IMF: Enhancing MENA Medium-Term Growth Prospects

BLOMINVEST BANK

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Contact Information

Helmi Mrad

helmi.mrad@blominvestbank.com

In the October 2024 issue of the IMF Middle East and Central Asia Regional Report, the report discussed navigating the evolving geo-economic landscape in the region. In this spotlight, we will focus on the main constraints hindering the medium-term growth prospects for MENA region and the ways to improve it.

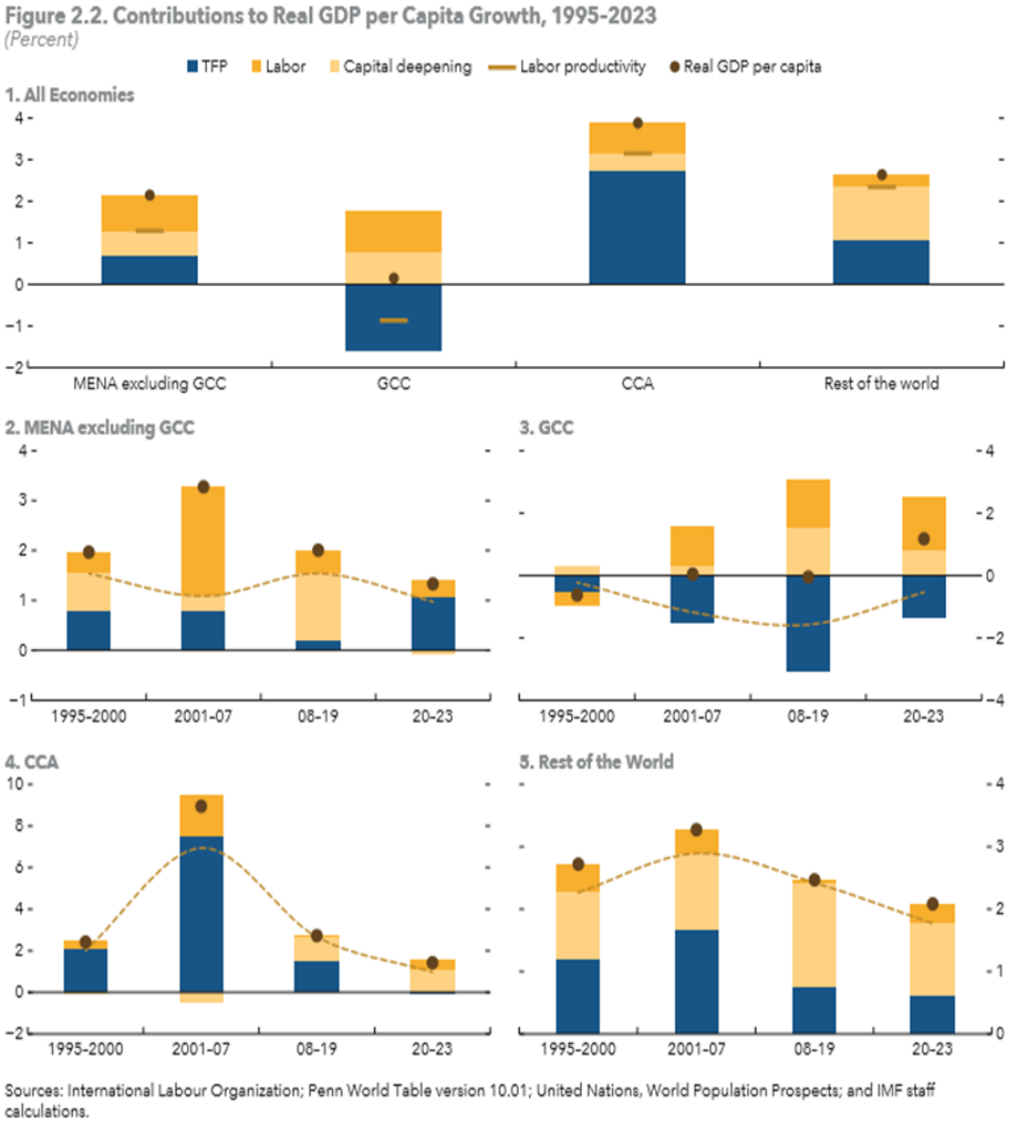
Growth prospects are following a declining trend worldwide due to slowdown in the growth of "Total Factor Productivity" (TFP, defined below). Over the past two decades, medium-term growth expectations worsened with GCC countries unveiled more volatility resulting from the fluctuations in oil prices .

