MIDDLE EAST and NORTH AFRICA

Growth in the Middle East and North Africa is set to accelerate through 2018 following the bottoming out of oil prices in 2016. For oil exporting economies, despite robust growth in the Islamic Republic of Iran, the recovery will be slightly slower than expected in mid-2016, reflecting fiscal consolidation plans (Gulf Cooperation Council countries and Iraq) and oil production capacity constraints (Iraq). Growth is projected to be somewhat more robust in oil importers than expected in mid-2016, driven by a broad-based strengthening of activity in these countries. Key risks to the outlook are a weaker-than-expected rise in oil prices and conflict-related spillovers. Challenges include staying the course with policy adjustment, particularly fiscal policy, to support medium-term macroeconomic stability; diversifying away from oil; developing more dynamic private sectors; and harnessing potential demographic benefits.

Recent developments

Growth

The Middle East and North Africa grew by an estimated 2.7 percent in 2016, down from 3.2 percent in 2015.[1] Growth was higher in oil-importing economies than in oil exporters, yet it slowed in both groups. Regional growth was 1.5 percentage points below its 1991-2008 average (Figure 2.4.1, Table 2.4.1).

Conflict plagues the region. The failed ceasefire in Syria in the fall of 2016, ongoing war in the Republic of Yemen, continued struggle in Iraq against the Islamic State (ISIS), and political crisis in Libya make clear that the cycle of conflict continues, with deep domestic and international effects. Exodus and internal displacement from conflict-affected countries has generated a humanitarian disaster. Infrastructure has been destroyed; access to food, water, utilities, and basic services has been curtailed; and health conditions have deteriorated. Cross-border spillovers—trade disruptions, fiscal pressures from spending demands for refugees and security, and weakened tourism—continue to ripple through the region (Rother et al. 2016).[2]

The slowdown in activity in 2016 was most notable in Gulf Cooperation Council (GCC) countries, where growth decelerated by nearly 2 percentage points. Oil sector weakness spread to non-oil sectors. In addition to holding back output growth in oil-exporting countries, the recent period of low oil prices has been associated with a slowdown in investment growth, predominantly through a severe terms-of-trade deterioration (Box 2.4.1). Yet GDP growth in the Islamic Republic of Iran and in Iraq is estimated to have strengthened considerably last year, bolstered by large gains in oil production and, in the former, a recovery in the agriculture,

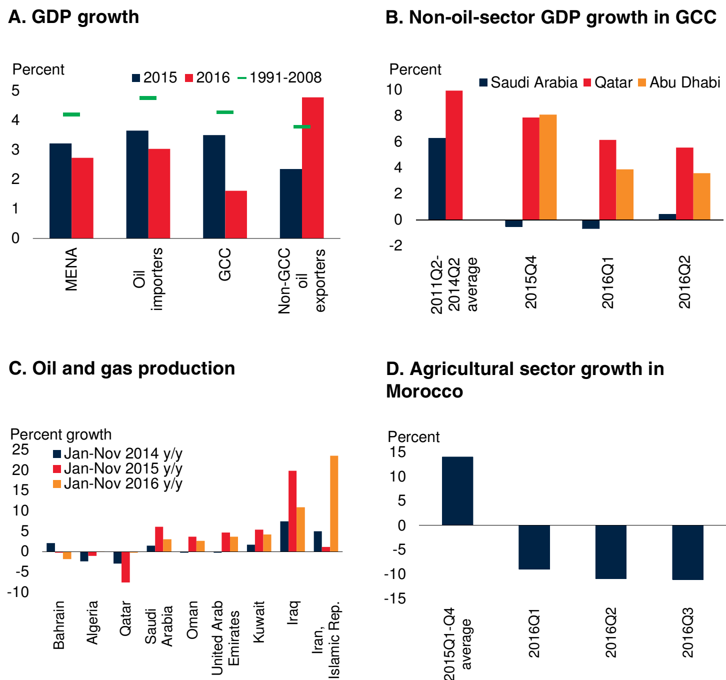
Note: This section was prepared by Dana Vorisek, with contributions from Jongrim Ha and Hideaki Matsuoka. Research assistance was provided by Shituo Sun.

[1]The World Bank's Middle East and North Africa aggregate includes 16 economies, and is grouped into three subregions. Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates comprise the Gulf Cooperation Council (GCC); all are oil exporters. Other oil exporters in the region are Algeria, the Islamic Republic of Iran, and Iraq. Oil importers in the region are Djibouti, the Arab Republic of Egypt, Jordan, Lebanon, Morocco, Tunisia, and West Bank and Gaza. The Syrian Arab Republic, the Republic of Yemen, and, as of this publication of *Global Economic Prospects*, Libya, are excluded from regional growth aggregates due to data limitations. The adjustment in the country set means that aggregate regional and subregional data in this version of *Global Economic Prospects* do not match those in previous versions.

[2]Using annual data for 1970–2014, Rother et al. (2016) find that countries bordering an area of high-intensity conflict experience an average annual decline in GDP of 1.4 percentage points. The impact is found to be even higher, at 1.9 percentage points, for countries in the Middle East and North Africa region.

FIGURE 2.4.1 Growth

Growth in the Middle East and North Africa slowed in 2016 in both oil-exporting and oil-importing economies. In GCC countries, the non-oil sector decelerated notably, reflecting fiscal consolidation and links to the weak oil sector. Growth in non-GCC oil exporters, on the other hand, strengthened, reflecting large increases in oil production in Iraq and the Islamic Republic of Iran. A drought in Morocco led to a large contraction in the agricultural sector.



Sources: Haver Analytics, International Energy Agency, national statistical agencies, World Bank.
A. Non-GCC oil exporters are Algeria, Iraq, and the Islamic Republic of Iran.
B. Figure shows real growth on a year-over-year basis.
C. Figure reflects growth in combined crude oil, natural gas liquid, and nonconventional oil production.
D. Figure shows real growth on a year-over-year basis. The agricultural sector represents 14 percent of gross value added in Morocco.

automotive production, and trade and transport sectors (IMF 2016m).

Among oil-importing economies, growth in Egypt dipped slightly, to 4.3 percent, in FY2016. Foreign currency shortages held back manufacturing production, and tourism fell off after the crash of a Russian airliner in the Sinai Peninsula in October 2015. Growth in Morocco eased 3 percentage points in 2016 to an estimated 1.5 percent, due largely to a drought-related contraction in the agricultural sector. A notable bright spot is Tunisia, where an uptick in growth from 0.8 percent to an estimated 2.0 percent reflects rising investment and government spending. Across commodity-importing countries, tourism sectors are still struggling from terrorist incidents and conflict spillovers. Only in Lebanon has tourism picked up as arrivals from Europe have recovered. Together with a strong real estate sector activity, strengthening tourism contributed to a modest growth recovery in that country in 2016.

Current account and fiscal balances

In addition to constraining growth, the decline in oil prices between 2014 and 2016 led to an acute deterioration of external and fiscal balances in oil-exporting countries (Figure 2.4.2). The major exception was the Islamic Republic of Iran, which was relatively less impacted by the oil price plunge because its oil proceeds had already been significantly reduced with the tightening of international sanctions several years prior. A steep slowdown in import growth and large public spending cuts among oil exporters in 2016 stabilized fiscal and current account balances in most oil-exporting countries, but only after they had reached historically high levels.

In oil-importing economies, falling oil prices helped Lebanon, Morocco, and Tunisia lower their current account deficits in 2016. Egypt, on the other hand, experienced balance of payment pressures stemming from a drop in remittances and official transfers (more than 70 percent of remittances to Egypt came from GCC countries in 2014 and 2015) and weakened tourism activity following several high-profile terrorism incidents (Figure 2.4.3). This wiped out Egypt's progress on reducing its current account deficit in the three years to 2014, bringing the deficit to 5.5 percent of GDP in fiscal year 2016.

From a weak starting position, oil importers have made limited progress in bringing down fiscal deficits during the period of low oil prices, although Jordan and Morocco have shown improvements. In Morocco, this has been achieved through the elimination of subsidies on diesel and gasoline and greater control of the wage bill. Jordan has reformed fuel subsidies and its electricity sector. However, the magnitude of fiscal adjustment in oil-importing countries has been insufficient to put government debt on a downward path in recent years. Debt stands at

nearly 100 percent of GDP in Egypt, almost 95 percent Jordan, and close to 145 percent in Lebanon. The slowdown in GDP growth in 2016 in some countries (Morocco and Jordan) has also contributed to a rise in debt-to-GDP ratios.

