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# Looking Ahead After A Year In Transition





**MIDDLE EAST AND NORTH AFRICA REGION**

**ECONOMIC DEVELOPMENTS & PROSPECTS, OCTOBER 2012**

## **LOOKING AHEAD AFTER A YEAR IN TRANSITION**



THE WORLD BANK



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# TABLE OF CONTENTS

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ACRONYMS .....	i
EXECUTIVE SUMMARY .....	ii
A YEAR OF TRANSITION.....	1
MACROECONOMIC DEVELOPMENTS AFTER THE REVOLUTIONS .....	6
THE ARAB REPUBLIC OF EGYPT .....	6
TUNISIA .....	10
THE REPUBLIC OF YEMEN.....	14
LIBYA.....	16
MULTI-SPEED GROWTH IN OTHER MENA COUNTRIES .....	19
GCC COUNTRIES.....	20
OTHER DEVELOPING OIL EXPORTERS.....	23
OTHER OIL IMPORTING COUNTRIES .....	25
KEY MESSAGES .....	29

## LIST OF FIGURES

Figure 1. Arab Spring Transition Timeline.....	2
Figure 2. Economic activity after the revolutions.....	4
Figure 3. Select macroeconomic indicators in post-revolutionary economies.....	5
Figure 4. Select economic indicators for Egypt, Arab Rep.....	9
Figure 5. Select economic indicators for Tunisia .....	13
Figure 6. Select economic indicators for Yemen, Rep.....	16
Figure 7. Select economic indicators for Libya .....	18
Figure 8. Macroeconomic outlook in rest of MENA .....	19
Figure 9. Economic indicators for Iran, Islamic Rep .....	24
Figure 10. Tourist arrivals in Lebanon and Jordan .....	26
Figure 11. Select economic indicators, Jordan .....	27
Figure 12. Regional growth outlook .....	28

## LIST OF TABLES

Table 1. Macroeconomic Outlook.....	22
Table 2. Subsidies in Morocco (percent of GDP).....	26





## WORLD BANK MIDDLE EAST AND NORTH AFRICA REGION

**ECONOMIC DEVELOPMENTS & PROSPECTS, OCTOBER 2012**

### **LOOKING AHEAD AFTER A YEAR IN TRANSITION**

#### **ACKNOWLEDGEMENTS**

This report is a product of the Office of the Chief Economist for the Middle East and North Africa Region of the World Bank. The report, led by Elena Ianchovichina in collaboration with Christina Wood and Lili Mottaghi, focuses on the economic challenges in MENA during the year of transition and pays special attention to four post-revolutionary economies – the Arab Republic of Egypt, Tunisia, the Republic of Yemen and Libya. It also discusses the region's short-term macroeconomic outlook and the risks ahead. Valuable country-specific inputs and comments were provided by the following group of country economists: Thomas Laursen, Antonio Nucifora, Wilfried Engelke, Ibrahim Al-Ghelaïqah, Kevin Carey, Sibel Kulaksiz, Chadi Bou Habib, Wael Mansour, Jean-Pierre Chauffour, Khalid El Massnaoui, Marc Schiffbauer, Sherine H. Al-Shawarby, Nancy Claire Benjamin, Karim Badr, Chahir Zaki, Amir Althibah, Hania Sahnoun, and Natsuko Obayashi. We also thank Melise Jaud for her inputs and data on economic indicators during past transitions. We are grateful to Manuela Ferro and Bernard Funck for their assistance and helpful suggestions. We thank the peer reviewers, Mick Riordan, Hedi Larbi, and Phil Keefer, for their useful comments. We thank Isabelle Chaal-Dabi for excellent administrative assistance during the preparation of the report and Malika Drissi for working on the design of the report's cover.

The report was prepared under the direction of Caroline Freund, Chief Economist, Middle East and North Africa Region of the World Bank.

For ease of analysis and exposition, we refer to Egypt, Tunisia, the Republic of Yemen and Libya as post-revolutionary economies. As in previous issues of this report, we also refer to three main groups of countries: the GCC oil exporters, developing oil exporters and oil importers. The first group contains the Gulf Cooperation Council (GCC) countries, namely, Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. The second group comprises the developing oil exporters such as Algeria, Islamic Republic of Iran, Iraq, Libya, Syrian Arab Republic, and The Republic of Yemen. Oil importers include economies with GCC links (Djibouti, Jordan, and Lebanon) and those with EU links and located in North Africa (Egypt, Morocco and Tunisia), as well as West Bank and Gaza. Developing MENA represents all MENA countries except the GCC oil exporters.



