

**MENA-OECD  
INVESTMENT  
PROGRAMME**

**DIVERSIFYING MENA ECONOMIES TO IMPROVE PERFORMANCE**

**- Working Group 4 -**

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## DIVERSIFYING MENA ECONOMIES TO IMPROVE PERFORMANCE

### Introduction

1. Despite their resources and substantial other advantages, the countries of the MENA region have recorded somewhat disappointing economic performances since the mid-1980s. Per-capita growth rates have lagged those of other developing regions, unemployment, particularly among the young, is very high, and, while other developing regions have been increasing their share of world markets, exports from MENA have barely kept up with the growth of world exports as a whole. Lagging economic performances have engendered serious social strains and complicated the task of carrying out needed reforms. MENA countries will need to achieve much better economic performances in the future than they have over the past twenty years if these strains are to be contained.

2. The economic problems of MENA countries have been attributed to their lack of economic diversification, in particular their dependence on oil and agriculture and the concentration of industry in relatively narrow range of low productivity activities. However limited diversification in this sense is symptomatic of more fundamental imbalances, namely the relatively underdeveloped private sector versus the public sector, and MENA's relatively limited integration, both within the region, and with the broader world economy.

3. Although due in part to MENA's resource endowments and special circumstances, the limited diversity that prevails today is substantially attributable to government policies. Traditionally governments in MENA have sought to shape economic outcomes through large public sectors, extensive regulation of the private sector, and protection from competition from the outside world. This approach has become progressively less viable, both because it has failed to deliver adequate economic progress and because governments can no longer afford to pursue it. While governments have been undertaking economic reforms for nearly three decades and have achieved notable successes, the overall payoffs have been limited by a lack of comprehensiveness and consistency in the reform programmes.

4. The remainder of this report examines the economic challenges facing the MENA countries and the policies that need to be taken to meet them. The next section reviews the main economic problems and the reasons for them. Section II reviews the progress that has been made on economic reforms and the areas where less progress has been made while the last section discusses lessons from international reform experiences, including those of OECD countries, that may provide useful insights in shaping future reforms in MENA.

### The challenges to economic performance

5. The MENA region has recorded important economic accomplishments over the past four decades. Thanks in no small part to the most rapid growth in real per-capita GDP of any developing region between 1960 and 1985 (3.7% annually), the level of absolute poverty according to the World Bank definition is lower than that of other major developing regions. There have been impressive gains in education levels and health standards. Income inequality is relatively low in comparison with other regions.

Table 1.

	1980	1985	1990	1995	2000	2001	2002	2003	2004	2005
<b>Algeria</b>	-5.4	5.6	0.8	3.8	2.1	2.6	4.0	6.9	5.3	4.6
<b>Bahrain</b>	7.5	-0.9	7.3	3.9	5.3	4.5	5.1	5.7	5.5	5.3
<b>Djibouti</b>	3.4	-0.2	5.8	-3.5	0.7	1.9	2.6	3.5	3.0	3.9
<b>Egypt</b>	3.4	7.4	2.4	4.5	5.4	3.5	3.2	3.1	4.1	4.8
<b>Jordan</b>	16.2	6.1	7.1	6.2	4.1	4.9	4.8	3.3	6.7	5.0
<b>Kuwait</b>	-20.4	-4.3	-26.2	1.4	1.9	0.7	-0.5	9.7	7.2	3.2
<b>Lebanon</b>	1.5	24.3	-13.4	6.5	-0.5	2.0	2.0	3.0	5.0	4.0
<b>Libya</b>	-3.8	1.0	-20.2	0.7	2.4	2.9	3.7	5.3	0.9	4.3
<b>Morocco</b>	3.8	6.3	4.0	-6.6	1.0	6.3	3.2	5.2	3.5	3.0
<b>Oman</b>	6.1	14.5	8.4	4.8	5.5	7.5	1.7	1.4	2.5	3.6
<b>Qatar</b>	-1.0	-13.0	-14.6	5.5	9.1	4.5	7.3	8.5	9.9	5.1
<b>Saudi Arabia</b>	7.9	-4.1	10.6	0.5	4.9	0.5	0.1	7.2	5.3	4.1
<b>Syria</b>	12.0	6.1	2.7	7.0	0.6	3.8	4.2	2.6	3.4	3.5
<b>Tunisia</b>	7.4	5.7	7.1	2.4	4.7	4.9	1.7	5.6	5.8	5.0
<b>United Arab Emirates</b>	-1.8	-2.5	16.6	7.0	12.3	3.5	1.9	7.0	5.7	4.5
<b>Yemen</b>	4.4	3.4	1.3	12.5	4.4	4.6	3.9	3.1	2.7	2.9

Source: IMF, World Economic Outlook, 2005

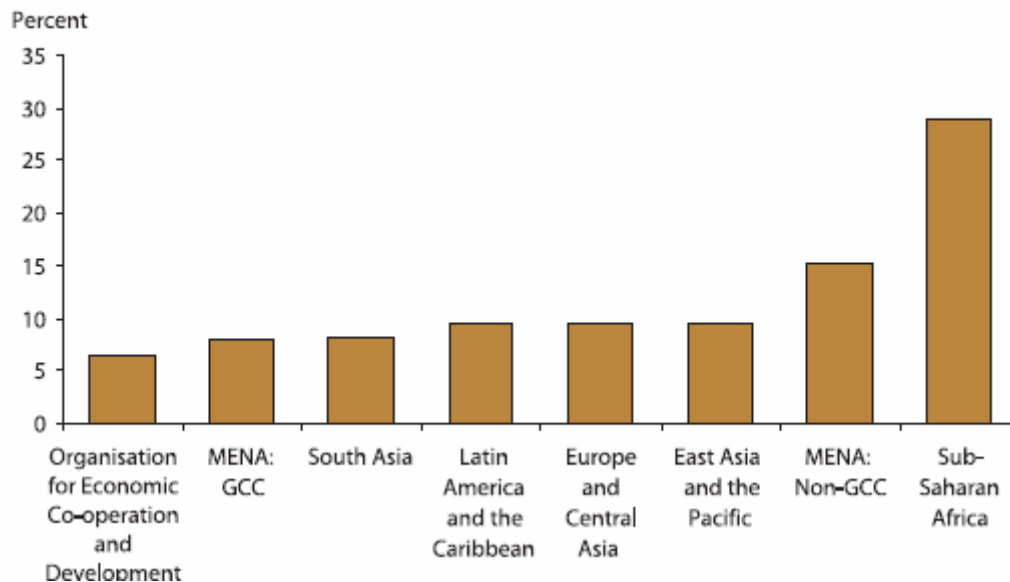
6. Despite this progress, MENA's economic performance deteriorated noticeably beginning in the mid-1980s and has fallen increasingly behind that of East Asia and other developing regions. The slowdown in real growth was greatest for the oil exporting members of the region but the performance of the non-oil exporters – Egypt, Jordan, Lebanon, West Bank and Gaza, Morocco and Tunisia—also deteriorated significantly. While declining oil prices in real terms and civil and military conflicts in several countries were important contributors, the deterioration in performance also reflects a lack of diversification in the region's economies which in turn can be traced to distortions induced by economic policies.

***Key indicators of macro performance have lagged during the 1990s***

7. Unemployment is arguably MENA's most serious economic as well as social problem. Nearly 18 percent of the regional workforce was unemployed in 2002, greater than in any other developing region, almost twice the rate for Latin America and more than four times that for East Asia (Figure 1). Unemployment rates in the early part of this decade were above 20% in several MENA countries, including Morocco and Algeria. Unemployment is concentrated among young, largely first time, job-seekers and is particularly high for women. More than 50 percent of the young are unemployed in a number of countries, including Egypt, Jordan, and Syria. The resulting waste of human resources is further compounded by the fact that the unemployed tend to be relatively well educated.

