Economic Challenges in the MENA region

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The past several years have been particularly challenging for most economies in the MENA region. MENA economies suffer from two central afflictions – poor institutions and high birth rates – that have led to a dearth of foreign direct investment, stagnant per capita growth and high unemployment, particularly among the young middleclass. These toxic combinations have contributed to a prevalent disfranchisement of the middle class in urban areas, which coupled with the internet, were a significant causal factor to the Arab Spring. The region remains fragile after these uprisings due to uncertainties arising from political transitions in Egypt, civil war in Syria with spillovers to neighboring economies. Underlying social unrest flourishes in many cities due to budding seeds of economic and political disenchantment and disfranchisement. As a result, the region's reputation for a risky business environment due to complicated, corrupt, opaque and entrenched regulations and ingrained ambiguities of the political regimes are likely to remain a drag on economic growth and development. Unresolved social problems and a wait- and-see attitude of both domestic and international investors will plague the economic recovery, job creation, business confidence and entrepreneurial investment possibilities over the coming years. On the positive side, many MENA governments recognize the need to address the daunting social and economic challenges to avoid further political unrest; further, economic integration efforts in the region are expanding markets and investment opportunities.

Many economies including Jordan and Egypt remain poor, with only 12% of the income level of the United States. Acemoglu and Robinson (2012), prominent Harvard economists, open their book, "Why Nations Fail" attributing the roots of pervasive discontent in Egypt and the wider MENA region to ineffective and corrupt economic regimes. Significant labor regulatory factors and an extractive government sector were key factors behind confiscation of a Tunisian man wares (due to lack of an expensive permit) and subsequent humiliation that lead to his self-inflicted burning and subsequent demonstrations that began the Arab Spring. From Tunisia to Iran, many of these economies were ruled by narrow elites that extracted resources from their country to benefit themselves (such as the estimated $50-70 billion of Mubarak's fortune) not the wider society. The problem is many of these regimes and/or their crony capitalistic partners remain in power, and have bestowed particular elites privileged access to favorable regulatory and financing dealings. The preferential treatment in turn allows them to dominate particular industries and generates MENA's uncompetitive and lethargic private sectors. These factors have contributed to weak macroeconomic fundamentals for all MENA economies outside the rich Gulf Cooperation Council (GCC) economies.

The central challenge of MENA economies is generate inclusive growth propelled not by the government, which has been a traditional source of middle class employment, but by the private sector. However, the governments have organized MENA economies to extract rents such as oil or tourism, and have inhibited entrepreneurs and merchants from using their talent, ambition, and ingenuity to start businesses and generate growth. In order to create these jobs, small and medium size enterprises (SME) must be persuaded that the current reforms are more than tentative, but credible, enduring and enforceable. Employment generation has been a principle focus of development economists for half a century (Lewis 1954, Baer and Hervé 1966). MENA economies need foreign direct investment in export-led labor intensive industries to absorb the labor force increases of 3-4% due to very high population growth; however, the non-oil exporting economies received only $65 billion over the past decade according to the World Bank, while the GCC economies with a much total population received more than double this investment. Overall, MENA receives half the annual FDI of Sweden, a country whose population is 1/20 of MENA countries.

During the 1960-1990s, a number of Asian economies were tremendously successful in job creation in manufacturing or internationally tradable service sectors; further, in the past 25 years, China has created tens of millions of jobs in industrial sector, much of it due to direct foreign investment and initially tied to industrial enterprise zones. However, the East Asian miracle of export led growth and embrace of globalization, in many cases fueled by FDI and technology transfer, is unlikely to be replicated easily in MENA economies for a number of reasons. MENA economies face significant downside economic risks that are summarized as follows, and then documented in further detail throughout the report. Overall, there has been significant de-globalization, as MENA share of world trade (excluding oil) has fallen by more than two-thirds.

ECONOMIC CHALLENGES TO GROWTH

Significant Labor Concerns

- The region faces a demographic imperative to create jobs due to high population growth leading to a labor force entry of 3.5-4% per year. As a result, there is a need to create 60 million jobs over the next decade.
- Very low labor force participation (1/3 of the workforce age is engaged), partially driven by a lack of women participation. The region has the lowest employment rate in the world.
- Foreigners account for much of the hiring and labor force in the Gulf region economies.
- Tremendous mismatch of job skill sets with high unemployment among college educated youth, leading to over-qualified and disenchanted youth.
- Unemployment among the young is twice the world average; i.e., 25-45% of youth are unemployed leading to 3% lower GDP growth. The OECD reports overall unemployment ranging from 10-25%.
- Civil service sector bloated with most of the educated workforce, distorting labor markets and crowding out the private sector. The public sector comprises 29% of total employment and 38% of total expenditures.
- Absence of technical skills in most MENA economies, although GCC economies are building partnerships with well-known American, European and Asian universities and recruiting talented professors from abroad.
- Share of informal employment has doubled in recent years, and is not engaged in export or technology intensive manufacturing but in low productivity service industries that evade taxation.
- Overall, the World Bank extensive survey of executives reveals restrictive labor regulations as the most important impediment to business activity.

Globalization Difficulties

- Low trade and not integrated into cross-national value chains.
- Low foreign direct investment outside oil, and nearly all in hotels, not in manufacturing or tradable services.
- Low manufacturing and non-oil exports.
- Low portfolio inflows and poorly developed stock markets.
- Little penetration of technological innovations or adoptions.

- Lack of government support for competition and free markets as well as the process of integrating though globalization; local entrepreneurs suspicious of globalization.

Institutional Problems

- Need to improve financing for middle-class entrepreneurs.
- Corruption and transparency measures are not only not improving, but in many MENA economies have declined since 1990.
- Severe labor market rigidities and regulations discourage expanding employment and foreign direct investment; e.g., the World Bank has identified labor regulations as a major constraint to businesses and more burdensome than other developing regions.
- Lack of inclusive growth strategies in non-oil economies.
- Resource curse of oil leading to overreliance on economic rents and lack of economic diversification implies subject to consider systematic risk.
- Substantial corruption and policy instability that raises the cost of business and the risks of investment.
- Significant costs of terrorism for Algeria, Egypt, Lebanon, Libya, Morocco, Syria and Yemen; Noland and Pack estimate that reducing the risk of terrorist activity to Jordan's level could boost FDI by 20-30% in the region.

Economic Factors

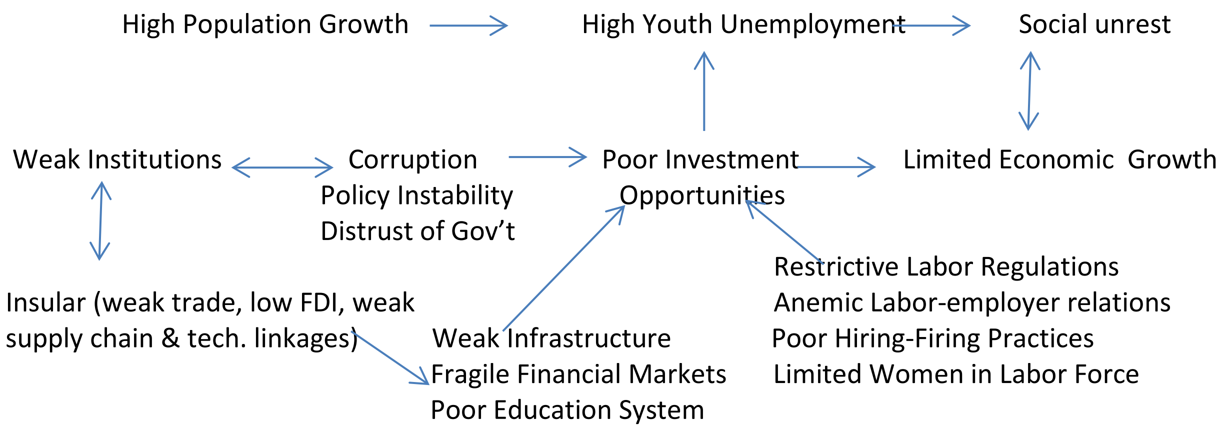
- Large budget subsidies that contribute to budget deficits and inflationary pressures.
- Poor financing to SME constrain entrepreneurs and innovations.
- Agricultural and social/personal services sectors account for 60% workers and explain these economies' low productivity.
- Poor financial infrastructure and diversification leads to limited financing opportunities.

Economic Effect

- Weak GDP growth per capita since 1980 has led to a restless middle-class creating political instability that threatens the prevalent brittle authoritarianism.

Figure 1 illustrates many of these causal factors and the vicious cycle pictured below can only be reversed with property rights and political stability – Uncertainties and downside risk are considerable.