## ACRONYMS

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CDS	Credit Default Swap
DPL	Development Policy Loan
EIU	Economist Intelligence Unit
EU	European Union
FDI	Foreign Direct Investment
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
IMF	International Monetary Fund
LFS	Labor Force Survey
MENA	Middle East and North Africa
MNACE	Middle East and North Africa Chief Economist Office
mbd	Million Barrels per day
NTC	National Transitional Council
OPEC	Organization of the Petroleum Exporting Countries
p/d	Per day
PIP	Public Investment Program
SCAF	Supreme Council of the Armed Forces
SMEs	Small and Medium Enterprises
T - BILLS	Treasury bills
UAE	United Arab Emirates
UN	United Nations
UNWTO	United Nations' World Tourism Organization
US	United States of America
WDI	World Development Indicators



## **E**XECUTIVE SUMMARY

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The Arab Republic of Egypt, Tunisia, Libya and the Republic of Yemen are recovering after a period of economic growth decelerations accompanying the Arab Spring uprisings of 2011. Economic recovery was relatively quick, with industrial production recovering in a matter of months and, in the cases of Egypt and Tunisia, the growth dips of 2011 were smaller than the average growth declines observed around the year of transition during past transitions to democracy. Importantly, the growth decelerations and recovery have taken place in a weak global environment, with events in the Eurozone posing particular challenges to Tunisia, and to a lesser extent, Egypt.

The transition process in these countries started in late 2010 with the uprising in Tunisia, followed quickly by protests in the other three countries in early 2011. In each of the four economies the uprisings were rooted in dissatisfaction over lack of voice and accountability, lack of jobs and opportunities, especially for young people, and a multitude of governance problems, particularly corruption, hampering opportunities for unconnected businesses. The transition process is now underway with varying degrees of speed and is far from complete. Uncertainty about the reform process and outcomes remains a binding constraint to private investment. Consequently, in most post-revolutionary economies of the region, post-transition growth is below potential and is lower than growth during the period immediately preceding the Arab Spring uprising, with negative consequences for unemployment and poverty outcomes.

Macroeconomic fundamentals weakened in the four countries as growth declined and governments responded to social demands with expansionary fiscal policies that have driven up fiscal deficits to unsustainable levels, increased the government debt burden and put upward pressure on real interest rates. Official foreign exchange reserves declined, in some cases steeply, in a move by governments to avoid currency depreciations, as exports, especially tourism receipts, contracted and investors remained on the sidelines. High oil prices helped Libya and the Republic of Yemen, but have exacerbated current account imbalances and fiscal deficits in Egypt and Tunisia.

Domestic pressures coupled with a challenging global environment and spillovers from regional events weighed heavily on the 2012 economic performance of some oil importers such as Jordan, Lebanon, and Morocco. Sluggish global growth, particularly in the Euro area, adversely affected export receipts, tourism revenue and FDI flows, and coupled with high international oil and food prices, weakened their external balances. Notably, Jordan and Lebanon have been affected by the conflict in the Syrian Arab Republic, whereas Morocco has been impacted by a weak harvest season. Fiscal deficits are expected to persist as growth decelerates and fiscal commitments inflate government expenditures.

High oil prices have supported economic growth in the GCC countries and Iraq. In 2012 economic growth of the GCC oil exporters will average 5.1 percent and of Iraq it will reach slightly above 11 percent. As a group, developing oil exporters other than those recovering from unrest are expected to grow at a much weaker pace of just half a percent, reflecting the impact of export restrictions on the Islamic Republic of Iran. Rising public spending however has increased considerably the fiscal breakeven price of oil, leaving the GCC economies' fiscal positions vulnerable to varying degrees to a negative oil price shock.

The regional growth prospects for 2013 reflect weaker global economic activity, especially in the EU, and moderating oil prices. Regional economic activity is expected to grow on average by 5.5 percent in 2012 and 3.5 percent in 2013.<sup>1</sup> The growth deceleration into 2013 largely reflects much weaker activity in oil exporting countries, which will grow at an estimated average of 3.4 percent in 2013 down from 6.5 percent in 2012. Libya is expected to grow faster than the average for the oil exporting group, but its growth will also decelerate in 2013 relative to 2012. By contrast, oil importers' economic growth will accelerate from an estimated 2.6 percent in 2012 to an estimated 3.7 percent in 2013, but Egypt and Tunisia will be growing slower than the average for the group.

Prolonged political and policy uncertainty and political and social unrest are serious downside risks to this macroeconomic outlook. Uncertainty is a key obstacle to investment and trade, particularly trade in services. Services exports have been an area of relative strength for MENA and the sector was booming prior to 2011 but concerns about security have triggered a major contraction in tourist arrivals to the region, leading to a jump in unemployment in countries such as Egypt and Tunisia. Unemployment has also increased in these countries as migrant workers returned home from places in unrest, notably Libya. Strengthening fundamentals to bolster macroeconomic stability will also be crucial to growth throughout developing MENA, while elevated international food commodity prices remain a concern.

