2. MENAP Oil Importers: Meeting Social Needs, Restoring Economic Confidence

The political and economic transformations in several MENAP countries are advancing slowly and are expected to extend well into 2012. These, together with a weakening in the global economy, have increased economic uncertainty in the region, leading to a sharp economic downturn and strains on macroeconomic stability. Governments have attempted to cushion the impact of the downturn, mainly through an expansion in untargeted subsidies and transfers, but they face limited fiscal room and rising borrowing costs. Accordingly, a difficult period lies ahead during the remainder of 2011 and in 2012, as economic recovery is expected to be a drawn-out process. Over the long term, leveraging the strengths of the region, while addressing weaknesses through a comprehensive reform agenda, can help it achieve higher and more inclusive growth—improving access to economic opportunities and providing better standards of living for its peoples.

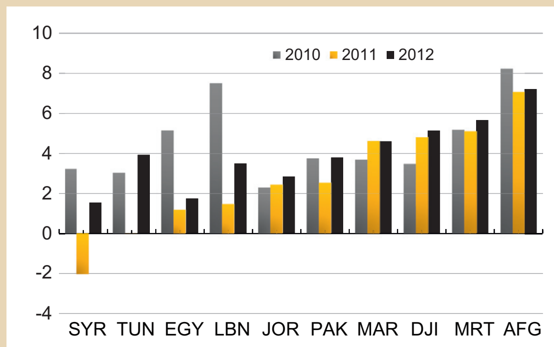
Sharp Downturn to Last through 2012

Economic risks for several MENAP oil importers have increased as the uncertainties inherent in political transition persist and social unrest continues. Transition governments in Egypt and Tunisia are in the process of defining a road map toward political and economic reform, while the conflict in Syria continues. There has also been social unrest in Morocco and Jordan, and, to a lesser extent, in Mauritania. Together with a worsening global economic outlook, especially in Europe, these circumstances have contributed to a sharp drop in investment and tourism activity. Average real GDP growth among MENAP oil importers is projected to drop below 2 percent in 2011, down from 4⅓ percent achieved in 2010.

The decline in tourism and investment has resulted in a severe economic downturn in Egypt, Jordan, Lebanon, Syria, and Tunisia in 2011 (Figures 2.1 and 2.2). Economic activity is also weak in Pakistan, a result of devastating floods and recent urban riots. Unemployment has increased with the economic slowdown, especially in Egypt and Jordan, and may increase further. In contrast, Afghanistan, Djibouti, Mauritania, and Morocco are growing robustly, with output projected to expand by 5 percent in 2011,

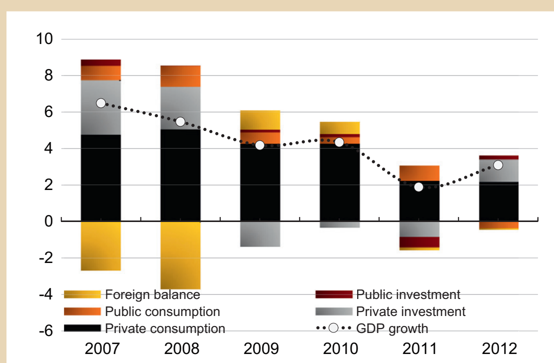
Prepared by Padamja Khandelwal with input from country teams.

Figure 2.1
Real GDP Growth Stalls in 2011
(Real GDP, annual percent change)



Sources: National authorities; and IMF staff calculations.

Figure 2.2
Private and Public Investment Have Declined
(Contribution to real output growth, percent)



Sources: National authorities; and IMF staff calculations.

Box 2.1

Mitigating the Impact of High Energy Prices: Oil Importers as Commodity Exporters

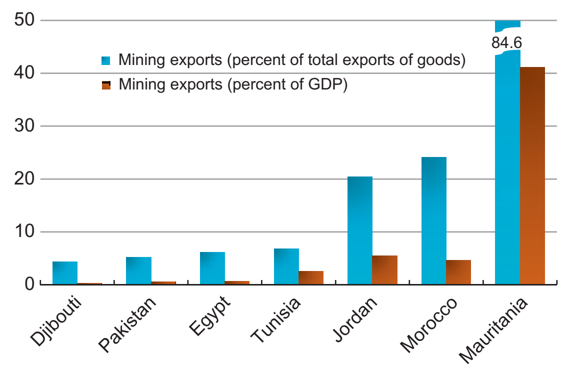
Mining plays an important role in the economies of several MENAP oil importers. Exports of nonfuel commodities are significant for Jordan (phosphates and potash), Morocco (phosphates), and Mauritania (iron ore, copper, and gold)—ranging from 20 percent of total exports to as much as 85 percent (Figure 1).

In recent years, there has been significant comovement in oil and commodity metals prices. For instance, during 2005–08, oil prices and commodity metals prices increased by 85 percent and 70 percent, respectively. These increases are a result of strong global economic activity, particularly demand from the manufacturing sector.

Figure 1

Nonfuel Commodity Exports

(Percent, 2010)



Sources: National authorities; and IMF staff calculations.

Impact on economic activity

Mining production represents a large part of commodity exporters' output, especially in Mauritania, where it accounts for nearly 15 percent of GDP. Consequently, higher commodity prices spur investments in the mining sector that help offset the drag on other sectors of the economy.

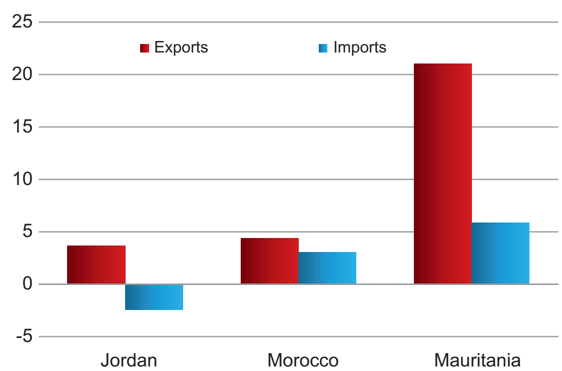
During recent boom episodes, increases in the fuel-related import bill were offset by increasing mining production and rising commodity exports. Hence, increases in commodity exports during 2005–08 were 1½ times as high as additional oil imports for Morocco and four times as high for Mauritania (Figure 2).

The recently observed strong, positive correlation between oil and metals prices may not always hold. Accordingly, any future decoupling of oil and metals prices could make these oil-importing commodity exporters vulnerable to a rise in oil prices.

Figure 2

Change in Mining Exports and Fuel Imports

(Percent of GDP, 2005–08)



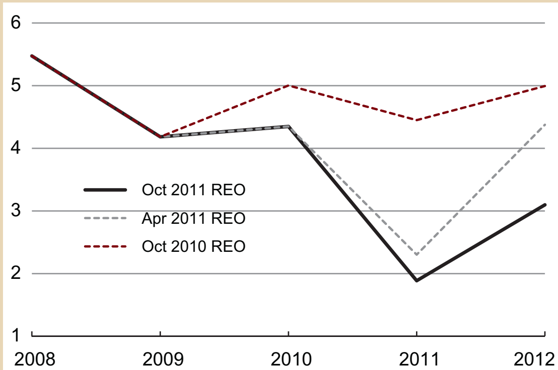
Sources: National authorities; and IMF staff calculations.

Prepared by Amine Mati.

albeit below long-term trends and accompanied by continued high unemployment. Rapid growth in Afghanistan is a result of increased security spending and construction activity, while high commodity prices and robust construction have provided a boost to economic activity in Mauritania (Box 2.1).

An uncertain political and economic environment and weaknesses in advanced economies will weigh on the region's growth prospects, leading to a much weaker recovery in 2012 than anticipated previously. Recent IMF growth forecasts have been revised downward, particularly in Egypt and Syria

Figure 2.3
Real GDP Growth Forecasts Revised Downward
(Annual percent change)



Sources: National authorities; and IMF staff calculations.

(Figure 2.3). Strong real sector linkages between Europe and the MENAP oil importers imply that a slowdown in the former will likely have a significant adverse impact on growth rates in the latter (Box 2.2). Thus, growth in 2012 is projected to be below long-term trends, with output falling below potential across the region.

Inflation Remains Stable as Food and Fuel Subsidies Rise

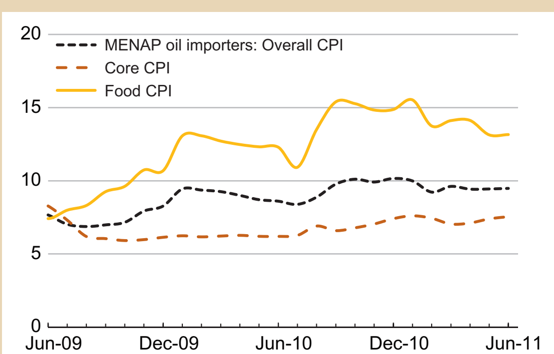
Inflation has been stable thus far in 2011, as the expansion of domestic food and fuel subsidies has muted the impact of rising global food and energy prices (Figure 2.4). With aggregate demand weak, there is limited evidence of second-round inflation effects. Monetary authorities have largely maintained an accommodative stance; real policy rates are close to zero or slightly negative in Jordan, Lebanon, Pakistan, and Tunisia and significantly below zero in Egypt (Figure 2.5).