Figure1: Economic Dynamics



Background and Macroeconomics

The primary focus of this chapter is the economies of MENA region. Israel is not considered as it has a more developed middle class; further its economic structure is modelled after OECD economies. The economic systems ranged from Soviet-style state intervention policies endorsed for decades by Algeria, Egypt and Libya to the freer economy of Jordan to the oil rich of Kuwait and Saudi Arabia. Although the economies examined are not a monolithic entity, and differ economically in several different dimensions, compared to other regional groupings in Latin America and Asia, they share more similarities than differences including religion, language (except for Iran) and brittle authoritarianism.

One common element was the rule of the Ottoman Empire state, which at one point stretched from Tunisia to the Arabia Peninsula to Iraq. This empire was absolutist, with an unaccountable sultan. Acemoglu and Robinson argue the Ottomans' economic institutions were highly extractive (benefiting themselves and fellow elites), and the absence of property rights discouraged business activity and entrepreneurship. Commerce was under state control and occupations were strictly regulated by guilds. The consequence was a tradition of poor economic institutions that hindered an industrial revolution fostering manufacturing and idea creation. More recently, for more than two generations, MENA economies pursued failed import substitution policies similar to Latin America and India that included government attempts to foster industrial development. The import substitution policies benefited state owned enterprises and the elites who ran them, and did not generate a competitive private sector. However, unlike other emerging economies, nearly all MENA economies have been slow in recent years to reverse these failed economic policies, and integrate into global value chains, pursue manufacturing and adopt the export based policies of the East Asian economies.

The Gulf States (as well as Algeria and Libya) economies differ considerably from the other MENA economies as their economies are built around high oil/gas exports. Algeria, Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and UAE derive 70%-85% of government revenue from rents, and 25-33% of income. Saudi Arabia and the other smaller GCC economies with their small populations have significantly higher per capita income due to oil and gas revenues than other MENA economies. Without this oil, Kuwait and Saudi Arabia would be only as rich as Guatemala or Egypt, as these oil rich economies have not formed diversified modern economies (Acemoglu, and Robinson, 2012).

From 1980-2000, however, MENA economic performance has been both volatile and anemic, while many developing economies adopted more competitive economies through export-led manufacturing. GCC economies particularly due to low oil prices in the 1980s experienced not only significant growth slowdowns but their real per capita GDP fell considerably. GCC economies and Algeria obtain 70-85% of their government revenues from oil, and their macroeconomic fundamentals, particularly, their budget deficit, rise and fall with the price of oil. During boom times, there have been insufficient efforts to save, and spending has concentrated on local real estate projects. As a result, their financial institutions are exposed to significant systematic risk; e.g., only one Gulf bank has survived since 1980.

In terms of standard of living, oil is a chief determinant of per capita GDP (in PPP dollars. Figure 2 presents the six major nonoil exporting MENA economies; note two-thirds of Arabs live in these major non oil-producing countries. Per capita GDP is relatively low and ranges from $2500 for Yemen to nearly $12000 for Tunisia. Growth in per capita GDP for Egypt and Jordan was 4.2% and 4.9%, but with population growth of 2.7% and 3.7%, increases in the standard living have been less than 2% since 1990.

How have the MENA economies fared relative to other developing economies? An extensive economic literature documents (and the Solow Growth model attests) that income per capital will converge across countries in terms of purchasing power parity if the correct institutions exist. This explains the rapid growth since 1960 of Korea and Malaysia that have nearly closed the gap with the OECD. However, these economies have transformed their regulatory environment and adopted pro-business policies. In contrast, non-oil exporting MENA economies such as Egypt, by the largest Arab economy in the world, is still a poor economy and has shown little signs of economic convergence.

Using a per capita GDP in Purchasing Power Parity terms from 1960–2000, Egyptian incomes remained only 17% of the industrial countries of the OECD, while the absolute difference in per capita incomes widened from roughly $7,000 in 1960 to nearly $20,000 in 2000 (see Noland and Pack, 2007). From 2000-2013, the gap has further widened to over $30,000 and the gap remains at 17%. Jordan, Syria and Yemen also have shown no tendency of convergence, while Tunisia from 1970-2013 has partially closed the gap from 21% of OECD income to 27%. However, in terms of standard of living, the gap still remains at over $20,000. The failure to convergence is further confirmation that technological innovation and investment are not occurring due to poor institutions. At the same time, Malaysia, a Moslem economy in South-East Asia, had approximately the same income as Egypt in 1960 but has closed the gap from 16% to 88%, and implies religion is not the problem holding back the MENA economies, but the prevalence of incorrect policies.

Figure 2: GDP per capita (PPP$) Non-Oil exporting MENA economies

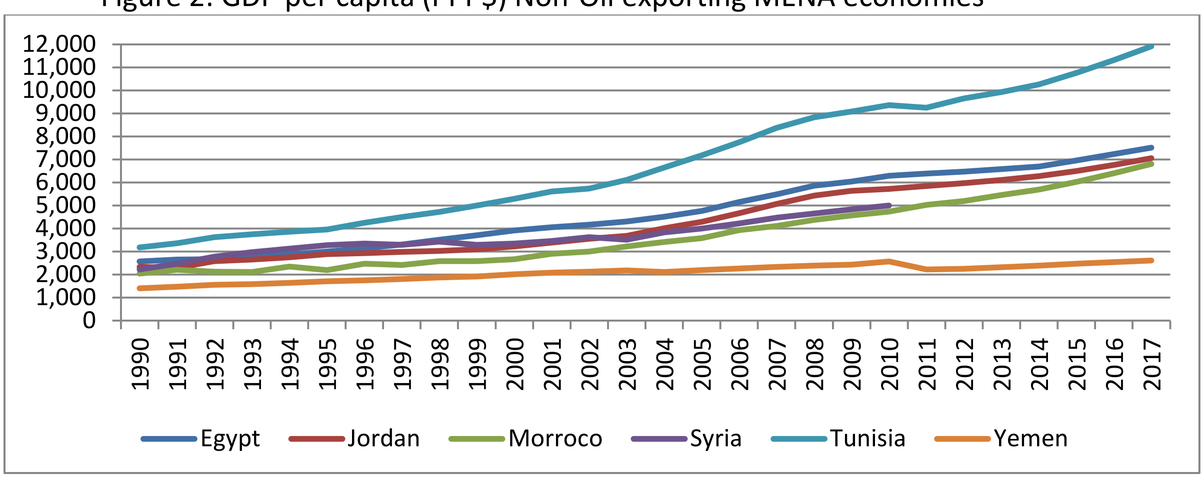
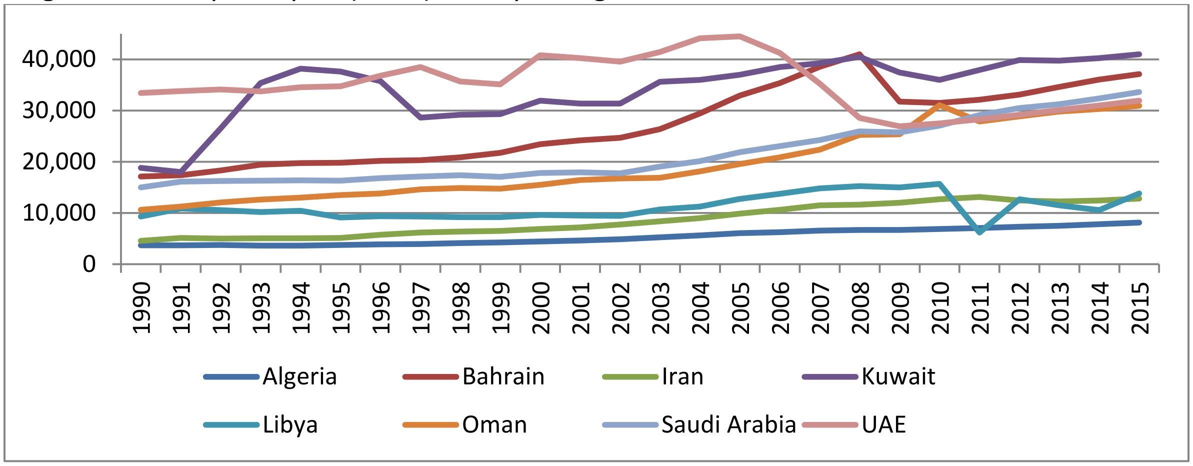


Figure 3: GDP per capita (PPP$) Oil exporting MENA economies



Surprisingly, Noland and Pack (2007) report that from 1980 to 2000, Saudi Arabia, the largest GCC economy, experienced a relative per capita PPP decline from 30% richer than the US to less than half the U.S.. This implies their average citizen went from a standard of living of New York or London to that of Sao Paolo, Brazil. Economies including Kuwait and Oman further suffered a similar fate of a fall in the standard of living. The boom income in the 1970s was not invested productively, and created few sustainable jobs. Additionally, much of the employment increases was on government payroll. GDP growth in these economies fell considerably in the 1980s when the price of oil fell, but then has accelerated until 2008 when the price of oil reached a peak. Since the financial crisis, Saudi Arabia and the UAE have struggled; e.g., Saudi Arabia's stock market peaked in 2007, but in 2014 was half this value. Since 2000, the boom in oil prices has reversed much of this decline and in 2013, per capita GDP in Saudi Arabia, Oman and UAE reached 82% of the OECD economies. As a result of higher oil prices over the past decade, many of the oil exporting economies are substantially richer (than non-oil exporting MENA economies) with Bahrain, Oman, Kuwait and Saudi Arabia, possessing per capita GDP in the range of $32-42,000.

