Public Disclosure Authorized
Public Disclosure Authorized
Public Disclosure Authorized
Public Disclosure Authorized

MIDDLE EAST AND NORTH AFRICA REGION
REGION MOYEN-ORIENT ET AFRIQUE DU NORD

39407

2006 Economic Developments and Prospects

Développements récents et perspectives économiques

FINANCIAL MARKETS IN A NEW AGE OF OIL

MARCHÉS FINANCIERS DANS UNE NOUVELLE ÈRE PÉTROLIÈRE

THE WORLD BANK
LA BANQUE MONDIALE

OVERVIEW • RESUME

MIDDLE EAST AND NORTH AFRICA REGION

2006

Economic Developments and Prospects

Financial Markets in a New Age of Oil

THE WORLD BANK **OVERVIEW**

© 2006 The International Bank for Reconstruction and Development
1818 H Street, NW
Washington, DC 20433
Telephone: 202-473-1000
Internet: www.worldbank.org
E-mail: feedback@worldbank.org

All rights reserved.

This report is a product of the staff of the World Bank. The findings, interpretations, and conclusions expressed herein do not necessarily reflect the views of the Board of Executive Directors of the World Bank or the governments that they represent. The World Bank does not guarantee the accuracy of the data included in this work.

OVERVIEW

For the third year in a row, the Middle East and North Africa region[1] (MENA) enjoyed a spectacular year of growth, buoyed by record high growth rates among the region's oil exporters. As oil prices continued their upward climb, the MENA region grew by an average of 6.0 percent over 2005, up from 5.6 percent over 2004, and compared with average growth of only 3.5 percent over the late 1990s. On an annual basis, MENA's average economic growth over the last three years, at 6.2 percent a year, has been the highest three-year growth period for the region since the late 1970s.

MENA's regional growth upturn has not been universally shared, however, and resource poor economies[2] are increasingly feeling the adverse impact of higher oil prices. In earlier periods, MENA's non-oil economies also benefited from rising oil prices, through a range of transmission mechanisms from the oil producers, including labor remittances and aid. Many transmission channels remain and have thrived during the current oil boom, including intraregional tourism and portfolio equity flows, but the overall magnitude of these channels is significantly diminished relative to prior booms. Moreover, with rising energy use, MENA's resource poor countries are increasingly experiencing the negative consequences of higher oil prices on the external and fiscal fronts, in the form of higher oil import bills and energy subsidies.

Growth patterns among oil producers[3], on the other hand, have been increasingly harmonized, reflecting a trend toward common development strategies. Compared with previous oil booms, the region's oil producers are increasingly demonstrating impressive fiscal restraint. They are building up liquidity, through external reserves, oil stabilization funds, and through paying down debt. They are also pursuing common strategies for diversification of the oil wealth into foreign assets, as a way to transform the finite oil wealth into longer-term revenue streams. They have worked almost in unison to develop trade ties and to encourage greater foreign participation in their economies. With increased prudence, the volatile growth outcomes among oil producers which characterized the 1970s and 1980s have been increasingly supplanted by a common growth effect.

Although oil prices dominate the region's external landscape, MENA has experienced other important developments on the trade front. Resource poor economies have dealt with the expiry of the Multi-Fibre Agreement in 2005, which had allowed privileged access for Tunisia, Morocco, and Egypt in textile and clothing products to European markets. Textile exports in Tunisia and Morocco have been hard hit, while Egypt has managed to maintain textile exports to date, in part by cushioning the impact with a December 2004 agreement on qualifying industrial zones between the US, Egypt, and Israel.

---

[1] The Middle East North Africa Region consists of Egypt, Jordan, Morocco, Tunisia, Lebanon, Djibouti, West Bank and Gaza, Algeria, Iran, Iraq, Syria, and Yemen, Saudi Arabia, United Arab Emirates, Kuwait, Libya, Qatar, Oman, and Bahrain.

[2] Resource poor economies include Egypt, Jordan, Morocco, Tunisia, Lebanon, Djibouti and the West Bank and Gaza.

[3] Dominant oil producers in the region include Algeria, Bahrain, Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, Syria, United Arab Emirates and Yemen.

