GLOBAL ECONOMIC PROSPECTS | June 2013 | Annex

MIDDLE EAST and NORTH AFRICA REGION

Overview

More than two years after the Arab Spring began, economic activity remains weighed down by elevated political tensions and continued civil strife in the region. Regional growth accelerated to 3.5 percent in 2012 from minus 2.2 percent in 2011 reflecting mainly a rebound in Libya's crude oil production to pre-war levels that doubled real GDP and a weak growth recovery in Egypt (to 2.2 percent in FY2012 from 1.8 percent in FY2011). Iran, the region's largest economy, slipped into recession, with GDP falling by an estimated 1.9 percent due to international sanctions and lower oil output while Algeria's growth remained subdued at 2.5 percent, supported by expansionary fiscal policy. Domestic demand and exports in Syria collapsed last year as the civil war intensified, with spillovers affecting activity in Jordan and Lebanon. Drought in Morocco reduced growth to 2.7 percent from 5.0 percent in 2011.

Outlook for 2013-15: Regional prospects depend critically on the evolution of domestic and cross-border political tensions. Aggregate regional growth is forecast to slow to 2.5 percent in 2013 mainly due to weakness in the region's three largest economies, before recovering to 4.2 percent in 2015 as tensions ebb and the Euro Area, the region's main trading partner, recovers.

Within the region, Egypt's GDP growth is forecast to slow to 1.6 percent in FY2013 on elevated political tensions and worsening macroeconomic imbalances, before recovering to about 4.8 percent in FY2015 as political tensions recede and reforms are undertaken, although there remain considerable downside risks to this forecast. GDP in Iran is forecast to contract for the second straight year by 1.1 percent due to sanctions and soaring inflation before recovering to about 1.9 percent in 2015. Growth in Algeria is expected to rise modestly to 2.8 percent due in part to temporary disruptions to oil production, before firming to about 3.5 percent in 2015. Elsewhere, growth in Iraq and Libya is expected to remain relatively buoyant driven by their mineral sectors, although rising violence poses a risk to near term stability in Iraq. Meanwhile rising farm output in Morocco and strengthening external demand over the medium term should help lift growth towards potential in Morocco and Tunisia. Jordan's and Lebanon's GDP growth is expected to remain subdued in 2013 reflecting spillovers from Syria.

Risks and vulnerabilities: Political uncertainty, polarization and conflict. Prolonged political crises and conflicts—elections are upcoming in several economies and conflicts are gaining intensity in Iraq and Syria—pose risks to near term recovery, and to long term potential growth rates by depressing investment and increasing the likelihood that urgent structural reforms are delayed. More generally the long term structural challenges facing the region – which are a source of current volatility – remain the same as before the Arab Spring. A failure of political consensus needed to tackle these structural weaknesses will mean that they will likely contribute to low growth rates even when calm returns to the region.

Weakening macroeconomic fundamentals and rising fiscal sustainability risks. Rising fiscal outlays to fund difficult-to-reform food and fuel subsidies are generating serious fiscal and current account imbalances among oil importers – a situation exacerbated by rising borrowing costs and exchange rate depreciation, although the recent moderation in global food prices could provide some respite in the near term.

Euro Area and US recovery. Protracted weakness in the Euro zone would hurt economies with close trade, investment and financial ties to it. Any increase in global risk aversion would also reduce already depressed capital inflows into the region. On the upside, better-than-expected economic outcomes in the US and Euro Area should support growth, particularly in economies where political tensions are relatively muted.

Commodity price and geo-political developments: Oil exporters in the region could be very vulnerable if the projected gradual decline in commodity prices occurs more sharply than in the baseline. While benefitting importers, it would cut into incomes, government revenues and foreign currency earnings of oil exporters – forcing potentially significant adjustments.

Recent Developments

Aggregate regional growth picked up in 2012 in the developing Middle-East & North Africa region to 3.5 percent in 2012, mainly reflecting a recovery from a 2.2 percent contraction in 2011 due to social and political unrest in Egypt, and armed conflict in Libya. Political (domestic and international) tensions continue to weigh on economic activity and investment across the region. International sanctions are contributing to rising inflation and negative growth in Iran, while spillovers from the intensifying civil conflict in Syria, including the disruption of land trading routes, have cut into economic activity in Lebanon and Jordan with the latter also affected by energy shortfalls in Egypt. At the same time, weak economic conditions in European trading partners have acted as a drag on non-oil exports and tourism receipts.

Among oil importers, growth remained subdued during 2012 reflecting spillovers from conflict within the region and weak external demand from Euro Area trading partners. The main exception to this trend was Tunisia, where GDP growth accelerated to 3.6 percent in 2012 from just below 2 percent in 2011, supported by a recovery in tourism and increased domestic demand following an earlier relaxation of fiscal policy. Egypt's economy grew by just 2.2 percent in 2012 in fiscal year terms, a modest recovery from the 1.8 percent outturn in 2011, supported by higher government spending and record remittance inflows. In calendar terms, the rebound was more substantial – 4.6 percent versus 0.5 percent in 2011 – but reflected a recovery from a low base.

Elsewhere, Lebanon's GDP growth is estimated to have remained flat at 1.5 percent in 2012 as elevated domestic political uncertainty and spillovers from the conflict in Syria undermined tourism and scarce public resources came under pressure from growing numbers of refugees (estimated at 1 million plus in a total population of about 4.3 million). At an estimated 2.8 percent, Jordan's growth was only slightly better than the 2.6 percent outturn in 2011, as slower manufacturing growth reflecting a domestic energy crisis offset higher public and private sector spending. However, private consumption in both Jordan and Lebanon benefited from added demand associated with a rising influx of Syrian refugees. Although Morocco has remained relatively free from political and social tensions, drought hurt agricultural output, while weak demand among Euro zone trading partners hit manufacturing and tourism, with growth slowing to just 2.7 percent from 5.0 percent in 2011 and the lowest since 2000.

