MIDDLE EAST and NORTH AFRICA

After an easing in tensions in early 2014, the Middle East and North Africa region is again experiencing major—and increasing—security challenges. In addition, since mid-2014, it is also adjusting to the oil price drop. This is a particular challenge for oil-exporting countries, many of which also face severe security issues. For oil-importing countries, the potential positive effect of lower oil prices is partially offset by spillovers from within the region, including through lower remittances and security problems, and by long-standing constraints on growth potential. Growth is expected to average about 2.2 percent in the developing countries of the region in 2015, and to pick up modestly in 2016-17. Risks remain tilted to the downside, more so than in other regions. Policy makers face the challenges of adjusting to lower oil prices and coping with security risks in the short-run, and bolstering growth, employment, and fiscal positions in the long-run.

Recent Developments

Regional growth rebounded to 2.2 percent in 2014 (from 0.5 percent in 2013) due to some easing in security risks (the Arab Republic of Egypt and Lebanon); strong, credit-fueled domestic demand growth (Algeria); public investment and sanctions relief under two interim nuclear agreements (the Islamic Republic of Iran); and a rebound in oil production in some oil-exporting countries (Libya, Iraq, and the Islamic Republic of Iran).[1]

In the first half of 2015, security challenges intensified in oil-producing developing countries. Rebel forces toppled the government in the Republic of Yemen, prompting aerial intervention by Saudi Arabia. Various rebel groups, most notoriously the militant group the Islamic State of Iraq and the Levant (ISIL), advanced into new territory in the Syrian Arab Republic. Conflicting factions in Libya have targeted oil installations to seize or destroy revenue streams. Associates of ISIL joined fighting in Yemen and Libya. ISIL fighters are reportedly massing at the Syrian border with Lebanon and clashing with Lebanese security personnel. In Tunisia, terrorist attacks have targeted tourists.

Growth in the region's oil-exporting developing countries[2] averaged 1.9 percent in 2014, a recovery from the 0.8 percent contraction in 2013. Oil production stabilized at around 8.2 million barrels per day (mbd) towards the end of 2014—25 percent below the pre-Arab Spring average (Figure 2.37)—but has since fallen again. Libya was hit hard in the latest quarter as its oil infrastructure came under attack; production fell from 0.7 mbd in 2014Q4 to 0.3 mbd in 2015Q1. The Islamic Republic of Iran remains under sanctions, with a cap on oil exports of 1.1 mbd. This limit may be eased if the international negotiations on Iran's nuclear program are successful. The Islamic Republic of Iran would then contribute an additional 0.7–1.0 mbd to an already oversupplied market, keeping prices low, potentially, for a considerable period.

Iraq, Libya, and the Republic of Yemen rely heavily on the oil sector for government revenues (Figure 2.36). As a result of security challenges and falling oil prices, they suffered large revenue declines and widening fiscal deficits. This led to sharp cuts spending and difficulties maintaining

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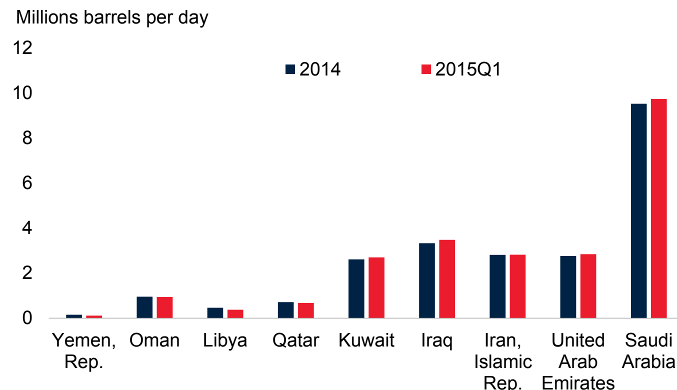
[1]This chapter covers low- and middle-income countries of the Middle East and North Africa region while high-income Gulf Cooperation Council (GCC) countries are excluded. The developing countries are further divided into two groups: oil-importers and oil-exporters.

[2]Developing oil-exporting countries are: Algeria, the Islamic Republic of Iran, Iraq, Libya, and the Republic of Yemen. Syrian Arab Republic is excluded due to data limitations.