Figure 1.

**International Comparison of Unemployment Rates, 2002**



*Source:* World Bank, 2004, Figure 2.9, p. 43

8. High unemployment is both a reflection of relatively sluggish employment growth against a rapidly rising labour force due to the young age of the population. Unlike other major regions, MENA’s labour force is growing more rapidly than its dependent population, creating a ‘demographic gift’ that is not being exploited.

9. The challenges posed by unemployment will only increase over the medium term. According to estimates by the World Bank (World Bank 2004), employment in the region will need to increase by nearly 80 percent between 2000 and 2020 simply to prevent the number of unemployed from rising further. This implies an annual average growth rate of employment of almost 4% annually, significantly above the 2-3% annual growth rates recorded in most MENA economies over the past 10 years. Employment will need to grow even faster, to nearly double from the current level, if the unemployed are to be absorbed.

10. Slow employment growth is primarily traceable to the relatively sluggish real GDP growth since the mid-1980s. Real GDP grew by only 2.8% annually during the past two decades, as compared to the 7.4% and 5.5% average growth rates for East and South Asia respectively over the same period. Although growth improved somewhat during the 1990s over the performance of the 1980s, averaging 3.4%, it still lagged that in Asia noticeably.

11. Growth in real GDP increases generated employment in MENA as much and in some cases more than in other developing regions: the elasticity of employment with respect to real GDP growth has averaged 0.7, about the same as that for Western Hemisphere developing countries and above that of East Asia (Gardiner, 2003). Estimates by Keller and Nabli (2002) for 16 MENA countries indicate that real

GDP growth will have to increase by at least two percentage points over the pace of the last decade if the unemployment rate is to be contained, much less reduced.

12. The overall result has been anaemic growth in output relative to the labour force that in turn has severely constrained the scope for reduction in unemployment and/or increases in real wages. Indeed, growth in labour as well as total factor productivity has also been sluggish. This has occurred despite the substantial improvement in education, suggesting that the returns to education have been relatively low (Gardiner, 2003).

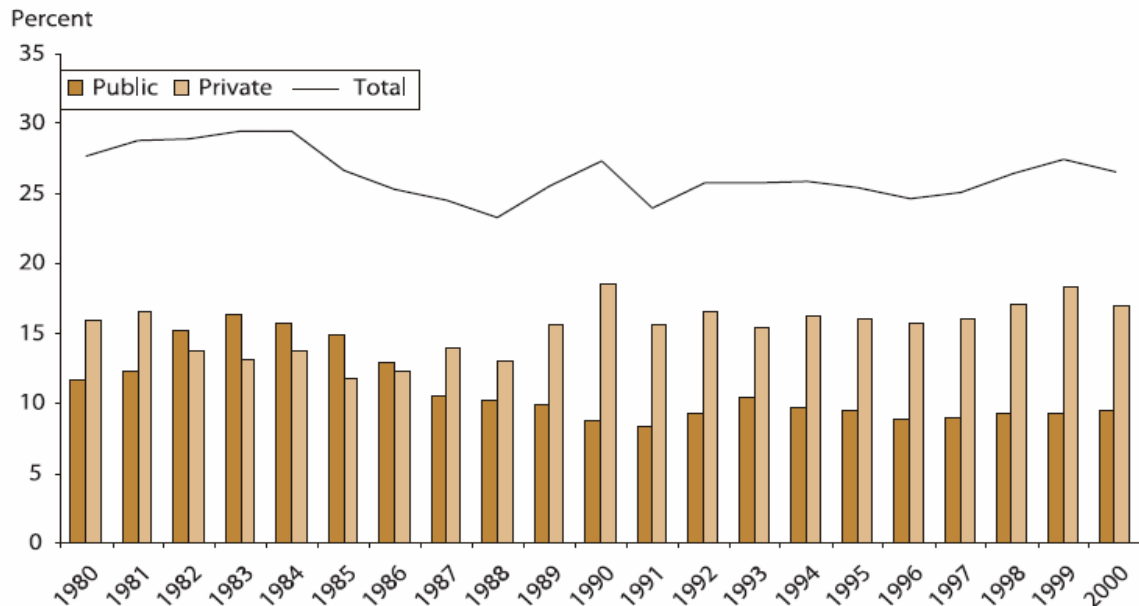
13. Slow real GDP growth has also been accompanied by considerable volatility in real growth for much of the period. Growth fluctuations have been the result of variations in real oil prices, particularly for the Gulf Cooperation Council (GCC) and other oil exporters, by conflicts and political instability in some of these countries as well as Jordan, Lebanon, and Syria, and by fluctuations in agricultural prices, notably for Morocco (ERF, 2005). Output volatility has been noticeably less for Egypt and Tunisia than for most of the rest of the region. Real GDP volatility also seems to have fallen noticeably during the latter half of the 1990s, due in part to more stable oil prices (until the last two years) and somewhat more stable political situations in several countries.

14. Underlying the slow growth in real GDP is a marked deterioration in investment performance over the past two decades. Growth in capital per worker fell from an average annual rate of 7.9 percent during the 1970s—then the highest rate among major regions—to 2.9 percent during the 1980s and to slightly negative in the 1990s. (Keller and Nabli, 2002) MENA's investment performance during the 1990s was the worst among all developing regions, including Latin America and Sub-Saharan Africa, which also suffered severe deteriorations in investment performance. The deterioration in investment performance reflects a sharp decline in public sector investment. The 1970s saw massive public sector investments in infrastructure financed in the case of oil exporters by rapidly rising oil revenues. Declining oil prices in real terms beginning in the mid-1980s forced governments to sharply cut back on investment.

15. However private sector investment has not been able to make up for falling government investment. Private investment is only about 14 percent of GDP for MENA as a whole, well below that of East Asia and short of that in most other developing regions.(Figure 2) The impact of slowing investment on growth in employment and real wages has been accentuated by stagnation in total factor productivity, although there was some improvement in this performance during the 1990s compared to the prior two decades.

Figure 2.

**Public and Private Investment in MENA as a Share of Gross Domestic Product, 1980–2000**



Source: World Bank, 2004, Figure 3.28, p. 83.

***Weak performance reflects limited economic diversification***

16. Underlying the problematic economic performances of MENA countries is their limited economic diversification. This limited diversification is manifest most directly in continued high economic dependence on oil and, in some cases, agriculture, and the concentration of non-oil industry and exports in low technology sectors in which world demand is growing relatively slowly. However the limited diversification of the real economy is symptomatic of a more fundamental imbalance between overbearing public sectors and the relatively underdeveloped private sector.

17. Despite efforts to diversify, the industrial and export base remains dependent on energy and energy related products and on agriculture. The GCC countries are most dependent on the oil sector, which still accounts for nearly one-third of GDP and three-quarters of government revenues. In these and other MENA countries (e.g. Egypt) with significant energy resources, industry tends to be concentrated in energy intensive activities, such as petrochemicals, fertilizers, iron and steel, and other areas that benefit from typically heavily subsidised energy inputs. In countries that are less abundant in energy resources, industry still tends to be dependent on other mineral resources, as in the case of Morocco and on agriculture as in the case of Morocco and to some degree Tunisia, and concentrated in a narrow range of low technology, low value-added activities (Jordan, Lebanon, and Syria). Development of higher technology sectors, where world exports are growing most rapidly, is still relatively limited. (ERF, 2005).