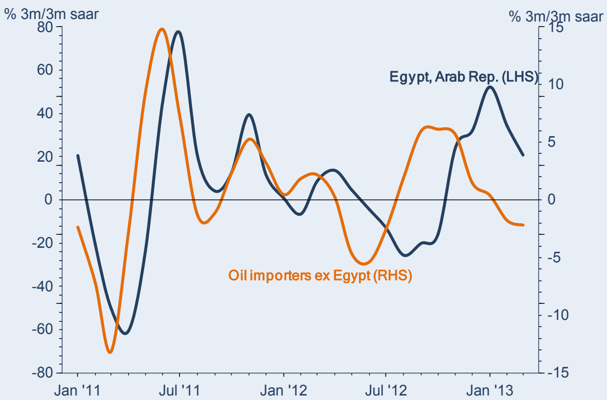
Among oil exporters, growth experiences have been mixed. Thanks to a post-conflict recovery in oil production, Libya's GDP expanded by 105 percent in 2012. Growth in Algeria was subdued at about 2.5 percent in 2012, supported mainly by rising government spending financed by relatively buoyant global energy prices. Post-war increases in crude oil production helped sustain an 8.4 percent increase in Iraqi GDP. Output in Iran, however, shrank an estimated 1.9 percent and inflation reached over 40 percent this year due to international sanctions and currency depreciations. Growth is showing signs of recovering in Yemen, but remains fragile with GDP barely expanding 0.1 percent in 2012 after contracting 10.5 percent in 2011. Although fraught with uncertainty, indications are that Syria's conflict has caused GDP to shrink by nearly a third – reflecting a collapse in both domestic demand and exports.

Nascent economic recoveries among oil importers have suffered repeated setbacks over the past year

Periodic eruptions of political and social tensions or renewed weakness in the Euro Area have repeatedly set back nascent recoveries among developing oil importing economies in the Middle-East & North Africa region, with growth turning increasingly volatile in Egypt and Tunisia. For instance, since 2011 Egypt has experienced three separate episodes of a sharp deceleration or contraction in activity as political and social tensions erupted, punctuating rebounds in activity. In Tunisia, a recovery in early 2012 led by tourism and service sector growth was interrupted by social unrest in the second quarter and lower demand in the Euro Area, the country's main trading partner.

Recent high frequency data up till March show a recovery in industrial output in Egypt from last

Fig MENA.1 **A recovery in industrial output at the end of 2012 lost momentum in Tunisia and Morocco in Q1**



Source: World Bank; Datastream.

years trough, led by manufacturing and construction, although PMI surveys up till May indicate weak business conditions. Among other oil importers, momentum has held up in Jordan, but weakened in Morocco and Tunisia (figure MENA.1).

Egypt and by extension Jordan, which has relied on cheap natural gas imports from the former to produce electricity, have faced severe energy shortfalls over the past year. In both countries – and indeed elsewhere in the region – energy demand has soared in recent years partly due to large subsidies in place. Energy shortages in Egypt, which is the second largest natural gas producer in North Africa after Algeria, reflect a longer term decline in supply, more conservative drilling plans by some major producers due to rising domestic uncertainty, and increasing reliance by Egypt on exports of crude oil to cover imports and debts, leaving less for refineries to process for domestic use. Egypt's natural gas exports to Jordan have suffered, at first because of sabotage that targeted the Arab Gas Pipeline in 2011, then by a temporary suspension of exports last October in an effort to cover a spike in domestic energy demand; and most recently in January this year because of rising social unrest in Egypt.

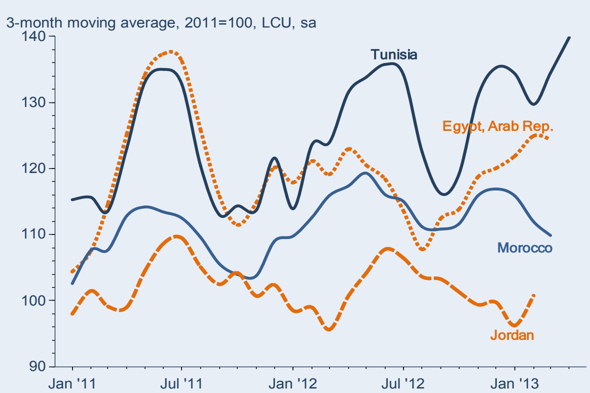
Export momentum weakened among some oil importers in the first quarter

Recent seasonally adjusted export earnings data from Q1 (figure MENA.2) indicate that exports are stabilizing in Egypt and Lebanon after rebounding at the end of last year, but contracting sharply once again in Morocco in Q1. Jordan meanwhile has been hurt by the closure of land trading routes through Syria: exports to other countries in the region – some 50 percent of total exports in 2012 (figure MENA.3) – fell by an annualized 21.7 percent seasonally adjusted pace in the three months through February. Tunisia's exports remained buoyant in Q1 helped by a recovery in agricultural, textile and some manufacturing exports.

Production in developing MENA oil exporters continues to contract

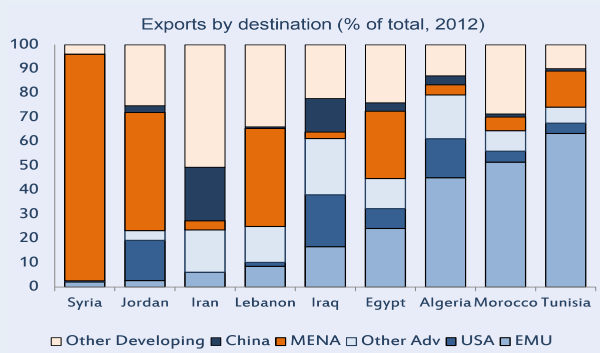
Industrial output in the MENA region resumed its downward trend in the second half of last year as

Fig MENA.2 **The recovery in exports among oil importers has lost momentum in Morocco and Jordan**



Source: World Bank; Datastream.

Fig MENA.3 **Jordan, which trades heavily with other MENA economies, has been hurt by the closure of land trading routes through Syria**



Source: World Bank; IMF Direction of Trade Statistics.

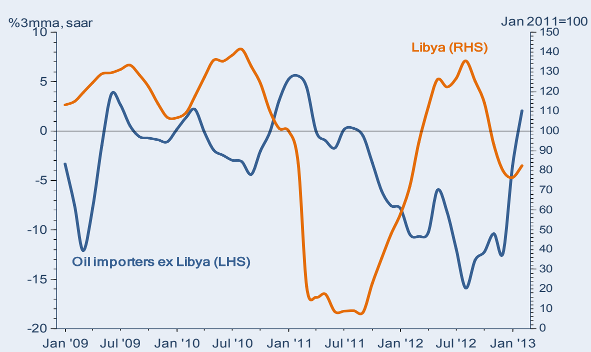
the boost from Libya faded. Aggregate regional production volumes fell by 27.2 percent annualized in Q4 last year, led by sharp drops of close to 16 percent in both Iran and Algeria.