Moderating food and fuel prices and continued weak aggregate demand will exercise a dampening effect on inflation in 2011–12, although wage increases, recently granted in the public sector in several countries, could filter through to the private sector and result in inflationary pressures as the economy recovers. In some countries, inflation will remain high in 2012 because of domestic factors: scaling back of commodity subsidies in Mauritania, and structural factors and entrenched expectations of high inflation in Egypt and Pakistan.

External Balances Are Worsening

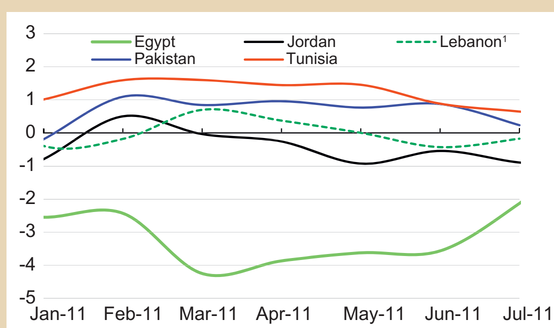
External current account balances are deteriorating for MENAP oil importers, largely the effect of higher food and fuel prices and declines in tourism. With their significant dependency on oil imports (as a share of GDP), a rise in global fuel prices increases import costs in these countries much more than in other countries (Figure 2.6). Thus, Djibouti, Lebanon, Jordan, Mauritania,

Figure 2.4
Inflationary Pressures Muted
(Consumer prices; period average, annual percent change)



Sources: Haver Analytics; and national authorities.

Figure 2.5
Real Policy Interest Rates Near Zero
(Percent)



Sources: National authorities; and IMF staff calculations.
[1]Average deposit rates.

Box 2.2

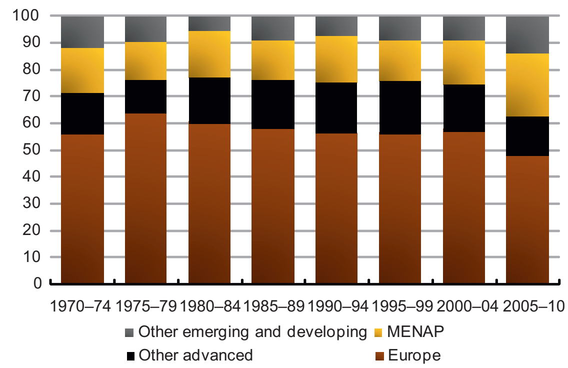
Global Linkages and Regional Spillovers from the Slowdown in Europe

MENAP oil-importing countries weathered the 2008–09 global financial crisis reasonably well. Their low degree of integration with international capital markets and small exposure to structured financial products—combined with positive spillovers from fiscal expansions in neighboring oil-exporting countries—helped offset the impact of the global slowdown. This positive outcome occurred notwithstanding declines in remittance inflows and tourism receipts in some countries with close links to Europe, particularly Morocco and Tunisia. Likewise, financial market tremors prompted by debt problems in southern Europe in early 2010 had only a limited impact on the region, relative to others with greater financial linkages.

Figure 1

MENAP Oil Importers: Goods Export Destinations

(Percent of total exports)



Source: IMF, *Direction of Trade Statistics.*

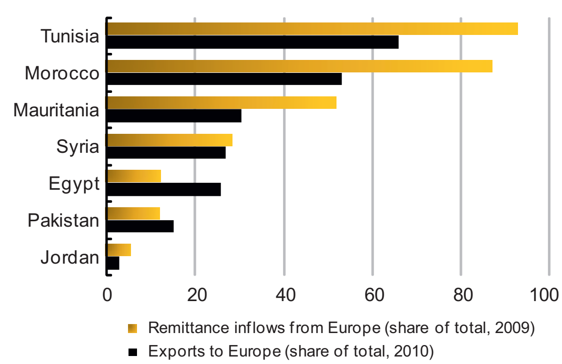
Possible risks ahead

Softer global growth and the fallout from the euro area sovereign debt crisis are taking their toll on European economic activity, with growth in the European Union set to slow from 1.7 percent this year to 1.4 percent in 2012, the euro area slowing more sharply from 1.6 percent to 1.1 percent, and risks tilted to the downside. A broadening or persistence of the current European sovereign debt crisis over the medium term, giving rise to a growth slowdown in Europe and declining oil prices, is likely to result in large negative spillovers for MENAP. While oil importers would generally benefit from a lower oil import bill, evidence suggests that the net effect of declining oil prices could be negative in some countries, if remittances or foreign direct investment from neighboring oil exporters were also to be substantially scaled back.[1] As described below, given the strong real sector links with Europe, especially for the Maghreb countries, and the large presence of European banks in some MENAP countries, the contagion could be significant.

Figure 2

Trade and Remittance Linkages with Europe

(Percent)



Sources: IMF, *Direction of Trade Statistics*; national authorities; and IMF staff estimates.

MENAP linkages with Europe

As MENAP oil importers' economies are closely linked to Europe, these countries are likely to be adversely affected by the slowdown in European economic activity via trade, investment, and remittance channels. Reflecting

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Prepared by Christine Ebrahimzadeh and Harald Finger.

[1] See Tobias Rasmussen and Agustín Roitman, 2011, "Oil Shocks in a Global Perspective: Are They Really That Bad?" IMF Working Paper 11/194.

Box 2.2 *(concluded)*

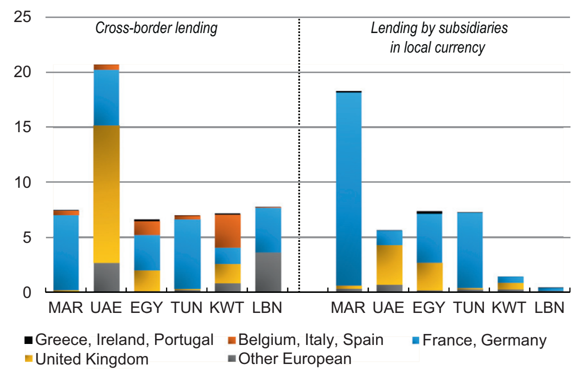
geographical proximity and close historical ties, MENAP oil importers' exports have mainly been oriented toward Europe, which has, on average, accounted for some 50–60 percent of those countries' total exports since the 1970s (Figure 1).

Evidence points to the particularly significant reliance of the Maghreb on Europe through various channels—Morocco and Tunisia, most notably, depend on Europe for about 90 percent of their total remittance inflows (Figure 2). In addition, the Maghreb depends on Europe as a destination for about 60 percent of its exports, as the source for 80–90 percent of its tourism revenues, and for about 80 percent of its total foreign direct investment.

Figure 3

European Bank Presence

(Percent of GDP, March 2011)



Sources: Bank for International Settlements; national authorities; and IMF staff calculations.

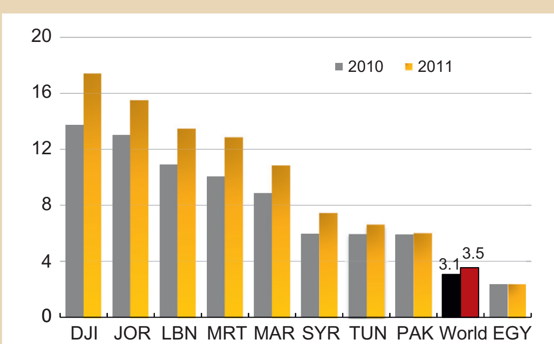
These real economic spillovers and links would likely outweigh any adverse impact on the region from financial channels, which—barring a major adverse shock to the European financial sector—are generally limited. Nonetheless, a marked spillover of the crisis into the core euro area and global financial markets could have repercussions for the MENAP region, with particular contagion risks for economies that are dependent on foreign financing and that have financial links to Europe. European banks have a sizable presence in MENAP, through locally incorporated subsidiaries as well as cross-border lending (Figure 3). Thus, subsidiaries of banks from core Europe are relatively large in Morocco, Tunisia, and Egypt and could suffer if the confidence of local depositors were shaken. In addition, cross-border lending by banks from core Europe is equivalent to 5–7 percent of GDP for some countries; this could be affected in the event of a renewed bout of global deleveraging.

and Morocco, the most oil-import-dependent economies in the region, are seeing deterioration in their oil import bills of more than 2 percent of GDP in 2011. Other countries are seeing smaller increases in import costs, because of weaker economic activity and lower oil intensity (Pakistan) or sizable domestic oil production (Egypt, Syria, Tunisia). This higher import bill is partly mitigated in some countries by increased mining exports (Box 2.1).

Figure 2.6

Oil Import Bills Rising

(Percent of GDP, 2010–11)



Source: IMF, *World Economic Outlook.*

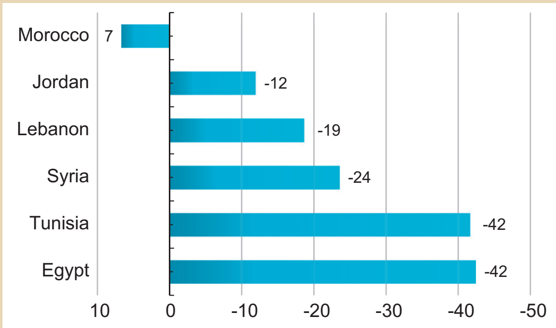
In the services sector, regional social disruptions resulted in double-digit declines in tourism arrivals in Egypt, Jordan, Lebanon, Syria, and Tunisia in the first five months of the year (Figure 2.7). Remittances have remained robust in most countries, except in Tunisia, where large numbers of workers have returned from conflict-ridden Libya.

