

In the rapidly globalizing world economy, countries' attractiveness for investment is judged not only against their own historical record and prospects, but also vis-à-vis developments in other countries. In this regard, MENA's macroeconomic conditions compare favorably relative to those in emerging markets (Chart 1). In most countries with growing international financial linkages, relatively sound economic fundamentals provide an important cushion against the disruptive impact on the real economy of sudden reversals in capital flows, such as experienced in Mexico (1995) and Thailand (1997). However, MENA's implementation of structural reforms, while accelerating, continues to lag that in many other emerging markets. As a result, the region's investment and saving rates remains well below those in the average developing country, let alone those in developing economies having recorded high rates of economic growth (Chart 2).

Unfortunately, not all economies have been participating in the generalized improvements in the region. The Palestinian economy, in particular, has been suffering another year of major disruptions caused by frequent border closures and, until October, Israel's withholding of tax revenues accruing to the Palestinian Authority. These two factors have contributed to worrisome unemployment rates, disrupted public investment, and undermined private investment. Some other economies, such as Lebanon, continue to face challenging financial conditions as they manage the complex task of massive reconstruction and macroeconomic stabilization (Box 1).

B. Macroeconomic Outcomes in 1996-97

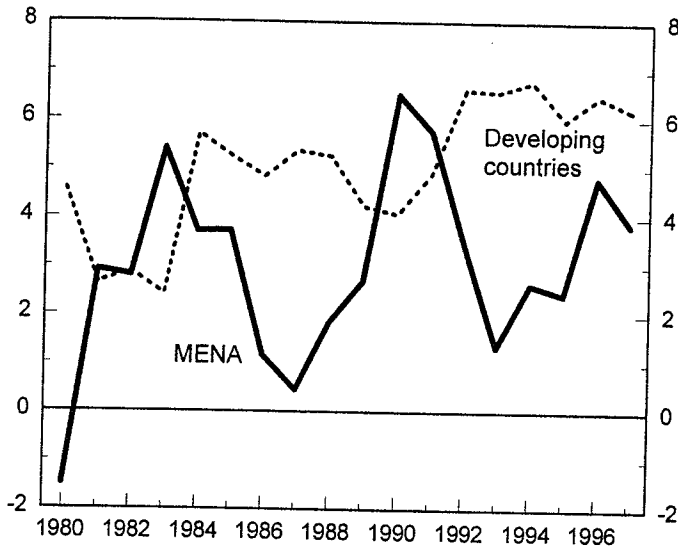
Growth in the MENA region picked up to 4.8 percent in 1996, and is projected at about 4 percent in 1997. In line with this favorable development, real GDP per capita has also increased for the group as a whole, reversing the declining trend of the previous three years. As a result, the region's real per capita income level is back to its level of 1990. Performance in this respect has been particularly noteworthy among the non-oil exporters, where real per capita GDP is estimated to have grown by about 3 percent in 1996 and a further 1.5 percent in 1997.

Egypt, the Islamic Republic of Iran, and Sudan are among the countries registering increasing real economic growth rates. Growth in Jordan remained relatively high at above 5 percent, albeit below the annual average of 6 percent recorded in the 1990s.

