

As detailed in recent IMF publications on the region (see listing at the back of this study), at the forefront of the structural policy agenda, to varying degrees across the region, are reforms aimed at:

- enhancing financial intermediation;
- addressing inefficiencies in the labor market and training schemes;
- deregulating domestic markets and production structures;
- liberalizing highly protective external trade regimes;
- strengthening institutions; and
- improving the availability and coverage of data to permit more timely analysis and policy responses, as well as better functioning markets.

The objective of this combination of policies is to develop more flexible economies that are guided by market forces and that can quickly respond to structural changes in the domestic and world economies. At the same time, the role of the State is being redefined to be more supportive of productive private sector activities.

While much remains to be done (as described in Section IV), there are signs that progress has been made in these areas and that the momentum for reform is accelerating in several countries in the region. Indeed, after being essentially marginalized from the process of globalization of financial markets, the region is now finding a more enthusiastic reception on the part of international capital markets: the flow of foreign capital to the region is increasing, sovereigns and corporates are finding a healthy appetite abroad for their debt and equity issues, and international credit ratings agencies have awarded relatively strong ratings to several countries and companies in the region. We are also witnessing increased interest on the part of foreign direct investment.

The following subsections discuss some of the more important ongoing structural changes.

a. Redefining the role of the government

A key element of structural reform among MENA countries has been to facilitate a more efficient allocation of resources and to reduce and redefine the role of government consistent with the requirements of a modern and dynamic economy. As part of this effort, *privatization* programs are underway in many MENA countries, although the pace and scope of these programs varies considerably, with Egypt, Kuwait, and Morocco making the most progress (Box 4 outlines Kuwait's privatization program). Privatization efforts are spreading to most countries in the region. Most recently:

- Jordan has expanded significantly the range of its privatization effort;
- the Islamic Republic of Iran has resumed the divestiture of government shares in industrial enterprises through sales on the Tehran Stock Exchange; and
- Israel intensified its privatization program. In July, the government signed an agreement to sell 12.5 percent of the electric company's stock as part of a plan

Box 4. Kuwait's Privatization Program

Origin

– Large government equity participation originated in the form of state support for economic development projects in the private sector, and subsequently, the acquisition of equity held by the private sector in the aftermath of the financial market crisis of the early 1980s.

– In 1994, the government adopted a comprehensive privatization program that encompasses the sale of government equity shares in existing companies (with the exception of the core oil activities), as well as the transfer of management of public utilities, ports, and health services to the private sector.

Objectives

– Broaden the scope of private sector activity and thereby increase the overall efficiency of the economy.

– Strengthen the ties to the domestic economy by enhancing local investment opportunities.

– Deepen the stock market.

– Create employment opportunities for Kuwaiti citizens.

– Contribute to the strengthening of public finances.

Divestiture of government shares

– At the outset of the privatization program, the Kuwait Investment Authority's (KIA) holdings of both listed and unlisted shares in some 50 companies were valued at KD 850 million, and represented between 5 percent and 99 percent of total equity, depending on the company. Since mid-1994, the KIA has sold equity shares in 22 companies, for a total of KD 760 million. The remaining holdings, now valued at some KD 1 billion, are expected to be sold over the next two years.

– The pace of the divestiture is largely driven by the absorptive capacity of the market. Privatization methods have included public subscription of shares, open auctions, as well as a combination of the two. Most of the public offers have been largely oversubscribed.

Next step: Privatization of public services and utilities

– Privatization of public utilities, including telecommunications, and water and electricity—currently administered by government ministries—is awaiting the adoption of a Privatization Bill before the National Assembly.

– In addition to issues related to the method and scope of privatization, the law covers the regulatory and pricing regime of the utilities concerned in view of their monopolistic nature. Issues of competition are also being addressed in the preparation of the privatization of the public transportation company and Kuwait Airlines. Moreover, plans are under way for the privatization of some 30 retail gas stations.

to reduce the state's share from 76 percent to 51 percent and, in early September, 43 percent of a major bank was sold.

A number of countries are joining the privatization effort. Algeria has published a list of firms selected for privatization over the coming few years. The Republic of Yemen has also initiated its program, which is expected to proceed once initial difficulties related to the bidding process are resolved.