In line with global trends, economies in MENA and in the Caucasus and Central Asia (CCA) experienced growth till the beginning of the global financial crisis. Since then, medium-term growth forecasts were pessimistic and actual economic growth has dropped below expectations. Moreover, income per capita in MENA and CCA regions lagged that of advanced and emerging markets economies in which the gap between advanced economies and MENA region (excluding GCC) widened whereas the gap with CCA remained stagnant. In terms of the growth of income per capita, that of MENA and CCA region did not keep the pace with that of emerging markets. It is worth mentioning also that income per capita for GCC economies has been progressively falling over time and is now near that of advanced economies.

This report showed the main contributors of real GDP per capita growth in 4 periods (P1: 1995 – 2000, P2: 2001 – 2007, P3: 2008 – 2019, and P4: 2020 – 2023) in MENA region, GCC, CCA & rest of the world. The following are the main contributors to the real GDP per capita growth:

- Labor / Employment
- Capital Deepening: It represents increase in capital to labor ratio and it increases the productivity of labor.
- Total Factor Productivity (TFP): The main factors that are structural drivers of TFP are macroeconomic stability, capital account openness (measures country' s attraction of cross-border capital inflows), digitalization, institutional quality, and financial integration (measured by financial market index, credits to private sector, market capitalization, and rating of credit market regulations.(

Main growth contributors in MENA and CCA regions differ than that of the rest of the world and vary across the considered time periods as shown in the below graphs:



Sources: International Labour Organization; Penn World Table version 10.01; United Nations, World Population Prospects; and IMF staff calculations.

In details, growth in MENA region (excluding GCC) in P1 was mainly driven by capital deepening and total factor productivity. Then, labor became the main contributor of growth in P2, and then capital deepening and total factor productivity in P3 and P4 respectively .

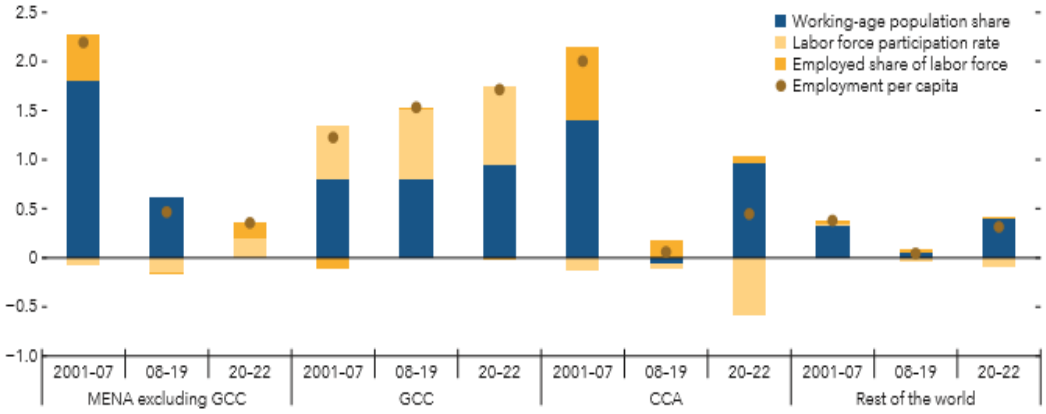
In GCC countries, labor was the main contributor to growth in P2, P3, and P4 as it depends heavily on talented expats from all over the world. It is interesting to note that in the GCC case, TFP has been negative. This is attributed to the developments of hydrocarbon sector, declining oil output due to voluntary production cuts and periods of low oil prices.

In CCA region, TFP was the main contributor to real GDP per capita growth till 2020 when capital deepening became the main contributor while TFP decreased to almost null.

In the rest of the world, TFP and capital deepening were the focal contributors in P1 and P2, and then capital deepening became the key contributor in P3 and P4. Since the global financial crisis and till the spread of the COVID-19 pandemic, capital deepening was the key contributor due to the sustained period of low global interest rates following the financial crisis.

The decline in labor participation in real GDP per capita growth overtime in MENA region (excluding GCC) resulted from the increase in labor force participation and employed shares of the labor force that did not compensate for the decrease in the growth of working-age (between 15 and 64 years) population shares. Regarding GCC, there was an upsurge in labor contribution to growth overtime as the working-age population share' s contribution remained almost constant accompanied with increase labor force participation.