Concurrently, the heightened uncertainty has led to a significant decline in capital inflows and put pressure on external reserves in the hardest-hit countries. Access to international capital markets has contracted sharply, with international issuance of securities declining by 40 percent during the first

Figure 2.7

MENAP Oil Importers Tourism Activity

(Jan–May 2011, percent change over same period of the previous year)

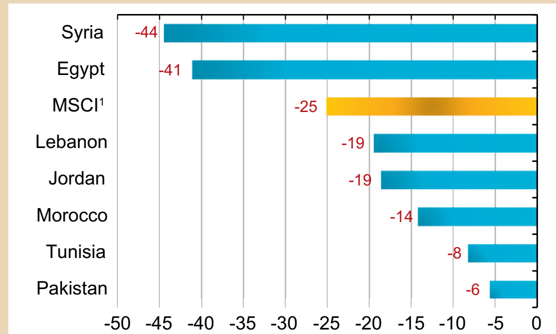


Source: United Nations World Tourism Organization, *World Tourism Barometer.*

Figure 2.9

Stock Market Indices Lower

(Percent change from Jan 10, 2011 to Sep 26, 2011)



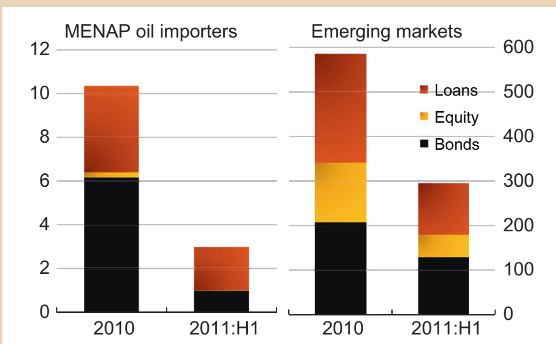
Source: Bloomberg.

[1]Emerging markets index.

Figure 2.8

International Capital Market Issuance

(Billion U.S. dollars)

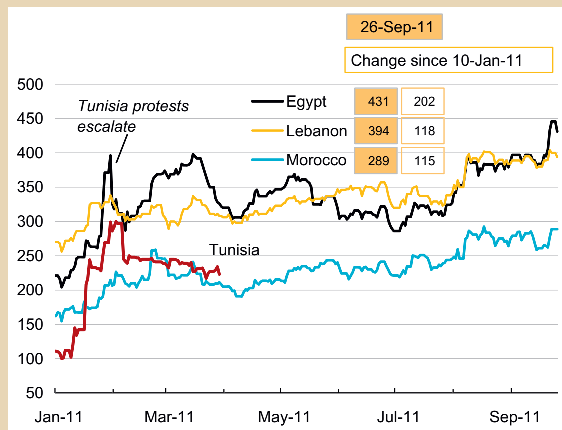


Source: Dealogic.

Figure 2.10

Sovereign Bond Spreads Higher

(Basis points)



Sources: Bloomberg; and Markit.

half of 2011, compared to an increase of almost 17 percent for emerging markets as a whole (Figure 2.8). Foreign direct investment (FDI) and portfolio inflows have also declined, especially in Egypt. The weakening in external flows is reflected in a fall of nearly 40 percent in foreign exchange reserves in Egypt, and of 5–10 percent in Jordan, Syria, and Tunisia. In Pakistan, strong exports and remittances have offset capital outflows. External financing needs—defined as the sum of current account deficits and external amortization—are large in the middle-income oil importers (especially Egypt and Lebanon) and are projected to reach US$50 billion a year in 2011–12.

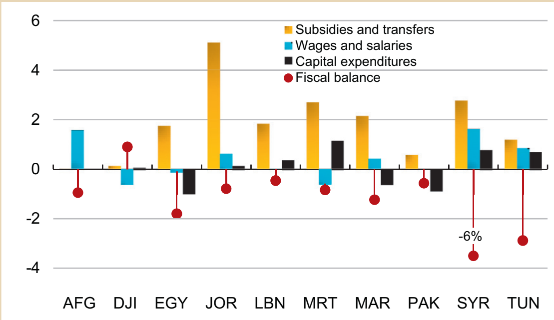
Financial Markets Have Taken a Hit

Stock markets in Egypt and Syria have declined markedly since earlier this year, reflecting the greater economic downturn and political uncertainty in these countries (Figure 2.9). Sovereign bond and CDS spreads have also widened, making it more costly for governments to borrow (Figure 2.10). Concerns over governance and asset quality have led authorities in Afghanistan to place the largest private bank (Kabul Bank) in receivership. Banks in Mauritania and Morocco have seen a small impact

Figure 2.11

Higher Expenditures on Subsidies and Transfers

(Percent of GDP, 2011 versus 2010)

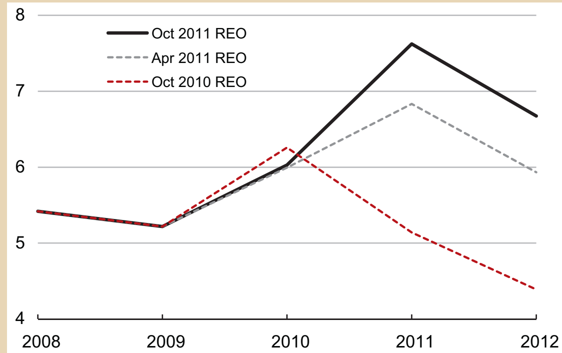


Sources: National authorities; and IMF staff calculations.

Figure 2.12

Fiscal Deficit Forecasts Revised Up

(Percent of GDP)



Sources: National authorities; and IMF staff calculations.

on asset quality with increases in nonperforming loans due to the downturn; balance sheets can be expected to deteriorate in Egypt and Tunisia. In some countries, the euro area turmoil could have an adverse impact, as European banks have a large presence (Box 2.2).

Spending Escalates with Universal Subsidies Rising Sharply

In response to growing social unrest, the economic downturn, and higher commodity prices, governments in the region have significantly expanded subsidies and transfers (Box 2.3 and Figure 2.11). These are high, exceeding 10 percent of GDP in Egypt, and more than 5 percent of GDP in most other countries. The increases have been only partially compensated for by cuts in expenditure in some countries (Egypt, Jordan, Mauritania, Morocco, Pakistan). Finally, public-sector wage bills have increased, though to a lesser extent, especially in Afghanistan, Egypt, Jordan, Morocco, Syria, and Tunisia.[1]

Recent studies illustrate that the bulk of the subsidies benefit the wealthy (Box 2.4).[2] Apart from the productive inefficiency of fuel subsidies, the relatively low marginal propensities to consume among the wealthy imply that subsidies have limited effectiveness in boosting consumption to help cushion the downturn.

IMF projections of fiscal deficits during 2011–12 have been successively revised upward, a consequence of downward revisions in growth and expansions in fiscal spending and tax exemptions (Figure 2.12). In 2012, a modest consolidation is envisaged as the regional political situation begins to stabilize and growth picks up. Fiscal financing needs—defined as the sum of the overall deficit before grants and external amortization—are estimated to be approximately US$50 billion a year in the middle-income oil importers, with Egypt accounting for nearly half the total amount.

Fiscal Deficits Increasingly Financed from Domestic Sources

Governments in many MENAP oil importers are increasingly financing fiscal imbalances from

[1] The increases in public-sector wages announced earlier this year in Egypt are reflected only in FY 2011/12 owing to delayed implementation.

[2] See IMF, April 2011 *Regional Economic Outlook: Middle East and Central Asia.*

Box 2.3

MENAP Oil Importers: Domestic Fuel Pricing

As energy prices have increased worldwide in 2011, many MENAP oil-importing countries have limited the pass-through to domestic fuel consumers, choosing instead to increase subsidies or reduce taxes (see table).[1] In fact, the pass-through in 2011 was not only limited but actually negative in several cases; that is, as international oil prices increased, domestic retail prices decreased.

Pass-through in 2011 has also declined dramatically relative to the substantial pass-through experienced in the previous commodity price boom (mid-2006 to mid-2008). This decline is indicative of a reversal of the commodity-pricing reforms introduced in recent years. As a result, not only is the average MENAP domestic fuel price below the international fuel retail price, but the gap between them has widened since 2009, raising national fuel subsidy costs by 0.6–2 percent of GDP (see figure).

Some countries in the region had previously put in place automatic fuel-pricing mechanisms, but these are largely inoperative at present (particularly in Jordan and Mauritania). Research on country experiences shows that keeping prices liberalized has been the most robust pricing mechanism for preventing a resurgence of subsidies, while well-targeted safety nets continue to be the best means of providing for the needy.[2]

Fuel Price Pass-Through

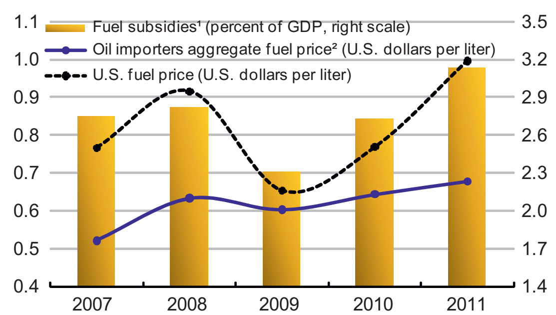
(Percent; end-of-period prices)

	Regular gasoline		Diesel	
	2006:Q2–2008:Q2	2010:Q4–2011:Q2	2006:Q2–2008:Q2	2010:Q4–2011:Q2
Egypt	56	0	22	0
Jordan	55	-26	123	-23
Lebanon	124	-9	119	109
Mauritania	91	14	30	14
Morocco	40	0	-18	0
Pakistan	50	56	38	0
Syria	63	0	57	-59

Sources: National authorities; and IMF staff calculations.

