just 8 percent of these countries' total exports. However, countries with strong trade links to the GCC countries, including Djibouti, Lebanon, Jordan, and Syria, are likely to benefit more than other oil importers.

The impact of growth in the GCC countries through remittances and FDI however is expected to be stronger and positive. UAE's share in cumulative outward remittances in the period 2001–08 was 20.1 percent and the oil importers most likely to be benefit include Jordan, Lebanon, and Egypt.[16] These are the countries for which remittances from the GCC countries represent a non-negligible share in GDP. Outward FDI from the GCC countries directed to other MENA countries is also believed to be significant.[17]

Remittance flows to developing MENA are expected to grow by 1.3 percent in 2010 and 3.4 percent in 2011. Demand for migrants in the Gulf is expected to pick up at a faster pace than that in the EU, since GCC countries are expected to grow at much higher rates than EU member states, have substantial financial resources and long-term infrastructure development plans. In addition, protectionism is on the rise in Europe.[18] A number of countries are imposing immigration controls in an attempt to deter future migration flows. Several European countries are considering measures that may reduce the inflows of new migrants. Italy recently passed a bill that criminalizes illegal immigration. France and Italy are urging other EU leaders to tighten border patrolling, particularly along the Mediterranean Sea. The EU is likely to favor skilled migrants at the cost of the unskilled, but some provisions such as high salary requirements for foreign workers could make entry difficult even for those with higher education. These policies could have a negative impact on the developing MENA countries.

Banks in oil importers are undergoing second round effects of the crisis, but are likely to weather these effects. NPL ratios have increased, however, these increases are expected to be moderate as growth declined but not substantially, and the recovery in these countries is underway. In addition, oil importers did not experience real estate bubbles and bank real

16 Other countries outside the region will also be affected including India, Bangladesh, Pakistan and Philippines.

17 Source: World Bank and Arab Monetary Fund.

18 Source: World Bank, DECPG, Migration and Development Brief No 11.

estate portfolios do not seem to be distressed. However, interest rate and liquidity risks have increased in many countries suggesting that credit will become more expensive, and access to credit may become more restricted as banks become more conservative in the contraction phase. The extent to which underserved sectors have been affected cannot be measured with accuracy due to lack of data. Most Central Banks in MENA have not been able to generate reliable data on SME lending.

Fiscal policy is expected to continue to be expansionary in the oil importers, resulting in further deterioration of fiscal balances (Figure 19), but some oil importers have less need and much less fiscal space to rely on public spending as a source of growth. In some countries including Lebanon, Jordan and Egypt, the fiscal situation may turn into a long term growth issue, unless these countries trim down their fiscal deficits in the years to come. For example, Lebanon remains vulnerable to external shocks despite high growth in recent years. Even with some fiscal adjustment, continued donor financing, and average growth of 6 percent, estimates suggest that debt will remain high, above 100 percent, in the next few years. This outcome is largely attributed to the high cost of servicing the existing large debt stock. Aware of these problems, the government of Lebanon has decided to change its debt financing strategy. In 2009, the government increased the net financing from domestic sources in domestic currency.

Though inflationary pressures have been low and are expected to remain this way in the near term, in countries such as Egypt, the core inflation index shows significant fluctuation, reflecting underlying structural problems. The government's plan to reduce energy subsidies, which are critical to reducing the fiscal deficit and improving economic efficiency, will place additional upward pressure on other prices, and with two major elections in the near future the prospect of high inflation will limit the scope for reforms. Managing inflation, in turn, will depend on prudent public finance and monetary management to ensure that financing of the fiscal deficits does not cause monetary expansion.

However, the crisis has not led to reform reversals and reforms have broadly remained on track. Some governments have plans to improve the efficiency of their social programs through better targeting of the poor, which will enable them to phase out subsidies in an effort to improve the sustainability of public finances. However, political factors in some countries may constrain reforms in the short term. Major public investments in some of these countries will continue and help growth in the near and long term. The hope is that when governments start reducing their spending, the private sector would have strengthened sufficiently to increase its contribution to growth.