Figure 2.3. Employment per Capita: Contributions to Growth, 2001-22
(Year-over-year percent change; contributions in percentage points)

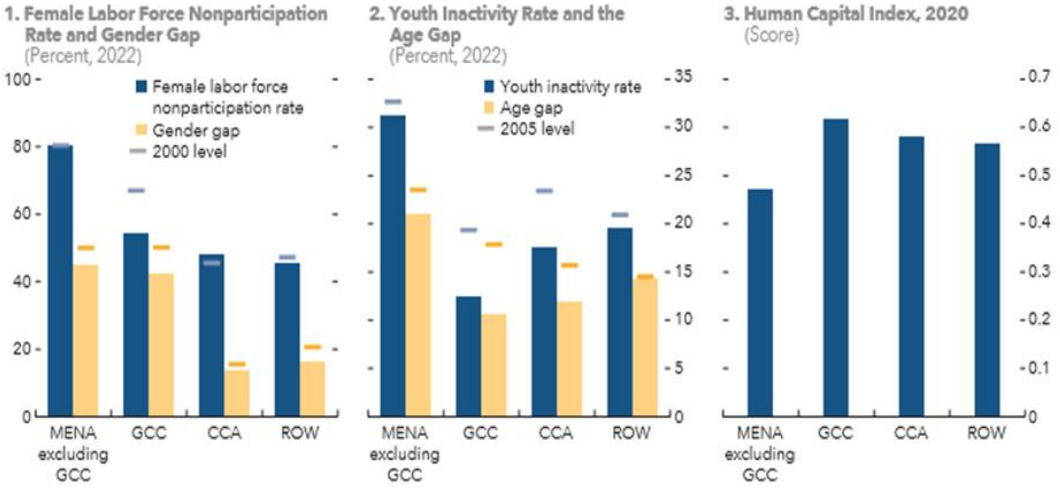


Sources: International Labour Organization; United Nations, World Population Prospects; and IMF staff calculations.
Note: The employed share of labor force is defined as 100 percent minus the unemployment rate. Countries weighted using purchasing power in international dollars. CCA = Caucasus and Central Asia; GCC = Gulf Cooperation Council; MENA = Middle East and North Africa (including Pakistan).

If countries work on female labor force participation through reducing the gap with the male labor force participation and lowering youth unemployment, potential growth gains can arise. In details, GCC and CCA economies made some progress in increasing female labor force

participation and decreasing youth unemployment. However in MENA region, the progress being made is still not enough as female participation is less than world average and youth unemployment exceeds 30% compared to world average of around 20%. There are several reasons that are hindering the improvement in youth employment, such as the lack of development of education systems that address market needs, few incentives to hire young workers, and the structure of its economies. In addition, MENA region countries must prepare plans to increase job opportunities as it will benefit from quicker rise in the share of working-age people compared to the rest of the world.

Figure 2.4. Labor Market: Selected Demographic Indicators



Sources: International Labour Organization; World Bank, World Development Indicators; and IMF staff calculations.
Note: The gender gap is the difference in male and female labor force nonparticipation rates. The youth inactivity rate is defined as the share of the population aged 15-24 years not in employment, education, or training. The age gap is the difference between the youth inactivity rate and the unemployment rate for adults over 25 years. The Human Capital Index is an international metric that benchmarks key components of human capital, including health and education, across countries. The index measures the level of human capital that a child could expect to attain by the age of 18. The index ranges between 0 and 1, with 1 meaning the maximum possible level is reached. CCA = Caucasus and Central Asia; GCC = Gulf Cooperation Council; MENA = Middle East and North Africa (including Pakistan); ROW = rest of the world.

