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Growth Erosion in MENAP during 2000–2018: Reasons and Remedies

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Abstract: The paper examines the reasons for growth erosion in the Middle East, North Africa, Afghanistan, and Pakistan (MENAP) region in the period preceding the Covid-19 crisis. Over the past two decades before the crisis the regions' growth has been lower relative to its peers, despite facing similar circumstances as those countries, such as low oil prices and weak external demand. The paper argues that key reasons for growth erosion in MENAP have been domestic, primarily negative total factor productivity, weak preparedness for shocks, insufficient fiscal buffers, unsystematic fiscal adjustment with arbitrary cuts in investment, and low investment efficiency. External factors—the decline in oil and other commodity prices, weak external demand, and geopolitical tensions—have also been important, but mainly for oil exporters. Key policy options to reinvigorate growth include leveraging technology and trade to improve productivity, developing a macroeconomic risk management system, implementing growth-friendly fiscal adjustment, improving growth inclusiveness, and fostering the private sector.

Keywords: growth, inclusiveness, technology, trade, oil price

JEL Classification numbers: D30, E21, E62, I32

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1 Growth in 2000s before the Covid-19 crisis: Three Steps Down

Growth has been a perennial problem in the Middle East, North Africa, Afghanistan, and Pakistan (MENAP) region. Low growth rates, their high volatility and vulnerability to exogenous shocks have not been conducive to job creation in the region and overall improvement in equity and prosperity in the region. Over the past two decades, the regions' growth has been lower relative to its peers, despite facing similar circumstances as those countries, such as low oil prices and weak external demand. The need to establish the reasons for low and unstable growth in the region and suggest actions policymakers could take to overcome the growth erosion trap motivates this research.

Each MENAP country has a distinct growth history. On a country-by-country basis, it is virtually impossible to detect any common trends, which suggests the need to examine trends in groups of broadly similar countries. The most obvious distinction for the MENAP region is between oil exporters and oil importers. Obviously, growth in oil exporters has depended on oil revenue, whereas in oil importers it has been strongly affected by exogenous shocks. Beyond these distinctions, the only two other trends that have been common for MENAP countries include extreme growth volatility across time and growth variability across countries (Appendix). Based on both metrices, growth has been far more volatile and variable in oil exporters than in oil importers. This extreme growth variability across MENAP countries calls for an aggregated approach in the search for the reasons for growth erosion in the region over the past two decades. Therefore, instead of trying to construct growth equations for each country, and then aggregating them bottom up into a set of common growth determinants, this paper uses a top-down approach by looking at broad growth-determining aggregates, such as investment, consumption, and exports, on average, during three subperiods since 2000.

In 2000–2017, MENAP growth fell by half. Average growth was almost 6% annually in 2000–2008 during a period of relative calm and stability. It dropped to 4% in 2009–2012 during the turbulent episode of the global financial crisis and the Arab Spring. Growth dipped further to 3% in 2013–2017, as a result of latent economic developments, before picking up more recently (Figure 1). During all three episodes, MENAP growth has consistently lagged other emerging markets and developing economies (EMDE), with the difference in growth rates gradually increasing from about 1 to almost 2% points (ppts). Growth in oil exporters, which has been above the average for the region, dropped the most and has been half the rate of comparator countries in the past few years.

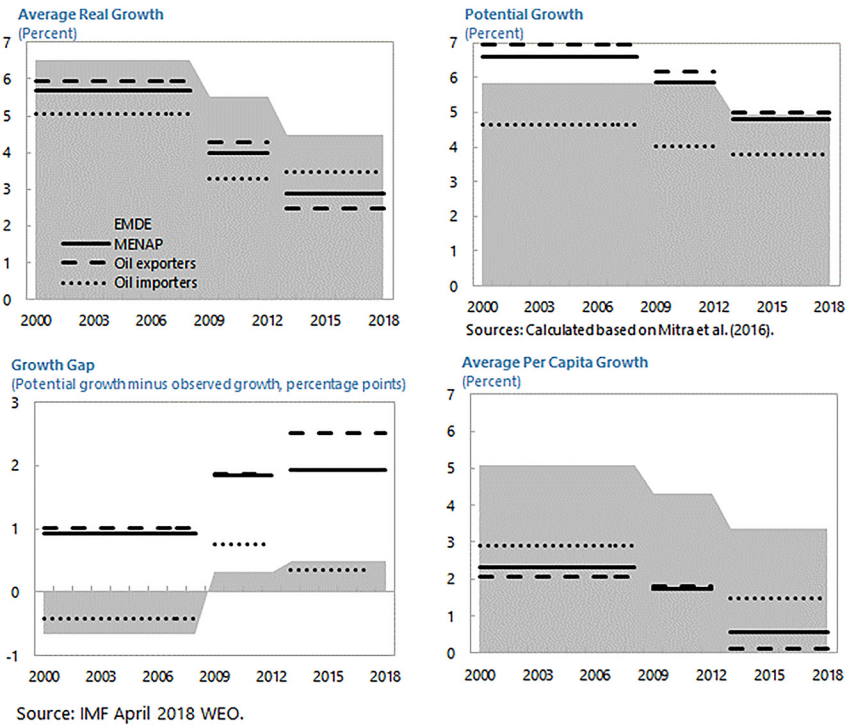


Figure 1: MENAP: Growth, 2000–2017 (percent).

Observed growth has been substantially lower than potential growth. Potential growth in MENAP[1], estimated with statistical filters and the production function approach, suggests that the region has been consistently underperforming its growth potential. Moreover, the gap between potential growth and observed growth doubled in 2000–2017, from 1 to 2 ppts, with significant differences between oil exporters and importers. The gap for MENAP oil-importing countries has been relatively moderate and broadly consistent with EMDEs; however, for MENAP oil exporters, the gap between potential and observed growth rates has tripled.

In per capita terms, growth in the region has been particularly low. With a rapidly increasing population, growth has been clearly insufficient to create employment and make a dent in poverty. MENAP per capita growth was half of the EMDE average during 2000–2008, a third of it in the turbulent period of 2009–2012, and a fifth of it in 2013–2017. While per capita growth in oil importers has still been

1 Defined as the underlying long-term growth, the rate of growth of output, which is consistent with stable inflation (Mitra et al. 2016).

positive and above the average for the region—albeit while declining—in oil exporters, it plunged to zero.

While growth declined in most countries across the world, growth erosion in MENAP was particularly pronounced. MENAP growth dropped by more than in EMDEs and most of its subregions. What explains this trend?

The purpose of the paper is to establish key exogenous and endogenous factors that may have led to growth erosion in MENAP during 2000–2018, before the Covid-19 crisis. The paper does not, however, aim to find the direction of causality from these factors to growth by developing and estimating a growth model for the region. In fact, the direction of causality between these factors and growth can vary depending on the economic structure of each country and the time period under consideration. Rather, this paper reviews the menu of possible factors that can be responsible for growth erosion. Each of these factors should be analyzed separately in country-specific contexts. The Covid-19 crisis has exacerbated further the causes of growth erosion and may have led to scarring. But this is left to further research.

2 Possible Reasons for Growth Erosion

2.1 Literature Review

Recent studies identify several common characteristics of economic growth in the MENA region. Research points at instability of growth and its low level by international standards. For example, looking at the history of growth of the MENA region (Makdisi, Fattah, and Limam 2006), find that growth performance in 1960–2000 has been both mixed and characterized by a higher degree of volatility compared to the other regions in the world. Relative to other regions, investment in the region has been less efficient, trade openness less beneficial to growth, and the impact of adverse external shocks more pronounced. In addition, total factor productivity in the MENA region, has not an important source of growth in comparison to other regions. This may reflect the lower quality of its institutions, modest stock of human capital and the educational system that focused on preparing students mainly for public sector employment. Within the MENA region, nonoil and diversified economies have fared much better than the oil-exporting countries both in terms of growth and total factor productivity.

Political instability may have been an important factor in growth in some MENA countries. Arayssi, Fakih, and Haimoun (2019) argued that political instability adversely affects growth. Consistent policies aiming at improving the efficiency and the operation of institutions, such as a country's legal system, citizen's participation in selecting government, freedom of expression, are needed to boost economic

growth and reducing poverty. In this context, a number of papers looked at the impact of the Arab Spring on growth. Beser and Kilic (2017) suggested that civil commotions started with the Arab Spring had brought economic and political crises, with many economic, social and political factors had been effective on starting this process. Arayssi et al. (2019) found that the Arab Spring had been negatively associated with growth, as civil disorder dampens economic growth, have negatively affected macroeconomic stability, burdened the budget balance, and increased the public debt.

