"Comparative Study of Crude Oil Trade in Middle East and North Africa for there Economic Development"

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DECLARATION BY THE GUIDE

This is to certify that the dissertation report on "Middle East and North Africa Economic Development" submitted to the University of Petroleum & Energy Studies, Dehradun, by Adhish Singhal, in partial fulfillment of the requirement for the award of the degree of Master of Science (Oil Trading) is a bonafide work carried out by him under my supervision and guidance.

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Executive Summary

For the third year in a row, the Middle East and North Africa region1 (MENA) enjoyed a spectacular year of growth, buoyed by record high growth rates among the region's oil exporters. As oil prices continued their upward climb, the MENA region grew by an average of 6.0 percent over 2005, up from 5.6 percent over 2004, and compared with average growth of only 3.5 percent over the late 1990s. On an annual basis, MENA's average economic growth over the last three years, at 6.2 percent a year, has been the highest three-year growth period for the region since the late 1970s. MENA's regional growth upturn has not been universally shared, however, and resource poor economies2 are increasingly feeling the adverse impact of higher oil prices. In earlier periods, MENA's non-oil economies also benefited from rising oil prices, through a range of transmission mechanisms from the oil producers, including labor remittances and aid. Many transmission channels remain and have thrived during the current oil boom, including intraregional tourism and portfolio equity flows, but the overall magnitude of these channels is significantly diminished relative to prior booms. Moreover, with rising energy use, MENA' resource poor countries are increasingly experiencing the negative consequences of higher oil prices on the external and fiscal fronts, in the form of higher oil import bills and energy subsidies.

Growth patterns among oil producers, on the other hand, have been increasingly harmonized, reflecting a trend toward common development strategies. They are building up liquidity, through external reserves, oil stabilization funds, and through paying down debt. They are also pursuing common strategies for diversification of the oil wealth into foreign assets, as a way to transform the finite oil wealth into longer-term revenue streams. They have worked almost in unison to develop trade ties and to encourage greater foreign participation in their economies. With increased prudence, the volatile growth outcomes among oil producers which characterized the 1970s and 1980s have been increasingly supplanted by a common growth effect.

Need of the Study

The purpose of making this dissertation is to analyze how much revenue earned from the sale of oil at a high price reaches to the actual producing countries. How the economy of the countries is balanced between the oil exporting country and oil importing country.

The steps taken by MENA's oil producers have been increasingly harmonized, reflecting a trend toward common development strategies. Compared with previous oil booms, the region's oil producers are increasingly demonstrating impressive fiscal restraint. They are building up liquidity, through external reserves, oil stabilization funds, and through paying down debt. They are also pursuing common strategies for diversification of the oil wealth into foreign assets, as a way to transform the finite oil wealth into longer-term revenue streams. They have worked almost in unison to develop trade ties and to encourage greater foreign participation in their economies.

How are they Cooperating among themselves, What are there strategies how are they planning, how the resourceful country is balancing the economy of a poor resource country.

Objective of the Study

2005 was a year of major developments in the Middle East and North Africa (MENA) region. A few events made international headlines over 2005: oil prices hitting record levels, the continuing turmoil in Iraq, building tensions regarding Iran's nuclear policy, the aftermath of political upheaval in Lebanon, and the uncertain political situation and aid implications in the West Bank and Gaza. But many of the developments that have not made headlines – the deteriorating impact of high oil prices on non-oil producers in the region, increasing moves by oil producers to channel windfalls into longer term assets, and progress with structural reforms – have been just as important in determining the direction of the economies in MENA.

With oil prices continuing their soaring advances, the efficiency with which the region channels the oil-related resources into the real economy will depend critically upon the region's financial sectors. It is thus particularly opportune to examine the state of the region's financial systems, to understand how they contribute to growth, promote efficiency, and enhance productivity – through corporate governance, through savings mobilization, and through their ability to protect against systemic shocks.

This is the reports that is been made to analyze the current scenario in the MENA region. Its aim is to shed light on recent key economic developments in the region, and the forces underlying the region's economic outcomes. It analyzes the region's medium term growth prospects given global forecasts, and, building on last year's issue, the report continues to chart the region's progress with implementing comprehensive structural reforms for longer-term growth., The important topic of MENA's financial markets is highlighted, to understand how financial systems are poised to meet some of the region's development objectives. As always, it is hoped that the report deepens the understanding of the region's development progress, prospects, and challenges.

Research Methodology

- Qualitative Research
- Secondary source of Data
- Analyzing Graphs and Charts

The research includes the qualitative research. Going through the secondary Data analyzing it, interpreting it and finally coming to an conclusion. Data have been Collected from various sources such as Sites, Books available on net as free publication Journal in Various magazines.

Chapter 2

Literature Review

RESEARCH FOR DEVELOPMENT IN THE MIDDLE EAST AND NORTH AFRICA,

Eglal Rached and Dina Craissati

This book explores the current challenges and opportunities of research for development in the Arab countries of the Middle East and North Africa. Experts from the region and development professionals from around the world provide a detailed portrait of the research environment and explore the relationship between science and policy. They also present and discuss new research initiatives in the areas of social and economic development, natural resource management, and information and communication technologies.

The Middle East and North Africa 2003 **By Europa Publications** , Routledge (UK).

The Middle East and North Africa 2003" provides impartial analyses and an invaluable collection of the latest statistics and directory data on all the countries and territories of the Middle East and North Africa. Providing background information on issues concerning the region as a whole, the introductory essays written by eminent writers, scholars, journalists and broadcasters provide a general survey and analyses of the contemporary social, political and economic situation.

Knowledge Economies in the Middle East and North Africa[: Toward New Development Strategies **By Jean-Eric Aubert, Jean-Louis Reiffers Published 2003 World Bank Publications**

This book, developed from papers prepared for a World Bank sponsored conference, assesses the challenges confronting the region¿s countries and analyzes their readiness for the knowledge economy based on a set of indicators. It provides quantitative analysis to help benchmark the countries against worldwide knowledge economy trends, identifies key implementation issues, and presents relevant policy experiences. The basic policy elements that underpin a strategy to prepare for a knowledge-based economy are discussed, including: the renovation of education systems, the creation of a climate conducive to innovation, and the development of an efficient telecommunications infrastructure as the foundation of a new era. The formulation of national visions and strategies is also discussed.

Chapter 3

Introduction to MENA

Introduction

For the third year in a row, the Middle East and North Africa region1 (MENA) enjoyed a spectacular year of growth, buoyed by record high growth rates among the region's oil exporters. As oil prices continued their upward climb, the MENA region grew by an average of 6.0 percent over 2005, up from 5.6 percent over 2004, and compared with average growth of only 3.5 percent over the late 1990s. On an annual basis, MENA's average economic growth over the last three years, at 6.2 percent a year, has been the highest three-year growth period for the region since the late 1970s.

MENA's regional growth upturn has not been universally shared, however, and resource poor economies2 are increasingly feeling the adverse impact of higher oil prices. In earlier periods, MENA's non-oil economies also benefited from rising oil prices, through a range of transmission mechanisms from the oil producers, including labor remittances and aid. Many transmission channels remain and have thrived during the current oil boom, including intraregional tourism and portfolio equity flows, but the overall magnitude of these channels is significantly diminished relative to prior booms. Moreover, with rising energy use, MENA's resource poor countries are increasingly experiencing the negative consequences of higher oil prices on the external and fiscal fronts, in the form of higher oil import bills and energy subsid ies. Growth patterns among oil producers3, on the other hand, have been increasingl harmonized, reflecting a trend toward common development strategies. Compared with previous oil booms, the region's oil producers are increasingly demonstrating impressive fiscal restraint.

They are building up liquidity, through external reserves, oil stabilization funds, and through paying down debt. They are also pursuing common strategies for diversification of the oil wealth into foreign assets, as a way to transform the finite oil wealth into longer-term revenue streams. They have worked almost in unison to develop trade ties and to encourage greater foreign participation in their economies. With increased prudence, the volatile growth outcomes among oil producers which characterized the 1970s and 1980s have been increasingly supplanted by a common growth effect.

Although oil prices dominate the region's external landscape, MENA has experienced other important developments on the trade front. Resource poor economies have dealt with the expiry of the Multi-Fibre Agreement in 2005, which had allowed privileged access for Tunisia, Morocco, and Egypt in textile and clothing products to European markets. Textile exports in Tunisia and Morocco have been hard hit , while Egypt has managed to maintain textile exports to date, in part by cushioning the impact with a December 2004 agreement on qualifying industrial zones between the US, Egypt, and Israel.

On the fiscal front, the sharp rise in oil prices has brought to the spotlight the MENA region's heavy subsidization of oil prices within the domestic market. While oil-importing economies are particularly affected, the reliance on energy subsidies pervades the region, with large fiscal implications. Several resource poor countries have implemented short term adjustments to oil prices, but the concerns of potential poverty impacts have held back more ambitious reforms. Among oil exporters, windfall revenues have delayed the perceived urgency for reform.

Over the medium term, general conditions for maintaining a solid pace for growth appear promising. Global oil prices are now anticipated to hold above $50/bbl through 2008, which will provide for a moderating, yet still substantial flow of oil revenues to MENA exporters. Should prudent budgetary policies prevail, prospects for the oil dominant economies are upbeat, with growth easing from 6.7 percent in 2005 to 5 percent by 2008. For the diversified economies, the anticipated recovery in European demand will be a key external factor for growth over 2006- 2008, as will the easing of oil prices, that should allow some of the costs of subsidies to be recaptured, and growth among resource poor economies is viewed to pick up above 5.5 percent.

Overall, on a base set of assumptions, including continued moderate progress in domestic reforms, the MENA region's growth is viewed to ease modestly in 2006 to 5.6 percent, and to establish a 5.2 percent pace over 2007-08, reflecting an acceleration for the diversified economies, contrasted with some slowing for oil exporters.

Overview Table 1: Global developments and MENA GDP growth

Growth, or as otherwise Specified	2004	2005	2006	2007	2008
World trade [a]	12.0	9.0	8.5	7.0	7.0
High income imports	8.9	6.6	6.7	6.2	6.2
Euro area	6.3	4.3	5.8	5.3	5.4
United States	10.7	6.2	5.0	3.8	3.8
Oil prices ($/bbl) [b]	37.7	53.4	59.0	56.0	53.0
Non-oil commodity prices [c]	17.3	13.4	5.4	-3.1	-5.9
MUV index [d]	6.9	0.0	2.4	2.6	0.8
US dollar LIBOR (%)	1.7	3.6	5.2	5.3	5.2
World GDP [e]	3.8	3.3	3.3	3.2	3.2
High income countries	3.2	2.8	2.9	2.7	2.8
Euro area	1.9	1.4	2.1	1.7	1.9
Developing countries	6.9	6.3	6.0	5.7	5.6
MENA [f]	5.6	6.0	5.6	5.2	5.2
Resource Poor	4.8	4.0	5.4	5.4	5.7
Resource Rich	5.9	6.7	5.5	5.2	5.0
Resource Rich Labor Abundant	4.7	5.5	5.3	5.1	4.8
Resource Rich Labor Importing	6.5	7.2	5.8	5.3	5.0

A: Goods and services (2000 $US); b: World Bank average oil price = equal weights of Brent, WTI, and Dubai crude oil prices; c: World Bank index of non-oil commodity prices in nominal $US terms; d: Index of manufactures unit value, G-5 countries (France, Germany, Japan, United Kingdom and United States); e: Real GDP in 2000 $US. f: MENA geographic region comprised of resource poor, labor abundant countries (Djibouti, Egypt, Jordan, Lebanon, Morocco and Tunisia); resource rich, labor abundant countries (Algeria, Iran, Iraq, Syria and Yemen) and resource rich, labor importing countries (Bahrain, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates).

Source: World Bank, 2006c.

Fig 3.1: Global Development and MENA GDP Growth

The oil shock MENA is experiencing has had important financial spillovers. Over the last few years, MENA has seen an upsurge in financial activity, as abundant liquidity has fed a rapid rise in credit growth, surging stock markets, and a booming real estate sector. Oil economies have been the primary recipients, but a financial market upswing has also reached some of the region's resource poor countries through increased cross border investment, remittance flows and tourism.

Many of the recent regional financial sector developments are positive. Strong credit growth and declining non-performing loans have improved bank profitability and asset quality. Rising equity capital has raised the breadth and depth of investment opportunities to investors. In addition, many countries in the region have utilized their strengthened positions to address long needed financial sector reforms, including public -sector bank restructuring and privatization, licensing private financial entities, improving bank supervision, and upgrading prudential regulations. However, several of the recent financial sector developments have raised exposure of some MENA economies to negative shocks. Banks have rapidly expanded financing for equity markets. Although the recent stock market gains have been built in part on impressive corporate profitability, stocks have also been increasingly speculative. Bank exposure to equity markets, both through lending as well as through substantial income from brokerage fees, leaves bank income and asset quality vulnerable as a result of recent market corrections. Banks have also increased exposure to the booming real estate sector, which may be vulnerable to contagion effects from the recent equity market weaknesses, and which may also face slowdown with growing oversupply.

But a more troubling aspect about MENA's financial markets is the seeming disconnect between the financial sector and the real private economy, despite the appearance of a relatively deep financial sector by macroeconomic indicators. Although regional banks have abundant liquidity, outside of the Gulf, few private businesses have access to bank finance. Even in countries with relatively high rates of lending to the private sector, credit remains concentrated among a select minority, and investment climate surveys suggest an average of more than 75 percent of private business investment in MENA is financed internally through retained earnings.

As a result, few of the assets accumulating to the region are channelled toward productive investment. Moreover, key elements of a well-functioning financial sector that could help boost sustainable and efficient growth, including bond and equity markets and contractual savings instruments, remain largely undeveloped outside of the Gulf.

A few critical facts lie at the heart of the structural disconnect between the relatively plentiful financial resources found across MENA and the scarcity of external financing for businesses.

Public sector ownership has significantly impacted the direction of credit in MENA, as well as the operating efficiency and the ability of the banking sector to conduct robust risk analysis. Bank regulatory frameworks, with limited market forms of oversight and discipline, have led to adverse credit allocation. Access to banking facilities remains comparatively limited across the region, and in many cases is restricted to public sector banking networks, concentrating credit provision upon a relatively privileged minority. Underdeveloped contractual savings and capital markets remove a source of competition for banks and an alternate avenue for firm finance.

Governance structures undermine formal financial relationships across much of MENA. And commercial-finance relationships are further undermined by a wealth of problems in MENA's business climate. The region's recent strong liquidity creates a window for the governments of the MENA region to either accelerate or postpone the complicated process of reform, both within the financial sector an in the economy in general. With the large windfall revenues accumulating to oil producers since 2002, a natural question emerges as to what impact oil is having on the reform process. To date, the large budget surpluses appear to have delayed the imperative for reform of the oil subsidy system in resource rich economies. Oil producers have also exhibited weaker reform progress over the last several years than the region's resource poor economies along two major structural reform fronts: improving the business climate and liberalizing trade.

However, the more subdued progress made by oil exporters in these areas of reform in large part reflects lack of improvements among GCC economies, which have traditionally maintained more open and business-friendly trade and investment policies. More importantly, as a group, the oil economies have demonstrated long-awaited progress in governance, an area in which the group demonstrates significant deficit relative to the rest of the world. Specifically, notable progress has taken place over the last five years in enhancing public sector accountability mechanisms, which augers well for continuing reform success. Although oil economies continue to rank in the bottom twentieth percentile relative to the rest of the world in terms of measures of public sector accountability (including political and civil liberties, freedom of information, etc4), over the last five years, oil economies have made greater progress in improving public sector accountability than all other regions of the world, on average ranking in the 65th percentile worldwide with regard to improving public accountability.

Worldwide, successful reform efforts have depended critically upon the support and participation of those in society whom reforms will impact. The governance improvements in MENA, in terms of enhancing the accountability of governments and granting greater voice in development to MENA's people, are important not only to take into account the needs and values of those who are affected by reforms, but also to ensure that in the transition to a new development model, the economic outcomes are socially acceptable among those who have benefited from the old systems. The MENA region continues to have the greatest gap with the rest of the world in terms of accountable and inclusive governance structures, on average ranking in the bottom quintile worldwide. It is thus an important development that both resource rich and resource poor economies in MENA are making a start at these vital changes.