FIGURE 2.36 Oil production

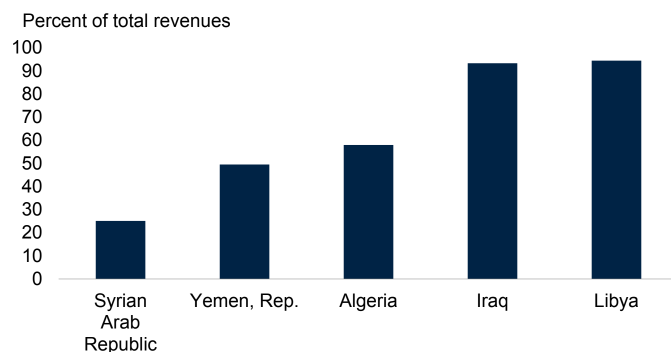
Oil production is rising modestly in high income oil exporting countries.



Source: International Energy Agency.

FIGURE 2.37 Oil revenues, 2014

Fiscal revenues are highly dependent on oil.



Source: IMF (2014a and b); IMF (2013a and b); IMF (2010).
Note: For Syria, data is for 2010.

basic state functions. In the Republic of Yemen, growth continued to be positive in 2014, but in Iraq, the economic disruptions of the ISIL insurgency, and flat government expenditures, contributed to a contraction in 2014. Algeria saw strong domestic demand and activity in non-oil sectors, partly as a result of double-digit credit growth.

Growth in oil-importing developing countries was broadly flat at 2.8 percent in 2014.[3] Growth in Egypt (on calendar year basis), Lebanon and Jordan picked up in 2014. In Egypt, the economy benefited from a rebound in tourism, public spending, and a return of confidence, as a result of political stabilization. In Lebanon, a mid-year lull in violence, rapid credit growth, and an inflow of refugees supported domestic demand (World Bank 2014c; Ianchovichina and Ivanic 2014). In Jordan, growth picked up slightly to 3.1 percent. Disruptions to transport routes limited the expansion, as did capacity constraints as Jordan absorbed a large inflow of refugees from Syria that began in 2013. In contrast, growth slowed sharply in Morocco to 2.6 percent due to a contraction in agricultural output after a bumper crop in the previous year and weak exports to the Euro Area.

Growth momentum appeared to be faltering in several oil-importing economies in early 2015. In Egypt, fragile export growth and higher costs of inputs (after a step depreciation in January) have held back industrial production and dented confidence. In Tunisia, tourist arrivals weakened even before the terrorist attacks in March. In contrast, on somewhat improved security, industrial production and tourism in Lebanon (especially from Arab countries) appears to have expanded in January and February.

The impact of trade-weighted U.S. dollar appreciation since mid-2014 on exchange rates and inflation differed depending on country circumstances, including the exchange rate regime. Both oil-importing as well as oil-exporting countries continued to face depreciation pressures. To maintain competitiveness, central banks in Algeria, Egypt, Morocco, and Tunisia allowed their currencies to depreciate by 4-8 percent against the U.S. dollar in the first three months of 2015. In trade-weighted terms, their exchange rates depreciated modestly. In contrast, pegs against the U.S. dollar in Iraq, Jordan, and Lebanon caused a significant trade-weighted appreciation (Figure 2.38).

Currency depreciations and the prevalence of administered fuel prices have limited the impact of lower global food and energy prices on domestic consumer prices (Figure 2.39). As a result, inflation has remained elevated in Algeria, Egypt, and Tunisia, and increased in Morocco. In contrast, in Lebanon, Jordan, and Iraq, which maintain exchange rate pegs against the appreciating U.S. dollar, inflation slid to near-zero (Jordan) or has turned negative (Lebanon, Iraq).

Fiscal deficits widened markedly in 2014 in oil-exporting developing countries, but narrowed marginally in oil-importing ones. For oil exporters,

[3] Developing oil-importing countries are: Djibouti, the Arab Republic of Egypt, Jordan, Lebanon, Morocco, Tunisia, and West Bank and Gaza.

