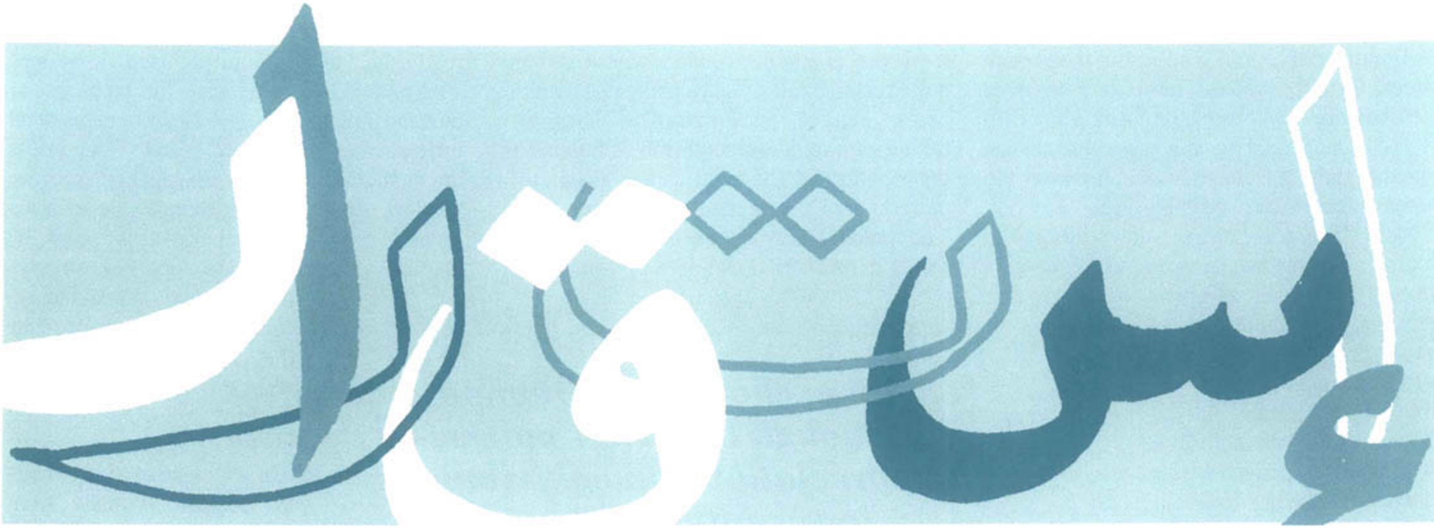

Growth and Financial Stability in the Middle East and North Africa

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This is a particularly opportune time for countries in the Middle East and North Africa to implement reforms to fulfill their considerable economic potential and reap the benefits of greater globalization and integration.

THE COUNTRIES of the Middle East and North Africa (MENA) face exceptional challenges and opportunities. The globalization and integration of the world economy, the progress being made toward peace in the Middle East, and the recent launching of the Mediterranean Basin Initiative by the European Union (EU) offer the region important opportunities. The hoped-for gains will be realized, however, only if the MENA countries meet the challenges of vigorously implementing macroeconomic and structural reform policies.

The MENA region is important to the world economy; it boasts a rich endowment of natural resources—including about two-thirds of the world's known oil reserves—a large labor force, and a respected tradition of trade. There is, however, considerable economic and financial diversity among countries: they vary considerably in economic size, population, public/private sector balance, and trade and financial linkages with the rest of the world.

Patterns of the past

Economic performance during 1989–94 was mixed. The region's GDP grew at an annual average rate of 3.2 percent, which compares favorably with the rates achieved in both Latin America and sub-Saharan Africa during the same period. (See chart.) Inflation performance has been relatively good, compared with other developing regions, averaging about 16 percent per year during 1989–94. (See chart.) Efforts to lower budget deficits and promote private savings have reduced domestic financial imbalances. Financial sectors have been reformed, and exchange rate regimes have been liberalized in a number of

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countries. Foreign assets remain significant, despite recent drawdowns in some countries.