On the fiscal front, the sharp rise in oil prices has brought to the spotlight the MENA region's heavy subsidization of oil prices within the domestic market. While oil-importing economies are particularly affected, the reliance on energy subsidies pervades the region, with large fiscal implications. Several resource poor countries have implemented short term adjustments to oil prices, but the concerns of potential poverty impacts have held back more ambitious reforms. Among oil exporters, windfall revenues have delayed the perceived urgency for reform.

Over the medium term, general conditions for maintaining a solid pace for growth appear promising. Global oil prices are now anticipated to hold above $50/bbl through 2008, which will provide for a moderating, yet still substantial flow of oil revenues to MENA exporters. Should prudent budgetary policies prevail, prospects for the oil dominant economies are upbeat, with growth easing from 6.7 percent in 2005 to 5 percent by 2008. For the diversified economies, the anticipated recovery in European demand will be a key external factor for growth over 2006-2008, as will the easing of oil prices, that should allow some of the costs of subsidies to be recaptured, and growth among resource poor economies is viewed to pick up above 5.5 percent. Overall, on a base set of assumptions, including continued moderate progress in domestic reforms, the MENA region's growth is viewed to ease modestly in 2006 to 5.6 percent, and to establish a 5.2 percent pace over 2007-08, reflecting an acceleration for the diversified economies, contrasted with some slowing for oil exporters.

Overview Table 1: Global developments and MENA GDP growth

Growth, or as otherwise Specified	2004	2005	2006	2007	2008
World trade [a]	**12.0**	**9.0**	**8.5**	**7.0**	**7.0**
High income imports	8.9	6.6	6.7	6.2	6.2
Euro area	6.3	4.3	5.8	5.3	5.4
United States	10.7	6.2	5.0	3.8	3.8
Oil prices ($/bbl) [b]	37.7	53.4	59.0	56.0	53.0
Non-oil commodity prices [c]	17.3	13.4	5.4	-3.1	-5.9
MUV index [d]	6.9	0.0	2.4	2.6	0.8
US dollar LIBOR (%)	1.7	3.6	5.2	5.3	5.2
World GDP [e]	**3.8**	**3.3**	**3.3**	**3.2**	**3.2**
High income countries	3.2	2.8	2.9	2.7	2.8
Euro area	1.9	1.4	2.1	1.7	1.9
Developing countries	6.9	6.3	6.0	5.7	5.6
MENA [f]	5.6	6.0	5.6	5.2	5.2
Resource Poor	4.8	4.0	5.4	5.4	5.7
Resource Rich	5.9	6.7	5.5	5.2	5.0
Resource Rich Labor Abundant	4.7	5.5	5.3	5.1	4.8
Resource Rich Labor Importing	6.5	7.2	5.8	5.3	5.0

A: Goods and services (2000 $US); b: World Bank average oil price = equal weights of Brent, WTI, and Dubai crude oil prices; c: World Bank index of non-oil commodity prices in nominal $US terms; d: Index of manufactures unit value, G-5 countries (France, Germany, Japan, United Kingdom and United States); e: Real GDP in 2000 $US. f: MENA geographic region comprised of resource poor, labor abundant countries (Djibouti, Egypt, Jordan, Lebanon, Morocco and Tunisia); resource rich, labor abundant countries (Algeria, Iran, Iraq, Syria and Yemen) and resource rich, labor importing countries (Bahrain, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates).

Source: World Bank, 2006c.

The oil shock MENA is experiencing has had important financial spillovers. Over the last few years, MENA has seen an upsurge in financial activity, as abundant liquidity has fed a rapid rise in credit growth, surging stock markets, and a booming real estate sector. Oil economies have been the primary recipients, but a financial market upswing has also reached some of the region's resource poor countries through increased cross border investment, remittance flows and tourism.

Many of the recent regional financial sector developments are positive. Strong credit growth and declining non-performing loans have improved bank profitability and asset quality. Rising equity capital has raised the breadth and depth of investment opportunities to investors. In addition, many countries in the region have utilized their strengthened positions to address long-needed financial sector reforms, including public-sector bank restructuring and privatization, licensing private financial entities, improving bank supervision, and upgrading prudential regulations.