MENA's privatizations have had a number of direct and indirect beneficial effects. In terms of direct impact, and while information is not yet comprehensive in view of the limited set of observations, initial indications are that several of the privatized firms are being more productive, have enhanced their capital, and have not pursued massive layoff programs. The indirect effects have included an important impetus to the development of domestic stock markets, attraction of foreign capital to related activities and, very importantly, a signal to the private sector as to the government's reform seriousness.

Facilitating greater reliance on market mechanisms has also encompassed *price and marketing reform, allowing the private sector into activities previously reserved only for the public sector, and upgrading the regulatory structure*. In this regard, several MENA countries have taken further steps to remove price distortions (including Egypt, the Islamic Republic of Iran, Morocco, Sudan, and the Republic of Yemen).

Algeria has taken far-reaching measures to liberalize price-setting mechanisms, including most recently, eliminating generalized food subsidies (Box 5). Jordan has undertaken an important overhaul of the subsidy system to reduce waste and mistargeting while ensuring government support for private sector importation, storage, and distribution of certain food items. The Republic of Yemen is currently developing a system for more efficiently targeting food subsidies. Public enterprises in the Syrian Arab Republic are now permitted greater price flexibility and the private sector may set its prices freely (with official monitoring)—a step toward full market determination of prices. Many countries have eliminated the concessional and preferential credit allocations in favor of more market-oriented approaches to promoting development of priority sectors.

At the same time, recognizing the enormous financing needs for infrastructure developments, several MENA countries have opened up sectors recently reserved exclusively for the public sector. This includes power generation, airports, and roads.

Such measures have, in turn, helped to strengthen the *structure of the budget* by reducing budgetary transfers to privatized enterprises, limiting the expansion of spending on wages and salaries, and cutting outlays on transfers and subsidies. Some countries have also taken measures on the revenue side to broaden the revenue base so as to reduce dependence on volatile revenue sources and better prepare themselves for reductions in external tariffs, including in the context of the Association Agreements with the European Union. For example, Egypt, Jordan, and Morocco have expanded the scope of their general sales tax, while Djibouti has extended the corporate tax to all enterprises and established a progressive tax on properties.

Box 5. Algeria: Letting the Markets Set Prices

The Algerian reform package launched in April 1994 is aimed at establishing a market-based outward-oriented economy. Thus, a cornerstone of the package was the necessary realignment of relative prices and subsequent price liberalization. This strategy was pursued through the following key measures:

- *Pursuit of an active exchange rate policy.* At the onset of the program, a 50 percent exchange rate devaluation corrected for the overvaluation of the dinar. A gradual shift in the exchange rate regime from a peg to a managed float allowed for greater flexibility in the event of adverse shocks. In addition, an interbank foreign exchange market was introduced at end-1995. Overall, between 1993 and 1996, the real effective exchange rate depreciated by about 30 percent as a result of nominal depreciation combined with tight demand management and incomes policies.

- *Liberalization of interest rates.* Notwithstanding a partial liberalization in the early 1990s, interest rates were still negative in real terms in 1994. The deregulation of interest rates, together with the deceleration in inflation brought about by tight demand management policies, has led to the emergence of positive real interest rates since 1996.

- *Liberalization of prices.* At the beginning of 1994, Algeria had a generalized system of subsidies, which cost the budget more than 5 percent of GDP while giving rise to shortages and black markets. In 1994, prices of inputs for agriculture and housing construction were freed, and controls on retail prices and profit margins were lifted for most goods and services, except for a limited number of products including a few essential food staples, energy products and public transportation fares, which remained subsidized. The generalized subsidies on these goods were eliminated over the following two years. This was done progressively so as to mitigate the social impact and repercussions on the general price level. The remaining consumer subsidy on gas and electricity tariffs (less than 1 percent of GDP in 1996) is to be phased out by end-1997.

- *Reform of social safety net.* To cushion the impact of the exchange rate depreciation and the elimination of generalized subsidies on the most vulnerable groups of society, the authorities reformed the social safety net. They replaced cash transfers that were both poorly targeted and costly to the budget by a decentralized public works program and an increase in the transfers received by pensioners and the disabled.