Fuel Prices and Subsidies

(Period average prices of regular unleaded gasoline and diesel; PPP GDP weighted for aggregation)



Sources: National authorities; U.S. Energy Information Administration; and IMF staff calculations.
[1]Includes Egypt, Jordan, Lebanon, Mauritania, Morocco, and Tunisia.
[2]Includes Egypt, Jordan, Lebanon, Mauritania, Morocco, Pakistan, and Syria.

Prepared by Jaime Espinosa Bowen.

[1] Pass-through is defined here as the ratio of the change in domestic retail fuel prices to the change in U.S. retail fuel prices, both measured in U.S. dollars. Retail fuel prices in the United States are typically used as a benchmark for tracking changes in international fuel costs, because of the liberalized U.S. pricing system. In recent years, the taxes included in U.S. retail prices have remained steady, at about US$0.11 a liter.

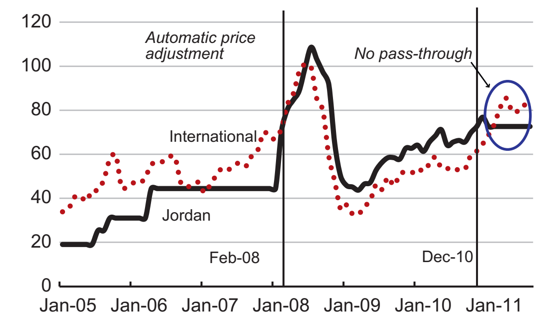
[2] Taimur Baig, Amine Mati, David Coady, and Joseph Ntamatungiro, 2007, "Domestic Petroleum Product Prices and Subsidies: Recent Developments and Reform Strategies," IMF Working Paper 07/71.

Box 2.4

Who Benefits from Energy Subsidies? Evidence from Jordan and Mauritania

Amid heightened social and political tensions in the region, energy subsidies increased substantially in Jordan and Mauritania following the latest spike in international oil prices. In Jordan, fuel price subsidies are expected to increase from about ½ of 1 percent of GDP in 2010 to nearly 2 percent of GDP in 2011, reflecting the impact of higher international prices on existing liquefied petroleum gas subsidy schemes and the authorities' decision in early 2011 to freeze fuel prices and stop implementing the monthly automatic adjustment pricing mechanism adopted in 2008 (Figure 1). Similarly, in Mauritania, the government expanded price subsidies and transfers from 2¾ percent of GDP in 2010 to 5½ percent of GDP in 2011. More than half the increase came from natural gas, electricity, and fuel price subsidies.

Figure 1
Domestic Diesel Prices in Jordan
(U.S. cents per liter)

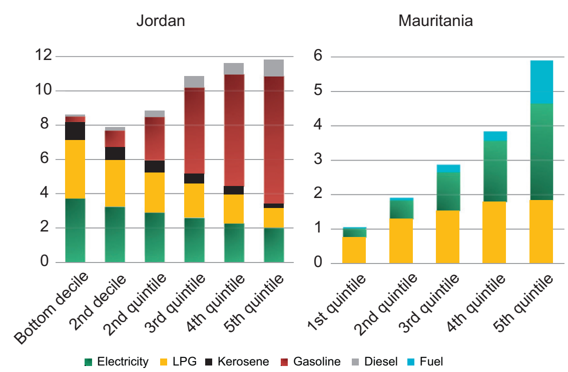


Sources: Jordan Ministry of Energy and Mineral Resources; and U.S. Energy Information Administration.

Existing universal (untargeted) energy price subsidies disproportionately benefit the rich, who account for a relatively high share of national energy consumption. Analytical evidence from the 2008 household surveys in Jordan and Mauritania shows that

- Fuel subsidies represent close to 8 percent of budgetary expenditures in Mauritania and 6 percent in Jordan.
- The budget share of energy products is lower among poor households (Figure 2). Households in the lowest income groups consume almost no gasoline, and as income increases, the expenditure share of gasoline increases (it more than doubles in Jordan).
- Benefits from energy subsidies are pro-rich. Gains from energy subsidies are at present distributed inequitably among households, with the benefits proportional to the amount spent by each household on different energy products. Thus, the richest 20 percent of households capture 40 percent of the subsidy benefits in Jordan and 65 percent of the benefits in Mauritania. In contrast, the poorest 20 percent of households receive less than 7 percent of the subsidy benefits (Figure 3). As a result, fuel subsidies—aimed initially at preserving the purchasing power of the poor and the middle class—end up biased heavily in favor of rich households.

Figure 2
Expenditure on Energy Products by Welfare Level
(Percent of total expenditure)



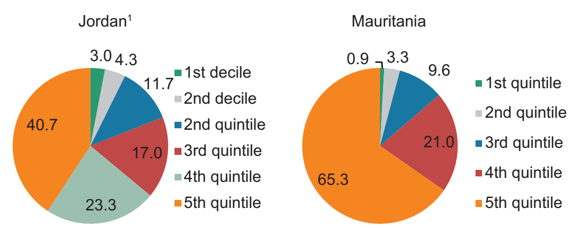
Source: IMF staff estimates based on information available in the 2008 household survey for Jordan and Mauritania.
Note: Household welfare quintiles are based on household consumption per capita. LPG refers to liquefied petroleum gas.

Prepared by Moataz El-Said, Amine Mati, and Younes Zouhar.

Box 2.4 *(concluded)*

- Fuel subsidies are a costly mechanism for the provision of social assistance to lower-income households. For example, in Jordan, it costs the budget about JD 14 to deliver JD 1 in transfers, via fuel subsidies, to the bottom quintile of the country's income distribution. Similarly, in Mauritania, only UM 1 out of UM 24 spent on subsidies reaches the poor (the bottom two quintiles). For both countries, a random distribution of benefits would have been less costly and more effective in assisting the poor.

Figure 3
Share of Benefit from Energy Subsidies

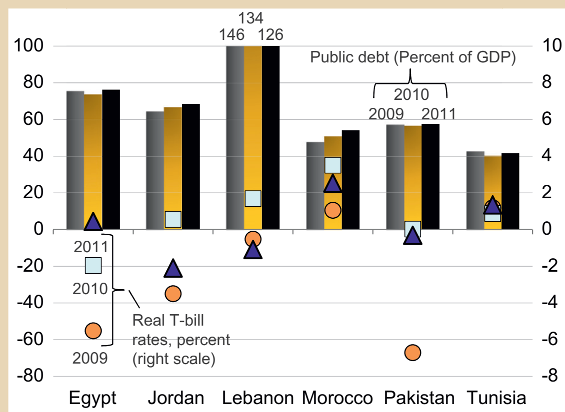


Source: IMF staff estimates based on information available in the 2008 household survey for Jordan and Mauritania.
[1]For Jordan, the distribution of gains accounts for both the direct and indirect effect of price subsidies. The latter refers to the impact of energy price subsidies on the price of other consumed goods and services that use energy in their production and distribution.

domestic banking systems. The overall fiscal deficit before grants is projected to exceed 8 percent of GDP in 2011, while grants have expanded only modestly (except in Jordan, which received additional grants of about 4½ percent of GDP this year), and borrowing costs in international markets have risen. As a result, governments in Egypt, Morocco, Pakistan, and Syria are relying heavily on domestic financing. In contrast, Djibouti, Mauritania, and Tunisia are relying on official external financing.

Even though nominal debt has risen, financial repression—as defined by high inflation and low or negative real interest rates—has helped to keep debt levels stable as the real value of domestic debt is being eroded in several countries (Figure 2.13). The excessive government reliance on domestic bank financing is squeezing the availability of credit to the private sector.

Figure 2.13
Public Debt Stable, Real Rates Close to Zero



Sources: National authorities; and IMF staff calculations.

The Road Ahead Is Challenging

The regional downturn has highlighted the challenge of preserving macroeconomic stability while maintaining social cohesion. In the near term, an expansionary fiscal stance is appropriate to mitigate the impact of the downturn, but limited fiscal space, and efficiency and equity concerns, call for replacing universal subsidies with targeted social safety nets. Resources can then become available for critical investments in infrastructure and education, and to support much-needed reforms.

With respect to the medium term, defining a comprehensive macroeconomic policy framework and inclusive growth strategy—through a broad consultative process—can help policymakers and stakeholders reach consensus on policy priorities, anchor expectations, and reduce economic uncertainty. Anchoring expectations by committing to medium-term fiscal consolidation now will also allow countries to maintain a countercyclical stance in the near term. This commitment should include concrete plans to unwind recent tax breaks and expenditure measures.