However, several of the recent financial sector developments have raised exposure of some MENA economies to negative shocks. Banks have rapidly expanded financing for equity markets. Although the recent stock market gains have been built in part on impressive corporate profitability, stocks have also been increasingly speculative. Bank exposure to equity markets, both through lending as well as through substantial income from brokerage fees, leaves bank income and asset quality vulnerable as a result of recent market corrections. Banks have also increased exposure to the booming real estate sector, which may be vulnerable to contagion effects from the recent equity market weaknesses, and which may also face slowdown with growing oversupply.

But a more troubling aspect about MENA's financial markets is the seeming disconnect between the financial sector and the real private economy, despite the appearance of a relatively deep financial sector by macroeconomic indicators. Although regional banks have abundant liquidity, outside of the Gulf, few private businesses have access to bank finance. Even in countries with relatively high rates of lending to the private sector, credit remains concentrated among a select minority, and investment climate surveys suggest an average of more than 75 percent of private business investment in MENA is financed internally through retained earnings. As a result, few of the assets accumulating to the region are channelled toward productive investment. Moreover, key elements of a well-functioning financial sector that could help boost sustainable and efficient growth, including bond and equity markets and contractual savings instruments, remain largely undeveloped outside of the Gulf.

A few critical facts lie at the heart of the structural disconnect between the relatively plentiful financial resources found across MENA and the scarcity of external financing for businesses. Public sector ownership has significantly impacted the direction of credit in MENA, as well as the operating efficiency and the ability of the banking sector to conduct robust risk analysis. Bank regulatory frameworks, with limited market forms of oversight and discipline, have led to adverse credit allocation. Access to banking facilities remains comparatively limited across the region, and in many cases is restricted to public sector banking networks, concentrating credit

provision upon a relatively privileged minority. Underdeveloped contractual savings and capital markets remove a source of competition for banks and an alternate avenue for firm finance. Governance structures undermine formal financial relationships across much of MENA. And commercial-finance relationships are further undermined by a wealth of problems in MENA's business climate.

The region's recent strong liquidity creates a window for the governments of the MENA region to either accelerate or postpone the complicated process of reform, both within the financial sector an in the economy in general. With the large windfall revenues accumulating to oil producers since 2002, a natural question emerges as to what impact oil is having on the reform process. To date, the large budget surpluses appear to have delayed the imperative for reform of the oil subsidy system in resource rich economies. Oil producers have also exhibited weaker reform progress over the last several years than the region's resource poor economies along two major structural reform fronts: improving the business climate and liberalizing trade.

However, the more subdued progress made by oil exporters in these areas of reform in large part reflects lack of improvements among GCC economies, which have traditionally maintained more open and business-friendly trade and investment policies. More importantly, as a group, the oil economies have demonstrated long-awaited progress in governance, an area in which the group demonstrates significant deficit relative to the rest of the world. Specifically, notable progress has taken place over the last five years in enhancing public sector accountability mechanisms, which augers well for continuing reform success. Although oil economies continue to rank in the bottom twentieth percentile relative to the rest of the world in terms of measures of public sector accountability (including political and civil liberties, freedom of information, etc), over the last five years, oil economies have made greater progress in improving public sector accountability than all other regions of the world, on average ranking in the 65th percentile worldwide with regard to improving public accountability.Worldwide, successful reform efforts have depended critically upon the support and participation of those in society whom reforms will impact. The governance improvements in MENA, in terms of enhancing the accountability of governments and granting greater voice in development to MENA's people, are important not only to take into account the needs and values of those who are affected by reforms, but also to ensure that in the transition to a new development model, the economic outcomes are socially acceptable among those who have benefited from the old systems. The MENA region continues to have the greatest gap with the rest of the world in terms of accountable and inclusive governance structures, on average ranking in the bottom quintile worldwide. It is thus an important development that both resource rich and resource poor economies in MENA are making a start at these vital changes.