Overall, as the figures below document the MENA economies suffer from a lack of economic dynamism that has led to high unemployment and low GDP growth relative to other emerging and developing economies.

Figure 4: Limited Convergence

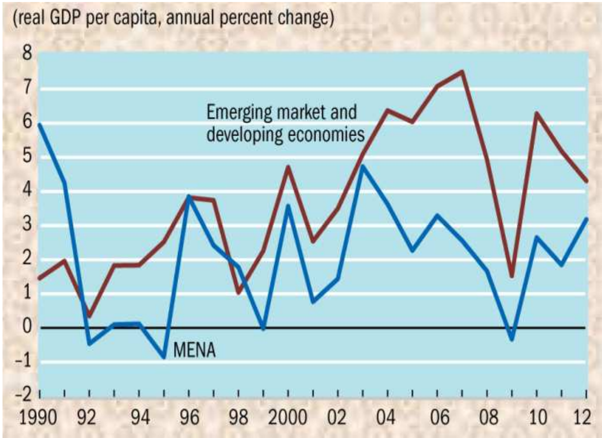
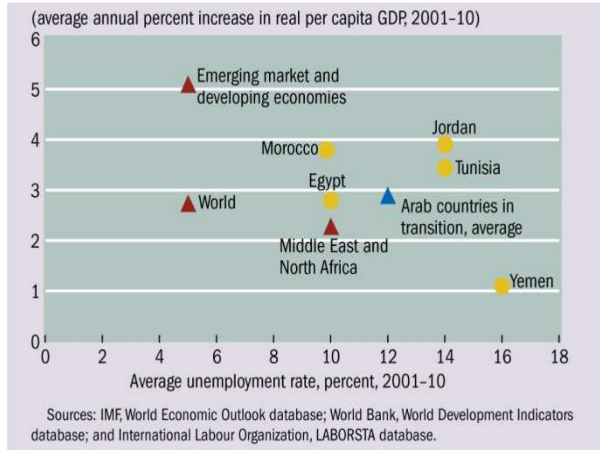


Figure 5: High Unemployment and low GDP growth



The International Finance Corporation (2014) has identified a number of constraints that are listed below that inhibit investment and growth. There are several reoccurring themes: pervasive regulatory policy uncertainty, limited skills and education of works, political instability, informal sector competition, high tax rates, cost of financing. These limitations and weaknesses occur due to anemic institutions that safeguard a proper capitalistic system.

Table 1: Problems of Doing Business in MENA economies

Country	Algeria	Egypt	Lebanon	Libya	Morocco	Syria	Syria	West Bank	Yemen	Iraq
Leading constraint	Corruption	Macro uncertainty	Tax rates	Political instability	Access to land	Tax rates	Corruption	Political instability	Corruption	Electricity
2nd leading constraint	Informal sector	Informal sector	Macro uncertainty	Electricity	Regulatory uncertainty	Electricity	Regulatory uncertainty	Macro uncertainty	Electricity	Political instability
3rd leading constraint	Access to finance	Skills/ education	Informal sector	Corruption	Access to finance	Informal sector	Courts	Regulatory uncertainty	Access to land	Corruption
4th leading constraint	Access to land	Regulatory uncertainty	Regulatory uncertainty	Tax rates	Tax rates	Access to land	Electricity	Corruption	Political instability	Access to finance
5th leading constraint	Electricity	Tax rates	Corruption	Cost of financing	Macro uncertainty	Access to finance	Skills/ education	Electricity	Regulatory uncertainty	Informal sector
6th leading constraint	Political instability	Corruption	Tax Adm	Informal sector	Informal sector	Courts	Customs & Trade regs	Transport	Courts	Access to land
7th leading constraint	Tax rates	Cost of financing	Licensing & permits	Skills/ education	Corruption	Corruption	Tax Adm	Crime, theft, and disorder	Tax rates	Crime & theft

Nasr and Pearce (2012)

A common element in all countries is weak institutions embodied by corruption and policy/regulatory instability. These factors are important in deterring FDI, jobs and growth in the MENA region (Chan and Gemayel, 2004 and Méon and Sekkat, 2004). Other important factors that we will discuss in this article are problems with the cost of financing, lack of infrastructure particularly electricity, poor tax administration and poor trade regime. Mohamed and Sidiropoulus (2010) and Mina (2012) further show that both property rights, control of corruption and political instability are critical in attracting FDI in Arab countries. As a result, the World Bank (2013) concludes that the business climate in MENA economies became less competitive compared to other developing economy regions over the last decade. The MENA region faces a severe resource trap unless they fix the investment climate and the rule to law as well as stabilize the prevailing political and macroeconomic uncertainty in the region. One critical factor not identified by Nasr and Pearce in the above table, but given by the OECD, IMF and World Bank as fundamental in hindering economic development in the MENA region is a properly functioning labor market.

Labor Market

A major problem holding back MENA economies are four fundamental obstacles in the labor market: lack of women in the labor force, a large and inefficient informal sector, mismatch of skills with market needs, and anticompetitive labor market practices. The World Economic Forum (2011) reports an inadequately educated labor force is a critical factor constraining doing business in the Arab World. The OECD (Sullivan et al., 2014) finds that employment in the non-agricultural public sector ranges from 28% in Tunisia to 42% in Jordan and 70% in Egypt, distorting labor markets and crowding out the private sector. Government employment and state owed enterprises act as a magnet that attract the most best talent, and reduce the pool for qualified candidates for the private sector. Further, the World Bank Entrepreneurship Survey (2008b) posits that MENA economies start new firms at a rate of 1/6 of richer OECD economies, tied only with Sub-Saharan Africa on the bottom of emerging economies. The UN (2014) concludes the severe unemployment problems among youth have accelerated in recent years due to stagnant world trade, tempered commodity prices and stagnate per capita economic growth in MENA economies. Youth unemployment is 45% in Algeria, 25% in Egypt and 30% in Jordan and Saudi Arabia. Moreover, youth unemployment has risen in recent years as commodity prices have fallen, world trade slowed and per capita economic growth in MENA stagnated.

A disturbing observation is that, in contrast to the OECD economies, where the unemployment rate for the more educated is half the rate for high school graduates, the pattern is reverse in many MENA economies. The likelihood of being unemployed for the college educated is 10x, 5x, 5x 3x, 25% more in Egypt, Morocco, UAE, Iran, Jordan than for workers with only an elementary school education, respectively. Even in Saudi Arabia, there is scarce demand for college educated skills in the private sector as college graduates suffer from a 43% unemployment rate (Sullivan, 2014). As a result, many young people are overqualified and receive low wages, and are disappointed. Forty percent of Jordanians are considered over-qualified. Two-thirds of the chronic unemployment problems occur for ages 20-40. The high youth unemployment, particularly among the college educated middle class, not only represents a loss of GDP for the economy (approximately 3% per year), but also has fueled political instability as in the Arab Spring. As the Table shows, the high unemployment rate existing outside the Gulf has been persistent for years, and implies a poorly functioning labor market. The governments urgently need to promote educational programs and initiates consistent with private sector demands.