The region has fully not used the potential of trade to enhance growth. Hoekman (2016) argues that MENA countries have failed to reach their economic potential in large part due to trade barriers, failure to diversify their economies, and lack of investment incentives. A typical MENA country exports less than half, and as little as one quarter, of its potential. Ambitious "top-down" regional initiatives central to MENA international relations have failed to bring about increased trade and economic growth. The author sees the intraregional trade as an opportunity for MENA to boost economic growth and job creation through lower nontariff barriers and reduced trade costs. Regional cooperation in MENA offers better prospects for supporting growth if pursued on an à la carte, bottom-up, pragmatic basis involving greater participation from businesses and communities. Much like Europe, regional cooperation could generate long-term payoffs for MENA that go beyond economic growth by creating incentives to sustain peace and security. In the same vein, Hamdan (2016) finds that the exports and imports have positive effect of economic growth in Arab countries and points at the need to increase the imports of technology improve labor productivity which can directly promote economic growth.

A relatively shallow financial sector has been a significant constraint to growth. Naceur and Ghazouani (2007) looked at the relationship between financial development and economic growth and found no significant relationship between banking and stock market development, and growth in MENA. Omri et al. (2015) examined the relationship between financial development, CO_2 emissions, trade and economic growth. They found unidirectional causality run from financial development to economic growth and from trade openness to CO_2 emissions. At the same time, there is feedback, i.e., bidirectional causality between CO_2 emissions and economic growth, economic growth and trade openness, and trade openness and financial development. Neutrality hypothesis was identified between CO_2 emissions and financial development. Arayssi and Fakih (2017) showed that the impact of finance on growth was positive pre-Arab Spring but lost some of its significance after it and became contingent on socio-political reforms aimed at improved institutional quality. Finally, Arayssi, Fakih, and Kassem (2019) found evidence that financial development is a strong positive contributor to growth, but

a well-functioning financial system is a necessary but not a sufficient condition to enhance growth.

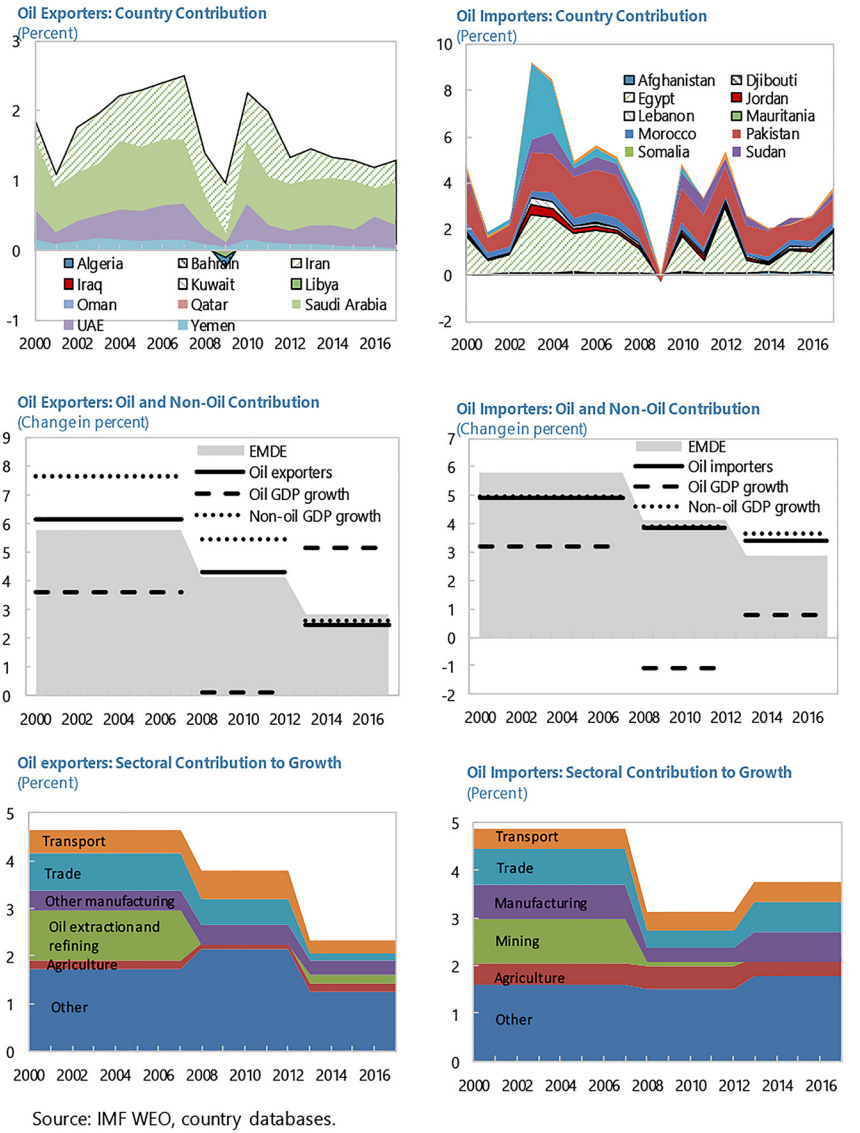
Several studies identify governance as an important impediment to growth. Hakimi and Hamdi (2017) pointed that corruption is a serious hurdle to economic growth in MENA countries since it affects investment activities and foreign direct investment inflows. Kutan, Samargandi, and Sohag (2017) scrutinize the role of institutional quality in the linkage of financial development and economic growth. They find that not all measures of financial development promote economic growth in the absence of institutional quality, but they all augment growth in the presence of institutional quality. Abdelbary and Benhin (2019) found a significantly negative impact of weak regulatory quality on growth underlining the importance of governance to improve the growth prospects. Finally, Arayssi et al. (2019) found that restructuring of governance institutions positively affect growth. Therefore, governments should pay closer attention to rebuilding public institutions, which would allow markets to operate under better economic conditions, potentially create more jobs and help reduce unemployment, and improve growth.

Labor, investment and other structural rigidities may have played a role in growth in MENA countries. Fakih and Ghazalian (2015) point at labor market constraints as prominent obstacles labor regulations and skill labor shortages. Fakih and Marrouch (2015) find strong evidence of a long-run relationship between employment and growth, which points at the need to increase the level of labor-promoting investments. Abdelbary and Benhin (2019) found strong positive impact of human capital and investment on growth. Al-Mulali (2011) identified oil consumption as an additional structural factor of growth of the MENA countries. Kutan, Samargandi, and Sohag (2017) find that access to foreign direct investment enhances the growth of MENA countries by the development of financial markets. Finally, Kalai and Zghidi (2019) found a long-run unidirectional relationship running from FDI to economic growth in MENA countries, supported by positive spillover externalities.

Overall, the literature on growth in MENAP focuses mainly on individual and country-specific determinants of growth. The following section offers a broader view on growth in this region, considering supply-side, demand-side, external and distributional factors insufficiently addressed in earlier literature.

2.2 Supply-side Factors

The overall growth in MENAP largely depends on oil exporters, which produce about 80% of its GDP. Of 11 oil exporters with available data, four contributed three-fourths of their combined GDP in 2000–2017: Saudi Arabia (27% of oil exporters' GDP), Iran (26%), UAE (11%), and Algeria (10%) (Figure 2). Among oil exporters, the



Source: IMF WEO, country databases.

Figure 2: MENAP: Country and sectoral sources of growth, 2000–2017 (percent).

contribution to growth from Saudi Arabia, Iran, and UAE has been lower in the last few years relative to the early 2000s, reflecting mainly fiscal adjustment driven by the decline in oil prices, lower oil production in Iran under sanctions, and regional conflicts. Sectoral contribution to growth in oil exporters confirms that dwindling oil

production and refining have been the main reasons behind low and declining growth.

Growth in oil exporters has been strongly affected by oil GDP, which has been variable. After below average performance in 2000–2008, the average oil GDP growth was almost flat in 2009–2012, reflecting mainly an oil output drop in Saudi Arabia (–10% in 2009) during the global financial crisis, Iran (–37% in 2012) during heightened sanctions, Algeria (consistent annual decline by 3% on average in 2006–2014), and Yemen (–13% on average in 2011–2012) with the onset of the civil conflict. Oil GDP recovered somewhat in 2013–2017, reflecting mainly the easing of sanctions on Iran (52% growth in 2016) and the return of Iraq to the oil market (21% annual growth in 2015–2016). Weaknesses in oil GDP most likely reflected several cuts in oil production to support prices and problems in oil refining and processing. The 2016 agreement by major oil-producing countries to cut crude oil output (the "OPEC+" agreement) helped increase oil prices, although they remained variable. The key uncertainties are related to the degree of compliance with the agreement, prospects for higher production by countries either exempt or not participating, and lower oil demand given the downside risks to global growth.