Inflation

Low global oil prices and exchange rate pegs to the U.S. dollar have kept import prices, and hence consumer price inflation, low (or negative) in most oil-importing economies (Figure 2.4.4). Yet deflation in Jordan and Lebanon is easing somewhat. Egypt is an outlier. There, strong inflationary pressure was accompanied by a growing gap between the official and black market exchange rates during FY2016 (the year ended June 30, 2016). The gap closed following the floating of the exchange rate in early November, but the long-delayed introduction of a value-added tax in October (of 13 percent, and set to rise to 14 percent as of fiscal year 2017/18) and rising import prices as a result of the flotation may result in an additional jump in inflation. This will be temporary, however, assuming monetary policy contains second-round effects.

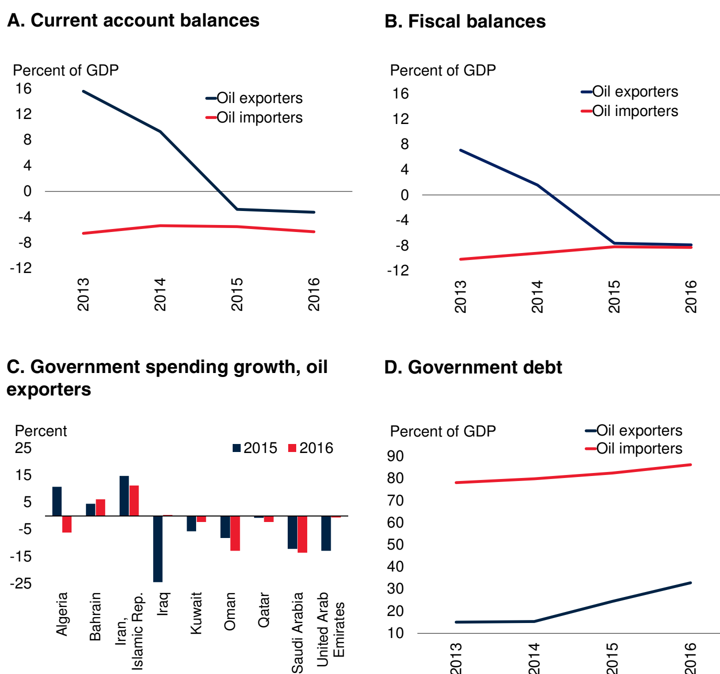
Inflation conditions are mixed in oil exporters. In the Islamic Republic of Iran, tighter monetary policy and low global food prices in recent years have been instrumental in reducing inflation from very high levels early in the decade, notwithstanding the uptick observed in recent months. In Algeria, the recent rise in inflation is the result of a currency devaluation in 2015. As yet, the rise in capital flows to GCC countries does not appear to have contributed to a rise in domestic prices, and the gap between spot and forward exchange rates (a measure of speculation about exchange rate devaluation or de-pegging) has narrowed significantly from early-2015 peaks. Inflation in GCC countries has been relatively stable following the removal of fuel and utility subsidies in several countries in 2016.

Financial sectors

For GCC countries, the impact of low oil prices on the financial sector has become increasingly pronounced. Banks' deposit growth, particularly

FIGURE 2.4.2 External and fiscal positions

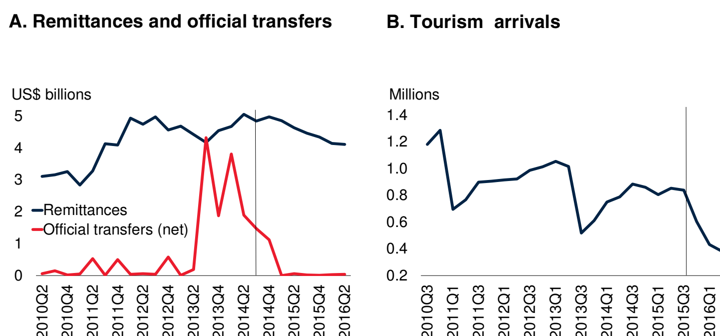
The drop in oil prices that began in 2014 led to an acute deterioration in fiscal and external balances in oil-exporting countries. These balances stabilized in 2016, in part due to sizable cuts in government spending. Oil-importing countries have made limited progress in improving current account balances in the low oil price environment, and they face large and still growing levels of debt.



Sources: Haver Analytics, International Monetary Fund, World Bank.
A.B.D. Figure reflects the GDP-weighted average for the two country groups.

FIGURE 2.4.3 Egypt: balance of payment pressures

The detrimental impact of low oil prices on oil-exporting countries has contributed to a drop in remittance inflows and official transfers to Egypt. At the same time, tourism in Egypt has been negatively impacted, especially after the Russian plane crash above Egypt's Sinai and the subsequent flight suspensions by major countries due to the perceived security risks. Together, these trends have generated balance of payments pressures.

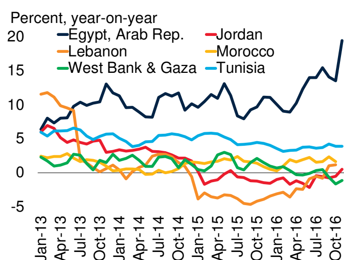


Sources: Haver Analytics, World Bank.
A. Data is seasonally adjusted. Vertical line marks the start of the decline in global oil prices. Last observation is 2016Q2.
B. Data is seasonally adjusted. Vertical line marks the downing of a Russian airliner in Egypt. Last observation is 2016Q2.

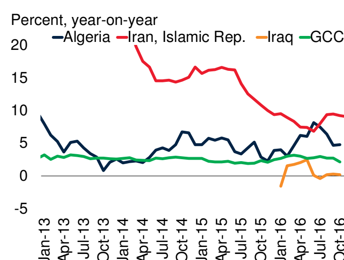
FIGURE 2.4.4 Inflation

Reflecting exchange rate pegs and low international commodity prices, inflation in most oil-importing economies remains low. A modest recovery in commodity prices in the second half of 2016 has contributed to a mild increase in inflation from negative levels in Lebanon and Jordan. Egypt is an exception, where high rates of inflation were accompanied by a growing gap between the official and unofficial exchange rates for much of 2016, though the gap closed following the floating of the Egyptian pound in early November.

A. Inflation: Oil-importing economies



B. Inflation: Oil-exporting economies

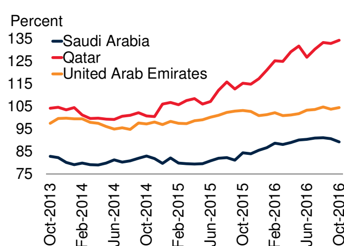


Sources: Haver Analytics, Iraq's Central Statistical Organization, World Bank.
A. Data is seasonally adjusted. Last observation is October 2016 for Lebanon and Morocco and November 2016 for other economies.
B. GCC line reflects median of the six member economies. Data for all economies except Iraq is seasonally adjusted. The period of very high inflation that the Islamic Republic of Iran experienced starting in early 2011, when inflation peaked at 45 percent, is not shown for ease of presentation. Last observation is November 2016 for Islamic Republic of Iran and Oman and October for other economies.

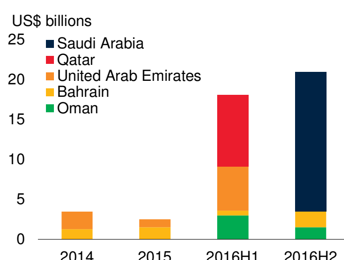
FIGURE 2.4.5 Financial conditions in GCC

The impact of low oil prices on the financial sectors in GCC countries has become increasingly pronounced, pushing down government deposits in banks, and contributing to a rise in the cost of interbank funding in some countries, particularly in Saudi Arabia. Reduced reliance on bank borrowing in favor of international bond issuance by GCC governments may relieve some of the liquidity pressure in banks.