Table 2: Persistent High Unemployment in Percentages

	Algeria	Bahrain	Egypt	Iran	Jordan	Kuwait	Morocco	Saudi Arabia	Syria	Tunisia
1990	19.8		8.0	14.2	16.8	0.5				16.2
1995	28.1		11.2	10.0	15.4	1.5	16.0			16.2
2000	29.5		9.0	16.0	13.7	0.8	13.4	4.6	13.5	15.7
2005	15.3		11.5	12.1	14.8	1.3	11.1	6.1	8.1	12.8
2010	10.0	3.6	9.2	13.5	12.5	2.1	9.1	5.5	8.6	13.0
2013	9.8	4.3	13.0	12.9	12.2	2.1	9.2	5.5		16.7
2019F	7.3	4.2	13.7	16.2	12.2	2.1	8.6			12.0

The MENA economies that are most successful in creating jobs had them filled by non-nationals and hence did not contribute to falling unemployment with jobless rates still averaging 12-15%. in many not oil-exporting economies. For instance, the World Bank (2008) finds that an effort by the Jordanian government to create jobs actually lead to more non-Jordanians hired due to mismatched skill sets and market needs. A similar phenomenon occurs in Gulf States, where foreign workers are willing to accept jobs for lower salaries and have higher productivity. Labor surveys in Jordan showed that rural (non-middle-class) Egyptians were willing to work at low wage jobs such as cleaning, construction and agriculture. The World Bank (2008) found the job prestige issue has generated a culture of shame that is prevalent throughout many MENA economies, and is at least partially a result of too-high expectations of employment prospects for middle-class workers, and a failure of a properly functioning job market in urban areas.

What has caused this dysfunctional labor market?

The OECD (Sullivan, 2014) finds that Tunisia, Morocco, and Egypt had official unemployment rates near 10% for over a decade. To further raise concerns, the unemployment rate paints only a partial picture as there is substantial unemployment in the informal sector. The IMF (2014) reports there are several common factors including very stiff labor market regulations that discourage firms from hiring and divert job seekers into the informal sector. The employment guarantees in many government's comparatively generous civil service compensation have led to a unrealistic of salary expectations in the private sector, and an excess demand for government jobs. e.g., 80% of graduates in Syria report a preference for civil service. The education system's strong focus on formal qualifications for entry into the civil service means that labor market entrants often do not have the right mix of skills for today's job market. The IMF (2014) concludes that improving the labor market will require MENA economies to address five key aspects:

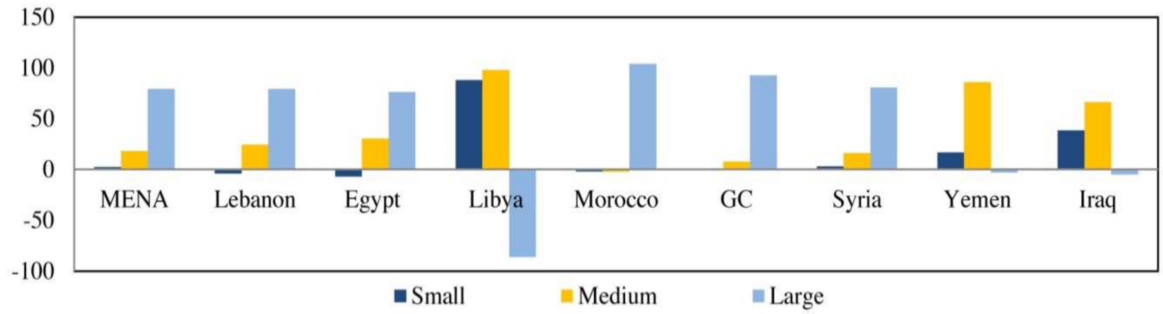
- Review labor market regulation to diminish disincentives for hiring while preserving adequate worker protection;
- Revisit public sector hiring practices and compensation practices to lessen the public sector's labor market dominance and bias;
- Reform the education system by aligning it more closely with the needs of private employers;
- Pursue active labor market policies to make quicker inroads into lowering unemployment;
- Accentuate policies and practices to promote youth and female employment;

Women face higher unemployment risk in Arab countries, and are often excluded from labor markets. Assaad and Barsoum (2007) find that young women are four times as likely to be unemployed as young men and face significant employment barriers due to unwelcoming cultural norms. Significant employer discrimination for married women, very little maternity leave benefits and costly child care further limit their participation. The ILO (2008) reports that in Gulf economies such as Qatar and Saudi Arabia, labor force participation rates for young women are below 10%. In sum, due to high youth unemployment, high unemployment among the college educated and low women participation, MENA economies possess the lowest labor force participation rates in the world.

Assaad and Barsoum (2007) report that recent job creation in MENA economies has been largely temporary and informal. Further, Nahr and Pearce (2012) find that the informal sector rewards unskilled workers, discourages educated workers and is particularly unfair to women. For example, in Egypt, the share of informal jobs among new labor market entrants rose from 15% to 32% from 1975-2005, and has not focused on hiring women. This has further increased their unemployment rates and led to discourage workers leaving the labor force as well as pervasive dissatisfaction with the political regime. Overall, less than 30% of the new job entrants are entering formal employment in the public and private sectors. More than half of this gray market sector in Egypt, Tunisia, Algeria, Morocco, Syria and other economies are composed of self-employed workers or relatively small, inefficient unregistered enterprises that do not pay taxes and employ relatively unskilled laborers (Richards and Waterbury, 2008). The informal sector has flourished due to prevalent barriers to the labor market and institutional constraints (discussed in the next section), and at least has the advantage of having very few barriers to entry and exit, while the downside lies in the absence of any labor market protections (including inconsistent and irregular wage payments on time due to corruption and lack of enforcement) as well as social security nets. According to the Nahr and Pearce (2012), an unintended consequence of reform in Algeria, Morocco and Egypt has been further growth in the informal sector.

As Figures 6-9 document below, the percentage of jobs created by small business remains very low in many MENA economies, as most jobs are created by large firms and governments. Further, SME represent a small fraction of total employment in many economies, and below other regions due to regulatory burdens. This is important because, Ayyagari et al. (2011) find that SME are instrumental in providing jobs for developing economies. Hence, excessive regulatory environment has inhibited the entrepreneurial environment in MENA economies, prevented small business growth and limited overall job opportunities and growth.

Figure 6: Percentage of Jobs Created by Firm Size in World Bank Enterprise Survey 2007-2011



World Bank Enterprise Surveys (2013)

Figure 7: Excessive Labor Regulations and employment mismatches constrain firm activity

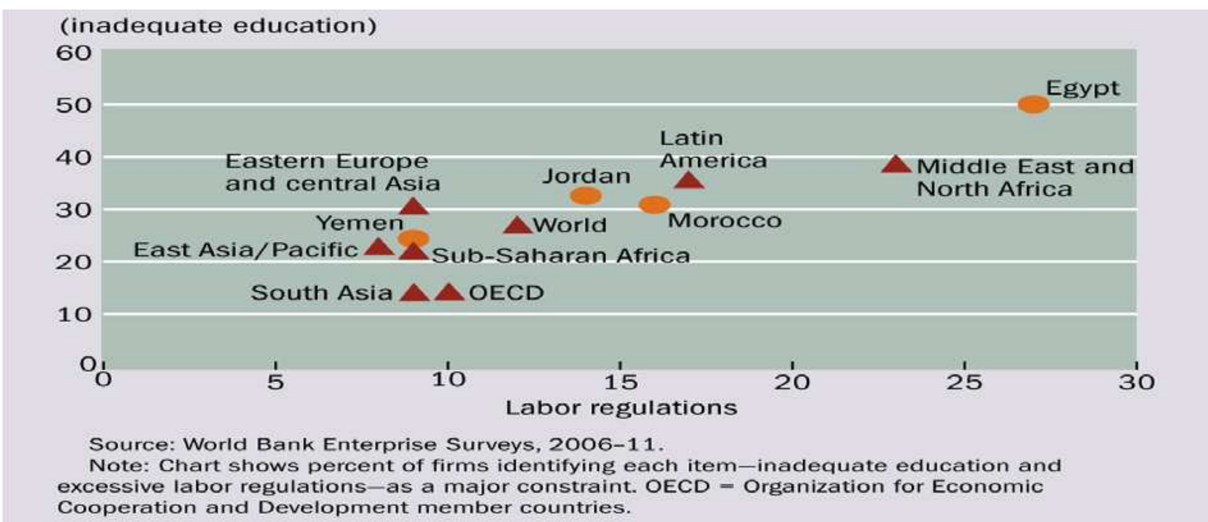
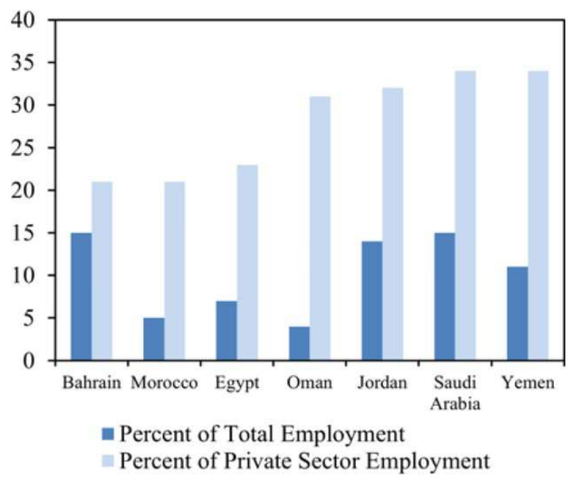
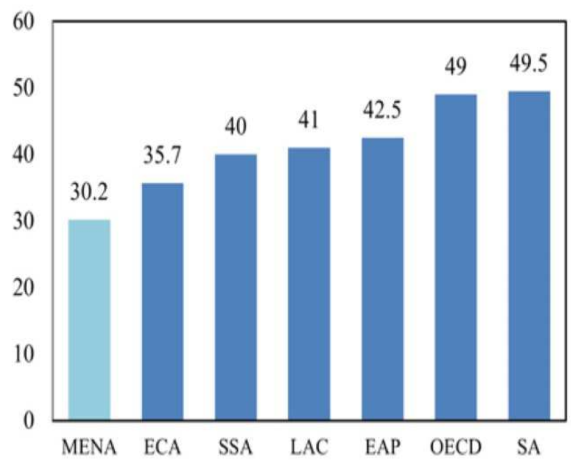


