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The MENA region: Challenges, opportunities and reforms

by Marwan Mikhael, BLOMINVEST Bank

When revolutions swept the Arab world starting 2011, journalists and politicians around the world called it the 'Arab Spring'. But with time it appeared that, as it should have been expected in the first place, movements towards democracy will take long and democracy may not be achievable in one shot. Countries possibly will go through several episodes of uprisings in order to achieve people's aspirations. Examples abound from the transition process of European countries during the 18th and 19th centuries. Some populations may not be ready for a full-fledged democracy comparable to the existing ones in the West. Some others may want a different kind of political system. Therefore it is a matter of trial and error for any population to reach the political arrangement that suits its culture and society. Most importantly, a political system is deemed a good one if it brings prosperity, freedom and well-being to the people.

The political upheavals that started in many Arab countries have not led yet to an improved well-being for the populations of concerned countries. Economic challenges throughout the previous three years have increased dramatically in the Middle East and North Africa (MENA) region. Fiscal imbalances have been aggravated, economic growth has been hit hard, unemployment jumped to unprecedented levels, monetary stability was shaken in many countries, capital markets development remains way behind that in advanced economies, corruption and lack of accountability are still hindering economic development, and bloated public sectors are constraining the level of enterprise creation.

These challenges are not confined to the countries of the Arab Spring; they are spread all over the MENA region.

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The Gulf Cooperation Council (GCC) countries went into a spending spree during the previous years which led to a large increase in the oil price level needed for their fiscal balances to break-even. Although they still enjoy fiscal surpluses, a decline in oil price below US$90 per barrel will push most of them towards a fiscal deficit. Oil-importing countries are already in the red on the fiscal front, with some such as Jordan and Egypt receiving large donations to be able to sustain their economies, domestic currencies, and current accounts deficits. The unemployment problem is spread all over the region, putting pressure on the authorities, and threatening to aggravate social exclusion and causing unrests.

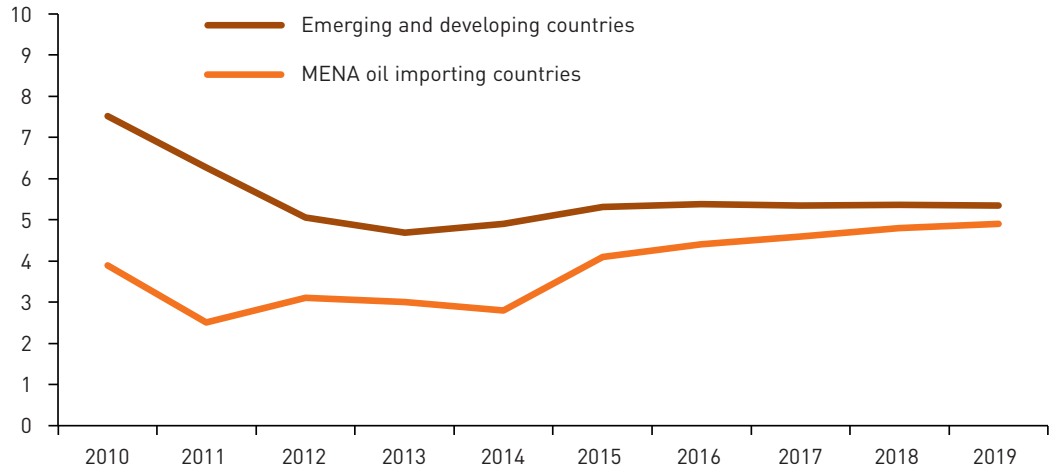
Economic growth is slowing

The combination of the global financial crisis and the Arab Spring had their toll on MENA economies. Real GDP growth in the region went down from an average of 5.7% during 2000-08 to 3.7% between 2009 and 2013. When dividing the region between oil importers and oil exporters, the situation is even more striking. The former got mostly hit by the political upheavals in transition countries. Growth in oil importing countries fell from an average of 5% during 2000-10 to 2.1% in the three years following the uprising. In the GCC countries growth was hit hard subsequent to the global financial crisis when it bottomed at 0.9% in 2009 before recovering in the years after.

Economic growth rates are expected to improve in 2014 and 2015, yet they will not return to their pre-2009 levels. The MENA region is projected to grow by 3.2% in 2014 and 4.5% in 2015 up from 2.2% in 2013. GCC countries will have a stable growth of around 4.2% in 2015 and 2016, same as in 2013, while oil importers will register the same growth rate of 2.7% in 2014 as the one registered in 2013. However they are expected to grow by 4.2% in 2015, which is the result of the improvement that should take place in several countries including Egypt, Tunisia, Jordan, and Lebanon.