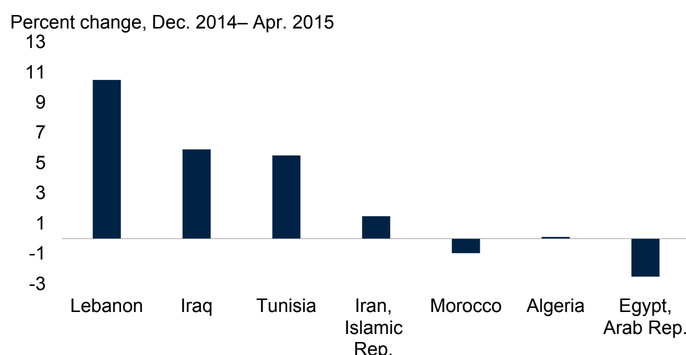
sharp oil revenue losses and rapid spending growth on public sector wages and subsidies have widened deficits to 5.2 percent of GDP from 2.7 percent of GDP in 2013. In oil-importing countries, fiscal balances have improved somewhat, as spending pressures from subsidies eased with falling oil prices, and as fuel and food subsidies were cut. Despite this improvement, fiscal deficits in oil-importing countries remain high at around 10 percent of GDP in 2014, and government debt around 90 percent of GDP. Egypt has financed its deficit with loans from the Gulf Cooperation Council (GCC), while Jordan and Tunisia have relied on official assistance.

Lower commodity prices have helped narrow current account deficits of oil importers by 1–2 percentage points of GDP, while current account balances declined in oil exporters. Despite intensified fighting in Libya, and tightened migrant regulation in Saudi Arabia, remittance receipts grew 8 percent in 2014. This partly reflects a rebound of remittances from GCC countries to Egypt, as political uncertainty in Egypt has settled.

Countries that regularly tap international financial markets (Egypt, Lebanon, Jordan, Morocco, and Tunisia) continued to receive capital inflows, with at times strong domestic and foreign investor demand (Lebanon and Tunisia). Bank lending was particularly robust in the energy sectors of Egypt and Jordan, amid improving growth prospects and expectations of medium-term oil price increases. International banks were also active in Lebanon's sovereign bond issuance.

FIGURE 2.38 Nominal effective exchange rates

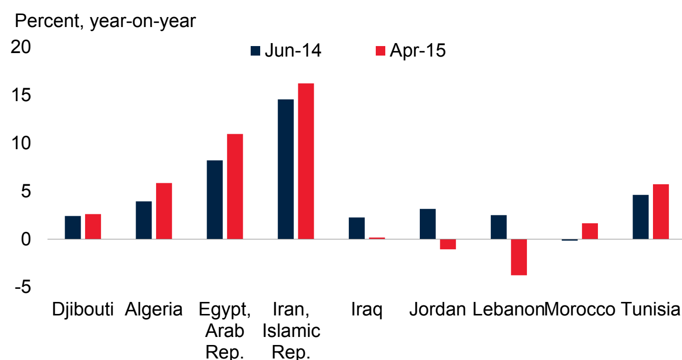
Exchange rates have appreciations in countries with exchange rates pegged to the U.S. dollar.



Source: World Bank Global Economic Monitor, JPMorgan.
Note: A negative number denotes a nominal effective depreciation.

FIGURE 2.39 Inflation

Depreciation has helped reduced inflation in countries with fixed exchange rates.



Source: World Bank.

Outlook

Much will depend on developments in the security situation, and—partly linked—to global oil prices. The baseline scenario assumes that the security situation in the region will remain fragile during 2015, and improve only gradually afterwards. Security concerns will dampen the outlook not only in the affected countries, but also neighboring countries where security risks will discourage tourism and reduce remittances because of the return of migrants.

Growth has been revised downward and is expected to remain flat at 2.2 percent in 2015. Lower oil prices have been a setback to oil-exporting countries that are already struggling with security risks, but they have so far failed to significantly lift prospects in oil-importing countries, which are facing various headwinds of their own. For 2016–17, growth is expected to rebound to 3.7 percent on improving external demand, strengthening confidence in some oil-importing countries, and the assumed gradual stabilization of security.

Political, social, and security stabilization in Egypt is expected to lift investor sentiment in the energy, transport (including investment related to the Suez Canal expansion), and tradable goods sectors. As a result, growth is expected to rise to 4.5 percent in 2015–17, on average. Elsewhere, economic gains will be supported by public infrastructure investment (Jordan), additional consumption demand from a large refugee population (Lebanon), and a return to normal agricultural output and successful diversification reform efforts (Morocco). Additional

positive factors include higher real household incomes from low oil prices and rising external demand as the Euro Area recovery gains traction. Resilient, albeit slowing, remittance growth is also expected to support activity. Improving investor confidence should attract capital inflows, especially into Egypt and Lebanon. Official financing is expected to remain robust, both to finance budgets in Egypt and Lebanon and to support refugee needs across the region. In Tunisia, however, the attacks in March are expected to set back tourism; growth is expected to remain weak at 2.6 percent in 2015.