18. The lack of industrial diversification is both a cause and consequence of the very limited integration of MENA economies with the world economy. Due in part to their relatively similar industrial structures but also to trade and investment restrictions, intra-regional trade, at 7.1% of total MENA trade in

2002, is the lowest among major world regions (ERF, 2005). MENA's share of world exports fell during the 1980s and in contrast to more rapidly growing developing regions, its share has been essentially flat over the past decade. MENA's 3.9% share of world exports in 2002 was the lowest of any developing region except Sub-Saharan Africa. MENA's ratio of non-oil exports to GDP (10%) is less than half the 24% ratio for East Asian developing countries. Evidence from a 'gravity' model of international trade developed at the IMF suggests that MENA countries are significantly under-trading given their economic characteristics (IMF, 2002; ERF, 2005).

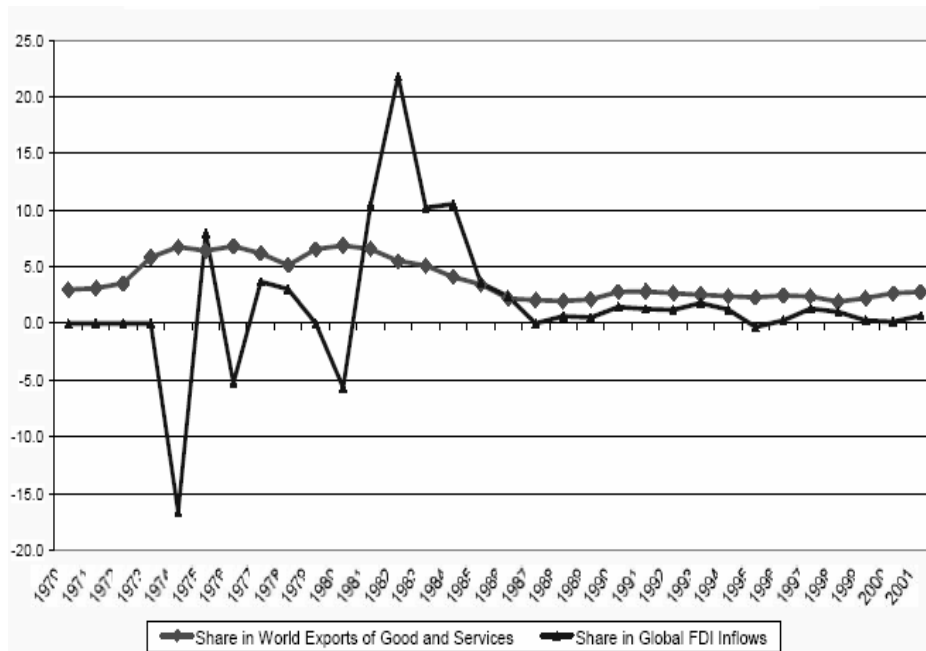
19. The relatively slow rate of export expansion and the concentration of exports in lower value-added activities has significantly limited the degree to which MENA has benefitted from the growth in the world economy. Despite near-term dislocations that can arise initially after opening, trade expansion generally has had a positive medium-term impact on employment in developing countries. A World Bank study suggests that on average, a ten percent increase in the ratio of non-oil exports to GDP is associated with an increase in the ratio of manufacturing employment to the population of 1.4 percentage points (Das Gupta et al, p. 15). On this basis, if half of the MENA gap in the non-oil export ratio with East Asia were closed, the unemployment ratio could be reduced by nearly 4 percentage points.

20. MENA's limited integration with the world economy is further manifest in the relatively low participation of its industries in the cross-border production chains that have become critical to the expansion of exports and the economic benefits it brings to the local economy (Dasgupta et al, 2002). Developing countries that have been most successful in expanding manufactured exports and in moving up the value-added chain have typically been those that have been successful in integrating with multinational networks and have a relatively high portion of their trade in parts. This ratio is relatively low in most of MENA, except in Tunisia, which has had more success in becoming part of EU companies outsourcing chains (Dasgupta et al, p 23). Integration into international production chains also requires developed transport, logistics, information, and other services that are often not well developed in MENA countries.

21. The quite limited role played by foreign direct investment in MENA economies is a further manifestation of its relative lack of integration with the world economy. FDI inflows into the oil industry dropped markedly after the 1980s, leaving MENA with only an average share of world FDI flows over 1990-2001 of only 1 percent. Overall, the region receives only about one-third of the amount of FDI of an average developing country of its size, and the FDI received is concentrated in a relatively small number of MENA countries (Abid and Davoodi, 2003). (Figure 3). FDI plays a critical role in linking local export-producing industries into world production chains and its limited role in MENA thus has reinforced its concentration in lower value-added and slower growing export sectors.

**Figure 3.**

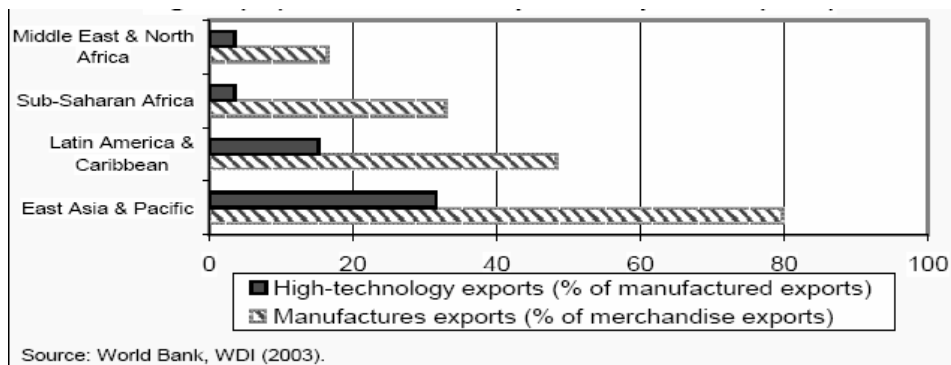
**MENA Share of World Non-Oil exports and FDI**



Source: Figure taken from ERF, 2005, Figure 3, p. 4.

Figure 4.

#### Indicators of Export Composition



Source: Figure taken from ERF, 2005.

22. Limited economic diversification is linked to several other economic problems (ERF, 2005).
- Concentration in a limited range of exports has accentuated the region's exposure to fluctuations in demand and changes in relative oil and agricultural prices. The result has been a high degree of volatility in export receipts, which in turn has contributed to the volatility in real GDP mentioned earlier. The high exposure to external shocks, along with the exchange rate regime and other institutional constraints, has made it more difficult to conduct effective counter-cyclical macroeconomic policies (ERF, 2004, p. 12).

- Dependence on oil exports has greatly increased the vulnerability of public finances. Oil revenues account for nearly three-quarters of government revenues in oil dependent MENA countries, leaving a deficit in public finances excluding oil revenues ranging from one-fifth to one-third of GDP. The decline in real oil prices starting in the mid-1980s was a major factor behind the growing difficulty of oil-dependent governments to sustain high levels of public employment and investment that had been built up during the 1960s and 1970s.

***Limited diversity reflects the imbalance between the public and private sectors***

23. The more fundamental manifestation of limited diversification of MENA economies is the imbalance in the economic weight of the public versus the private sector. Despite some downsizing over the past decade, the public sector in most of MENA remains unusually large, particularly in terms of employment. Public sector employment (including workers in public enterprises) was nearly 18 percent of the total labour force in the late 1990s and government wages amounted to nearly 10 percent of GDP; these ratios are higher than in any other major region, including formerly socialist countries of Eastern Europe and the former Soviet states (World Bank, 2004, p. 95)<sup>1</sup>.

24. In contrast and despite significant differences across countries, MENA private sectors tend to be relatively underdeveloped. The private sector supplies a relatively low share of total investment. The formal part of the private sector is particularly limited, with a large portion of employment in the informal sector.

25. Development of the private sector has been further hindered by weaknesses in governance. Surveys place the MENA region noticeably behind East Asia and Latin America in key measures of governance quality, including the overall effectiveness of government, accountability, regulatory quality, and corruption (Abed and Davoodi, 2003).