Overview Table 2: Structural reform progress in MENA, 2000-2005

Country/Region	Trade Policy		Business Climate		Governance: Quality of public administration		Governance: Public sector accountability	
	Current status	Reform progress	Current status	Reform progress	Current status	Reform progress	Current status	Reform progress
Algeria	44	71	13	38	38	91	29	91
Bahrain	..	62	..	..	77	26	23	91
Djibouti	..	51	..	74	..	..	..	..
Egypt	43	100	11	36	43	92	25	84
Iran	22	74	57	44	16	19	21	4
Iraq	..	..	66	..	..	..	..	..
Jordan	47	86	58	89	66	67	34	60
Kuwait	53	65	59	7	58	24	31	65
Lebanon	61	80	37	31	..	..	..	..
Libya	..	27	..	..	11	64	0	42
Morocco	38	52	61	54	73	83	33	81
Oman	71	11	78	15	61	75	16	81
Qatar	..	..	..	..	60	89	13	74
Saudi Arabia	39	77	80	26	57	77	5	69
Syria	18	43	30	5	15	67	7	74
Tunisia	51	57	83	93	74	87	22	22
UAE	..	..	43	14	59	6	17	41
Yemen	62	82	35	57	28	71	20	89
MENA	**46**	**63**	**51**	**42**	**49**	**63**	**20**	**64**
Resource poor	**48**	**71**	**50**	**63**	**64**	**82**	**28**	**62**
Resource rich	**44**	**57**	**51**	**23**	**44**	**55**	**17**	**65**
RRLA	**36**	**67**	**40**	**36**	**24**	**62**	**19**	**64**
RRLI	**54**	**48**	**65**	**15**	**55**	**52**	**15**	**66**
East Asia Pacific	**56**	**37**	**61**	**47**	**43**	**45**	**41**	**48**
Europe Central Asia	**51**	**69**	**48**	**64**	**47**	**46**	**52**	**51**
Latin America / Carib	**57**	**50**	**40**	**51**	**46**	**50**	**57**	**43**
High Income OECD	**70**	**64**	**84**	**50**	**89**	**47**	**91**	**49**
South Asia	**41**	**48**	**48**	**41**	**48**	**53**	**39**	**31**
Sub-Saharan Africa	**34**	**27**	**27**	**43**	**34**	**53**	**37**	**55**
WORLD	**50**	**50**	**50**	**50**	**50**	**50**	**50**	**50**

Note: Regional averages reflect the simple average of the data for the countries included. a. Current status (trade, business, or governance) reflects country's current placement in a worldwide ordering of countries based on that structural reform indicator, expressed as a cumulative frequency distribution, with 100 reflecting the country with the most friendly /open/accountable policies or structures (worldwide) and 0 representing the country with the most unfriendly/closed/unaccountable policies or structures (worldwide). b. Reform progress reflects the improvement in a country's rank between 2000 and 2005 in a worldwide ordering of countries based on that structural reform indicator, expressed as a cumulative frequency distribution, with 100 reflecting the country which exhibited the greatest improvement in rank and 0 reflecting the country which exhibited the greatest deterioration. Source: World Bank staff estimates from country data.

With diminishing positive links to the oil economies (and increasing negative impacts from higher oil prices), the resource poor economies in the MENA region have maintained a solid pace of reform, generally exceeding other regions of the world across all areas of reform. In both trade reform and business and regulatory reform, the resource poor economies have made, on average, stronger progress over the last five years than all other regions of the world. Largely in connection with recent bilateral and multilateral trade agreements, and led by deep tariff reductions undertaken in Egypt, resource poor economies on average ranked in the 71st percentile with regard to tariff reform over the last five years. With regard to reform of the business climate, the steps taken by resource poor economies placed them in the top 63rd percentile, on average. Nonetheless, much stronger progress can take place, particularly with regard to trade liberalization. The resource poor economies as a group continue to maintain some of the highest tariffs in the world, ranking in the bottom 25th percentile worldwide with regard to low tariff protection.

In the area of governance, resource poor economies have also demonstrated significant progress. In the area of improving public sector accountability, resource poor countries ranked, on average, in the 62nd percentile with regard to reform progress, second only to the gains made by the MENA region's resource rich economies. In improving the quality of public sector administration, the group ranked in the 82nd percentile with regard to reform, the strongest progress worldwide, led by strong achievements in Egypt, Tunisia and Morocco.

Along with across the board policy reform, MENA economies continue to look to selective industrial policies designed to enhance specific sector competitiveness and growth to complement more broad-based structural reform. Although the views on industrial policy are changing, and a variety of economic justifications can be made for their use, MENA's own unsuccessful history with industrial policies (and the difficulty in transitioning out of them) should serve as a cautious reminder that the most effective policies for promoting growth rely on strategies to create a neutral and internationally competitive business environment.