Due to continued security challenges and low oil prices, growth is expected to nudge downwards in oil-exporting countries to 1.1 percent on average in 2015. However, as oil prices stabilize and recover and security concerns gradually ease, growth is expected to rebound to 3.3 in 2017. In Iraq, an agreement between the central government and that of the Kurdish region is expected to allow for an expansion in oil production. For the Islamic Republic of Iran the baseline scenario assumes sanctions relief in line with the interim steps taken so far. In Libya, the baseline scenario assumes that oil output will expand very gradually amid a challenging security situation. If, however, a comprehensive political agreement is reached, oil exports could quickly resume and GDP rebound by more than 50 percent in 2016.

The decline in oil prices will have major, and enduring, effects on fiscal and external positions in oil-exporting and oil-importing countries alike. Exporters will continue to rein in spending in a (procyclical) effort to offset sharp falls in oil revenues. Nevertheless, their fiscal deficits are expected to widen to 8.2 percent of GDP in 2015. In contrast, deficits in oil importers should narrow to about 8.7 percent of GDP in 2015, as a result of lower costs of fuel subsidies. By 2017, improving growth and adjustment measures should help narrow deficits for both oil-importing and -exporting countries by an average of about 6 percent of GDP.

Current account balances are expected to improve in oil-importing countries and deteriorate in oil-exporting countries. In some oil-exporting countries, however, where new oil production is expected to be available for export, current account balances are expected to improve (Algeria, Iraq). Still-robust growth in GCC countries, driven by government spending that benefits sectors that heavily employ migrants, as well as strengthening Euro Area growth, will raise remittance inflows especially in Egypt, Jordan, Tunisia, and Yemen.

Risks

Risks remain tilted to the downside—more so than in other regions—as a result of security challenges. The key risks remain an escalation of violence and oil price volatility.

Security risks loom large across the whole region. Violence could escalate in countries that are currently experiencing conflict, and could spread to neighboring countries, as demonstrated in the terrorist attacks in Tunisia. Even if violence does not permanently disrupt economic activity, it could disrupt or sever transport links that are critical for the small, open economies in the region (Ianchovichina and Ivanic 2014). Activity in the tourism sector would contract and domestic and external investor confidence would weaken. This would especially dampen FDI in non-natural resource sectors. Although FDI in the natural resource sector tends to be less sensitive to security risks, it may also decline if oil prices fall further, or do not gradually recover as currently expected (Burger, Ianchovichina, and Rijkers 2015; Witte et al. 2015).

If violence damages oil installations and disrupts oil production on a large scale, oil prices could spike sharply for an extended period. The economic disruption would outweigh any benefit from higher oil prices for the region as a whole, although some oil-exporting countries unaffected by the disruption may benefit. Oil-importing countries, however, would see spikes in inflation, fiscal and external pressures. These could be accompanied by sharp slowdowns or reversals in capital inflows. Since virtually all countries in the region (except the Islamic Republic of Iran) have current account deficits in excess of 5 percent of GDP, a disruption or reversal of capital inflows could cause large exchange rate pressures. Conversely, a further fall in oil prices would intensify the external and fiscal pressures currently faced by oil exporters, while growth in oil importers could continue to be held back by structural impediments to growth. Long-standing problems,

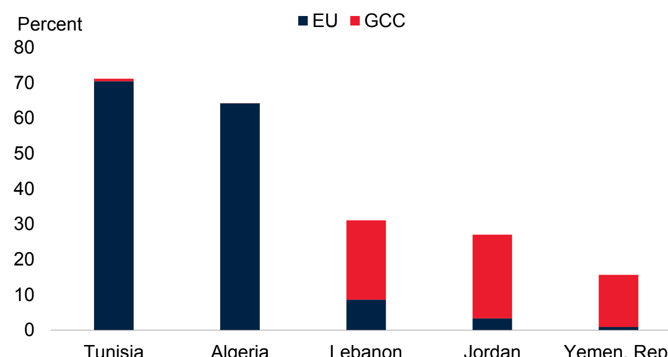
including high unemployment, especially among youth and women, and the poor quality of basic services, such as education and health, remain unsolved (World Bank 2015k).