More recently, aggregate regional production volumes excluding Libya (figure MENA.4) picked up in Q1. However this reflected a stabilization in in output in Iran following sharp declines over the past year due to crippling US and EU sanctions that had led to oil production falling to 2.63 mbd in September - the lowest in 23 years according to the International Energy Agency (IEA). As per latest IEA estimates, Iran's production was about 2.65mbd in May, with the country likely to cut output going ahead as exports to Asian buyers dwindle due to a tightening of international sanctions. Japan for example bought only 8000bd of Iranian oil in April, down 97 percent from April 2012. Prior to the sanctions, Iran used to produce about 3.5mbd and export about 2.5mbd of oil.

There have been production setbacks in other countries too, notably Algeria in the aftermath of the militant attacks in mid-January on the *Amenas* gas plants which account for about 10 percent of the country's total gas output. Along with a slow recovery from these attacks, heightened security after the attacks also hurt crude oil production which temporarily fell to 1.14 million bpd in March from 1.16 mbd in February according to the IEA, although levels have since recovered.

Iraq surpassed Iran as the second largest oil producer in OPEC at the end of 2012. However crude oil production and exports fell slightly at start of this year reflecting disputes between Baghdad and the semi- autonomous region of Kurdistan that led to a halt in exports from the Kirkuk Ceyhan pipeline and weather-related disruptions in southern Iraq. Libya's production has also fallen in recent months—most recently by 60,000 bpd in March— with reports suggesting that an ageing infrastructure is affecting output.

Fig MENA.4 **Oil exporters ouput contracted for most of 2011 and 2012, led by declines in Iran, and recently Algeria**



Source: World Bank.

Activity in Syria has collapsed as the conflict has intensified, and it is likely that the economy contracted by nearly a third during 2012, possibly even more. As of December 2012 industrial production volumes were half their level at end-2011. Although difficult to gauge the true extent of economic damage from the conflict, mirror statistics from trading partners indicate that exports and imports fell by an unprecedented 85 and 79 percent respectively in 2012.

Current plans by developing oil exporters to significantly raise investment may prove optimistic

Given stagnating or declining production levels and sharply increasing domestic demand, oil exporters will need to invest heavily in infrastructure, exploration and production to raise production levels. However private capital and FDI inflows may fail to materialize because of security risks, poor legal environments for investment and political uncertainty, and, in the case of Iran, international sanctions.

In Iraq, government estimates count on capital expenditures of $30 billion per year in energy infrastructure to meet its production targets. But progress on this front is likely to be slow due to payment disputes with the Kurdish Regional Government, and delays in the passage of a law that would govern the development of Iraq's oil and gas wealth (the law was first announced in 2008, but has yet to be passed). Algeria is also planning to invest significantly in hydrocarbon exploration, notably in shale gas, and in refineries. However raising private investment may prove challenging given political uncertainty generated by upcoming presidential elections in spring 2014 and earlier reversals in investor-friendly provisions in investment laws that may deter investors.

Inflation pressures built up in 2012, and persist

The latest CPI data show that price pressures have remained strong, with annual inflation rising close to or over 7 percent (y/y) in Egypt, Tunisia and Jordan and, to over 10 percent (y/y) in Lebanon in the first few months of 2013 (figure MENA.5). In part this reflects partial fuel and energy tariff reforms in some economies (Jordan, Tunisia, Egypt) to contain soaring fiscal burdens from subsidies. In Jordan and Egypt, shortfalls in energy provision slowed production in other sectors and contributed to inflation pressures, with the latter also affected by a 13 percent depreciation of the currency since December. Growing inflation pressures in Egypt also likely reflect the negative impact of prolonged political and social tensions on absorptive capacity and potential output in the face of continued sharp increase in government expenditures (up 30 percent y/y in the first half of FY 2013).

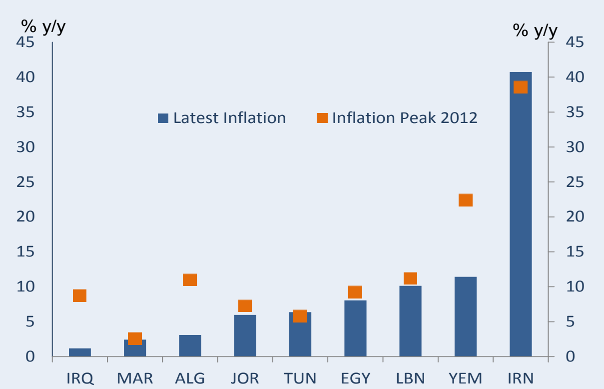
Similar supply side constraints, combined with sanctions and a sharp fall in the value of the Iranian Rial have contributed to rising inflation in Iran, which (per official estimates) touched 38.5 percent in December. The market value of the Iranian currency dropped to 37,000 Rial per US Dollar in October from 25,000 in September compared to an official exchange rate of about 12,000 Rial. With the currency dropping further since the start of the year, inflation touched 40.7 percent (y/y) in March.

However inflation pressures remain subdued in several economies, including Morocco and Iraq, helped by generous food and fuel subsidies. Inflation in Yemen fell into single-digits in 2012 to about 7 percent (but has since accelerated), from a peak of 24.6 percent in October 2011, as improving security eased supply bottlenecks after the formation of transition government in early 2012. Inflation in Algeria decelerated to 3.1 percent in April on slower growth in (mostly imported) food prices.