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<sup>1</sup> The macroeconomic outlook for the region excludes Syria where the situation is rapidly developing and information on key macroeconomic variables is unavailable.

## A YEAR OF TRANSITION

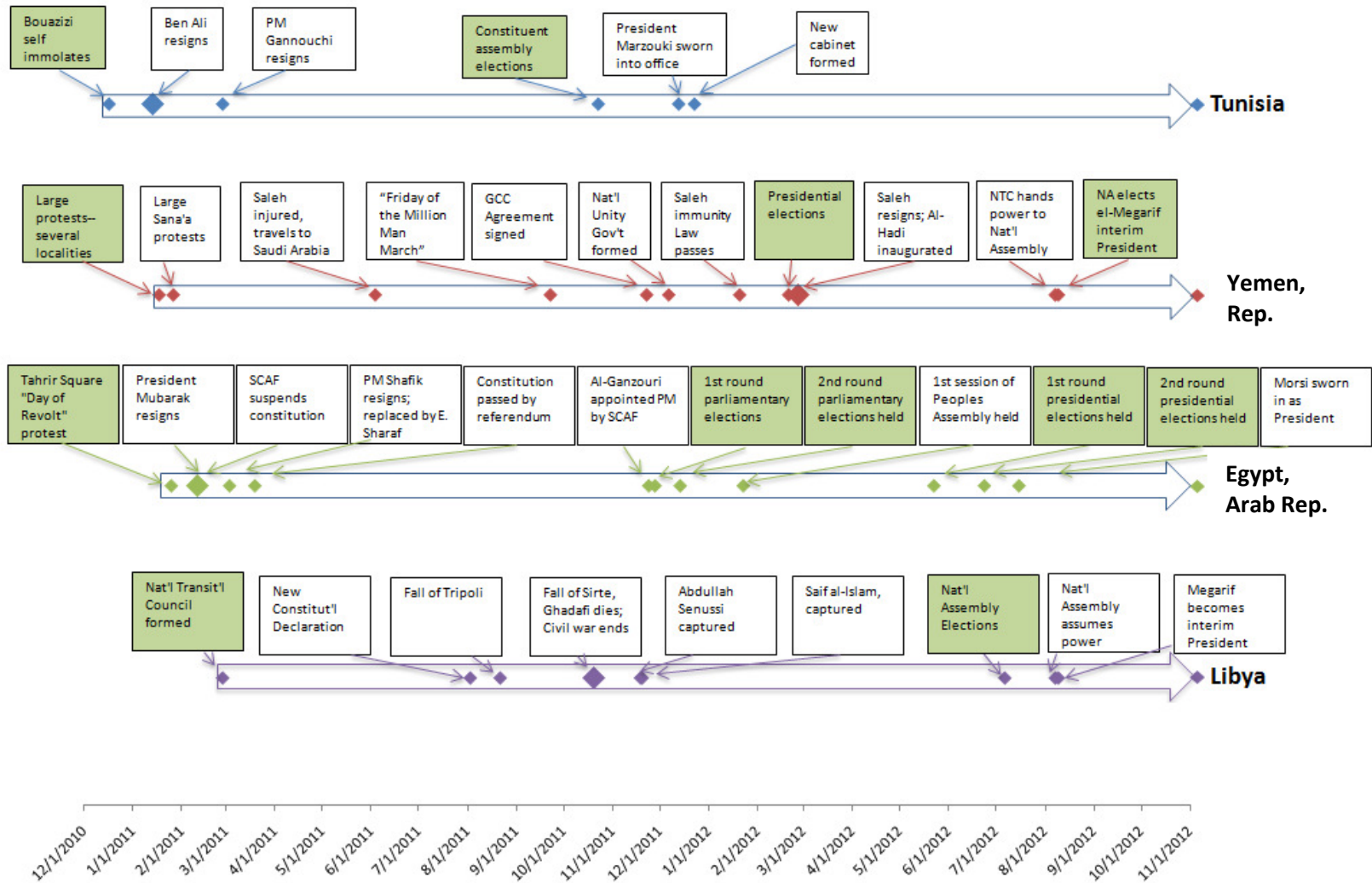
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The report focuses on the economic developments and short-term outlook for four MENA economies – Tunisia, Egypt, the Republic of Yemen and Libya. These four countries are given special attention because each of them experienced a revolution and a major political change in 2011 and is undergoing a process of political transition toward democracy. The sudden change had important economic consequences. While other countries in the Middle East and North Africa are undergoing political change, the economic ramifications were muted as compared with the changes observed in the four MENA post-revolutionary economies.