Spillovers from the uneven oil output weighed on nonoil growth in oil-exporting countries. Performance of the nonoil sector strongly depends on the oil sector, and its growth remained below EMDE averages in recent years. While the contribution to growth from nonoil activities has been broadly unchanged, growth in two key nonoil sectors—trade and transport—has clearly followed the declining trend of oil output. The contribution to growth of other nonoil sectors, including manufacturing, agriculture, real estate, government, and social services, remained broadly unchanged.

In addition to oil, these countries export other products. Some of them have recently started developing sectors other than oil, such as tourism. However, the growth rates of such other industries in oil-exporting countries have been highly unstable and variable from country to country. Therefore, given their relatively low weight in GDP, such nonoil industries could not to affect the overall declining growth trend.

Growth in oil exporters has an important impact on oil importers. As a result of official transfers, remittances, and FDI from oil exporters, growth in oil importers (e.g., Egypt and Jordan) may in part reflect growth fluctuations in oil exporters. This means that a collapse of oil prices could have wide-ranging consequences for the region, and could be the most important risk to the outlook.

Finally, a simple growth accounting points at low productivity in MENAP as a drag on growth. An IMF study found that in MENAP, relative to countries in other regions, productivity tended to contribute little to growth, while labor contributes significantly more (REO, October 2017, Box 1). This finding reflects policies that favor

the employment of low-wage foreign workers in the private sector, while nationals with high wages are employed mainly in the public sector. Globally, there is a positive association between capital and productivity contributions to growth during high-growth periods, suggesting productivity gains increase business profitability and promote private investment, and vice versa. The productivity-investment link is largely absent in most MENAP oil-producing countries.

Box 1 Growth Accounting

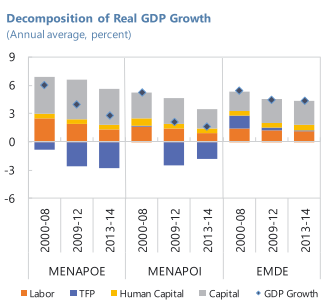
Growth drivers on MENAP countries have been substantially different from EMDEs. Following Dabla-Norris et al. (2013), growth of GDP per capita can be decomposed into labor utilization and average labor productivity, the latter reflecting contributions from capital stock per worker (capital intensity), human capital per worker, and total factor productivity (TFP):

$$Y_t = K_t^{\alpha}(A_t H_t)^{1-\alpha} = K_t^{\alpha}(A_t h_t L_t)^{1-\alpha}$$

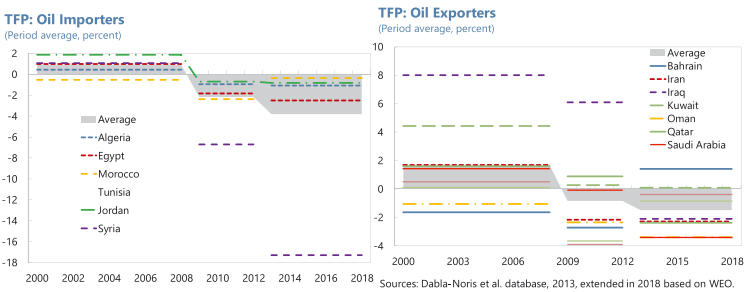
where Y, K, H, h, L, and A stand for output, physical capital, effective labor input, human capital per person, employment, and total factor productivity (TFP), respectively, while α and (1-α) refer to the capital share and the labor share.

TFP has been the main drag on growth in MENAP. Both MENA oil exporters and oil importers have invested massively in the past two decades, even more than the rest of EMDEs. Their labor utilization has been broadly comparable to that of EMDEs. However, the contribution of TFP to growth has been negative, particularly after 2012.

The negative TFP contribution to growth may reflect the dropping labor and capital productivity in MENAP. Although the TFP is a residual and may capture measurement errors, it is usually interpreted as an indicator of technological change, negative in the case of MENAP. This increasing negative input of TFP in growth differentiates MENAP from all other EMDEs, where TFP has been positive, and may be an important explanation of growth erosion in MENAP.



The negative TFP contribution has been broad-based in MENAP. Among oil importers, the largest drop in TFP was in Syria, in particular with the onset of the civil conflict there, and in Egypt, reflecting the gradually deteriorating economic situation. Among oil exporters, the TFP decline has been broad-based and affected Saudi Arabia, Qatar, Oman, Iran, and Iraq.



The impact of oil importers on the region's overall growth is substantially lower, as they produce only about 20% of MENAP's GDP. Among oil importers, three countries produce three-fourths of the output: Egypt (36% of oil importers' GDP), Pakistan (32%), and Morocco (9%). The lower regional growth reflects mainly growth deceleration in Pakistan, Egypt, and Sudan in 2013–2017, relative to 2000–2007, and a virtually complete disappearance of the contribution from Syria with the onset of civil conflict in the country. The growth patterns have reflected the vulnerabilities stemming from the region itself. Some regional conflicts and security risks have become more protracted and escalated, leading to further human loss, destruction of infrastructure, outward migration, disruption of regional trade routes and cross-border investments, and shrinking tourism, including in neighboring countries.

In oil importers, nonoil GDP growth has been declining, but not as fast as in the rest of EMDEs. Among key sectors, mining has clearly weighed negatively on growth, as a decline in commodity prices reduced government revenues and export receipts and widened current account deficits in Egypt (gold, phosphates, refined products), Pakistan (cotton and cement), Mauritania (iron ore, gold, copper), Morocco (phosphates, wheat, vegetables), and Sudan (oil and gold). The oil GDP in oil importers where oil is produced (Egypt, Mauritania, Sudan, Syria, and Tunisia) shrank in 2009–2012, and did not recover thereafter. This was primarily the result of the split of Sudan, with most oil fields remaining in South Sudan; a complete discontinuation of oil production in Syria; and highly unstable and declining oil

output in Mauritania. Although the oil sector is secondary in most oil-importing countries, its decline was the largest single factor in the growth slowdown in oil importers. The contribution to growth of most other sectors also declined—in particular, trade and transport—while agricultural activity remained vulnerable to weather and price developments (Morocco, Pakistan, Somalia). Furthermore, social tensions and reform fatigue increased as growth remained subdued and unemployment remained high, undermining the impetus for much-needed fiscal and structural reforms.

2.3 Demand-side Factors

National saving declined in both oil exporters and oil importers in the 2000s. The demand-side drivers of growth have been determined mainly by the saving-investment dynamics, and they differ substantially between oil exporters and oil importers (Figure 3). MENAP national savings have been traditionally high and have exceeded the EMDE average, reflecting mainly consistent current account surpluses in oil exporters. This is also despite the fact that national savings in oil importers have been historically very low. However, with the drop of oil prices during the recent latent growth episode, MENAP national saving dropped below the EMDE average. In oil importers, the decline of national saving has been particularly strong, and these countries had to rely increasingly on capital inflows from the rest of the world.

Lower national saving affected both investment and consumption. In oil exporters, investment has been the main growth driver, while in oil importers, final consumption has been propelling growth. Investment in MENAP has been historically high and remained relatively high even during the turbulent and the latent growth episodes, staying broadly in line with the average EMDE ratio. At the same time, while oil importers underinvested relative to the averages, their high consumption has supported growth for the region. In oil exporters, the level of investment remained broadly unchanged in the turbulent and the latent growth episodes, and even increased, but still has not been sufficient to preserve growth, suggesting low investment efficiency.