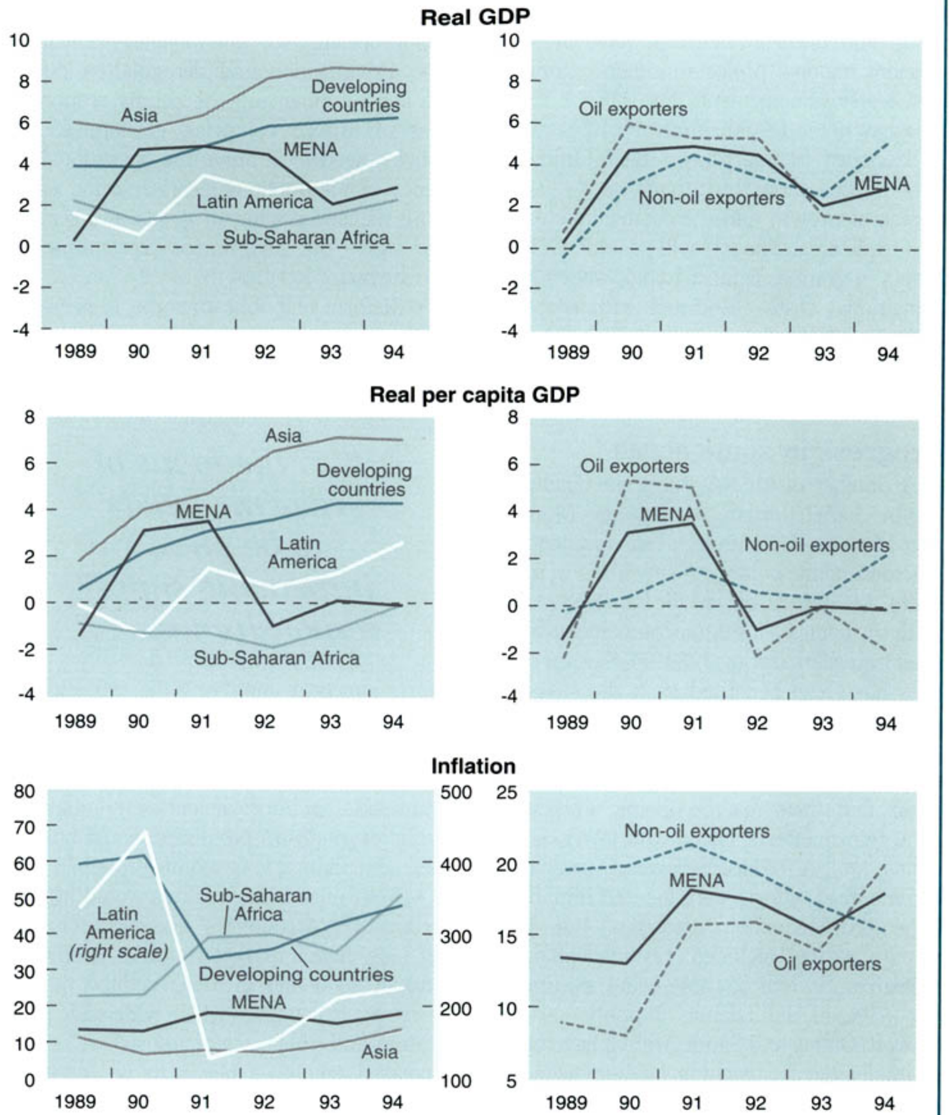
Nevertheless, growth in these countries' output has failed to keep pace with their rapidly growing populations, and real per capita GDP has stagnated. (See chart.) There has been little progress in addressing unemployment problems, further aggravating social pressures in a number of countries. Domestic saving remains low and constitutes a constraint to higher investment. MENA countries' participation in the process of globalization and integration of international capital markets has been relatively limited—especially when compared with Asian and Latin American countries.