Overview Table 2: Structural reform progress in MENA, 2000-2005

Country/Region	Trade Policy		Business Climate		Governance: Quality of public administration		Governance: Public sector accountability	
	Current status	Reform progress	Current status	Reform progress	Current status	Reform progress	Current status	Reform progress
Algeria	44	71	13	38	38	91	29	91
Bahrain	..	62	..	..	77	26	23	91
Djibouti	..	51	..	74	..	..	..	..
Egypt	43	100	11	36	43	92	25	84
Iran	22	74	57	44	16	19	21	4
Iraq	..	..	66	..	..	..	..	..
Jordan	47	86	58	89	66	67	34	60
Kuwait	53	65	59	7	58	24	31	65
Lebanon	61	80	37	31	..	..	..	..
Libya	..	27	..	..	11	64	0	42
Morocco	38	52	61	54	73	83	33	81
Oman	71	11	78	15	61	75	16	81
Qatar	..	..	..	..	60	89	13	74
Saudi Arabia	39	77	80	26	57	77	5	69
Syria	18	43	30	5	15	67	7	74
Tunisia	51	57	83	93	74	87	22	22
UAE	..	..	43	14	59	6	17	41
Yemen	62	82	35	57	28	71	20	89
MENA	**46**	**63**	**51**	**42**	**49**	**63**	**20**	**64**
Resource poor	**48**	**71**	**50**	**63**	**64**	**82**	**28**	**62**
Resource rich	**44**	**57**	**51**	**23**	**44**	**55**	**17**	**65**
RRLA	**36**	**67**	**40**	**36**	**24**	**62**	**19**	**64**
RRLI	**54**	**48**	**65**	**15**	**55**	**52**	**15**	**66**
East Asia Pacific	**56**	**37**	**61**	**47**	**43**	**45**	**41**	**48**
Europe Central Asia	**51**	**69**	**48**	**64**	**47**	**46**	**52**	**51**
Latin America / Carib	**57**	**50**	**40**	**51**	**46**	**50**	**57**	**43**
High Income OECD	**70**	**64**	**84**	**50**	**89**	**47**	**91**	**49**
South Asia	**41**	**48**	**48**	**41**	**48**	**53**	**39**	**31**
Sub-Saharan Africa	**34**	**27**	**27**	**43**	**34**	**53**	**37**	**55**
WORLD	**50**	**50**	**50**	**50**	**50**	**50**	**50**	**50**

Note: Regional averages reflect the simple average of the data for the countries included. a. Current status (trade, business, or governance) reflects country's current placement in a worldwide ordering of countries based on that structural reform indicator, expressed as a cumulative frequency distribution, with 100 reflecting the country with the most friendly /open/accountable policies or structures (worldwide) and 0 representing the country with the most unfriendly/closed/unaccountable policies or structures (worldwide). b. Reform progress reflects the improvement in a country's rank between 2000 and 2005 in a worldwide ordering of countries based on that structural reform indicator, expressed as a cumulative frequency distribution, with 100 reflecting the country which exhibited the greatest improvement in rank and 0 reflecting the country which exhibited the greatest deterioration. Source: World Bank staff estimates from country data.

Fig 3.2: Structural Reform and progress in MENA

With diminishing positive links to the oil economies (and increasing negative impacts from higher oil prices), the resource poor economies in the MENA region have maintained a solid pace of reform, generally exceeding other regions of the world across all areas of reform. In both trade reform and business and regulatory reform, the resource poor economies have made, on average, stronger progress over the last five years than all other regions of the world.

Largely in connection with recent bilateral and multilateral trade agreements, and led by deep tariff reductions undertaken in Egypt, resource poor economies on average ranked in the 71st percentile with regard to tariff reform over the last five years. With regard to reform of the business climate, the steps taken by resource poor economies placed them in the top 63rd percentile, on average. Nonetheless, much stronger progress can take place, particularly with regard to trade liberalization. The resource poor economies as a group continue to maintain some of the highest tariffs in the world, ranking in the bottom 25th percentile worldwide with regard to low tariff protection.

In the area of governance, resource poor economies have also demonstrated significant progress. In the area of improving public sector accountability, resource poor countries ranked, on average, in the 62nd percentile with regard to reform progress, second only to the gains made by the MENA region's resource rich economies. In improving the quality of public sector administration, the group ranked in the 82nd percentile with regard to reform, the strongest progress worldwide, led by strong achievements in Egypt, Tunisia and Morocco.

Along with across the board policy reform, MENA economies continue to look to selective industrial policies designed to enhance specific sector competitiveness and growth to complement more broad-based structural reform. Although the views on industrial policy are changing, and a variety of economic justifications can be made for their use, MENA's own unsuccessful history with industrial policies (and the difficulty in transitioning out of them) should serve as a cautious reminder that the most effective policies for promoting growth rely on strategies to create a neutral and internationally competitive business environment.

Chapter 4

RECENT ECONOMIC OUTCOMES AND SHORT-TERM DEVELOPMENT PROSPECTS IN MENA

The Middle East and North Africa region5 (MENA) enjoyed another exceptionally strong year of economic expansion, buoyed by the record high growth rates among the region's oil exporters. As oil prices continued their upward climb, the MENA region grew by an average of 6.0 percent over 2005, up from 5.6 percent over 2004, and compared with average growth of only 3.5 percent over the late 1990s. On an annual basis, MENA's average economic growth over the last three years, at 6.2 percent a year, has been the highest three-year growth period for the region since the late 1970s.

MENA's regional growth upturn has not been universally shared, however, and resource poor economies are increasingly feeling adverse impact of higher oil prices. In earlier periods, MENA's non-oil economies also benefited from rising oil prices, through a range of transmission mechanisms from the oil producers, including aid and labor remittances. Many transmission channels remain and have thrived during the current oil boom (including intraregional tourism and portfolio equity flows), but the overall magnitude of these channels is significantly diminished relative to prior booms. Moreover, the positive benefits from these transmission channels have been increasingly overshadowed by the detrimental external and fiscal consequences of higher oil import bills and surging oil subsidies.

Economic growth patterns among oil producers have been increasingly harmonized, reflecting a trend toward common development strategies. Compared with previous oil booms, the region's oil producers are increasingly demonstrating impressive fiscal restraint. They are building up liquidity, through external reserves, oil stabilization funds, and through paying down debt. They are also pursuing common strategies for diversification of the oil wealth into foreign assets, as a way to transform the finite oil wealth into longer-term revenue streams. With this increased prudence, the volatile growth outcomes among oil producers which characterized the 1970s and 1980s have been increasingly supplanted by a common growth effect.

Although oil prices dominate the region's external landscape, MENA has experienced other important developments on the trade front. Resource poor economies6 have dealt with the expiry of the Multi-Fibre Agreement (MFA) in 2005, which had allowed privileged access to Tunisia, Morocco, and Egypt in textile and clothing products to European markets. Textile exports in Tunisia and Morocco have been hard hit , while Egypt has managed to maintain textile exports to date, in part by cushioning the impact with a December 2004 agreement on qualifying industrial zones (QIZs) between the US, Egypt, and Israel.

On the fiscal front, the sharp rise in oil prices has brought to the spotlight the MENA region's heavy subsidization of oil prices within the domestic market. Although oil-importing economies are particularly affected, the reliance on energy subsidies pervades the region, with large implications on fiscal positions. Several resource poor countries in the region have implemented short term adjustments to oil prices, although the concerns of potential poverty impacts have held back more ambitious reforms. Among oil producers, windfall revenues have delayed the perceived urgency for reform.

Over the medium term, two major elements are likely to shape the outlook for the broader MENA region. Developments in critical non-oil export markets for MENA will carry substantial influence on the outlook for the region's diversified economies, largely within the resource poor, labor abundant group. And at the same time, the dynamics of the oil market are anticipated to change as global demand and supply conditions evolve over the next years.

General conditions for maintaining a solid pace for growth over the next years appear promising. Global oil prices are now anticipated to hold above $50/bbl through 2008, which will provide for a moderating, yet still substantial flow of oil revenues to MENA exporters. Should prudent budgetary policies prevail, prospects for the oil dominant economies are upbeat, with growth easing from 6.7 percent in 2005 to 5 percent by 2008. For the diversified economies, the anticipated recovery in European demand will be a key external factor for growth over 2006- 2008, as will the easing of oil prices, that should allow some of the costs of subsidies to be recaptured. On a base set of assumptions, including continued moderate progress in domestic reforms, the MENA region's growth is viewed to ease modestly in 2006 to 5.5 percent, and to establish a 5.2 percent pace over 2007-08. Overall growth reflects a pick-up for the diversified economies above 5.5 percent, contrasted with a slowing for oil exporters toward the 5 percent mark.

Recent Economic Development

The Middle East and North Africa region experienced another stellar year of economic growth, as oil prices continued their upward climb over 2005. Growth in the region averaged 6.0 percent over 2005

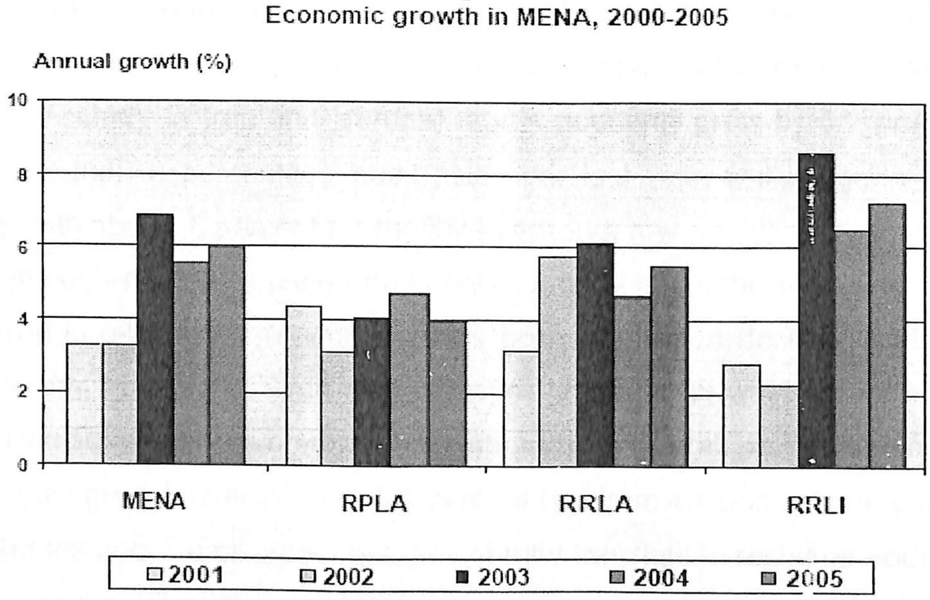


Fig 4.1: Economic Growth in MENA 2000-2005

Over past three years, GDP in the region7 has grown by an average of 6.2 percent a year, the highest three year average growth rate for the region in nearly three decades.

Above all, MENA's recent growth upturn reflects the spectacular events in the oil market, where continuing tight supply and volatility in response to external conditions have resulted in surging oil prices over the last three years. Combined with production increases, rising oil prices havse fueled extraordinary economic growth among oil producers8, which together grew 6.7 percent over 2005 and accounted for 84% of regional growth last year9. Most impressive has been the economic expansion among the region's resource rich and labor importing economies, which grew by more than 7 percent over the year. Most of the group has benefited from OPEC10 production increases, including Saudi Arabia , which expanded by 6.5 percent (more than a percentage point gain over growth in 2004, and behind 2003, the highest rate of economic growth experienced by the economy in fifteen years). Other OPEC producers, including Kuwait, Libya, the United Arab Emirates and Qatar, all realized economic growth rates in excess of 8 percent last year.

MENA's resource rich labor abundant (RRLA) economies (excluding Iraq) also reaped the benefits of higher oil prices, supported by expansionary fiscal policy (particularly in Iran and Yemen). Iran's economy grew by 5.9 percent last year, more than a percentage point gain over last year, while Algeria saw economic growth above 5 percent for the third year in a row.

Although higher oil prices have only partially offset the effects of the substantial drop in oil exports (stemming from both production declines and loss of oil re-exports from Iraq), Syria also managed stronger growth over 2005 as a result of sizeable expansion of non-oil exports to Iraq. Overall, RPLA economies recorded robust growth over 2005 of 5.5 percent (up from 4.7 percent last year)

But the boon to oil producers did not fully translate to resource poor economies in the region. Growth among resource poor economies averaged 4 percent over the year (down from 4.8 percent in 2004), chiefly reflecting the sharp growth contractions in Morocco and Lebanon, and slower growth in Tunisia . Stagnating European demand and a severe drought contributed to a reduction in Morocco's economic growth of almost two-thirds from 2004 (and the lowest annual growth rate for the country in five years) as well as to a drop in growth in Tunisia.

Diminished investor confidence and shaken security following the February 2005 assassination of former prime minister Hariri, meanwhile, resulted in Lebanon's economic growth collapsing to 1 percent over 2005, down from more than 6 percent growth the previous year. Elsewhere, resource poor countries fared better, including Egypt, where the economic revival has been driven by both manufacturing exports and strong growth of services, including tourism and Suez Canal receipts. Jordan has also posted strong growth reflecting the rapid expansion of private spending and investment financed by surging capital inflows.

Following a strong economic rebound recorded in 2004, growth in Iraq averaged a sluggish 2.6 percent over 2005, with the country unable to capitalize from soaring oil prices. The sabotage of oilfield installations has thwarted Iraq's ability to increase oil export revenues. And continuing attacks on power and transportation facilities has seriously detracted from developing the non-oil sector of the economy, worth about 33 percent of GDP. The continued lack of security, both in terms of sectarian violence and insurgent activity, has stalled Iraqi reconstruction and remains the fundamental threat to a sustained economic recovery.

On the per capita basis, MENA's recent economic expansion has been undermined by continuing rapid population growth, particularly among the resource rich labor importing economies, where 2005's growth rate of 7.2 percent amounted to only 3.9 percent on a per capita basis. Overall, MENA's per capita growth over the last two years (averaging 3.9 percent a year), while a marked improvement over the 1990s, remains off the pace of developing countries as a group (overall, and excluding China and India), and well behind the growth in other middle income regional sub-groupings

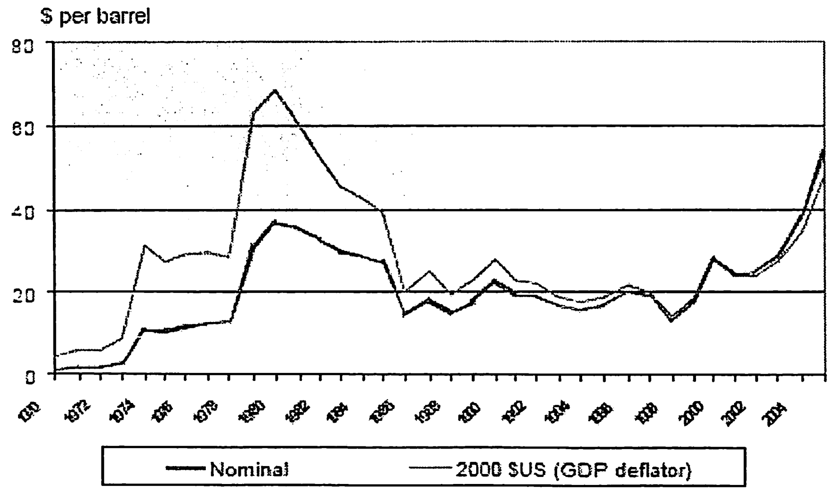
Growth of GDP per capita	1995-1999	2003	2004	Estimate 2005
MENA Geographic Region (exc. Iraq)	**1.7**	**4.9**	**3.8**	**4.0**
MENA Geographic Region (inc. Iraq)	..	*3.4*	*4.3*	*3.8*
Resource Poor Labor Abundant	2.8	2.3	3.0	2.2
Resource Rich Labor Abundant (exc. Iraq)	1.5	4.3	3.1	3.7
RRLA Economies (inc. Iraq)	..	*-0.8*	*5.3*	*3.2*
Resource Rich Labor Importing	0.4	5.3	3.3	3.9
Developing countries	2.1	4.2	5.5	4..7
Excluding transition economies	2.5	3.9	5.4	4.7
Excluding China and India	0.8	2.6	4.6	3.4
Low-income countries	3.5	5.3	4.7	4.8
Latin America and the Caribbean	2.5	-0.1	2.8	1.5
South Asia	4.1	6.2	5.1	5.4
Excluding India	1.9	3.3	4.1	4.8
Sub-Saharan Africa	1.8	2.1	3.3	3.0
Middle income countries	2.3	4.3	5.9	4.9
East Asia and the Pacific	5.9	7.8	7.9	7.4
Excluding China	1.3	4.3	4.9	3.0
Europe and Central Asia	1.5	5.9	7.0	5.2
Latin America and the Caribbean	0.9	0.6	4.1	3.1
South Asia	3.6	4.8	4.2	3.5
High income countries	2.0	1.3	2.6	1.9
World	1.6	1.4	2.7	2.0

a: Does not include Libya. Source: World Bank staff estimates.