The role of exports, an important growth driver in MENAP, has declined in recent years. On average for MENAP countries, and particularly for oil exporters, exports have been substantially higher as a share of GDP relative to EMDEs. Also, exports performed relatively well even through the turbulent period of 2009–2012, although they declined in 2013–2017, reflecting mainly weakness in international demand before the recent pickup in activities. In line with the international trend, export has become a less important growth factor, as export-oriented

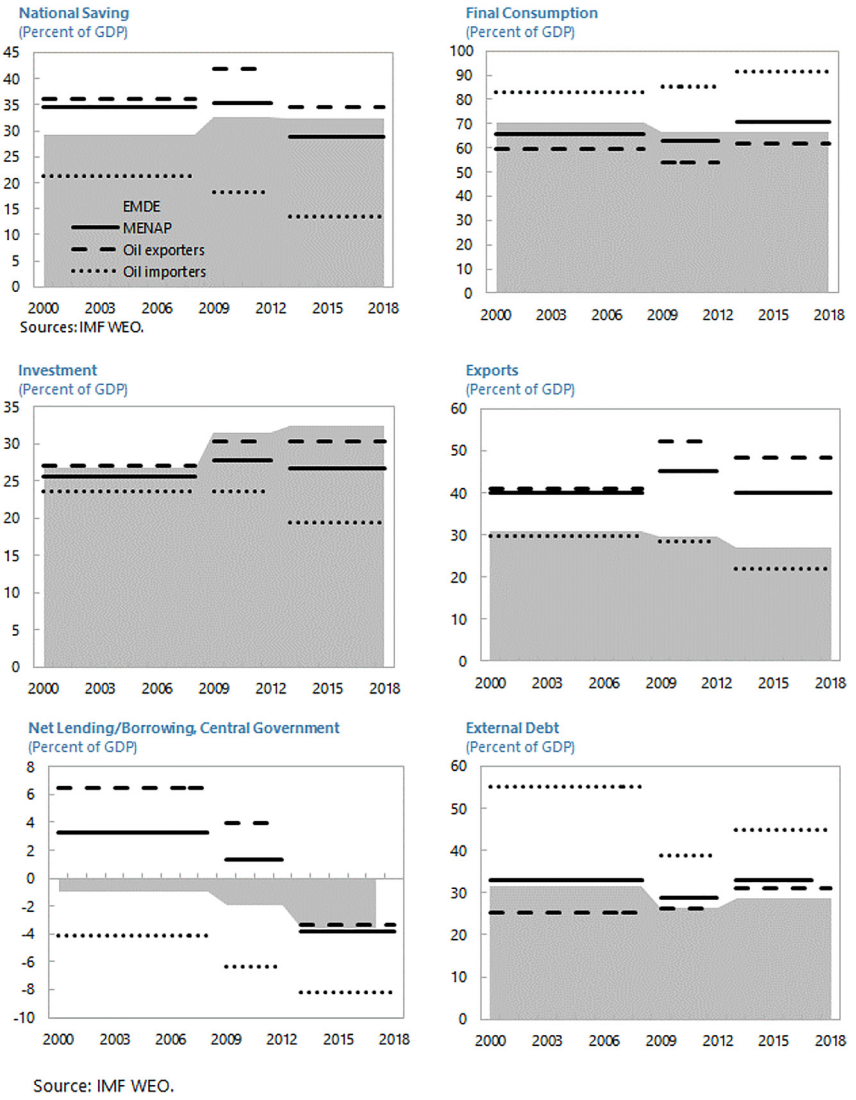


Figure 3: MENAP: Demand-side growth factors, 2000–2017 (percent of GDP).

industrialization has reached its limits. This applies less to low- and middle-income countries in MENAP, especially Egypt, that has a large population and relatively low wages. In these types of countries, there could be potential for export-oriented growth.

Fiscal adjustment has negatively affected aggregate demand and may have been a factor behind dwindling growth in MENAP. While fiscal deficits have been a constant feature of oil importers, MENAP oil exporters have had substantial fiscal surpluses, including during the global financial crisis and the Arab Spring[2]. Since 2013, however, with the drop of oil prices, the region's oil-exporting countries' fiscal surpluses turned into deficits comparable in magnitude to the deficits of other EMDEs. Deficits jumped from 1% of GDP in 2014 to 11% of GDP in 2016. About half of MENAP oil exporters (Iran, Kuwait, Qatar, United Arab Emirates) had fiscal deficits of less than 5% of GDP in 2016, while the other half had deficits well above 10% of GDP. The countries with low deficits typically have substantial buffers (Kuwait, Qatar, United Arab Emirates), or are less dependent on oil revenues (Iran) (MCD REO, October 2017).

Since 2017, the pace of fiscal adjustment in MENAP slowed. In oil exporters, with rising oil prices the average fiscal deficit dropped to 5% of GDP and reduced pressure for adjustment. As a result, fiscal adjustment in Saudi Arabia was less than initially set out in the budget as higher expenditures were supported by higher-than-expected nonoil revenues. In Qatar, the availability of fiscal buffers allowed for more gradual fiscal adjustment than expected. Outside the GCC, fiscal adjustment efforts continued in 2017, especially in Iran and Iraq, However, large increases in expenditures are expected to generate significantly larger fiscal deficits in Algeria, where adjustment is expected to resume from 2019, and Iran (MCD REO, April 2018). In MENAP oil importers, subsidy reforms, reduced capital spending, and stepped-up revenue mobilization are helping sustain an improvement in the fiscal position from a deficit of 6.8% of GDP in 2016 to 6.5% in 2017.

In the absence of contingency plans, fiscal adjustment, where it took place, has been partial and somewhat disorderly. In oil exporters, fiscal adjustment measures fell mainly on domestically financed capital expenditure (Algeria, Iraq, Iran) and nonwage current spending, and only marginally on the wage bill (Iraq). The introduction of value-added taxes and excise taxes has been delayed. Overall, none of the MENAP oil exporters—even countries with projected medium-term surpluses—have accumulated sufficient resources to protect the economic well-being of future generations once hydrocarbon resources are exhausted. Fiscal efforts to broaden the revenue base and to reduce dependence on oil receipts have not been sufficient and needed support by improvements in fiscal frameworks and institutions. However, only a few oil exporters achieved progress in this area (Algeria, Kuwait, Qatar, Saudi

2 Fiscal deficit (net ending/borrowing) may not necessarily be an optimal measure for the demand impact of fiscal policy because it tends to be sensitive to oil price fluctuation, in particular in oil exporters. A nonoil primary balance, nonoil cyclically adjusted or structural primary balance, possibly together with a "fiscal impulse" calculation, may bring additional information.

Arabia, and UAE). More broadly, strengthening public financial management, including improving transparency and accountability, would have supported the fiscal adjustment efforts and could generate additional fiscal space.

Instead of fiscal adjustment, many oil exporters opted to finance the growing fiscal deficits by debt. Increasing debt levels, beyond country-specific thresholds, have been shown to depress growth. The overall debt level of MENAP oil exporters increased by an average of 10% points of GDP each year since 2013, exceeding for the first time the average for EMDEs—although remaining at a sustainable level. In oil importers, debt, after some decline due to debt relief, started increasing again and already substantially exceeds the average for EMDEs. In Egypt, Lebanon, and Sudan debt already exceeds 80% of GDP (MCD April 2018 REO). Countries with market access have tapped significant amounts from international markets. While issuing debt internationally avoided crowding out the private sector, most countries were not sufficiently prepared for the deterioration in international market conditions. Only a few MENAP economies (Kuwait, Oman, Saudi Arabia, and UAE) developed an asset-liability management strategy to account for the development on international financial markets, and the accompanying risks and established debt management offices. In most other MENAP countries with limited external financing options (Iran, Iraq, Libya, Yemen), domestic debt issuance, and even monetization of the deficit, have become the main instruments for deficit financing. Debt service crowds out growth-enhancing expenditures—for instance, interest payments are, on average, between 5 and 10% of GDP for Egypt and Lebanon. The ensuing crowding out of the private sector and inflation have taken a toll on regional growth.

Obviously, the impact of fiscal adjustment on growth depends on the balance between the demand-side and supply-side. In MENAP, recent fiscal adjustment stemmed from the emergence of significant deficits. It reflected at least in part the stabilizing role of fiscal policy with respect to external shocks, such as the global financial crisis or the drop in international oil prices. It is possible that on balance, considering the role of fiscal policy over the entire period, the impact of fiscal policy on demand has not been necessarily negative. The supply-side dimension of fiscal policy, such as tax policy changes, may affect not only demand but also incentives and thereby the supply side, which can affect long-run growth.

