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EMERGING DEVELOPMENTS AND CHALLENGES IN THE ARAB WORLD

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Introduction: The events of the last few weeks are a watershed for Tunisia, Egypt, and other MENA countries. The ongoing political events will resonate regionally and globally and, if followed by sound transitions to better governance structures, these events provide a unique opportunity to change MENA's political and social landscape. The root cause of the political turmoil in MENA is fatigue with long-standing authoritarian rule and weak political and economic governance as confirmed by public concerns over voice, social justice, accountability and access to services. The MENA Region also has its strengths: its youth, resource base and the resilience shown during the global crisis. Prior to the political turmoil, economies were recovering as the global economy rebounded. Tunisia further curbed its fiscal deficit and Egypt had embarked on a fiscal consolidation program. Both countries have foreign exchange reserve cushions and benefitted from foreign flows and tourism.

The economic and social impact will be significant in the short term with slippages in economic growth, fiscal revenues and tourism and FDI receipts. As global equity markets grew, Egypt and Tunisia's fell 21% and 14% respectively in January. Macroeconomic imbalances and vulnerabilities will increase. Large parts of the population lack adequate access to jobs, land, services, finance and justice. They may be further affected as inflationary pressures grow depending, among others, on oil and food prices. Fiscal difficulties are likely, particularly in Egypt as government and public enterprises face wage and other pressures.

Longer-term Challenges: Aside from short term difficulties, deep-rooted challenges remain:

- *Inequitable Growth:* One example is MENA's high unemployment rates – 20-25% for youth in some countries, and steeper for university graduates and women. Note that female labor force participation rates in MENA are among the lowest globally. The population at the lower end of the spectrum is quite vulnerable - the number of poor almost doubles in Egypt when a cut-off of $2.50 is adopted. Regional disparities are quite significant too.
- *Below Potential and Non-labor Absorbing Growth:* Largely due to lack of economic diversification, low private investment, averaging 15% of GDP, less than half the East Asia level, with significant barriers to entry and an incentive framework promoting privilege rather than competition. Economic reforms have been undertaken over the years yet World Bank surveys at the firm level report that the quality of reform implementation has been low with institutions tied to outdated regulations and practices[2]. Another Bank study recognizes the rise in total factor productivity since 2005 in Egypt, but note that growth is explained by factor accumulation and not productivity growth[3]. Labor productivity remains low and for higher growth there is a need to move from a low-wage, low value-added economy to a skill-intensive, technology-based economy.
- *Dysfunctional Labor Markets and Education Systems:* According to recent Bank analysis, high labor taxes (social contribution), rigid labor regulations and skill mismatches are among key reasons why firms do not expand

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[2] For more on reform implementation see Benhassine, Najy and Stone, Andrew "from Competition to Privilege: Unlocking Private-Led growth in the Middle east and North Africa", The World Bank, 2009.

[3] Herrera, Santiago, et al"Egypt Beyond the Crisis" Policy Research Working Paper, The World Bank, 2010.

employment[4]. Others include high labor taxes, insufficient innovation and entrepreneurship and lack of labor market clearing mechanisms. Quality of education, as illustrated by international testing mechanisms, has been compromised as access expanded. To remedy would require an overhaul of the governance of the education system and changing the modes of learning, teacher incentive frameworks and reforming higher education systems.

- *High Financial and Social Exclusion:* Access to finance is low with social protection system fragmented and inefficient – almost 8% of GDP largely subsidizes fuel and inefficient public food distribution systems that do not reach poor.
- *Trade Integration and Diversification:* This is low at both the product and market level. Regional trade within MENA and non-oil trade with the rest of the world have been low, impeding growth and employment.

Client ownership and close cooperation among all stakeholder including development partners: Supported by public demand, authorities have a unique opportunity to address these daunting challenges and seek a "break with past" and a paradigm shift that defines clearly the path of political, economic and social transformation. Moving in a calibrated manner, the region will need to ensure the quality and speed of short-term economic policy responses and position itself for addressing medium-term challenges. The pace and sequencing of reforms will need to be coordinated to ensure macroeconomic stability is maintained, while judging institutional capacities for the implementation of programs.