The revolutions began in Tunisia in late 2010 and quickly spread to Egypt, the Republic of Yemen and Libya. Large anti-government protests and civil conflict eventually led to the ouster of long-standing governments in the four countries and set in motion the process of transition (see Figure 1). In all four post-revolutionary countries protests were rooted in dissatisfaction over lack of voice and accountability, lack of jobs and opportunities, especially for young people, and a multitude of governance problems, particularly corruption, hampering opportunities for unconnected businesses. In Tunisia mass demonstrations ultimately forced President Ben Ali to resign within a month. Major demonstrations took place in mid-January 2011 in Egypt and the Republic of Yemen, and a month later anti-Ghadafi forces in Libya formed the National Transitional Council, which served as the face of the revolution and eventually presided over the transition. Government ouster happened quickly in Egypt as President Mubarak resigned 18 days after the onset of mass demonstrations. In Libya military intervention by Western forces hastened the fall of the Ghadafi regime, whereas in the Republic of Yemen the GCC brokered an agreement for an orderly handover and the government fell after the Saleh immunity law was passed.

In each of the four countries, the transition authorities have been charged with implementing agreed time-bound actions leading to democratic elections for new constitutions, presidents and/or parliamentary bodies. The process is underway with varying degrees of speed. In Tunisia, the process of conducting an election for a Constituent Assembly to preside over the transition and draft a new constitution to govern the conduct of presidential and parliamentary elections is underway and Tunisia's new elections are now expected to be held no later than June 30, 2013. In Egypt, the transition to elected government (itself transitional) underpinned by a new constitution was much quicker, with parliamentary and presidential elections concluded within the 18 months following the fall of the Mubarak regime. However, the country lacks a full constitution and parliament, and the transition framework remains uncertain, having been reshaped multiple times by a series of constitutional declarations, laws, decrees, legal challenges and court rulings.

Figure 1. Arab Spring Transition Timeline





In the Republic of Yemen, the agreement brokered by the GCC enabled the orderly handover from President Saleh to an elected President Hadi, albeit the sole candidate on the ballot. He has a two-year mandate to form a new constitution, reform the electoral process and hold new elections in 2014. In Libya, the National Transitional Council formed in the course of the civil war handed over power after 18 months to an elected national assembly – the General National Congress – which elected an interim President to preside over the next phase of the transition.

As in past transitions, economic growth in the four post-revolutionary economies decelerated in 2011, the year of transition.<sup>2</sup> Growth decelerations lasted just one year – the average observed during past transitions to democracy – whereas industrial production recovered in a matter of months (Figure 2, top charts). The growth dips in Tunisia and Egypt were less dramatic than the average growth declines observed around the year of transition during past transitions to democracy (Figure 2, bottom left chart).

Importantly, growth decelerations and recovery have taken place in a weak global environment, with events in the Eurozone posing particular challenges to Tunisia, and to a lesser extent, Egypt. Developed countries grew by 1.6 percent in 2011 and their growth is expected to decelerate to 1.4 percent in 2012, with the Eurozone expected to contract by 0.3 percent. Growth in developing countries is also expected to decelerate to 5.3 percent in 2012 from 6.1 percent in 2011. Consistent with expectations, the 2012 price of Brent crude oil has remained high, averaging US\$112 per barrel in August, but along with global growth it is likely to moderate to an average of US\$103 in 2013.

The transition process is still far from complete and uncertainty about the reform process and outcomes is a binding constraint to private investment. Consequently, in most post-revolutionary economies of the region, the recovery has been weak, growth remains below potential and growth during the period immediately preceding the Arab Spring, with negative implications for unemployment and poverty outcomes (Figure 2, bottom right chart).