WORKING TOGETHER TOWARDS RECOVERY AND IMPROVED CRISIS RESILIENCE

During the past year, the World Bank Group responded actively to the economic downturn in the MENA region and tailored this support to the needs of the countries. In Iraq, where the fall in oil prices severely affected public finances, the World Bank provided financial support through a development policy loan, working closely with the International Monetary Fund. In oil importing MENA countries, such as Egypt, Jordan, Morocco and Tunisia, the World Bank has been providing technical support through diagnostics work as well as quick-disbursing financial support through several development policy operations focusing on financial sector, public sector reforms, and trade integration. These operations also help build crisis resilience for the future. In the GCC countries, the short-term response of the World Bank Group was to step up economic and financial monitoring and engage in strategic reimbursable technical assistance. IFC's Global Trade Finance Program has helped businesses, especially small ones, access trade finance, while its Global Trade Liquidity Program has helped infuse liquidity into the trade finance market. IFC has also helped banks across the MENA region by sharing views and solutions on how to successfully navigate the crisis, structure robust risk management systems, and train key bank staff on risk management.

III. FACING THE CHALLENGES AHEAD

INCLUSIVE GROWTH REMAINS ELUSIVE

Overall, standards of living in MENA have nearly stagnated as economic growth in per capita terms has been low relative to other developing regions (Figure 24), and not sufficient to raise household incomes.[19] The region is struggling as economies have not been able to generate jobs for the millions of young people entering the workforce. Unemployment rates have dropped in the past five years to 11 percent, but unemployment for young people between ages 15–24 is more than 25 percent—double the world average. High unemployment rates, low labor force participation, especially for females, and informality translate into one of the world's lowest formal employment rates—less than half of the adult population is formally employed. Private investment has not increased commensurately with reform acceleration and despite a move in many countries from a model of state-led growth to one relying more on the private sector. Among key longer term growth challenges are access to finance, which is very low in MENA, firms' competitiveness, and the non-competitive business environment facing enterprises in MENA.

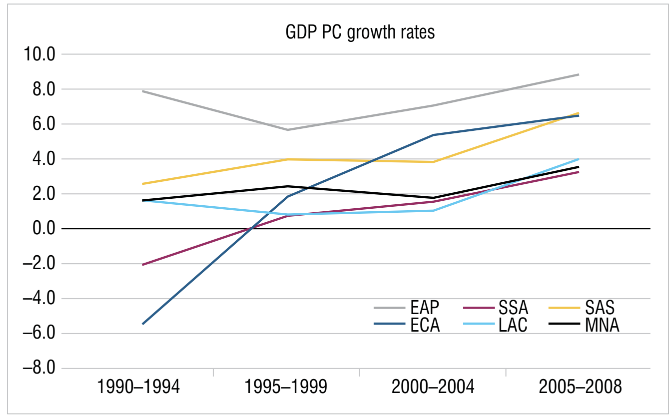
These outcomes are a cause of concern, but they also signal that MENA's potential for growth which could be a lot higher than growth in the last two decades, provided MENA countries tackle their key constraints to sustainable and inclusive growth. Apart from finance and business environment other long-term growth issues relate to education quality, climate change and water resource management.

ENSURING ACCESS TO FINANCE WITHOUT COMPROMISING FINANCIAL STABILITY

In MENA, the issue of access to finance was a major one before the crisis, despite the fact that many countries in MENA have large banking sectors. The region lags in a number of areas including loan and deposit accounts per capita, microfinance coverage, different aspects of financial infrastructure, especially legal rights, public registry coverage, and private bureau coverage in non-GCC countries. A higher percentage of firms in MENA identify access to finance as a major constraint

Figure 24. Real, per capita GDP growth

(%, annual averages)