The structural impediments that characterize many economies in the region have affected their performance in recent years. Three structural elements are particularly evident:

- ***Poorly diversified economic base.*** This is most pronounced in the case of oil exporters, where the oil sector often accounts for more than 50 percent of GDP. The agriculture sector accounts for a similar proportion of GDP in Somalia and Sudan, and about 25 percent of GDP in Iran, Mauritania, and Yemen. Only a few countries can boast a significant and well-diversified manufacturing sector—Israel, Morocco, and Tunisia.
- ***Vulnerability to external shocks.*** MENA countries are significantly more sensitive to international price developments than those in other developing regions. Fluctuations in oil prices not only have a major direct impact on export receipts and government revenues in the oil-exporting countries of the region but also—through labor market and capital linkages—have important consequences for several other countries in the region. Concurrently, because of their heavy reliance on imports of foodstuffs, a large number of MENA countries are vulnerable to fluctuations in their prices on world markets. In countries heavily dependent on agricultural output and exports (e.g., Morocco and Sudan), economic performance remains highly vulnerable to weather conditions.
- ***Dominant role played by the public sector.*** In general, the public enterprise sector has been insufficiently exposed to competitive forces and has become dependent on government transfers and subsidies.

Developing countries and MENA region: growth and inflation rates, 1989–94

(annual changes, in percent)



Source: IMF, 1995, *World Economic Outlook: A Survey by the Staff of the International Monetary Fund* (Washington, October).

A subdued external outlook

Developments in the external environment affect individual countries in the MENA region through the goods and labor markets, and, to a lesser extent, through capital flows. Medium-term projections suggest the region faces opposing external influences. With regard to the goods market, buoyant external demand is projected for non-oil products, which account for one-fourth of the region's exports, with Israel accounting for almost half of this total. However, a subdued international price outlook for petroleum and potential upward pressure on food import prices could create serious risks.

Remittances received from nationals working abroad help the balance of payments accounts of several countries in the region and favorably influence their investment performances. Unfortunately, prospects for increased labor migration to Europe, as well as for larger intraregional labor flows, are less favorable than in the past.

A number of countries of the region have intensified financial sector and other reforms that encourage the mobilization of funds from international sources. Recent developments—including, among others, the financial crisis in Mexico—suggest, however, that the countries of the region will have to compete for capital inflows in a more cautious investor climate.

Changes in the regional environment also have important implications for the MENA countries' outlook. Progress toward resolving the long-standing Arab-Israeli conflict—through the establishment of a just, durable,

and comprehensive peace—would help ease several important constraints on the region's growth and development—the high level of military expenditures, perceptions of socio-economic risk that have discouraged investment, and uncertainties that have inhibited efficient regional projects in energy, tourism, and water management. The MENA region also has much to gain from the EU's recently launched Mediterranean Basin Initiative, which focuses on the private sector as the engine of growth and the establishment of a free trade area. The EU will provide ECU 4.7 billion in grant assistance to help alleviate the transitional costs associated with economic and structural reforms, and a similar amount of loans will be provided by the European Investment Bank.

Progress in some areas

A number of MENA countries—including Egypt, Israel, Jordan, Mauritania, Morocco, and Tunisia—have undertaken commendable macroeconomic policy reform efforts in recent years. All of them, except for Israel, have done so in the context of Fund arrangements for at least two years during 1989–94. Several countries have also benefited from the sustained implementation of structural reforms.

In response to the changing external environment, the oil exporting countries have also intensified their macroeconomic and structural reform efforts. Faced with lower oil revenues and a reduced flow of investment income, these efforts were focused initially on expenditure-reduction measures but more recently have included revenue-enhancing measures. Several of these countries (including Algeria, the Islamic Republic of Iran, Kuwait, Oman, and Saudi Arabia) have begun to implement far-reaching medium-term programs encompassing further deficit-reduction measures, structural reforms, and private sector promotion policies.