Fig 4.2: Growth of GDP per Capita

<u>Oil market developments shape regional outcomes</u>

For the third straight year, crude oil prices rose sharply over 2005, from an average of $38 a barrel over 2004 to more than $53 over 200511, an increase of more than 40 percent year on year (Figure 1.2). Oil price developments over the past three years reflect a continuing tight market, with exceptionally large demand growth (particularly emanating from China) especially for refined products driving prices upward. Over 2005, oil markets also experienced significant volatility in response to external conditions, and the year saw prices spike in August following Hurricane Katrina, subsequently weaken with a mild US winter, and spike again following a natural gas dispute between Russia and the Ukraine.



Note: Oil price = average of West Texas intermediate, Brent and Dubai crudes.

Fig 4.3: Crude Oil Prices Vs GDP

Strong gains for region's resource rich economies

As the demand for oil has expanded, additional supply has been accommodated primarily through OPEC producers, to the benefit of several MENA economies (Figure 1.3). Over the last three years, Saudi Arabia has increased output from an average of 7.4 to 9.2 million barrels per day (an increase significantly higher than the total increase of OPEC production quotas13). Strong production drives also took place in Kuwait (with crude production up 33 percent in the last three years), Qatar (up 24 percent), and the UAE (up 23 percent). Non-OPEC oil producers in the region,14 on the other hand, have generally not been able to capitalize on higher oil prices with increased production, partly reflecting depleting reserves and

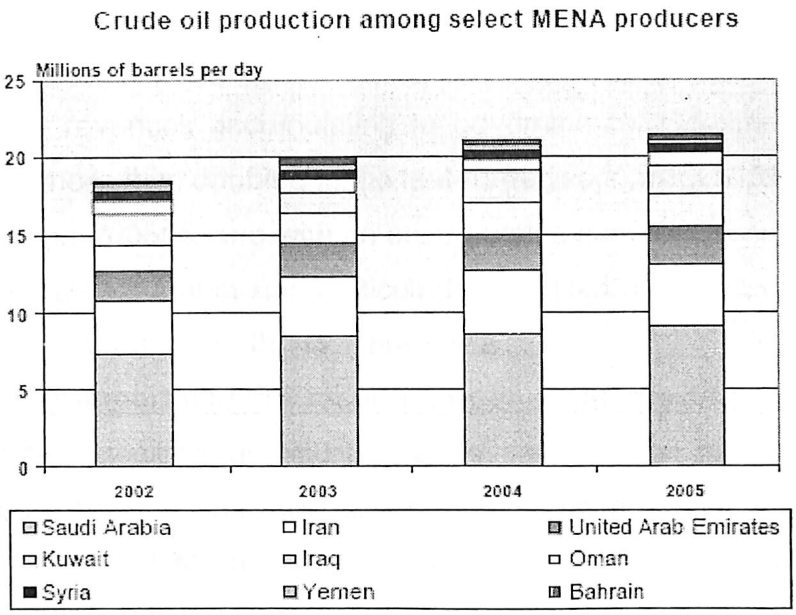


Fig 4.4: Crude Oil Production among select MENA producers

in part due to a shortage of refinery capacity. In fact, in Bahrain, Syria, and Yemen, oil production in 2005 was between 10-15 percent lower than production over 2002.

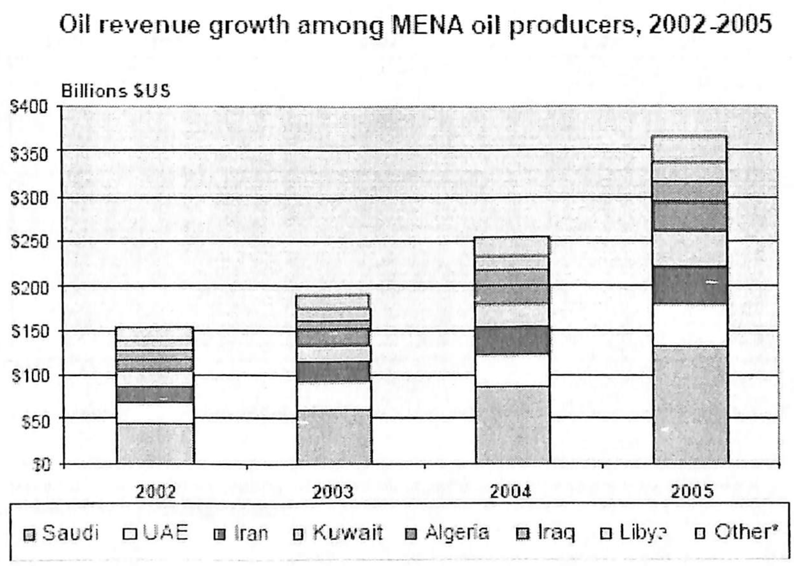


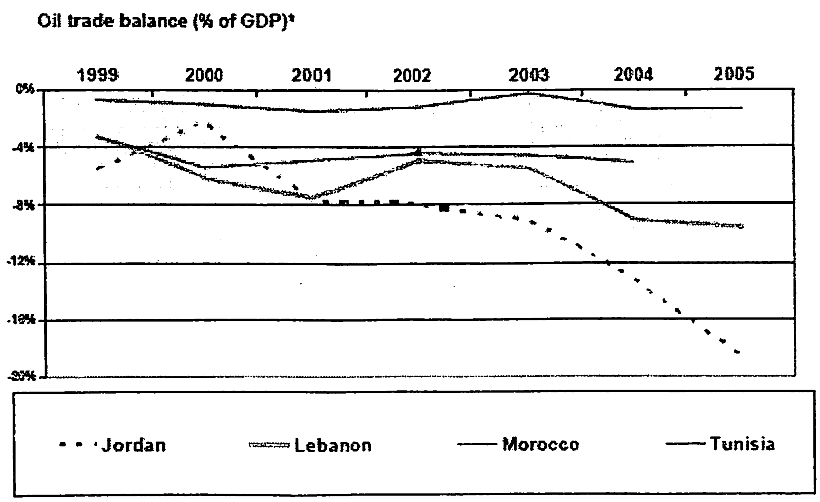
Fig 4.5: Oil Revenue Growth among Mena Oil Producer

With climbing oil prices and increased production, oil producers have seen substantial increases the dollar value of oil exports, and consequently, in oil export revenues accumulating to governments. Government revenues from oil have more than doubled in the last three years, from $154 billion in 2002 to $365 billion in 200515, and with an accumulated gain in revenues of $350 billion since 2002. Saudi Arabia has particularly benefited, realizing a tripling in government revenues from oil in the last three years.

Higher import bills for resource poor economies

But higher oil prices and increased consumption has meant sharply rising oil import bills for the net oil-importing economies in the region, with Jordan, Lebanon and Morocco posting the largest increases. In Lebanon, oil and oil derivative import volumes grew by 9 percent over 2005, and since 1999 by more than 25 percent a year .The impact has been most severe in Jordan, which was heavily relying on cheap oil from Iraq in the context of the oil-for-food program16. With oil imports growing significantly more rapidly than GDP, the oil trade deficit to GDP ratio jumped from only 2 percent in 2000 to almost 19 percent by 2005

Oil trade balance among select resource poor economies



Oil trade balance represents exports minus imports of petroleum, refined petroleum, and natural gas products as a percentage of GDP.

Fig 4.6: Oil Trade Balance

Reliance on oil subsidies becomes a fiscal challenge

The sharp rise in oil prices has also brought to the spotlight the MENA region's heavy subsidization of oil prices within the domestic market, a policy officially designed to protect poor households. Although the resource poor economies are particularly affected, the reliance on oil subsidies pervades the region, with large implications on fiscal positions. Among oil importers, Jordan has been particularly impacted by these subsidies, not only due to rapidly rising oil prices but also the recent loss of the oil and gas arrangements with Iraq. At the end of 2004, oil subsidies represented 3.1 percent of GDP, and 11.3 percent of total current expenditures. A year later, they amounted to 5.8 percent of GDP and 19 percent of current expenditures, this despite the first round of reduction in oil subsidies in September 2005 (without this reduction, oil subsidies would have grown to an estimated 7.2 percent of GDP over 2005). In Lebanon, surging Treasury transfers to the public electricity company to cover these higher oil costs have resulted in government consumption spending increasing by more than 8 percent a year over the last two years (compared with spending reductions in the years prior).

But the problem is not limited to the oil importers, and in fact, the degree of oil price subsidization is far greater in oil producing economies. For the most part, resource rich economies have been able to more than offset the negative impacts on the budget with strongly rising revenue streams. At the same time, these rising budget surpluses have provided limited incentive for reforming the energy subsidy systems. As a result, and over the last several years, little if any progress has occurred in reducing these subsidies among the region's oil producers

<u>Diverging relationship between oil prices and growth among non-oil economies</u>

An important feature of the current growth environment in MENA is the substantially weaker overall ties between oil price movements and growth outcomes among the region's resource poor economies. Twenty to thirty years ago, the economic growth outcomes in MENA's resource poor economies were deeply linked to oil price movements, as the resource poor economies in the region received strong benefits from oil windfalls through vigorous transmission channels, especially labor remittances, official aid and capital inflows.

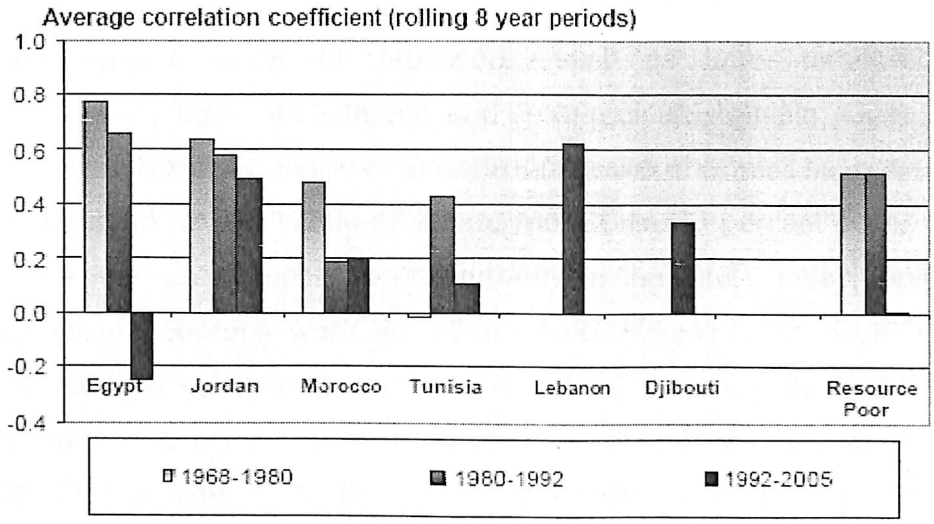


Fig 4.7: Correlation between real oil prices and economic growth among MENA's resource poor economies

Although there remain positive transmission channels from oil producers to the resource poor economies and these channels have experienced a boost under the current oil boom (particularly through rising portfolio equity inflows, FDI, and intra-regional tourism), the relative size of combined transmission mechanisms from oil producers to resource poor economies in the region has declined substantially over time. Additionally, with rising energy use among resource poor economies (relative to the past oil booms), the costs of higher oil prices (in terms of oil imports and oil import subsidies) have increased for non-oil economies. As a result, the correlation between economic growth and oil price movements has steadily declined among most of the resource poor economies in the region , and for the group, has moved from an average of 0.5 over the 1970s and 1980s to almost zero over the last decade.

Egypt is most indicative of a changing growth environment. Over the late 1960s and 1970s, Egypt's economic growth moved almost in lock-step with real oil price fluctuations (with a correlation of nearly 80 percent between real oil prices and growth), cemented through Egypt's own foreign exchange earnings from oil and oil related revenues, as well as through the various transmission channels from the region's major oil producers, such as labor remittances, economic assistance, direct investment, and intra-regional tourism. Over the past three decades, however, many of these transmission channels have weakened. Where at the peak of the 1980s oil boom, more than 20 percent of the Egyptian labor force was employed abroad (primarily in the Gulf), today, only 7 percent of Egyptian laborers work in other Arab states17, as Gulf countries have increasingly substituted expatriate Arab for (less costly) South Asian laborers.
Labor remittances to GDP in Egypt have fallen from a high of almost 14 percent in 1979 to little more than 3 percent today. Foreign direct investment (FDI) inflows reached a peak of almost 7 percent of GDP in 1979, but averaged less than 1 percent of GDP by 2003 (but recently have climbed to more than 4 percent in 200518). Official aid, which reached more than 19 percent of GDP in 1975, accounts for less than 2 percent of GDP today. And at the same time, with rising energy consumption and a leveling off of production, Egypt's net oil exports have declined as a share of GDP from more than 20 percent in 1980 to about 3 percent currently

Even resource poor economies which maintain strong ties with the oil-exporting economies are beginning to carry new costs with higher oil prices. Although regional oil wealth has spurred greater foreign direct investment and capital flows into Jordan, for example, and has resulted in higher tourist receipts, rising oil prices have also become increasingly taxing on both the fiscal and external fronts. In the previous oil boom era, with significantly lower energy consumption, rising oil prices could be more easily accommodated.
At the height of the 1980 oil boom, for example, oil imports in Jordan represented less than 10 percent of GDP, and oil subsidies absorbed about 3

percent of GDP . That is little more than half of their relative costs today (oil imports representing 19 percent of GDP, and oil subsidies 6 percent of GDP).

Added to weakened transmission channels and higher costs, an additional element weakening the connection between oil price movements and growth among resource poor economies has been the group's increasing progress with structural reform. Beginning in the 1980s and 1990s, many of the resource poor economies adopted programs of macroeconomic stabilization and structural reform designed to restore macroeconomic balances and promote private sector led development. Although the pace has varied, these reforms have resulted in more diversified economies than under the prior oil booms, with stronger non-oil export sectors to support growth. Between 1988 and 2005, for example, non oil exports as a share of GDP more than doubled in Jordan, Morocco and Tunisia. As outward orientation has strengthened, the dependence of resource poor economies on oil price developments has weakened.