Moreover, these growth rates remain far below the growth rates recorded in other emerging economies and most importantly, they are not enough to reduce the large unemployment rates of MENA countries. Labour market is growing at a healthy pace while economic growth is slow. MENA has the highest unemployment rate of all regions,

Real GDP growth **Exhibit 1**



Source: IMF

which is equal to 19% compared to 15% in sub-Saharan Africa and 9% in South Asia. When looking into youth unemployment, the situation is bleaker with rates hovering around 25%, more than double the world average. This high unemployment adds to the very low labour participation rate, as 56% of MENA population is not in the workforce, which drastically reduces countries' economic potential.

Reforms are needed to seize the existing opportunities

For them to reduce the unemployment rate and increase the potential growth in the region, MENA countries should embark on a large structural programme that entails short and long term reforms on multiple fronts. Of course, reforms that are needed or how they are catered will differ from one country to another, but many of them are common to most countries in the region. On the short to medium term, MENA countries, especially oil importers, need to put their fiscal house in order. On the long term, three main reforms are of utmost importance, namely fighting corruption, economic integration, and education reform.

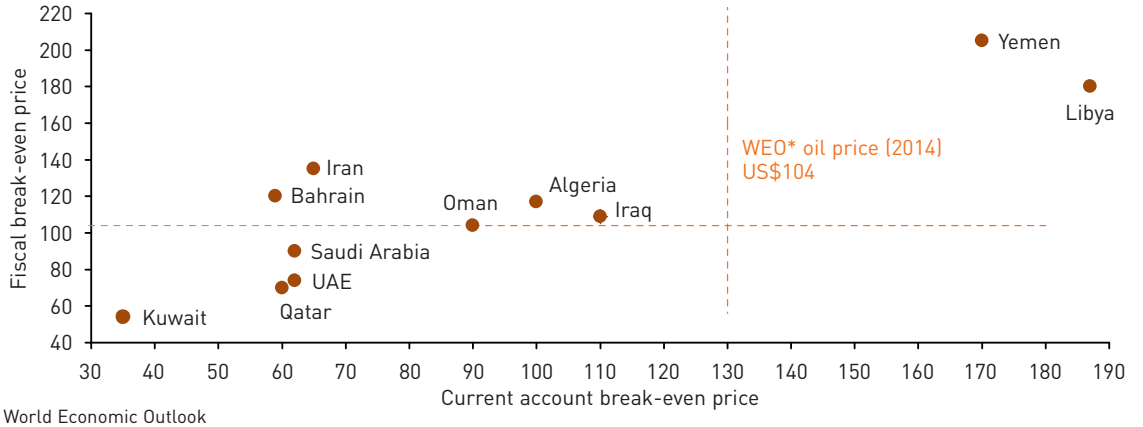
The importance of implementing reforms is clearly highlighted when comparing the MENA region's economy to any advanced economy. For example, the combined GDP of MENA countries sums up to US$2.9 trillion for a population of 321 million, compared to a GDP of US$3.4 trillion and a population of 82 million for the German economy alone.

The MENA region has the potential to close the gap with advanced economies. For one, the region is rich in natural resources, with its total production of oil contributing to more than the third (35%) of the world production. Second, some of the MENA countries have the necessary lands to fulfil the agricultural needs of the region, yet MENA countries import more than 85% of agricultural products for consumption from outside the region. Third, population growth in MENA economies is high, which should render the available workforce abundant compared to a negative population growth in Germany for example.

Fiscal reform is an urgent matter

An urgent matter in several MENA countries has been to balance the fiscal accounts. Some oil importers in the

Break-even oil prices (US$ per barrel, 2014) **Exhibit 2**



* World Economic Outlook

Source: IMF

region have high fiscal deficits hovering or exceeding 10% of GDP namely Egypt, Jordan, West Bank and Gaza, and Lebanon. External help has been extended to some of these countries by international donors in order to alleviate the impact of social unrest and increased budget spending. In addition, technical and financial assistance to balance fiscal account have been provided by the IMF to Morocco, Tunisia and Jordan.