- *Trade liberalization.* The realignment in relative prices was accompanied by a major liberalization of the external trade and payments system, to provide appropriate market incentives to the productive sector. In 1994, the authorities dismantled the cumbersome system of exchange controls, giving importers free access to foreign exchange for all but a short list of imports. This negative list was eliminated at the end of 1994. In addition, the authorities lowered the maximum custom duty rate from 60 percent in 1994 to 45 percent as of January 1, 1997, and consolidated its tariffs into five rates. Algeria accepted Article VIII obligations in September 1997, and the Algerian dinar will be fully convertible for current account transactions by end-1997.

b. *Development of the private sector*

As a complement to reducing the role of the state, most MENA countries are taking steps to encourage the development of the private sector through *deregulation, opening their economies to greater foreign participation, adopting transparent civil and commercial procedures, and harmonizing tax provisions.*

Until now, a number of MENA countries have been characterized by a complex bureaucratic network of regulations that have inhibited investment. Indeed, the bureaucracy of the region had assumed almost legendary proportions in the perceptions of certain investors. While the policy agenda remains large, it is encouraging that some countries have recently introduced legislation aimed at simplifying investment procedures and streamlining business applications (the *guichet unique* in Mauritania, the one-stop shop for licensing of new investment projects in Lebanon, and the Unified Investment Law in Egypt). Morocco has recently adopted a new commerce code and corporate law, increasing the transparency of the legislative framework governing foreign and domestic private investment. Similar steps have been taken by Jordan.

Labor market concerns are rightly at the forefront of the policy agenda for most MENA countries. This is also the case for the members of the GCC, which, while having no major unemployment problems at this time, face the prospects of a rapidly increasing labor force.⁷ The labor situation is rendered more complex by the interaction of the fiscal retrenchment and civil service reform being undertaken by countries where the government has essentially played the role of employer of first and last resort.

Measures outlined above aimed at expanding private sector activity have as a central objective the absorption of the increasing number of nationals seeking work. In support of that goal, some countries have taken action to strengthen training and education programs, so as to provide the population with the skills needed by the emerging private sector. At the same time, however, while development plans of certain MENA countries set out clear goals for reducing structural rigidities in the labor market, concrete steps remain to be taken in most cases. The difficulties that Europe is having in this regard serve as an important reminder as to the complexity of the policy challenge and the need to move decisively.

c. *Reforming the financial and external sectors*

Financial sector reform in progress in many MENA countries is helping to enhance the integrity of financial systems, promote financial intermediation, and improve the investment climate. Its importance cannot be overstressed. The financial sector acts as the nerve center of the economies and problems there often spread to other sectors. Moreover, the history of banking problems in a very large number of industrial and developing countries illustrate the importance of maintaining progress, especially during the “boom times” when the seeds of future problems are often sown.

⁷See El-Erian and Sassanpour (1997) and Sassanpour and others (1997).

Some countries of the region have taken, or are considering, steps to open the banking sector and local stock markets to greater foreign participation. Prompted by past difficulties in the banking sector and, in certain countries, concern about moral hazard, prudential regulation and bank supervision have been strengthened in many countries. In addition, with the recent explosion in the activities of local stock markets, the authorities of the countries concerned are taking actions to ensure stronger market infrastructure, particularly with respect to payments and settlement, custodian services, and information disclosure. Israel has been undertaking an extensive program of financial liberalization for a number of years.⁸

As the financial markets in the region have tended to be rather thin until recently, the banking authorities in some countries have taken steps to deepen the financial sector through the introduction of new instruments (the Islamic Republic of Iran, Jordan, and Lebanon), reform of the stock market (including, for example, by privatizing the management—Morocco and Tunisia), and development of a secondary market (Egypt and Jordan). (Boxes 6 and 7 outline recent progress in Jordan and Tunisia.)

MENA economies, particularly the non-oil ones, have among the most protective external trade regimes in the world.⁹ Recognizing the benefits of globalization, and the need to compete in an increasingly integrated world environment, a growing number of MENA countries have committed regionally and internationally to opening their markets through *exchange and trade liberalization*. Such commitments have been made in the context of World Trade Organization (WTO) membership, Association Agreements with the European Union, reinvigoration of the Arab free-trade initiative, and unilateral actions.