A. Loan-to-deposit ratios



B. International sovereign bond issuance



Sources: Haver Analytics, Dealogic, World Bank.
A. Saudi Arabia line reflects private sector loan-to-deposit ratio. For other countries, total loan-to-deposit ratio is shown. Last observation is October 2016.
B. Data for United Arab Emirates is the sum of issuance by Abu Dhabi, Dubai, Ras al Khaimah, and Sharjah. 2016H2 bar reflects issuance through December 14, 2016.

the part sourced from the government, is lagging well behind credit growth, and is in some cases contracting because of growing public finance needs and slowing economic activity. Liquidity conditions, as measured by banks' loan-to-deposit ratios, steadily tightened in 2016 as a result in several countries, most notably in Qatar and Saudi Arabia (Figure 2.4.5). Central banks responded by injecting liquidity into banks, among other actions. For Saudi Arabia, however, central bank actions have failed to contain a rise in the cost of interbank funding. Increasing government reliance on international debt issuance, which rose in 2016 as these countries financed large fiscal deficits, may help to relieve some of the liquidity pressure on domestic banking sectors.[3]

Aside from the liquidity squeeze, banking sectors in GCC countries have been resilient through the period of low oil prices, with capital ratios adequate and non-performing loan (NPL) ratios low. Banks are uncompetitive, however, and lending is highly concentrated among large, well-established firms (Caggiano and Calice 2016). In most oil-importing countries, as well, banking systems are broadly stable. Tunisia, with elevated NPLs, is an exception, although banking regulation passed in July 2016 to tighten prudential standards and establish a deposit guarantee fund is expected to improve banking stability in the medium term. And while banking sector indicators remain sound in Egypt, reliance on banks to finance growing government budget deficits and the foreign currency shortage is restraining business and household borrowing.

Recent reforms

Despite difficult macroeconomic conditions, there has been progress on fiscal adjustment and structural reform since mid-2016. Kuwait increased fuel prices in August, as did the United Arab Emirates in September. Oman is scheduled to remove electricity subsidies for large users in January. Saudi Arabia announced significant reductions to public wage spending in September, one of the many provisions of the National Transformation Plan approved in June. Several oil-exporting economies have cut capital spending.

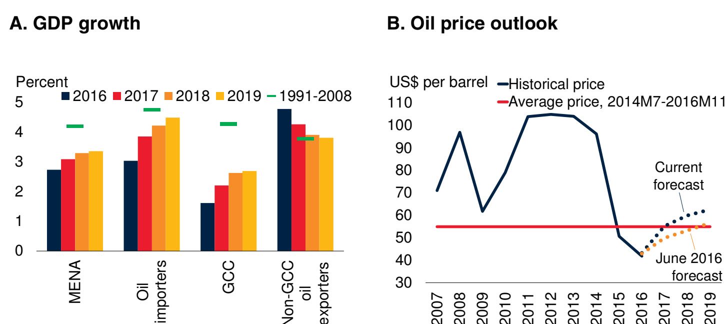
[3] GCC countries have also financed deficits through sovereign wealth funds (SWFs) and other fiscal buffers. Non-GCC oil-exporting countries with large fiscal deficits (Algeria and Iraq) have relied heavily on such sources.

Tunisia's parliament passed legislation that will simplify the steps required to set up investment projects and ease repatriation of project profits to foreign investors. Jordan enacted legislation to enable direct investment in energy and infrastructure projects from GCC countries (IMF 2016n). Across the region, there was an acceleration in the pace of business reforms in 2016, although the business environment remains poor relative to other regions (World Bank 2017).

Following two years of unrestrained output to gain market share, OPEC decided at the end of November to limit production to 32.5-33 million barrels per day in 2017. This was followed, in early December, by an agreement between OPEC and non-OPEC producers to curtail production. The plan, if implemented, would be the first agreed production cut since 2008.

FIGURE 2.4.6 Growth outlook

Regional growth is expected to accelerate during the forecast period in both oil-exporting and oil-importing countries but will remain well below the long-term average in GCC countries. The outlook is highly dependent on the path of oil prices, which has been revised up modestly since mid-2016. The end-November OPEC agreement to cut production is not expected to significantly impact global oil prices.



Sources: Haver Analytics, National Statistical Agencies, World Bank.
A. Non-GCC oil exporters are Algeria, Iraq, and the Islamic Republic of Iran.
B. Historical oil prices reflect the average of monthly data for each given year. All historical and forecasted oil prices are in nominal U.S. dollars.

Outlook

Growth in the Middle East and North Africa is forecast to recover modestly, to 3.1 percent in 2017 and to 3.3 percent in 2018 and 2019, with the pickup in activity strongest among oil-importing countries (Figure 2.4.6). Growth in oil exporters is projected to rise at a slower pace, supported by an envisaged upturn in oil prices from an average of $43 per barrel in 2016 to $55 in 2017, $60 in 2018, and $63 in 2019 and unchanged conflict conditions. Continued rebalancing in the global oil market, as consumption rises and non-OPEC supply declines, will support the envisaged rise in prices.

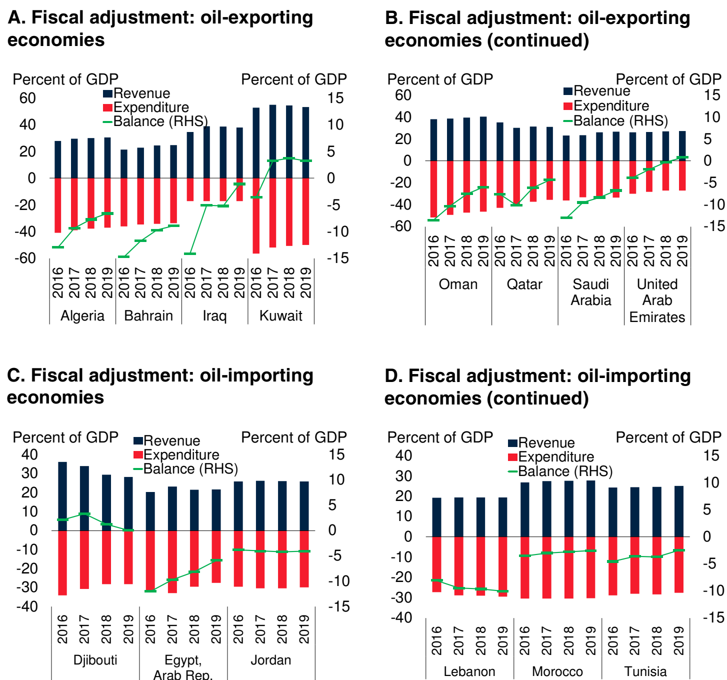
Among oil exporters, the pace of recovery will be slower than expected in June 2016, largely because of developments in Saudi Arabia and Iraq (Table 2.4.2). While growth in GCC countries will rise—particularly in Qatar in 2017, with new gas production expected to come onstream—the pace will remain well below its long-term average. The growth forecast for Saudi Arabia, at 1.6 percent in 2017 and 2.5 percent in 2018, has been lowered as more details about the country's fiscal and structural adjustment plans emerged and as the scope of the slowdown in the non-oil sector became clearer.

Growth in non-GCC oil-exporting countries is expected to be slightly above long-term average rates through 2019, supported mainly by the robust Iranian outlook. Growth in the Islamic Republic of Iran depends critically on the successful negotiation of deals to bring foreign investment into the country, but the forecast also reflects the government's intention to continue to expand oil production. Iraq is expected to experience a significant growth slowdown in 2017 due to oil production capacity constraints and cuts in public investment under the fiscal consolidation program. Algeria is set to experience a slow slide in growth rates, as spending on public works has been slashed and meaningful tax and subsidy reform has been delayed.

Oil-importing countries are expected to experience a broad-based growth acceleration during the forecast period, with growth returning to just under its long-term average by 2019. In Egypt, the pace of growth, currently envisaged to rise to 5.4 percent in FY2019 (after dipping to 4.0 percent in FY2017), is highly dependent on two issues: how quickly the economy can adjust to the adoption of a floating exchange rate regime that occurred in November, and how rapidly the government applies fiscal consolidation. Higher agricultural sector output in Morocco is expected to support a

FIGURE 2.4.7 Fiscal adjustment

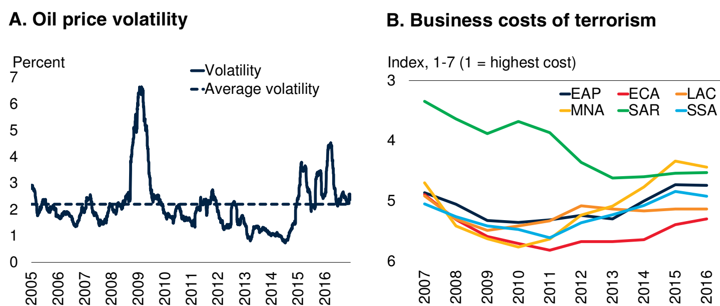
Fiscal consolidation is needed across the region. Even by the end of the forecast period, the expected adjustment will not be sufficient to bring fiscal balances out of deficit in most countries—in both oil exporters and oil importers.