One significant upside risk is a possible permanent agreement between the Islamic Republic of Iran and the international community. If signed and implemented, economic recovery in that country would be substantial, with growth rates in excess of 6 percent per year in the latter part of the forecast period. This would raise the regional growth rate by 2–2.5 percentage points per year as well.

The GCC countries and the Euro Area are the region's largest trading partners and the outlook is subject to downside risks to growth in both (Figure 2.40). In GCC countries, low oil prices may induce a slowdown in government spending in areas where many migrant workers (e.g. construction) or a broad-based reduction in import demand amid slowing growth. Although the recovery appears to be strengthening in Europe, it is fragile and could be derailed. As the euro depreciates with quantitative easing of the ECB, countries with U.S. dollar pegs are especially vulnerable to losing competitiveness and growth momentum (Iraq, Jordan, and Lebanon).

FIGURE 2.40 Share of exports to GCC and Euro Area countries, 2013

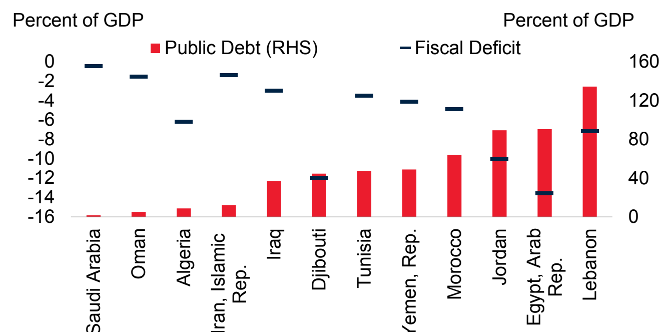
The slowdown in oil-exporters in the region dampens activity in trading partners.



Source: UN Comtrade.
Note: The GCC includes Bahrain, Kuwait, Qatar, Oman, Saudi Arabia, and United Arab Emirates.

FIGURE 2.41 Public debt and deficits, 2014

Debt and deficits remain elevated in oil-importing countries.



Source: World Bank, IMF

Policy Challenges

Policy makers face a dual challenge: adjusting to lower oil prices and dealing with security risks in the short run, and bolstering growth and employment in the long run. Fixed or heavily managed exchange-rate regimes, and the large role played by governments in these economies, make economic adjustment more difficult.

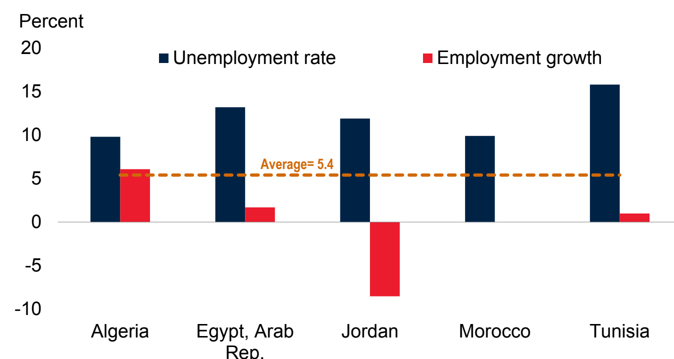
In countries with some exchange-rate flexibility, central banks are often caught between the desire to stem depreciation to preserve financial stability (or contain inflation), versus the need to support weak activity (Algeria, Morocco, and Tunisia) or a nascent recovery after several years of low growth (Egypt). This trade-off is of particular concern in countries where inflation is expected to remain high, as recent currency depreciation passes through to prices (Algeria, Egypt, and Tunisia).

Fragile security in Iraq, Libya, Syria, and the Republic of Yemen is causing sizeable refugee flows. For example, Lebanon's population has increased by 19 percent and Jordan's by 8 percent since 2013 (Abdih and Geginat 2014). The need to provide basic services to the refugees is placing pressures on government budgets in Iraq, Jordan, Lebanon, and Tunisia—all countries with substantial fiscal financing needs, government debt, and fiscal deficits (Figure 2.41). Fulfilling government functions while maintaining sustainable fiscal balances will require new revenues and/or streamlining inefficient expenditures, including fuel and food subsidies.