Some countries have already undertaken concrete steps to ensure greater market access to foreign goods and services. For example, Egypt has recently implemented two further rounds of tariff-cuts that are expected to enhance competition, as well as improve the welfare of consumers. Jordan has also reformed the tariff system, and reduced import restrictions significantly. Looking forward, both countries, as well as Lebanon and the Syrian Arab Republic, will face the challenges being confronted by Israel, Morocco, and Tunisia as they implement the free-trade component of Association Agreements with the European Union.

d. Strengthening institutions and enhancing information dissemination

Institution building is an important part of structural reform programs of many countries. Efficient and transparent institutional structures, whether those carrying out key government functions and policies, or those providing the judicial and legislative framework for commercial activity, are key to creating an enabling environment for investment and promoting a vibrant private sector. The challenge is a particularly acute one for the low-income economies of the region and those emerging from years of disruptions or occupation.

⁸See Clifton (1994).

⁹See Alonso-Gamo, Fennell, and Sakr (1997).

Box 6. Jordan: Recent Financial Sector Reforms

The Central Bank of Jordan (CBJ) has implemented a number of important measures over the last year to deepen and liberalize the financial system.

- **Reserve requirements.** To allow more flexibility in holdings of required reserves, regulations on reserve requirements were changed in November 1996. Banks are now permitted to maintain a daily minimum balance of 80 percent of their reserve requirements with the CBJ during a one-month maintenance period and may hold the remaining 20 percent on a period-average basis during the maintenance period. Moreover, to eliminate discrimination against intermediation in the Jordan dinar (JD), the reserve requirement on foreign currency deposits was lowered from 35 percent (remunerated) to 14 percent (nonremunerated). Regulations on reserve requirements on dinar and JD deposits are thus identical.

- **Resident and nonresident accounts.** To facilitate banking operations, the distinction between these accounts was abolished for several types of operations in November 1996. These include identical treatment of resident and nonresident foreign currency deposits (FCDs) with respect to current payments, elimination of the ceiling on residents' FCDs, permission to banks to manage investments in foreign currencies for both residents and nonresidents, and the application of identical regulations governing margin foreign exchange transactions to residents and nonresidents.

- **Swap operations.** To enhance the efficiency of the foreign exchange markets, swap operations in foreign exchange are now permitted as of November 1996, allowing bank clients to sell foreign exchange at the spot rate and repurchase it at a forward rate for any period of time.

- **Auctions of CBJ Certificates of Deposit (CDs).** Starting last April, the authorities have modified the auction procedure for CDS, allowing more flexibility in interest rates while also lengthening the maturities of CDS offered (to include 12 months in addition to 3 and 6 months maturities).

- **Liberalization of the capital account.** The CBJ liberalized all transactions in foreign exchange last June. Restrictions on foreign investment have been relaxed and the rules and regulations relating to the Amman Financial market have been improved, contributing to increased investor interest in Jordan.

In addition to these measures, the authorities are also undertaking reforms in the areas of money market development, banking supervision and regulation, payment system reform, and the introduction of deposit insurance.

Djibouti and Mauritania are taking steps through civil service reform and by enhancing policymaking capacity, with support from the international community. Nowhere is the importance of institution building more clear than in the Palestinian economy, which has had to establish the major institutions required to administer and implement economic policy. Here, the authorities, together with the international community, are putting in place sound budget procedures and tax administration, as well as set in place the basic functions

Box 7. Tunisia: Recent Financial Sector Reforms

Shift to indirect instruments of monetary policy

- General controls on interest rates were abolished in 1994. Preferential interest rates under a mandatory lending scheme, whereby banks had to lend at least 10 percent of total deposits to certain priority sectors (agriculture, export activities, and small- and medium-sized enterprises) were abolished in November 1996.

Public sector's preferential access to savings reduced

- Since 1989, the system of mandatory holding of treasury bills by banks (legally abolished in 1994) has been replaced by auctions. In 1991, the treasury ceased the issuance of low-interest bearing development bonds (*bons d'équipements*). The introduction of longer term treasury instruments (*bons du trésor négociables*) since 1993, sold via public offerings to banks and tradable on the stock market, has contributed to the development of nonbank long-term financing.