Sources: International Monetary Fund, World Bank.
Note: Data for 2016 is estimated; that for 2017-19 is forecasted.

FIGURE 2.4.8 Major risks to the outlook

Risks to the regional growth outlook remain tilted to the downside. They would arise predominantly from a slower-than-expected recovery in oil prices and conflict-related spillovers. Elevated oil price volatility could also set back growth by making intended government spending and investment paths unattainable. The costs of terrorism to business in the Middle East and North Africa have risen rapidly since 2010, and are now higher than in any other emerging and developing region.



Sources: Bloomberg, World Bank, World Economic Forum Global Competitiveness Index.
A. Volatility is the standard deviation of day-on-day changes in the price of West Texas Intermediate oil over the previous three-month window. Average volatility is average three-month volatility over the period January 1, 1985–present. The last observation is December 21, 2016.
B. Data was collected via surveys, in which participants were asked: "To what extent does the threat of terrorism impose costs on businesses in your country?" Figure reflects the simple average of countries in each region. EAP is East Asia and Pacific, ECA is Europe and Central Asia, LAC is Latin America and the Caribbean, MNA is Middle East and North Africa, SAR is South Asia, and SSA is Sub-Saharan Africa. For MNA, 16 countries (but not Iraq) are included. Vertical axis is inverted for ease of interpretation.

growth recovery in 2017. Jordan is poised to benefit from a recovery in investment and exports, the latter following the mid-2016 agreement with the European Union to relax rules of origin for Jordanian imports. In Lebanon, improved political stability following the end-October election of a president after a two-and-a-half-year vacancy should support higher investment, contingent on a government being formed expeditiously.

Even with oil prices on the rise, and a degree of spending consolidation during the past two years, fiscal adjustment will be needed through the medium term in most oil-exporting economies (Figure 2.4.7). While the increase in oil prices and the implementation of major tax reforms, and privatization (e.g., as part of the National Transformation Plan in Saudi Arabia and the latest International Monetary Fund program in Iraq) will improve revenue generation, continued restraint in spending will be needed. In highly oil-dependent economies such as those in the Middle East, the resulting improvement in fiscal balances would help correct current account imbalances, much more effectively than exchange rate adjustment (Behar and Fouejieu 2016). However, except for Djibouti, Kuwait, and the United Arab Emirates, the expected budget adjustments will not be enough to bring fiscal balances out of deficit, at least through 2019.

Risks

The primary downside risks to the outlook for the region stem from oil prices and conflict. Though oil prices are projected to recover, the recovery is expected to be modest, with prices in 2019 not much above the average since mid-2014, when oil prices began to plunge (Figure 2.4.6). A significant derailing of the expected path of oil prices, whether from changes in supply or demand conditions, geopolitics, conflict conditions, or other sources, would be reflected in the growth outlook and in fiscal and external balances in oil-exporting economies, with adverse spillovers to neighboring economies. In addition, continuation of the elevated oil price volatility observed in 2015 and 2016 would undermine intended government spending and investment paths, even with well-laid fiscal plans (Figure 2.4.8).

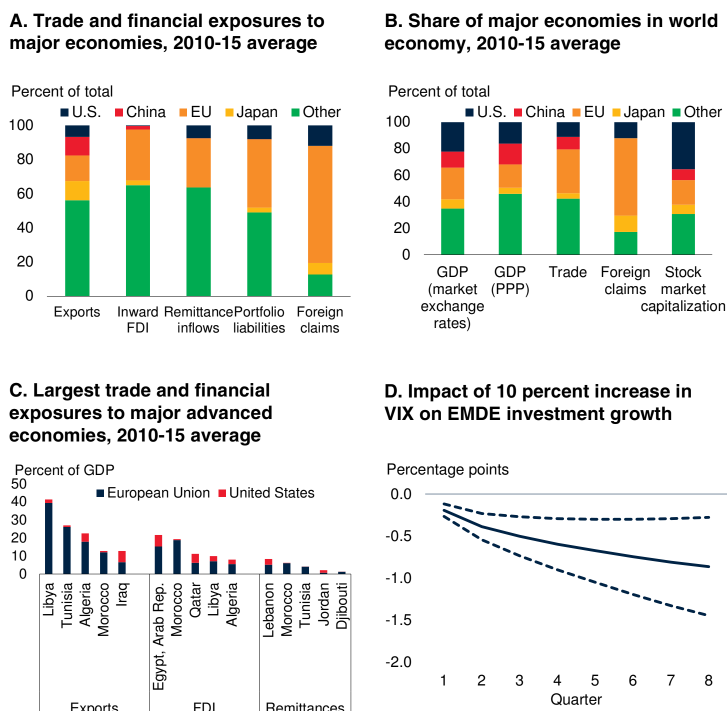
Spillovers from existing conflicts in several countries and a heightened incidence of terrorism, which have already had significant damage on physical and human capital, also remain a risk for regional growth (World Bank 2016n). The economic, security, and humanitarian spillovers from the prolonged conflict in Syria could have yet more adverse spillovers on neighboring countries. In Iraq, notwithstanding the recent gains in the fight against ISIS, there is a medium- to long-term risk of economic disruption through rising sectarianism. Escalating conflict-related risks could be expected to increase economic uncertainty and slow investment. The costs of terrorism to business in the Middle East and North Africa are already higher than in other emerging and developing regions.

Across the region, deep fiscal and structural reforms on the horizon could trigger popular discontent among populations reliant on government support for products and services, with possible negative spillovers for confidence, foreign investment, and growth. In Algeria, for instance, long delays in tax and subsidy reform, despite acute fiscal pressures, likely reflect the political risk related to scaling back longstanding food and fuel subsidies. Similar political risk was likely behind Egyptian authorities' reluctance to implement an additional round of fuel subsidy reductions in FY2016. The social response to subsidy reform in the Middle East and North Africa in recent years has been mixed. In some countries, the process has been marked by vigorous protests. In others, compensatory measures, such as targeted cash transfers, have contributed to a calmer reception (Verne 2016).

Spillovers from major economies, as well, could impact economic conditions in the Middle East and North Africa. The region relies principally on the European Union for financial flows, although the United States contributes materially to flows to certain countries (Figure 2.4.9). The stock of U.S. foreign direct investment (FDI) in Egypt, for instance, averaged 6 percent of domestic GDP during 2010–15, and 5 percent in Qatar. Lebanon received remittance inflows from the United States of more than 3 percent of its GDP during the same period. Heightened policy uncertainty in the

FIGURE 2.4.9 Risks of uncertainty in major advanced economies

Among major advanced economies, the Middle East and North Africa is reliant principally on the European Union as an export destination and a source of financial inflows, though the United States contributes materially to financial inflows in some countries. This suggests some potential negative effects from an increase in U.S. policy uncertainty.