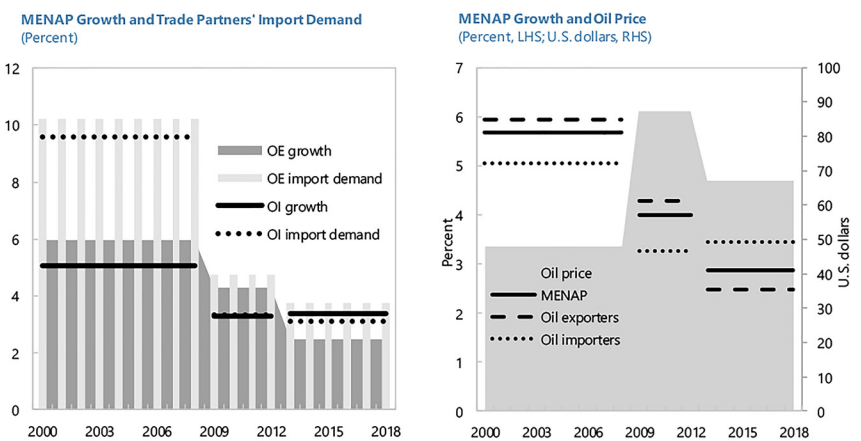
2.4 External Factors

Numerous external factors, broadly exogenous to most MENAP countries, affect their growth. Three of them stand out: external demand, oil prices, and in the MENAP region, geopolitical conflicts. Weak external demand, depressed commodity

prices, and heightened geopolitical tensions have been common to most countries of the world—both oil exporters and oil importers. Until late 2017, growth across the world was anemic for almost a decade after the global financial crisis. Yet, growth erosion in MENAP has been deeper than in EMDEs.

Import demand in key trade partners and oil prices are the two most important external factors affecting growth. In oil exporters, growth was relatively high in 2000–2007 at 6%, when external demand for their exports was also high and average oil prices were relatively low, at about US$40 per barrel (Figure 4). In the turbulent period of 2009–2012, growth dropped to 4% and external demand also declined substantially, while oil prices were very high, at about US$90. Finally, during the recent latent growth episode, growth dropped further to 3%, along with import demand, and oil prices declined to US$70 on average. In oil importers, the trends have been broadly similar, although the growth levels have been lower than in oil exporters, except for the recent episode.

Geopolitical tension and conflicts also dampened growth in MENAP, and continue to be dominated by security conditions and oil production capacity. The situation worsened substantially after the Arab Spring in 2011–2012. According to the UN security designation, seven MENAP countries (Afghanistan, Iraq, Libya, Pakistan, Somalia, Syria, and Yemen) were designated as high or substantial security risk locations (Figure 5). These countries produce in 2017 about 18% of regional GDP (11% excluding Pakistan). Growth risks for MENAP oil exporters remain tilted to the downside. Considerable uncertainty surrounds the oil price outlook, but, on balance, risks from oil price volatility appear more on the

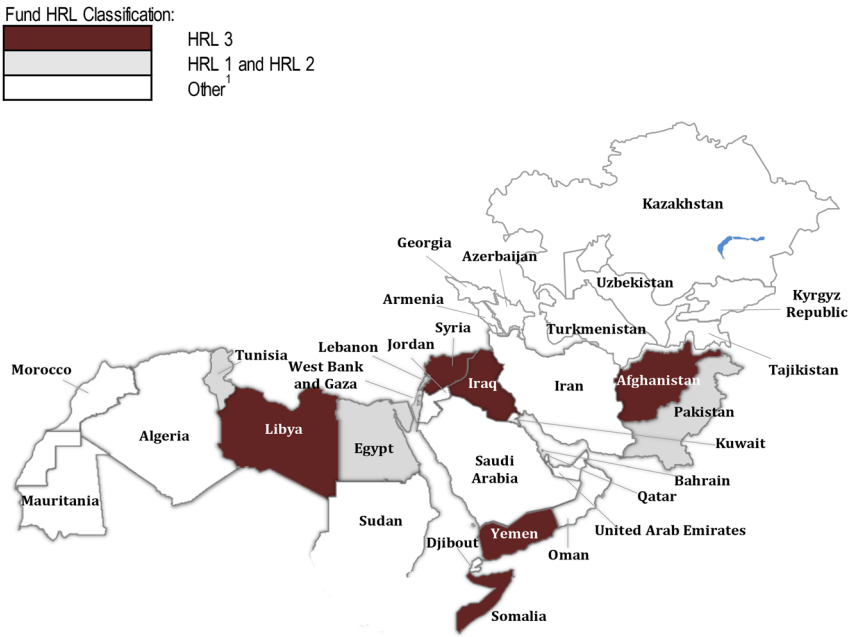


Source: IMF WEO.

Figure 4: MENAP growth factors: External demand and oil price, 2000–2017.

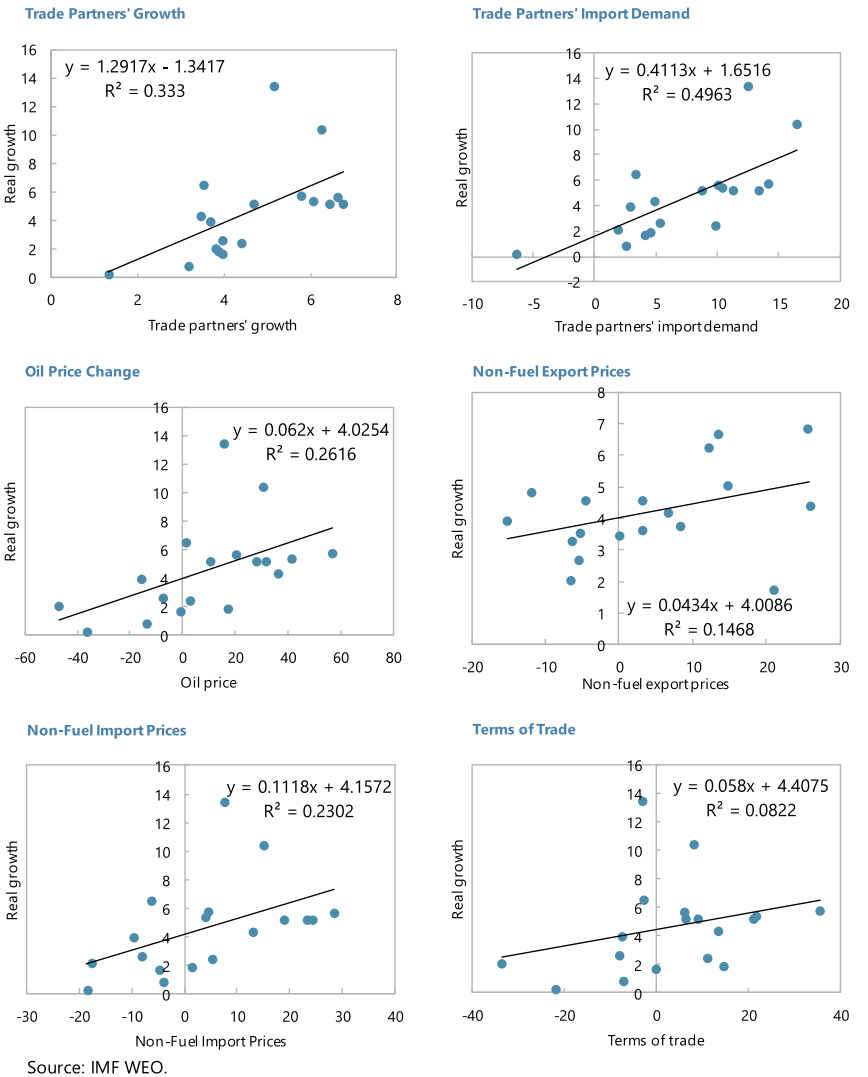
downside given the substantial fiscal and current account deficits. Downside risks from regional conflicts and geopolitical developments also remain. There are also other, more global risks that could affect the region, such as a possible shift toward inward-looking policies in advanced economies. This shift could affect global growth, impacting MENAP oil exporters, especially if such policies drive oil prices lower.

External factors have played a significant role in MENAP oil exporters' growth. In oil exporters, three external factors clearly correlate with growth —trade partners' own growth, trade partners' import demand, and oil prices (Figure 6). Thus, an increase in the demand for MENAP exports in its trading partners usually helps lift growth, and stagnant and declining demand in trading partners dampens growth. The pursuit of inward-looking policies by advanced economies is harmful for growth. Obviously, oil prices also affect growth, mainly through public and private consumption, and investment. For example, the recent episode of lower oil prices has dampened both oil and nonoil growth in MENAP oil exporters. Other external factors seem of lesser importance. Although there is some positive correlation with nonfuel import and export commodity prices, as well as with the terms of trade, these factors seem secondary.



Sources: IMF, and Microsoft Map Land.

Figure 5: MENAP: UN security level map, 2017.