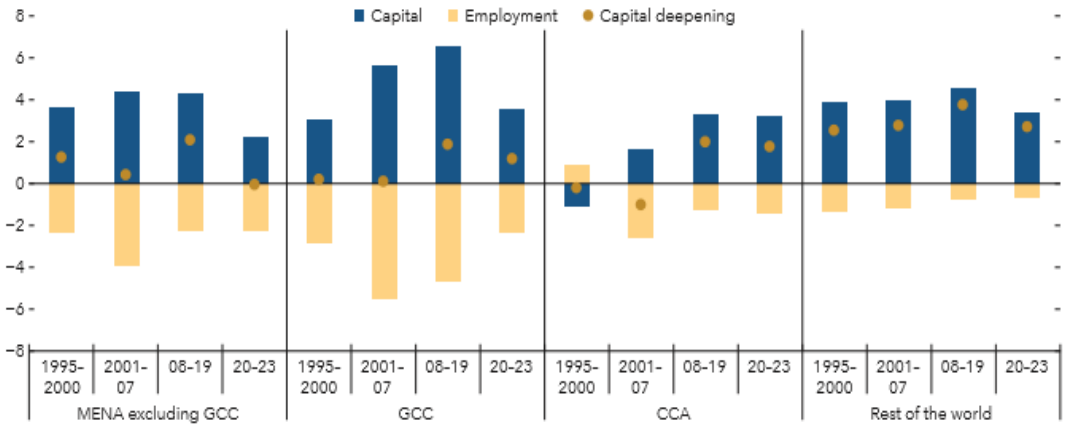
As important, MENA region countries should make efforts to reduce gender gap in labor force and lower youth unemployment as 1% increase in women participation will result in a 1% increase output per capita on average, and 1% decrease in youth unemployment will yield in a 0.2% increase output per capita.

Furthermore, MENA region countries scored lower than GCC, CCA and rest of the world in terms of human capital index indicating that they are not prioritizing investment in human capital.

Governments' major roles in financial sectors are crowding out private sector investments; and relatively strong employment growth rates resulted in poor capital deepening growth; thus decreasing capital deepening' s share of contribution in growth especially in MENA and CCA regions .

It is crucial for MENA and CCA region countries to take necessary actions to increase capital deepening, as a 1% increase in capital per worker leads to an increase of around 0.67% in MENA and CCA countries, and more in countries with capital intensive economies such as hydrocarbon producers as in GCC. For MENA and CCA countries to close the gap with the rest of the world in terms of capital deepening since 1995, they have to increase capital deepening by roughly 2%, which will boost increases in GDP per capita of around 1.3% in MENA, 1.5% in GCC, and 1.4% in CCA region. An example of these actions would be undertaking reforms that stimulate private investment such as improving financial markets and enhancing savings rates and/or capital inflows.

Figure 2.6. Contributions to Capital Deepening, 1995-2023
(Average year-over-year percent change; contributions in percentage points)

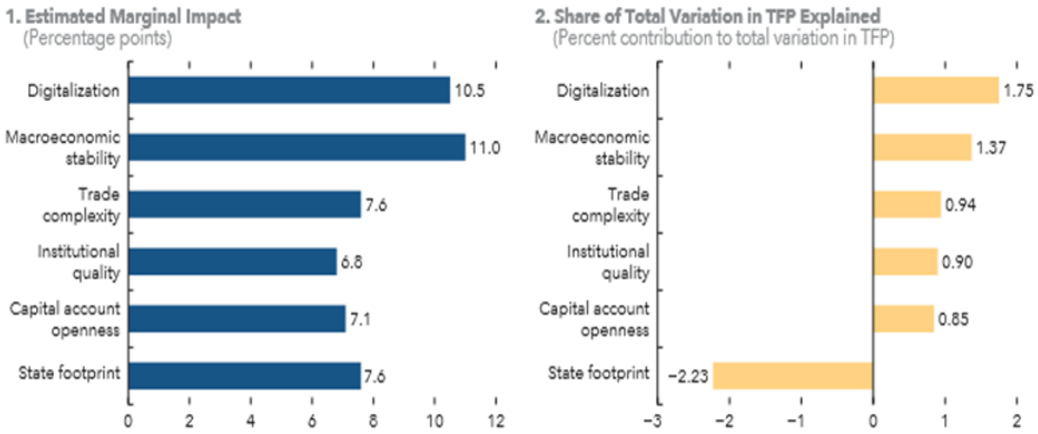


Sources: IMF, World Economic Outlook database; and IMF staff calculations.
Note: Countries weighted using purchasing power in international dollar weights. Figures obtained through a decomposition exercise of capital deepening, where capital deepening is defined as the amount of capital utilized per employed worker. CCA = Caucasus and Central Asia; GCC = Gulf Cooperation Council; MENA = Middle East and North Africa (including Pakistan).