Restoring public confidence will require a swift change of governance structures, safeguarding of the public interest and protecting the vulnerable through innovative well-targeted programs with due regard to fiduciary concerns and engaging civil society in economic reforms, while re-energizing the private sector to unleash its economic potential. To support transition governments the Bank stands ready to address immediate challenges, while engaging on medium-term issues. Upfront commitment on changes in economic governance would facilitate effective implementation of programs adopted.

In response to the global economic crisis, in the last 18 months the World Bank Group has been heavily engaged with both Egypt and Tunisia and has delivered substantial economic and sector work. This can be channeled to develop an understanding of the complex issues at hand and prepare appropriate responses. Aside from assessing initial economic and financial costs of the events, engagement is underway to develop short-term policy responses, while maintaining a dialogue on medium-term challenges.

Changing Methods of Engagement*:* Besides navigating the shoals of transitional governments while being cognizant of the rising sense of social entitlement, it is critical that development partners be inclusive and coordinate closely. There is a need to reach out further to civil society including academics, the private sector and NGOs and visibly demonstrate our adaptability and flexibility, while carefully managing expectations and risks. Assistance has to include a range of products: quick budgetary support (to meet the growing financing requirements) and a rapid investment response to support the required poverty interventions, employment generation and special areas programs. This has to be accompanied by advisory support, strengthening of institutional capacities and the provision of entrepreneurship and other training programs. However, the development partners should clearly be coordinated primarily by the MENA countries themselves, and any complementary mechanisms should have their support.

Strengthening Governance Frameworks*:* Moving forward in this area will have high payoff for incoming regimes. Advocacy in this area should involve focus on improving:

- Transparency and opening up access to information and economic data;
- Reducing/removing barriers to entry;
- Competition and anti-trust policies;

[4] MNSHD, "The Labor Market Policy Reform Agenda in MENA", MNA Knowledge and Learning Quick Note, #35, The World Bank, March 3011.

- Fostering independent NGOs and associations;
- Developing conflict-of-interest regulations for all officials; and
- Public administration reforms.

Fostering inclusive growth*:* Countries in the region can no longer continue to be employers of first and last resort. Private sector led, job-creating economic growth has to be the cornerstone of development strategies. The World Bank Group (WBG) will support faster and effective responses to establish an enabling policy environment fostering competition, technology adoption and innovation and skills enhancement backed by qualitative changes in education. In response, supportive global and European engagement would benefit trade and private flows by opening up markets, encouraging labor mobility, legal and regulatory harmonization, service liberalization, etc. In the current environment, IBRD and IFC will be open to restructuring portfolios to better align and sharpen areas of intervention. Increasing access to finance for underserved segments of the population, improving infrastructure services, raising the quality of education and health services, and supporting high value-added sectors is ever more key to enhance employment opportunities and regional competitiveness.

Within this overarching framework, IFC plans to assign priority to increasing social inclusion by better addressing the needs of the less-well-off. The IFC will explore more opportunities with Tier II and Tier III companies despite higher short-term risks and investments in disadvantaged regions within MICs. In the short-term, IFC will (i) undertake a coordinated private sector needs assessment in affected countries; (ii) stress test the portfolios; (iii) help clients restructure their portfolios and provide additional financing to mitigate against further losses; and (v) provide rapid financing through short-term finance instruments such as trade finance, SME risk-sharing facilities, SME credit lines, microfinance etc.

IBRD and IFC, while focusing on short term challenges, will also increase regional investments and provide high quality Advisory Services to build the institutional capacity in public and private entities. Priority areas of advisory focus include improving corporate governance/transparency, investor rights, alternate dispute resolution, access to finance and credit information systems, bank risk management, PPPs to address structural and capacity constraints facing the private sector. Support for transfer of seized assets will be important to help government entities and the private sector players to refocus their priorities.