Similarly, the region's accommodative monetary policy stance remains broadly appropriate for the near term, in the face of below-trend growth and negative output gaps, moderating food and fuel prices, and the weakening global economy. As the economy recovers, however, monetary policy should normalize to prevent second-round inflation effects from recent wage increases and past increases in food prices. Policy rates may need to be raised sooner if international reserves continue to come under pressure in countries with fixed exchange rates; in Egypt, greater exchange rate flexibility may be warranted. Over the medium term, and depending on each country's specific circumstances, the monetary policy toolkit could be expanded by gradually moving away from the use of exchange rates as a nominal anchor. This movement would give monetary policy more room to maintain price stability, with exchange rates that can adjust in response to real shocks and help maintain competitiveness.

Downside risks from the external environment have increased sharply in recent months, as concerns have intensified over continuing financial sector weakness and sovereign debt sustainability facing advanced economies. Compared to expectations in spring 2011, a significantly higher likelihood is attached to further weakness in advanced economies' growth and to the unfolding of a tail event in Europe.[3] MENAP oil importers, especially in the Maghreb, would be affected by adverse developments in Europe (Box 2.2), as they would face contagion via real sector linkages in trade, tourism, FDI, and remittances; these effects would include higher costs of external financing. Financial sector spillovers have been limited so far, but could come into play if the crisis spreads to countries in the core euro area. In the wake of the Arab Spring, most countries have already used their fiscal and international reserve buffers to respond to deteriorating economic conditions and have much less room remaining to respond to future shocks.

Nonetheless, the largest downside risks to MENAP oil importers at this juncture are the future of domestic policies and political uncertainty in some countries. Delays in stabilizing the political situation and implementing reforms will continue to adversely affect investor sentiment and growth while raising borrowing costs and public debt. On the upside, credible and timely elections in Egypt and Tunisia and the resolution of the conflict in Syria, together with early signaling of the commitment to comprehensive change in a transparent and credible manner, could have a large positive impact in the region.

The Way Forward to Inclusive Growth

Maintaining macroeconomic stability and meeting the rising demands of the population will not be easy. Given the significant risks to the global recovery, rising borrowing costs in international markets, and declining capital inflows, some of the pressures can be alleviated through external and fiscal financing from official sources. Such support can help preserve reserve cushions against additional shocks, reduce pressure on domestic credit and interest rates, and mitigate budget pressures for social spending. Regional and international partners—such as the recent Deauville Partnership—can help formulate and implement a reform agenda through technical assistance, debt relief, and concessional financing.

Key components of the reform agenda are

Labor markets. Reducing rigidities in labor markets can help to create jobs and lower unemployment—which is particularly high among youth—in

[3] See IMF, September 2011 *World Economic Outlook*.

MENAP oil importers.[4] Reforming education systems will boost the pool of skilled workers demanded by the private sector and will enhance opportunities for investments in human capital, thereby aiding social mobility. Decreasing the regulatory and tax burden in product and labor markets and improving the quality of institutions and governance can help reduce the size of the informal economy and make growth more inclusive. Workers will thereby gain better social protection, benefits, and career prospects (Annex 2.1).

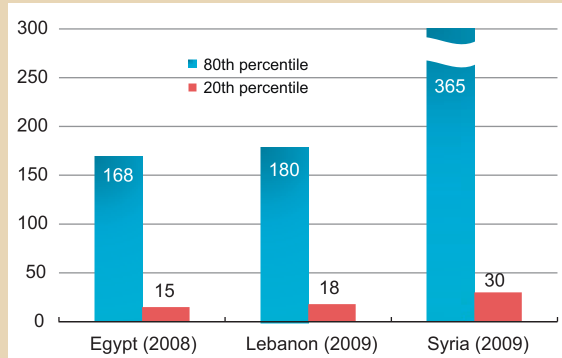
Business environment and access to government services. Improving the region's business environment will be important in reducing the costs of doing business and strengthening competitiveness.[5] To this end, it will be critical not only to improve the underlying legal framework, but also to narrow the gap between the legal framework and its implementation, so as to make access to government services more equal. Experience on the ground reveals significant variation in access to government services—for example, in Egypt it can take one-fifth of firms nearly six months to obtain an operating license, while others can do so in about two weeks (Figure 2.14 and Annex 2.2).

Access to financial services and trade environment. Improving corporate governance and disclosure and deepening capital markets will help businesses, especially small and medium-sized enterprises, to access credit and attract

Figure 2.14

All Firms Are Not Created Equal

(Days required for a firm to obtain an operating license)



Source: World Bank and European Bank for Reconstruction and Development, Business Environment and Enterprise Performance Survey (BEEPS).

investment.[6] There is also a need for the MENAP region to more fully exploit trade as an engine of growth, particularly by making trade regimes less restrictive. Efforts should continue to be made to diversify both the composition and destination of exports, for closer integration with faster-growing emerging markets.

Policymakers in the region need to better leverage its many assets: a dynamic young population, vast natural resources, a large regional market, and an advantageous geographic position with proximity to the euro area. Although the region faces difficulties in the short term, pursuing the reform agenda in a comprehensive way can help deliver higher standards of living and ensure more equal access to economic opportunities over the medium and long term.

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[4] See IMF, October 2010 and April 2011 *Regional Economic Outlook: Middle East and Central Asia.*

[5] See IMF, October 2010 *Regional Economic Outlook: Middle East and Central Asia.*

[6] See IMF, May 2010 *Regional Economic Outlook: Middle East and Central Asia.*

Annex 2.1. MENA Oil Importers: Addressing Informality and Promoting Inclusion

The informal sectors of MENA oil importers are large, with negative implications for workers who enjoy little or no social protection and career prospects—thereby undermining inclusiveness. To reduce informality and foster inclusive growth, policymakers need to improve the business environment, relax labor market rigidities, reduce the tax burden, provide informal workers with access to skills upgrading, and create an environment that fosters a level playing field for all workers and firms.

How Large Are Informal Economies in the Region?

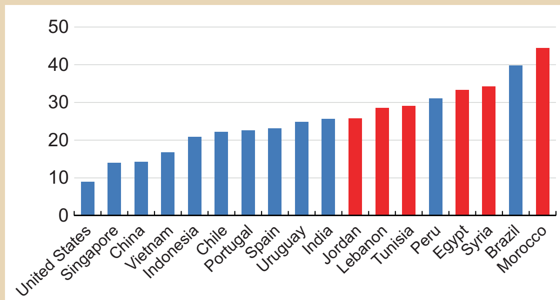
The informal sector is widespread across the oil-importing countries of MENA. The size of the informal economy in these countries (as a share of formal—officially measured—GDP) is large, also when compared with other emerging-market countries, with estimates ranging from 26 percent in Jordan and about 30 percent in Lebanon and Tunisia to about 34 percent in Egypt and Syria and 44 percent in Morocco (Figure 1).[1]

Such high levels of informality imply that many workers in MENA oil-importing countries have little or no social protection or employment benefits; these conditions undermine inclusiveness in the labor market. According to the most recent World Bank World Development Indicators,[2] 43 percent of the labor force in Egypt and 51 percent in Tunisia do not contribute to a retirement pension scheme. The numbers for Jordan and Lebanon are 62 percent and 67 percent, respectively. In Syria and Morocco, more than 70 percent of the labor force lacks pension coverage.

Figure 1

Size of the Informal Economy

(Percent of GDP, 2008)



Sources: For MENA and Latin American countries, authors' estimates; see note 1 in the text for methodology. For all other countries, estimates are as reported in Schneider and others and are for 2007.

What Drives Workers and Firms into the Informal Economy?

An excessive regulatory burden in product and labor markets, an excessive tax burden, and low quality of institutions and/or governance have all conspired to drive workers and firms in the region into the informal economy. Burdensome regulations in product markets—for example, in the form of lengthy, expensive, and complicated procedures to start and operate businesses; stringent labor regulations; high labor costs—such as minimum wages that exceed productivity, and high severance pay—and high taxes have increased the costs of

Prepared by Yasser Abdih and Jiwon Kim.

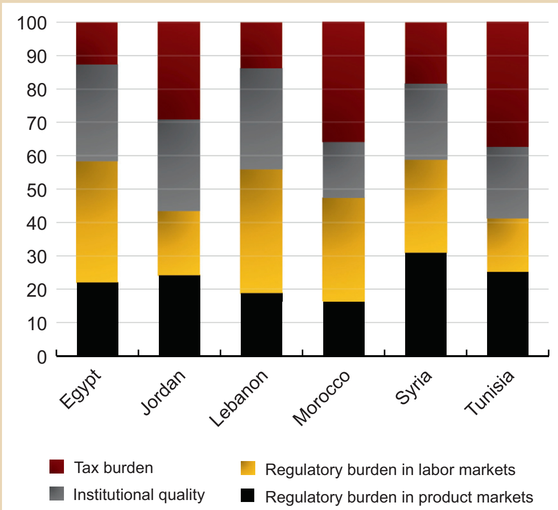
[1] The size of the informal economy is estimated using a Multiple Indicator–Multiple Cause (MIMIC) model, typically used in the literature (see Friedrich Schneider, Andreas Buehn, and Claudio Montenegro, 2010, "New Estimates for the Shadow Economies All Over the World," *International Economic Journal*, 24(4), pp. 443–61). By looking at measurable indicators and drivers of the informal economy, the MIMIC model obtains an estimate of its size. Based on previous research in this area, measurable indicators of the informal economy include currency as a fraction of broad money, and self-employment as a fraction of total employment; and measurable drivers used are indices capturing the regulatory burden in product and labor markets, the tax burden, and institutional quality.