Tourism-related revenues and jobs improved slightly in 2012,

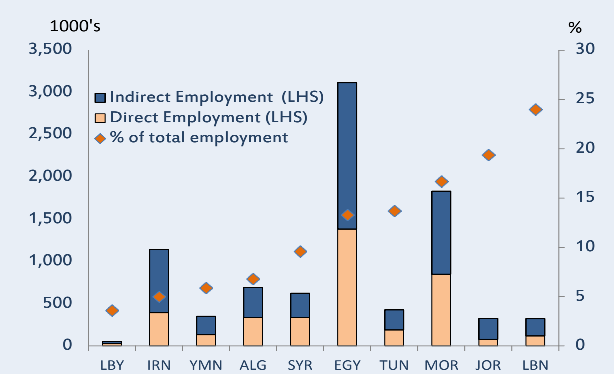
Tourism inflows, a key source of foreign exchange and jobs (figure MENA.6) in the region, are recovering. According to the United Nations World Tourism Organization (UNWTO), aggregate tourist arrivals in North African economies rose 8.7 percent to 18.5 million in 2012, only slightly below the peak of 18.8 million visitors in 2010. In Tunisia, tourism revenues in 2012 reached $2.1 billion, up 30 percent from the previous year, supporting a strong recovery in the service sector. In Egypt, tourism revenues stabilized at around $10bn during 2012, although well below the $12.5 billion earned in 2010. As a result, the sector, which employs roughly one in every eight Egyptian workers (directly and

Fig MENA.5 **Inflation remains persistently high in many economies**



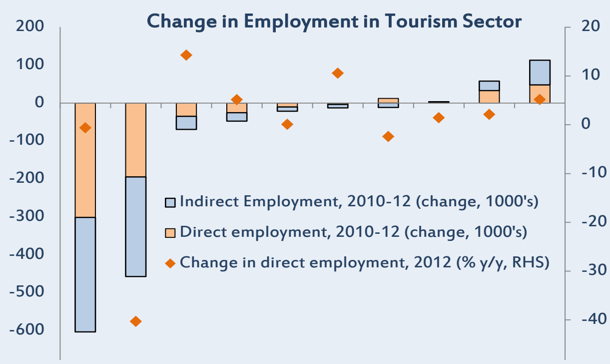
Source: World Bank; Datastream.

Fig MENA.6 **A significant share of the workforce is employed by the tourism industry**



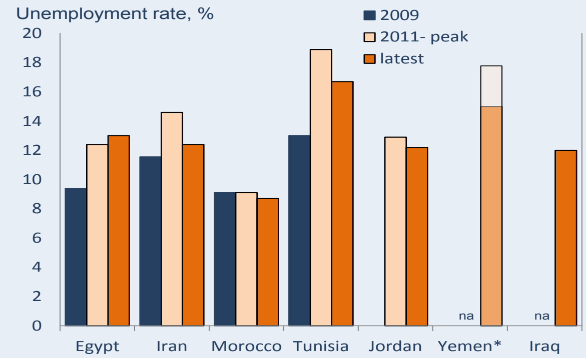
Source: World Bank; UNWTO; World Travel and Tourism Council.

Fig MENA.7 A modest recovery in tourism during 2012 has yet to reverse sharp job losses in the sector during 2011



Source: World Bank; UNWTO; World Travel and Tourism Council.

Fig MENA.8 Unemployment rates have declined modestly in some countries, but generally remain high



Source: World Bank.
* range for Yemen

indirectly), only shed 14,000 jobs per industry estimates, versus half a million or so tourism related losses during 2011 (figure MENA.7).

The number of tourists to the Middle East economies (including high-income economies in the region) fell at a slightly slower pace in 2012 (-4.9 percent vs -6.7 percent in 2011) to 52.6 million. Jordan, which reported a 15.3 percent increase in earnings in 2012, Morocco and Iran have benefited from instability in neighboring countries, attracting visitors from the GCC economies and Central and South Asia that otherwise would have headed to traditional tourist hotspots such as Egypt and Lebanon.

Recent data however suggest that tourism related gains in Tunisia and Egypt are likely to have been lost in the wake of recent social unrest. Revenues from tourism fell 7.5 percent from a year earlier in Q1 in Tunisia, hit by security concerns after a political assassination in February, although the unrest has since eased. Reports from Egypt indicate sharp drops in hotel occupancy.

Unemployment rates have eased slightly, but remain high

High levels of unemployment, one of the catalysts for the Arab Spring uprisings, have shown modest signs of improvement in some economies. In Tunisia, the official jobless rate fell from 18.9 percent in 2011 to 16.7 percent in 2012 helped by a recovery in tourism. Growing tourism inflows have also supported a decline in official unemployment rates in Jordan, Morocco and Iran.

Nonetheless, unemployment remains extremely high (figure MENA.8), particularly among the youth and in urban areas. In oil exporting economies, strong growth in capital-intensive hydrocarbon sectors has boosted overall growth, but failed to generate many jobs. For instance, in Iraq, the oil sector accounts for only 1 percent of total employment versus a contribution to GDP of about two-thirds. In addition, large commodity export inflows contribute to Dutch Disease pressures, undermining the development of non-oil sectors that could potentially provide jobs. More generally, job creation across the region is being held back by a difficult business climate (figure MENA.9), and further hampered by political and economic uncertainty among oil importing economies.

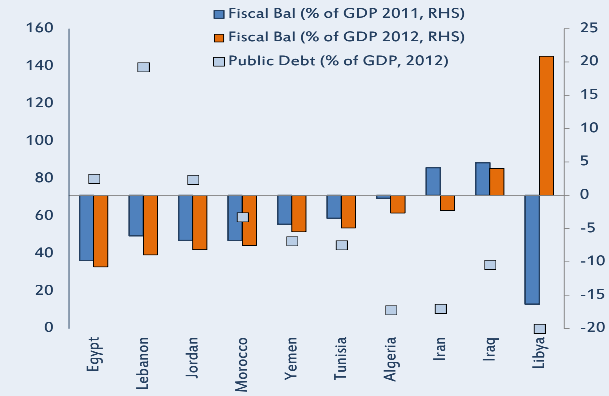
Remittance inflows rose during 2012

With remittance inflows estimated at $49 billion in 2012, the Middle East and North Africa region experienced the fastest expansion of remittances in the world, growing by 14.3 percent in 2012 compared with 2011 (World Bank, 2013). Egypt received a record US$19 billion (8 percent of GDP), up from $14.3 billion in 2011, making it the sixth largest receiver of official remittances in the world. Although Egypt has a large stock of highly

Fig MENA .9 **…In part reflecting a difficult business climate made worse by political uncertainty and social unrest**

Source: World Bank.