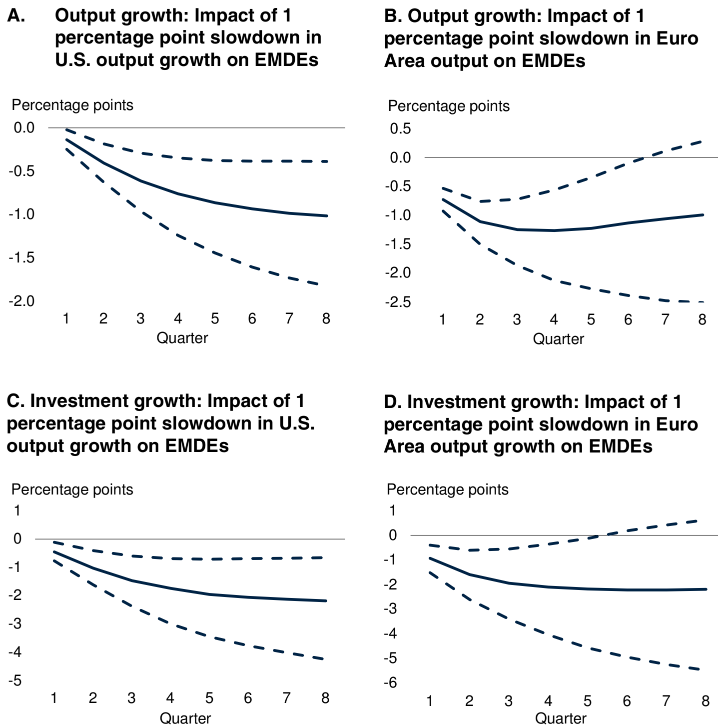


Sources: Bank for International Settlements, Haver Analytics, International Monetary Fund, World Bank.
A.B.C. Exports (A.) includes exports of goods only. Foreign claims refer to total claims of BIS-reporting banks on foreign banks and nonbanks. Stock market capitalization is the market value of all publicly-traded shares. FDI data is available only to 2014. Inward FDI and portfolio investment are presented as stocks. Other indicators are flows. Trade (B.) includes both exports and imports. "US" stands for United States; "EU" stands for European Union.
C. Figure shows exports to the United States/European Union, remittances from the United States/ European Union, and FDI from the United States/European Union (all in percent of GDP). Chart shows only the countries with the largest exposures to the United States and Euro Area. FDI is presented as a stock. Other indicators are flows.
D. Cumulative responses of EMDE investment to a 10 percent increase in the VIX. Solid lines indicate the median responses and the dotted lines indicate 16-84 percent confidence intervals. Vector autoregressions are estimated with sample for 1998Q1-2016Q2. The model includes, in this order, the VIX, MSCI Emerging Markets Index (MXEM), J. P.Morgan Emerging Markets Bond Index (EMBIG), aggregate real output and investment growth in 18EMDEs with G7 real GDP growth, U.S. 10-year bond yields, and MSCI World Index as exogenous regressors and estimated with two lags.

United States or the Euro Area could potentially reduce these shares significantly. A growth or investment slowdown in either the United States or the Euro Area could be expected to be accompanied by slowing output or investment growth across emerging and developing economies (Figure 2.4.10). For GCC countries, the normalization of monetary policy in the United States could pose an indirect risk to growth. The cost of external financing, on which countries in

FIGURE 2.4.10 Spillovers from the United States and the Euro Area

A slowdown in U.S. or Euro Area output growth would reduce output growth in EMDEs considerably. EMDE investment would respond more strongly, possibly reflecting investor concerns about long-term growth prospects.



Sources: Haver Analytics, International Monetary Fund, World Bank.
Notes: Cumulative impulse response of weighted average EMDES output growth (A.B.) or investment growth (C.D.) at 1-8 quarter horizons to a 1 percentage point decline in growth in real GDP in the United States (A.C.) and Euro Area (B.D.). Growth spillovers based on a Bayesian vector autoregression of world GDP (excluding the source country of spillovers), output growth in the source country of the shock, the U.S. 10-year sovereign bond yield pulse JP Morgan's EMBI index, investment (C.D.) or output (A.B.) in EMDEs excluding China and oil price as an exogenous variable. Solid lines indicate the median responses and the dotted lines indicate 16-84 percent confidence intervals.

the region are becoming more dependent, would rise. In addition, maintenance of currency pegs with the U.S. dollar would require central banks to raise domestic interest rates, despite the environment of subdued economic activity.

Policy challenges

Countries in the Middle East and North Africa face four key economic challenges: ensuring macroeconomic stability, of which sound public finances are a key aspect; diversifying oil-exporting economies away from hydrocarbons; facilitating a more dynamic private sector; and harnessing the benefits of the region's demographic profile through labor market reforms.

Macroeconomic stability

Sustained efforts to achieve more sustainable fiscal positions in both oil-exporting and oil-importing countries in the region are essential for macroeconomic stability. Authorities who have announced country-level plans to broaden tax bases and improve fiscal discipline will now need to carry them out. Credible fiscal plans and their robust implementation are critical to maintaining good sovereign credit ratings and access to international financing.

Appropriate monetary and financial sector policies will help support fiscal sustainability. Banking sectors in GCC countries remain sound, but it is possible that selectivity in lending may increase and borrowing costs for public and private sector clients will rise and that asset quality will come under pressure. Empirical evidence suggests that changes in oil prices in these countries have a significant impact on non-performing loan ratios (Khandelwal, Miyajima, and Santos 2016; Miyajima 2016).

In Egypt, the central bank must navigate the recent move to a more flexible exchange rate regime. Gradually reducing inflation is a priority, including by ensuring that the new value-added tax results in only a one-time increase in inflation rather than an ongoing spiral. In the Islamic Republic of Iran, the central bank needs to complete the unification of the exchange rate, which is behind schedule, and address weaknesses in the banking sector. Tight banking sector supervision and regulation will help reduce high levels of nonperforming loans and increase low bank capital. Continued efforts to tighten anti-money laundering regulations and combat the financing of terrorism will help to reintegrate Iranian banks into the global financial system.

Diversification

For oil exporters in the region, diversifying away from dependence on oil is important to reduce the boom-bust cycles related to oil price developments. While there has been some progress over the long term (for example in Bahrain and the United Arab Emirates), dependence on oil

remains strong (Figure 2.4.11). Government reliance on oil and gas for revenue is substantial. Further, as hydrocarbon industries are largely publicly owned, it will be important to address shortcomings in private sector development, so that the direct negative effects of oil price fluctuations are not so concentrated. This includes implementing policies to reduce reliance on jobs in the public sector, which accounts for 80 percent or more of employment of nationals in some GCC countries (Sommer et al. 2016). In the short and medium term, however, the deteriorating environment for global trade will be a challenge to developing non-oil sources of export revenue.

Private sector development

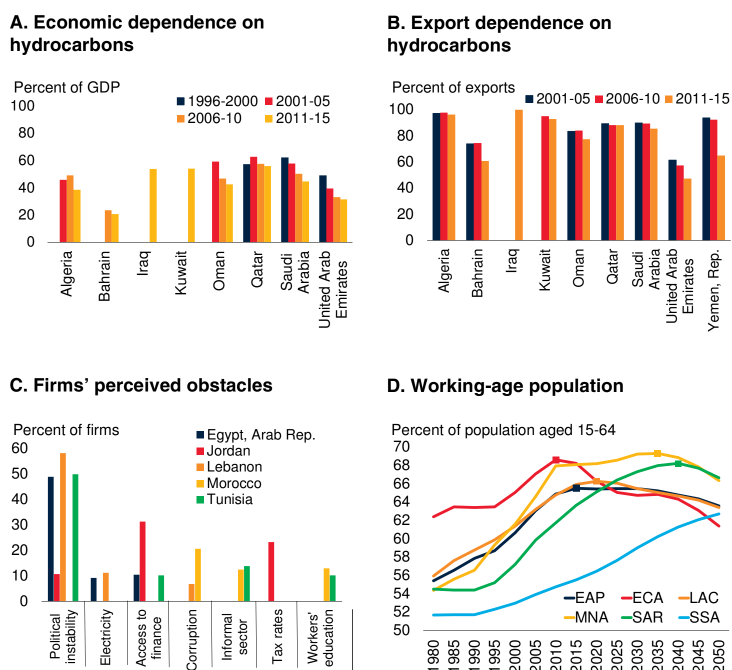
In oil-importing economies, as well, reforms to facilitate a more dynamic private sector will yield important dividends. Enterprise surveys covering the seven oil-importing economies in the region highlight four primary reform needs: improving the business environment, including reducing corruption and improving electricity supply; reducing financial exclusion, especially for small- and medium-size firms; improving labor market participation and labor productivity, including bolstering employment opportunities for women and youth and enhancing labor force skills; and increasing openness to trade, including through more effective customs and trade regulations (EBRD, EIB, and World Bank 2016). The most formidable obstacle cited in enterprise surveys, however, is political instability.

Harnessing demographic benefits

Domestic authorities across the region must adjust policy in order to seize the benefits of the region's demographic profile. Not only does the region have the highest share of working-age population among all developing regions, but the share of working-age population is expected to continue to grow through 2035, much longer than in several other emerging and developing regions. A growing working-age population share can confer important benefits, including higher growth and lower poverty (World Bank 2015c). However, taking advantage of this will depend on sufficient employment opportunities for those of working age. Unemployment rates, particularly among youth, remain very high, while the capacity of labor markets to absorb new entrants will decline in the medium term in some countries (IMF 2016o). Demographic and labor market conditions highlight the urgency of reducing incentives to work in the public sector, better aligning the skills and education of the young workforce to market demands, and lessening labor law rigidity. Fostering a more inclusive economic environment may improve social cohesion (OECD 2016) and help prevent violent extremism in the region (World Bank 2016o).