[2] World Bank, World Development Indicators, September 2011.

Figure 2

Contribution of Determinants to the Size of the Informal Economy

(Percent)



Sources: Authors' estimates. See also notes 1 and 3 in the text.

operating in the formal economy and hence have provided strong incentives for workers and firms to operate informally where they can avoid those costs.

These incentives are exacerbated when the quality of institutions is low. Weak institutional quality can take the form of low quality of public services or weak enforcement of regulations. For example, a judicial system that is weak in regard to resolving conflicts and enforcing contracts would reduce the benefits of belonging to the formal economy (or reduce the opportunity cost of informality) and hence would provide more incentives for workers and firms to operate informally. Weak institutional quality can also take the form of corruption, which could limit access to government services to a privileged few or advantage a few large "protected" or "connected" firms at the expense of many small ones (thereby reducing the benefits of formality). Corruption can also reduce the costs of informality—for example, informal firms can pay bribes to avoid large fines and penalties when detected. Either way, corruption increases the incentive to operate in the informal economy.

For the typical MENA oil-importing country, the regulatory burden in product markets, institutional quality, and the tax burden each explain, on average, about 24 percent of the overall size of the informal economy. Labor market rigidities contribute about 28 percent, on average (Figure 2).[3]

A comparison of drivers across countries indicates that the tax burden appears particularly important in Morocco and Tunisia (Figure 2). Both these countries have a high corporate tax rate, at about 30 percent, significantly above the average for developing countries of about 20 percent.[4] In Morocco, surveys of small firms reveal that a high tax burden is the most significant obstacle to formalization—over 50 percent of surveyed firms identify the level of taxes as the major reason for not registering their business.

Notable among other drivers, rigid labor market regulations appear to be particularly relevant in Egypt, Lebanon, Morocco, and Syria. And indeed, data from enterprise surveys indicate that worldwide, the percentage of firms identifying labor regulation as a major constraint on their business operations is, on average, greatest in these countries.[5] In Egypt, for example, termination regulations are overly stringent—severance payments for established employees (including the cost of advance notice requirements) amount to up to 132 weeks' worth of their final salaries. In Syria and Morocco, these payments are equivalent to 80 weeks and 85 weeks, respectively[6]—much higher than the average 39 weeks in the East Asia and Pacific region and 26 weeks in the developed

[3] To compute the contribution of each causal variable (driver) to the size of the informal economy, we multiply the estimated coefficient of the causal variable from the MIMIC model by its value, and then divide by the estimated size of the informal economy. See also note 1.

[4] Roberta Gatti, Diego Angel-Urdinola, Joana Silva, and Andras Bodor, 2011, *Striving for Better Jobs: The Challenge of Informality in the Middle East and North Africa* (Washington: World Bank).

[5] See IMF, October 2010 *Regional Economic Outlook: Middle East and Central Asia.*

[6] World Bank, 2008, *Doing Business 2009* (Washington).

world.[7] Such high firing costs impede the expansion of formal employment and either force formal firms completely into the informal economy or drive them to hire workers informally so that these costs can be avoided.

What Can Policymakers Do?

The barriers to business and labor formality are also barriers to inclusive growth. To remove them, policymakers should

Improve the business climate and create a level playing field for everyone. Policy should focus on improving the regulatory framework for businesses—by, among other measures, simplifying entry regulations and reducing compliance costs—while at the same time creating an environment that fosters a fairer enforcement of regulation. Such an approach not only is conducive to investment and growth, but also is inclusive as it allows all firms and workers to compete fairly.

Reform labor market institutions. Overly restrictive labor market regulations in the region impede job creation in the formal sector, contribute to driving firms and workers into the informal economy, and reinforce segmentation in the labor market, with the result that workers in the formal sector enjoy protection while informal workers have little or no protection at all. Policy should, therefore, aim at relaxing such rigid regulations to achieve more compliance and improved employment outcomes, while at the same time preserving the right to collective bargaining and developing effective social protection systems to better protect the income position and employment transitions of all workers.

Reduce the tax burden. Reducing corporate tax rates (where they are high) and simplifying tax regulations, for example, would increase formality and, in fact, could also increase tax revenues, as evidence from Egypt and Brazil suggests.[8] This can happen through three channels that increase the tax base. First, such reforms will provide incentives for existing informal firms to formalize and hence pay taxes. Second, existing formal firms will have greater incentive to invest and earn more income, which is also conducive to growth. Finally, new firms will have greater incentive to operate in the formal economy.

Provide informal workers with access to skills upgrading. Existing training programs in the region typically target the unemployed, and rightly so, given that they are a vulnerable group in society. However, many informal workers are also vulnerable, and in certain cases they are even worse off than some of the unemployed. For example, micro evidence from Egypt suggests that unemployment tends to increase with household incomes.[9] This could suggest that individuals from relatively wealthy households have higher reservation wages—buoyed by family support—and, hence, can tolerate a longer duration of unemployment while seeking a higher-paying job. On the other hand, individuals from poorer households—with similar skill levels—will tend to accept lower-paying jobs in the informal sector. Therefore, any inclusive growth agenda should provide all vulnerable groups in society—including informal workers—with access to skills upgrading.

[7] Navtej Dhillon and Tarik Yousef (eds.), 2009, *Generation in Waiting: The Unfulfilled Promise of Young People in the Middle East* (Washington: Brookings Institution Press).

[8] See note 4.

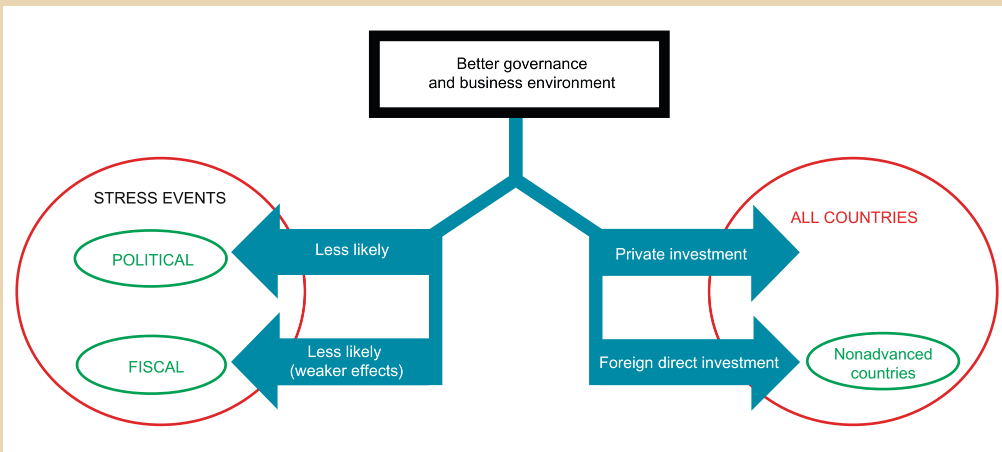
[9] See note 4.

Annex 2.2. A Closer Look at Governance and the Business Environment in MENAP

Countries in the MENAP region lag behind others in quality of governance and have not improved much in this regard during the past decade. While business climate reforms over the same period have improved the global ranking of many MENAP countries, a significant implementation gap remains between laws and regulations on paper and practice on the ground, and inequality of access to services, including those provided by the financial sector, is a key impediment. Tackling labor market efficiencies would improve the business environment and help address MENAP's looming unemployment problem.

Figure 1

Business Environment and Governance: Linkages with Investment and Stress Events



Sources: See note 2 in text.

Good business environment and governance foster both inclusive growth and macroeconomic stability. They encompass transparency and predictability in policymaking, efficiency, and equity in access to government services and resources.

Existing empirical work shows a link between good governance and investment (Figure 1). Recent analysis finds that better governance is associated with a higher share of private investment in total investment—a "vote of confidence" measure—and with higher foreign direct investment.[1] Better governance is also associated with fewer stress events, particularly political ones.[2]

Prepared by Mark Horton, based on work by Carlos Caceres, Nadeem Ilahi, Anna Kochanova, Kamal Krishna, and Chunfang Yang.

[1] The IMF has a mandate to consider governance issues when these have a significant macroeconomic impact or constrain a government's ability to pursue policies aimed at external viability and sustainable growth.

[2] See Carlos Caceres and Anna Kochanova, forthcoming, "Investment Promotion and the Role of Governance" and "Country Stress Events: Does Governance Matter?" IMF Working Papers.