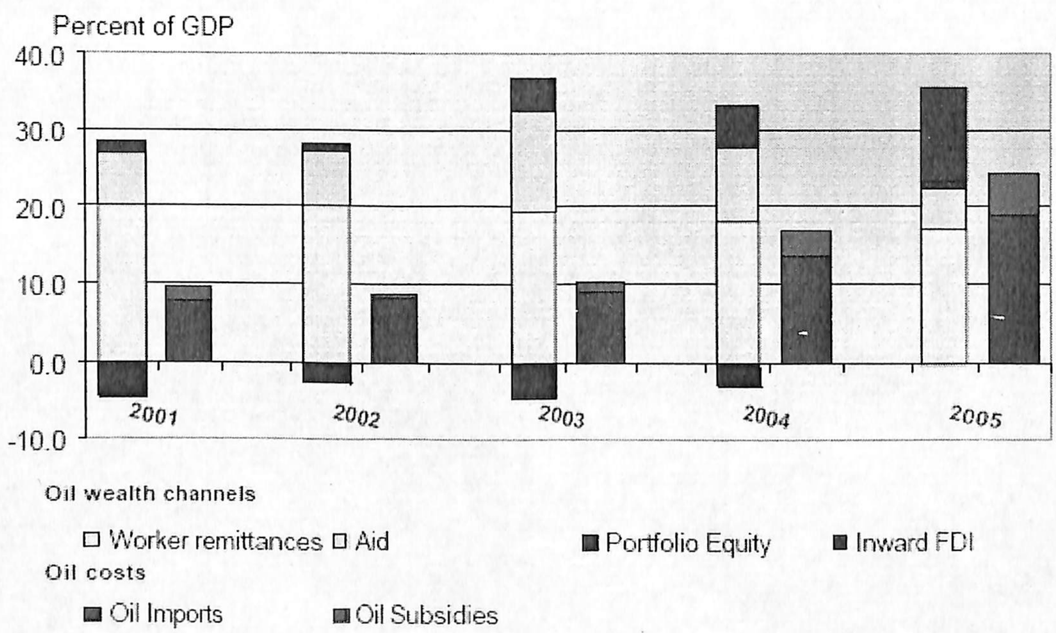


Fig 4.8:: Oil related wealth and costs 2000-2005

Export growth robust throughout the region

Riding the wave of higher oil export values, MENA has achieved exceptional export growth since 2002, primarily among oil exporters but broad-based throughout the region. With oil exporters seeing a more than doubling of oil exports as a result of terms of trade movements (from about $186 billion in 2002 to $440 billion by 2005), MENA economies have experienced a doubling or tripling of the average annual rate of growth of exports of goods and services over the last three years. Not surprisingly, oil dominates the region's export landscape. More than three quarters of the recent growth in exports of goods and services has come from oil exports among the region's dominant oil producers. With the increase in the price of oil and production increases in several MENA countries, oil has grown to account for more than two thirds of regional exports by 2005, up from only about half in 1998.

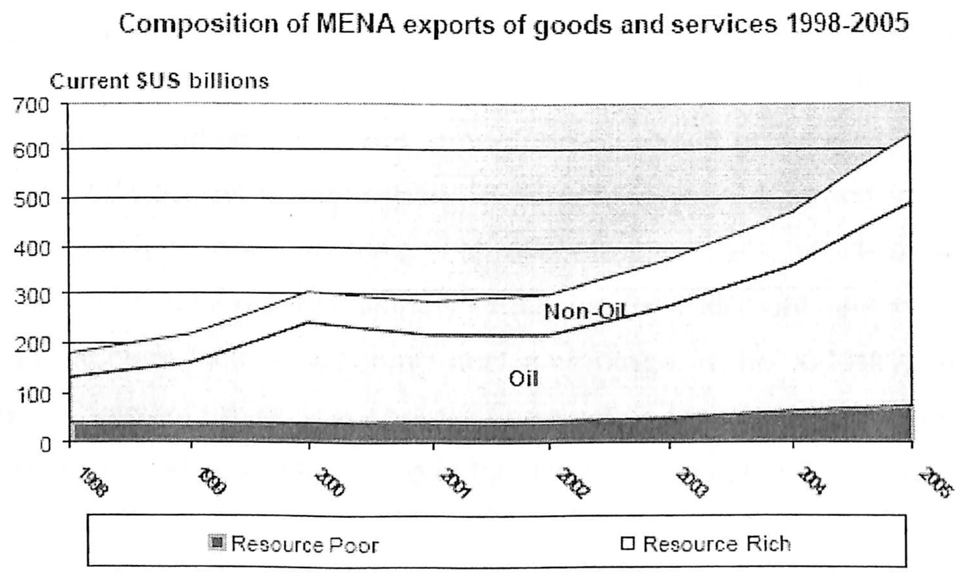


Fig 4.9:Composition of MENA export of Goods and Services 1998-2005

But export growth has also been strong among the region's resource poor economies, supported in part by strong growth in service exports. Egypt's service exports increased by an average of 20 percent a year between 2002-2005 (compared with growth averaging about 4 percent a year between 1998-2002), the result of surging Suez Canal receipts and strong growth in tourism. Other RPLA economies also experienced an upswing in exports of services, primarily reflecting strong gains in tourism. International tourist receipts to both Morocco and Tunisia grew by 15 percent a year over the last two years 22, resulting in exceptional service export growth. Even in Jordan, although tourism has been hit by regional political disturbances, service exports have expanded by an average of 14 percent a year (up from negative growth of 3 percent a year), on the strength of larger remittances and strong advances in transport and communication services destined for Iraq. Although Lebanon realized strong growth in tourism up to 2004, in 2005, in the face of the difficult security situation, tourism receipts – which account for about 5 percent of GDP – are estimated to have declined by some 11 percent, and overall service exports declined by 2.4 percent from 2004.

Oil producers have realized strong growth in energy-dependent exports

Regional oil producers have benefited not only from exceptional oil export growth, but additionally from strong non-oil export growth, which between 2002 and 2004 averaged more than 16 percent a year. A strong impetus has been energy-dependent industries such as petrochemicals, which as oil prices have risen, have become increasingly expensive for traditional centers of production to manufacture With a widening cost advantage in the industry, many countries have bolstered their petrochemical production facilities. As a result, over the last two years, 90 percent or more of the non-oil export growth in Saudi Arabia

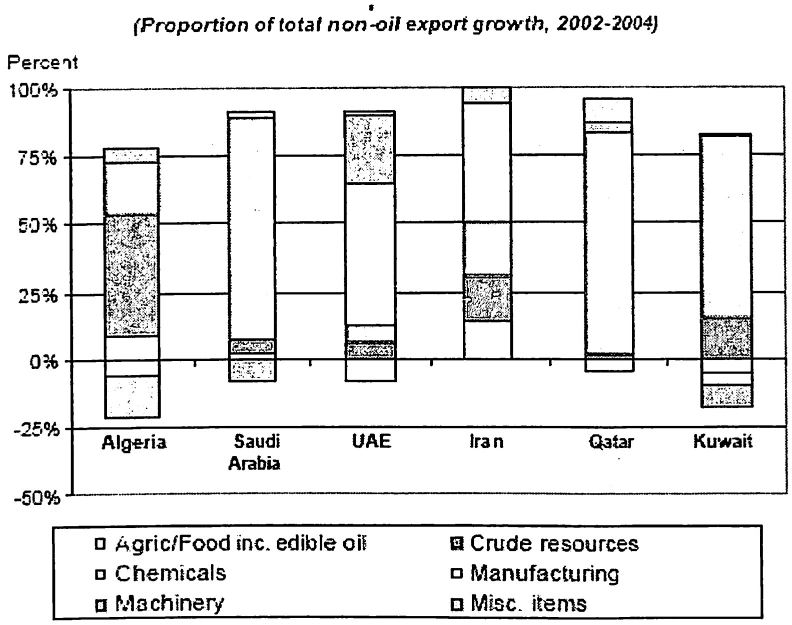


Fig 4.10: Non-oil export growth among select MENA oil exporters

Resource poor economies face several new external challenges

Resource poor economies, on the other hand, have seen a few unfavorable changes to the external landscape over the last few years. On the export side, the expiry of the WTO Multifibre Agreement (MFA) on textile and clothing in January 2005 has impacted merchandise exports among several RPLA economies. The MFA had allowed a privileged access to a few MENA economies' (mostly from the resource poor economies: Tunisia, Morocco, Egypt, but also from the United Arab Emirates) in textile and clothing products to European markets. To date, Egypt has not experienced a major downturn in total textile exports, evidenced by woven apparel exports increasing in value by 6 percent over 2005.23 In part, the effects of the MFA expiry have been cushioned by the December 2004 agreement on qualifying industrial zones (QIZs) between the US, Egypt, and Israel, providing tariff free access for Egypt's apparel exports to the US..

The Egypt textile and apparel companies represent 77 percent of the 471 companies listed under the QIZ protocol. But other countries have already started to feel the pinch. 2005 saw Tunisian textile exports to Europe decline by 6 percent, and textile production in the country declined by an equivalent amount over the first 6 months of 2005. The weakening export market has affected jobs in the sector, which are down 9 percent from employment values in 2004. Thanks to a strong pickup in textile exports to the US (42 percent year on year), however, Tunisian textile exports managed to remain a growing sector in 2005, albeit at a sluggish 1.5 percent pace. The impact on Morocco, however, has been sharper. Over the first six months of 2005, Morocco's clothing exports; representing 34 percent of merchandise exports, declined by some 13 percent from 2004 values, and of the export loss, more than 90 percent were in the textile export categories that were liberalized with the MFA removal. Partly as a result, both Morocco and Tunisia have experienced sharp downturns in merchandise export growth rates from 2004.

Oil producers have substantially improved their external positions

Oil producers have also significantly raised their external reserves, providing a substantial buffer for the external account, and partially insulating them from the exchange rate appreciation which marked earlier oil booms. In the past three years, external reserves among the oil exporters has risen from about $140 billion to more than $300 billion in 2005 (and from 12 percent of goods imports to almost 15 percent). External reserves, in months of imports

Country	2000	2001	2002	2003	2004	2005
MENA Total	**11.4**	**12.0**	**11.7**	**12.7**	**13.2**	**13.7**
Resource Poor	**8.7**	**9.0**	**10.5**	**12.3**	**10.6**	**10.0**
Egypt	10.2	10.4	11.6	12.0	9.7	10.0
Jordan	10.1	8.9	11.0	12.7	9.0	7.1
Lebanon	16.9	12.2	15.5	23.5	18.0	18.7
Morocco	5.8	10.4	12.0	13.3	13.0	11.8
Tunisia	2.7	2.7	3.1	3.4	4.1	3.7
Djibouti	3.9	4.3	4.5	5.1	4.1	4.2
Resource Rich	**12.5**	**13.2**	**12.1**	**12.9**	**14.0**	**14.8**
Resource Rich Labor Abundant	**11.7**	**14.5**	**15.1**	**15.8**	**15.9**	**18.5**
Algeria	15.8	23.2	23.3	29.9	29.1	33.8
Iran	9.7	11.2	11.7	10.2	10.8	14.6
Syria	8.9	9.1	9.9	11.1	8.1	5.4
Yemen	12.9	15.5	15.8	15.0	15.9	14.2
Resource Rich Labor Importing	**12.7**	**12.6**	**10.8**	**11.6**	**13.1**	**13.1**
Bahrain	4.3	5.0	3.8	3.5	3.3	2.4
Kuwait	13.4	17.0	13.8	9.3	8.3	8.4
Oman	6.4	5.5	6.8	7.1	5.4	4.6
Qatar	3.4	3.4	3.9	6.4	8.4	8.9
Saudi Arabia	20.7	20.4	17.1	21.1	25.5	21.2
United Arab Emirates	5.4	5.1	4.9	4.0	4.1	4.5
Libya	38.3	35.3	24.3	31.5	33.7	43.8

Fig 4.11: External reserves, in months of imports

Oil stabilization funds have also been utilized for reserve building. Established to collect surplus hydrocarbons receipts, the funds are designed to lower the impact of volatile oil prices on government spending and on the economy. Oil producers in the region have set exceedingly conservative assumptions for the average price of oil for the purposes of their budgets (in 2005, for example, both Qatar and Algeria budgets called for an average price of oil over the year of only $19; Saudi Arabia's budgetary estimate was $25). As a result, with the real oil prices substantially higher than budgeted assumptions, significant revenues have accumulated within the funds.

Not all of these surplus revenues have actually gone into the stabilization funds, however. In Iran, for example, the fund was established in 2000 as part of the country's Third Five-Year Plan (Third Plan) , conceived to absorb all foreign exchange earnings above the reference price (which between March 2000 and March 2005 has averaged between $12 a barrel and $19 a barrel). However, the unexpectedly robust rise in oil prices (averaging more than $35 over the period) resulted in both increases in the regular "oil share" of the budget and repeated withdrawals from the fund. As a result, while some $74 billion should have been accumulated in the fund between March 2000 and 2005 according to the original guidelines, instead the total deposits have amounted to a mere $29 billion26. Despite these draw-downs, the build-up in both oil stabilization fund assets and foreign reserves have provided oil producers in the region significant cushions against future oil price slides and sudden reversals in capital flows.

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Fiscal Developments

Strong upturn in fiscal balances among oil producers

Record revenues from oil exports have swelled state coffers for the region's oil producers, who collectively have seen total revenues more than double over the last three years, from $202 billion in 2002 to $433 billion in 200528. Over the last year alone, revenues as a percent of GDP among oil producers rose from 40.5 percent to more than 45 percent.

By and large, the phenomenal growth in government revenues has been met with fiscal restraint. Total expenditures as a percent of GDP among resource rich economies are below preoil boom levels, although in current dollar terms they have increased by about 12 percent a year between 2002-2005 (slightly higher than over the period 2000-2002, where expenditure growth averaged 7.9 percent per year). Resource rich and labor importing economies in particular have shown fiscal prudence with this oil boom, where expenditure growth has only averaged 10percent a year, despite extraordinary spending outlays in Saudi Arabia to pay down public domestic debt (see Box 1.3 on debt reduction among oil producers). While there is evidence of higher spending on the horizon, including a strong expansion of infrastructure spending, the resource rich and labor importing economies have to date maintained unprecedented fiscal discretion.

Spending advances have been more robust among the resource rich and labor abundant countries, with a tripling in the rate of growth of government spending in Algeria (a result of strong increases in the wage bill, but also reflecting significant payments toward external debt reduction) and a surge in Iran's public spending, particularly in the run-up to presidential elections. With rapid revenue advances and only moderate spending increases, fiscal positions have improved sharply for MENA oil producers, who posted a fiscal surplus of 16 percent of GDP over 2005, up from 10 percent in 2004, and only 2 percent of GDP in 2002

Debt reduction among MENA's oil producers

Many of the oil producers have reacted to the windfall revenues with remarkable prudence, ot only evidenced through relative small spending advances, large surpluses, and the build-up of foreign assets, but also through a draw-down of external and government debt obligations. On the external debt front, the most significant debt reduction has come from Algeria, where sizable surpluses in the balance of payments have allowed Algeria to initiate a process of early payoff of external debt. As a result, the external debt -to-GDP ratio has declined from 41 percent of GDP in 2001 to 16 percent of GDP by 2005, and by November 2005, Algeria's debt to the IMF was fully repaid.

Although countries in the GCC carry some external debt, the majority of debt is domestic, and a few countries have utilized the oil wealth to substantially draw-down domestic debt obligations. Most notably, Saudi Arabia has initiated a massive debt repayment process, and in the span of just three years has reduced the stock of domestic debt from 97 percent of GDP to just 41 percent by 2005. Debt reductions have also occurred in Kuwait and Oman.

Country/debt indicator	Debt as a proportion of GDP				
	2001	2002	2003	2004	2005
Algeria (external debt)	41	41	35	26	16
Iran (external debt)	7	6	7	8	9
Syria (external debt)	110	106	101	90	..
Yemen (external debt)	53	51	48	42	33
Saudi Arabia (Govt. debt)	94	97	82	65	41
Bahrain (Govt. debt)	30	32	37	34	31
Oman (Govt. debt)	25	19	18	13	11
UAE (external debt)	27	27	24	..	..
Qatar (Govt. debt)	16	38	44	44	51
Kuwait (external debt)	32	32	27	23	17

Source: World Bank staff estimates.

The special case of oil subsidies in MENA

Energy subsidies represent a special, and significant, expenditure item in many of the economies in MENA, and with the recent rise in oil prices, the impact on the budget has been particularly evident. Energy subsidy rates vary in the region.

Estimates of energy subsidies as a percent of GDP in a few MENA countries demonstrate diverging burdens for the region, ranging from 5.8 percent of GDP in Jordan to some 15.7 percent in Iran, the highest in the region. Other recent estimates include 6.5 percent in Yemen, 8.1 percent in Egypt, and 12 percent of GDP in Syria.

Aside from the enormous fiscal drain of these subsidies, with the exception of Jordan, energy subsidies in MENA are also regressive and untargeted. With energy consumption generally more modest among the poor, energy subsidies disproportionately benefit rich rather than poor households. In Egypt, individuals in the richest quintile receive more than two-and-a half times the energy subsidy received by the poor, the disproportion being the greatest for gasoline, for which 93 percent of the benefits go to the richest quintile 29. And the artificially low prices result in energy inefficiency, excessive consumption, and environmental damage.