***Economic policies are substantially responsible for the limited diversification***

26. The limited diversification and related imbalances in MENA countries are in large part traceable to economic policies. Particularly in oil exporting countries but to a lesser extent in others, policy has sought to implement a ‘social compact’ based on heavy government support for individuals and involving heavy state intervention in the economy. This approach has become increasingly unaffordable as well as outmoded by changes in the external economic environment.

27. The heavy weight of the public sector has been an important drag on efficiency and productivity in the economy as a whole. Particularly in the GCC countries, the traditional dominance of public sector employment along with its relatively high wages and benefits have tended to limit supplies of skilled labour to the private sector and to concentrate skilled labour in lower productivity public jobs or in queues waiting for those jobs (World Bank 2004, p. 95). The ratio of public sector to private wages is higher in MENA than in any other developing region (World Bank, 2004, p. 132) The virtual halt to public sector job growth as a result of fiscal strains has been a major contributor to the increase in unemployment among young relatively educated workers and has tended to depress their participation in the labour force.

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19. Public sector employment as a share of total employment varies from a low of around 10 percent (Morocco) to as high as 40 percent in Egypt. See World Bank, 2004, p. 98.

28. Government policies aimed at protecting employment and incomes outside the public sector have also often inhibited private sector development. Often heavy regulation of private business has discouraged new business formation as well as employment. Restrictions on hiring and firing, minimum wages, and other labour market regulations further discourage employment<sup>2</sup>. MENA governments have made extensive use of active labour market policies but their cost, estimated by the World Bank at around 1.5% of GDP, is relatively high by international standards. Regulatory policy has often lacked transparency and been prone to manipulation by ‘insiders’, adding to uncertainty and thereby discouraging investment by less well connected private investors (World Bank, 2004).

29. Government dominance has also limited the development of the financial sector and its capacity to support the private sector. Government owned banks dominate the financial system in many of the countries and in many cases are weighed down by high levels of non-performing loans and low profitability.

30. Traditional trade policies to protect import producing sectors have also become an important impediment to private sector development in many MENA countries. Trade regimes are relatively open in the GCC countries, Yemen, Jordan, and Algeria (Abid and Davoodi, 2003) and a number of countries have trade association agreements with the EU. Nevertheless, the overall level of import protection is higher than that in other developing regions except South Asia (Dasgupta et al, 2002). While beneficial in many respects, the trade association agreements with the EU have led to some trade diversion by lowering tariffs on imports from Europe relative to those from lower cost suppliers elsewhere in the developing world. The region’s limited participation in the WTO—nearly half of its countries are not full members of the WTO—has also limited its benefits from multilateral trade liberalisations.<sup>3</sup>

31. Development of ‘tradeables’ sectors have been further discouraged by heavy and costly regulation and underdeveloped and inefficient supporting infrastructure. For example, according to a survey of 250 companies in nine MENA countries (see Dasgupta et al, 2002) non-transport trading costs (and excluding customs duties and domestic taxes) to conform to product standards, inspections, and other transshipment regulations were nearly 11% of the transactions value.<sup>4</sup> Inefficient state owned transport and other infrastructure are substantially responsible for the fact that average freight cost (nearly 12% of the value of the goods shipped) is nearly three times that of other regions<sup>5</sup>.

32. Finally, exchange rate policies have also been an impediment to export expansion in a number of cases. The maintenance of fixed nominal exchange rates against the dollar led to serious overvaluation in a number of MENA countries during the 1970s and 1980s. The overvaluation eased somewhat during the

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<sup>2</sup>According to the World Bank report (World Bank 2004), government regulations on private labour markets are probably no more restrictive on average than those in other developing regions. The regulations also differ considerably across MENA, with restrictions of hiring and firing more stringent in Egypt, Algeria, and Tunisia than in Jordan, Morocco, or GCC states with large imported labour. Moreover, labour market regulations tend to be less stringently enforced in the formal private sector than in the public sector.

<sup>3</sup> As of 2003, only about one-third of MENA countries had subscribed to the International Monetary Fund’s Article VII on current account convertibility.

<sup>4</sup> The survey also found that it took on average 2-10 days to release goods from customs and that trading companies spent some 95 person-days per company in dealing with necessary documents to clear customs.

<sup>5</sup> Again, the situation varies significantly across countries. Morocco and Jordan have relatively efficient customs administrations. (World Bank, 2004).

1990s as a result of reforms to improve exchange rate flexibility, but still remained relatively high compared to other regions (Nabli and Végañzonès-Varoudakis, 2002).

### **Review of reforms that have been undertaken**

33. MENA countries have been undertaking economic reforms for several decades. The GCC countries began efforts to diversify their economies away from complete reliance on oil beginning in the 1970s. Four other countries with more limited energy resources and traditionally more diversified industrial bases, namely Egypt, Jordan, Tunisia, and Morocco (the ‘early reformers’), began somewhat broader economic reforms in the 1980s, while another wave of reforms started in the 1990s in Algeria, Libya, Lebanon, Syria, and Yeman (the ‘late reformers’). (ERF, 2005)

34. The content of the reforms have varied among countries reflecting their differences in economic endowments, initial conditions, and history, but they share at least two common themes. The most explicit objective is to develop more diverse economic structures with in industries with greater productivity and potential for growth. The broader, and more fundamental, objective is to revise the traditional ‘social contract’ (World Bank, 2004) under which the government sought to be the main actor in determining economic and social outcomes. Implementation of this ‘contract’ was characterised by state dominance of economic activities, heavy intervention and regulation of non-state economic sectors, extensive social welfare systems and redistribution policies, and an emphasis on import substitution and heavy protection of domestic industries. As noted in the introduction, fundamental changes to this ‘contract’ are essential to the achievement of greater economic diversification in the first sense and involve a wide range of broader reforms, including macroeconomic reforms and extensive structural policies to improve the functioning of markets and develop the private sector. As indicated below, there has been important progress in these reforms but it also has been uneven across the region as well as within individual countries.

### *Considerable progress has been made in improving macroeconomic stability*

35. Macroeconomic instability became a major problem in the MENA region beginning in the 1970s, as the booms sparked by the increases in oil prices in 1973 and later in the decade spurred over-investment, inflation, and large-scale government and external borrowing that led to busts as oil prices declined during the latter half of the 1980s. Beginning in the late 1980s with Jordan, Tunisia, and Morocco and in the early 1990s in Algeria, Syria, and Egypt, MENA governments began major stabilisation agreements that led to a marked improvement in macroeconomic performance during the 1990s. Macroeconomic policy stability in much of MENA is now on a par with that of Asia developing countries and better in certain respects than that of the Latin American developing region as a whole.