"Total Factor Productivity Growth" (TFP) proved to be significant for real GDP per capita growth, after analyzing historical spans in the period between 2000 and 2023 for 18 economies in the MENA and CCA region as per data availability. According to the report, 8 key factors were identified as structural drivers for TFP growth:

- Macroeconomic stability
- Digitalization, measured using fixed broadband subscription and ratio of high-technology exports to total manufactured exports
- Trade Complexity, measuring the diversity and sophistication of exports
- Capital Account Openness, using ratio of foreign direct investments (FDI) inflows to GDP. It reveals country' s attraction to cross-border capital flows.
- Labor and Inclusion, measured using female labor force participation rate
- Institutional Quality, the measure captures the quality of institution and regulatory frameworks, displaying governance and the rule of law
- Financial Integration, it evaluates the development of financial markets by measuring financial markets and institutions index, credit to private sector, market capitalization, and ratings of credit market regulations
- State Footprint, measuring the extent and effectiveness of government intervention through analyzing government effectiveness index, government consumption, share of banking assets held by state-owned enterprises

Figure 2.8. Drivers of TFP Growth, 2000-23

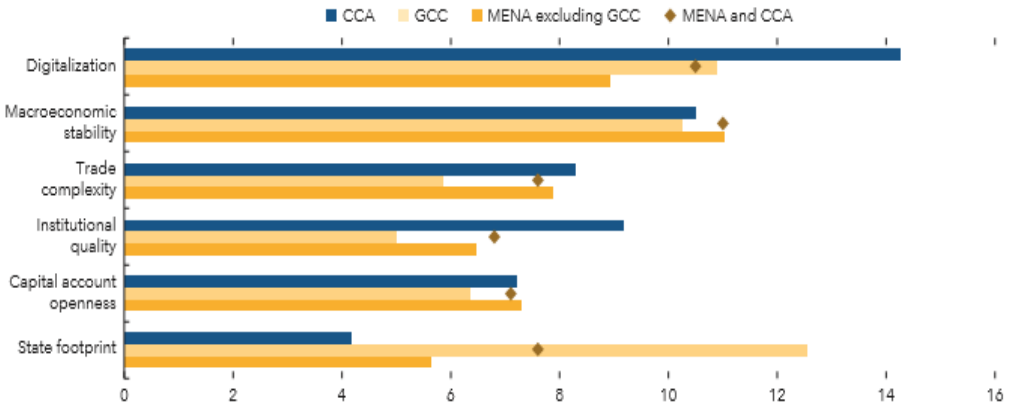


Source: IMF staff calculations.
Note: The bars in panel 1 represent the estimated beta coefficients of the drivers (βi). All estimates are significant at the 10 percent level. The bars in panel 2 show the contribution of each explanatory variable in percentage terms (following the methodology of Sterck (2019) based on data dispersion measured by mean absolute deviation). The contributions of the six key drivers listed do not add up to 100 percent in the chart, as contributions from insignificant explanatory variables (labor and inclusion; financial integration) and the residual term are not shown for brevity. See the Online Annex 2 for full results. TFP = total factor productivity.

"Digitalization", "Macroeconomic Stability", and Trade Complexity" are positively correlated with TFP growth, as advancements in these factors leads to higher TFP growth. However, state footprint appeared to have a negative correlation with TFP growth. In details, and as per the above graph, "Digitalization have the strongest positive effect on TFP growth in which countries with high levels of digitalization experienced on average 1.75% growth in TFP. Second is "Macroeconomic Stability", in which enhanced "Macroeconomic Stability" is linked with 1.37% higher TFP growth. As to "Trade Complexity" increases, TFP growth could be increased by around 0.94%. However, high level of "State footprint" reduces TFP growth by 2.23% on average, while its reduction improves TFP growth.

"Macroeconomic Stability" and "Digitalization" were significant factors contributing to the variation in TFP growth in MENA region and CCA, while the remaining factors varied across the regions. Below graph shows the contribution of the six key factors in TFP growth across the three regions.