Fig MENA.10 **Fiscal balances have deteriorated in the region as have debt levels**



Source: World Bank; Datastream; IMF.

skilled expatriates in the US, the UK and other OECD countries, about two-thirds of its migrants are working in oil rich countries within the MENA region, which benefitted from relatively buoyant oil prices last year. Inflows were up by 10 percent in Tunisia and 6 percent in Jordan but remained broadly stable at about US$7.4 billion in Lebanon.

Public finances have deteriorated sharply raising fiscal sustainability concerns

Broad structural public finance reforms are needed in developing MENA economies, to ensure fiscal sustainability, and to limit vulnerability to adverse economic shocks. Public expenditures as a share of GDP tend to be large, and dominated by relatively rigid wages and entrenched subsidies, with a narrow revenue base heavily dependent on revenues from a few key sectors.

Deteriorating public finances during 2012 (figure MENA.10) in the region reflected a number of factors. These include: slippage in revenues due to underlying economic weakness; rising costs of imported but heavily subsidized food and fuel commodities; and expansionary fiscal policies to shore up flagging economies and to contain social discontent. Government outlays were up 15 percent and 11 percent (y/y) in Algeria and Morocco during 2012 and by 30 percent (y/y) in the first half of the current fiscal year in Egypt.

Rising fiscal deficits and public sector debt have added to growing fiscal sustainability concerns, notably in Lebanon and Egypt where spending pressures exacerbated by rising borrowing costs have pushed interest expenditures to about 40 percent and 25 percent of total revenues respectively in these economies. To finance its revenue shortfalls Egypt has relied heavily on borrowing from the domestic banking sector, and grant aid from the Gulf economies. Rising public-sector borrowing is crowding out private sector borrowing and increasing the exposure of the banking sector to sovereign risk. Meanwhile, delays in tax reforms have delayed the approval of a US$4.8billion loan from the IMF, and in turn, assistance from other multilateral and bilateral partners despite indications that the fiscal deficit will reach over 12 percent of GDP in FY2013. Among oil exporters, fiscal surpluses have shrunk as revenues, despite strong growth, have failed to keep pace with surging public expenditures.

A number of economies are attempting fiscal consolidation in order to manage funding pressures and risks, with a focus on fuel and food subsidies given their significantly large share of total spending. Jordan liberalized fuel prices last year as part of an IMF $2billion loan program, and a gradual reform of electricity tariffs is planned this summer to curb contingent liabilities associated with rising indebtedness of the state owned electricity company (which has been forced to sell power at below cost). Tunisia raised fuel prices by nearly 7 percent in March, the second hike in six month, despite strong domestic opposition as inflation has increased. Algeria's 2013 budget plans support fiscal consolidation of about 2 percent of GDP in the overall balance led by a decline in public sector wage expenditures, but worryingly also predicated on continued buoyancy in commodity prices and strong external demand which may not materialize. Lebanon, which posted a modest primary deficit of 0.4 percent in 2012, its first in several years, on rising public sector wage costs and weak revenue growth, is planning 3 percent worth of GDP expenditure cuts during 2013.

However, fiscal reforms have slowed in Morocco, and Iran. Following a small hike in fuel prices in June and a cut in the subsidy of imported wheat last year, Morocco has shifted consolidation efforts towards cuts in public investment spending (of about 2 percent of GDP for 2013) despite a subsidy bill estimated at 6 percent of the GDP. Although subsidy reforms have been proposed they remain highly politically contentious. Iran's parliament has blocked the second phase of fuel subsidy reforms, with budget proposals for 2013 projecting about a one-third increase in overall spending over 2012 levels. Recently Egypt has taken some tentative steps towards liberalizing fuel and energy subsidies and tax reforms are also in the works as the fiscal situation has deteriorated, but reforms remain difficult given lack of political consensus and elevated social tensions.

External vulnerability has increased among oil importers

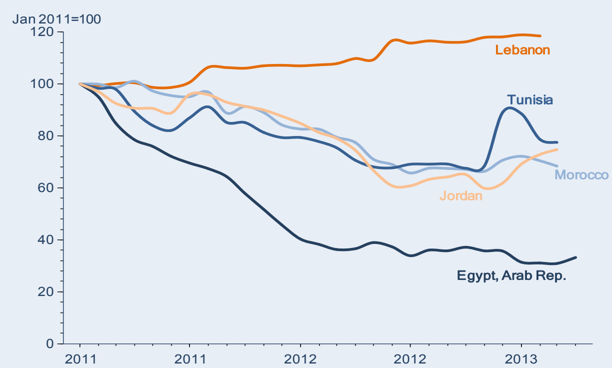
Rising current account deficits and balance of payments pressures combined with managed or fixed exchange rates have resulted in external financing difficulties, falling foreign exchange reserves (figure MENA.11), and repeated sovereign credit rating downgrades in several oil importing economies in the region. Higher current account deficits reflected an increasing cost of food imports compounded by weak European demand for North African exporters, reaching over 16 percent of GDP in Jordan and Lebanon (despite remittances estimated at 18 percent of GDP in the latter), and 9.6 percent in Morocco and 8.1 percent in Tunisia. Egypt posted a 3.1 percent of GDP deficit, with the trade deficit rising to 10.4 percent led by a sharp drop in merchandise exports and surging imports.

Trade deficits have shown signs of modest improvement entering 2013 in Jordan, Lebanon, Egypt and Tunisia. Foreign exchange reserves have also been partly bolstered in recent months reflecting external support from the IMF (Jordan), support from other regional economies (Jordan, Morocco and Tunisia), a rebound in foreign direct investment in Tunisia (up 85 percent during 2012) and short term private capital inflows in Lebanon. That said, excepting Lebanon, reserves are down by roughly a quarter in Tunisia, Jordan and Morocco compared to January 2011, amounting to only slightly higher than the critical 3 month import cover threshold in Tunisia and Jordan.

In Egypt, reserves are down by two-thirds from January 2011 (figure MENA.11), amounting to less than 2 months of import cover and the currency has fallen some 12 percent since late December. Dwindling reserves have forced the central bank to hold weekly foreign exchange auctions since December, and to raise its benchmark rate to 10.25 percent (up 75bp) in March to support the currency and combat inflation. Reflecting Egypt's precarious fiscal and external position, CDS spreads have widened substantially to close to 700 basis points and the country has received substantial financing assistance from Qatar and Libya.