Banking supervision strengthened and competition increased

- Since 1991, prudential supervision by the Central Bank of Tunisia (BCT) has been strengthened, and commercial banks have been moving toward meeting tighter central bank rules on provisioning and a minimum capital-to-risk-weighted-assets ratio of 5 percent, which is considered broadly equivalent to the 8 percent Cooke ratio. The BCT has agreed with individual banks on action plans to phase in full compliance with the new prudential standards by the end of 1997.

- Through a partial restructuring of the government-owned agricultural bank (BNA) in 1996, BCT removed a substantial portion of problem loans from the banking system. The average return on assets has been steadily increasing from 0.6 percent in 1993 to 0.9 percent in 1996. The average return on equity declined during 1992-94 reflecting major recapitalization operations, in particular by public banks in 1992 and 1994, which tended to increase the share of private ownership. In particular, the government effectively privatized *Banque de Sud*, the country's sixth largest bank in October 1997, reducing its stake from 42 percent to 30 percent by not participating in a recent share issue.

- To foster competition, an amendment to the banking law in 1994 and subsequent legislation lowered the barriers between the commercial and development banks, while permitting the establishment of new financial institutions (investment banks) that provide financial services such as project finance, equity participation, and portfolio investment. The requirement to open at least one rural branch for every four new branches a commercial bank opens was abolished in late 1996.

Securities market reform

- Based on reforms of the legal and regulatory framework of the stock market in 1989 and 1994, banking and brokerage functions were separated, and management of the Tunis bourse was transferred to the brokers' association. In 1996, an independent supervisory commission (*Conseil du marché financier*) was set up to ensure transparency of transactions in the stock market and to enforce disclosure and prudential requirements of publicly traded firms. In addition, the Tunis stock market acquired an electronic quotation system.

Financial deepening

- Various measures of the depth of financial markets confirm the progress made to date. The ratio of M4 (broad money including the *bons cessibles*) to GDP, an indicator of financial deepening, has approached in recent years levels prevalent in France. Stock market capitalization and turnover have increased sharply since 1993, albeit from a low level. Real interest rates have been positive since the mid-1980s, and have broadly converged during the 1990s toward the level of comparable rates in France.

required of government, including the conduct of monetary policy. In its massive efforts to reconstruct and rehabilitate after the war, Lebanon is strengthening its institutional framework; most recently in the fiscal area through important steps to strengthen tax administration and computerization.

Countries in the region are also starting to recognize the importance of *timely compilation and public dissemination of comprehensive information* on all sectors of the economy. As recent experience in other regions has demonstrated, dissemination of data is a crucial element in maintaining the confidence of private investors and in ensuring the sound management of the economy. In this light, and given the relatively limited regional tradition of economic data dissemination, many countries of the region have initiated action to strengthen data collection and enhance information systems. Some countries have already begun to disseminate economic data via the Internet (e.g., Israel, Jordan, Kuwait, and Lebanon).

e. Protecting the poor from the adverse effects of reform

The implementation of macroeconomic and structural reforms inevitably have an adverse impact on certain segments of the population, at least in the short term. At times, it is the poorest segments of the population that are least able to protect themselves. Accordingly, effective social safety nets are an integral component of successful economic development efforts.

To *protect the poorest segments of the population* that are adversely affected by adjustment, some MENA countries are implementing social safety nets and other social programs, often with the assistance of the World Bank and other creditors and donors. It is recognized that such programs should be appropriately targeted and should, to the extent possible, have limited distortionary effects on economic efficiency and incentives.

With these objectives in mind, the Republic of Yemen has established a social welfare fund, introduced an employment generating scheme for unskilled workers, and set up a vocational training program. Jordan is implementing a social productivity package, incorporating a community development fund, a job training and placement service for the unemployed, and a credit facility to encourage the establishment of small enterprises. A Social Fund has been in operation in Egypt for some time with similar objectives. Social issues have come to the forefront in Lebanon, and Phase II of the reconstruction program emphasizes building up the social infrastructure.

IV. The Next Step Forward

Despite the improvements in economic prospects in many MENA countries outlined above, much remains to be done in terms of consolidating progress achieved and extending the benefits of macroeconomic stabilization and reform more deeply and widely.

The extent of the challenge facing countries in the region should not be underestimated: there are hurdles that must be overcome and opportunities to be seized.