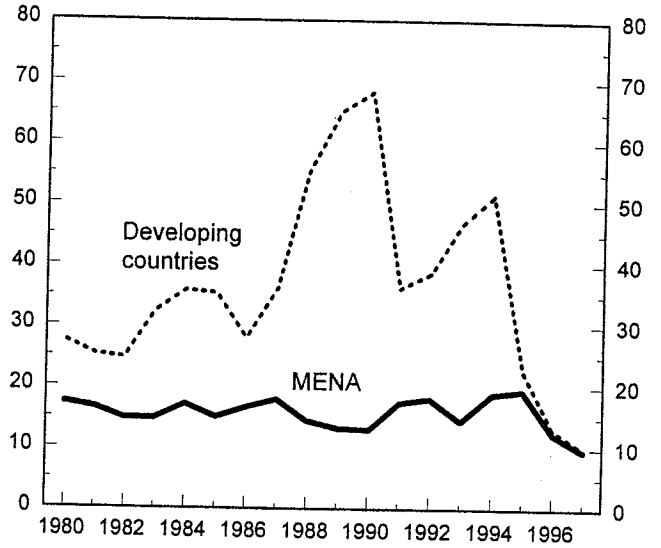
Not all economies registered increasingly buoyant economic growth rates. In Lebanon, for example, the growth rate has been below recent trends reflecting the slowdown in construction and the impact of the April 1996 bombings. Syria also experienced lower growth, as did Morocco owing to the less favorable weather conditions in 1997 and after a year of sharp recovery in GDP. Developments in the Palestinian economy were more worrisome, with output estimated to have remained stagnant or to have contracted for the second consecutive year. Indeed, the pickup in confidence and signs of sustained growth observed earlier have been undermined by recent disruptions to the regional peace process—a process accentuated by border closures and the interruption of revenue transfers. Growth in Israel slowed in 1996-97 owing to the winding down of the effects of the large wave of immigration during 1990-91, the deteriorating security situation, and high domestic interest rates.

Chart 1. Macroeconomic Conditions are Relatively Sound...

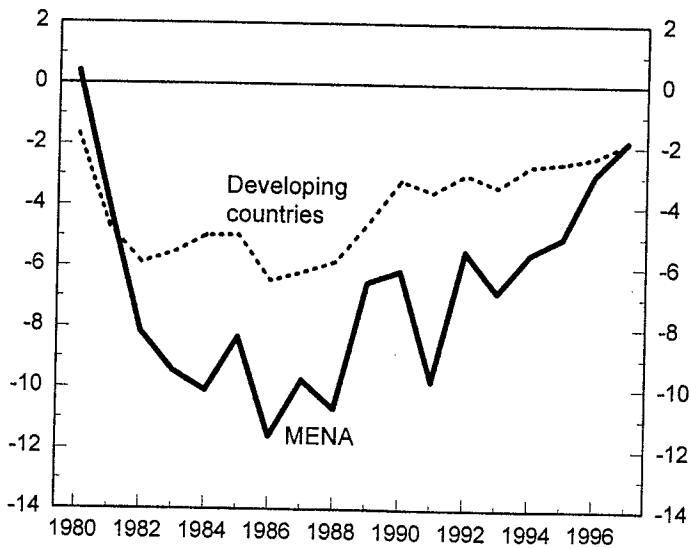
Real GDP Growth 1/
(Annual changes, in percent)



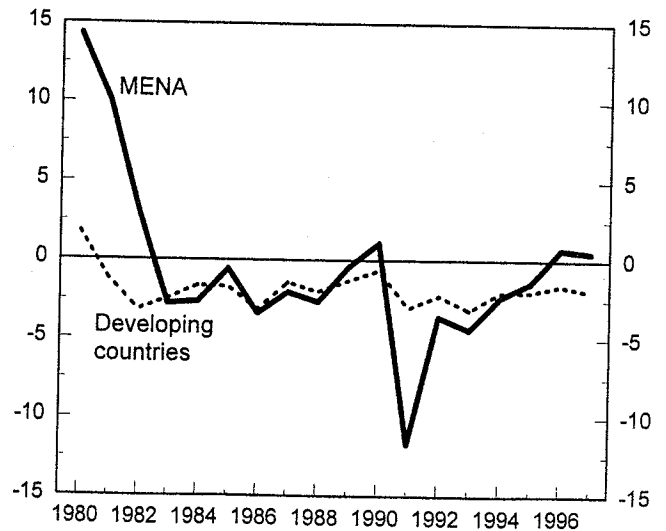
Inflation
(Annual changes, in percent)



Central Government Fiscal Balance
(In percent of GDP)



External Current Account
(In percent of GDP)

