Harnessing the Global Recovery: A Tough Road Ahead

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Introduction - Global Outlook: Compared with the past three years, 2014 seems hopeful and 2015 could be a turning point for MENA countries. After a slowdown in 2013, recovery in high income economies is expected to boost global growth to 3.2% in 2014, an increase of 0.8% from 2013. Global output is to improve further in 2015 with real GDP growth of 3.4% (Figure 1).

In addition to growth expansion in the United States, the United Kingdom, as well modest recovery in the Euro Zone countries, global growth will continue to be driven by growth in developing countries, expected to be between 5.3-5.5% in 2014 and 2015 respectively, led by China and India. The World Bank estimates that growth in the US will increase by 1% to 2.8% in 2014 and 2.9% in 2015. The Euro Zone will improve to 1.1% in 2014 and to 1.4% in 2015, versus 2013’s negative 0.4 % growth. The Euro Zone rebound is largely export-led, with Germany and France expanding at a solid pace, and Spain exiting recession.

Higher global demand is expected to boost MENA energy and manufactured exports in countries that have trade linkages with high-income countries (Figure 2).

The outlook in the Euro Zone (especially Southern Europe), China and to some extent the US, are key for most MENA countries. While growth in the US and the Euro Zone area is expected to expand, growth in China will moderate slightly to 7.5 and 7.7

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% in 2014 and 2015, due to slower credit growth and rising capital cost. However China’s growth remains high enough to keep demand for hydro-carbon exports from MENA steady. Most oil-importing countries in MENA are likely to see a slight boost in tourism, FDI and remittances due to the global recovery, but domestic security remains a challenge. The World Travel and Tourism Council estimates that tourism revenues will increase by 7% in 2015 over 2014. Still, the global recovery remains fragile and downside risks, including continued low inflation in high-income economies, could weaken demand and delay economic recovery.

The MENA Region: After three years of slowdown, MENA’s economic performance is to improve in 2014 but growth will remain below the 2000-2014 average. Growth will reach 3.3% in 2014 and accelerate to 4.6% in 2015. MENA oil exporters, especially the GCC countries, are expected to lead regional recovery with growth reaching 3.5% in 2014 and 4.8% in 2015. Large stimulus packages in the GCC together with flow of funds to the region, particularly Egypt and Jordan, will boost regional growth rates as capital and current spending continue to rise. Between 2011 to August 2013 some $21.5 billion has been pledged by the GCC, (mainly Saudi Arabia, UAE, Kuwait and Qatar) to countries in transition, with Egypt getting 50% of this amount. In oil exporting countries, growth in Iran is expected to turn positive after two years of contraction from the sharp decline in oil production and trade following tightening of international sanctions. Oil importers including Egypt, Tunisia, Lebanon and Jordan, remain fragile but a slight rebound in growth is expected. Egyptian growth is expected to be supported by Gulf funds ($17 billion committed since July 2014) and Tunisia and Morocco could benefit from the recovery in the Euro Zone. Still, ongoing political and social tensions remain a major risk, and high debt and current account and fiscal deficits leave these economies vulnerable to economic and external shocks. Economic recovery will vary across MENA. GCC growth is expected to remain sustainable, exceeding 4% in 2014 and 2015. Large fiscal spending has made these countries vulnerable to negative oil price shocks, however. The IMF estimates that most of these countries need oil prices higher than $90 per barrel (p/b) to balance budgets. A scenario in which oil prices decline to $90 p/b could increase fiscal pressures particularly in Bahrain (already with a fiscal deficit), and Oman (fiscal deficits expected in 2014 and 2015), given their high fiscal breakeven prices of over $130 and $100 p/b and declining oil production, and to some extent in Saudi Arabia and the UAE going forward.

Positive political developments in the transition countries could lead to gradual improvements in economic prospects. Tunisia approved a new, constitution protecting basic freedoms. Yemen’s National Dialogue, an inclusive two-year process, reached an agreement on the country’s path. Egypt’s new constitution, though adopted in a polarized period with concerns about freedom of expression, offers safeguards on women’s rights and religious freedom.

Among transition countries, Egypt has embarked on two stimulus packages amounting to 3% of GDP. These are to boost growth to 2.7% in 2014 and 3.8% in 2015, up from 2% in 2013. This mild recovery, however, is stimulus-driven; foreign direct investment (FDI) and private sector investment have yet to resume. In Tunisia growth is to reach 3 and 4.5% in 2014 and 2015, respectively. Jordan, with increased public investment from Gulf funds, could see growth of 3.5% in 2015. Lebanon’s growth is expected to double in 2014 compared to 2013 but will remain well below its pre-conflict level due security and political challenges arising from the war in Syria.

Growth in developing oil exporters including Iran, Iraq, Algeria, Libya and Yemen is expected to rebound but will remain below pre-Arab-Spring levels. Real GDP growth is expected to reach 6.8% in 2015, from -0.7 in 2013. In Iran, the new reformist government is moving to better improve international relations and growth will turn positive (1.5%) in 2014 and accelerating to 2.3% in 2015 after two years of negative growth. Political tensions are expected to gradually subside in Yemen and Libya and growth could be higher in 2015 compared to 2014. Growth recovery in Yemen would be mainly driven by non-oil sectors. In Libya political turmoil held back oil production, a major contributor to output and fiscal revenue.