Governance: Serious Weaknesses, Scope for Improvement

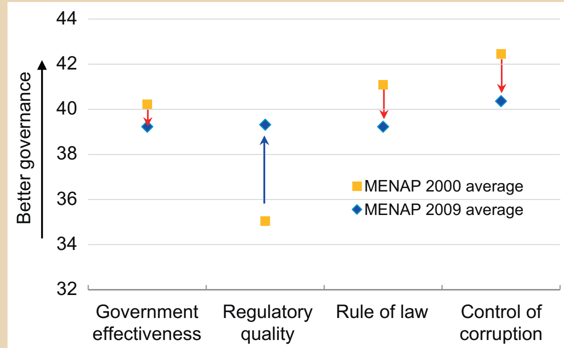
Most MENAP countries do not fare well on global governance rankings, and those rankings appear to have deteriorated over the past decade. As a group, the MENAP region ranks below the 50th percentile on many of the governance themes covered by the *Worldwide Governance Indicators* (WGI) of the World Bank.[3] In recent years, only a handful of MENAP countries—Jordan, Saudi Arabia, Tunisia, and some Gulf states—have ranked above the 50th percentile, for some of the WGI subindicators. There was little improvement over the 2000–09 period, when only regulatory quality improved in a significant manner, while scores on other subindicators either fell or remained unchanged (Figure 2).

Cross-country analysis points to a positive link between good governance and strong macroeconomic performance. A comparison of *government effectiveness* and *regulatory quality* subindicators of the WGI with per capita income and sovereign credit ratings reveals a clear association: countries with good governance also exhibit higher income and stronger credit ratings (Figures 3 and 4). Interestingly, several MENAP hydrocarbon-rich countries stand out in such comparisons—they obtain a higher credit rating than would typically be expected, given their level of government effectiveness and regulatory quality (Figure 4). This suggests there is scope for these countries to continue investing in the institutional improvements necessary to increase the dynamism of the nonhydrocarbon economy.

Figure 2

Governance

(Percentile, 2000 and 2009)



Source: World Bank, Worldwide Governance Indicators.

Business Environment: Many Challenges

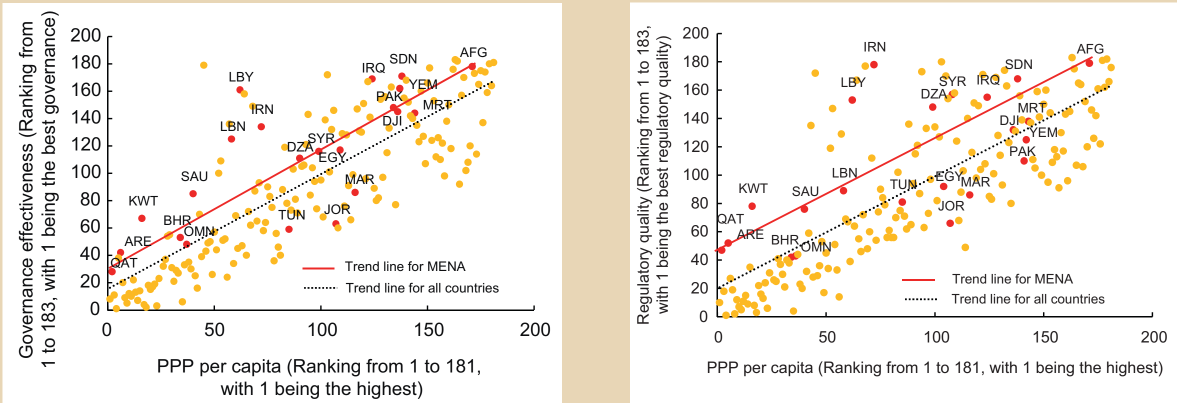
A number of MENAP countries fare well on global business environment rankings, though some are among the worst. The World Bank's *Doing Business* (DB) and the World Economic Forum's *Global Competitiveness Indicator* (GCI) rank MENAP countries particularly highly. Bahrain, Qatar, Saudi Arabia, and the United Arab Emirates all rank above the 50th percentile, according to DB (Figure 5).[4] However, several MENAP countries also rank near the bottom—Pakistan and Libya are among those characterized as having among the most difficult business environments.

MENAP countries' performance on business environment rankings does not always tell the full story. Some business environment indicators, such as DB, are based on an assessment of rules and regulations, and may not adequately capture the true business climate if experiences on the ground are different. Firm-level responses—a useful check on whether formal rules and regulations pertaining

[3] This Annex draws heavily on the WGI, which is generally seen as perhaps the most comprehensive indicator of governance quality. As an "indicator of indicators," it aggregates a host of publicly available governance assessment indicators (both de jure and de facto). It groups governance into six broad thematic subindicators: government effectiveness, regulatory quality, control of corruption, rule of law, voice and accountability, and political stability/absence of violence. See http://info.worldbank.org/governance/wgi/index.asp.

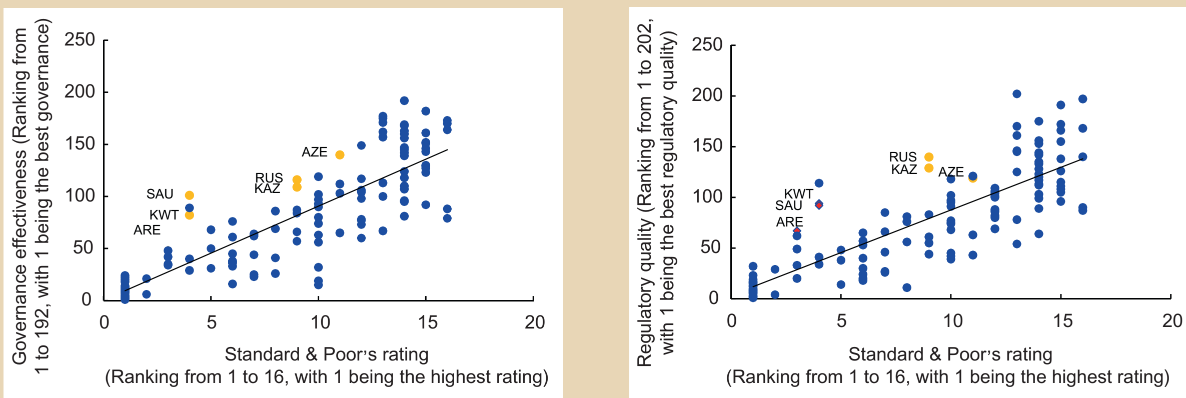
[4] DB rankings cover the regulatory environment related to nine key steps needed to set up, operate, and close a business (www.doingbusiness.org). The GCI ranks countries across 12 "pillars" of competiveness, including institutions, infrastructure, macroeconomic environment, efficiency of financial, goods, and labor markets, health and education, and innovation (www.weforum.org.)

Figure 3
Governance Indicators and Per Capita Income



Sources: World Bank, Worldwide Governance Indicators, 2009; and IMF, April 2011 *World Economic Outlook.*

Figure 4
Governance Indicators and Sovereign Credit Ratings[1]



Sources: Standard & Poor's, 2011; and World Bank, Worldwide Governance Indicators, 2009.
[1]Countries above the trend line have a better credit rating than is warranted by their governance indicators.

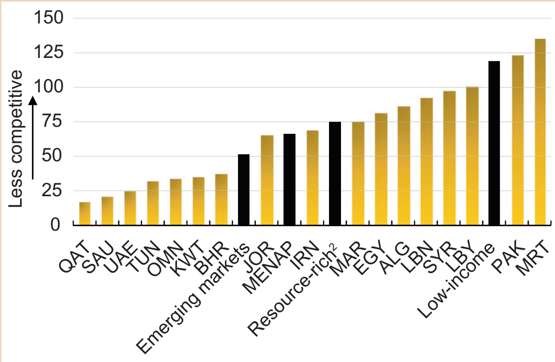
to business activities work well in practice, or if implementation needs to be strengthened—reveal a significant implementation gap in several MENAP countries.[5] For example, while laws and regulations suggest that it should take new firms in Lebanon and Syria 15–20 days to get an operating license, firms report serious delays in practice, and it takes the median firm 60–90 days (Figure 6).

This observed deviation between de jure rules and de facto practice may shed light on why countries with seemingly good business environments and governance, or with significant improvements in rankings in recent years, have come under pressure recently.

The unequal application of rules and regulations highlights problems of "ad hoc-ism," lack of inclusion, and inequality of access, in MENAP's

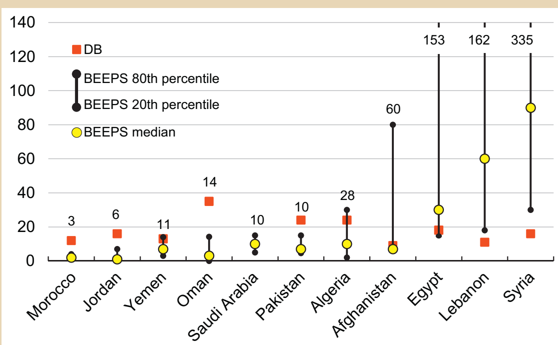
[5] Data are taken from World Bank and European Bank for Reconstruction and Development, Business Environment and Enterprise Performance Surveys (BEEPS).

Figure 5
WEF Global Competitiveness Indicator Rank[1]



Sources: World Economic Forum, *Global Competitiveness Report 2010–2011*.
[1]A total of 17 MENA countries are surveyed by the *Global Competitiveness Report*, excluding Afghanistan, Djibouti, Iraq, Sudan, and Yemen.
[2]The 41 resource-rich countries that are included in the Revenue Watch Institute's 2010 index.