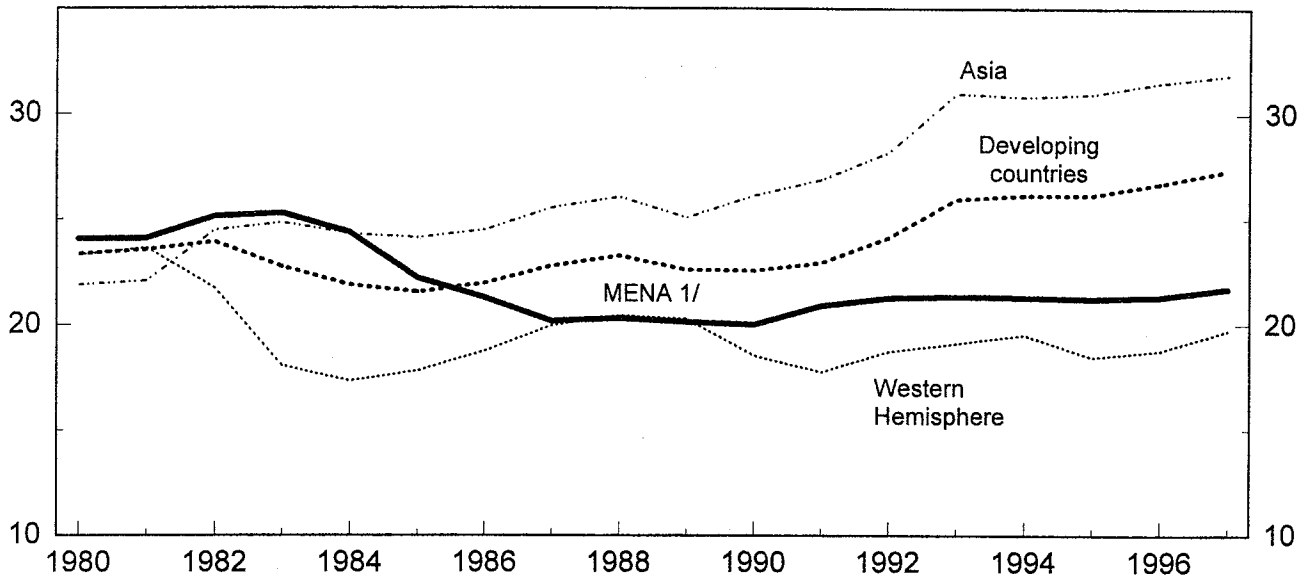


Source: IMF, *World Economic Outlook*.

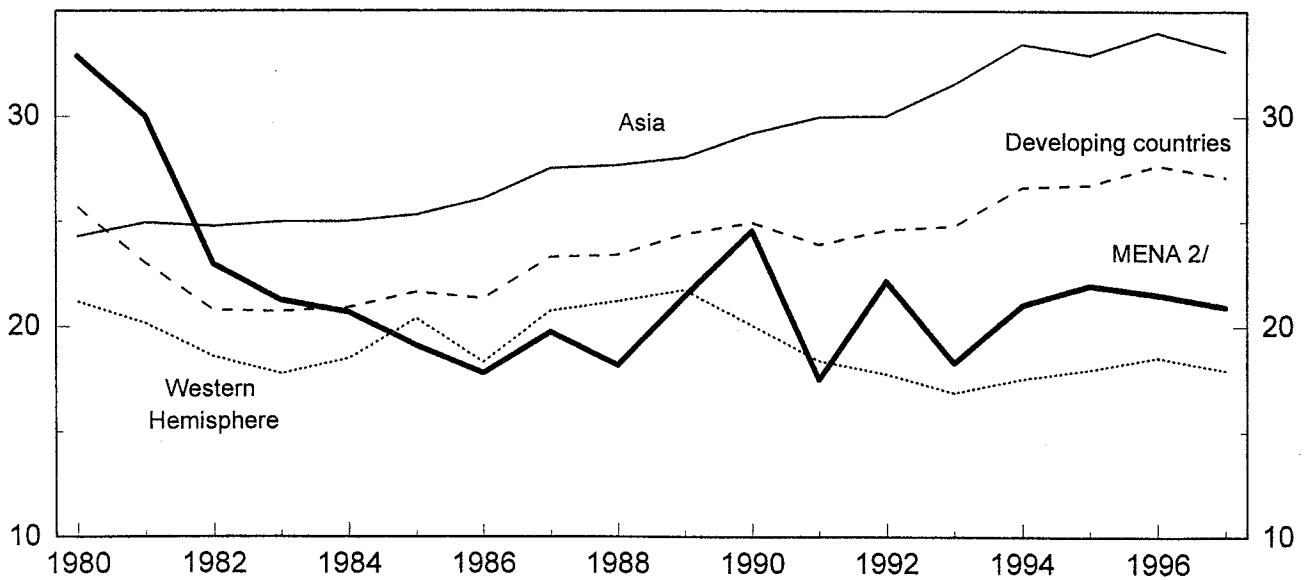
1/ Excludes Kuwait in 1990-93.