Price adjustments and other energy policies

Aware of the large fiscal impacts, authorities of a few economies in MENA have, with varying success, undertaken to mitigate the budget impact of subsidies and transfers by adjusting retail price. However, with the exception of Jordan, the reforms to date have been timid, and in no country in the region are oil prices currently market determined. Part of the hesitancy to undertake ambitious price reforms is explained by concerns about the poverty impact, as well as the fear of political backlash. In both Lebanon and Yemen, efforts to reduce or offset these oil subsidies were met with riots. Governments have also worried about the inflationary impacts of rising oil prices to consumers.

But surging budget surpluses among oil producers have also seemed to contribute to a backing off from oil subsidy reform. In Iran, the government asked parliament in October to approve a new pricing formula that would ration the availability of subsidized gasoline (the draft bill stipulated that car owners be provided with "smart cards", fixing subsidized petrol allowance and forcing drivers to pay full price when they exceeded the ration). But parliament has backed off from implementing the scheme – a modest step in the right direction -- until 2007 at the earliest. Energy subsidies will continue throughout 2006 according to revised bill, which froze any adjustments to domestic prices of oil products, gasoline, electricity, and water and postalservices, for the budget period. In Saudi Arabia, meanwhile, the heavily subsidized domestic prices of gasoline and diesel have actually been lowered in early 2006 by nearly 30 percent, in an effort to soften the impact of the country's recent stock market declines. And equally telling, no other resource rich economy has attempted to enact subsidy reform since the oil boom began.

In Jordan and Egypt, on the other hand, the issue is being approached by price reform. In Egypt, there is a general consensus to move from implicit to explicit, and from direct to indirect cash subsidies, and to strengthen the safety nets. And in Jordan, the government voted for measures to allow a gradual reduction of the oil subsidies on diesel, fuel oil, liquefied petroleum gas, and kerosene and to liberalize the domestic market for petroleum products over three years.

The first round of reduction in oil subsidies became effective in September 2005, and despite the continual rise in oil prices, subsidies for the last four months of the year increased only by 49 percent, compared to the same period of 2004—in contrast, subsidies up to September increased by 139 percent over the same period in 2004.

The poverty impact of higher oil prices

Although energy subsides have contributed to significant deterioration of fiscal positions among resource poor countries, many governments in the region have been hesitant to remove them, mainly because these subsidies have buffered the poor from the direct shock of higher oil prices. But rising oil prices may have poverty impacts beyond consumer budgets, through growth itself. To the degree that higher growth benefits the poorest households, there may still be a poverty impact from the higher oil prices, even if it has not been directly passed on to consumers.

A recent World Bank study estimated the impact of the recent increase in oil-price on poverty through the growth channel31, and three resource poor economies are found to be particularly affected: Djibouti, Jordan and Lebanon. In

Djibouti and Jordan, the impact was especially large, estimated as a 4.7 percent rise in the poverty headcount, and in Lebanon, the increase in the poverty headcount was estimated at approximately 2.6 percent.

The experience with oil price adjustments in some MENA economies

In **Morocco,** oil products have been subsidized since 1995. Prices were indexed on the Rotterdam oil price up until 2000, but increasing oil prices pushed the Moroccan government to interrupt this indexation in September 2000, which has translated in the widening of the *Caisse de la Compensation* deficit. Prices were kept unchanged until 2004, when they were raised by between 2.9 and 3.5 percent, depending on the product. Further increases were introduced in May1 and August 2005, and in January 2006. As of May 2005, the energy bill was evaluated at MD 7 billion (Ministry of Finance), however, the recent price adjustments will reduce it to MD 5 billion, equivalent to a 20 percent cutback. The **Tunisian** government has controlled for the budget deficit by increasing several times the retail oil prices. In 2004, prices were adjusted up by about 5 percent (February and August), but the decision was offset by a three percent increase of the minimum wage to attenuate the burden on some 280,000 workers. More rises followed in February, June and September 2005.

The Government of **Jordan** made its first reforms of the oil and gas subsidies by raising the price of gasoline and fuel oil by 10.6 and 33.3 percent, respectively on July 9, 2005. In September, the government announced additional increases, varying from 5 percent for gasoline, 20-22 percent for diesel and kerosene, and JD 0.25 for LPG cylinders. Prices are likely to further increase as the Jordanian government has embarked in long-term reform toward the removal of oil subsidies.

In **Egypt**, prices were adjusted upward in 2004, when the Government introduced two new types of gasoline with higher octane levels at higher prices, and increased the prices of diesel to LE 0.6/litre (up by 50 percent), fuel oil to LE 300/ton (up by 65 percent), and natural gas to LE 0.21/cubic meter (up by 49 percent). This is a major step given that there was no change in the nominal domestic price of any petroleum product between 1997 and 2004. While the price of LPG froze at its 1991 level (LE 2.5/12.5 kg cylinder), prices of gasoline were last adjusted in 1992 (LE 0.9/litre for octane 80 and LE 1.0/litre for octane 90), kerosene and diesel in 1993 (LE 0.4/litre for kerosene and ordinary diesel), and natural gas and fuel oil in 1997 (LE 0.141/cubic meter and LE 182/ton, respectively). In addition, the depreciation of the exchange rate by 30 percent over 2003-04 widened the gap between domestic and international domestic prices of all energy products.

In **Yemen**, the government has been trying to phase-out subsidies on oil derivatives for at least seven years. A first rise in gasoline of 40 percent in 1998 led to riots and a death toll of 50. In July 2005, the government raised the price of diesel and oil as well as kerosene and cooking gas significantly: pump prices for diesel jumped from YR17/litre (8 US cents/liter) to YR45/litre, while those for oil almost doubled. These price hikes were combined this time with pro-poor supportive measures such as sales tax cut, production and consumption taxes cancellation, and 200,000 additional individual covered under the Social Care System. However, despite safety measures, riots led to 13 dead and the government withdrew part of the price hike: new prices were cut by 20-30% and oil prices remain at around half their market rate..

In **Lebanon**, the government imposed in May 2004 a price cap on gasoline and increased excise taxes to offset the rise in world oil prices. As in Yemen, these price hikes resulted in riots, occurring in the Southern suburb of Beirut and claiming five lives.

In **Iran**, oil and gas prices are among the cheapest in the world, but gas subsidies have had the largest fiscal implications. Because of refining limitations, some 40 percent of the country's gas consumption is imported at market prices, and consumption has risen. In 2005, the government introduced a proposed rationing scheme for gas, in which each car owner would have a "smart card" allowing the purchase of a certain amount of gas at the subsidized rate, after which further fuel would have to be purchased at market prices. The scheme was intended to be implemented in 2006, but mixed reaction by the Majlis to the bill has resulted in freezing any adjustments to domestic oil prices, gasoline or electricity. As a result, prices will remain unchanged until at least 2007.

Country	Total growth (%)[a]	Poverty Elasticity[b]	Poverty impact[c] (%)
Mauritania	4.08	-2.12	8.65
Moldova	3.22	-2.45	7.87
Belarus	2.13	-3.20	6.81
Kyrgyzstan	1.83	-3.34	6.11
Uzbekistan	1.61	-3.63	5.84
Armenia	2.49	-2.22	5.53
Tajikistan	2.09	-2.56	5.35
Guyana	3.06	-1.73	5.28
JORDAN	**1.93**	**-2.45**	**4.73**
DJIBOUTI	**3.40**	**-1.39**	**4.72**
Ukraine	1.20	-3.34	4.02
Georgia	1.63	-2.33	3.80
Jamaica	1.63	-2.22	3.63
Sao Tome and Principe	2.50	-1.39	3.48
Singapore	1.75	-1.82	3.18
Estonia	1.33	-2.33	3.10
Mongolia	1.83	-1.64	3.01
Macedonia	0.86	-3.48	2.98
Tonga	1.29	-2.22	2.88
Lithuania	0.95	-2.93	2.78
Guinea-Bissau	1.98	-1.39	2.75
Latvia	0.93	-2.93	2.73
Bulgaria	0.93	-2.93	2.71
LEBANON	**1.01**	**-2.56**	**2.58**
Pakistan	0.88	-2.81	2.47

Fig 4.12:Poverty impact of oil price rise: most severely affected countries

With growing recognition among MENA governments that, in order to ensure fiscal sustainability, they must reevaluate present energy subsidy systems, there has been increasingly` interest on understanding the impact on the poor from reducing energy subsidies. To that end, poverty simulations undertaken in three MENA countries attempted to approach this question by analyzing the impact of setting all energy prices to import parity. In all cases, potential impact on the poor would be great, without compensatory measures. In Iran, such a policy would be equivalent to an across-the-board price increase of 308 percent on all energy products, and would result in an increase in household expenditure by 33 percent for the urban poor and 47.6 percent of the rural poor,. The estimated results for Yemen were similar, where price increases for oil products would correspond to

104 percent increase on average, and the increase in expenditure would account for, on average, 14.4 percent of household budgets for the poorest households and 7.1 percent of household budgets for the richest. Most of the expenditure increase originates from LPG consumption, the major energy product of poor households in Yemen. In Egypt, another approach to simulate the poverty impact of subsidy removal took into account other relevant effects, namely the welfare-enhancing effect of energy reform in the production sector as well as likely quantity responses to the price increase. The study simulated a 50 percent reduction in overall energy subsidies without any compensation for potential losses through other social protection schemes, and resulted in an estimated increase in the incidence of poverty of 4.5 percentage points, with most of the increase in poverty arising from the phasing out of LPG subsidies. In absolute numbers, the reduction of energy subsidies by half would increase poverty in Egypt by almost 3 million people .

But the simulations above only point to the potential increase in poverty without compensatory measures. With a large portion of energy subsidies currently benefiting the nonpoor, removing oil subsidies and directing some of these budgetary savings to the poor could eliminate these negative impacts on the poor. In Egypt, for example, it was shown that if only half of the savings from the subsidy reduction were used in a new, untargeted cash transfer program, the negative impact on the poor would be largely eliminated.33 And in Iran, a seminal study of the oil subsidy scheme found that the wealth that would be freed up from the subsidy removal could be far better invested to create jobs, while developing a well-targeted and efficient social safety net system that could replace the transitory transfer system.

With the vast proportion of energy subsidies benefiting the non-poor, removing energy subsidies and replacing them with programs that are better targeted to the poor could have strong positive social impact. Moreover, although these subsidies emerged with the aim to protect the poor, they now represent an ever-growing fiscal burden, a burden which ironically may present its greatest risk to the poor, in terms of preserving important social expenditures.

NEAR-TERM PROSPECTS

In the wake of quite strong performance over the last three years, two major elements are likely to shape the outlook for the broader MENA region over the period through 2008. First, the external environment for growth will be shifting over this period in line with the business cycle in the OECD countries, affecting global growth and trade patterns. Developments in critical non-oil export markets for MENA will carry substantial influence on the outlook for the region's diversified economies, largely within the resource poor , labor abundant group. At the same time, the dynamics of the oil market are anticipated to change as global demand and supply conditions evolve over the next years. In this context, OPEC policy will play an important role in establishing the price level that emerges, and consequently, the level of hydrocarbon revenues anticipated to accrue to regional oil exporters.

External environment for growth

In broad terms, the external environment for growth in the MENA region appears favorable Long dormant, economic activity in the Euro Area is showing signs of increased vigor, with expectations that GDP growth and import demand will be picking up in 2006 and 2007 to be benefit of MENA exporters of manufactured goods, especially textiles, clothing and similar products. At the same time, the balance of supply and demand forces suggest that global oil prices will remain at fairly high levels through 2008, continuing to rise into 2006 (to $59/bbl) 35, before easing to $53/bbl by 2008. This pattern of global oil price (a base case with substantial associated risks) would serve to sustain oil revenue flows to MENA exporters at high, albeit diminishing levels. Together these factors point to a pick-up in growth for those countries more dependent upon economic conditions in Europe, and a moderate easing in activity for most oil exporters in the region—both as revenues scale back to a degree, and as outlays (domestic and import spending) gradually adjust toward new equilibrium levels consistent with government policy.

Oil-exporting countries

Among the resource rich, labor importing economies, the strong trend of recent growth is anticipated to ease from 7.2 percent to 5.8 percent in 2006, as additional gains in oil and gas production generally come up against capacity constraints, although efforts are being made to enhance capacity in the medium and long term . Though GDP measures of output] fall in line with this development, there remains much accrued hydrocarbon revenues to be expended though fiscal accounts and capital outlays. GDP growth in Kuwait, Qatar, Saudi Arabia and the United Arab Emirates is anticipated to remain strong, while new oil production capacity in Oman should help to bolster growth there. For the group, hydrocarbon revenues are anticipated to remain at quite high levels despite the moderation in oil price, easing from $260 billion in 2005 toward $225 billion by 2008. The current account surplus is seen diminishing from some $185-to $80 billion, as more of the windfall is expended on imports, and the overall fiscal position is seen to drop from current surplus of 21 percent of GDP to a still-high 15 percent.

For the *resource rich, labor abundant countries*, economic activity will be driven by a combination of factors. In Algeria, increased oil and gas output, in several cases through massive new facilities will serve as a driving force for growth. In contrast, shift of paradigm is underway in Iran, in which large-scale increases in domestic subsidies and transfers underpin a revival of private consumption spending. While in Syria and Yemen dwindling natural resources, and in the former country, increasing geopolitical tension and lack of market opening are likely to restrain growth potential. Still advances in GDP are respectable, easing from 5.5 percent in 2005 toward 4.8 percent by 2008.

Risks.

A number of economic and geo-political risks present tensions to the base outlook.

Among these: The potential for much *lower* oil prices in the intermediate term should demand ease-or actually contract in response to the much heightened level of price. It appears that MENA exporters have budgeted oil prices in a conservative fashion, and adjustment to weaker revenues may present fewer problems than might be envisioned. More problematic is the potential for much *higher* oil prices in the intermediate term, should one-or more of the currently heated geopolitical situations in the region give way to upward bidding on futures prices. In this case, the primary risk is to the health of the global economy, and in turn for the potential of a sharp slump in oil price in the aftermath. Finally, there is the risk of a reversion to difficult growth conditions in Europe, implying a volatile export market for the diversified economies of the region. If the removal of the Agreement on Textiles and Clothing results in complete domination of the textile - clothing market by large Asian producers, growth in the Maghreb could be quite adversely affected.

Although the external environment is a principal determining factor of regional growth over the medium term, MENA's longer term growth prospects will be driven in large part by changes in the policy environment, which will determine the climate for growth of the private sector and the prospects for job creation. Gauging the region's recent progress with structural reform, then, can provide important insight into longer term growth prospects..

Building Greater Oil Production Capacity in MENA

Rising oil prices and burgeoning demand have pushed MENA oil producers towards the limits of their upstream crude oil production in the past year. In August 2005, spare capacity among the six primary oil producers in the Gulf (Iran, Iraq, Kuwait, Qatar, Saudi Arabia, and the UAE) was estimated at 1.7 million barrels per day (bpd), the lowest spare capacity they have maintained since 2003. The lack of spare oil capacity has largely been shaped by the fact that OPEC countries, particularly Saudi Arabia, have boosted production to meet global demand. However, there are underlying concerns about future capabilities of the region to generate spare capacity due to limitations on manpower, equipment shortages and, more importantly for the long term, aging oil reservoirs.

Supply shortages have triggered a renewed effort at exploration in the region. Kuwait most recently discovered new oil and gas deposits which could boost the country's reserves by some 10 percent. Algeria made 13 discoveries in 2004 and at least 6 in 2005. The country plans to increase production capabilities from a current 1.4 million bpd to 2 million bpd. UAE has agreed to add 200,000 bpd, increasing total production capacity to 2.7 million bpd. In an effort to develop greater upstream production to improve their spare capacity, most- MENA producers are having to exploit heavy crudes. Heavy crude oils are sold at a discount rate due to the higher costs of refining them before they become end-use products. As spare capacity decreases, producers are more inclined to increase upstream production on heavy crudes despite the price discounts. Saudi Arabia currently produces 11 million bpd of heavy crudes and is planning to produce 12.5 million bpd by 2009, by investing heavily in oil field developments. Kuwait has taken similar steps, launching a pilot heavy crudes scheme in 2005.