Current account positions among oil importers improved last year, but are likely to face pressures this year reflecting lower oil prices, and growing

Fig MENA.11 Foreign exchange reserves have fallen sharply in some oil importing economies



Source: World Bank, Datastream.

import needs as they invest in production and refining capacities. Libya's current account position has improved, buoyed by recovery in crude oil production and continued elevated international prices, but current account positions have deteriorated in Syria and Iran, with the latter facing difficulty in securing buyers for its oil in Asia as international sanctions have tightened.

Financial flows to the region recovered slightly in 2012 but remain much lower than in 2010

Capital flows to the developing MENA region recovered modestly in 2012 to an estimated $17.5 billion after almost halving to $15.8 billion in 2011. The improvement reflected an increase in net FDI flows (up 22 percent) to Egypt, Morocco and Tunisia, although overall levels remain well below pre-Arab Spring inflows (table MENA.1). Morocco and Lebanon have also successfully issued sovereign debt over the last year worth $1.5billion (in December) and $1.1 billion (in April, 20 percent of which was bought by overseas investors) respectively. Other sovereigns including Jordan and Egypt are considering debuting sukuk bonds later this year in international capital markets to finance fiscal deficits.

Outlook

The outlook for the region as a whole remains dominated by domestic political developments, with added risks from external demand, commodity price and geo-political developments. Output for the region as a whole is projected to rise by 2.5 percent in 2013 (table MENA.2), and gradually firm to 3.5 percent and 4.2 percent in 2014 and 2015, buoyed on the one hand by stronger demand in the Euro Area and an assumed easing of regional political tensions, but held back on the other hand by declining oil prices and an assumed tightening of macroeconomic policies that begins to alleviate growing fiscal and inflation tensions.

In Egypt, the near term outlook remains difficult reflecting weak investor and consumer confidence on account of upcoming elections in the fall, widening fiscal and current account imbalances and delays in negotiating an IMF program. Egypt is expected to import natural gas for the first time in decades which will further add to external financing pressures. Official estimates project a bumper wheat harvest this year in Egypt, which could reduce food imports, but these are regarded as too

Table MENA.1 Net Capital Flows to Middle East and North Africa

	2008	2009	2010	2011	2012e	2013f	2014f	2015f
Capital Inflows	23.7	30.9	31.4	15.8	17.5	16.9	22.2	30.0
Private inflows, net	25.4	28.4	30.2	14.8	16.9	15.2	19.8	27.1
Equity Inflows, net	30.0	27.5	24.2	15.2	17.9	14.5	18.1	24.0
Net FDI inflows	29.6	26.3	22.3	15.4	18.9	15.0	17.0	22.1
Net portfolio equity inflows	0.4	1.2	2.0	-0.2	-1.0	-0.5	1.1	1.9
Private creditors. Net	-4.6	0.9	5.9	-0.4	-1.0	0.7	1.7	3.1
Bonds	-0.8	0.1	3.2	-0.6	-1.1	-0.7	0.5	1.8
Banks	-0.6	-1.3	-0.9	-0.02	-2.0	-0.8	0.8	1.4
Short-term debt flows	-1.9	3.0	4.5	0.9	2.3	2.8	1.5	0.9
Other private	-1.3	-1.0	-0.8	-0.6	0.0	0.0	0.0	0.5
Official inflows, net	-1.7	2.4	1.3	0.9	0.6	1.7	2.4	2.9
World Bank	-0.3	0.9	0.8	0.9	-0.2			
IMF	-0.1	-0.1	0.0	-0.1	0.1			
Other official	-1.3	1.6	0.4	0.1	0.7			

Source: The World Bank

Note: e = estimate, f = forecast

optimistic by some observers. Absent any major fiscal or balance of payments crisis, growth is expected to slow to 1.6 percent in the current fiscal year from 2.2 percent last year. Conditional upon a subsiding in political tensions and reforms being undertaken, growth should firm to about 3.0 percent next year and to about 4.8 percent in 2015, although this forecast remains subject to substantial downside risks (table MENA.3).

Growth is expected to pick up slowly in Tunisia. Although civil unrest experienced in February has receded, there remain tensions between conservative and secular forces. Exports showed signs of recovery in Q1, but a slow pace of recovery in Euro zone, its main trading partner, should temper gains in external demand and tourism inflows in 2013. Accordingly, growth is expected to rise to about 3.8 percent, only slightly higher than 3.6 percent in 2012, and to gradually pick up further to about 5 percent in 2015 as the external and internal environment improves.

Growth in Jordan is forecast to pick up somewhat to 3.3 percent in 2013 (from 2.8 percent), as confidence in the economy improves due to reforms taken as part of the IMF program, and also reflecting the boost to sentiment and activity from

Table MENA.2 **Middle East and North Africa forecast summary**

(annual percent change unless indicated otherwise)	00-09[a]	2010	2011	Est. 2012	Forecast 2013	2014	2015
GDP at market prices [b]	3.9	4.6	-2.2	3.5	2.5	3.5	4.2
(Sub-region totals-- countries with full NIA + BOP data) [c]							
GDP at market prices [c]	4.3	4.9	1.2	-0.3	1.2	2.6	3.5
GDP per capita (units in US$)	2.8	3.3	-0.4	-1.8	-0.3	1.1	2.1
PPP GDP [d]	4.3	5.2	1.0	-0.4	0.9	2.4	3.4
Private consumption	4.1	4.2	2.8	0.7	2.2	3.0	3.9
Public consumption	3.7	3.6	3.8	2.9	3.5	3.1	3.2
Fixed investment	6.9	3.0	2.7	-0.6	1.3	2.5	3.3
Exports, GNFS [e]	4.3	5.5	-3.5	-8.1	0.9	3.5	5.0
Imports, GNFS [e]	7.5	4.8	0.2	0.6	4.8	6.2	5.4
Net exports, contribution to growth	-0.6	0.2	-1.3	-3.0	-1.4	-1.2	-0.5
Current account bal/GDP (%)	5.2	1.6	1.5	-1.9	-3.3	-3.4	-3.1
GDP deflator (median, LCU)	5.9	8.4	6.4	4.2	4.2	3.7	3.3
Fiscal balance/GDP (%)	-0.5	-2.4	-3.7	-6.5	-6.4	-5.3	-4.7
Memo items: GDP							
MENA Geographic Region [f]	4.1	4.8	3.6	2.5	2.6	3.2	3.8
Selected GCC Countries [g]	3.8	4.6	6.1	5.3	3.8	3.8	4.0
Developing Oil Exporters	3.6	4.5	-4.4	3.5	2.1	3.1	3.8
Developing Oil Importers	4.5	4.8	1.6	3.5	3.1	4.1	4.7
Egypt	4.4	6.0	0.5	4.6	2.3	3.9	4.9
Fiscal Year Basis	4.3	5.3	1.8	2.2	1.6	3.0	4.8
Iran	4.6	5.9	1.7	-1.9	-1.1	0.7	1.9
Algeria	3.4	3.3	2.4	2.5	2.8	3.2	3.5