Chart 2. But Investment and Savings Rates are Still too Low...

Gross Fixed Capital Formation (In percent of GDP)



Gross National Savings (In percent of GDP)



Source: IMF, *World Economic Outlook*.
1/ Excludes Djibouti, Lebanon, and Sudan.
2/ Excludes Lebanon.

Box 1. Lebanon's Reconstruction Program

Since the end of the civil war, Lebanon has embarked on an ambitious **program of reconstruction and economic stabilization**. The reconstruction effort was initiated in 1992 with the National Emergency and Reconstruction Program (NERP). In 1994, this was integrated into the much more ambitious and widely known **Horizon 2000** program, which has become the envelope for all government financed and/or sponsored reconstruction efforts:

1. **The Vision.** The Horizon 2000 program outlines the government's investment plans for the 1995–2007 period. It goes beyond the initial emergency works under NERP and targets primarily the **rehabilitation and expansion of the infrastructure capital stock so as to lay the foundations for future economic growth**. In the preparation of the program, the government targeted an annual average real GDP growth rate of 8 percent so as to double per capita GDP by 2007. Taking into account that a sufficient stock infrastructure capital is an essential part of an enabling environment for private sector growth, a frontloaded path for government capital expenditure was a key element of the plan, allowing the public sector to be the catalyst for a general recovery in the economy. Later, growth was envisaged to be driven mainly by private sector activities and investment, allowing the government to reduce its budget deficits and its debt.

2. **The Achievements 1993–96.** The acceleration in government capital expenditure coupled with the nominal stabilization efforts was associated with **high rates of economic growth**, with the average annual growth rate during 1993–96 amounting to 7.4 percent. Moreover, the target of Phase I of the Horizon 2000 program, the **rehabilitation of basic infrastructure**, has largely been achieved. Major benefits are already tangible, including the 24-hour electricity provision for most users, better functioning telecommunication systems, rehabilitated road networks in Beirut and its northern and southern suburbs, and some 1,200 renovated public schools.

3. **The Future.** The Horizon 2000 Program has always had the character of an indicative framework, allowing the government to adjust to actual needs and macroeconomic constraints. Given recent macroeconomic and public finance developments, the government is adapting its plans accordingly:

- **Focus on social infrastructure.** During Phase II, the authorities are now shifting their attention from basic infrastructure to social infrastructure projects to achieve a well-balanced distribution of the reconstruction benefits across sectors, regions, and groups, and to ensure an environmentally sustainable growth. During Phase II, public capital expenditure will target projects in the education, health, water supply, wastewater, and solid waste sectors. Estimates of Phase II projects vary, but investments in the order of US\$5 billion over the period 1998–2002 are foreseen.

- **Greater private sector participation.** Given the budgetary constraints and its intention to promote the roles of the private sector and foreign direct investment in the economy, the government has started to increase private sector participation in the reconstruction, including through B.O.T. (Build-operate-transfer) and O.T. (operate-transfer) projects.