Fig. 8 SMEs as Employers in MENA

Fig 9: SME as % of total private jobs by region



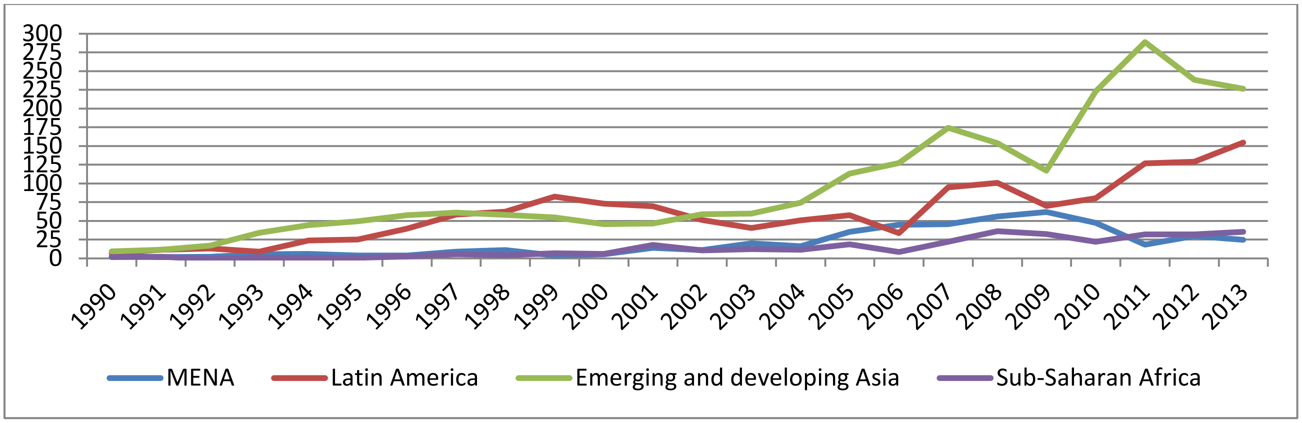


Nasr and Rostom, 2013

Investment

Many MENA economies impose significant obstacles to trade that inhibit globalization, and results in unimpressive manufacturing export performance. The lack of FDI hence is both a cause and effect of a weak economic performance and poor local policy environment. Behar and Fruend (2011) show that a chief cause of MENA's underperformance that predates the political instability of the Arab Spring is the failure to upgrade exports and integrated them into global production chains, due to poor governance. A second investment problem is government investment in infrastructure including roads and electricity. For export opportunities to expand, electricity has to be more reliable, particularly in summer months, which frequently experience brown-outs or black-outs due to their growing population and air conditioning use. The government however has not kept pace with new power plants. To meet investment targets for employment generation, financial inflows to Arab economies will have to rise significantly and be sustained, and the governments will need help from the World Bank and other development agencies to build infrastructure to facilitate export opportunities.

Figure 10: Net Direct Investment



As the table below documents most of the investment in the MENA region has been in natural resources followed by nontradeable services. Manufacturing and tradeable services have not received much FDI, and hence it has not fueled export-led growth and technology adoption. Burger et al. (2013) shows the impact of political instability on FDI depends critically on the type of investment; that is, political instability throughout the region has led a dearth of FDI in non-oil tradeable goods sectors. In contrast, the nontradeable and resource sectors are relatively imperious to shocks, and hence have received the bulk of FDI. This is important as there are significant positive spillovers (externalities) from high-tech manufacturing as it enables the economy to catchup to the global technology frontier; that is, when manufacturing takes off, it can generate millions of jobs for unskilled workers, including women, who were previously employed in traditional agricultural, petty services or housework (Rodrik, 2011). In contrast, FDI in oil or hotels have contributed to a resource curse. This is known as Dutch Disease and creates governance problems, limited direct job-creating effects and bolsters and a higher exchange rate, which is not conducive to manufacturing. Hence, the political instability has led to continued underinvestment in labor-intensive sectors, aggravating unemployment and thereby generating a vicious circle of more political instability. MENA faces a manufacturing imperative, but it is not meeting this goal with Greenfield investment.

Table 3: Greenfield Investment 2003-2012 into MENA ($ billions)

	Resources/Oil Manufacturing	Non-Oil Manufacturing	Commercial Service	Non-Tradables
GCC	136.6 (31)	87.1 (20)	114.9 (26)	106.0 (24)

Bahrain	4.1 (15)	3.7 (13)	13.7 (49)	6.4 (23)
Kuwait	1.6 (18)	0.2 (2)	4.4 (52)	2.4 (28)
Oman	7.5 (18)	16.4 (40)	5 (12)	11.9 (29)
Qatar	46.5 (45)	11.9 (12)	14.7 (14)	29.2 (29)
Saudi Arabia	69.1 (52)	30.1 (23)	23.1 (17)	11.4 (9)
UAE	7.8 (6)	24.8 (19)	54 (41)	44.9 (34)
Developing Oil Importers	49.7 (20)	30.9 (13)	74.4 (31)	88.2 (36)
Egypt, Arab Rep.	31.9 (31)	12.1 (12)	18.9 (18)	41.6 (40)
Lebanon	0.4 (4)	1.2 (11)	5.6 (54)	3.2 (31)
Morocco	9.9 (21)	8.1 (17)	15.4 (33)	13.8 (29)
Jordan	2.3 (8)	5.8 (19)	15.4 (50)	7.1 (23)
Tunisia	5.2 (12)	3.8 (8)	16.3 (37)	19.3 (43)
West Bank/Gaza	0.0 (0)	0.0 (0)	0.7 (61)	0.5 (39)
Developing Oil Exporters	96.6 (39)	35.4 (14)	51.7 (21)	66.0 (26)
Algeria	21.1 (33)	19.2 (30)	12.7 (20)	11.9 (18)
Iran.	23.2 (67)	10.0 (29)	0.7 (2)	1.0 (3)
Iraq	24.6 (36)	1.3 (2)	18.8 (28)	23.3 (34)
Libya	9.7 (25)	1.7 (4)	3.1 (8)	24.0 (62)
Syria	11.7 (35)	2.5 (7)	14.7 (44)	4.5 (13)
Yemen, Rep.	6.2 (62)	0.7 (7)	1.6 (16)	1.4 (14)

World Bank, 2013 (% of investment)

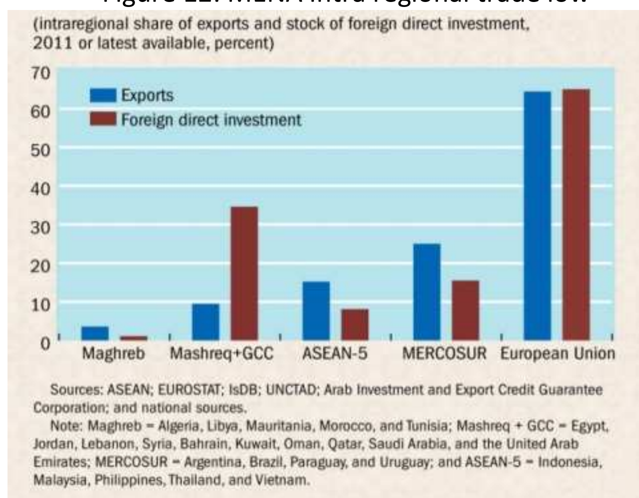
The political instability associated with the Arab Spring has entrenched the resource dependence of many MENA economies, skewed the economies toward nontradeables and led to a sharp downturn in manufacturing – exactly the investments the non-oil MENA region needs. International investors in the rent seeking resource industry do not demand better governance and continue to pursue investment projects in politically instable economies confronted with political turmoil and poor governance.