As for oil exporters, most of them saw their fiscal surpluses reduced or turned into deficits. Saudi Arabia had its fiscal surplus declining from 14.6% of GDP in 2012 to 8.3% of GDP in 2013. The fiscal surplus of Kuwait has also declined by 5 percentage points of GDP between 2012 and 2013. Hence there is a need to boost fiscal surpluses in order to reduce the fiscal break-even oil price. This could be done through an improvement in non-oil revenues and/or a reduction in spending.

In this context, reforming the fiscal sector becomes a priority. On the revenue side, there is a need to broaden the tax base, which is better than across-the-board rate increase, improve collection, and increase the progressivity of income tax. On the expenditures front, it is important to reorient spending. Real growth of public sector wages has to be contained and complemented by a civil service reform in the medium term. Eliminating oil subsidies and partially replacing them with targeted subsidies towards the poor, and increased capital spending should also be on the agendas of MENA Governments. The cost of oil subsidies in MENA countries is around US$250bn per year.

Fighting corruption through the reduction of government size

Corruption and the misuse of political power have always existed in the MENA region. Transparency International's Corruption Perceptions Index (2010) perceived the MENA region as being very corrupt, with an average score of 3.1 over 10. The only two MENA countries to perform well in the index are Qatar (7.7) and the United Arab Emirates (6.3).

Tackling corruption through improving accountability is one of the most difficult tasks in MENA countries. There are two important measures that will reduce corruption and which are relatively easy to implement. The first measure is to shrink government size. The second measure is to increase automation and reduce contact between civil servants and tax payers or clients.

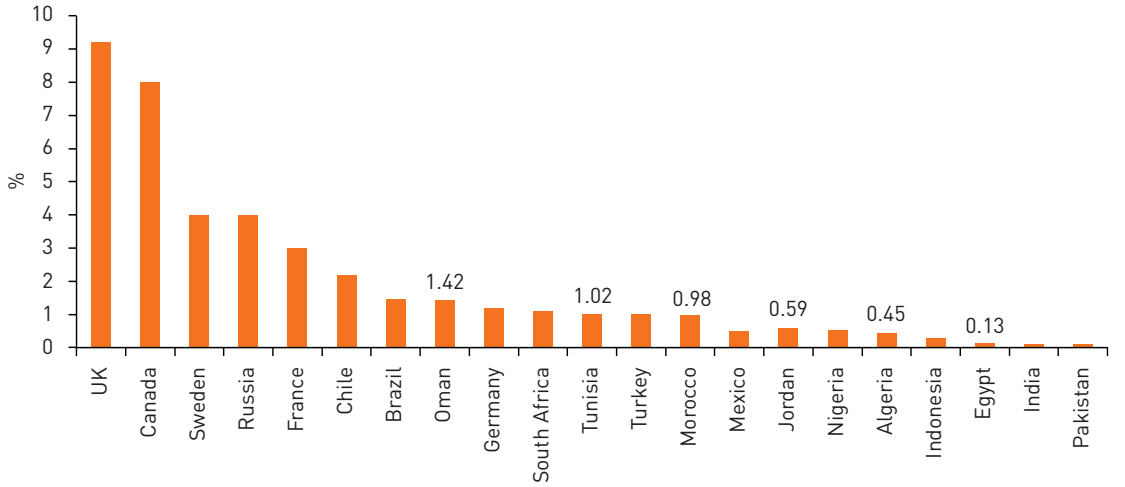
Not only the bloated government size is increasing the probability of corruption, large public enterprises are crowding out the private sector, as most government projects are allotted to these enterprises. Moreover the share of public sector employees of the total labour force became high, exceeding 50% in the GCC countries and hovering 35% in Jordan and Egypt, and 22% in Tunisia. Hence any increase in public sector wages will exacerbate the situation and will render the public sector even more attractive to new graduates further inflating government size. The latter will have the tendency to cater their education and skills towards the needs of the public sector, which will make it more difficult to satisfy labour market demands by the private sector. Reducing the government size could be achieved through privatisation of public enterprises after dividing the largest ones into smaller entities.

Another consequence of corruption and large public sector is the low level of enterprise creation in the MENA region. World Bank Group Entrepreneurship Survey (WBGES) data show that there is a wide variation in firm entry density across regions and income groups. High-income countries register, on average, four new firms per 1000 working-age people (15-65 years), whereas MENA countries register only 0.63 new firms (ahead of only sub-Saharan Africa). Data vary significantly from country to country within the MENA region; Tunisia and Oman register the highest entry rates, with over one entry per 1,000 people of working age.