Source: World Bank, WDI

to their business growth than in any other region except Sub-Saharan Africa. Credit remains concentrated and large segments of households and SMEs remain underserved. The slowdown of credit has added urgency to the access agenda because the credit tightening expected in the post-crisis period affects disproportionately the underserved segments, typically high risk households and firms.[20]

This situation is worse in developing oil exporting countries which have state-dominated financial sectors. Prior to the financial crisis, these countries had some of the highest nonperforming loan rates in the world which curbed the efficiency of financial intermediation, and resulted in low access to credit. By contrast, in many of the GCC countries NPLs were low, and firms had high access to credit. Furthermore, the extent of NPLs has been directly linked to the prominence of state-owned banks, and in some cases lending to SOEs and connected private firms which resulted in misallocation of financial resources. Privatization and opening of the sector to competition have been hailed as the answer to these problems, but the experience in some countries, including Syria, has been one in which private banks have continued to serve well-connected clients, limiting access

19 MENA region has the second highest population growth rate in the world after Sub-Saharan Africa.

20 The extent to which underserved sectors have been affected cannot be measured with accuracy due to deficiencies in data collection although some recent Investment Climate Assessments have captured the contraction of credit to SMEs.

to credit for small and medium-sized enterprises. In many cases, the main issues have been information asymmetries and weak legal protection for creditors and borrowers.

Branch networks in MENA are more limited than in most other regions. And, although the density of these networks is comparable to that in Latin America, 'branchless banking' approaches which compensate for restricted bank networks have not emerged on any scale in MENA, unlike in Latin America. Only Morocco allows non-financial firms to serve as agents for banks, while MENA countries have the highest requirements in terms of documents needed to open a deposit account. Islamic micro and SME finance has grown but coverage remains limited.

In addition to the access agenda, MENA governments will have to face a challenging financial stability agenda. The financial crisis has revealed the failure of Pillar 3 in Basel II on disclosure and market discipline, even in advanced countries such as the US. The pre-conditions for effective market discipline are weaker in MENA than in developed countries due to weaker institutions and less sophisticated market players, and the generous support programs during the crisis that may have weakened these institutions further. Most MENA countries will also need to make an effort to deal more effectively with systemic risk and implement the recommendations issued by the Financial Stability Board. Very few Central Banks in MENA have been able to develop an effective macro-prudential supervision function, and produce reliable financial stability reports. MENA countries have not introduced counter-cyclical elements in their provisioning rules and increase capital charges for systemically important institutions.

TOWARD DOMESTIC AND REGIONAL FINANCIAL ARRANGEMENTS

The response to the crisis worldwide can be expected to alter the global financial climate in the future. Some of the expected changes include a tightening and broadening of the scope of financial market regulation, a generalized increase in risk aversion, introduction of rules and policies intended to moderate financial market volatility in developing countries, and increased reliance on domestic intermediation and efforts to deepen regional financial markets. What would be the implications of these changes for MENA and other countries?

The tightening of financial conditions may affect firms' ability to finance FDI. Similarly, changes in the legal status of financial institutions and the expected expansion of regulation to encompass more of their activities could further depress developing-country Mergers & Acquisitions (M&A) deals. However, crises typically affect FDI to developing countries less than they affect debt flows. The expectation is that this time again global FDI flows have dropped by just 30 percent in 2009, while net private debt flows have declined by 90 percent.

Tightening of the financial regulation would improve the stability of financial markets but will also constrain developing countries' access to international debt markets. The necessity to rebuild banks' capital basis and heightened risk aversion will reduce cross-border lending and foreign bank participation in developing countries. Restrictions on financial institutions' ability to assume risk may also limit developing country borrowers' ability to issue bonds in international markets, as regulatory structures are extended to many of the institutions that participate in the market. The elimination of some instruments may also reduce the ability of some regulated institutional investors, notably public and private sector pension funds, from taking both direct and indirect positions in some forms of developing-country debt.