**Table 2.**

### **Inflation rates in the MENA region (1995-2005)**

<b>Country</b>	<b>1995</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
<b>Algeria</b>	29.8	18.7	5.7	5.0	2.6	0.3	4.2	1.4	2.6	3.6	3.5
<b>Bahrain</b>	3.1	-0.1	4.6	-0.4	-1.3	-3.6	-1.2	-0.5	1.6	4.9	3.7
<b>Djibouti</b>	4.9	3.5	2.5	2.2	2.0	2.4	1.8	0.6	2.0	3.0	3.0
<b>Egypt</b>	9.4	7.1	6.2	4.7	3.7	2.8	2.4	2.4	3.2	8.1	9.9
<b>Jordan</b>	2.3	6.5	3.0	3.1	0.6	0.7	1.8	1.8	2.3	3.4	3.5
<b>Kuwait</b>	2.5	3.0	0.8	0.6	3.1	1.6	1.4	0.8	1.0	1.8	1.8

<b>Lebanon</b>	10.3	8.9	7.7	4.5	0.2	-0.4	-0.4	1.8	1.3	3.0	2.0
<b>Libya</b>	8.3	4.0	3.6	3.7	2.6	-2.9	-8.8	-9.9	-2.1	-1.0	1.8
<b>Morocco</b>	6.1	3.0	1.0	2.7	0.7	1.9	0.6	2.8	1.2	2.0	2.0
<b>Oman</b>	-1.1	0.5	-0.5	-0.5	0.5	-1.2	-1.1	-0.6	-0.4	1.6	0.6
<b>Qatar</b>	3.0	8.8	1.1	2.9	2.2	1.7	1.4	1.0	2.3	7.5	3.0
<b>Saudi Arabia</b>	5.0	0.9	-0.4	-0.2	-1.3	-0.6	-0.8	0.2	0.6	0.2	1.0
<b>Syrian</b>	7.7	8.9	1.9	-1.0	-3.7	-3.9	3.0	0.6	5.0	3.5	4.0
<b>Tunisia</b>	6.2	3.7	3.7	3.1	2.7	3.0	1.9	2.8	2.8	3.6	2.5
<b>United Arab Emirates</b>	4.4	3.0	2.9	2.0	2.1	1.4	2.8	3.1	2.8	3.8	1.9
<b>Yemen</b>	62.5	40.0	4.6	11.5	8.0	10.9	11.9	12.2	10.8	12.5	14.2

*Source:* IMF, World Economic Outlook, 2005

36. Arguably the greatest improvements have been recorded in fiscal consolidation and reduction in inflation. The average public sector deficit in seven of the largest MENA countries was nearly 7.5% of GDP in the 1980s but fell to about 1.5% of GDP in the 1990s, with virtually all countries recording marked reductions (Nabli and Véگانзонès-Varoudakis, 2004). Egypt and Jordan reduced their public deficits from nearly 17% and 10% respectively during the 1980s to below 2% during the 1990s. Inflation performances in most MENA countries have also improved considerably since the 1980s, with the exceptions of Algeria and Iran where inflation rose during the 1990s. In many cases, MENA inflation rates fell to levels in line with those of Asian developing countries during the 1990s, and to well below the rates in Latin America during that decade.

37. Admittedly, progress on macroeconomic policies has been greater in some countries than others and in some cases there has been some slippage during this decade. Inflation, as measured by the consumer price index, remained relatively high in Egypt during the 1990s, averaging about 10 percent, but was brought down to below 5 percent in the early part of this decade, but rose again in 2003-2004 (IMF, 2005). However inflation accelerated again during 2003-2004, although it has recently begun to fall back. Moreover, due to large past deficits, government debt levels remain relatively high in a number of countries, such as Lebanon, where public debt is nearly 175 percent of GDP (World Bank, 2004).

38. Indicators of external balances and debt give a mixed picture but there has also been significant improvement. External debt rose sharply in many countries during the 1990s, due in part to the lagged consequences of large-scale public investment projects during the 1980s. External debt reached 60-70% of Gross National Income in Morocco, Egypt, Tunisia, and Algeria during the 1990s, and was over 100% in Syria and Jordan. However there were marked improvements in current account balances, with substantial declines in deficits during the 1990s and the development of surpluses in some countries. These have contributed to a significant easing of external debt burdens in number of countries, notably Egypt, during this decade.

39. Finally, although much of MENA continues to peg their currencies against the U.S. dollar, there have been important reforms to increase exchange rate flexibility in a number of countries. (Jbili and Kramarenko, 2003). Morocco has maintained a peg against a basket of currencies since the 1990s in which the weight of the euro was increased in 2001, while Tunisia has sought to maintain a relatively fixed real exchange rate, although it has been allowing significant real depreciation in recent years. Egypt, beginning in 2000, and Iran, beginning in 2002, have adopted managed floating exchange rate regimes. These regimes should help to reduce the risk of prolonged currency misalignments that have been a substantial problem in the past. Greater exchange rate flexibility will also help to increase the ability of monetary

policy to cope with domestic fluctuations in demand. However, at least in some countries, the scope to allow exchange rates to float is constrained by the underdeveloped state of financial markets and limited interest rate flexibility.

*Mixed progress on external opening*

40. Policies toward international trade and investment have been evolving in MENA countries but reforms have tended to be partial and focused more on giving exports preferential treatment than on opening the domestic economy to foreign competition. Progress has also been relatively uneven across countries.

41. A major theme in trade opening has been promotion of exports through preferential policies. A large and growing number of MENA countries have established ‘export zones’ to attract foreign companies and to help domestic countries gain access to foreign markets. The popularity of these arrangements has been spurred in part by the relative success of Tunisia in developing its textile exports by plugging into the supply chains of European companies (Box 1). A number of MENA countries have been able to attract investments from textile producers in other regions, including Asia, under these arrangements. Exports have been further encouraged by the advent of the ‘trade association’ agreements of several MENA countries with the European Community initiated beginning in the mid-1990s as well as the trade access agreements with the U.S. undertaken by Jordan and the West Bank/Gaza. There also has been some progress toward greater integration within the region, notably with the establishment of a customs union among GCC economies<sup>6</sup>.

42. Somewhat less progress, though, has been made in liberalisation of imports or FDI. There have been several rounds of tariff reductions that have reduced unweighted-average tariffs noticeably. (Table 1). Nevertheless, MENA still has the highest level of tariff and non-tariff barriers among major developing regions except South Asia<sup>7</sup>. [Tariff rates are even higher in some MENA countries: for example Egypt’s average effective tariff rates are nearly 31 and 48% respectively (Dasgupta et al, 2002).]

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<sup>6</sup> The ultimate goal is to create a monetary and currency union among these countries by 2010.

<sup>7</sup> According to the World Bank (2003), weighted average tariff rates in the region were nearly 17 percent earlier in this decade compared to 12.5 percent for lower middle-income countries as a whole, and were exceeded only by South Asia. Non-tariff barriers (measured as the portion of lines in tariff schedules that have at least one-such barrier) stood at 16 percent in MENA compared to 13 percent for lower-middle income countries generally.

**Table 3.**

Country	Average Tariff	
	1997	2004
Bahrain	8	5
Egypt	35.5	9.1
Iran	28	22.7
Jordan	23.7	13
Kuwait	6	5
Lebanon	17.5	5.7
Libya	21.5	18.5
Oman	4.8	5
Qatar	7	5.2
Saudi Arabia	12.3	6
Sudan	28	22.6
Syrian Arab Republic	35	25
United Arab Emirates	8	5
Yemen, Republic of	12.9	12.6
Average (includes Pakistan)	19	12
1/ Average tariff is the unweighted mean of all tariff lines and includes other duties and charges		

*Source:* IMF 2005, p. 7.

***Box 1: Tunisia's experience with textile sector development***

Tunisia's relative success in developing its textile sector has sparked considerable interest. Tunisia's development of its textile and other export industries has been based on its efforts to attract foreign investment and its free trade agreement with the EU, enacted in 1995, which allows participating countries to use EU origin materials and parts to make final products that can be sold [duty free] in EU markets. To take advantage of the opportunities offered by the agreement, the government maintains an 'offshore' export zone whereby certified foreign and domestic companies are given generous tax preferences (also extended in some cases to agriculture and other priority domestic sectors) along with exemption from duties on imported capital and intermediate goods. Exporters participating in the zone also receive expedited treatment in customs and related procedures compared to those of importing firms that are not in the zone.

Tunisia's textile industry has advanced considerably under this regime. By 2002, textile exports were up to \$3.2 billion and accounted for nearly 50 percent of the country's total exports, and employment was more than 200,000. Tunisia is the fourth largest non-EU supplier of textiles to the EU and was until recently the largest non-EU supplier to France. Foreign investors include major clothing companies from Europe and the United States along with suppliers from Asia. Based on these investments, Tunisia's textile firms have been the most successful in MENA in plugging into international supply chains.