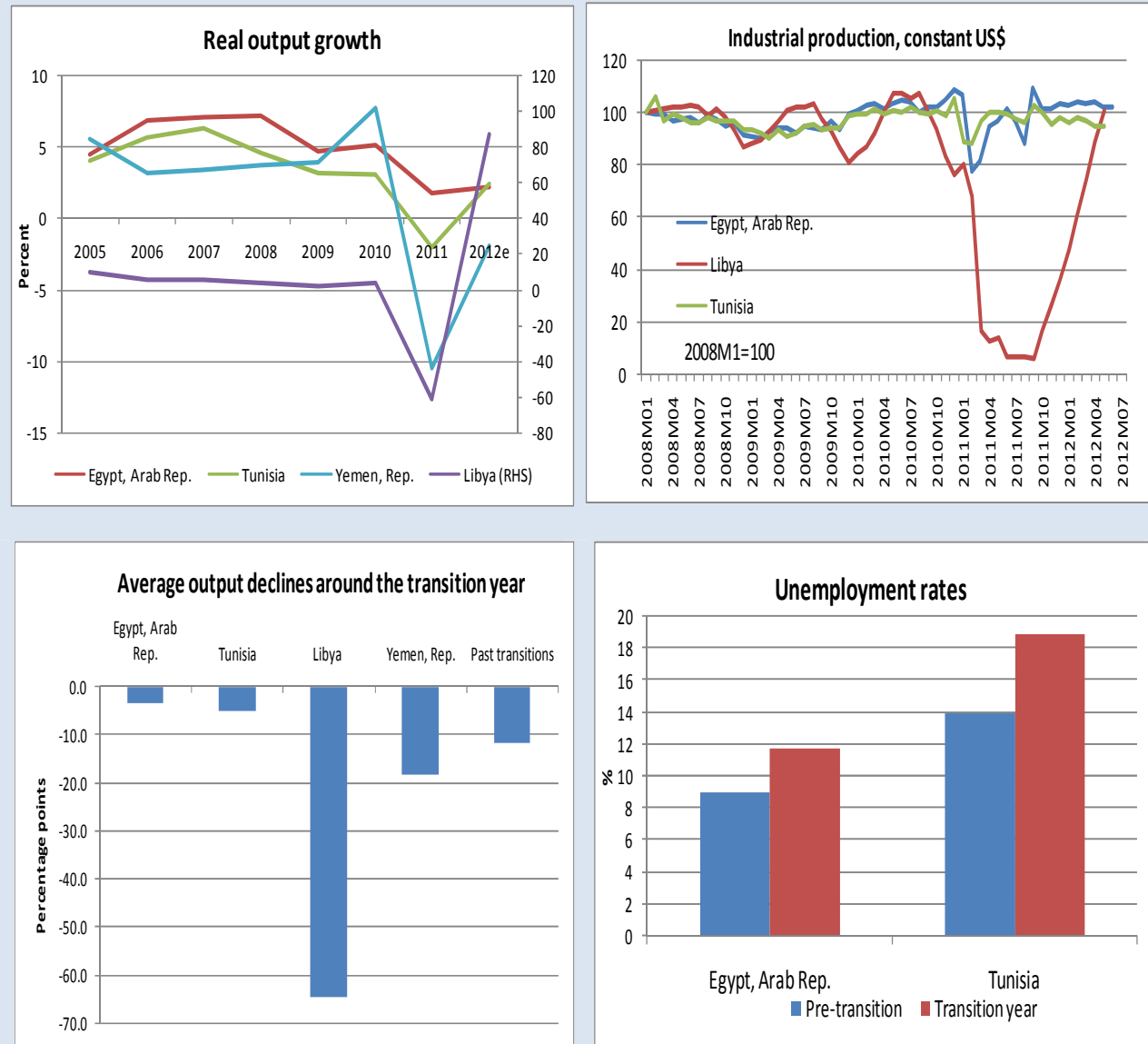
Over the past year, macroeconomic fundamentals weakened substantially in the four post-revolutionary economies (Figure 3). As growth decelerated, exports declined and social pressures escalated, governments responded with expansionary fiscal policies that have driven up fiscal deficits to unsustainable levels, increased the government debt burden and put upward pressure on real interest rates. Official reserves declined, in some cases steeply, in a move by governments to avoid currency depreciations as exports, especially tourism receipts, contracted and investors fled to safety. High oil prices helped oil exporters, but have exacerbated current account imbalances and fiscal deficits, especially in countries where governments subsidize

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<sup>2</sup> A paper by Freund and Jaud (2012) titled “Democratic transitions: successful, gradual and failed” discusses the experience of countries during transitions over the past 50 years. They find that in these transitions growth declined on average by about 11 percentage points around the transition year but recovery followed soon after, usually in a year.