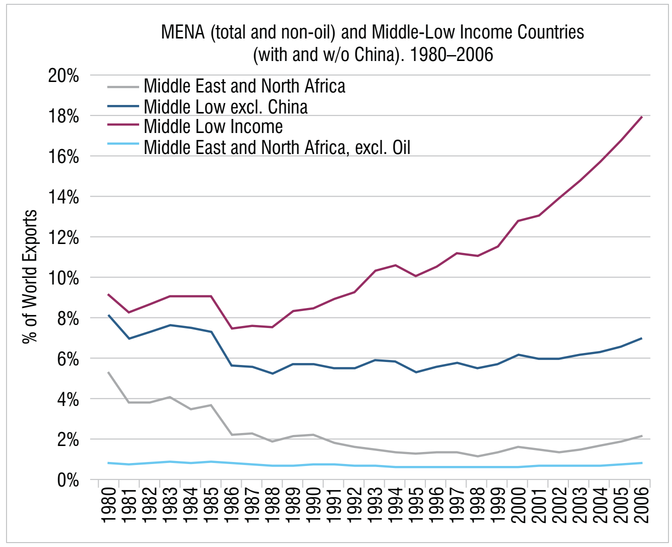
MENA debt and equity markets were not immune to the overall increase in risk aversion and pullback in capital flows, but risk premiums are falling towards their pre-crisis levels, and are at par with other emerging markets when we exclude Iraq from the regional average (Figure 20). The increase in spreads in the aftermath of the crisis led MENA countries to avoid foreign debt markets, and instead rely on domestic debt markets for new debt issues. There was also increased interest in official and multilateral debt. The sharp drop in equity markets reduced the firms' appetite for IPOs, suggesting that unless markets come to life, firms may need to rely more on credit to meet their capital needs. With borrowing spreads approaching their pre-crisis levels, some MENA governments are now considering a return to foreign debt markets, for instance, Qatar, Egypt, and Morocco. Still, countries such as Iraq that rely most heavily on external debt financing to meet their current account obligations and finance investment may be most vulnerable to a change in the extent to which such financing is available.

The severity of the financial crisis and the uncertainty about how the financial system will evolve has sparked interest in regional and domestic financial markets. If successful, regional financial integration should help lower domestic borrowing costs by reducing transaction costs and by reducing risk, notably lowering the likelihood of contagion. Regional financial integration could also support regional trade integration and reap the benefits of scale economies achievable through the amalgamation of regional exchanges, along with attendant standardization of requirements and regulatory cooperation. It could also improve coordination of fiscal and monetary policies among closely linked regional economies.

Pursuing integration in MENA might be a good strategy given the mix of countries, which include both capital exporters (the GCC countries) and capital importers (oil importing countries). As banks in the OECD countries become more risk-averse, GCC banks may even have a motive to become more active at home, and perhaps in the region. There is evidence that GCC countries have started taking advantage of investment opportunities in the MENA region.[21] GCC capital, for instance, could be deployed for opportunities related to increased intra-Arab trade in services, to exploit increasingly broad trade agreements between Arab countries and the USA or the EU, or to fund intra-regional public projects in logistics, water, and energy.

In the face of external financing constraints, some countries are also beginning to look at ways to facilitate remittance flows, including incentives to increase remittances through formal channels. Pakistan, for instance, has introduced a scheme which subsidizes remittance service providers for a certain part of their marketing expenses, depending on the volumes transferred. Countries are trying to facilitate cheaper and faster remittances. Many migrant-sending countries are trying to search for new migrant-destinations and negotiate mobility partnerships with these new countries. Finally, improving the domestic investment climate by leveling the playing field for all economic actors is going to be critical in creating incentives for channeling remittances into productive investments.

Figure 25. Shares in world exports



Source: COMTRADE data.

