

Policy Brief

July 2016
PB-16/22

Politics, Policies and Prospects of the MENA Region

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Summary

The MENA region is vital for Europe economically as a source of energy and as a large and historically rapidly growing market. Politically, however, it is a source of unwanted migration, conflicts, and geopolitical instability. This Policy Brief analyzes the diversity of the MENA region by highlighting some economic features. It also discusses a reform agenda for the region based on the prospects of this area.

The MENA region, defined as the group of countries stretching from Morocco in the West to Iran in the East and Sudan to the South, is vital for Europe economically as a source of energy and as a large and historically rapidly growing market. Politically, however, it is a source of unwanted--though more often than not, needed--migration, conflicts, and geopolitical instability. Terrorist acts may cause a small number of casualties compared to road accidents, for instance, but they have an entirely disproportionate effect on tourism and investment, and on the way the public perceives the effectiveness of political leaders. The breakdown of centralized control in the wake of the invasion of Iraq, of the Arab uprisings, and civil wars, complicates the picture enormously. The decision by the United States to downsize its commitments in the region adds further to the problem, as Europeans are entirely unprepared to respond effectively in a coordinated fashion. Yet, if Europe is to

assure its energy supplies, diversify away from reliance on Russian gas, control its borders and find again the path to growth, relations with its Southern neighbors are critical. It is not sufficiently appreciated how large and potentially dynamic the MENA market is. According to the World Development Indicators of the World Bank, the region's GDP is around 3.5 trillion \$ at current market prices in 2014, approximately the size of Germany's and its population of around 417 million people represent nearly 82% that of Europe. Contrary to common perception, it has historically been a fast growing part of the world, around 5%-5.5% a year over 2000-12², the pre-crisis high-oil-price period, and, while Europe's population is stabilizing or falling in some countries, and aging, population growth in MENA – though decelerating--remains around 2% a year, with the proportion of young workers rising rapidly.

1. The author is grateful to Rim Berahab for excellent research assistance.
2. IMF, WEO, April 2016.

The Region's Diversity

The MENA region – though stereotyped in the public eye – is better defined by its diversity than by its unity. It includes countries that are much richer per capita than the US or Germany, such as Qatar, but it also includes Yemen, poorer than many countries in Sub-Saharan Africa. The region includes some of the world's largest oil and gas exporters, but also Morocco, whose oil imports in 2013 amounted to 10% of GDP³. Though all countries of this region – Iran being the big exception – were once settled by Arabs, and Arabic is spoken and Islam is practiced throughout the region, the similarities rapidly fade from there. The cultural and institutional heritage of a country such as Morocco, a historically cosmopolitan nation, former French and Spanish colony with a strong Western orientation, whose founding people include Berbers and Jews, is very different to that of Saudi Arabia, a country with a “light” history of colonization, and strong attachment to the most conservative and literal forms of Islam. Beyond language and the dominant religion, the similarities are slight between Egypt, a relatively poor country of some 89 million⁴ whose state origins goes back thousands of years, and where very few foreigners nowadays reside, and the UAE, enormously rich, where the state as we intend it is a relatively new concept and the immigrant population outweighs that of natives by 5 or 6 to 1. Iraq and Libya are similar in that they are both relatively young states whose borders were drawn by colonial powers⁵. However, inside, they contain disparate and historically hostile communities, namely the Sunnis, Shias, and Kurds of Iraq, and the warring tribes from the East and West of Libya. Political differences and historic rivalries run deep between Sunni Saudi Arabia and Shiite Iran.

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Yet, despite the diversity of interest, world views and economic outcomes, it is a conceit of institutions such as the World Bank and IMF, American and European diplomats, and sometimes of Arab leaders themselves, to group these countries together. Focusing specifically on the economic dimension, there is no doubt that all countries of the region are affected to a degree by the

global business cycle, and that neighboring economies tend to transmit shocks to each other to some extent. However, for example, a recession in Europe has a much bigger impact on the Mediterranean MENA countries than on the Gulf, whose energy exports are oriented predominantly to Asia. A fall of the oil price has almost diametrically opposite effects on Saudi Arabia and on Morocco. With few exceptions, the MENA countries have only very small trade connections with each other. Their connections through worker remittances, foreign investment, and when times are good, foreign aid, are somewhat stronger, but tend to be one-directional, from the Gulf states to the oil-importers. This means that transmission of the business cycle within the region is actually quite weak⁶, especially as the energy exporters have very big financial buffers and so are able to mitigate the effects of low oil prices and of their business cycle more generally over many years if they choose to. The absence of political coherence and the weak economic links within the MENA region help explain why this is the only developing region which still lacks a multilateral development bank dedicated to it.