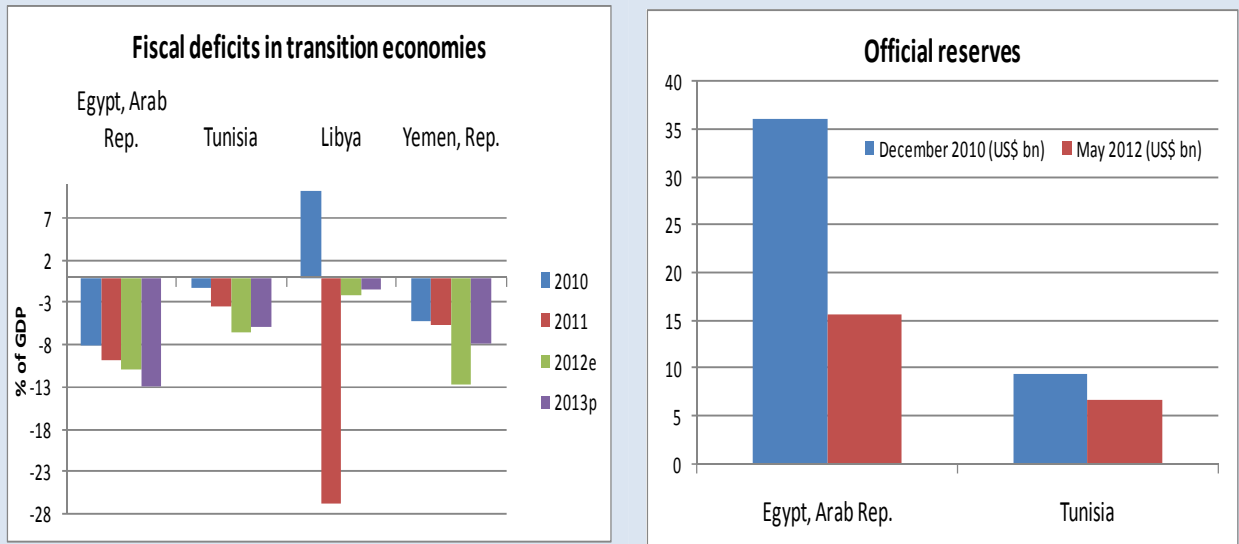
energy products. The report presents next the macroeconomic developments and the outlook for 2013 for each of the four countries.

**Figure 2. Economic activity after the revolutions**



Source: World Bank.

Figure 3. Select macroeconomic indicators in post-revolutionary economies



Source: World Bank.

Note: Monthly official foreign exchange reserves data on Libya and Yemen, Rep. were unavailable.



## MACROECONOMIC DEVELOPMENTS AFTER THE REVOLUTIONS

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### THE ARAB REPUBLIC OF EGYPT

The revolution of 2011 in Egypt followed a decline in economic growth. The economy grew at 4.9 percent a year during 2009-10 – slower than the average annual 6.5 percent posted during the pre-financial crisis years from 2005 to 2008 (Figure 4). With the revolution of 2011 came production stoppages and widespread strikes which dampened Egypt's economic performance. Some of the sectors that maintained growth after the financial crisis—tourism and manufacturing—also led the post-revolutionary decline as strikes and political uncertainty halted investments, deterred foreign investment and tourists. In 2011 tourism contracted by 19.4 percent, manufacturing was down by 3.8 percent, while construction, transportation and trade were up by 0.3 percent, 3.4 percent, and 2.1 percent, respectively. Overall, real economic growth reached just 1.8 percent in 2011 and was over 3 percentage points lower on average than growth in 2010 (Figure 2). Following the growth slowdown unemployment rates jumped up to almost 12 percent at the end of fiscal year 2011 from the 9 percent range observed in the two years preceding the Arab Spring (Figure 4). The fiscal deficit widened in the wake of the Arab Spring (Figure 4) as the government ramped up spending on wage increases, fuel and food subsidies, whereas government revenues declined due to the fall in economic activity and trade.

Economic growth is recovering slowly in 2012, with real GDP growth expected to increase to only 2.2 percent for fiscal year 2012 (Figure 4). Growth is driven by higher consumption and investment on the demand side and some rebound in manufacturing, tourism, construction, and communications on the supply side. Nonetheless, unemployment extended its upward trend, reaching 12.6 percent at the end of fiscal year 2012, while inflation pressures inched up to 11 percent in 2012. These developments put pressure on the government to deliver on the social protection and employment fronts, at a time when fiscal space is severely constrained.

The fiscal deficit has expanded compared to 2011 due to increased current spending on wages, subsidies, interest on debt, whereas financing it has become more expensive and has strained the lending capacity of banks. The budget deficit has been financed largely by domestic T-bills, bonds and overdraft borrowing from the central bank. The latter has been sterilized by the drawdown of foreign reserves. Though trending downward since end-August, yields on T-bills remain unsustainably high at 13.6 percent in mid September for 12-month maturities. To help sustain bank liquidity, the central bank gradually lowered the reserve requirement from 14 to 10 percent in the first half of 2012, and allowed the government to run large overdrafts. Still, the large government financing needs leave little room for banks to finance the private sector.