THE IMPERATIVE OF IMPROVING THE COMPETITIVENESS OF MENA'S FIRMS

MENA's non-oil share in total world exports of goods has remained under one percent for more than 30 years (Figure 25), and despite doubling its services exports, MENA's share in total services trade has also stagnated at around 2.8 percent in the period 1990–2006. These outcomes reveal serious competitiveness issues and suggest that the region has missed opportunities to increase growth and create new productive jobs. MENA's productivity is comparable to that of many middle-income countries of Latin America and surpasses that of Sub-Saharan Africa. However, a comparison with high-growth East Asian countries, Brazil and Turkey shows big gaps in total factor and labor productivity, and these gaps are huge for non-GCC countries.[22]

The key problems that plague the business environment include policy and regulatory uncertainty and discretion in implementing regulations which distort the level playing field and encourage corruption. On the one hand, the mix of regulatory uncertainty, discretionary implementation and enforcement of rules makes it difficult for economic actors—firms and banks—to assess expected returns to prospective

21 Source: World Bank and Arab Monetary Fund.

22 Source: World Bank (2009) From Privilege to Competition: Unlocking Private-Led Growth in the Middle East and North Africa.

investment. On the other hand, the uncertainty and the way business is done encourages firms to make informal payments in an attempt to tip the playing field in their favor but these payments increase costs and lower actual returns.

These problems, coupled with barriers to entry and exit, have created an environment of stagnation. Firms in MENA stay longer in business than firms in other regions. The median age of manufacturing firms in MENA is the same as the one in OECD countries, although many MENA countries have been in the process of transition away from a state-led to a market-based economy—a process expected to be accompanied by dynamic entry of new firms that drive less productive firms out of business and increase productivity.

MENA's exporting firms have not been able to improve the sophistication of their products, and expand their export basket. Indeed, except for UAE, MENA countries export much fewer products than the number expected for their level of development. Furthermore, while FDI has increased in recent years, it has risen only slightly as a share of GDP over the last 35 years and the gaps between the rates observed in MENA and those in other regions have widened the substantially.[23] Stagnant foreign direct investment rates suggest limited opportunities for foreigners to invest and earn returns comparable to those in other regions. The composition of foreign and domestic investment also indicates that returns have been attractive mostly in the oil sector and a few non-tradeables sectors, while FDI directed to export-oriented manufacturing has remained limited. These developments, coupled with the fact that FDI and remittances from GCC oil exporters to non-GCC countries has been on the rise, suggest that the non-GCC countries might be suffering from Dutch disease.

Finally, there is evidence that some of MENA's non-oil exports might have been displaced by products made in China and India. While China's share in the EU market has risen dramatically, the importance of the EU as a market for MENA's nonoil exports has declined. China appears to be a much more formidable competitor than India since India's products largely compliment MENA's.[24] GCC oil exporters have been more severely affected by competition with China and India than non-GCC countries in the few non-oil product categories they export. This outcome could be explained with the fact that a number of non-GCC countries have privileged access to EU markets, and partially to the US market. In domestic markets, imports from China and India have lowered consumer prices but increased competition for domestic producers in non-GCC countries. Pressures have been stronger in labor-intensive industries such as textiles, apparel, leather, and furniture. Manufacturing with intensive use of skilled labor and technology has been less affected, but it accounts for a small share of domestic production.

23 Source: World Bank (2009) From Privilege to Competition: Unlocking Private-Led Growth in the Middle East and North Africa.
24 Source: World Bank (2000) Strengthening China and India's Trade and Investment Ties to the Middle East and North Africa.