- **More foreign financing.** The government also hopes to increase the share of long-term concessional foreign financing, which has been lower than envisaged so far, thereby reducing the budgetary interest burden resulting from the relatively high domestic interest rates. In December 1996, during the "Friends of Lebanon" meeting, the international community pledged grants and concessional loans in the order of US\$3.2 billion to support the reconstruction efforts for 1997–2001.

Earlier progress in reducing inflation has been consolidated. The region's average inflation rate, as measured by changes in consumer price indices, declined to 12.4 percent in 1996, and to an estimated 9.6 percent in 1997. This represents a significant reduction from the levels registered in the early 1990s (of 15–18 percent). It reflects the pursuit, in many countries, of greater fiscal restraint and prudent monetary policies. The rate of inflation was 6 percent or below for more than one-half of the countries, and for countries with above average rates, such as the Islamic Republic of Iran, Sudan, and the Republic of Yemen, the rate of inflation was on a sharply declining trend. Inflation in Israel, after showing a rising trend early in 1996, was brought back down by a sharp tightening of monetary conditions in mid-1996 and is likely to fall below 10 percent in 1997. The lower inflation in the region has not only imparted a certain degree of financial stability, but is also helping with efforts to protect the poorest segments of the population.

MENA's outstanding external public debt, while still high in some countries, has been on a declining trend while foreign exchange reserves continue to increase. The ratio of external debt to GDP has been reduced from over 35 percent in the early 1990s to 31 percent in 1996, and an estimated 29 percent in 1997. This ratio has declined from 100 percent to 70 percent in the non-oil exporters, while for the oil exporters, it increased initially from 14 percent in 1991 to 22 percent in 1994, before declining to 13 percent in 1997. Likewise, MENA's debt burden, as measured by the ratio of total debt service to total exports of goods and nonfactor services, has declined to 11 percent in 1996 from over 16 percent just two years previously. A further decline is projected for 1997.

The recent decline in the external debt indicators reflects both the pursuit of more prudent fiscal policies, with a consequent reduction in the need for external financing of those deficits, as well as, in some country cases, exceptional debt relief from official creditors. For the GCC countries, the improvement in debt indicators reflects the repayment of foreign loans contracted to pay for outlays related to the 1991 regional crisis.

In view of these favorable developments, it is not surprising that we have also witnessed a continuing decline in market risk premia and related borrowing costs. Moreover, a number of countries have obtained in 1997 relatively favorable ratings from international credit rating agencies, including at the investment grade level.

C. Intermediate Policy Targets

As expected, these improvements in macroeconomic indicators have reflected strengthening intermediate policy variables.

MENA's sustained improvement in the fiscal balances has been particularly impressive. The overall government deficit for the region declined from close to 9 percent of GDP in 1986–90 to less than 3 percent of GDP in 1996, and an estimated 1.8 percent of GDP in 1997. The reduction has been most pronounced in the oil-producing countries, where the fiscal balance is projected to be only slightly in deficit (of 1 percent of GDP) in 1997. Clearly, the sharp increase in oil prices in 1996 and consequent impact on oil revenues explains in part the dramatic fiscal improvement. In virtually all cases, the gains from the oil price increases were not used to relax spending constraints but were directed

toward reducing public indebtedness and/or increasing official reserves. In fact, in many countries undertaking fiscal reforms, consolidation efforts have been intensified in the past two years.

The improved budgetary position has facilitated the implementation of prudent monetary policy while alleviating constraints on the provision of noninflationary credit to productive private sector activities. The expansion in liquidity associated with the heavy financing requirements of the budget, particularly in the non-oil exporting economies—growth in broad money averaged about 22 percent in the early 1990s for this group—had fueled inflationary pressures. However, with the adoption of fiscal restraint and an improvement in budgetary positions, broad money growth for these countries has been reduced to 16.5 percent in the past two years, permitting a reduction in inflation and an improvement in external positions. Within the overall credit expansion, there has been a change in composition, allowing resources to be redirected in support of private sector development.