Regional oil producers are also attempting to develop new technology and extraction techniques to extend the life of aging reservoirs and boost production in existing wells. Oman, which has heavier crudes than its neighbors, has invested heavily in new techniques that will boost well production, such as steam and polymer injection. Such investment is also key for Iran and] Iraq. However, Iran's ability to import new oil production technology is limited by economic sanctions. Iraq's adoption of new technology is limited by the security environment. Currently, these countries are depending largely on the reinjection of gas and water into wells, and in Iraq, the reinjection of excess fuel oil. Although reinjection is a standard practice in many older wells, it can negatively affect the long term health of a well if not managed properly.

On the downstream side of oil production, producers in the Gulf are investing heavily in refining. Recent global supply constraints are largely the result of a lack of global refining capacity, not a lack of crude oil production upstream. Refining capacity has been particularly hampered in developing nations given the diverse product requirements due to varying environmental standards and local resistance to the development of new refineries. To bolster global refining capacity and to help cover their own growing domestic needs , MENA oil producers are increasingly investing in refineries. Together, they are planning to add more than 4 million bpd capacity in the next decade, and many of these refineries are being built primarily for export purposes.

Saudi Arabia is planning to double its total oil refining capacity, both within the Kingdom and abroad, to 6 million bpd by 2010. Proposed refineries in Saudi Arabia will add a capacity of 400,000 bpd within the next 3 years. These refineries are designed specifically to produce high end cleaner fuels to meet the demands in the key export markets of Europe, Asia and the US. Iran plans to raise its refining capacity to 2 million bpd in the near term. Currently, the country produces 1.64 million bpd, having raised that from 1.35 million bpd in 2000 by increasing refining efficiency. The country plans to build three refineries for medium crude in coming years. However, much of this increased capacity will be directed towards the domestic market, as Iran currently imports 132,000 bpd of gasoline. Kuwait plans to spend some $10 billion through 2011 to upgrade and increase its petroleum refining capacity. And Iraq expects to bolster its refining capacity to 1 million bpd by the end of 2006 to meet domestic fuel needs. Current refineries in Iraq, if operating at maximum capacity, can produce 750,000 bpd, but due to outdated technology, power outages, and sabotage, they are operating much below capacity. Smaller oil producers have also taken steps to expand their refining capacities this year. Yemen has announced the development of a private refinery in Ras Issa that will begin construction in mid-2006, a $450 million project supported by the IFC that will provide an additional 60,000 bpd. Its end products will primarily be targeted to the domestic market. Syria has also announced that it will move forward on increasing production at its two current facilities and reconstructing a third. Syrian efforts are focused on maintaining a position in regional oil markets as its own upstream production slows.

Alleviating the supply situation in MENA countries in the long term will arguably require greater cooperation between industry producers, refiners and associated contractors along the production train. Important to this is enhancing relationships between national oil companies and international firms, which would improve production and refining capacity and boost overall investment in the oil infrastructure of the region. However, the national oil companies in the region remain resistant to such suggestions, at least in the area of upstream production. Saudi Arabia has welcomed limited participation by internationals in its downstream sector, but upstream production continues to exclude international firms. The Kuwaitis government proposed a greater role for international firms in upstream production several years ago, but the proposal remains under intense political debate in the Kuwaiti parliament. Of countries in the Gulf, only Qatar and the UAE have created significant roles in production for international firms. Algeria passed a law in 2005 that strips Sonatrach of its monopoly on oil distribution, storage and refining, while allowing international firms more independence in taking on research and exploration contracts. However, it is too early to judge the true impact of this legislation on the role of Sonatrach and international firms in Algeria.

Chapter 5

FINANCIAL SECTORS IN A NEW AGE OF OIL

MENA's oil shock has had important financial spillovers. Over the last few years, MENA has seen an upsurge in financial activity, as abundant liquidity has fed a rapid rise in credit growth, surging stock markets, and a booming real estate sector. Oil economies have been the primary recipients, although a financial market upswing has also reached some of the region's resource poor countries through increased cross border investment, remittance flows and tourism. Increased liquidity has directly or indirectly fed a rapid rise in bank deposits and a simultaneous demand for credit from the real economy. Lending has accordingly expanded, improving access to finance for corporations, households and consumers alike, and facilitating some of the strongest growth in investment and consumption that MENA has seen for decades. In addition, many countries in the region have utilized their strengthened positions to address longheaded financial sector reforms, including public -sector bank restructuring and privatization, licensing private financial entities, improving bank supervision, and upgrading prudential regulations. Many authorities have looked to invest this oil windfall, building upon long held ambitions to become regional hubs for finance, business and tourism, and bank credit has flowed into a series of gargantuan real estate, tourist and commercial ventures. Project finance has also boomed, with banks competing to supply long-term finance to a wave of new industrial and infrastructure initiatives, largely in the Gulf. In the process, bank profitability has reached record levels.

However, several of the recent financial sector developments have raised exposure of some MENA economies to negative shocks. Banks have rapidly expanded financing for equity markets. Although the recent stock market gains have been built in part on impressive corporate profitability, stocks have also been increasingly speculative. Bank exposure to equity markets, both through lending as well as through substantial income from brokerage fees, leaves bank income and asset quality vulnerable as a result of recent market corrections. Banks have also increased exposure to the booming real estate sector, which may be vulnerable to contagion effects from the recent equity market weaknesses, and which may also face slowdown with growing oversupply.

But a more troubling aspect about MENA's financial markets is the seeming disconnect between the financial sector and the real private economy, despite the appearance of a relatively deep financial sector by macroeconomic indicators. Although regional banks have abundant liquidity, outside of the Gulf, few private businesses have access to bank finance. Even in countries with relatively high rates of lending to the private sector, credit remains concentrated among a select minority, and investment climate surveys suggest an average of more than 75 percent of private business investment in MENA is financed internally through retained earnings.

As a result, few of the assets accumulating to the region are channelled toward productive investment. Moreover, key elements of a well-functioning financial sector that could help boost sustainable and efficient growth, including bond and equity markets and contractual savings instruments, remain largely undeveloped outside of the Gulf.

A few critical facts lie at the heart of the structural disconnect between the relatively plentiful financial resources found across MENA and the scarcity of external financing for businesses. Public sector ownership has significantly impacted the direction of credit in MENA, as well as the operating efficiency and the ability of the banking sector to conduct robust risk analysis. Bank regulatory frameworks, with limited market forms of oversight and discipline, have led to adverse credit allocation. Access to banking facilities remains comparatively limited across the region, and in many cases is restricted to public sector banking networks, concentrating credit provision upon a relatively privileged minority. Underdeveloped contractual savings and capital markets remove a source of competition for banks and an alternate avenue for firm finance. Governance structures undermine formal financial relationships across much of MENA.

Record oil receipts and strong economic growth present an important challenge for the financial systems of MENA, to channel this liquidity into the real economy, boosting sustainable, efficient and equitable growth. To do so, the region must address a range of underlying structural deficiencies that inhibit efficient and sound resource allocation.

RECENT UPTURN IN FINANCIAL ACTIVITY IN MENA

Windfall liquidity drives strong credit growth

Banks dominate MENA's financial systems, and over the last three years, the exceptional increases in liquidity from oil and oil-related wealth in MENA have fed a rapid rise in bank deposits and a simultaneous demand for credit from the real economy. Between 2002 and 2005, deposits to the banking sector rose in real terms by an average of 15 percent a year37, led by strong deposit growth among resource rich Economies Among resource rich and labor importing economies, bank deposits increased in current dollar terms by $95bn between 2002 and 2005, or more than $30 billion a year, more than three times the pace established over the previous four years (about $10bn a year). Resource rich and labor abundant economies saw even greater deposit growth in banking institutions, with deposits growing by $45bn over the last three years, and with the average annual growth in deposits increasing almost four-fold rela tive to the 1998-2002 period.

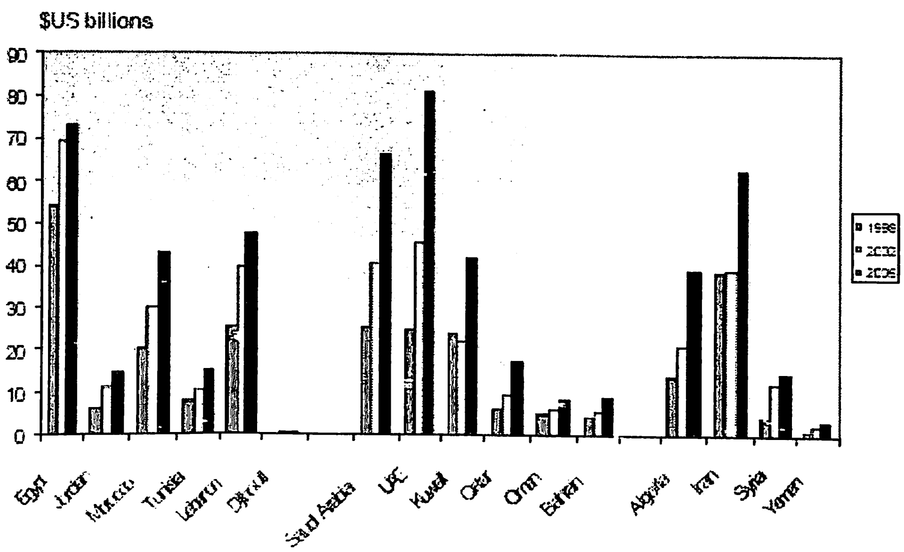


Fig 5.1: Bank Deposits in Mena

But the frenetic pace was not matched among resource poor countries, despite the transmission of parts of the oil wealth through capital flows and remittances. Deposits among resource poor countries grew by some $33 billion over the last three years (about $11bn a year), a pace down slightly from the four year period prior to the start of the oil boom (about $12bn a year).

A broad categorization of financial market development in MENA

the developments within the Middle East and North Africa region are often discussed in terms of three broad country groupings, corresponding to countries with similar resource endowments: the resource poor and labor abundant economies (Egypt, Jordan, Morocco, Tunisia, Lebanon, Djibouti, and the West Bank and Gaza), resource rich and labor importing economies (the six countries of the GCC: Saudi Arabia, United Arab Emirates, Bahrain, Oman, Qatar, and Kuwait, as well as Libya), and the resource rich and labor abundant economies (Algeria, Iran, Iraq, Syria and Yemen).

These categorizations are also useful in discussing the broadly similar characteristics of countries in the region in terms of financial sector size, ownership, access and governance. The resource rich and labor importing economies are generally high income states and, on average, these countries have large financial markets, low levels of state ownership and high foreign penetration. Governance is broadly good and access to credit in line with income levels (Libya is a notable exception).

Resource poor and labor abundant economies, on the other hand, generally share a high level of financial market development relative to their income level as well as relative to the rest of the region. Levels of governance are better than those in transition markets and generally are ahead of their income peer group. The degree of state and foreign ownership within the banking sector varies widely, as does the concentration of banking systems. In addition, the financial systems of these emerging markets provide relatively limited access to finance given their income level and shareholder protection is particularly low. Finally, the resource rich and labor abundant economies display a more state-led approach to financial sector development, in line with their approach to general economic management. Broadly categorized as lower middle income (Yemen is an exception), their financial markets exhibit some depth, but considering their income levels, their banking systems are relatively small in terms of assets and private credit relative to GDP. The banking sectors are also highly concentrated and largely state owned and the quality of financial system governance is below the resource rich labor importing Gulf or resource poor economies.

Rising liquidity in the banking sector, combined with increased demand for credit stemming from high-return investment opportunities, have helped trigger substantial loan growth to private sectors. Bank credit to the private sector as a percent of GDP has risen across most countries of the region, with the strongest loan growth occurring among the region's resource rich economies. Between 2002 and 2005, bank claims to the private sector rose from an average of 17.4 percent of GDP to 21.1 percent for resource rich and labor abundant economies, and from 38 percent of GDP to 42.5 percent among resource rich and labor importing economies .But the upturn in private sector credit has not been universal, and a large portion of the region – some 40% in terms of population -- have not benefited from the liquidity or credit upturn 38.

Corresponding to the slower growth in deposits, private sector credit growth has been more subdued among the resource poor economies in the region, and as a share of GDP has fallen slightly, from 59% to 57%, although a few countries, including Jordan and Morocco, have also seen strong gains in private sector lending. Corresponding to rising capital inflows and worker remittances, increased commercial bank deposits in Jordan have translated into private sector lending as a share of GDP increasing from an average of 73 percent in 2002 to almost 86 percent by 2005. Overall, credit to MENA's private sector as a share of regional GDP has risen from an average of 35 percent to 39 percent over the last three years.

A strong beneficiary of the credit upturn has been consumer lending, which in a few countries has been extended at startling rates. In Saudi Arabia, consumer lending grew by an average of 57 percent a year over 2004 and 2005 (compared with overall private sector credit growth of 39 percent), and now and represents more than 40% of all loans.39 In Jordan, consumer credit, including credit destined for stock markets, saw a 58 percent increase over 2005 (relative to a 30 percent increase in total credit to the private sector). Loans to finance investments into soaring stock markets almost certainly contributed to part of the dynamic consumer credit growth. While margin lending to stock investors is estimated to account for between 5-15 percent of total bankloans in the GCC, for example, the total proportion of bank credit exposed to stock markets is almost certainly higher, with widespread evidence that much of consumer and even corporate lending also flowed into stocks.

But additionally, MENA's credit growth has supported real estate loans and sizeable increases in corporate business. Corporate finance volumes in MENA are thought to have increased from US$11bn in 2003 to almost US$19bn in 200440, with project finance among the GCC accounting for some three quarters. Over 2005, some $19bn in project finance was extended among the GCC countries alone (a 34% increase over 2004), dominated by credit activity in the UAE (about $8 billion over 2005, or some 6 percent of GDP, with a single project, the Dolphin Energy's Dolphin Gas Project, accounting for almost forty percent of the overall corporate finance extended by the UAE of 2005).41 Corporate credit facilities among GCC countries advanced strongly in several key sectors, including oil and gas and finance. Mortgage lending has also been a beneficiary of the increased credit, particularly in high target real estate segments such as Dubai. This has been partially supported by housing finance reform efforts throughout the region, although mortgage markets remain significantly underdeveloped (Box 2.2). Particularly in the Gulf economies, the banking sector has increased credit and relaxed financing terms to the real estate sector, and loans of up to 95% of the principal have become available with maturities of 20 to 25 years. Across Bahrain, Oman and Qatar personal loans and construction lending have risen to 53%, 44% and 37% of total lending respectively. In the UAE 13% of the banking sector's loan portfolio is dedicated solely to real estate and construction.

Enhanced bank profitability in the Gulf

The surge in low cost funding from deposits, increased lending, particularly to the consumer segment, and declining delinquency rates has translated into soaring profitability, particularly within the resource rich and labor importing economies. It is estimated that the top 100 Arab banks by size enjoyed a 36% increase in profits before tax to almost US$12bn in 2004.43 Of this total, US$9.6bn can be accounted for by the GCC states alone, mostly by Saudi Arabia and the UAE. On average, GCC countries enjoyed the highest return on average assets (ROAA) within MENA, at 2.4%. This compares well to other upper middle income countries, at 1.8% on average .Net interest margins have also increased, although formost countries remain off the levels in upper middle income economies worldwide Strong credit growth and declining non-performing loans over 2002 to 2005 contributed toward rising profitability. Lending deposit spreads have widened thanks to the increase in higher margin consumer le nding as well as the rise in low cost demand deposits and strong fee income has also been an increasingly important factor in many Gulf countries. As with credit growth, however, resource poor economies have largely not benefitted from rising bank profitability, with several countries, including Egypt and Tunisia, experiencing a rise in non-performing loans as a proportion of total gross loans over the last few years.