Fiscal deficits, although declining in the forecast period, are expected to remain high in oil importing countries of the region in the medium-term. In particular, there is a need to ensure that the fiscal windfall from lower oil prices is channeled to efficient,

FIGURE 2.42 Unemployment rate and employment growth, 2013

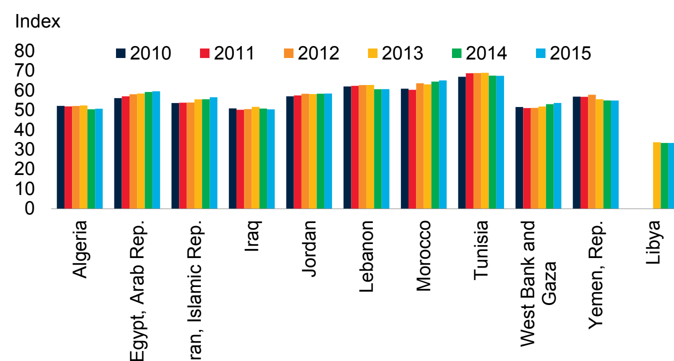
Unemployment remains high and above the developing country average.



Source: Haver Analytics.
Note: The orange line is the weighted average unemployment rate of all developing countries in 2013.

FIGURE 2.43 Business climate: distance to frontier

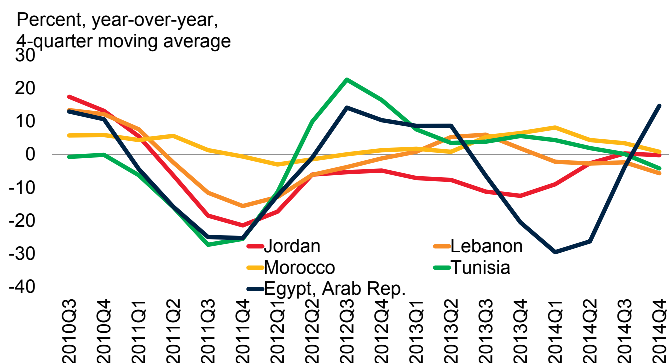
The business environment remains challenging in most MENA countries.



Source: Doing Business 2015, World Bank.

FIGURE 2.44 Growth in tourism arrivals

Tourism a key service export, remains weak.



Source: UN World Tourism Report.

growth-enhancing public investment, or towards debt reduction, as warranted. In the past, this windfall was spent on higher current spending, namely salaries and subsidies. In addition, these fiscal windfalls could also be used to tackle difficult reforms where some upfront expenditures may be required, for example on cash transfers to mitigate reform costs or recapitalization of financial sectors.

Unemployment remains high across the region despite some easing in Algeria, Egypt, and Jordan (Figure 2.42). As a result of an uncertain political and security situation in several countries, there has been little progress in structural reforms. Yet these remain critical to generating job-rich growth in a difficult environment. Labor market reforms need to tilt incentives away from public employment; reforms to level the playing field and increase competition between firms are needed; and a significant strengthening in institutional quality is required (World Bank 2015k, Figure 2.43).

Another long-term challenge is that the development model that dominated in the region—where the state provided free health and education, subsidies for food and fuel, and jobs in the public sector—has reached its limits. While this model delivered high school enrollment rates, basic health care and public sector jobs, it failed to provide quality education, health care, or jobs in the private sector (Devarajan and Mottaghi 2015). To generate private-sector jobs and quality public services, a new development model is needed in which the state facilitates competition in domestic markets in order to generate private sector jobs, and organizes public services in ways that enable citizens to hold officials accountable.

TABLE 2.7 Middle East and North Africa forecast summary

(Annual percent change unless indicated otherwise)