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Three Salient Economic Features

Bearing in mind that, In the MENA region, all generalizations must be treated with caution, three related economic features stand out.

First, there has been a massive deterioration in the region's economic performance over the last 3-4 years. According to the IMF, the Arab World (MENA less sanction-hit Iran) saw very rapid growth over 2000-12, 5.5% a year, associated with a large regional current account and fiscal surplus originating in the oil states. Inflation remained moderate⁷. Since 2012, growth across the region has been cut in half, and, although inflation remains contained, nearly all countries of the region have seen a massive deterioration of their fiscal and current account balance. This deterioration finds reflection in opinion surveys, which point to a vast increase in the number of people who don't have enough money to buy food and who don't see good prospects of their children finding a job. The Arab

3. According to calculation from the UNCTAD Database.

4. According to WDI Database.

5. Survey of the Arab World, The Economist, May 2016.

6. See Global Economic Prospects, the World Bank, January 2016.

7. IMF WEO April 2016; see also IMF Middle East and Central Asia Regional Economic Outlook, October 2015.

uprisings actually occurred in the wake of a long period of relative economic prosperity, and were contained in part by using up the state's reserves accumulated over that period to increase subsidies and buy favor. In the wake of the crisis, most countries are now experiencing economic deterioration against a background of rapidly depleting or already depleted reserves. Large oil importers such as Morocco, Lebanon and Jordan, represent a partial exception, although the latter two countries now have to contend with a massive influx of refugees⁸.

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Second, the confidence of investors is at ebb as domestic and international tension, and open warfare, pervades large parts of the region. Saudi Arabia and Iran stand out as major regional powers confronting each other in multiple arenas, from OPEC negotiations to a proxy war in Yemen. Despite the simmering tensions, the lifting of sanctions on Iran is likely to be a game changer for Iran's economic prospects. The prospects for Iraq and Syria depend critically on the outcome of the international war on ISIS and on the strategies of foreign powers involved in the Syrian civil war. Compared to these sources of strife, the hundred-year war between Palestinians and Israelis currently is backstage, though it could quickly fire up again. Important as these international conflicts are, domestic rifts arguably have equally disruptive economic effects. The tension between Islamists and secular society infects the whole region. It conditions investor confidence, tourism, subsidy regimes, and fiscal policy more broadly from reformist regimes such as Morocco and Tunisia to repressive ones like Egypt, where the situation is very fragile. The Sunni/Shia divide plays an important role in both international and domestic arenas. The flood of refugees from Syria into Jordan and Lebanon dwarfs that towards Europe, and, as already mentioned, conditions every aspect of those economies.

Third, low oil prices have dramatically affected the capacity of oil exporters to spend, invest, grow, and buy social peace. Some 390 billion \$ have been lost in oil revenues between in 2015⁹. Low oil prices have, on

the other hand, greatly facilitated the needed fiscal and balance of payments adjustment needed in countries such as Morocco. The longer low oil prices last, the greater the pressure on large-population-oil exporters – from Algeria to Saudi Arabia – to dismantle the intricate layers of state support and state ownership and to allow for market forces to work. Ideally, these countries should be able to achieve greater export diversification and become less dependent on their oil and gas exports. However, they confront two large impediments. First, they may find it difficult if not impossible to navigate the political waters of subsidy and public employment withdrawal. Second, any investor in new export sectors has to contend with the strong likelihood of a return to more normal levels of oil prices. These would make investments that look profitable today into dead ducks a few years down the road. A more promising path for these economies is liberalization that encourages development of more efficient domestic (non-tradable) service sectors capable of employing large numbers of people, combined with the build-up of sovereign wealth invested abroad when times are good.