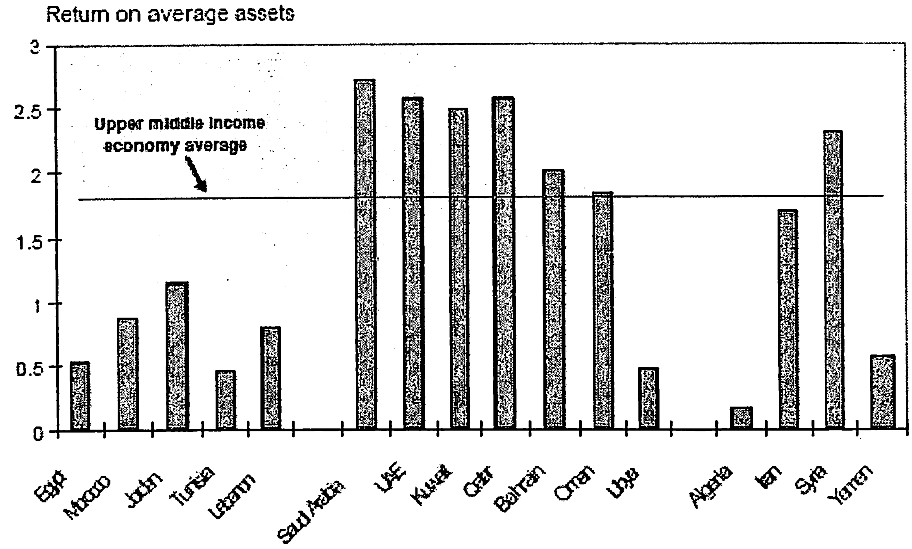


Fig 5.2:Return on Average Assets

Exposure to economic shocks heightened

At the same time that bank profitability has risen across the Gulf economies in particular, the acceleration in credit to the consumer and real estate segments has also raised the exposure of banking systems to economic shocks. Financing for equity initial public offerings (IPOs) has expanded rapidly in a number of countries, but substantial bank income is also derived from brokerage fees, raising the overall exposure to stock markets. In Saudi Arabia, for example, more than 70 percent of some bank's operating income stems from brokerage fees. Banks have also increased their exposure to the booming real estate sector both through lending and more directly, as some banks have activity sought to diversify their assets through the creation and syndication of funds invested in high yield projects and property.

The increasing exposure of MENA banks to these two high-return segments makes bank portfolios increasingly open to contagion effects. The real estate segment of bank assets may be vulnerable to recent sharp equity corrections, as investors unwind leveraged positions. Real estate oversupply may also take its toll on profitability and loan quality, should the region experience an economic slowdown.

MENA's expansion in real estate has been particularly excessive across the Gulf. In Qatar, construction permits increased 23% year on year in 200445 while the annual value of traded land permits in Bahrain rose by over 70% between 2002 and 2004. Kuwait has also enjoyed a rebound in activity, with annual building permits rising by 40% in 2002 and 2003. In some cases this has translated into increased hous ing and rental prices, and there is evidence of localized speculation emerging in some property markets, with undeveloped real estate lots trading hands on secondary markets.48 Outside of the Gulf, construction has accelerated in markets such as Jordan and Iran. In the former, construction activity has grown due to the impact of reconstruction and the decision of many Iraqis to reside there, causing annual residential construction to double over 2000-2004. 49 Iran's construction sector has also seen substantial growth, with private sector investment in urban construction rising by 170% between 1999 and 2003.

Rising equity markets, with recent corrections

The region's windfall liquidity has also had important spillovers to MENA's equity markets, which by any measure performed impressively between 2002-2005. Against a backdrop of accelerating economic growth, expanding private credit , and growing corporate profitability, the region's equity markets rose almost fivefold between 2002 to the end of 2005 (and some markets, including Dubai and Egypt rose more than ten-fold over the period). These equity market gains have provided a valuable source of financing to private sector companies and an important route for state divestment of assets and wider public ownership. In tandem with capital gains, the markets greatly expanded in terms of liquidity, with average daily traded volumes rising from under US$1bn per day to over US$6bn during 2005. This has proved advantageous for capital raising by both the private and public sector, and there had been an increasing number of initial public offerings (IPOs) and rights issues across a variety of corporate sectors. Increased activity has also had advantageous effects in terms of widening domestic share ownership as well as further liberalization of market access to foreign investors both from within the region as well as outside Over US$1tn was gained in market value between 2002 and late 2005. Of this, the Gulf countries saw the bulk of the gain in market capitalization at over US$ 934bn, a rise of 675%

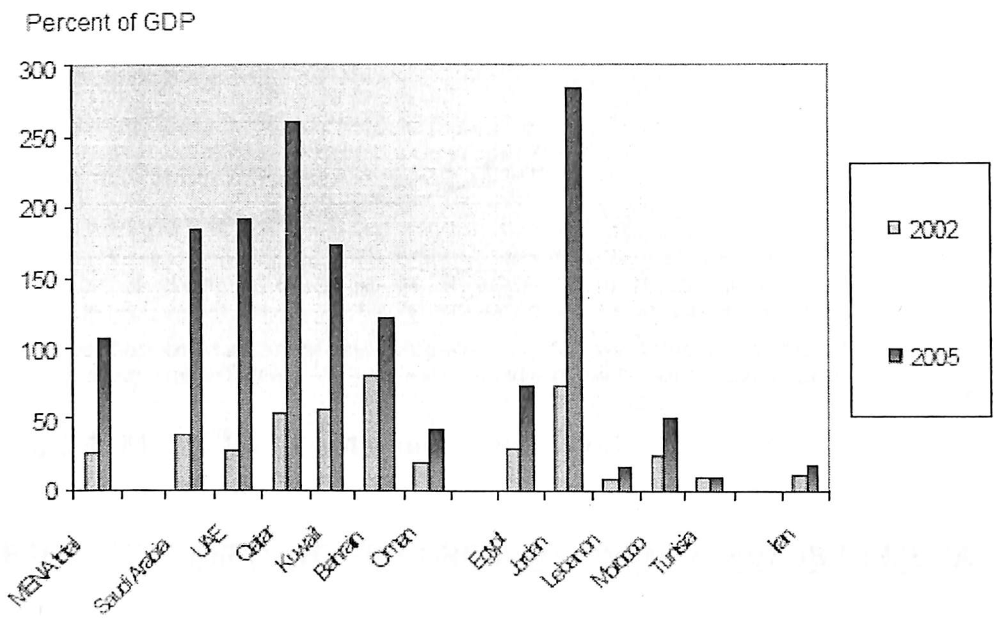
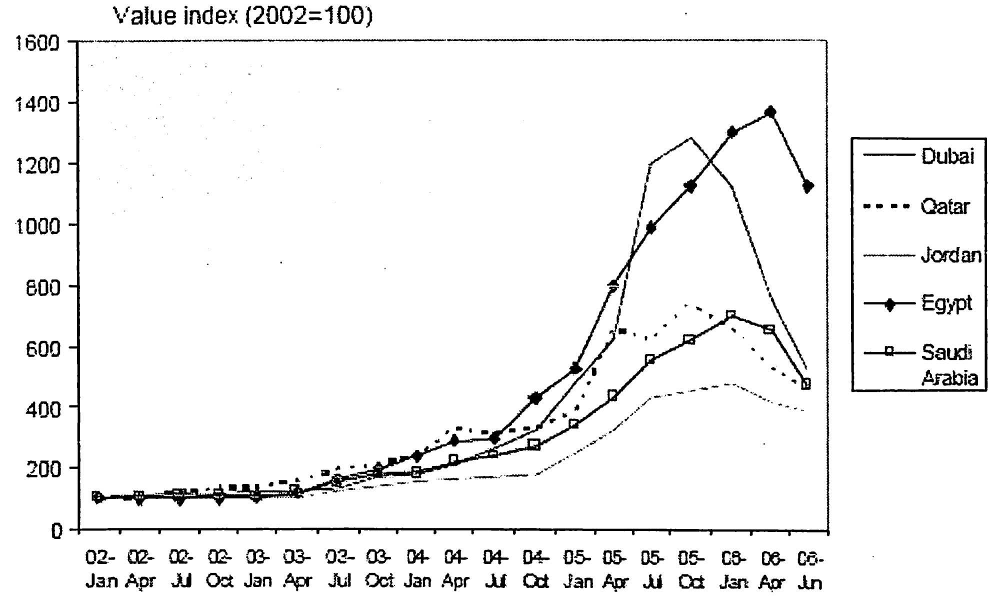


Fig 5.3:Market capitalization to GDP in MENA, 2005 versus 2002



Source: Bloomberg.com: World Indices. Egypt=Egypt CSE Case 30 Index; UAE=Dubai Financial Mkt. Index; Saudi Arabia=Tadawul All Share Index; Jordan=Amman SE General Index; Qatar=DSM 20 Index.

Fig 5.4: MENA Equity Markets, 2002-2006

FACTORS INHIBITING THE GROWTH-FINANCE NEXUS IN MENA

In the long-term, the degree to which the financial intermediation of oil related flows will enhance economic efficiency, per capita GDP growth and stability across MENA will depend upon whether assets have been and will continue to be channelled toward productive investment. Ample empirical evidence exists on the positive and robust relationship between finance to growth. Countries with well developed financial systems tend to grow faster, and financial intermediaries can impact long run equilibrium growth rates through a variety of mechanisms, including mobilizing savings, collecting and analyzing information, screening potential entrepreneurs, allocating investment to highest return projects, exerting corporate control, sharing risk, providing liquidity as well as overcoming asymmetric information problems that typically exist in financial markets.

The channels by which the financial sector can enhance growth include improving resource allocation, enhancing the efficiency of investment, accelerating the pace of total factor productivity growth and technological change and hence contributing to long run economic growth68. Another important channel linking financial development to economic growth is the role of well-functioning financial intermediaries in improving borrowing firms' access to external sources of funding hence easing their financing constraints and promoting their investment and growth.

But in MENA, six critical factors lie at the heart of the structural disconnect between the relatively plentiful financial resources found across MENA and the scarcity of external financing for enterprises:

(1) high levels of public sector ownership significantly impact the direction of credit, operating efficiency, and the ability of the banking sector to conduct robust risk analysis;

(2) regulatory frameworks, with limited market forms of oversight and discipline, have created adverse outcomes for credit allocation;

(3) banking access remains comparatively limited across the region and in many cases is restricted to public sector banking networks, concentrating credit provision upon a relatively privileged minority;

(4) contractual savings and capital markets remain underdeveloped, removing a source of competition for the banks and an alternate avenue for firm finance;

(5) governance structures undermine formal financial relationships across much of MENA;

(6) a host of problems with the business climate further undermine commercial finance relationships

However, patterns of ownership are beginning to change

Although state ownership of bank assets and the share of the public sector in total credit remain high, recent years have seen an encouraging trend toward state bank privatizations and the selective opening of domestic banking systems to foreign entrants. Increased profitability, greater integration into the global economy and the prospect of monetary union in the GCC by 2010 has helped drive a wave of cross border investment in the Gulf. Merger and acquisition activity has also accelerated outside of the Gulf and governments are proving more amenable to the entry of foreign banks.

In the resource rich and labor abundant countries, a notable feature has been the issuance of new licenses for private sector banks. In 2004 and 2005 the Syrian authorities issued a total of 6 new bank licenses and in Iran 4 new private banks have come into operation since a law was passed in 2001 (with 2 more licenses issued in 2005).73 In Algeria, some 15 private banks were issued licenses between 1998-2003, although the six state-owned banks continue to control the overwhelming majority of bank assets.

Privatization and the divestment of residual stakes held by state banks have also been prevalent in Egypt, reducing the total number of banks from 57 at the end of 2004 to 46 by late 2005.74 Tunisia has also privatized two banks since 2002, while Morocco has seen some consolidation and has announced its intention to sell public stakes in the banking sector. Finally, the Lebanese banking sector has clearly outgrown its borders and banks have acquired positions across MENA in the last few years.

With a monetary union planned for 2010 the GCC financial markets are becoming increasingly integrated. Bahrain, Qatar, Dubai and, as of May, Saudi Arabia 75 are all moving ahead with competing plans to become regional financial hubs and considerable cross-border activity has been seen within the GCC . Banks from across the region have opened branches and sought new licenses within each others jurisdictions.

Limited bank access

As a whole, MENA also exhibits below average access to banking facilities, in part due to poor physical access. In terms of number of bank branches and ATMs per 100,000 people, MENA ranks ahead of low and lower-middle income countries, but still falls far short of high income comparisons .in addition, relative to GDP per capita, average loans and deposits are large. Both measures indicate that the banking sector may currently serve a relatively wealthy segment of the population. Given the importance in providing basic banking services to the smaller firms and the poorer segments of the population, skewed access is an issue to address.

Improving the impact of financial sectors on growth in MENA

Record oil receipts and strong economic growth present an important challenge for the financial systems of MENA, to channel this liquidity into the real economy, boosting sustainable, efficient and equitable growth. In some countries, particularly the GCC, the financial system is beginning to act as a more efficient conduit for savings: lending to the private sector is rising, capital markets have somewhat deepened and national systems have become more integrated into the global financial system. With several states vying to become regional financial hubs, competitive pressures are likely to accelerate further market development and opening, with positive spillover effects for the wider economy.

At the other end of the spectrum lie several financial systems that, despite recent growth in lending to the private sector, are relatively underdeveloped in scale and sophistication, characterized by high operational costs, weak risk management practices and poor asset quality. Largely isolated from outside influence and with sometimes non-existent capital markets, the real economy remains dependent upon a fragile banking system that is inadequate to the task ahead.

Not only has this impeded current growth, but may create future vulnerabilities when the present pace of economic growth subsides. For the region to meet the challenge of effectively intermediating the large oil related flows, and to build the financial infrastructure that can be an engine for growth and productivity improvements, the region must address a range of underlying structural deficiencies that inhibit efficient and sound resource allocation. In the chapter that follows, the recent progress with some of these reforms is evaluated.

Chapter 6

STRUCTURAL REFORM PROGRESS FOR LONG-TERM GROWTH

Although continuing high oil prices are expected to contribute to solid growth for oil producers in the medium term, and an anticipated recovery in European demand should provide for stronger economic growth among the region's resource poor labor abundant economies, longer term growth prospects throughout the region depend upon the progress that is made in transitioning to sustainable sources of stronger economic growth and job creation, through implementing broad-based structural reform.

Over the last three to five years, MENA has taken a number of steps to transition to more open, private-sector oriented economies with more efficient and accountable governments. With the large windfall revenues accumulating to oil producers since 2002, a natural question emerges as to what impact oil is having on the reform process. As noted in chapter one, the large budget surpluses accumulating to oil producers appear to have delayed the imperative for reform of the oil subsidy system in resource rich economies. Based on structural reform measurements, oil producers95 have also exhibited weaker reform progress over the last several years than the region's resource poor 96 economies along two major structural reform fronts: improving the business climate and liberalizing trade.

However, the more subdued progress made by oil exporters in these areas of reform in large part reflects lack of improvements among GCC economies, which have traditionally maintained more open and business-friendly trade and investment policies. Perhaps more importantly, as a group, the oil economies have demonstrated long-awaited progress in governance, an area in which the group demonstrates significant deficit relative to the rest of the world. Specifically, notable progress has taken place over the last five years in enhancing public sector accountability mechanisms, which augers well for continuing reform success. Although oil economies continue to rank in the bottom twentieth percentile relative to the rest of the world in terms of measures of public sector accountability (including political and civil liberties, freedom of information, etc, over the last five years, oil economies have made greater progress in improving public sector accountability than all other regions of the world, on average ranking in the 66th percentile worldwide with regard to improving public accountability.

Worldwide, successful reform efforts have depended critically upon the support and participation of those in society whom reforms will impact. The governance improvements inMENA, in terms of enhancing the accountability of governments and granting greater voice in development to MENA's people, are important not only to take into account the needs and values of those who are affected by reforms, but also to ensure that in the transition to a new development model, the economic outcomes are socially acceptable among those who have benefited from the old systems. The MENA region continues to have the greatest gap with the rest of the world in terms of accountable and inclusive governance structures, on average ranking in the bottom quintile worldwide. It is thus an important development that both resource rich and resource poor economies in MENA are making a start at these vital changes.

Progress over 2005

Over the last year, achievements have been made on the trade policy front by several of the resource poor economies which had not yet undertaken deep reform. Under the EU Association Agreement, Tunisia's tariffs on imports originating in the European Union (EU) were lowered, while imports from the 16 other members of the Greater Arab Free Trade Area have been admitted completely duty free since January 2005. In addition, Tunisian customs carried out reforms to simplify import procedures, with special emphasis on documentation and the implementation of the WTO Agreement on Customs Valuation. Although technical import inspection procedures remain lengthy and complex, a start was made on reforming these procedures in 2005.