The widening of the current account deficit to 3.1 percent of GDP in 2012 from 1.2 percent of GDP in 2011 reflects mainly a soaring trade deficit which reached 12.3 percent of GDP due to much higher petroleum imports, lower tourism receipts, partially compensated by higher remittances, and higher interest payments. The balance of payments has been under pressure

from the widening current account deficit and a large, albeit moderating, capital account deficit. The Central Bank of Egypt has kept the exchange rate broadly stable against the dollar by drawing down reserves, aiming to provide a measure of stability with a nominal anchor. However, with still high inflation, this has led to real effective appreciation of about 7 percent raising concern over the export competitiveness of Egypt's economy. Egypt has received financial support recently from Qatar and Turkey, expected to boost foreign exchange reserves by US\$5 billion to US\$20 billion by end 2012, thereby making it easier for the Central Bank of Egypt to maintain the value of the currency this year.<sup>3</sup>

Still the near-term outlook for the economy remains challenging. Real GDP growth is projected to accelerate mildly to about 3 percent in 2013 with significant downside risks (Table 1). Demand will likely pick up only slowly, as domestic and foreign investors remain on the sidelines until greater political and institutional clarity is assured, including clarity about the valuation of the Egyptian pound. The revolution and its turbulent aftermath have caused many people to postpone large purchases, and a deteriorating external environment, particularly in Europe – a major trading partner and a source of tourists – further dampens hopes for a strong recovery.<sup>4</sup> Inflation is expected to temporarily rise into the low double digits over the next year or two due to expected supply shocks such as energy price hikes associated with subsidy reforms, and some pass-through from higher food prices.

In the absence of corrective measures, the fiscal situation is expected to worsen further in 2013. Proposed reforms under the draft 2013 budget, comprising reductions and targeting of fuel and other subsidies among other reforms, are unlikely to be timely or deep enough. The fiscal deficit is projected to worsen to about 13 percent of GDP in 2013, due to still high fuel subsidies, not fully compensated by proposed liberalization of tariffs for energy intensive sectors,<sup>5</sup> and a wage bill inflated by further increases in salaries and pensions of public sector employees in 2012.<sup>6</sup>

Structural constraints and the high public debt exacerbate vulnerabilities and limit the room for policy maneuver. Non-oil tax revenues represent only 11 percent of GDP, which is low by international standards and public expenditure is dominated by largely pre-determined wages, subsidies, and interest payments (over three-quarters of budget spending), leaving little room for investment spending. Private sector credit is being crowded out by high government financing needs, thereby offering little support for the recovery.

The external financing gap is projected to remain substantial and foreign reserves could reach dangerously low levels—one month of imports excluding gold—by early 2013 absent

<sup>3</sup> Source: JP Morgan “Middle East and North Africa Today,” Sept 19, 2012.

<sup>4</sup> Exports to Europe amount to about 45 percent of total exports (about 5 percent of GDP) and European tourists account for about 70 percent of all tourist arrivals.

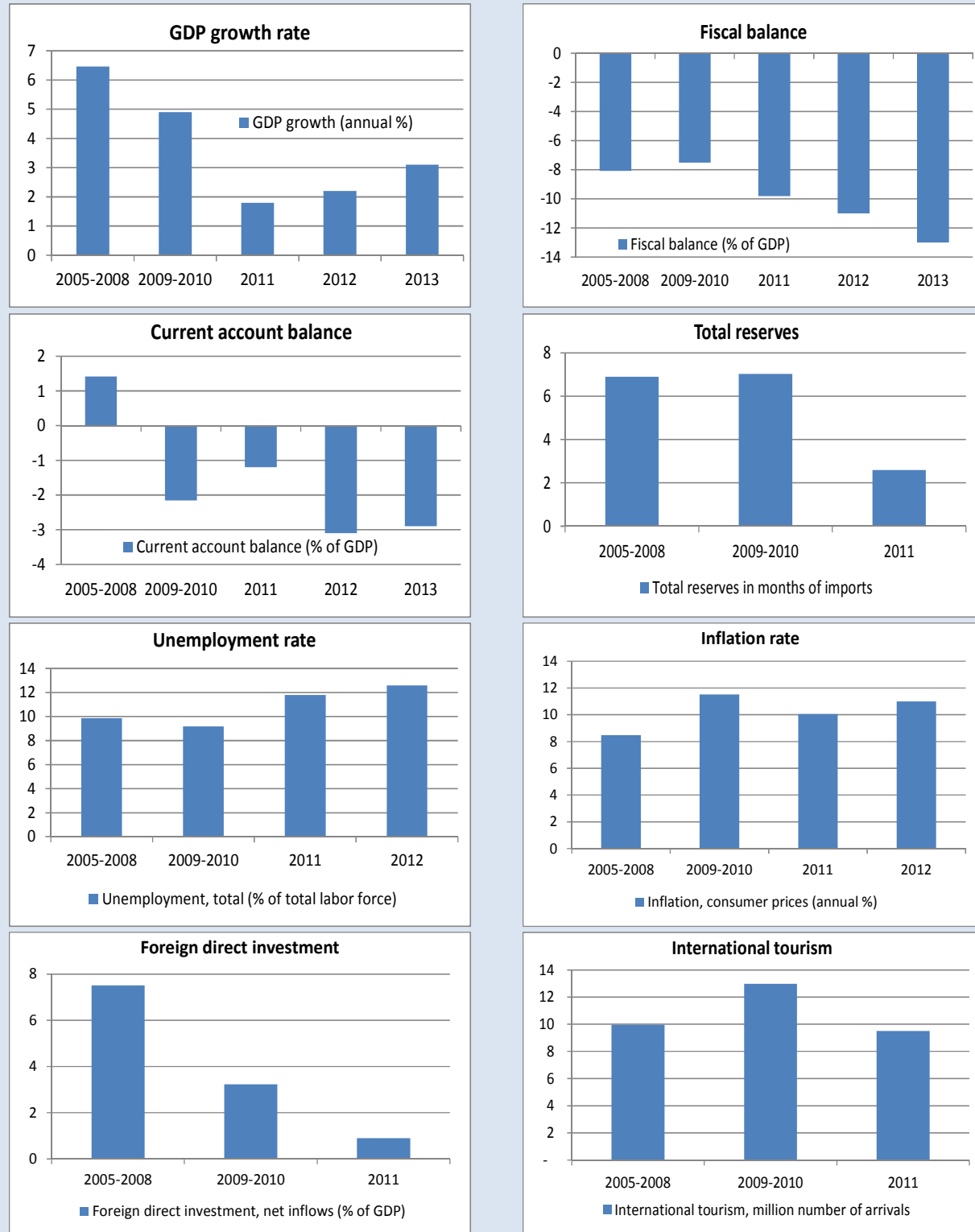
<sup>5</sup> Energy-intensive industries include petrochemicals, aluminum, ceramic, and steel. These account for some 80 percent and 15 percent of total fuel oil and natural gas consumption, respectively, with these two sources of energy accounting for about 25 percent of total energy subsidies.