FIGURE 2.4.11 Policy challenges

The extended period of low oil prices has reinforced the need for oil exporters to diversify their economies. Across the region, there is a need to undertake reforms to facilitate a more dynamic private sector. Such reforms could help reduce high reliance on the public sector employment across the region and, in the medium and long term, create more jobs for the large working-age population.



Sources: Haver Analytics; European Bank for Reconstruction and Development (EBRD), European Investment Bank (EIB), and World Bank (2016); World Integrated Trade Solutions (WITS); United Nations.

A. Figure shows the simple average of the share of oil and gas production in GDP over the indicated year spans. Qatar shows the share of mining and quarrying (which includes oil and gas) in GDP.

B. Figure shows the simple average of the share of oil and gas exports as a share of total goods exports over the indicated year spans.

C. Individual bars reflect the share of firms choosing the indicated issue as their top obstacle in firm-level surveys conducted in 2013. "Informal sector" category was presented as "informal sector policies" in surveys.

D. Figure shows simple average of working-age population across countries in each region. Markers along the lines indicate the peak of the working-age population share; in Sub-Saharan Africa, the share is expected to peak in 2075. EAP is East Asia and Pacific, ECA is Europe and Central Asia, LAC is Latin America and the Caribbean, MNA is Middle East and North Africa, SAR is South Asia, and SSA is Sub-Saharan Africa.

TABLE 2.4.1 Middle East and North Africa forecast summary

(Real GDP growth at market prices in percent, unless indicated otherwise)

	2014	2015	2016	2017	2018	2019	2015	2016	2017	2018
			Estimates	Projections			(percentage point difference from June 2016 projections)			
EMDE MENA, GDP[a]	**3.3**	**3.2**	**2.7**	**3.1**	**3.3**	**3.4**	**0.4**	**-0.1**	**0.0**	**-0.1**
(Average including economies with full national accounts and balance of payments data only)[b]										
EMDE MENA, GDP[b]	3.4	3.2	2.6	3.1	3.4	3.5	0.5	-0.1	0.0	0.1
GDP per capita (U.S. dollars)	1.4	1.3	0.9	1.5	2.0	2.1	0.5	-0.1	0.0	0.2
PPP GDP	3.5	3.2	2.8	3.3	3.6	3.7	0.5	-0.1	0.0	0.1
Private consumption	6.3	2.3	2.8	3.0	3.4	3.5	-0.3	0.0	0.0	0.1
Public consumption	7.0	-0.5	-0.6	0.9	2.1	2.3	-2.8	-0.8	0.2	-0.1
Fixed investment	6.6	2.7	-1.4	3.7	3.5	3.9	5.3	1.0	1.9	1.2
Exports, GNFS[c]	2.4	0.9	4.9	5.2	4.9	5.0	-2.6	0.0	0.6	0.5
Imports, GNFS[c]	7.1	-1.3	0.8	4.9	5.2	5.4	-2.2	1.3	1.6	1.2
Net exports, contribution to growth	-1.7	1.0	2.0	0.6	0.3	0.3	-0.4	-0.6	-0.4	-0.4
Memo items: GDP										
Oil exporters	3.4	3.1	2.7	2.9	3.1	3.1	0.5	-0.1	-0.1	-0.1
GCC countries[d]	3.2	3.5	1.6	2.2	2.6	2.7	0.6	-0.4	-0.1	-0.1
Saudi Arabia	3.6	3.5	1.0	1.6	2.5	2.6	0.1	-0.9	-0.4	0.2
Iran, Islamic Rep.	4.3	1.7	4.6	5.2	4.8	4.5	0.1	0.2	0.3	0.1
Oil importers	3.0	3.6	3.0	3.9	4.2	4.5	0.3	0.1	0.2	0.2
Egypt, Arab Rep.	3.7	4.4	4.2	4.4	5.1	5.4	0.8	0.4	0.0	0.5
Fiscal year basis	2.9	4.4	4.3	4.0	4.7	5.4	0.2	1.0	-0.2	0.1

Source: World Bank.
World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not differ at any given moment in time.
a. EMDE refers to emerging market and developing economy. GDP at market prices and expenditure components are measured in constant 2010 U.S. dollars. Excludes Libya, Syrian Arab Republic and Republic of Yemen due to data limitations.
b. Sub-region aggregate excludes Djibouti, Iraq, and West Bank and Gaza, for which data limitations prevent the forecasting of GDP components.
c. Exports and imports of goods and non-factor services (GNFS).
d. Gulf Cooperation Council (GCC) countries includes Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and United Arab Emirates.
For additional information, please see www.worldbank.org/gep.

TABLE 2.4.2 Middle East and North Africa economy forecasts[a]

(Real GDP growth at market prices in percent, unless indicated otherwise)

	2014	2015	2016	2017	2018	2019	2015	2016	2017	2018
			Estimates	Projections			(percentage point difference from June 2016 projections)			
Algeria	3.8	3.9	3.6	2.9	2.6	2.8	1.0	0.2	-0.2	-0.1
Bahrain	4.4	2.9	2.0	1.8	2.1	2.4	0.0	-0.2	-0.2	0.2
Djibouti	6.0	6.5	6.5	7.0	7.0	7.0	0.0	0.0	0.0	0.0
Egypt, Arab Rep.	3.7	4.4	4.2	4.4	5.1	5.4	0.8	0.4	0.0	0.5
Fiscal year basis	2.9	4.4	4.3	4.0	4.7	5.4	0.2	1.0	-0.2	0.1
Iran, Islamic Rep.	4.3	1.7	4.6	5.2	4.8	4.5	0.1	0.2	0.3	0.1
Iraq	0.1	2.9	10.2	1.1	0.7	1.1	0.5	3.0	-3.6	-4.5
Jordan	3.1	2.4	2.3	2.6	3.1	3.4	0.0	-0.7	-0.7	-0.5
Kuwait	0.5	1.8	2.0	2.4	2.6	2.8	3.1	0.7	0.8	0.2
Lebanon	1.8	1.3	1.8	2.2	2.3	2.5	-0.2	0.0	-0.1	-0.2
Morocco	2.6	4.5	1.5	4.0	3.5	3.6	0.1	-0.2	0.6	-0.1
Oman[b]	2.5	5.7	2.5	2.9	3.4	3.6	2.4	0.9	1.0	0.8
Qatar	4.0	3.6	1.8	3.6	2.1	1.3	-0.3	-1.5	0.1	-1.9
Saudi Arabia	3.6	3.5	1.0	1.6	2.5	2.6	0.1	-0.9	-0.4	0.2
Tunisia	2.3	0.8	2.0	3.0	3.7	4.0	0.0	0.2	0.5	0.7
United Arab Emirates	3.1	3.8	2.3	2.5	3.0	3.3	0.4	0.3	0.1	0.0
West Bank and Gaza	-0.2	3.5	3.3	3.5	3.5	3.6	0.0	0.0	0.0	-0.1

Source: World Bank.
World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of economies' prospects do not significantly differ at any given moment in time.
a. GDP at market prices and expenditure components are measured in constant 2010 U.S. dollars. Excludes Libya, Syrian Arab Republic, and Republic of Yemen due to data limitations.
b. A recent rebasing of Oman's GDP has resulted in significant revisions to historical and forecast growth rates compared to June 2016.
For additional information, please see www.worldbank.org/gep.

BOX 2.4.1 Recent investment slowdown: Middle East and North Africa

Severe terms-of-trade deteriorations and uncertainty associated with deep political changes have weighed on investment in the region. Investment growth slowed from 4.4 percent in 2010 to 2.6 percent in 2015. Investment needs remain sizable in non-Gulf Cooperation Council EMDEs in the region, especially in transport and energy infrastructure.

The Middle East and North Africa (MNA) accounted for 4 percent of global investment, on average, during 2010–15.[1] Investment growth in the region slowed from 4.4 percent in 2010 to 2.6 percent in 2015, far below the long-term (1990–2008) average of 7.2 percent, with considerable divergence among oil exporters and importers (Figure 2.4.1.1).