Morocco also made some progress over the year in deepening trade liberalization.

Although the level and dispersion of multilateral tariffs remain high (the simple average tariff is 30 percent), over 2004, MFN tariffs were reduced for goods freely traded with the EU, and in the context of the FTA with the EU, and further tariff reductions were applied in March 2005 on selected intermediate and consumption goods. Customs services have been streamlined, and implementation of the free-trade agreement with the United States began January 2006. Morocco signed an important agreement with Turkey, which will allow it to take advantage of cheaper Turkish inputs in the production of its own textiles to European markets.

Among resource rich economies, in December, Saudi Arabia joined the World Trade Organization (WTO), following 12 years of negotiations. In meeting the WTO requirements, the Kingdom undertook important steps in liberalizing its trade regime, particularly for import licensing, customs valuation and fees, standards and technical regulations, and revising its legislation for intellectual property rights and patent registration. In terms of specific markets, Saudi Arabia has agreed to revise the rules it applies to agricultural imports, including shelf-life restrictions and other non-tariff measures that have long hindered the importation of agricultural goods to the Kingdom. Almost all agricultural tariffs will be lowered to 15 percent or less.

Membership in the WTO is expected help the Saudi economy diversify more rapidly , improve competitiveness, and create new employment opportunities. Oman, meanwhile, completed its negotiations to conclude its free-trade agreement with the United States.

Among the resource rich and labor abundant economies, widespread smuggling of imported goods in Yemen, combined with a desire to harmonize tariff rates with GCC, prompted the Yemeni government to move strongly in lowering import tariff rates over 2005, reducing the number of bands from 4 to 3, with the maximum rate still at 25 percent, but with two-thirds of the commodities attracting only a 5 percent tariff rate. After the recent changes, the unweighted tariff rate fell to 7 percent, the lowest average tariff outside GCC in MENA.

Quantifying progress with trade reform

MENA's trade policy was evaluated in two ways. First, the trade policy status in 2005 was assessed based on current information on average tariffs, the prevalence of non-tariff barriers (in terms of percent of tariff lines), and behind-the-border constraints to trade, including average time required for both exporting and importing goods. Second, the region's progress with trade policy reform was evaluated, based on the progress made with reducing average tariffs (the only trade policy indicator widely available in 2000, the initial period for comparison).

Based on these evaluations, MENA countries have demonstrated strong progress over the last five years in the area of trade reform, with continued progress by many countries to lower barriers to trade and to establish trade ties through regional and bila teral trade agreements. MENA countries, on average, rank in the 63rd percentile in terms of their progress in lowering import tariffs, only slightly behind developing countries of Europe and Central Asia and high income/OECD economies.

Particularly strong progress has occurred among the resource poor economies of the region, led by deep tariff reform in Egypt. With average tariffs declining from around 21 percent to 9 percent, Egypt's progress in reducing import tariffs places it at the top of the worldwide ordering of countries in terms of tariff reductions 106. But strong progress also occurred in Jordan and Lebanon, and as a group, the region's resource poor economies ranked in the 71st percentile with regard to reducing tariffs over the la st 5 year, greater than any other region of the world.

Resource rich economies exhibited weaker progress, but this partly reflects the lower average tariffs initially (with an average tariff level in 2000 of 16.1 percent, compared with more than 24.3 percent among resource poor economies

BUSINESS CLIMATE

Developments in business and regulatory reform

Just as MENA's trade policies will impact the development of competitive export oriented businesses, MENA's policies and practices regulating business will impact the development of a productive, competitive private sector which can drive economic development and job growth. Thus, a critical focus of MENA's economic transition relates to creating a procompetitive business environment, free of excessive regulation.

With diminishing links to oil economies, resource poor economies in MENA have led the way in improving the regulatory environment for private investment. Both Morocco and Tunisia, as part of their industrial modernization efforts under the Mise a niveau program, undertook various measures to create a more favorable investment climate.

Structural reforms in Tunisia have included significant progress in privatizing state enterprises, some strengthening of the banking sector, streamlining several business procedures, and reforming the legal framework for asset recovery and bankruptcy.

But a strong drive to attract business has also emerged from resource rich labor importing countries, particularly through opening up and capturing greater foreign investment. Bahrain passed an amended Commercial Law in 2003, streamlining the conditions for the operation of private enterprises and easing the restrictions on foreign ownership 110. Under the new law, Bahrain has become one of the first countries in the GCC to abolish the sole agency commercial law. In 2003-2004, a number of key sectors such as telecommunications, electricity generation and petrochemicals were opened to competition. The UAE has also established new laws on foreign ownership, and has set its sights on several new industrial free trade zones targeted at attracting more foreign firms 111. Plans tc attract FDI to Qatar are leading to the creation of a "onestop-\ shop" for investors. A recent law allowing foreign ownership in pre-specified sectors, with the approval of the Finance Minister in each case is being proposed (with up to 100 percent ownership in selected sectors such as tourism, health and education). Under the terms of Saudi Arabia's accession to the WTO, significant steps are also being taken toward removing the barriers to foreign direct investment. Among the sectors expected to witness foreign entry are insurance, banks and other financial intermediaries (banks can now set up branches and existing banks can increase their foreign equity from 40 percent to 60 percent), and energy companies operating in the downstream and midstream sectors.

The Gulf economies have also moved aggressively over the past few years to establish themselves as regional and international hubs for a variety of services, including financial services, trading, tourism, and transport. Bahrain and Qatar have established themselves as regional financial hubs, and in 2005, the Qatar Financial Center created a financial free-zone for international banks and investment companies. But other services are also emerging. Kuwait is developing a technology free-trade zone. Qatar is positioning itself as a regional education and health services hub, most recently establishing Education City and Hamad Medical City.

Industrial policy as a complement to market forces

Along with across-the-board reforms of the business environment, several MENA economies continue to utilize industrial policies (designed to promote specific industries or sectors) to complement more broad-based, policies that promote market forces. In Morocco, for example, a new industrial strategy—"Emergence"—was adopted in 2005, designed to enhance specific sector competitiveness and employment creation and improve the country's growth potential. The strategy focuses on the identification of specific sectors' weaknesses and strengths, and upgrading the industrial sector through the modernization of its production processes and the consolidation of its competitive edge.

Tunisia as well, in the midst of progress along certain structural reform fronts, continues to maintain a dualistic system of investment promotion and trade policy. Generous privileges are extended for investments in selected economic ctivities and for exporting, by supporting the creation of "offshore" firms, but the government still discourages foreign investment in protected service sectors. For more than 30 years, the strategy pursued by Tunisia has consisted of promoting exports, especially manufactured goods, while heavily protecting enterprises that supply the local market. This strategy has created a dualism within the economy between an export sector whose competitiveness depends largely on concessions (including tax exemptions, transport cost subsidies, facilitated customs procedures, and foreign exchange concessions) and a domestic sector that is still heavily protected (despite the opening up of bilateral trade in nonagricultural products under the Association Agreement with the European Union).

The continued use of industrial policies throughout MENA comes at a time of renewed interest in their effectiveness. Although economists agree that market forces and private entrepreneurship need to be the driving forces behind growth and productivity enhancements, increasing analysis of late has focused on the complementary role to market forces that that industrial policies can play.

While a variety of economic justifications can be made for the use of selective industrial policy (including coordination problems and information externalities) several caveats for their use are warranted, particularly for MENA economies. MENA has a long history with industrial policy (from infant industry protection to state planning to widespread consumer subsidies), and though the limits of the region's protective interventions were realized as early as the 1980s, the transition out of these policies has been painstaking, in large part because it has involved the profoundly difficult task of cutting back economic rents that have been built over years.

Moreover, the international history of industrial policy has demonstrated, if nothing else, the ability to "get it wrong." Well motivate or not, worldwide experience with industrial policies` has been remarkably divergent, with as many (or more) failures as successes, and with significant unintended consequences (including rent-seeking and corruption).

MENA's recent selective interventions to promote various industries appear on the surface, at least, to be intrinsically different than the past (less aimed at protecting domestic industries than improving their chances for international competitiveness). And indeed, most countries maintain a mixture of both mainstream free-market measures and industrial policies.

Nonetheless, given the region's difficulty with extracting itself from the legacy of past industrial policies, MENA should be cautious in looking to a new system of industrial policies to promote growth, but instead look to create neutral and internationally competitive business environment.

Conclusion

The Middle East and North Africa region experienced another stellar year of economic growth, as oil prices continued their upward climb over 2005. Growth in the region averaged 6.0 percent over 2005. GDP in the region has grown by an average of 6.2 percent a year, the highest three year average growth rate for the region in nearly three decades.

MENA's resource rich labor abundant (RRLA) economies) also reaped the benefits of higher oil prices, supported by expansionary fiscal policy (particularly in Iran and Yemen). Iran's economy grew by 5.9 percent last year Although higher oil prices have only partially offset the effects of the substantial drop in oil exports (stemming from both production declines and loss of oil re-exports from Iraq), Syria also managed stronger growth over 2005 as a result of sizeable expansion of non-oil exports to Iraq.

But the boon to oil producers did not fully translate to resource poor economies in the region. Growth among resource poor economies averaged 4 percent over the year (down from 4.8 percent in 2004), chiefly reflecting the sharp growth contractions in Morocco and Lebanon, and slower growth in Tunisia.

But higher oil prices and increased consumption has meant sharply rising oil import bills for the net oil-importing economies in the region, with Jordan, Lebanon and Morocco posting the largest increases. In Lebanon, oil and oil derivative import volumes grew by 9 percent over 2005, and since 1999 by more than 25 percent a year The impact has been most severe in Jordan, which was heavily relying on cheap oil from Iraq in the context of the oil-for-food program. With oil imports growing significantly more rapidly than GDP, the oil trade deficit to GDP ratio jumped from only 2 percent in 2000 to almost 19 percent by 2005.

The resource poor economies in the region received strong benefits from oil windfalls through vigorous transmission channels, especially labor remittances, official aid and capital inflows. Although there remain positive transmission channels from oil producers to the resource poor economies and these channels have experienced a boost under the current oil boom particularly through rising portfolio equity inflows, FDI, and intra-regional tourism), the relative size of combined transmission mechanisms from oil producers to resource poor economies in the region has declined substantially over time. Additionally, with rising energy use among resource poor economies , the costs of higher oil prices (in terms of oil imports and oil import subsidies) have increased for non-oil economies. As a result, the correlation between economic growth and oil price movements has steadily declined among most of the resource poor economies in the region.

Limitation to the Study

- Latest Data's are not available.
- Data's related to the Study are concentrated to the fiscal policies
- Data's related to Oil & Gas to be used in the study

STATISTICAL TABLES

Gross Domestic Product and Prices Real GDP Growth (percent per year), 1995-2005

Country	1995-2000	2000-2002	2003	2004	2005
MENAregion (incl. Iraq)	..	3.0	5.6	6.3	6.0
MENA (excl. Iraq)	3.7	3.3	6.9	5.6	6.0
Resource Poor Labor Abundant	4.7	3.7	4.1	4.8	4.0
Egypt	5.6	3.3	3.1	4.2	4.9
Jordan	3.2	5.5	4.1	7.7	7.2
Lebanon	1.9	3.5	4.9	6.3	1.0
Morocco	3.6	4.7	5.5	4.2	1.5
Tunisia	5.6	3.5	5.6	5.8	5.0
Djibouti	-0.5	2.3	3.2	3.0	3.2
West Bank and Gaza	..	-12.5	6.1	6.2	6.3
Resource Rich Labor Abundant (incl. Iraq)	..	3.1	1.2	7.2	5.3
Resource Rich Labor Abundant (excl. Iraq)	3.4	4.5	6.1	4.7	5.5
Algeria	3.2	3.3	6.8	5.2	5.5
Iran	3.5	5.3	6.7	4.8	5.9
Iraq	..	-7.2	-41.4	46.5	2.6
Syria	2.4	3.3	2.5	3.6	4.0
Yemen	5.5	4.2	3.1	2.6	3.8
Resource Rich Labor Importing	3.3	2.5	8.6	6.5	7.2
Saudi Arabia	2.7	0.3	7.7	5.2	6.5
United Arab Emirates	5.2	6.0	11.3	8.5	8.0
Kuwait	1.9	2.9	13.4	6.2	8.5
Qatar	11.8	5.9	5.9	9.9	8.8
Oman	3.4	4.6	1.4	3.1	4.1
Bahrain	4.3	4.9	7.2	5.4	6.9
Libya	1.6	3.3	9.1	9.3	8.5

Gross Domestic Product and Prices GDP (in constant $US billions), 1995-2005

Country	Average 1995-2000	Average 2000-2002	2003	2004	2005
MENA region (incl. Iraq)	..	779.3	846.6	899.7	953.4
MENA (excl. Iraq)	660.2	755.1	833.5	880.5	933.8
Resource Poor Labor Abundant	156.4	184.9	199.0	208.5	216.8
Egypt	84.4	102.8	109.5	114.1	119.7
Jordan	7.6	8.9	9.8	10.5	11.3
Lebanon	16.0	17.2	18.6	19.8	20.0
Morocco	31.2	35.1	38.6	40.2	40.8
Tunisia	16.7	20.2	21.9	23.2	24.4
Djibouti	0.5	0.6	0.6	0.6	0.6
West Bank and Gaza	..	4.0	3.8	4.0	4.3
Resource Rich Labor Abundant (incl. Iraq)	..	208.6	218.3	234.0	246.4
Resource Rich Labor Abundant (excl. Iraq)	161.5	184.4	205.2	214.9	226.7
Algeria	48.8	55.1	61.0	64.1	67.7
Iran	87.2	100.8	113.9	119.4	126.5
Iraq	..	24.1	13.1	19.2	19.7
Syria	17.2	18.6	19.7	20.4	21.3
Yemen	8.2	9.9	10.6	10.9	11.3
Resource Rich Labor Importing	342.3	385.8	429.3	457.2	490.2
Saudi Arabia	174.7	189.2	204.2	214.9	229.0
United Arab Emirates	61.1	75.0	87.9	95.3	103.0
Kuwait	34.7	37.8	44.4	47.2	51.2
Qatar	13.3	18.7	21.1	23.2	25.2
Oman	18.1	21.0	22.0	22.7	23.6
Bahrain	7.0	8.4	9.4	9.9	10.6
Libya	33.3	35.7	40.2	43.9	47.6

External Sector Exports of Goods and Services (as percent of GDP), 1995-2005

Country	Average 1995-1999	Average 2000-2002	2003	2004	2005
MENA region (incl. Iraq)	..	..	..	49.1	..
MENA (excl. Iraq)	34.2	39.9	43.8	48.6	54.4
Resource Poor Labor Abundant	24.5	24.5	28.5	33.2	34.6
Egypt	18.1	17.0	21.7	29.2	31.1
Jordan	48.5	43.9	47.5	52.0	51.1
Lebanon	12.8	14.8	18.8	20.5	20.8
Morocco	28.0	32.7	32.5	33.1	35.0
Tunisia	42.8	45.7	43.9	46.4	47.2
Djibouti	38.9	37.0	39.9	37.3	36.9
West Bank and Gaza	..	..	..	..	..
Resource Rich Labor Abundant (incl. Iraq)	..	..	..	37.3	..
Resource Rich Labor Abundant (excl. Iraq)	23.6	32.0	31.8	34.4	37.7
Algeria	27.5	38.2	38.3	40.2	45.3
Iran	19.0	27.4	28.2	31.8	34.1
Iraq	..	..	..	69.1	..
Syria	39.9	37.5	32.0	28.7	29.2
Yemen	38.2	39.4	39.0	38.1	43.1
Resource Rich Labor Importing	45.4	51.6	57.1	62.5	69.1
Saudi Arabia	36.8	41.6	46.1	52.7	60.8
United Arab Emirates	77.7	72.8	79.1	81.9	84.9
Kuwait	49.4	50.8	53.9	60.5	66.5
Qatar	47.1	65.0	62.3	71.5	73.2
Oman	46.8	57.6	56.2	57.0	59.1
Bahrain	78.5	85.2	82.3	83.3	79.8
Libya	26.0	42.4	65.4	72.0	86.7

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