Source: IMF WEO.

Figure 6: MENAP oil exporters: External factors of growth, 2000–2017 (percent).

For MENAP oil importers, the external environment has clearly been a secondary growth factor. There is no statistically significant correlation between any of the six external growth drivers and growth in MENAP oil importers (Figure 7). Economic activity in key trading partners affects growth mainly through remittances, exports, FDIs, and tourism. With the notable exception of remittances, growth performance in most of these areas reflects mainly domestic policies rather

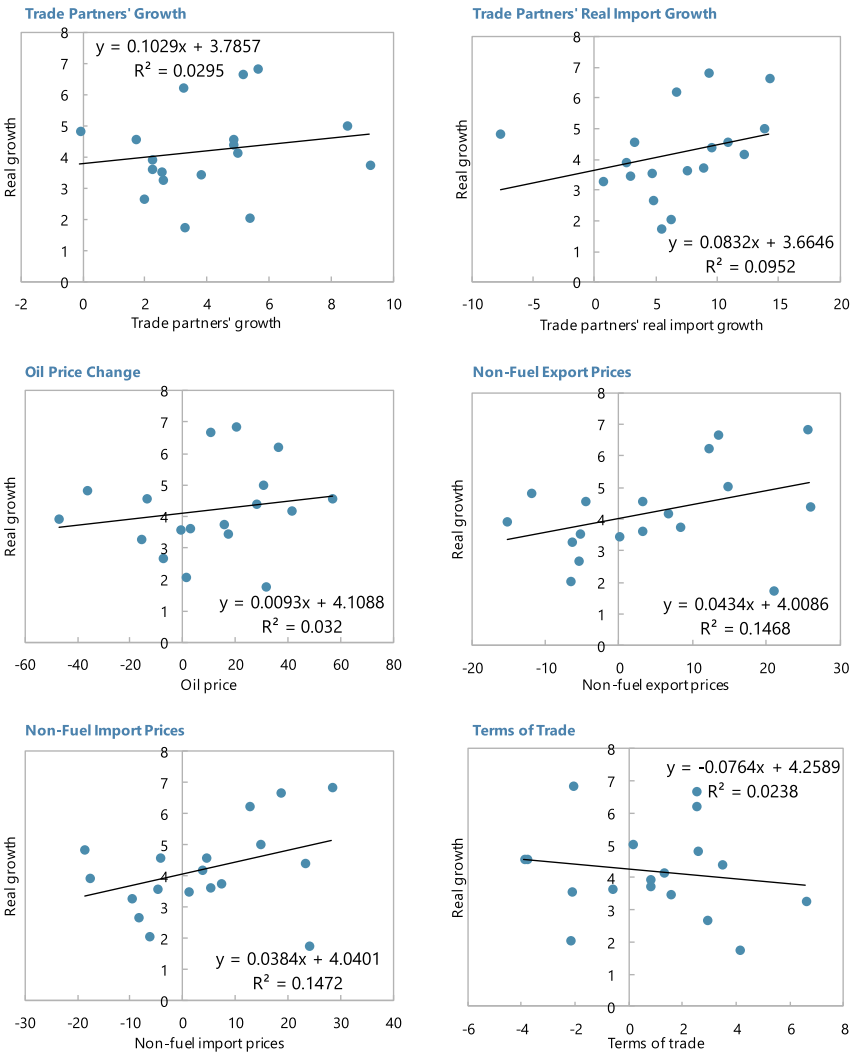
than the conditions in trading partners. For example, Egypt's investment and exports rose due to the floating of the exchange rate, the lifting of foreign currency restrictions, and the implementation of the industrial licensing and investment laws; exports increases in Morocco and Pakistan reflected upgraded export capacity; larger FDIs inflows to Egypt and Morocco were related to improvements in the local business climate; and regulations and higher tourism arrivals to Egypt, Jordan, Morocco, and Tunisia improved local security conditions (IMF 2017a).

2.5 Distributional Factors

Inclusiveness generally affects growth. Higher inclusiveness, defined here as equality of opportunities, is usually associated with higher growth. Earlier research suggests that improved inclusiveness boosts growth while lack of inclusiveness dampens it (Kireyev and Chen 2017). A dynamic measure of growth inclusiveness can be derived from growth incidence curves. Growth incidence curves (GIC) help identify the extent to which each decile of households benefits from growth in terms of its impact on real consumption expenditure (Figure 8). In plotting GICs, the vertical axis reports the growth rate of consumption expenditure, and the horizontal axis reports real consumption expenditure percentiles. The GIC assesses how consumption at each percentile changes over time. A stylized case allows for the identification of some characteristics of growth inclusiveness. The parts of the curve above the *X*-axis are the deciles that benefit from growth, and the parts below the *X*-axis are the deciles that lost because of growth.[3]

Between two data points, for which comparable household surveys are available, per capita expenditure of the poor clearly improved relative to the rich only in 2009–2014 in Iran, as the authorities have taken steps to improve growth inclusiveness. In 2010, the government implemented a universal cash transfer funded by the elimination of fuel subsidies. Each citizen received the equivalent of US$45. For large and poor families, the transfers doubled incomes. As a result, the GINI coefficient improved from 0.41 to 0.37 with a sharp drop in inequality in rural areas. The GIC for Iran shows that the cash transfer was particularly beneficial to the poorest 10% of the population, who saw their consumption rise by 3.3%. At the same time, consumption of the richest 10% declined by 2.2%. Tunisia in 2005–2010

3 Data constraints limit the use of GICs in MENAP countries. At least two household surveys are needed, which should cover the consumption or expenditure of the population. These surveys should be based on a comparable methodology and use comparable data, including household and socio-demographic variables (i.e., head of household, education, marital status, employment and residence). Even when comparable household surveys are available, numerous data challenges remain.



Source: IMF WEO database.

Figure 7: MENAP oil importers: External factors of growth, 2000–2017 (percent).

also seemed to have taken steps to improve inclusiveness, but the efforts were insufficient and piecemeal, in particular for the middle class, and were taken too late to prevent major civil unrest in 2010–2011.

Some other countries of the region present a very different growth picture from the point of view of inclusiveness. For example, in Djibouti between 2002 and 2013,

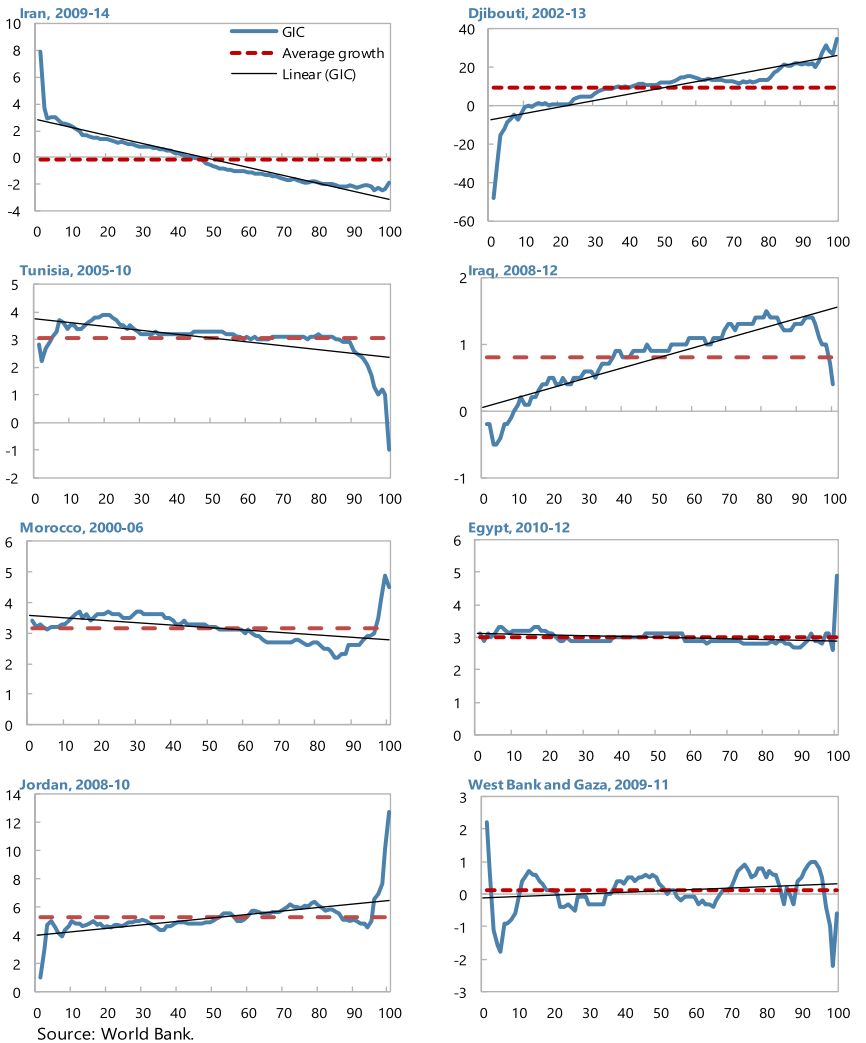


Figure 8: MENAP: Distributional factors of growth, 2000–2014 (percent).