This box discusses the following questions:

- How has investment growth in the region evolved?
- What were the main sources of the investment slowdown?
- What are the remaining investment needs?
- Which policies can help address investment needs?

The Box documents the recent slowdown in investment growth in the Middle East and North Africa due to the severe terms-of-trade deteriorations in oil-exporting economies and uncertainty associated with deep political changes in several oil-importing economies. Remaining investment needs are sizable, especially in the transport and energy sectors.

How has investment growth in the region evolved?

In 2015, investment growth remained below its long-term average in 70 percent of EMDEs in the region, and investment contracted 30 percent of the EMDEs in the region. However, investment developments have diverged between oil exporters and oil importers since the broad-based slowdown in investment growth during 2010–13.

Investment growth in oil-exporting economies has evolved in line with oil prices, which rose rapidly in 2010 and 2011. When the steep oil price decline began in mid-2014, governments initially responded with additional fiscal stimulus, often in the form of public investment. As a result, investment growth in oil-exporting economies rose more than 3 percentage points in 2014, to 7.3 percent. Yet, sharp oil revenue losses and fiscal constraints brought project delays and cancellations in 2015. Investment growth fell to an average of 2.4 percent in 2015, the slowest pace since 1994, and investment contracted in three of the four largest oil-exporting economies in the region (Algeria, Islamic Republic of Iran, and Saudi Arabia). Preliminary data suggest further contraction in investment in 2016 in oil-exporting economies. For example, Saudi Arabia, the largest economy in the region, experienced a 16 percent year-on-year contraction in the first half of the year.

Among oil-importing countries, investment growth decelerated sharply in 2011, to 0.2 percent, when mounting political tensions during the Arab Spring were rapidly followed by an intensifying Euro Area sovereign debt crisis. The sharp recovery of investment growth in 2015, to 4.0 percent, reflected efforts to address infrastructure needs in the Arab Republic of Egypt and Morocco, the two largest oil-importing economies in the region, while investment contracted in several smaller oil importers (Jordan, Lebanon, Tunisia). The private sector contributed more strongly than the public sector to investment growth in Egypt, a typical pattern among oil importers. Even with the recovery in 2015, investment growth in oil-importing countries was still below the long-term average of 5.1 percent. Heightened balance of payments and fiscal pressures in Egypt were likely accompanied by weaker investment growth in 2016. Recently-implemented structural reforms and expansionary policy among oil-importing countries may lift investment in the medium term, however (IMF 2016p).

What were the main sources of the investment slowdown?

A severe terms-of-trade deterioration in oil exporters, far-reaching political changes, and spillovers from armed conflict in several countries in the region weighed heavily on activity and sentiment. As growth prospects dimmed, especially among oil-exporting countries, investment growth slowed sharply across the region.

Oil-exporting countries—where oil and gas accounts for, on average, 40 percent of GDP, 70 percent of fiscal revenues, and 80 percent of goods exports—have been

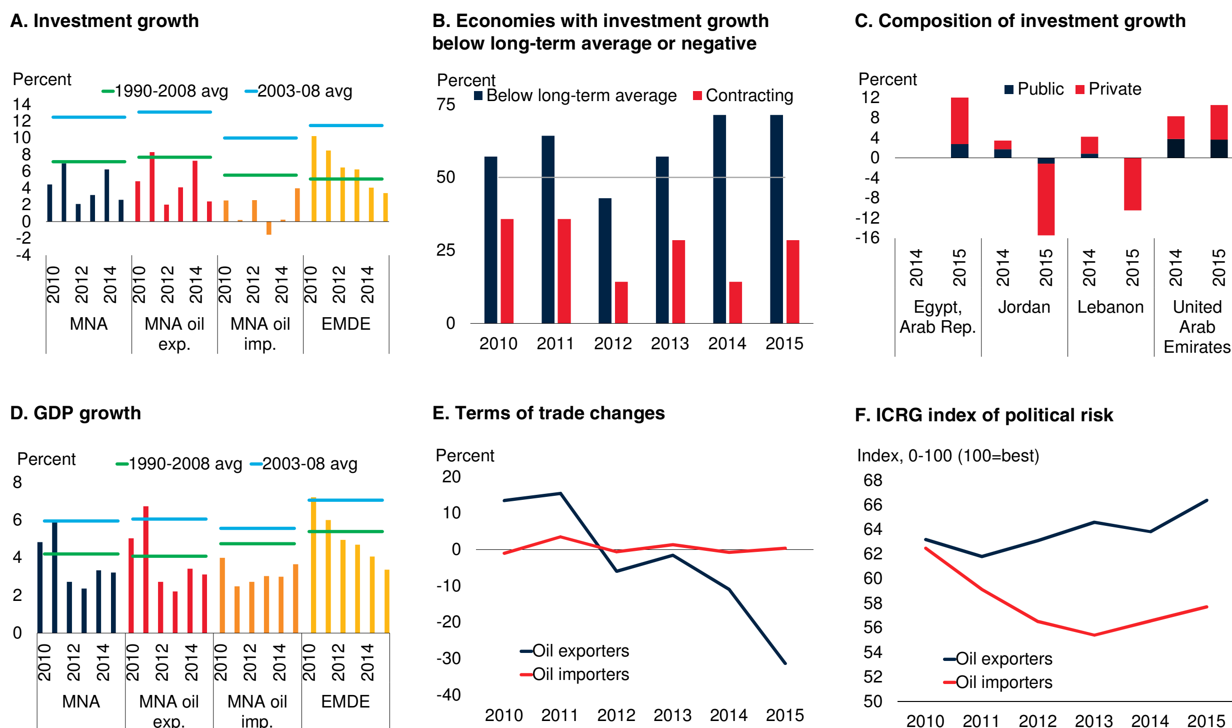
Note: This box was prepared by Dana Vorisek.

[1] Throughout this box, unless otherwise specified, investment refers to real gross fixed capital formation (public and private combined). For the sake of brevity, "investment" is understood to indicate investment levels. Investment growth is measured as the annual percent change in real investment.

BOX 2.4.1 Recent investment slowdown: Middle East and North Africa *(continued)*

FIGURE 2.4.1.1 Investment growth slowdown

Investment growth slowed from 4.2 percent in 2010 to 0.5 percent in 2015. The slowdown reflects a severe terms of trade deterioration in oil exporters, spillovers from armed conflict, and worsening political uncertainty in oil importers.



Sources: Haver Analytics, Political Risk Services Group (PRS), World Bank.
A. Averages weighted by investment levels. Oil exporters include Algeria, Bahrain, the Islamic Republic of Iran, Kuwait, Oman, Saudi Arabia, and the United Arab Emirates. Oil importers included Djibouti, Egypt, Jordan, Lebanon, Morocco, and Tunisia. "EMDE" is emerging market and developing economies.
B. Economy coverage is the same as for panel A.
C. Figure shows growth rates of gross fixed capital formation in constant 2010 U.S. dollars.
D. Averages weighted by GDP levels. Oil exporters include Algeria, Bahrain, the Islamic Republic of Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. Oil importers include Djibouti, Egypt, Jordan, Lebanon, Morocco, Tunisia, and West Bank and Gaza.
E. Investment-weighted averages. Oil exporters include Algeria, Kuwait, Oman, Saudi Arabia, and the United Arab Emirates. Oil importers include Egypt, Jordan, Lebanon, Morocco, and Tunisia.
F. ICRG is the International Country Risk Guide, produced by the PRS Group. Chart shows investment-weighted averages of country-specific political risk indexes in the ICRG. An increase denotes greater political stability. Oil exporters include Algeria, the Islamic Republic of Iran, Iraq, Kuwait, Oman, Saudi Arabia, and the United Arab Emirates. Oil importers include Egypt, Jordan, Lebanon, Morocco, and Tunisia.

hard-hit by the sharp oil price decline since mid-2014. The terms of trade of oil exporters in the region deteriorated sharply between 2011 and 2015. Panel regression estimates suggest that the terms-of-trade shock accounted for nearly all of the slowdown in investment growth (Chapter 3). A two-year growth contraction in the Islamic Republic of Iran in 2013 and 2014 also contributed to the slowdown.