Risks: MENA countries share many structural problems that have prevented their economies from moving to a higher, sustainable growth path. They have long suffered from high unemployment, low
labor force participation rates particularly among women, and sluggish rates of job-creating growth. The regional unemployment rate is 11% and is much higher for those under 24, exceeding 50% in Yemen and Libya. Job markets in almost all countries in MENA are segmented with a sharp division between the protected and the excluded. Burdensome regulations put new and small firms at a disadvantage. Labor markets are skewed toward public sector jobs which offer attractive benefits and wages resulting in high wage expectations among job seekers and university graduates. Corruption is prevalent in many countries in MENA and particularly in public sector hiring. A recent survey in Tunisia showed that 8 out of 10 think that Wasta or connections are critical for a public sector job.

**Employment:** Estimates from the World Bank show that over the next 7 years (2014-2020) the region must create some 28 million jobs just to keep the unemployment rate from rising (Figure 3 and 4). This translates into creating 4 million jobs per year. Prior to the 2011 revolutions, the region historically created about 3.5 million jobs per year with an average GDP growth rate of 5%. The slowdown in economic activity in the transition countries post-Arab Spring (2011-13) and the spillovers to neighboring countries have been holding back output resulting in growth averaging about 2-3%. Under the scenario of a continued slowdown in economic activity, the average unemployment rate in the region will increase substantially, with youth and females being affected the most.

**Income Inequality:** Income inequality has remained low in some of the countries in the MENA region contributing to an unprecedented reduction in poverty, reaching 2.4% in 2010. For example Egypt’s Gini coefficient was below the median for middle-income countries and in Iran, the Gini coefficient declined slightly after the removal of universal subsidies. The incomes of the bottom 40% have been growing at higher rates than average incomes in almost all MENA countries for which data exist. The bottom 40% in Tunisia saw faster income growth than the average, while the poverty rate fell by half. Vulnerability, however, has increased and a large proportion of people are exposed to external shocks. World Bank data show that, while only 1% of population in Egypt, Morocco and Algeria lived under the basic poverty line of $1.25 a day (PPP) in 2010, a large number of people lived very close to the poverty line. A slight increase in the poverty line (from $1.25 to $2.00 per day) could push about 10% of population of these countries into poverty. This suggests that a large segment of population in MENA (for example; Yemen 45%, Djibouti 30% and Iraq 20%) is in a state of vulnerability. In the event of an adverse shock, these households are at risk of falling into extreme poverty.

**Economic Diversification:** Lack of economic diversification has contributed to growth volatility in MENA. Oil exporters rely primarily on only one export commodity (oil) and oil importing countries lack multiple trading partners. Many governments have tried to diversify their exports, with limited success. A recent World Bank study (2013) suggests that, for resource-rich countries, a better strategy is to diversify their accumulated wealth instead of their exports. In the process of diversification, governments need to invest the rents from natural capital (resources) in physical and “intangible” capital, which includes education, innovation and strong institutions that foster competition, rather than simply subsidizing particular industries. Such a strategy will better prepare the economy for the post-oil era.

**Intangible Capital in MENA:** With its accumulated wealth dominated by natural capital, MENA has produced less intangible capital per capita in the 1995-2005 than any other region. Indeed, World Bank data shows that it has declined in MENA while increasing in other developing regions (Figure 4). Rapid growth in developing regions other than MENA is partly due to education but also from improvements in institutions, governance and other
factors that contribute to more effective use of country assets.

Figure 4. Changing volume of intangible capital per capita (1995-2005)

Source: World Bank

*MENA’s Fiscal Space and Subsidy Challenges:* Fiscal spending in almost all MENA countries is dominated by a large civil-service wage bill and general subsidies. Both have risen after the Arab Spring to prevent further discontent. Especially in the oil importers, this has reduced the fiscal space for capital spending infrastructure investments, lowering the prospects of higher growth in these countries (Figure 6). Higher current spending together with lower revenues have increased fiscal deficits and public debt, making countries vulnerable to even slight economic shocks. In Tunisia, energy subsidies are at 5% of GDP, equivalent to the government’s total budget deficit. General subsidies in Libya (11% of GDP in 2013) and Yemen (9% of GDP in 2012) exceed government spending on education and health. Also, Food and fuel subsidies benefit the rich more than the poor. A recent World Bank study shows that low-income households in Tunisia receive only 2% of energy subsidies while high income households receive 67% of the subsidy on petrol and 60% on diesel. In Egypt, ballooning subsidies (9% of GDP) have kept Egypt’s fiscal deficit at a very high 13.7% of GDP; spending on petroleum subsidies is to increase by 10% in the fiscal year ending in June 2014. On food subsidies in rural Upper Egypt, the richest quintile received 48% more in per capita benefits than the lowest quintile. In Iran where in 2012 universal subsidies replaced unconditional cash transfers, fiscal savings were lower than expected, forcing increased borrowing from the CB, and leading to a sharp increase in the fiscal deficit and inflation rate.

The external financing needs of the countries in transition have been on the rise since the onset of the Arab Spring, estimated at $50 billion in 2015. From January 2011 to August 2013, an estimated total of $38.5 billion of external funds have been disbursed, and more than half has come from the GCC. Weak private sector activity, low levels of external financing forced governments to resort to foreign reserves or increased borrowings. Foreign reserves in Egypt and Tunisia now cover only 4 months of imports. Governments in oil rich countries including Yemen, Libya and Iran have also been tapping to their large foreign reserves. Yemen’s foreign reserves are estimated to cover only 3 months of imports in 2015. Libya’s reserves have also dropped to about $100 billion in 2014 and are expected to decline further to $82 billion in 2015 from $122 billion in 2013 when the government started running budget deficits.

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