	00-10[a]	2011	2012	2013	2014e	2015f	2016f	2017f
GDP at market prices, developing economies[b,c]	4.5	-0.1	1.3	0.5	2.2	2.2	3.7	3.8
GDP at market prices, geographic region[b]	4.6	3.5	3.7	2.6	3.0	3.0	3.6	3.8
(Average including economies with full national accounts and balance of payments data only)[d]								
GDP at market prices, developing countries[c,d]	4.8	2.6	-1.1	0.9	3.3	2.4	3.3	3.5
GDP per capita (units in US$)	3.1	1.1	-2.6	-0.5	1.8	1.0	2.0	2.2
PPP GDP[e]	4.8	2.5	-1.0	1.0	3.3	2.5	3.4	3.6
Private consumption	4.7	4.7	3.3	3.0	3.4	3.5	3.5	3.5
Public consumption	3.2	2.5	2.4	1.5	5.1	3.7	2.9	2.9
Fixed investment	7.0	0.1	-8.0	-1.1	1.1	2.4	6.8	4.2
Exports, GNFS[f]	5.3	1.4	-5.0	-0.2	1.8	4.6	4.8	5.1
Imports, GNFS[f]	8.2	0.4	1.3	-1.9	3.7	5.3	6.2	6.7
Net exports, contribution to growth	-0.6	0.3	-2.0	0.6	-0.7	-0.4	-0.7	-0.8
Consumer prices (annual average)	7.1	12.0	13.8	19.2	10.9	...	...	...
Fiscal balance (percent of GDP)[g]	0.1	-4.0	-3.8	-5.9	-7.2	-8.3	-6.4	-5.6
Memo items: GDP								
Developing Economies, ex. Libya	4.5	3.0	-0.6	1.1	3.1	2.3	3.5	3.6
High Income Oil Exporters[h]	4.6	7.7	6.1	4.6	3.8	3.8	3.5	3.8
Developing Oil Exporters	4.2	-1.8	0.5	-0.8	1.9	1.1	3.3	3.3
Developing Oil Importers	5.0	2.6	2.5	2.6	2.8	3.9	4.3	4.6
Egypt	4.8	2.0	2.1	2.1	3.2	4.3	4.7	4.8
Fiscal Year Basis	4.9	1.8	2.2	2.1	2.2	4.2	4.5	4.8
Iran	5.0	3.9	-6.6	-1.9	3.7	1.0	2.0	2.0
Algeria	3.9	2.8	3.3	2.8	4.1	2.6	3.9	4.0

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. Growth rates over intervals are compound weighted averages; average growth contributions, ratios and deflators are calculated as simple averages of the annual weighted averages for the region.
b. GDP at market prices and expenditure components are measured in constant 2010 U.S. dollars.
c. Geographic region includes developing and the following high-income countries: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and United Arab Emirates.
d. Sub-region aggregate excludes Djibouti, Iraq, Libya, Syria and West Bank and Gaza, for which data limitations prevent the forecasting of GDP components or Balance of Payments details.
e. GDP measured at PPP exchange rates.
f. Exports and imports of goods and non-factor services (GNFS).
h. Includes all developing economies, except Syria for which data is not available.
i. High Income Oil Exporting Countries: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and United Arab Emirates.

TABLE 2.8 Middle East and North Africa economy forecasts

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

	00-10[a]	2011	2012	2013	2014e	2015f	2016f	2017f
Algeria	3.9	2.8	3.3	2.8	4.1	2.6	3.9	4.0
Djibouti	3.9	4.5	4.8	5.0	6.0	6.5	7.0	7.1
Egypt, Arab Rep.	4.8	2.0	2.1	2.1	3.2	4.3	4.7	4.8
Fiscal Year Basis	4.9	1.8	2.2	2.1	2.2	4.2	4.5	4.8
Iran, Islamic Rep.	5.0	3.9	-6.6	-1.9	3.7	1.0	2.0	2.0
Iraq	-0.4	10.2	10.3	4.2	-0.5	-1.0	5.5	5.9
Jordan	6.3	2.6	2.7	2.8	3.1	3.5	3.9	4.0
Lebanon	5.9	2.0	2.2	0.9	2.0	2.5	2.5	2.5
Libya	4.3	-62.1	104.5	-13.7	-24.0	0.5	15.0	10.9
Morocco	4.9	5.0	2.7	4.4	2.6	4.6	4.8	5.0
Tunisia	4.7	-0.5	3.7	2.3	2.3	2.6	3.4	4.5
Yemen, Rep.	4.3	-12.7	2.4	4.8	0.3	-2.8	2.8	3.4
West Bank and Gaza	3.3	12.2	5.9	2.2	-0.8	0.9	4.3	4.1

	00-10[a]	2011	2012	2013	2014e	2015f	2016f	2017f
Recently transitioned to high-income countries[b]								
Oman	3.3	-1.1	7.1	3.9	4.1	3.7	3.6	3.5
Saudi Arabia	5.1	10.0	6.8	5.1	4.3	4.6	4.1	4.3

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 significantly differ at any given moment in time. Data for Syria are excluded due to uncertain political situation.

a. GDP growth rates over intervals are compound average; current account balance shares are simple averages over the period.

b. The recently high-income countries are based on World Bank's country reclassification from 2004 to 2014.