In oil importers, deepening political uncertainty associated with profound institutional changes in 2011 weighed heavily on investment. Political risk deteriorated particularly sharply in Egypt and Tunisia, where civil uprisings led to regime change, and has not yet recovered to 2010 levels. Developments in the larger economies in the region had spillovers to confidence in the smaller ones (World Bank 2015r). On average, such political uncertainty may have been associated with slower investment growth of approximately 1.5 percentage points during 2011–15 (see Chapter 3).

What are the remaining investment needs?

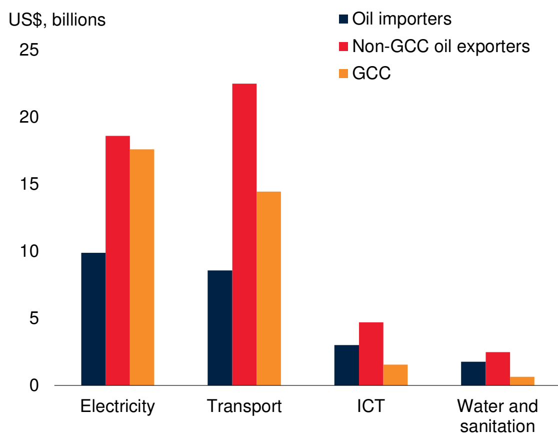
A ramping up of infrastructure investment is needed across MNA (Figure 2.4.1.2). In oil-importing and non-GCC oil-exporting countries, where the quality of infrastructure is on par with that in all EMDEs, there is significant underinvestment in the transport (in particular, roads) and electricity sectors. In Lebanon, frequent blackouts make

BOX 2.4.1 Recent investment slowdown: Middle East and North Africa *(continued)*

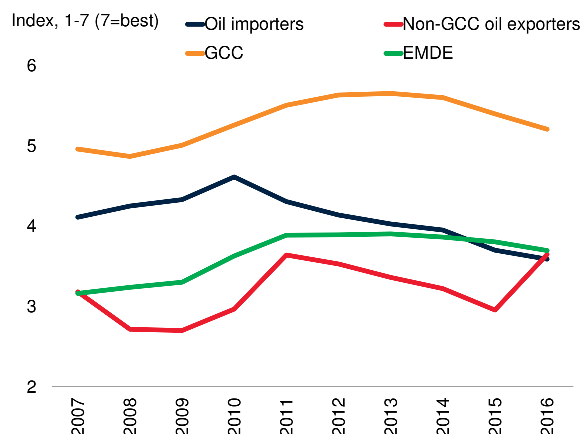
FIGURE 2.4.1.2 Infrastructure, health, and education indicators

Infrastructure investment needs are high, especially in electricity and transport. While the Middle East and North Africa performs well relative to other EMDEs on basic health measures, it is at or below the EMDE average in terms of education indicators, despite considerable long-term gains.

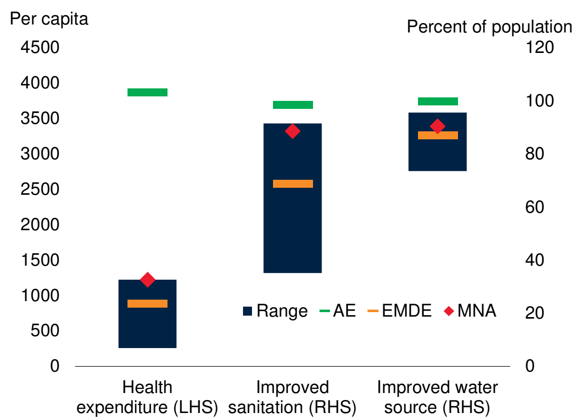
A. Infrastructure investment needs



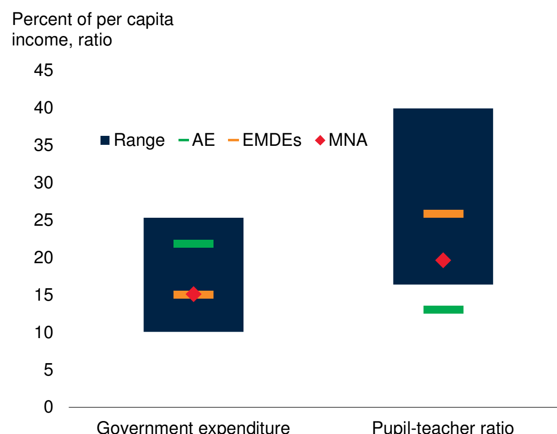
B. Quality of infrastructure



C. Selected health care indicators



D. Selected education indicators



Sources: Estache et al. (2013), World Economic Forum Global Competitiveness Index, World Bank.

A. Values are constant 2005 U.S. dollars and indicate annual investment needs for 2011-20. Oil importers include Djibouti, Egypt, Jordan, Lebanon, Morocco, and Tunisia. Non-GCC oil exporters include Algeria, the Islamic Republic of Iran, Iraq, Libya, Syria, and the Republic of Yemen. Gulf Cooperation Council (GCC) countries include Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

B. Unweighted averages of survey data. Data was collected using the question: "How would you assess general infrastructure (e.g., transport, telephony, energy) in your country? (1 = extremely underdeveloped—among the worst in the world; 7 = extensive and efficient—among the best in the world)." Oil importers include Egypt, Jordan, Lebanon, Morocco, and Tunisia. Non-GCC oil exporters include Algeria, the Islamic Republic of Iran, Libya, and the Republic of Yemen. GCC countries include Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

C. Blue bars denote range of unweighted regional averages across EMDE regions. Health expenditure per capita in purchasing power parity terms, unweighted averages of 199 EMDEs, 34 AEs, and 17 MNA economies. Access to improved sanitation facilities (in percent of population), unweighted averages for 150 EMDEs, 33 AEs, and 19 MNA economies. Access to improved water sources (in percent of population), unweighted averages for 148 EMDEs, 34 AEs, and 18 MNA economies. Latest available data available during 2011-15.

D. Blue bars denote range of unweighted regional averages across EMDE regions. Government expenditure per primary student (in percent of per capita income), unweighted averages of 87 EMDEs, 32 AEs, and 8 MNA economies. Pupil-teacher ratio in primary education (headcount basis), unweighted averages for 165 EMDEs, 31 AEs, and 14 MNA economies. Latest available data available during 2011-15.

BOX 2.4.1 Recent investment slowdown: Middle East and North Africa *(continued)*

electricity a binding constraint to competitiveness and doing business, and in recent years this was also the case in Egypt (World Bank 2015r; Le Borgne and Jacobs 2016). Large numbers of Syrian refugees in Jordan and Lebanon have compounded existing strains on infrastructure in those countries. In Syria, the cost of rebuilding infrastructure damaged or destroyed by war is estimated to be on the order of $100–200 billion (Gobat and Kostial 2016). Iraq, as well, faces large infrastructure investment needs, which have risen as a result of conflict.

GCC countries also have outstanding infrastructure investment needs, predominantly in electricity generation. With higher income levels, however, these countries also have greater capacity to fulfill such needs (IMF 2014a). GCC countries' planned medium-term public spending on infrastructure generally tracks their infrastructure investment needs, while planned spending in oil-importing and non-GCC oil-exporting countries lags far behind needs (Ianchovichina et al. 2013).

Besides contributing to growth, higher investment in infrastructure could also help improve labor market conditions in MNA. One study estimated that each $1 billion of infrastructure investment has the potential to generate 110,000 infrastructure-related jobs, on average, in oil-importing MNA countries (Estache et al. 2013). It is key that countries prioritize investment projects to suit country conditions, however.

MNA scores well relative to other emerging and developing regions on basic health measures. However, the region is at or below the EMDE average in terms of education indicators, despite considerable long-term gains (World Bank 2011). MNA does not necessarily need to increase the level of investment in education, which has risen substantially over several decades, but rather to invest with the goal of increasing the quality of education, thereby supporting growth and lowering poverty (World Bank 2008).

Which policies can help address investment needs?

Several policy measures could support investment in MNA. Across the region, the scaling back of subsidies since 2014 has created space for increased public spending on investment in infrastructure, health, and education (IMF 2016p). High public sector wage expenditures could be reduced, with funds reallocated to investment. Improvements in governance and investor protection could also support private sector investment, as could incentives to undertake public-private partnerships (e.g., in Morocco; EBRD 2015a). In some oil importers, the electricity sector would benefit from additional privatization (Lebanon) or efforts to incentivize the private sector's contribution to electricity generation (Egypt). Finally, improved security conditions in the region are a prerequisite for a sustained pickup in investment.

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