Trade

The IMF (Mati, 2013) shows that trade restrictiveness is a critical hurdle holding most MENA economies back. Despite recent tariff reforms over the past two decades with the European Union and United States, tariff barriers remain high. For instance, tariffs average 14% in Algeria, 15% in Egypt, 26% in Iran, and 17% in Morocco. As a result, trade has not been an engine of growth like many successful emerging economies. As the figures below illustrate, exports in MENA are half that of other emerging economies and many MENA economies still have possess considerable trade barriers. Trade particularly in the Magreb has concentrated on Europe, but the European economies have stagnated since 2000. Regional trade is small between the Magreb economics, and empirical evidence in Asia has shown that increasing MENA's openness to trade could boost GDP per capita by more than a full percentage point. Given their close proximity, economic models predict these economies should be exporting substantially more to each other.

Figure 11: MENA non-oil Exports Low

Figure 12: MENA Intra regional trade low



Mati (2013)

Irreversibility in investment implies that fundamental uncertainty about the future environment impedes it. For example, current FDI in MENA tourism facilities is delayed or side-tracked due to doubts that future anti-Western governments may scare away tourists as tourists may become targets in violent political struggles. Manufacturing will not receive funds in the MENA region as long as the labor market is subject to substantial protocols, inputs subject to tariffs, procedures inhibit ready access to electricity and regulations slow startups and corruption distorts the playing field. Gereffi (1999) reports that the presence of buyer and seller-led international production networks are critical components of an effective development strategy; the MENA region however lacks these links as globalization investment patterns have skipped this region. Further, the willingness of foreign and local firms to undertake long-term commitments can be enhanced by democratic regimes that are less likely to encounter violent opposition and may be more likely to live up to its policy reform commitments.

The bright spot is that most MENA economies have begun to liberalize their trade regimes and initiated programs to encourage export diversification. This is important as the Prebisch-Singer premise is that reliance on exports of primary products will lead to deteriorating terms of trade, GDP volatility and low growth rates. Morocco is an example of a MENA economy that has been moderately successful in trade and investment liberalization. The Euro-Mediterranean Free Trade Agreement launched in 1995 has been slow to be implemented, but countries such as Algeria, Egypt, Jordan, Morocco and Tunisia have signed and expressed wiliness to lower trade barriers and increase investment with Europe.

Government Deficits and subsides.

Most MENA economies have large government deficits which have contributed to inflation, higher interest rates and currency instability. Egypt has experienced the most chronic deficit and debt programs among major MENA economies. Public Debt in Egypt is over 90% in 2014, and budget deficits have exceed 7% for a decade (2004-2014). Jordan's deficits have averaged 6% from 2004-2014, and contributed to a debt exceeding 80% in 2014. The average MENA fiscal balance in 2013 was -10% with public debt of 75%, compared to only -3% in other emerging and developing economies and public debt of 35%. This is problem since the bond markets are not fully developed, and imply government financing problems contribute to inflation and currency instability. What factors contribute to the MENA region's chronic fiscal balance difficulties?

Subsidies are a large component of government spending in the MENA region. For instance, subsidized bread remains a lifeline for many Egyptians, as the economy has experienced 10% annual food price increases for over a decade. State-run bakeries sell bread from 5 piasters (0.7 cents) per piece to 50 piasters (7.1 cents) and in private owned-bakeries, the cheapest bread is 25 piasters (3.5 cents) (Hyde, 2014). The subsidy policy however has become an increasingly heavy burden on the state budget, and mired in politics due to its importance to Egypt's poorer classes. In 1977, an attempt to end such subsidies led to riots that required army intervention, and more recently, in 2008, shortages in subsidized bread also led to fights that killed eight people (Hyde, 2014). Figure 13 illustrates the regressivity of subsidies; for example, in both urban and rural areas, the top 20 percent of households receive the largest share by far of the total subsidy spending, and the share of benefits received by other households decreases with their wealth, proxied by household expenditures. The Egyptian government's food subsidy initiative is intended to safeguard the most vulnerable from rising food prices, but only 30% of Egyptians need this protection while in excess of 70% benefit from it Rohac (2013). Hence, while it does deliver relevant food and energy to the poor and mitigate poverty, the program is poorly targeted, which implies it is too expensive. The IMF also has found that Egypt's energy subsidies are very regressive (Arze Del Granado, 2010). Figure 14 reveals that the benefits from food subsidies are distributed more evenly than energy subsidies across different segments of the population, although they tend to have an urban bias.

Table 4: Egyptian Subsidies

Egypt Millions $	2007–2008	2008–2009	2009–2010	2010–2011	2011–2012	2012–2013
Food Subsidies	2,356	3,019	2,410	4,691	4,338	3,811*
Petro Subsidies	8,632	8,983	9,531	9,696	13,687	10,029*
Total Subsidies	17,801	20,095	20,395	24,107	29,291	20,894*
% of GDP	13.8	13.5	11.8	12.2	13.3	13.0*

*Estimated, Rohac (2013)

Figure 13: Egypt Per Capita Annual by Benefits from Food Subsidies (in US$)

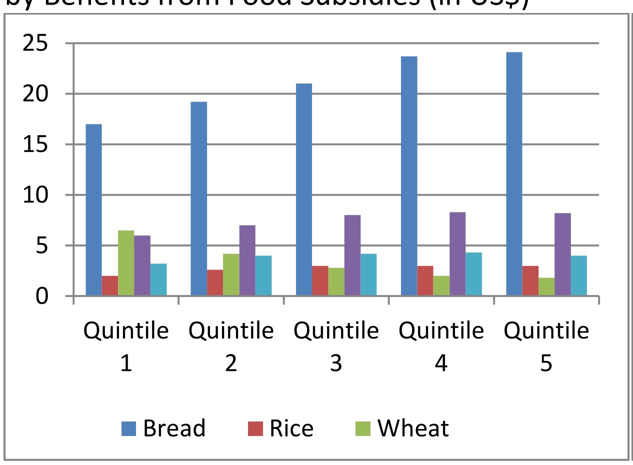
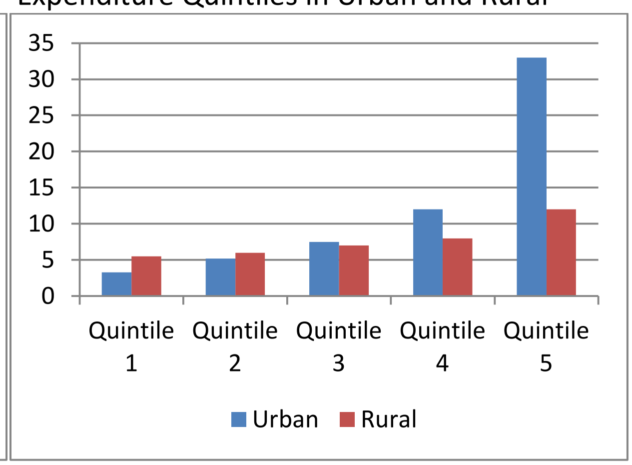


Figure 14: Egypt: Distribution of Petro Subsidies Expenditure Quintiles in Urban and Rural



Rohac (2013)

Morocco also lacks properly targeted subsidy programs to the poor that the government cannot afford. The subsidies have large leakages, defined as the percentage of commodities that are resold on black markets; e.g, for the basic coarse (baladi) bread, leakages total 31% of the supply. A World Bank (2010) study concludes that “[i]f leakages are eliminated and coverage is narrowed, the government of Egypt (GoE) could save up to 73 percent of the cost of food subsidies.” Table 5 shows large subsidies for basic necessities (comprising 7% of total household expenditures) occur in Morocco, and similar to Egypt, the subsidies are regressive as the rich benefit more. World Bank analysis (Verme et al., 2013) reveals the upper quintile benefits from total subsidies more than twice the middle quintile and 3.5 times the lowest quintile. For instance, sugar and flower subsidies benefit the upper quintile four-five times more than the middle quintile. The good news is that the Moroccan government in 2013 started to reform the subsidy system as part of a budget deficit reform target of 3%.