The external current account position has strengthened. The region as a whole recorded a small current account surplus of 0.7 percent of GDP in 1996, with the same projected for 1997. The non-oil exporting countries registered a deficit of 4.7 percent of GDP in 1996, reflecting primarily higher import costs associated with the rise in oil prices and higher cereal prices. The oil exporters benefited from oil export price increases, which together with relatively stable net service receipts, resulted in a current account surplus of 4 percent of GDP in 1996, with a somewhat smaller surplus projected for 1997.

In sum, the favorable reversal of past economic trends in the region reflects the strengthening of reforms by a number of countries. Some MENA countries that initiated macroeconomic stabilization programs in the early 1990s, or even earlier—for example, Israel, Morocco, Tunisia, Egypt, and Jordan—have been reaping rewards for a relatively sustained period and are now moving more vigorously to implement structural reforms (Box 2). Others, which have recently embarked on comprehensive macroeconomic stabilization programs—for example, the Islamic Republic of Iran and the Republic of Yemen—have already begun to show favorable results. Still others have yet to embark on full-fledged economic reform programs and have thus not shared sufficiently in the economic turnaround experienced by many countries in region.

III. The Intensification of Structural Reforms

A. Addressing Structural Impediments

Full development of the economic potential of the region has in the past been constrained by macroeconomic instability and serious structural impediments.³ With several

³Israel differs in economic circumstances from most countries in the region. It is considered among the advanced economies in the sense that its economic structure is most akin to that of the industrial countries (a distinguishing feature of its industrial sector is the preponderance of high-tech industries). Furthermore, its economy is highly integrated in the world economy.

Box 2. Egypt: From Stabilization to Structural Reform

Egypt has made commendable progress in achieving macroeconomic stability since the early 1990s.

Key indicators for 1996/97 demonstrate continued progress:

- Inflation moderated to 6.2 percent (from 21 percent in 1990/91).
- A prudent fiscal policy resulted in a deficit of 0.8 percent of GDP (from 18 percent in 1990/91).
- Tight monetary conditions were maintained.
- The external position strengthened, with surpluses on both current and capital accounts, and an overall balance of payments surplus US\$1.3 billion. Reserves stand at more than US\$20 billion—equivalent to 16 months of imports.

Building on the success of stabilization measures, the authorities have begun to turn their attention to the structural reform effort.

Privatization. The program was initiated in 1996, and has recently been intensified. Majority divestitures of government shares have been completed for 42 companies, including in the industrial, agricultural, construction, retail, and tourism sectors. More than one-fourth of the state-owned enterprise sector is now in private hands.

Tax and civil service reform. GST coverage has been extended and the income tax system reformed, so as to reduce distortions, encourage compliance, simplify administration, and widen the tax base. Civil service reform encompassing measures to streamline and reduce manpower is in progress.

Financial sector reform. The government has recently divested majority public holdings in joint-venture insurance companies and banks and has announced plans to divest ownership in a major public bank. Prudential regulation and bank supervision have been strengthened, and instruments for active use of indirect monetary policy are being developed.

Trade liberalization and exchange system. Tariff rates and import surcharges have been reduced; import bans have been eliminated and replaced with tariffs; and steps have been taken to enhance the operations of the foreign exchange market. The capital account is free of restrictions.

Deregulation. The regulatory framework is being simplified to encourage private sector investment, and steps are under way to liberalize the rental property market. Energy price distortions are being removed.

As a consequence of recent actions.....

Buoyed by strong macroeconomic performance and structural reform, confidence has risen, as demonstrated by the following developments:

- Real GDP growth increased to 5 percent.
- Egypt's access to international capital markets has increased and the terms, improved.
- Private sector investment has risen.
- Portfolio and foreign direct investment has increased.
- Stock market activity has surged.