There nevertheless remains a clear need for sustained reform efforts in most countries, even those that have made significant progress in recent years. Adjustment will inevitably involve short-term costs, given the resource reallocation requirements. The emphasis must therefore be on minimizing these costs through proper planning and sequencing of policies, and protecting the most vulnerable segments of their populations.

Policy challenges

The priorities for domestic policies are clear. As is generally recognized by policymakers in the region, the focus of reforms needs to be on structural measures aimed at improving the supply responsiveness of the MENA economies in order to ensure sustained growth, employment creation, and development. However, the effectiveness of such measures also depends on the implementation of a consistent and supportive mix of macroeconomic stabilization policies, including pursuit of appropriate fiscal and monetary policies.

- Privatization and deregulation policies are key to enhancing the supply responsiveness of MENA countries' economies. Such policies need to improve the operational efficiency of the public enterprise sector, ensure more realistic pricing of goods and services, and signal the government's commitment to private sector-led growth.
- Reform of public finances is needed to further strengthen domestic savings and reduce the MENA economies' vulnerability to adverse external shocks. On the revenue side, efforts aimed at improving the elasticity and efficiency of the tax system need to be supported by improvements in administrative efficiency and tax enforcement. On the expenditure side, an improvement in the quality of public expenditure programs would enhance their contribution to economic growth.

". . . the focus of reforms needs to be on . . . improving supply responsiveness . . ."

- Reform of labor markets would improve certain MENA countries' prospects for creating jobs. Labor market rigidities need to be reduced soon and in a determined manner. Moreover, in countries where wide-scale privatization and public sector reform are needed, increased emphasis needs to be placed on labor-retraining schemes.
- The human resource base of the region is its key asset. Since education is the most important means of increasing the productivity and incomes of workers, there is a particular need to intensify efforts to educate the female population. As the experiences of other developing countries have shown, improved education opportunities for girls and women could also contribute to a reduction in population growth.
- Domestic and foreign direct and portfolio investment opportunities would be enhanced through the measures outlined above. However, additional steps are needed to simplify investment procedures at the local level and reduce barriers facing foreign investors. Determined actions in these areas, along with a stable macroeconomic environment, promise greater returns than the current approach, which places excessive emphasis on incentives, concessions, and tax-free zones.
- A strengthening of the financial intermediation system is essential to enhance financial savings and channel resources to the most productive sectors, as well as ensure that increased inflows of foreign investment do not destabilize the domestic financial system. To achieve these objectives, financial institutions need to be exposed to a sufficient degree of competition. The remaining controls on rates of return and other charges need to be reduced in the context of further progress toward indirect monetary control, and prudential regulatory and supervisory regimes need to be improved.
- Measures are also needed to broaden the bank-based financial systems of MENA countries in order to mobilize resources—from domestic, regional, and international sources—and allocate them to productive investments in support of growth and development. Equity markets have an important role to play in this regard.
- The liberalization of the external trade and payments regime provides an important complement to domestic deregulation efforts. To this end, trade reforms need to aim to reduce tariff and nontariff barriers and simplify the tariff structure. Efforts in this direction need to be accompanied by the elimination of remaining state-trading monopolies and the harmonization of their institutional structures with those in most other market economies.

The ongoing integration efforts, both within the region and with the EU, offer a favorable environment in which the MENA countries can undertake the required policy actions. It is important, however, that regional integration efforts reinforce, rather than replace, progress toward multilateral trade liberalization. Integration schemes need to be consistent and mutually reinforcing, and it needs to be recognized that the rewards of integration will materialize only if they are supported by appropriate domestic policy reforms.

For several countries in the MENA region—particularly the low-income ones—determined policy implementation needs to be supported with significant external assistance. Such assistance facilitates the process of adjustment and reform, provided it is available on a timely basis and on appropriately concessional terms. F&D

This article is based on a longer paper by the authors, "Macroeconomy of the Middle East and North Africa: Exploiting the Potential for Growth and Financial Stability," which is to be published in the IMF's Pamphlet Series.