Despite these accomplishments, the experience is subject to several qualifications that are of potential relevance to efforts elsewhere to develop export industries. Tunisia's textile exports have remained concentrated on lower-value added segments and most go to the EU. Most inputs remain imported and spill-overs (apart from employment) to the domestic market appear to have been limited. [In particular, private domestic investment has remained relatively anemic, except in the electrical machinery category]. Some of the investment in Tunisia was fostered by efforts of textile producers in Asia and Latin America to get around quotas on their shipments to the EU imposed under the multi-fibre agreement (MFA). Moreover, the cost of the preferential tax concessions has been high and growing relative to GDP, reaching nearly 2.3 percent of GDP in 2001 and exceeding the value of FDI inflows into Tunisia (World Bank, 2004b).

With the expiration of the MFA, the prospective entry into the EU of several Eastern European and Cyprus, and the upcoming [revised trade association agreement due to take effect in 2010], Tunisia's textile industry, and exporters generally, are expected to face new and formidable competitive challenges. According to press reports, employment in the industry fell by several thousand jobs in the first half of 2005 and a recent World Bank study has estimated that as many as 100,000 jobs could ultimately be lost if further reforms are not undertaken.

43. Moreover, trade liberalisation via bilateral arrangements has had some problematic consequences. In particular, the arrangements of Tunisia and several other countries with the EU have led to a substantial rise in relative tariffs on products from often lower-cost non-EU producers, leading to significant trade diversion.

44. In any case, the preferential approaches to exports are coming under further strains from broader liberalisations in the world trading environment. The EU is requiring further reductions in tariffs on its products in countries associated with it. This will place further strains on relatively inefficient protected domestic industries and which could increase trade diversion further. MENA's attractiveness as an investment outlet for textile producers in Asia and other developing countries is likely to diminish as a result of the expiration of the multi-fibre agreement, which will make it easier for those producers to ship to markets in the U.S. and Europe directly.

***Government dominance is giving way to the private sector but gradually***

45. Reforms in MENA countries have been giving increasing emphasis to reducing and transforming the state's role in the economy and fostering the development of the private sector. As in many other developing countries, this involves a complex of policies to downsize the public sector, transform government from a major direct actor in the economy to arms length regulator, and to create the institutions and arrangements ('framework conditions') for effective functioning of markets and businesses. Governments in MENA countries are committed in principle to making these changes but the reforms in many cases are at an early stage.

46. As noted earlier, growth in public sector employment has been curtailed and its share of total employment has at least leveled off. But substantial reductions in public sector employment remain for the future and productivity in the public sector remains low.

47. Privatisation of government enterprises has been underway for some time but progress has been irregular and is far from complete. Egypt began its privatisation programme in 1991 and by 2000 had

privatised more than half of the enterprises originally under government control. However progress has slowed noticeably since 2000, due in part to the difficulties of restructuring of the remaining enterprises. Morocco has also achieved considerable privatisation since beginning its programme in 1992. Jordan's privatisation programme did not really get under way until 1997 but has since managed the sale of several major enterprises, including the telecommunications company, although the government retains a large number of businesses.

48. Their relative success have spurred some other governments in the region, notably Lebanon along with several GCC countries (Oman, Saudi Arabia) to institute privatisation programmes. Although there have been some promising initial results from these newer programmes, [such as the partial privatisation of \_\_\_\_\_ in Saudi Arabia], there are still in an early stage.

49. The MENA region made considerable progress in financial development during the 1960s and 1970s but development seems to have slowed in the 1990s<sup>8</sup>. According to the extensive set of indicators developed in a recent study by Creane et al (2004), the region, which led other developing areas in financial development in the 1960s, had fallen well behind the East Asian 'tigers' by the 1990s and was about even with Latin America. However there is considerable variation in the extent of development of financial systems across the region. Lebanon, Jordan, along with several GCC states (e.g. Kuwait and Oman) have relatively developed banking and non-bank financial sectors that are also fairly well integrated into international financial markets. Financial systems are noticeably less developed in Algeria, Egypt, Syria, and Iran. However the region compares more favourably with others in terms of the quality of its financial regulation and supervision (see also Saidi/MENA, 2004).

50. Financial system development in the region appears to be negatively related to the extent of government intervention. Countries with extensive state ownership of banks, such as Algeria and Egypt, tend to have less developed financial systems than those where private sector ownership is dominant (e.g. Lebanon and Jordan). State dominated banking systems in the region tend to have the greatest problems of non-performing loans. Stock markets also tend to be less developed in countries where public ownership of banks prevails, in part because public ownership of non-financial enterprises is also relatively high. A further barrier to the development of financial markets in the region is the general lack, or limited development, of formal pension or other social security systems, which in other developing countries have been a key catalyst to capital market development.

### **The need for a more comprehensive reform strategy**

51. Despite the progress that has been made, reforms taken in MENA have yet to show sustained impacts in terms of improved export, real growth, or employment performance. Indeed, as noted earlier, some of the progress made during the 1990s seems to have been eroded. Although this can partly attributed to the fact that the effects of reforms can take considerable time to be manifest, it can also be argued that it reflects the tendency to take piecemeal reforms, the failure to take other more difficult but equally or more important measures, and the lack of a comprehensive framework for coordinated and mutually reinforcing reforms. The need for a deeper and more comprehensive reform effort is becoming all the greater as changes in the international economy mean that MENA countries will face even greater competition than they have in the past.

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<sup>8</sup> Financial market development is discussed at length in the accompanying OECD paper for this workshop.

52. International experiences with problems similar to those now facing MENA, including the experiences of OECD countries, provide a number of insights about how reforms to improve economic performance can most productively be pursued. Insights concerning several of the key areas of most important to MENA are discussed in the remainder of this section. Underlying these are a number of general principles.

- First, given the wide range of initial conditions, history, and other circumstances of countries, there can be no specific formula for reforms that can be expected to work for all countries or all times. Specific reforms obviously need to be carefully tailored to individual country conditions and, as already noted, changes in technologies and in the international environment, are both making reforms more essential and changing their required nature. Thus, while past successes in particular countries can provide useful guidelines as to what is likely to work (or, as often, about those policies that seemed like good practices at the time but have proved to be ineffective or counterproductive), they cannot provide any blueprint.
- Second, experience has increasingly highlighted the need for reforms to focus on creating the conditions in which businesses and individuals can make economically intelligent decisions and in which markets can carry out their functions rather than on direct interventions in economic decisions. [Development strategies based on attempts by governments to ‘pick winners’ or to promote development by favouring certain sectors over others, where they appear to have been successful at all, seem to have done so mainly in earlier stages of development and may have worked in part by overcoming distortions that had not yet been corrected. This is not to rule out the potential need for special government help in certain areas where markets are found to be unable, at least for a time, to be sufficient, for example in dealing with natural monopolies, or allowing SME to develop or encouraging innovation. However international experience indicates that the scope where such interventions are likely to be successful is rather narrower than used to be believed: for example, there are many activities in electric power provision and other areas that used to be viewed as natural monopolies that have proved to be successfully opened to competition. Moreover, direct interventions are likely to be most effective when based on economic characteristics, for example in providing special help to small and medium sized businesses generally, rather than to particular industries].
- And third, international experience increasingly underscores that there are often substantial synergies between reforms in different areas. As discussed further below, work of the OECD Secretariat, together with that of the World Bank, IMF, and other multilateral institutions, has highlighted the mutual dependence among macroeconomic stability, product market competition, and labour market performance. Accordingly, the payoffs to specific reform measures are likely to be greatest if they are embedded in a coherent and coordinated broad based macroeconomic and structural reform effort.