Improving economic integration

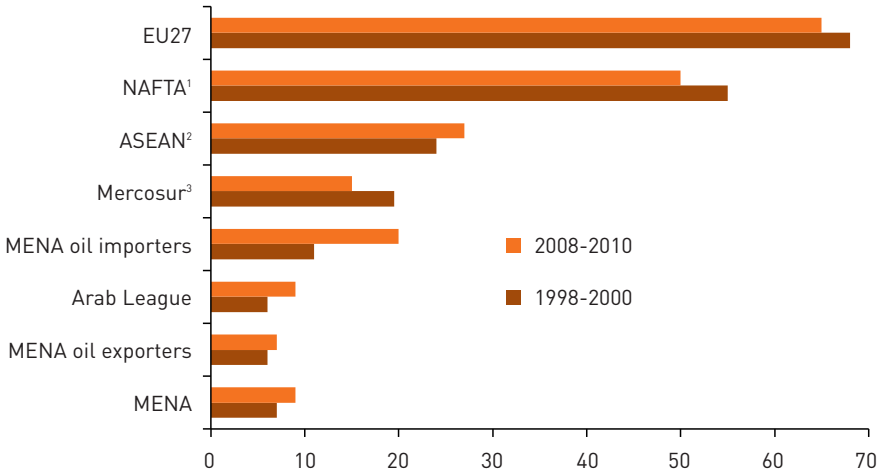
The MENA region is one of the least integrated in the world economy as reported by the OECD. "Although home to 5.5% of the world's population (on average for 2008-10) and 3.9% of the world's GDP, the region's share of non-oil world trade is only 1.8%". By contrast, East Asian

Firm entry density: 2004-09 averages (in %) **Exhibit 3**



Source: OECD

Share of exports within region **Exhibit 4**



1 North American Free Trade Agreement
2 Association of Southeast Asian Nations
3 Or also known as the Southern Common Market

Source: OECD

countries, which have adopted more liberal trade and investment regulations, have experienced a significant increase in trade, employment, and per capita income. However, when taking into account oil and gas, the MENA region total exports will account for 6.2% of total world trade.

The MENA region needs not only to improve its integration within the world economy, but also its intra-region integration. "Intraregional exports of goods have averaged less than 8% of total exports in the MENA region over the 2008-10 period, as compared to 25% in the Association of Southeast Asian Nations (ASEAN) and 66% in the EU".

Because of corruption, and outdated and complicated laws and regulations, the MENA region endures constraints to economic competitiveness in general, and trade barriers in particular, although important efforts have been deployed in the past few years. Of critical importance is the need to improve trade-related infrastructure and strengthen trade facilitation activities.

Education

Education seems to be the most important factor barring the advancement of MENA countries to the level of developed countries level. Problems encompass lagging behind developed countries in the level of math and sciences, high dropout rates, high repetition rates, weak foreign languages skills and a large gap between fresh graduates and the requirements of the labour market. In some countries, there is a need to build new schools but in most of the countries, this is not the main reason behind the high ratio of uneducated or poorly educated workforce. There is no doubt that some countries within the region are more advanced regarding several education performance indicators than others, however most of the countries still need to do reforms when it comes to the education sector.

Major efforts have to be done in order to catch up with East Asian economies that relied on high investment in education to drastically enhance their international standing regarding per capita income, and low unemployment levels. Countries in the MENA region have to take serious measures starting from adapting education to labour market demand, changing the curriculum to become in tandem with international standards, especially in public schools, changing some laws and regulations to make education compulsory for both genders, and encouraging women to enter the labour market.

Conclusion

The reforms and measures mentioned earlier in this chapter are not exclusive and other issues should be addressed too. These include, but are not limited to, the access to finance, mainly by small and medium-sized enterprises; the development of direct financing through capital markets for companies by encouraging them to get listed and enhancing trading through improved regulation and through the diversification of market players; improving the business environment, not through the reduction of taxation as taxes are already low in the region, but through the elimination of regulatory hurdles and the simplification of laws to create and dissolve companies and hiring and firing of employees; strengthening the rule of law, and modernising the judicial systems. The region has the resources, but it needs stability to enact the right laws and implement the right measures in order for its countries to rise from the status of frontier economies, or developing countries, or countries in transition, to the status of emerging or even advanced economies.

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