APPENDIX TABLE: MACRO ECONOMIC OUTLOOK

	Real GDP Growth				Fiscal balance				Current account balance			
	2008	2009 est.	2010 Proj.	2011 Proj.	2008	2009 est.	2010 Proj.	2011 Proj.	2008	2009 est.	2010 Proj.	2011 Proj.
	(Annual percentage change)				(in percentage of GDP)				(in percentage of GDP)			
MENA region	**5.4**	**2.2**	**4.4**	**4.8**	**13.2**	**–1.9**	**1.6**	**4.0**	**15.9**	**2.5**	**6.1**	**6.8**
Oil Exporters	**4.9**	**1.3**	**4.3**	**4.6**	**16.6**	**–0.9**	**3.7**	**6.5**	**19.6**	**4.2**	**8.8**	**9.5**
GCC countries	**6.2**	**0.8**	**4.4**	**4.9**	**25.3**	**0.5**	**6.6**	**10.8**	**25.1**	**5.7**	**12.2**	**15.2**
Bahrain	6.1	2.6	3.5	3.9	8.0	–7.6	–4.3	–1.5	10.6	1.6	3.6	6.1
Kuwait	6.4	–1.2	2.3	4.4	25.8	9.0	17.3	22.8	44.7	19.2	29.9	37.1
Oman	12.3	3.6	4.8	4.7	13.9	2.2	6.9	7.6	9.1	–2.2	2.6	3.3
Qatar	15.8	9.0	18.5	14.3	12.0	11.8	8.9	13.3	33.0	15.7	22.7	30.8
Saudi Arabia	4.4	0.1	3.9	4.1	33.0	–4.6	1.2	6.0	28.6	5.5	8.4	10.5
United Arab Emirates	5.1	–0.7	0.6	3.1	20.5	0.4	9.8	13.5	8.8	–2.7	7.3	7.7
Developing oil exporters	**2.9**	**2.2**	**4.2**	**4.2**	**4.3**	**–2.8**	**–0.5**	**0.2**	**11.9**	**2.4**	**3.7**	**1.1**
Algeria	2.4	2.1	4.6	4.1	8.1	–8.4	–6.6	–5.4	20.1	0.9	3.9	5.3
Iran, Islamic Republic of	2.3	1.8	3.0	3.2	0.0	–2.7	–1.4	–1.3	7.2	2.6	2.4	1.6
Iraq	9.5	4.2	7.3	7.9	—	—	—	—	—	—	—	—
Libya	3.8	2.1	5.4	6.2	24.6	10.6	15.8	17.7	40.7	16.8	23.5	0.0
Syrian Arab Republic	5.2	4.0	5.0	5.5	–2.8	–5.5	–4.4	–3.4	–3.6	–4.5	–3.9	–3.5
Yemen	3.6	3.8	7.9	4.4	–4.5	–8.4	–7.5	–2.8	–4.6	–6.1	–3.5	–1.5
Oil importers	**6.8**	**4.8**	**4.5**	**5.2**	**–4.8**	**–5.7**	**–7.0**	**–6.4**	**–4.1**	**–4.7**	**–5.0**	**–4.5**
Oil importers with GCC links	**8.7**	**6.1**	**5.2**	**5.5**	**–9.8**	**–9.7**	**–9.1**	**–8.3**	**–16.8**	**–13.4**	**–14.9**	**–14.9**
Djibouti	5.8	5.0	4.5	5.4	1.3	–2.8	–0.9	–0.5	–39.2	–19.9	–13.7	–19.5
Jordan	7.9	2.8	3.9	4.5	–9.4	–11.0	–7.3	–7.8	–11.3	–5.6	–10.1	–10.5
Lebanon	9.3	8.0	6.0	6.0	–10.5	–9.1	–10.7	–9.2	–20.1	–18.5	–18.3	–17.9
Oil importers with EU links	**6.5**	**4.6**	**4.4**	**5.2**	**–3.9**	**–5.1**	**–6.7**	**–6.0**	**–1.9**	**–3.3**	**–3.3**	**–2.7**
Egypt	7.2	4.7	5.0	5.5	–6.9	–6.9	–8.4	–8.1	0.5	–2.3	–2.7	–1.9
Morocco	5.6	5.0	3.0	4.4	0.4	–2.2	–4.6	–2.9	–5.2	–5.4	–4.8	–4.3
Tunisia	4.5	3.1	4.0	5.0	–1.2	–3.3	–3.5	–3.3	–4.2	–2.8	–2.9	–3.2

Source: World Bank data

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