Source: World Bank.

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 2005 U.S. dollars.

c. Sub-region aggregate excludes Iraq and Libya, for which data limitations prevent the forecasting of GDP components or Balance of Payments details.

d. GDP measured at PPP exchange rates.

e. Exports and imports of goods and non-factor services (GNFS).

f. Geographic region includes high-income countries: Bahrain, Kuwait, Oman, United Arab Emirates and Saudi Arabia.

g. Selected GCC Countries: Bahrain, Kuwait, United Arab Emirates, Oman and Saudi Arabia.

Table MENA.3 Middle East and North Africa forecast summary

	00-09[a]	2010	2011	Est. 2012	Forecast 2013	2014	2015
Algeria							
GDP at market prices (% annual growth) [b]	3.4	3.3	2.4	2.5	2.8	3.2	3.5
Current account bal/GDP (%)	22.3	7.3	10.5	7.7	5.4	4.5	3.9
Egypt, Arab Rep.							
GDP at market prices (% annual growth) [b]	4.4	6.0	0.5	4.6	2.3	3.9	4.9
Fiscal Year Basis	4.3	5.3	1.8	2.2	1.6	3.0	4.8
Current account bal/GDP (%)	1.1	-2.0	-2.3	-3.1	-3.5	-2.8	-2.1
Iran, Islamic Rep.							
GDP at market prices (% annual growth) [b]	4.6	5.9	1.7	-1.9	-1.1	0.7	1.9
Current account bal/GDP (%)	6.4	7.1	5.9	-0.1	-2.5	-3.3	-3.0
Iraq							
GDP at market prices (% annual growth) [b]	-1.0	0.8	8.5	8.4	9.0	8.0	8.0
Current account bal/GDP (%)		3.0	12.5	7.0	3.8	3.0	4.0
Jordan							
GDP at market prices (% annual growth) [b]	6.1	2.3	2.6	2.8	3.3	3.4	4.5
Current account bal/GDP (%)	-4.4	-7.1	-12.0	-17.3	-15.4	-14.2	-12.7
Lebanon							
GDP at market prices (% annual growth) [b]	4.4	7.0	1.5	1.5	2.0	2.3	4.0
Current account bal/GDP (%)	-16.8	-20.4	-12.5	-13.8	-14.7	-13.6	-13.2
Libya							
GDP at market prices (% annual growth) [b]	3.8	3.5	-53.9	104.5	15.0	10.0	8.0
Current account bal/GDP (%)		19.5	9.1	35.8	24.0	18.0	9.0
Morocco							
GDP at market prices (% annual growth) [b]	4.6	3.7	5.0	2.7	4.5	4.8	4.7
Current account bal/GDP (%)	0.2	-4.5	-7.9	-9.5	-9.7	-8.8	-8.0
Syrian Arab Republic							
GDP at market prices (% annual growth) [b,c]	4.6	3.2	-3.2	-30.0	-10.0	-2.0	3.0
Current account bal/GDP (%)	2.7	-0.6	-1.7	-8.2	-8.8	-7.5	-6.7
Tunisia							
GDP at market prices (% annual growth) [b]	4.1	3.0	-1.8	3.6	3.8	4.8	5.1
Current account bal/GDP (%)	-2.7	-4.8	-7.4	-8.1	-8.4	-7.4	-6.4
Yemen, Rep.							
GDP at market prices (% annual growth) [b]	3.5	7.7	-10.5	0.1	4.3	4.5	4.6
Current account bal/GDP (%)	1.2	-3.7	-4.0	-1.4	-2.3	-2.8	-2.1

Source: World Bank.

World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not significantly differ at any given moment in time.

Djibouti, West Bank and Gaza are not forecast owing to data limitations.

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

b. GDP measured in constant 2005 U.S. dollars.

c. The estimate for GDP decline in Syria in 2012 is subject to significant uncertainty.

the signing of an $18bn deal with Iraq to build an oil pipeline from southern Iraq to Aqaba. The pipeline which is expected to be completed by 2017 should help spur FDI and domestic activity and help lift growth to over 4 percent by 2015. However there remain downside risks from the conflict in Syria. Morocco's economy should benefit from the recovery in agricultural sector output, which should lift growth to about 4.5 percent in 2013 from 2.7 percent in 2012 and to remain buoyant at just under 5 percent in the medium term supported by the recovery in the Euro Area.

Aggregate growth among oil exporters should slow in the near term reflecting a stabilization of production to a more sustainable pace in Libya, recession in Iran and production and export setbacks in Algeria and Iraq. Algeria's growth is expected to pick up modestly to about 2.8 percent in 2013 (from 2.5 percent) in 2013 and gradually firm thereafter. Iran's economy is expected to remain weak until some sort of resolution with Western governments over its nuclear issues can be reached. Until then domestic investment and private consumption should remain subdued with growth projected at about 1.9 percent in 2015, well below its average growth of 4.5 percent between 2000 and 2009.

Although a tentative agreement on oil payments between the Iraqi government and the Kurdish semi-autonomous region was reached in early May, longer term plans to raise Iraq's oil output to about 3.3 million bpd (from nearly 3 million bpd currently) may prove challenging given the recent history of tensions between the two and also given the scale of infrastructure investment needed to realize the higher output. Accordingly medium term growth is projected to remain at close to last year's outturns of about 8.5 percent. Near term risks have increased, however, given the escalation in conflict in recent months.