- First, many countries in the region are attempting to overcome years of economic underperformance, with entrenched vested interests and deep-rooted structural weaknesses.
- Second, the external environment, while relatively favorable to many MENA countries in the past two years, cannot and should not be relied upon to generate the windfall gains recently experienced by some countries.
- Third, the world economy is evolving structurally at an accelerating pace, generating large rewards for reforming economies. As a result, MENA countries face a stark choice: they must either move rapidly to restructure their economies so as to participate in the evolving globalization and reap the rewards such a process offers, or maintain the status quo and risk missing out on the potential to generate the wealth-enhancing effects that will bring greater affluence to their people.
- Finally, recent setbacks to the establishment of a comprehensive, just, and durable peace continue to undermine potentially positive region-wide economic activities.

As a result of these factors, the onus of comprehensive adjustment and reform falls squarely on the MENA countries themselves. They must create the conditions for sustainable growth if they are to be able to meet the needs of their rapidly-growing populations.

Given the different starting points of individual MENA economies—in terms of both policies and initial income and wealth conditions—there is no single set of recommendations that fit all countries in the region. However, for presentational purposes—and at the risk of some overgeneralization—it is possible to think of MENA countries as being classified into two groups.

In the first group, we find countries that have advanced in macroeconomic stabilization and structural reforms, and that are being increasingly recognized by domestic, regional, and international investors. These countries must maintain their policy efforts, especially in deepening and widening structural reforms which, in international comparison terms, are still lagging. This is critical if they are to succeed in raising savings and investment rates, improve total factor productivity and, thereby, sustain a high rate of economic growth. This will require, in addition to intensifying the reform efforts outlined above, the move to a second generation of reforms that would further advance the transformation of the role of the state in the economy and increase the transparency of government economic operations.

These countries also face the challenge of “managing their growing success” in an increasingly rewarding but complex world economy. This year’s financial and economic turbulence in Southeast Asia serves as an important reminder of the complexity and stakes of the challenge. The rapid and sizable capital flows that are an important feature (and benefit) of globalization also present countries with a need to maintain a consistently vigilant approach to policymaking. While capital inflows reinforce and reward good policies, policy slippages can generate rapid and destabilizing capital outflows, creating

unsustainable exchange rate pressures and exposing weaknesses in the financial system. Countries can also be subject to contagion effects—the transmission to the domestic economy of shocks occurring elsewhere in the international economy.

There are important lessons to be drawn from other countries' experience with greater integration into the international financial system: there is no room for complacency, even—or perhaps especially—when economic conditions are good. MENA countries will need to manage carefully the risks that accompany the enormous advantages associated with globalization. Diligence in monitoring risks is crucial. In this regard, efforts to increase transparency in financial and government operations and to disseminate to the public timely and comprehensive data on all aspects of the economy will be key to ensuring successful monitoring by both the private and public sectors and to facilitating rapid policy response by the authorities concerned.

Outlined above are the challenges facing those countries that have already progressed down the road of economic reform. For the second group of countries, those that have yet to embark decisively on this journey, the path is even clearer. Determined action is needed in the short term if they are to set a sound foundation for growth and avoid being marginalized in the rapidly globalizing economy. For some countries, the immediate challenge is to reverse unfavorable macroeconomic and debt dynamics. For others, there is a need to tackle longstanding weaknesses in the structural aspects of their economies, starting with the exchange and payments system, the financial sector, and the regulatory structures.¹⁰

While the initial adjustment is likely to be difficult, the payoff will be large in terms of providing for the basic needs of, and ensuring employment opportunities for, the rapidly growing populations in these countries. Indeed, these countries should draw encouragement from the experience of other economies in MENA. The speed with which the latter have benefited from improvements in investor sentiment—domestic, regional, and international—provides an important demonstration effect as to what is both possible and desirable.

V. Conclusion

Recent economic performance for the region as a whole has been favorable, reflecting not only positive developments in certain aspects of the external environment but, more importantly and increasingly, the pursuit of appropriate domestic policies in many countries. As a result, growth has picked up, inflation has moderated further, and the financial balances—domestic and external—have improved.

Of course, performance has varied across countries in the region. Those implementing sustained, far-reaching reforms have generally fared commensurately better. Others, including those facing particularly difficult noneconomic factors, continue to lag with large immediate and medium-term costs for their population.

¹⁰The main areas of reforms are analyzed in IMF (1996).