The Economic Reform Agenda¹⁰

Economic growth in developing countries depends critically on catching up with the technology frontier; this is what enables them to grow far more rapidly than was ever possible in the past or is possible in advanced countries today. The vast majority of econometric examinations of growth suggest that productivity – closely related to technology – that drives long-term growth, rather than factor accumulation. This catch-up growth, the adoption and spread of technologies available at the frontier, depends on the existence of four conditions, which I call the four Cs, Confidence, Connectivity, Competence, and Cost. These conditions are – at least to some degree – all necessary. MENA countries have a lot to do to better fulfill each of these conditions.

Take first, confidence. Confidence depends on macroeconomic as well as political stability. The deterioration of fiscal and current account balances presents the risk of large tax hikes, currency devaluation, or outright sudden stop of financing, deterring investors in most countries. The picture, as always, varies. Confidence in the macro-economy of the small population resource-rich Gulf States remains solid, and quite good in Morocco. Macro-economic confidence in Iran has been

8. Dadush, "The Economic Impact of Forced Migration", OCPCC.

9. IMF, Regional Economic Outlook, April 2016.

10. This section draws on Karim El Aynaoui, Uri Dadush, Karim El Mokri, Rim Berahab "The unmet Challenge of Interdependence in the EU-MENA Space: A View from the South", May 2016, Policy Paper, OCP Policy Center.

boosted by the end of international sanctions. Given the prospect of higher energy prices in the long-run there remain opportunities for investment in the energy sector where political conditions allow, including in renewables. However, for the most part, energy investments are not of the kind likely to generate – by themselves- a sustainable and self-reinforcing process of development and job creation across the broader economy. Still, under a normalization scenario, the region clearly presents large potential opportunities: it operates far from the technology frontier, has a young and rapidly growing population, enormous capacity to self-finance, and has been capable of rapid growth in the recent past.

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Take, next, the connectivity condition. There is no doubt that the region has become vastly better connected to the rest of the world over the last quarter century. Tariffs have come down as have barriers to foreign investment, while the penetration of cell-phones has become universal and nearly 40% have access to the internet¹¹. In addition, heavy investments in transport infrastructure and the proximity of the region to Europe or to the busiest sea-lanes greatly facilitate trade. Virtually no economy of the

region is land-locked. Trade has increased sharply as a share of GDP in the non-oil economies and, in part by virtue of much higher oil prices, among oil exporters. Numerous trade agreements have been signed with the EU, the US and among countries of the region. Despite these favorable trends, trade flows among countries of the region remain tiny and far below what would be predicted based on gravity models. Researchers differ on whether the MENA region tends to under-trade with Europe as well. What is sure is that the trade agreements signed with Europe have generally disappointed, enabling a wide range of imports, while diverting some trade from more efficient Asian exporters, and yielding relatively modest results by way of exports of agricultural products and diversification onto manufactures exports. Restrictive rules of origin and overly demanding Sanitary and Phytosanitary Standards have inhibited utilization of preferences in sectors from meat to garments. With few exceptions, such as Morocco's hosting of Renault and Bombardier, there is little sign of the region becoming integrated in Global Value Chains.

What about competence – the skill of the region's workers and their ability to adopt advanced techniques and approaches? Here too, it is clear that great progress has been made in terms of the investments in education, as well as in the basic measures of attainment, such as literacy.

Table 1: MENA countries Distance to Frontier Ranking (2011 vs 2016)

	DTF 2011	DTF 2016	Change of DTF btw 2012 & 2016
UAE	71,73	75,1	3,37
Bahreïn	67,19	66,81	-0,38
Qatar	67,71	65,97	-1,74
Oman	65,88	65,4	-0,48
Tunisia	68,35	64,88	-3,47
Morocco	60,28	64,51	4,23
Saudi Arabia	69,81	63,17	-6,64
Kuweït	60,65	60,17	-0,48
Jordan	57,26	57,84	0,58
Iran	56,98	57,44	0,46
Lebanon	61,93	56,39	-5,54
Egypt	56,86	54,43	-2,43
Iraq	48,36	46,06	-2,3
Algeria	50,7	45,72	-4,98
Yemen	56,74	44,54	-12,2
Syria	50,72	42,56	-8,16
Libya		31,77	31,77

Source: Doing Business Database

11. World Development Indicators, 2016

For example net enrolment ratios rose from 86% to 94.2% between 2000 and 2013 for primary schooling and from 62% to 71.7% for secondary education, mainly among girls.. However, measures of higher-level attainment, such as PISA scores, which evaluate the ability of 15 year olds to understand a text and perform mathematics, are much less encouraging. For example PISA scores indicate that the low learning outcomes in MENA region on average in comparison to its income level.