Investors are now looking to the further intensification of the structural reform program.

countries having achieved significant improvements in their macroeconomic positions, emphasis is now firmly being placed on eliminating structural impediments that have undermined investment and factor productivity gains. These impediments have also distorted the region's interlinkages with the rapidly globalizing world economy while limiting the beneficial spillover effects domestically of the economic and financial improvements.

While it is difficult to quantify the extent of structural rigidities in MENA, a review of three basic features of the region provide an important, albeit far from comprehensive indication, of the structural constraints that have inhibited economic growth and employment creation. These features are now being addressed as governments in the region establish the conditions for sustained economic growth.

- *First*, the region's investment performance has been disappointing. Looking at three indicators of investment activity—domestic (private and public) investment, foreign direct investment, and portfolio investment (Box 3)—it can be seen that the MENA region has been insufficiently attractive in both absolute terms and relative to other regions.⁴ While political and other risk factors have had an impact, the main factor is an insufficiently strong domestic economic “enabling environment,” including structural impediments to a high return/low risk outcome for domestic, regional, and international investors.
- *Second*, the government's dominant role in the economy has tended to undermine productive private sector activities rather than support them.⁵ In some cases, it has also encouraged the emergence of a rather insular private sector that is more comfortable living on rents and off the largess of the government rather than follow the example of the successful Asian economies in competing internationally for the more prosperous world markets.
- *Third*, the region's institutional and human development strategies have lagged, weakening a fundamental pillar of a successful development strategy. Public institutions in several countries in the region suffered gradual erosion, while the private sector progressed slowly in establishing an internationally competitive corporate culture and structure. Spending on social sectors, while relatively high for the region as a whole, has been shown to have had relatively low productivity.⁶ As a result, the contribution of one of the region's key attributes—its human resource base—has been well below potential.

Many countries of the region have now turned their attention to structural reform and economic liberalization in an effort to create an environment that is conducive to investment, while ensuring that policies needed to maintain financial balance remain in place.

⁴See Bisat, El-Erian, and Helbling (1997); and El-Erian and Sheybani (1997).

⁵See Eken, Helbling, and Mazarei (1997); and World Bank (1995).

⁶This is discussed in Shafik (1994) and Serageldin (1996).

Box 3. Investment as the Spur for Growth—How Has MENA Fared?

Growth performance in the 1980s through the mid-1990s has been disappointing in MENA, especially in comparison with the high rates achieved in other regions of the world. Given the importance of investment to growth, a review of MENA's investment performance might help to explain the underlying causes of weak growth in the region. (For more detailed analysis, see Bisat, El-Erian, El-Gamal, and Mongelli, 1996; and Bisat, El-Erian, and Helbling, 1997.)

Past investment performance in MENA has been weak

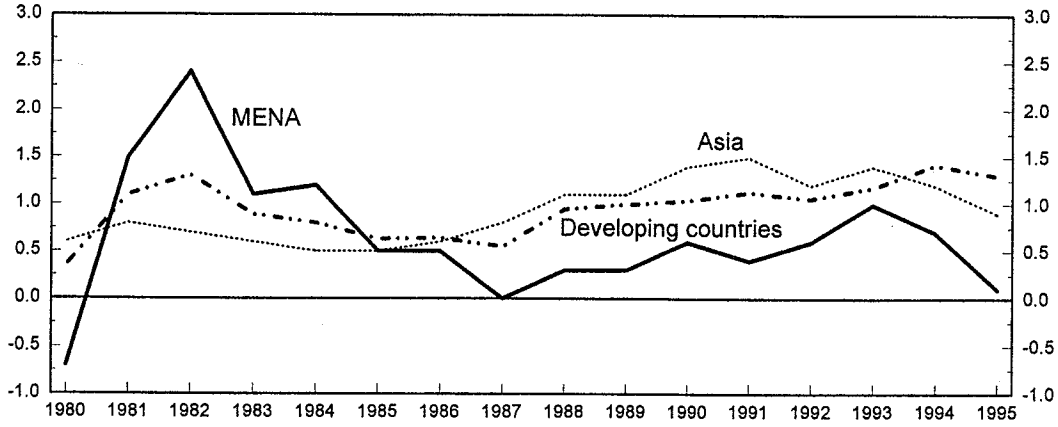
- The MENA region has suffered from an unimpressive investment performance since the early 1980s, particularly when compared with the high investment rates of the 1970s in MENA and the high rates characteristic of the fast growing Asian countries. The slowdown in investment coincided with the fall in oil prices of the 1980s, which dramatically reduced government revenues available to support the large capital investment programs that had been pursued by governments in oil producing states. Non-oil exporting countries experienced an even greater decline in investment, as they found it necessary to curb expansive public investment programs in view of deteriorating macroeconomic balances.
- The flow of foreign direct investment (FDI) into the MENA region has also been sluggish at best. Since the 1980s, FDI has averaged between 0.5 percent and 0.7 percent of GDP, most of which was directed to the energy sector. In Asia, FDI averaged more than 1 percent of GDP a year over this period. Portfolio investment has also traditionally been low in most countries of the region.