### ***Fostering productive well-diversified industry***

53. Government efforts to target certain industries for development and to promote certain state enterprises were fairly widespread in the OECD in the first decades after World War II. However under the pressure of experience this approach has receded in favour of efforts to improve the environment for business and investment rather than to seek to ‘pick winners’.

54. Evidence from OECD as well as other economies increasingly points to competition and private ownership and control as the keys to promoting healthy development of the business sector. Competition encourages investment and innovation and further promotes productivity by promoting the survival of the most efficient firms while inducing those that are not sufficiently efficient to exit the market. In OECD countries at least, multi-factor productivity tends to be higher in countries where competition and private sector ownership have greatest scope (Nicoletti et al, 2002).

55. Experience as well as an increasing amount of empirical analysis indicates that privatisation of public enterprises is both necessary and beneficial to the overall economy. Public enterprises played a major role in the economies of a number of OECD countries through the 1970s and was motivated by widespread views that governments needed to control certain sectors to ensure that they could compete internationally or to ensure that certain social goals were met. However the experience with public enterprises became progressively disappointing: they were often unprofitable and sometimes imposed heavy fiscal burdens on their government owners; their ability to compete was often hampered by government restrictions on their employment or other decisions or imposition of non-commercial objectives; and it proved difficult to ensure their effective governance. Conceptually, private enterprises have greater incentives (as well as greater freedom) to operate profitably than do public enterprises and there is greater scope for changing ownership and control of enterprises that perform poorly in the market place.

56. However the gains from privatisation are not automatic: private businesses need to be fully exposed to competition and free of non-commercial mandates imposed by regulation; stock markets need to be sufficiently developed and free to be able to provide accurate signals about listed companies performances and to provide a market for control.

***How much government intervention and what type?***

57. A key question for MENA and developing economies generally is the degree to which governments should seek to foster particular sectors or outcomes as part of their diversification strategies and if so how this should be done. A number of governments in the region have developed ‘visions’ or other assessments of those sectors where their country has the greatest comparative advantage or capacity for rapid growth and high value-added. At the least such efforts can be quite useful for identifying the conditions and requirements necessary to realise the potential in those sectors. Such planning can also be very useful in shaping policies to best improve a country’s overall competitiveness, for example in deciding in what areas to focus efforts to improve education and skill levels of the work force.

58. However efforts to develop particular sectors through preferential treatment are more problematic. In particular, the rapid changes in technology and other dimensions of the economic environment make it very difficult for government planners to reliably determine the best sectors for development and the actual record in ‘picking winners’ has not been encouraging in this respect. The task is all the more formidable now given the growing tendency to divide up production among countries, since the question becomes less one of determining what industries a country should specialise in and more one of identifying the portions of the production process in given sectors it is most likely to be competitive in.

59. Within MENA, some governments, such as Tunisia and a number of GCC states, have focused industrial policies on improving the overall environment for business, with special emphasis on policies important to those segments seen as most promising for development. Other countries, such as Egypt and Morocco have more actively sought to promote key sectors.

60. These differences in approach are manifest in policies toward small and medium-sized businesses (SMEs). Both the importance of SMEs and their special problems are widely recognised and nearly all governments have programmes to foster their development. In the OECD in the past, governments often sought to foster SMEs through tax breaks and other preferences but the emphasis has shifted over time toward a focus on improving SMEs capabilities and improving the business environment within which they operate (Box 2).

61. SMEs are particularly critical in MENA countries, where they make up more than 90 percent of all businesses and account for most non-agricultural employment. Several countries, including Tunisia, Morocco, Algeria, and Egypt have instituted broad programmes, known as *Mis à Niveau* (MAN), to upgrade the competitive capabilities of SME in order to prepare them for global competition as trade integration with the EU proceeds. Under the MAN, governments provide financial and other assistance to qualifying businesses to help them upgrade their product quality, technology, and marketing capabilities.

62. The MAN concept has sparked considerable interest elsewhere in the region, based in substantial part on the success the programme appears to have had in Tunisia since its inception in 1995. Nearly 2500 enterprises were enrolled in the programme by early 2003, nearly half of those with employment of 10 or more persons, and 40% of which were in the textile industry. And firms participating in the programme significantly outperformed industrial firms as a whole during the 1997-2000 (Marniesse and Filipiak, 2004, pp. 114-115).

63. Given its relative success, several features of the Tunisian programme that are broadly consistent with international 'best practices' for SME development are worth noting.

- The programme does not give preferential treatment to certain economic sectors over others. Criteria for participation are based on firms' economic potential, in particular their management capacity and coherence of their market plans. In contrast, the MAN programme in Egypt gives priority to certain sectors (e.g. textiles and leather, food processing, and electrical machinery) and involves considerable participation by the Ministry of Industry.
- The programme is open to firms in key service sectors that support industrial firms, such as information processing and management and business consulting.
- Participation begins and is predicated on a comprehensive evaluation of the strengths and weaknesses of the management and other capabilities of the candidate firm itself along with an assessment of prospects for the market(s) in which it operates.
- Although participation in MAN and the evaluation is an essential part of a participating firm's dossier for obtaining bank financing for upgrading, banks are not required to provide loans for the participants.

64. The results of the MAN programmes in other MENA countries have been less impressive. The programme in Morocco made little headway in the five years after its inception in 1997, and had to be restarted in 2002. By 2003, only about 100 firms had completed the initial diagnosis stage of participation (Marniesse and Filipiak, 2004, p. 167). The poorer results have been attributed to failure to take complementary steps to improve the environment for SME, notably to reduce regulatory burdens on businesses and restrictions in labour markets and to sufficiently liberalise the trade regime (with consumption goods continuing to be highly protected). (ERF, 2005; Marniesse and Filipiak, 2004).

65. Overall, the contrasting performances of the MAN programmes underscores that their value is essentially to serve as a vehicle for accelerating and broadening the dissemination to individuals of the benefits of essential broader reforms. The success of the Tunisian programme is probably substantially attributable to the progress made on these broader reforms while the disappointing outcomes of the Morocco MAN probably reflect the lack of progress in these areas. The programmes cannot be regarded as a substitute for such reforms and their payoffs are likely to be at best limited when real growth is sluggish and the private sector remains impeded by excessive regulation and a bloated public sector.

**Box 2: The Bologna Charter for fostering SME development**

SMEs play a key economic role in all economies, including those of the OECD. Nearly all member countries have programmes to assist SMEs and there is considerable variation in their extent and content. On behalf of its members, the OECD Secretariat has for a number of years been surveying and analysing the experiences of its members to distill lessons and best practices.

In June 2000, the OECD entered into a dialog with non-member countries on SME development at a Ministerial level conference in Bologna, Italy. This conference adopted the ‘Bologna Charter for SME Policies’ and agreed to engage in an ongoing dialog of periodic discussions and monitoring concerning the principles and recommendations in the Charter.

At the second such conference, hosted by the Government of Turkey, in 2004 in Istanbul, the OECD issued a report seeking to analyse the role and characteristics of SMEs and to distill lessons for best policies to promote their development and integration into the world economy. The report underscored the key role of SMEs in developing and transition economies. Development of SMEs capacities to participate in the international trade and to link with FDI are key to development strategies. SMEs are coming under increasing pressure from imports and foreign competition and the majority are unable to effectively meet the opportunities and challenges presented by globalisation and trade liberalisation. SMEs are particularly vulnerable to misaligned exchange rates, limited access to finance, cumbersome bureaucratic procedures in setting up and developing a business, poor infrastructure, and a lack of effective supporting institutions.

The overall recommendations enunciated in the report are: to integrate policies for SMEs in the overall national framework for development; to carry out policies to strengthen the capacities of SMEs to compete in domestic, regional, and international markets; to promote coherence between national trade and investment policies and bilateral and multilateral development cooperation efforts; and to seek to maximise the spillovers of management skills and technology from multi-national enterprises to local SMEs.