«Economic growth in developing countries depends critically on catching up with the technology frontier»

Last and not least, we need to consider the cost of doing business¹². Without a competitive cost structure, i.e. not just the cost of labor and all other inputs but also red tape etc., there is unlikely to be sustained investment in tradable activities. Non-tradable activities are perhaps less sensitive to a high cost of doing business than activities which confront international competition, but are nevertheless deterred by high costs which lower the return to investment. As can be seen from Table 1, most MENA countries do not do well on Doing Business, as their distance from the frontier is considerable (especially in comparison to their income per capita) and, with few exceptions, their relative performance deteriorated since 2012.

Prospects

How should one think about the region's economic prospects against this background? Unfortunately, even under quite favorable international assumptions – namely continued recovery and an eventual pick up in oil prices – the answer is not good. The region's multiple conflicts are not abating and the political vacuum resulting from the downscaling of American involvement from the region and Europe's incapacity to act in concerted fashion is likely to remain in the foreseeable future. A wide range of MENA economic outcomes is possible, but bad or very bad ones are more likely than good ones, and a wide dispersion of outcomes across countries of the region must be expected.

A return over the next 2-3 years to anything like the growth the MENA region enjoyed prior to 2012 is very unlikely. In fact, the worsening imbalances across most of the region may result in growth that is slower or at least not significantly better than the 2.5%-3% growth of the recent period, half the pre-crisis period. A notable

exception is likely to be Iran as international sanctions are lifted and oil production increases, even if it is oil sold at relatively low prices. The conflict in Libya may be nearing some resolution or perhaps abatement, it is difficult to tell. A resolution of the issues in Iraq, Syria and Yemen, appears distant and there is a significant possibility of political disruption leading to worse outcomes in Egypt or in one or the other large population oil exporters, such as Algeria for example. Despite the great power vacuum, it appears unlikely that other major international conflicts, such as between Iran and Saudi Arabia, will break out mainly because incumbents already have their hands full handling restive populations in difficult economic times. Unfortunately the same cannot be said of domestic conflicts. The rifts or faultiness exposed by the political changes of recent years- those between Islamists and the secular power, and the tribal and ethnic divisions- are obviously very deep, and the capacity of central government to contain them has been dangerously weakened¹³. The Palestine-Israel conflict remains flammable. Even for oil importers benefiting from low oil prices, this is not a context favorable to private investors, nor to attract tourists, nor for governments of companies to invest in a diversified economic base requiring long gestation periods. There continue to be exceptions, such as Morocco, of countries that are handling the transition much better than others, but those economies, too, will suffer from an adverse neighborhood effect. The low population oil exporters still have large resources and their large immigrant population is quiescent so they will probably wade through this period relatively unscathed.

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In the long run, the economic prospects for this region depend crucially on the capacity of people that differ in religious beliefs and in tribal origin, to accept and tolerate each other, while continuing to build the pluralistic institutions of the modern state. The process may or may not require some redrawing of borders. Over the last several hundred years, Europeans went through a not-dissimilar process. Judging, just to take one example, by the continued divisions between the Scots, Irish and the English, including quite recent armed opposition in Northern Ireland, the process is not yet complete. For the sake of the region and for that of their European neighbors, one can only hope that the MENA countries can do it all much faster.

12. Doing Business, World Bank 2016

13. Survey of the Arab World, The Economist, May 2016

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Uri Dadush is a senior associate in Carnegie's International Economics Program. He focuses on trends in the global economy and is currently also tracking developments in the eurozone crisis. Dadush is interested in the impact of the rise of developing countries for financial flows, trade and migration, and the associated economic policy and governance questions. He is the co-author of four recent books and reports: *Inequality in America: Facts, Trends and International Perspective* (Brookings, 2012), *Juggernaut: How Emerging Markets Are Reshaping Globalization* (Carnegie, 2011), *Currency Wars* (Carnegie, 2011), and *Paradigm Lost: The Euro in Crisis* (Carnegie, 2010). He has published over a dozen Carnegie papers and policy briefs as well as numerous journal articles.

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