growth was not inclusive. The poorest in society—captured by those at the bottom 10% of the income distribution—saw their consumption fall by 13%. By way of contrast, Djibouti's rich, the top 10%, saw their per capita consumption grow by 26% over this period. The same is true for Iraq in 2008–2012, where the gap between the rich and the poor increased. Insufficient information is one reason why the distributional dimension of growth has not been sufficiently in the center

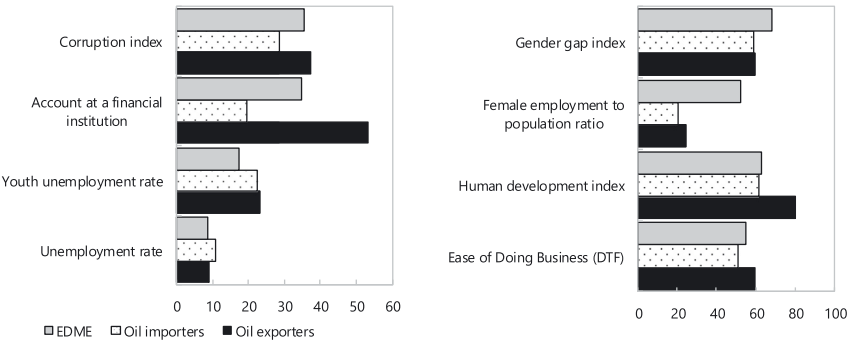
of the authorities' attention. Household surveys, which are critical for any distributional analysis, have not been conducted regularly in all MENAP countries. And even if when they were, the results at times have not been published or published with significant delays which made them less relevant for policy making.

In all other available cases, the distributional impact of growth is hard to distinguish. In Morocco in 2000–2006, Jordan in 2008–2010, Egypt in 2010–2012, and West Bank and Gaza in 2009–2011, growth has not led to any visible changes in the distribution, which, in all cases, remained highly unequal. In Iraq, and West Bank and Gaza, per capita growth was close to zero, and even negative in Iran. Statistical deficiencies of the household surveys can be part of the reason why the distributional impact of growth is hard to detect in these countries. For example, the two-year time lag between two surveys in some countries may not have been sufficient for any meaningful changes in consumption patterns of different deciles of the population.

Other social indicators also point to insufficient growth inclusiveness. With poverty rates and a GINI inequality coefficient unavailable for most countries in the region, the impact of social outcomes on growth inclusiveness can be assessed only indirectly (Figure 9). About one-third of the region's population is estimated to live in poverty. In 2010–2015, the average unemployment rate stood at 9% in oil exporters and 11% in oil importers, both higher than in EMDEs. With over 60% of the population under the age of 30, the region desperately needs higher growth and more jobs. Meanwhile, youth unemployment was about 23% relative to 17% in EMDEs. The region faces a legacy of some of the lowest employment rates globally: less than one in two works. In large part, this reflects low participation by women, who are three times less likely than men to be in the labor force. The situation is similarly difficult for youth: only one in four works. MENAP oil importers fare particularly poorly in financial inclusion, corruption, human development, and ease in doing business, relative to EMDEs and MENAP oil exporters.

3 Remedies: Policy Options

The diagnostics of the reasons for growth erosion in MENAP point at possible remedies. Based on earlier research (such as Fabrizio et al. 2017; Mitra et al. 2016), several broad policy directions stand out: leveraging technology and trade to improve productivity, developing a macroeconomic risk management system, implementing growth-friendly fiscal adjustment, improving growth inclusiveness, and developing the private sector and financial resilience. The application of these recommendations would have to be adapted to MENAP countries, which may have different fiscal, investment, and employment multipliers, region-specific fiscal and



Source: World Development Indicators, World Bank.

Figure 9: Selected social and inclusiveness indicators, 2010–2015.

risk-management rules, different weight and role of the private sector in growth, and other regional challenges.

To improve productivity, MENAP governments could focus on strengthening innovation and education, research and development, technology transfers, and entrepreneurship. To support capital accumulation and the adoption of new technologies, possible steps include: boost investment through carefully selected public investment projects and by removing obstacles to private investment; ease access to credit and stimulate investment in physical capital; and send clear signals about the directions of economic policy, particularly fiscal, monetary, structural, and trade policies, to attract FDIs (see Adler et al. 2017 for details). Also, fiscal policy could support innovation through payroll tax relief for researchers and refundable tax credits (see IMF Fiscal Monitor 2016 for details). Additional investment by MENAP governments in education, infrastructure, and institutions would facilitate technology transfers from advanced economies. Fiscal incentives to foster innovative entrepreneurship should be targeted to new companies rather than small companies. Innovation can also be promoted by tax design—for example, through provisions to offset taxable losses. Finally, redirecting public spending toward productive public investment can stimulate private sector activity and strengthen long-term growth prospects by raising worker productivity. For example, investment of the resources saved from the reform of the energy subsidies (estimated at around 3% of GDP in 2016, on average, for the Arab world) could boost output by about 2% points over six years for every percentage point of GDP reduction in subsidies (Fedelino et al. 2017).

MENAP countries could leverage better the international business cycle. Global growth upturns would allow to reap the full benefits from trade through export-led growth. Illustrative calculations suggest that achieving greater trade openness, coupled with increased global value chain (GVC) participation, export diversification, or product quality, could raise the level of income by some 5–10% within five to 10 years (MCD REO, October 2017). Oil importers are better placed than other countries in the region to take advantage of global trade, given their better integration into GVCs and more diversified export bases. However, they could still improve the quality of their exports. In contrast, oil exporters should focus on economic diversification to produce and export a broader range of goods and services. Most countries would benefit from deepening access to export markets through trade agreements and by leveraging new integration opportunities, such as China's Belt and Road Initiative. Structural reforms to foster investment and job creation, as well as targeted fiscal policies to mitigate adjustment costs, may be needed to relieve any negative consequences of increased openness and to ensure the resulting boost to growth is as inclusive as possible. Trade openness, underpinned by the expansion of the multilateral trading system, can bring about higher productivity, greater competition, lower prices, and improved living standards (IMF 2017b; World Bank/WTO 2017). Most MENAP countries have outlined ambitious diversification strategies and are developing detailed reform plans, but implementation should be accelerated, particularly to exploit the stronger global growth momentum.

To increase growth, MENAP government could also target new technologically advanced industries with high employment multipliers. While research on employment multipliers is very sparse, a survey of the literature indicates that one job created in an infrastructural sector can generate 1.2–3.5 additional jobs (Ianchovichina et al. 2013). For example, investment in railroads, ports, electricity, and communication sectors have far greater potential to create induced and indirect job effects than investments in the roads, bridges, or water. Direct employment refers to employment directly involved in the production of products or services in a given sector. Such direct employment also generated employment in the sectors that supply goods and services to the given sector. Revenue spent by those who are both directly and indirectly employed generates induced employment elsewhere in the economy. For example, the employment multiplier of 4 means that each direct job creates an indirect job, and that each of those two jobs creates an induced job—thus, a total of 4 jobs per direct job (1 direct, 1 indirect, 2 induced). Therefore, beyond investment in electricity and railroads, policymakers should focus on creating firms in high-tech industries through investment in specific skills and financing.

Fiscal adjustment should become growth friendly. To preserve positive growth dynamics in a high debt environment, MENAP countries would benefit from fiscal adjustment while pursuing policies that enhance growth and inclusiveness and set debt anchors to guide debt sustainability over the longer term. On the revenue side, reforms should broaden the tax base and rebalance the tax system from income to consumption taxes. On the expenditure side, fiscal policies could seek to focus investment spending on projects with high growth multipliers while rebalancing current spending toward areas that support long-term growth potential, such as education and health, and that maintain the productivity of public infrastructure assets, such as maintenance expenditures. Priority structural reforms in the fiscal domain include enhancing the effectiveness and transparency of public institutions, especially for domestic resource mobilization and debt management. To preserve long-term sustainability, the authorities should consider adopting fiscal and debt rules, which were found to be effective in comparator countries.