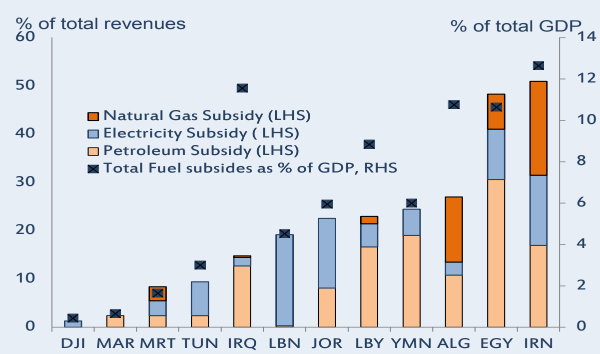
Capital inflows are expected to recover gradually in the region, rising to about US$30 billion in 2015, led mainly by growing FDI inflows as political tensions ease and reflecting infrastructure investment opportunities in both oil importing and exporting economies, including Algeria, Iraq and Jordan. Private capital flows to Egypt are likely to remain weak in the near term due to continued uncertainty there. However inflows should pick up, including inflows from GCC economies into construction and tourism sectors which have been diverted elsewhere into the region. For the region, equity inflows are also expected to recover but should remain modest compared to the pick up in bond inflows.

Risks and Challenges

The main risks and challenges facing the region are domestic. While a weaker outturn in the Euro Area would certainly impact the region, its likely influence pales compared with the potential impact of increased social and political tensions, or compared with the likely impact of a failure to address growing macroeconomic imbalances, including fiscal deficits bloated to unsustainable levels by fuel and food subsidies that amount to over a fifth of government revenues in several economies (figure MENA.12) and rising debt levels that threaten long-term fiscal sustainability, and for oil exporters the potential impact of a more pronounced than projected decline in commodity prices.

Political tensions and security risks remain elevated and there are growing signs of domestic political polarization in several economies. Elections are due in a number of countries this year or early next year, making for a challenging reform environment at a time of domestic unrest and persistently high levels of

Fig MENA .12 **Subsidy reforms are crucially needed to improve fiscal sustainability**



Source: World Bank, IMF (2013).

unemployment. Already heightened tensions in Iraq and Lebanon could be further worsened by spillovers from Syria, with potentially destabilizing effects for these economies.

Over the longer term, the structural challenges facing the region—and which are currently a source of ongoing social and political tensions—remain much the same as before the onset of the Arab Spring. Consequently, unless progress is made on building political and social consensus needed to undertake the necessary structural reforms, then it is very likely that the developing Middle East and North Africa region will continue to lag other developing regions and that growth rates will remain relatively low even when calm is eventually restored to the region.

Much of the region faces ***very real challenges on the fiscal front***, due in part to increased social spending to assuage tensions that have arisen in the context of the Arab Spring, but also because of high fuel and food prices that have sharply increased the cost of subsidy programs (figure MENA.12). Dealing with this would be difficult enough at the best of times, but is particularly challenging in the current slow growth and socially volatile period. Still, with such expenditures at some 6 percent of GDP in many countries, inaction does not appear to be an option. Experience from other countries suggests that explicitly combining a reduction in subsidies with a reinforcement of targeted assistance of the very poor can make such a reform more politically acceptable and minimize the negative poverty effects – while still reducing fiscal deficits.

Inaction risks a fiscal crisis, where markets refuse to finance additional deficits forcing a much sharper, less acceptable and more damaging cut in government spending. This is particularly the case for economies running low on foreign exchange reserves, with slowing of domestic reform efforts further undermining fiscal solvency and investor confidence, both domestic and overseas. In Egypt, a delay or halt in future aid disbursements could spiral into serious balance of payments difficulties given its already low level of reserves and undermine confidence in the banking sector which has high levels of exposure to sovereign debt.

Commodity price and demand/ supply risks: The economies of oil exporters are particularly vulnerable to a shift in the price of oil. As discussed in the main text, global supply has responded to the higher prices of the past 10 years, and as a result large gaps have been generated between hydrocarbons in North America and the rest of the world. As existing bottlenecks increasingly allow this new supply (and that coming from Sub-Saharan Africa and elsewhere) to reach global markets, prices could decline much more quickly than in the baseline. In such an instance government revenues and current account balances would come under pressure.

Simulations discussed in the main text show the effects of a fall in real oil prices to $80 per barrel by mid-2014. They suggest that developing oil exporters in the Middle East and North Africa region (along with exporters in sub-Saharan Africa) would be hardest hit by such a decline, with GDP declining by 1.4 percent relative to the baseline, government balances deteriorating by as much as 2.1 percent of GDP and current account balances by 3.5 percent in 2014. For countries, like Algeria or Iran, where fiscal balances are already under pressure this could force sharp adjustments in demand, policy and exchange rates. Conversely, oil importers with stressed fiscal and balance of payments positions would benefit from such a decline, with GDP 0.5 percent higher relative to the baseline on average, and current accounts and fiscal balances improving by 0.5 and 0.2 percent of GDP respectively in 2014.

In the current environment, regional oil exporters will no longer be able to rely on high and rising prices, but will increasingly need to rely on increased output. This in turn necessitates reforms that would allow them to invest heavily in infrastructure, and exploration to raise current production levels which have stagnated or been steadily declining in recent years. However, private capital and FDI inflows may fail to materialize because of security risks, poor legal environments for investment and political uncertainty to varying degrees in Algeria, Iraq, Libya and Yemen and international sanctions in the case of Iran.

Economic developments in the Eurozone: The Eurozone (and to a lesser extent the US) account for the bulk of the region's manufacturing, service and hydrocarbon exports.

Any setback to the ongoing recovery there could undermine exports and tourism in oil importing economies and export and fiscal revenues in Algeria and Iraq. Heightened risk aversion could also reduce already depressed capital inflows into the region and dent confidence, particularly in countries with large macroeconomic imbalances, high levels of debt and severely depleted fiscal and reserve buffers. On the upside, a faster than expected recovery in the Euro Area could provide positive tailwinds to these economies, reducing balance of payment and exchange rate pressures.

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