Establishing Sustainable Social Protection Systems: These will need to be coordinated with broader social insurance and labor market policies. In the immediate, one could consider:

- *Targeted cash transfer programs* for poor and vulnerable groups*;*
- Establishing a *Community Driven Development (CDD) fund to empower local communities* to finance small public projects in disadvantaged regions with high unemployment rates;
- Establish an *'Emergency Employment Package'* to provide immediate short-term mitigation responses to the unemployment crisis, including School-to-Work Transition programs for new graduates.

In the medium-term, the World Bank will engage in developing appropriate labor market policies and regulatory frameworks, promote private intermediation, revise social security systems (including tax wedges, social contributions, and pensions), and liberalize professions. Emphasis will have to shift from protecting jobs to protecting workers' income through social support, unemployment insurance, and active measures to assist during periods of transition. Recent enterprise surveys note that high labor taxes and rigid labor regulation are the top reasons why firms in Tunisia, Egypt, Lebanon, and Syria do not expand employment.

In tandem IFC will sharpen its interventions in:

- employment generating real sector investments - retail, tourism, ICT, telecommunications etc.;

- increased access to finance for underserved segments (mortgages, student loans) to better address the needs of youth and the poor;
- improving the quality of post-secondary education services (especially technical and vocational education) to meet private sector needs and increase youth employment;
- Increase investments in agribusiness and higher value-added sectors where the IFC can help in technology transfer and international best practices to build a competitive and knowledge economy.

Reducing Food Price Volatility*:* MENA countries import 30% of the world's traded wheat. By 2030 this will rise to 55%. The sharp rise in food prices have triggered concerns about food security, malnutrition and increased poverty. This is of particular concern for MENA countries due to fast population growth, limited water and arable land resources, and significant dependence on international food commodity markets.

- Surging international prices place significant pressure on national and household budgets, depending domestic consumption subsidy levels and the pass-through. The poor will be hardest hit since they typically spend 35 to 65 percent of their income on food.
- After the 2008 food price crisis, the World Bank launched rapidly disbursing operations to strengthen safety nets for the poorest in Yemen, Djibouti and West Bank and Gaza.
- Lending for agriculture productivity and irrigation efficiency has increased since 2008, with $450 million in project commitments for Morocco, Egypt, Yemen, Tunisia, and Djibouti. Projects in Egypt and Tunisia are particularly relevant as they emphasize CDD approaches with strong local accountability and transparent resource-allocation.
- The World Bank is supporting analytical work on issues such as bread distribution systems and poverty targeting in Egypt and the agriculture sector in Egypt, Morocco, and Tunisia. The World Bank leads an ongoing study with ten regional countries on the efficiency of wheat import supply chains and on improvements to increase food security.

Global and Regional Economic Integration*:* Responding to our countries, the WBG has launched regional programs within the context of our policy on economic integration. Two regional financing facilities are being launched, one on the Micro and SME sector and the other on infrastructure. Both will focus on trade and employment generation with guarantees for risk-mitigation. The Bank and partners are also scaling-up solar energy in MENA. World Bank studies show this can create some 80,000 jobs, so long as exports access green energy markets in Europe[5]. The expectation is that Europe will take action demonstrating the feasibility of the Mediterranean Solar Plan, sending a strong signal to MENA on integration, jobs, technology transfer, and climate change. The Bank is also proposing to finance cross-border trade facilitation and transport infrastructure in the Mashreq and the Maghreb. This will serve to integrate each sub-region and also connect them more efficiently to Europe and neighboring regions, including the GCC for the Mashreq. Work is ongoing on maritime transport and marine highways in the Mediterranean. These are flexible regional programs that move at each country's pace. Clearly, MENA's economic future is in better accessing regional and global markets - for goods and services, for capital, and for labor.

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[5] Roger Coma-Cunill, Chandra Govindarajalu, Silvia Pariente-David, Jonathan Walters "Clean Technology Fund Investment Plan Approved for Concentrated Solar Power in the MENA region" , MENA Knowledge and Learning Quick Note #15, The World Bank, December 2009.