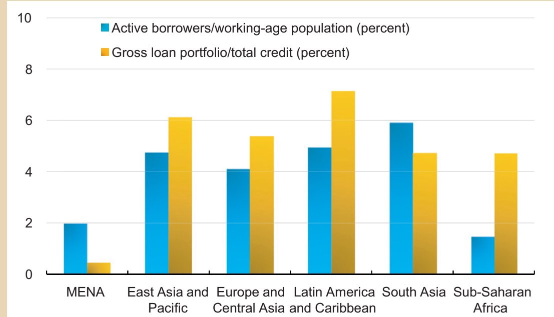
Figure 6
Number of Days Required to Obtain an Operating License (Firm Level)
(80th–20th percentile difference)



Sources: World Bank and European Bank for Reconstruction and Development, Business Environment and Enterprise Performance Survey (BEEPS); and World Bank, Doing Business (DB) Survey.
Note: From 2003 to 2010; data for each country vary by year.

business climate. In addition to the broad difference between the de jure and de facto business environment, there is also a wide divergence in the experience across firms within the same country: for instance, while the median firm in Syria is able to acquire an operating license in less than 100 days, for one-fifth of the firms, it can take one year or more. Lags of six months or more are also evident in Egypt and Lebanon (Figure 6). This divergence indicates that the playing field in MENAP is not level, particularly when it comes to firms on the

Figure 7
Microfinance by Region



Source: Douglas Pearce, 2011, "Financial Inclusion in the Middle East and North Africa," Policy Research Working Paper 5610, World Bank.

"outside" of the system—most likely, those that are small and less formal.

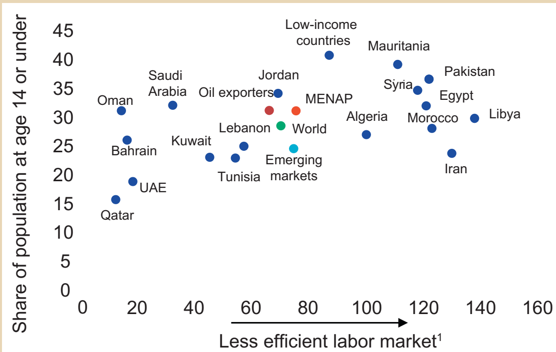
Inequality of access is also evident in the financial sector. While countries in the MENAP region have generally high outstanding credit to the private sector (in relation to GDP) when compared with other country groupings and regions (except for OECD and East Asian countries), small and medium-sized enterprises in MENAP have disproportionately low access to finance.[6]

Banks in the MENAP region tend to cater to a narrow set of clients, including the public sector and large corporations, and connected lending is pervasive—the ratio of exposure to top 20 loans to bank equity is nearly four times higher in MENAP than in North America. In addition, MENAP countries also rank relatively low on access to microcredit (defined as credit in which the average outstanding loan size is less than three times per capita income), and the gross microcredit loan portfolio in MENAP is significantly smaller, as a share of total credit, than that in other regions (Figure 7).[7]

[6] See Roberto R. Rocha, Zsofia Arvai, and Subika Farazi, 2011, *Financial Access and Stability: A Road Map for the Middle East and North Africa* (Washington: World Bank).
[7] See Douglas Pearce, forthcoming, "Financial Inclusion in the Middle East and North Africa: Analysis and Roadmap Recommendations," Background Paper, MENA Financial Sector Flagship Report, World Bank.

Figure 8

Labor Market Efficiency and Youth Population



Sources: World Economic Forum, *Global Competitiveness Report 2010–2011*; and World Bank, *World Development Indicators 2009*.

[1]Includes cooperation in labor-employer relations, flexibility in wage determination, rigidity of employment, hiring and firing practices, redundancy costs, pay and productivity, and reliance on professional management.

Business environment reforms would also need to address one of the MENAP region's main challenges—how to create employment opportunities for its large youth population. Business environment indicators help shed light on how well labor markets function in MENAP, and many countries in the region are at the bottom of global labor market efficiency rankings.[8] Matching labor market efficiency against the share in the population of those under age 14 reveals the gravity of the problem that some MENAP countries face in absorbing new entrants (Figure 8). The challenges are most acute in Egypt, Libya, Mauritania, Pakistan, and Syria.

[8] A modified labor market efficiency indicator was constructed using the following subindicators of the World Economic Forum's *Global Competitiveness Report*: labor-employer cooperation, wage flexibility, employment rigidity, hiring and firing practices, and pay and productivity.

Selected Economic Indicators: MENAP Oil Importers

	Average 2000–05	2006	2007	2008	2009	2010	Projections 2011	2012
Real GDP Growth	**4.4**	**6.2**	**6.5**	**5.5**	**4.2**	**4.3**	**1.9**	**3.1**
(Annual change; percent)								
Afghanistan, Rep. of	…	5.6	13.7	3.6	20.9	8.2	7.1	7.2
Djibouti	2.4	4.8	5.1	5.8	5.0	3.5	4.8	5.1
Egypt	4.0	6.8	7.1	7.2	4.7	5.1	1.2	1.8
Jordan	6.0	8.1	8.2	7.2	5.5	2.3	2.5	2.9
Lebanon	3.4	0.6	7.5	9.3	8.5	7.5	1.5	3.5
Mauritania	3.7	11.4	1.0	3.5	-1.2	5.2	5.1	5.7
Morocco	4.4	7.8	2.7	5.6	4.9	3.7	4.6	4.6
Pakistan	5.0	5.8	6.8	3.7	1.7	3.8	2.6	3.8
Syrian Arab Republic	3.8	5.0	5.7	4.5	6.0	3.2	-2.0	1.5
Tunisia	4.4	5.7	6.3	4.5	3.1	3.1	0.0	3.9
Consumer Price Inflation	**3.9**	**7.1**	**7.0**	**13.3**	**11.1**	**8.7**	**9.8**	**9.6**
(Year average; percent)								
Afghanistan, Rep. of	…	7.2	8.6	30.5	-8.3	0.9	13.4	1.2
Djibouti	2.1	3.5	5.0	12.0	1.7	4.0	7.1	1.9
Egypt	4.7	7.6	9.5	18.3	11.7	11.4	11.2	11.0
Jordan	2.1	6.3	4.7	13.9	-0.7	5.0	5.4	5.6
Lebanon	0.5	5.6	4.1	10.8	1.2	4.5	5.9	5.0
Mauritania	6.6	6.2	7.3	7.3	2.2	6.3	6.2	6.3
Morocco	1.5	3.3	2.0	3.9	1.0	1.0	1.5	2.7
Pakistan	4.6	7.9	7.8	12.0	20.8	11.7	13.9	14.0
Syrian Arab Republic	2.7	10.4	4.7	15.2	2.8	4.4	6.0	5.0
Tunisia	2.7	4.1	3.4	4.9	3.5	4.4	3.5	4.0
General Government Fiscal Balance	**-5.3**	**-4.8**	**-5.2**	**-5.4**	**-5.2**	**-6.0**	**-7.6**	**-6.7**
(Percent of GDP)								
Afghanistan, Rep. of	…	-3.1	-2.0	-4.3	-1.6	0.9	0.0	-1.8
Djibouti	-1.8	-2.4	-2.6	1.3	-4.6	-0.5	0.4	0.0
Egypt[1]	-9.9	-8.2	-7.3	-6.8	-6.9	-8.1	-9.9	-8.7
Jordan[1]	-3.1	-3.5	-5.7	-5.5	-8.9	-5.4	-6.1	-5.9
Lebanon[1]	-15.3	-10.4	-10.8	-9.5	-8.2	-7.3	-7.8	-8.3
Mauritania[1,2]	-6.6	35.8	-1.6	-6.5	-5.1	-1.9	-2.8	-3.8
Morocco[1]	-5.2	-2.0	0.3	1.5	-1.9	-4.5	-5.8	-5.0
Pakistan	-2.7	-3.7	-5.5	-7.3	-5.2	-5.9	-6.5	-5.3
Syrian Arab Republic	-2.1	-1.1	-3.0	-2.9	-2.9	-5.1	-11.0	-9.1
Tunisia	-2.6	-2.9	-2.8	-0.7	-2.6	-1.2	-4.1	-4.3
Current Account Balance	**-0.4**	**-1.3**	**-2.2**	**-4.4**	**-4.4**	**-3.3**	**-3.3**	**-3.8**
(Percent of GDP)								
Afghanistan, Rep. of	…	-5.7	0.9	-1.6	-2.6	2.7	-0.8	-4.4
Djibouti	-0.4	-11.5	-21.4	-24.3	-9.1	-4.8	-10.8	-11.6
Egypt	1.6	1.6	2.1	0.5	-2.3	-2.0	-1.9	-2.2
Jordan	0.0	-11.5	-16.8	-9.3	-3.3	-4.9	-6.7	-8.4
Lebanon	-15.2	-5.3	-6.8	-9.2	-9.7	-10.9	-14.7	-13.8
Mauritania	-18.8	-1.3	-17.2	-14.8	-10.7	-8.7	-7.5	-7.5
Morocco	2.2	2.2	-0.1	-5.2	-5.4	-4.3	-5.2	-4.0
Pakistan	1.6	-3.9	-4.8	-8.5	-5.7	-2.2	0.2	-1.7
Syrian Arab Republic	-2.3	1.4	-0.2	-1.3	-3.6	-3.9	-6.1	-6.1
Tunisia	-3.0	-1.8	-2.4	-3.8	-2.8	-4.8	-5.7	-5.5

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

[1]Central government.

[2]Includes oil revenue transferred to the oil fund.