But there are recent signs of an improvement

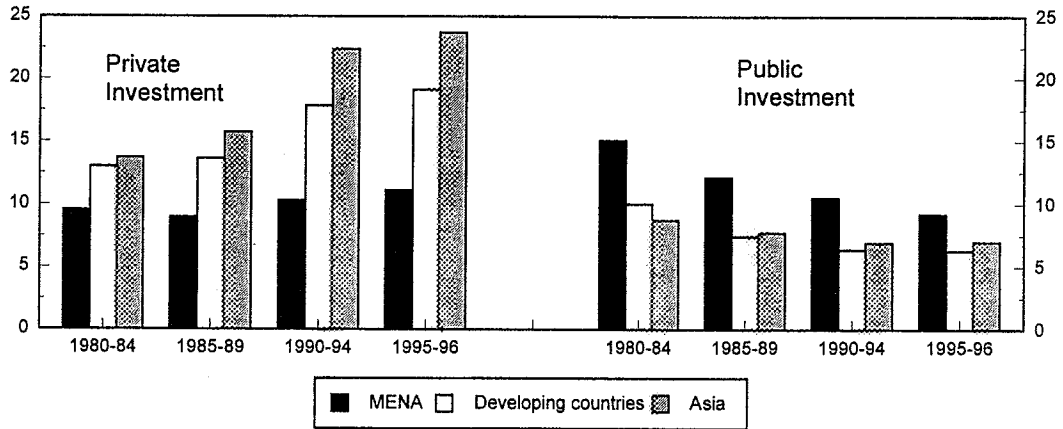
- A recent pickup in investment in both oil and non-oil MENA countries reflects growing private sector confidence. Capital inflows to the region have increased, most notably in Egypt and Jordan. A number of countries have seen renewed access to international capital markets (Egypt, Jordan, Lebanon, Morocco, and Tunisia). Many have experienced a surge in portfolio investment as evidenced by stock market activity (Egypt and certain GCC countries). Some MENA countries have received investment grade ratings by international ratings agencies.
- Also noteworthy is the dramatic shift from public to private sector investment in the region, especially in the Maghreb countries. Traditionally, public sector investment has overshadowed private sector investment activity in MENA, in contrast to the pattern observed in developing countries as a group and in the high growth Asian economies (see chart). While this characteristic reflects in part the dominance of investment by the state in oil-related activities in MENA, it also represents, more generally, the legacy of the policies pursued in the 1970s, which placed the state at the center of most productive activity. Since 1991, there has been a gradual reversal of this pattern, with private investment increasing and public investment declining, reflecting the liberalization of policies, including privatization and deregulation, which has boosted private sector investment.

Box 3. (Concluded)

Foreign Direct Investment, 1980 - 95
(In percent of GDP)



Private and Public Investment, 1980 - 96
(In percent of GDP)



Private and Public Investment in the MENA Region, 1980 - 96
(In percent of GDP)