MENAP countries would benefit from developing a macroeconomic risk management system. The existing risk management system and practice have failed to capture the nature of risks faced by MENAP countries in the past two decades and have not offered specific measures to mitigate them. Learning from the experience, MENAP countries could consider developing risk management systems to reduce their exposure to risks and create adequate buffers to absorb them (IMF Fiscal Monitor 2016). Such a system should be capable of adapting to a volatile environment with possibly large shifts in commodity prices, capital flows, and exchange rates. In this context, strong medium-term budget and debt management frameworks are crucial to enforcing discipline, guiding annual budgets, and dealing with unexpected shocks. MENAP oil exporters, in particular, would benefit from avoiding procyclical fiscal policy, while generating adequate buffers to cope with the high volatility of fiscal revenue. MENAP oil importers could create fiscal buffers, mainly by mobilizing additional domestic revenue (MCD REO, October 2017). Comprehensive, reliable, and timely public reporting on the state of public finances can also reduce fiscal vulnerabilities by fostering more precautionary, informed, and accountable fiscal policy.

Growth benefits could be distributed more equally to make growth more inclusive. Pro-growth reforms that create distributional trade-offs can be complemented by policies that limit the adverse distributional effects of reforms (Fabrizio et al. 2017). For example, resource mobilization measures can reduce inequality if the additional resources are channeled into highly progressive spending. Infrastructure investment, if executed efficiently, can increase output and reduce inequality. Reforms to infrastructure can boost productivity while reducing

sectoral productivity gaps, with beneficial effects on both growth and equality. Growth inclusiveness can be improved through fiscal redistribution. Progressive taxation and transfers are key components of efficient fiscal redistribution (IMF Fiscal Monitor: Tackling Inequality 2017). In MENAP countries fiscal redistribution has been limited, reflecting low and insufficiently progressive tax systems and strong reliance on regressive indirect taxes. At the top of the income distribution, marginal income tax rates that increase with income levels can achieve greater progressivity. Overall, the appropriate combination of progressive tax and transfer instruments should reflect country-specific circumstances, including administrative capacity, the performance of the existing safety net, underlying fiscal pressures, and social preferences.

Growth in MENAP countries would increase in they could develop further the private sector by improving the business environment. Despite the anticipated pickup in growth, bold structural reforms should be accelerated to enhance private sector activity and foster a more dynamic, competitive, and inclusive economy. Improving the business environment, including by bolstering the quality of infrastructure, will be critical. Labor market and education reforms, improving productivity, and enhancing access to finance will also help. Irrespective of recent improvements, the region still scores poorly on the World Bank's Ease of Doing Business rating and has slipped, from about 40% below the level of best performer in 2014 to 53% below in 2017/18 (see Doing Business Report 2017). To boost the private sector, MENAP countries should improve access to finance, especially for SMEs; reduce red tape; expand opportunities for private activity and jobs; attract foreign private sector investment; and develop special economic zones.

Bolstering financial resilience of the financial sector to external shocks, including through enhanced macroprudential policy frameworks and exchange rate flexibility would also help growth. Overall financial stability risks remain elevated as global political and policy uncertainties are opening new channels for negative spillovers (see Global Financial Stability Report 2017). MENAP countries with strong international financial and trade links could be challenged by tighter global financial conditions or adverse trade measures. A sudden reversal of market sentiment or a global shift toward inward-looking protectionist policies could reignite capital outflows and hurt growth prospects, testing the resilience of MENAP economies. As the impact of this tightening of global financial conditions would be significant—about one-third as severe as the global financial crisis—and more broad-based, MENAP countries and other emerging markets may be disproportionately affected.

4 Conclusions

Economic growth is fundamental. Growth in MENAP countries have been affected by unfavorable external conditions, including low demand and oil prices, as well as inward-looking policies. An unfavorable global economic environment has a negative impact on growth in all EMDEs, but growth erosion in MENAP has been even deeper. While many factors are country specific, some reasons common for the region can be identified. The Covid-19 pandemic has exacerbated problems, reduced growth further, and led to contraction on most countries. The reasons generally include negative total factor productivity; insufficient contingency planning and fiscal buffers; fiscal adjustment that has been unfriendly to growth, with cuts in investment and debt buildup; low overall public investment efficiency; declining productivity; insufficient diversification; internal political instability; and insufficient inclusion. These factors have led to growth erosion in MENAP: growth in recent years has been half in real terms, and a fifth in per capita terms, of what it had been two decades ago. Exogenous factors have been important, but still secondary, for growth erosion. They included the decline in oil and other commodity prices, weak external demand, and regional geopolitical tensions.

An important distinction should be made between exogenous and endogenous, as well as temporary and permanent, growth factors. Obviously, for the authorities, exogenous and permanent growth factors, which are largely outside their immediate control, pose more difficult challenges than endogenous and temporary factors. Weak external demand is completely exogenous, but may be temporary, while low national saving is fully endogenous but can be deeply entrenched and viewed as almost a permanent feature of an economy. For example, fiscal adjustment should not have such a persistent effect on growth. Policy measures should be adapted to mitigate the impact of each of these groups of factors.

Good policies with appropriate design can generate a meaningful impact on growth in MENAP. Key remedies include leveraging technology and trade to improve productivity, developing a macroeconomic risk management system, implementing growth-friendly fiscal adjustment, improving growth inclusiveness, and developing the private sector and financial resilience. The cyclical upturn in the global economy creates a unique opportunity to leverage external demand and access to technology to promote export-led growth. Temporary negative repercussions on some individuals and communities should be addressed through targeted fiscal policies and investment in new technologically advanced industries with high employment multipliers.

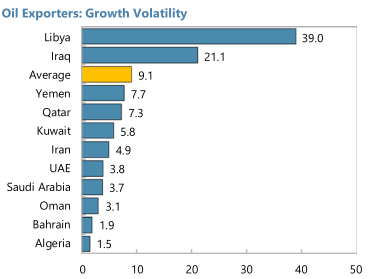
The limitation of this study is reflected in its generic approach based on high-level macroeconomic indicators for the region. The study intentionally avoids delving in country specifics so that to suggest a general framework for the analysis

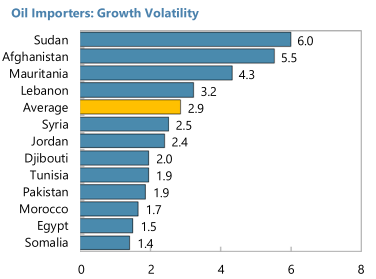
of growth in MENAP. The only substantive distinction is made between oil exporters and oil importers. Also, many other factors outside economics, which may have affected growth, have not been considered. Obviously, each country has had its own impediments to growth, which, starting from the suggested overarching framework, may be a good direction for further country specific research.

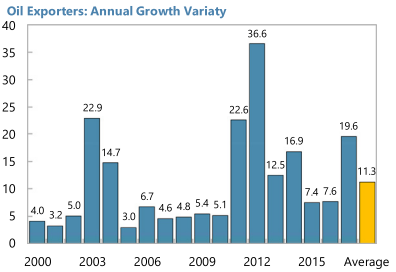
Appendix Growth in Individual MENAP Countries, 2000–2017 (Standard Deviation).

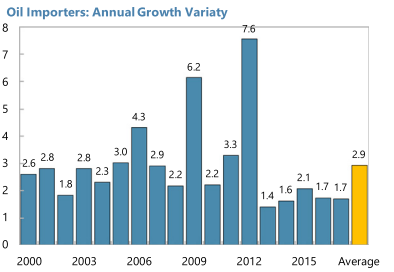
Extreme growth variability among MENAP countries points to several common trends:

- Across time, *growth in oil exported has been on average three times more volatile than in oil importers. Libya and Iraq have been the two oil-exporting countries where annual growth fluctuated from –125 to +67% and from –8 to +82% respectively. Among oil importers, growth in Sudan and Afghanistan from –18 to +11% and from 1 to 21%, respectively.*
- Across countries, *in each given year growth variability in oil exporters has been almost four times higher than in oil importers. For both groups of countries, 2012 was the year with the most variable growth rates across countries. Oil exporters also experienced growth variability in 2003, 2011, and 2016. Among oil importers growth was the most variable in 2006 and 2009, but its magnitude was still nothing close to oil exporters.*









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