Table 5: Prices of Subsidized Products (October 2013, Moroccan DH)Product Unit

Product	Subsidized Price	Unit Subsidy	Unsubsidized Price	Subsidized Price/Unsubsidized
LPG	3.50	6.50	10.00	35.0
Gasoline	12.77	0.80	13.57	94.1
Diesel	8.84	2.60	11.44	77.3
Sugar	6.00	5.00	11.00	54.5
Flower	55.00	0.70	5.70	87.7

Verme, El-Massnaoui, and Abdelkrim Araar (2013)

The result of excessively large government subsidy programs is high inflation, exchange rate instability, and high government deficits. These are toxic mixes that lead to an instable macroeconomic environment, and are ill-conducive to export led growth and foreign direct investment. As a result, streamlining subsidies is urgent due to their large share in the government budget which reduces space for pro-poor and pro-growth expenditures.

A second problem that contributes to fiscal imbalances is poor tax collection. Many SME escape taxes, since they operate in the informal economy and use cash. They along with many medium to large enterprises possess inadequate accounting records and audit trails. Further, complicated tax systems and lack of computerization encourage tax avoidance and evasion, and lead to a system that many view as arbitrary, heavy-handed and unfair, and limit new business creation.

Financing

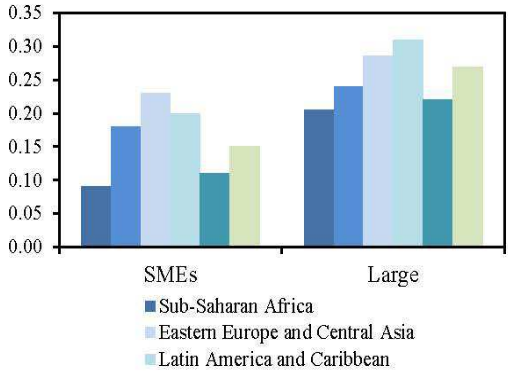
Finance is vital for inclusive growth: broad-based growth that is sustainable, across most economic sectors and includes a large part of the nation's labor force. A properly functioning banking system expands economic opportunities and improves financial intermediation for SMEs across sectors and includes sound business loans to the poor, middle-class and rich. As reviewed by Levine (2005), a large and growing body of research confirms that financial markets and intermediaries enable improved long-run economic growth; e.g., Levine and Zervos (1998) find that countries with better functioning financial systems grow faster over many decades. Recent estimates conducted by McKinsey (2014) show a considerable financing gap exists for SME lending in MENA. The estimated SME credit gap for Egypt is $1.05 billion, for Jordan it totals $ 547 million, $497 million for Morocco, $247 million for Tunisia, and for Lebanon the SME credit gaps totals US$26 million. Note, Lebanon, with its decade's long tradition of a banking sector, is the only economy outside the Gulf with adequately functioning financial intermediaries. McKinsey documents that SME lending has to increase by 125-150% in MENA economies to meet demand. This implies a dire shortfall of financing funds, and is more than double Sub-Saharan Africa, the second highest region lacking financing. (Stein, Goland, and Schiff 2010). The dearth of financing inhibits growth and job creation. Fortunately, there is a growing awareness among many MENA economies that SME entry into many industries has been blocked due to lack of finance and markets, and this has held back growth and competitiveness of their economies.

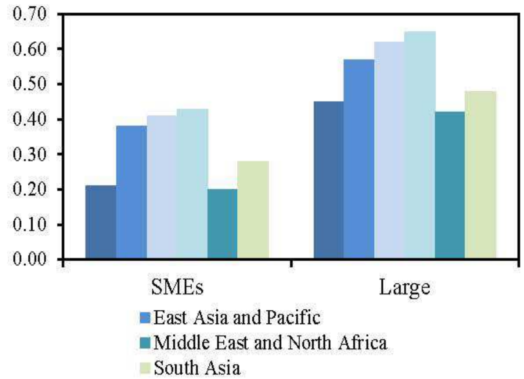
What about stock market finance? Saudi Arabia is the region's biggest stock market by far and also the world's last sizeable market that has not opened to international capital flows. Its $370 billion capitalization as of June (2014) is down from a high of approximately $850 billion in 2007. It dwarfs the Gulf's second market, Qatar, at about $110 billion. The slow stock market recovery does not bode well for the future. Currently, foreigners (excluding GCC nationals who have special access) can only buy Saudi shares through swap deals made by international investment banks or via a small number of exchange-traded funds. These arrangements can be costly and inconvenient, and hence foreigners own less than 5% of the market and account for 2.8% of stock trading turnover. Israel and Iran have the 2nd and 3rd highest capitalization in the region, with a market cap between $140-150 billion. Egypt and

Morocco's stock market are only between $50-60 billion, implying a low amount of equity. Jordan and Tunisia have less than $30 and 10 billion, respectively.

A World Bank report (Nahr and Pearce, 2012) documents that critical financial challenges include obstacles to business creditworthiness, weak financial intermediaries lending capacity, and bank liquidity. Major constraints to business activity include weak legal and regulatory intermediaries that lead to substantial information asymmetries including endemic adverse selection and moral hazard. An anemic judicial and legal system further does not adequately enforce proper accounting regulation to ensure satisfactory financial reporting. The poor financial infrastructure has led to the failure to broaden access to finance for entrepreneurs and SMEs and has boosted lending risk. A key reason for the poor financial infrastructure is the cozy historical connections between large banks and large industrial groups that weaken good lending practices and limits banking competition, resulting in a lack of many non-banking financial institutions and instruments. On the demand side, Nahr and Pearce posit that MENA economies face crucial constraints of accessing business creditworthiness, liquidity of the financial intermediaries, and the availability of risk-sharing instruments. Surveys of banks reveal that a lack of business transparency, difficulties in using collateral, especially movable collateral, and uncertainty over creditor rights as primary barriers to their greater involvement in finance (Figures 19-20). Several MENA economies suffer from government-enforced interest rate caps, the absence of national SME strategies, the scarcity of credit information and scoring system, and lack of integration of SME credit information into public credit registries or private credit bureaus.   Nahr and Pearce also cite low quality financial statements, informality, and lack of business skills of enterprises as relevant key aspects of lack of transparency and information asymmetry on the part of SMEs. Information asymmetry further has not yet been successfully tacked in MENA economies, and hence remains a relevant constraint for growth in SME financing. As the Figures below illustrate, the percentage of firms that obtain investment finance from banks and lines of credit are low, and on par only with Sub-Saharan Africa. Financing opportunities for both SME and large firms are far below Eastern Europe, Latin America, South Asia and East. Asia.

Figure 15: % of Investment Finance by Banks   Figure 16: % of Firms with a Line of Credit





Nahr and Pearce, 2012

Recent surveys by the World Bank (Nahr and Pearce, 2012) of MENA economies show that SME were able to only access less than 10% of banks' credit in 2011 with a financial gap reaching more than 125% of current outstanding banking finance to SMEs. There was $80-100 billion in total formal SME outstanding credit in 2011, but $110-140 billion more is needed implying a substantial gap in the range of 125-150%. This gap is considerably higher than the 11-15% in East Asia, 5-6% in OECD and 30-35% in South Asia.

Institutions

The most critical economic challenge confronting MENA economies is to reverse the region's reputation as a risky business environment. Economic and political uncertainty as well as institutional risk lie at the heart of the region's challenges and inhibit successful globalization. The World Bank (Nasr and Pearce, 2012) finds that crony capitalism and endemic corruption generated growth that was less than half the per capita growth of other average emerging economies, and was not inclusive and broad-based. Poor institutions effectively raised barriers to entry and block financing opportunities for millions of entrepreneurs and SMEs. Unfortunately, Nugent (2014) reports data from the International Country Risk Guide, Heritage Foundation and Transparency International that demonstrates that most MENA economies have become more corrupt and less transparent since 1990; note the Heritage foundation index that measures corruption had a substantial fall for most MENA economics from 1990 to 2009 and again from 2009 to 2014.