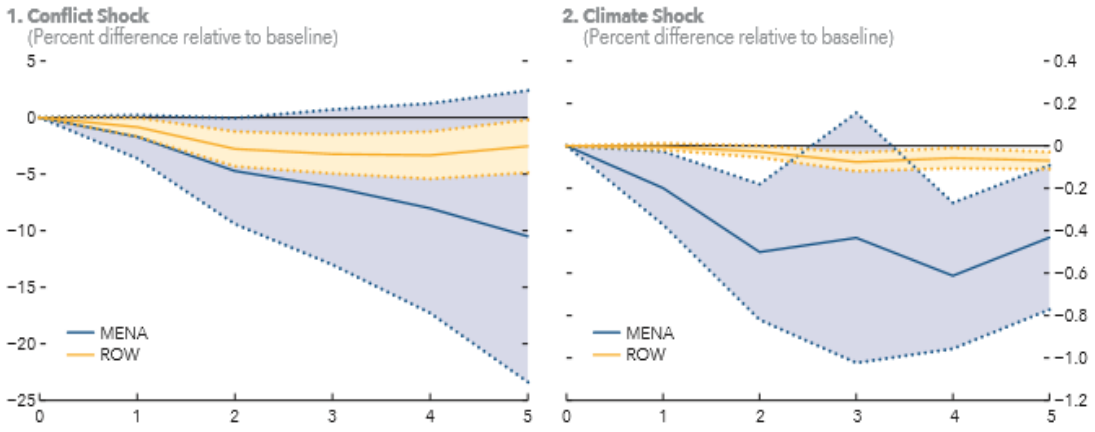
Figure 2.9. Total Factor Productivity: Share of Total Variation in TFP Growth Explained by Region, 2000-23
(Percent contribution to total variation in TFP growth)



Source: IMF staff calculations.
Note: The bars represent the relative contributions of the drivers to the mean absolute variation of TFP growth within each subregion, following the methodology of Sterck (2019). The contributions of the six key drivers listed do not add up to 100 percent in the chart, as contributions from insignificant explanatory variables (labor and inclusion; financial integration) and the residual term are not shown for brevity. See Online Annex 2 for full results. CCA = Caucasus and Central Asia; GCC = Gulf Cooperation Council; MENA = Middle East and North Africa (including Pakistan).

Besides the structural factors that affect TFP, MENA and CCA regions have been also affected by shocks from climate changes and conflicts since early 1990s, as the latter have large and long-lasting negative impact on productivity in the MENA region with around 10% lower level of TFP for five years after a severe conflict shock. However, in case of damages from extreme climate events, TFP level drops by 0.5% for 5 years as shown in the below graphs.

Figure 2.10. Total Factor Productivity: Impacts of Conflict and Climate Shocks



Source: IMF staff calculations.
Note: Dynamic responses estimated using local linear projections. Bands show the 90 percent confidence interval around the point estimates. The shocks occur in year 1. The conflict shock is equivalent to the occurrence of a severe conflict in the country (at the 75th percentile of the world distribution of conflict intensities). The climate shock is equivalent to 1 percent of GDP loss because of material damages arising from extreme climate events. MENA = Middle East and North Africa (including Pakistan); ROW = rest of the world.

In conclusion, although changes to demographic factors have been more favorable to MENA and CCA regions compared to the rest of the world, the capital accumulation restraint resulted in a decline in growth expectations. In order to reverse the trend and boost the economic growth, MENA and CCA regions countries should perform country-specific policies and reforms. As such, they have to increase the level of capital per worker and support job creation to take advantage of the favorable changes of demographic factors, and perform reforms to boost TFP growth.

Some of the actions that should be taken to lift employment and labor productivity are:

- Improve female employment by improving the quality of education and training programs targeted for women. In addition, incentives and subsidies could be given to businesses that hire female employees such as tax incentives which will improve job creation for women especially in sectors where women are underrepresented.
- Boosting youth employment and engagement by improving education programs to cope with labor market needs and providing needed capital through business incubators and accelerators in order to support young entrepreneurs.
- Investing in education, especially in science and technology and ensuring that skills taught match with future labor market demands.

It is clear that capital deepening in MENA and CCA regions is lower compared to the rest of the world. As such, more capital provision via improving financial markets, in addition to encouraging private sector investments along with reducing governments' role in financial sectors, growth will be stronger and sustainable. In addition, boosting TFP growth can also play a vital role in increasing growth opportunities by strengthening all TFP factors and not only the main ones (digitalization, strengthening macroeconomic stability and reducing state footprint). One example of such factors that should be strengthened is the quality and quantity of research and development (R&D) that is trailing compared to advanced economies, where R&D in MENA and CCA regions do not exceed 2% of GDP compared to 3% in advanced economies. That also includes

governments' role in increased investments in R&D. Finally, applying policies to reinforce macroeconomic fundamentals can limit the economic impacts of conflicts; and mitigation plans should be present in order to be ready for any climate change consequences.

For your Queries:

BLOMINVEST BANK s.a.l.

Research Department

Zeituna Bey

POBOX 11-1540 Riad El Soloh

Beirut 1107 2080 Lebanon

Helmi Mrad

helmi.mrad@blominvestbank.com

Research Department

Tel: +961 1 991 784

research@blominvestbank.com