The report notes that there is no single way to strengthen SME competitiveness in a globalised world and that each country must find its own way based on its own circumstances. However it highlights a number of suggestive lessons from case studies, including the following.

- Investment climate reforms need to be carefully prioritised and sequenced
- Policies should be focused on promoting self-help by the private sector by removing obstacles rather than through direct financial or other government support.
- More attention should be given to improving the enabling environment for the private sector and this will also help to attract foreign investment
- Corruption, lack of infrastructure, policy instability and inconsistency, regulatory complexity and uncertainty, inadequate property right and other legal frameworks, and labour market rigidities are the main obstacles to the business environment and investment for all businesses

- The costs from over-regulation are particularly heavy for smaller businesses
- Foreign investors are more attracted by a favourable overall business environment than by elaborate incentives

***Encouraging FDI and increasing its payoffs***

66. As noted earlier, FDI is a key to the development of tradeables sectors. MENA countries have considerable potential to attract FDI given their geographic proximity and trade agreements with the EU, but they also face stiff competition, notably from some of the states slated for eventual full EU membership. Furthermore, policies to foster FDI need to focus as much on quality -- such as the degree to which FDI promotes development of domestic suppliers and fosters technological upgrading -- as much as quantity.

67. As emphasised in OECD reviews of FDI policies in several non-members, the most effective policies for encouraging productive FDI are largely the same as those needed to foster domestic investment. For example, the recent OECD review of FDI policies in China emphasised the importance of improving protection for intellectual property rights, achieving greater transparency in laws and regulations, strengthening competition law, and reforming the judicial system to ensure better enforcement of laws and contracts—all of which are equally critical to the development of domestic businesses. Weaknesses in these areas not only discourage FDI inflows but also tend to make foreign investors reluctant to rely on domestically owned suppliers or to transfer technology to domestic partners.

68. Within MENA, the success of the United Arab Emirates in diversifying their economies further highlights the importance of the overall business environment in attracting FDI (Box 3).

69. Since the 1990s, a large portion of international FDI flows have been associated with mergers and acquisitions. This trend partly reflects a growing preference for multinational businesses to achieve greater control over their investments in host countries. The ease with which foreign companies' can acquire or form partnerships with domestic companies is an important factor in countries' ability to attract FDI and reap its benefits.

**Box 3: The diversification of the United Arab Emirates**

The United Arab Emirates (UAE) is widely regarded as a major success story in economic diversification. The country's oil dependency ratio, whether measured by the share of revenues from oil to total government revenues or the ratio of non-oil exports to total exports dropped from 90% in 1980 to 50-60% in 2004 (IMF/UAE, 2005). The non-oil sector grew at an average annual rate of 8% between 1995 and 2004, compared to 5% growth in this sector in other GCC countries during the same period. Exports have diversified considerably from an original dependence on energy based products toward electrical goods, light machinery, and transport equipment and the UAE now has one of the most diversified export structures within MENA.

Dubai has played a leading role in the diversification of the UAE. Faced with the prospect of dwindling oil reserves, Dubai developed a strategy to promote tourism, finance, and other services along with diversification of its industrial base. ....

The relative success of the UAEs diversification has rested on three key pillars.

- The trading and foreign investment regimes has been one of the most open in the MENA region, with an average (simple) tariff rate in 2004 of 5 percent, less than half that of the region as a whole.
- Trade has been further facilitated by relatively well-developed port and other key infrastructure facilities and by relatively efficient customs and other administrative procedures. According to a World Bank Investment Survey, the average number of days required to process a shipment was less than 3 days in the UAE, well below that in other major exports such as China (nearly 10 days) and Brazil (nearly 14 days).
- Investment has been supported by key elements of a favourable business environment, including stable macroeconomic policies and relatively flexible labour markets. Major state-owned enterprises are operated on a commercial basis.

As with other countries in the region, the UAE has also used special export zones to attract foreign investment. Foreign businesses in the zones are given exemption from corporate and other major taxes and, probably equally importantly, operate free from restrictions on ownership.

The UAE authorities have ambitious plans for further diversification, particularly in services. Dubai in particular is trying to position itself as a regional financial center. To achieve these goals, further reforms in areas where the UAE now compares less favourably with other regions, notably in rule of law, investor protection, and contract enforcement are likely to be needed.

70. Experience does not suggest that special export zones or other preferential policies to attract FDI cannot be beneficial under the right circumstances but does suggest that they are to some degree ‘second best’ solutions to distortions that reforms ultimately need to correct. Special export zones and other preferences granted to foreign businesses effectively help to make up for the greater costs and uncertainties they face in the host country: for example, an important benefit of special export zones to foreign businesses is that they provide more expedited administrative procedures than in the domestic economy. Once broader reforms to improve the general business environment have succeeded, the need for such special preferences wanes. Such preferences can also impose a substantial fiscal cost to the government, requiring offsetting taxes in other areas or cuts in potentially beneficial expenditures.

### ***Improving labour markets***

71. MENA’s labour markets are also likely to need reforms to function more effectively. As in other countries, weaknesses in labour market performance stem from a mixture of labour-market specific problems, such as rigidities in hiring and firing and high ‘wedges’ between the cost of a worker to an employer and the compensation received by the worker, along with broader problems.

72. The search for strategies and specific means to improve labour market performance has been a key priority of the analysis efforts of the OECD since the early 1990s and was the basis for the promulgation in 1995 of the OECD *Jobs Strategy*. The strategy has served as the basis for an extensive, peer-review driven, process of periodic analyses and discussions among OECD members of progress in the key reform areas identified by the study. Through these means, the Strategy has had considerable influence on the reforms they have undertaken. The strategy is not static; it has evolved over time in light of

experience; nor does it attempt to provide a particular blueprint for reforms, and indeed a number of distinctive approaches seem to have had considerable success (Brandt et al, 2005). Nevertheless, a number of broader insights are consistent with other international experiences and of relevance to MENA's efforts.

73. The Jobs Strategy highlights and emphasises the critical importance of macroeconomic stability to sustained growth in employment and real wages. As the experience in MENA and many other countries indicates, boom and bust cycles caused by unsustainable macroeconomic policies depress real growth and investment over the longer-term and can lead to hysteresis effects in labour markets as workers who become unemployed during downturns suffer a degradation of their skills and their employability during upturns. Maintenance of low inflation is particularly important: low inflation contributes positively to labour market performance by promoting lower real interest rates, which boosts real growth in output and thus the demand for labour and by encouraging capital deepening, which enhances labour productivity and real wages.

74. A number of studies have provided extensive evidence of extensive interactions between reforms in labour and product markets. In OECD countries, limits on competition have been found to be associated with higher rates of unemployment in the non-agricultural sector (Nicoletti et al, 2002) and countries where product market regulation is relatively high have tended to specialise in relatively less R&D intensive activities and lower wages. Opening of previously heavily regulated sectors to greater competition may result in some loss of job security for its employees but there is no solid evidence, at least for OECD countries, that greater competition permanently increases wage inequality. The overall implication is that reforms to improve product markets can significantly enhance the payoffs to labour market reforms—and vice-versa.

75. Active labour market policies (ALMP), such as employment subsidies, training programmes, and job search assistance have been widely employed in OECD countries. The results of such policies have been mixed but overall the evidence suggests that these policies need to be carefully targeted if they are to work or be cost-effective. There is some indication that programmes to improve information, facilitate search, and otherwise enhance labour market functioning are more cost-effective than outright subsidies or other less precisely targeted programmes. Subsidies and some other of these programmes can be fairly expensive so that it is important that they be carefully targeted. The need for more precise targeting of ALMP in MENA has also been emphasised by the World Bank (World Bank, 2004).

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