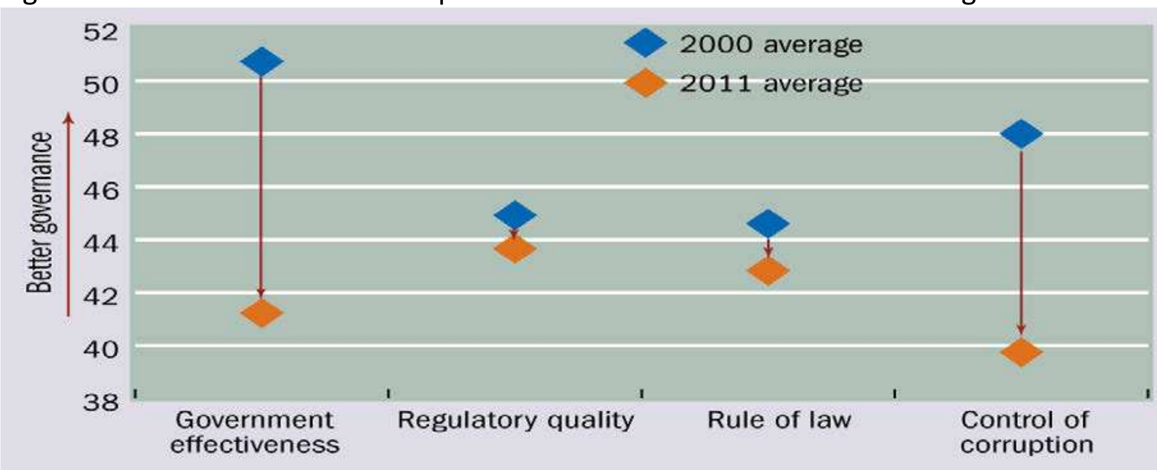
Table 6: Indices of freedom from Corruption

	ICRG		Heritage	Foundation		Transparency International		
	1990	2009	1990	2009	2014	1998	2011	2013
Algeria	3.9	1.5	50	30	28.7	2.6	2.9	3.6
Bahrain	2	2	70	50	49.4	6.1	5.1	4.8
Egypt	2	2	30	33	28.6	2.9	2.9	3.2
Iran	3	2	n.a.	25	34.4	3	2.7	2.5
Iraq	2	4.4	n.a.	n.a.	13.7	2.2	1.8	1.6
Jordan	3.8	3	n.a.	47	45.6	4.7	4.5	4.5
Kuwait	3	3	70	43	43.5	5.3	4.6	4.3
Lebanon	1	1	50	35	24.5	3	2.5	2.8
Libya	1	1.5	10	25	19.3	2.1	2	1.5
Morocco	3	3	50	35	33.3	3.7	3.4	3.7
Oman	3	2.5	70	47	48.2	6.3	4.8	7.8
Qatar	2	2.5	90	60	72.4	5.6	7.2	6.8
S. Arabia	2	2	70	34	43.7	4.5	4.8	4.6
Sudan	2	1	n.a.	30	9.8	2.3	1.6	1.1
Syria	2	2	n.a.	24	n.a.	3.4	2.6	1.7
Tunisia	3	2	50	42	39.2	5	3.8	4.1
UAE	3	2.5	90	57	66.4	4.2	6.8	6.9
Yemen	3	2	10	25	19.4	2.6	2.1	1.8
MENA	2.46	2.2	51.4	38.5	31.9	4.1	3.72	3.8
Israel					59.3	7.1	5.8	6.1
Turkey	2	2.5	10	41	44	3.4	4.2	5
Singapore	5	4.5	90	93	91.2	9.1	9.2	8.6
USA					72	7.5	7.1	7.3

Nugent (2014)

A key problem with anemic institutions is their impact on doing business. For instance, Egypt ranks very poorly in ease of doing business with a composite rank of 128 (IFC, 2014). This is driven by difficulties with obtaining construction permits that takes 129 days (rank 149), 54 days for electricity (105), 63 days for registering property (105), 1010 days (146) for enforcing contracts. Overall the composite rank for other economies such as Algeria is 153, with weakness in starting a business 25 days (rank 164), construction permits 241 days (147), obtaining electricity 180 days (148), registering property 63 days (176), paying taxes with 29 payments per year (174), trading across borders 17 days to export (133) and 630 days to enforce contracts (129). For Morocco, the composite rank is 87 with difficulties in obtaining electricity 62 days (97) and getting credit (109). In contrast, Saudi Arabia's composite rank is high (26); nonetheless, there are difficulties in starting a business 21 days (84), trading across borders (69), enforcing contracts 635 days (127) and resolving bankruptcies 2.8 (106). UAE also ranks high except in obtaining credit (86), protecting investors (98), enforcing contracts (100) and resolving bankruptcies 3.2 years (101). Not surprisingly, the UAE is excellent in obtaining construction permits 44 days (5), getting electricity 35 days (4) and trade 7 days to export (4).

Figure 17: Governance and Corruption are serious obstacles and becoming worse



Source: World Bank, *Worldwide Governance Indicators*.

Ahmed (2013)

A recent World Bank study by Freund and Rijkers (2012) documents that reforming poorly functioning institutions is critical in jumpstarting “employment miracles’, where the unemployment rate drops by 3% over a four year period. Additionally, these authors (2012) find that a one point improvement in economic regulation (proxied by the Economic Freedom Index) boosts job creation by 3.5-5%. These findings advocate that better regulation advances average labor market outcomes as well as diminishes vulnerability.

How close are MENA economies to break-out growth? The Washington Consensus was used in the 1990s as a set of guiding principles for emerging economies to jump-start their growth. However, these guidelines have been called too naïve and market-oriented as well as missing relevant the importance of institutions. An Arab Development Report (Chaaban, 2010) found that IMF and World Bank loans to several Arab countries were linked to the Washington Consensus reforms yet did not show positive results. Harrigan et al. (2006) additionally documents that although countries such as Egypt, Jordan, Morocco and Tunisia adopted IMF structural reforms consistent with the Washington Consensus, these economies, except for Tunisia (since it adopted more export-led growth strategies), benefited only marginally.

Recently, a number of financial crises plagued many adopters of the Washington Census. In response to these crises, a post-Washington Consensus (see below) was adopted that additionally emphasized the importance of limiting corruption, improving corporate governance as well as proper capital market openings and exchange rate regimes. More recently, the World Bank (2014) has adopted principles of inclusive growth that emphasize the relevance of a competitive environment with governments committed to growth and sound micro and macroeconomic policies that benefit most citizens. The World Bank's shift emphasizes growth diagnostics and the identification of constraints to inclusive growth, which should be addressed sequentially. These are more country specific rather than a bucket list of pro-market policies.

Unfortunately, most MENA economies due to their extractive nature are not fully committed to policies of reform. As mentioned, their labor markets are highly regulated, uncompetitive, not internationally integrated and do not generate employment growth. On the positive side, MENA economies are investing in the public sector and have not rushed their capital market integration. As noted above, their safety nets are precarious as much of the money is misspent, generating large government deficits. Overall, it is unclear whether many/most of the MENA economies are committed to good policies, and as a result, job and productivity growth may be years away.

Table 7: From the Washington Consensus to Inclusive Growth

Original Washington Consensus	*post-Washington Consensus (Original WC plus)*	*Inclusive Growth*
Secure property rights	Anti-corruption	Competitive environment
Deregulation	Corporate governance	Gov't commitment to growth
Fiscal discipline	Independent central bank and IT	"Good policies"
Tax reform	Financial codes and standards	Public sector investment
Privatization	Flexible labour markets	Labour market deregulation
Reorientation of public expenditures	WTO agreements	job and productivity growth
Financial liberalization	"Prudent" cap account opening	International integration
Trade liberalization	Non-intermediate exchange rate regimes	Exchange rate management
Openness to FDI	Social safety nets	"Prudent" capital account opening
Unified and competitive exchange rates	Targeted poverty reduction	Social safety nets

Saad-Filho (2010)

Summary

Unemployment remains a critical problem with most MENA economies. Fundamental to the lack of job creation is low foreign direct investment due to poor business regulations, weak governance and lack of government commitment toward free markets. The economic recovery in the MENA importing countries has been further delayed by security concerns and rising political uncertainty. One bright light however maybe Morocco, as the government has made a series of budget reforms and modest efforts on business reform; further, Morocco has increased both its trade and FDI connections to Europe. According to McKinsey (2014), excluding Saudi Arabia (which has substantial financial flow interconnectedness), Morocco performs well and ranks 53, climbing 46 spots over the 1995-2012 period. McKinsey documents that the connectedness/globalization across all five types of flows (people, goods, service, financial, information/data) actually declined for the MENA region over the past fifteen years; e.g., Yemen, Tunisia, Syria and Egypt plummeted 22, 19, 16 and 12 positions. Thus, while other regions are deepening their knowledge connectedness and further trade ties, MENA has not become more globalized.

How quickly the MENA economies will resolve corruption, regulatory difficulties and globalize among multiple dimensions is unclear, and hence the regional outlook for the next several years is shrouded in instability and policy ambiguities. Macroeconomic volatility and uncertainty due to inefficient subsides and government spending has fueled government deficits, inflation and exchange rate volatility. Structural and microeconomic reforms will likely take two steps forward, and then retreat since reforms entail belt tightening and eliminating extractive policies that benefit the elites that still influence policy. Constrained growth is the most likely outcome in the absence of significant, sustained economic reforms, which will not be easily accomplished.

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