<sup>6</sup> Public sector salaries are scheduled to increase by 50 percent over the 2011/13 period.

exceptional financing. While the external current account may improve somewhat, driven by a gradual recovery of tourism and FDI as the domestic situation stabilizes, large exceptional financing—in the magnitude of US\$10-15 billion—would likely be needed from bilateral and multilateral partners to stabilize reserves and the value of the Egyptian pound.

Risks to the outlook stem from uncertainty about the political situation, the ability to deliver the required deep structural reforms, and disorderly currency devaluation. The latter is more likely the longer foreign exchange reserves remain at their current low level. Successful conclusion of the June 2012 presidential election and subsequent events consolidating civilian leadership have created some positive momentum in financial markets, but the market sentiment remains fragile as risk perceptions measured by credit default swap (CDS) spreads and the forward exchange rate remain elevated.

Figure 4. Select economic indicators for Egypt, Arab Rep.



Sources: World Bank, IMF and UNWTO.



## TUNISIA

Weakened somewhat by the 2008 global financial crisis, Tunisia nonetheless entered the transition period from a reasonably strong macroeconomic position (Figure 5). The fiscal deficit was relatively low, averaging 2.1 percent of GDP during 2009-10. The resilience of tourism receipts and remittances, and to some extent foreign direct investment (FDI) inflows, enabled the country to record comfortable reserve levels despite the worsening current account balance. Implementation of fiscal stimulus packages geared toward job creating infrastructure investments and measures in support of SMEs and employment allowed Tunisia to avoid an increase in the unemployment rate, which even declined slightly during 2009-10 (Figure 5). Due to appropriate monetary policy, food subsidies and moderate increases in non-food prices, inflation held steady at about 4 percent despite increases in international commodity prices and public sector wages.

In 2011 in spite of supportive policies, Tunisia's economy contracted by 1.8 percent. The combined impact of social turmoil, the weakness in EU markets, and the spillover effects of the war in Libya dampened Tunisia's macroeconomic performance and exports and resulted in contractions of tourism, mining, and foreign investment. The interim government sought to mitigate the revolution's impact on the economy and boost the recovery. Proactive fiscal and monetary policies<sup>7</sup> succeeded in sustaining consumption growth at a rate similar to the one registered in 2010. However, the policies were only partially effective as investment spending fell significantly due to social strife and weak execution capacity at the local levels. On the positive side, a good rainy season supported growth in primary agriculture and processed food. Mechanical and electrical manufacturing also posted positive growth in 2011, partially compensating for the poor performance in other sectors.

The current account widened considerably to 7.3 percent of GDP in 2011 (Figure 5) due to deteriorating trade balance and the sharp drop in tourism receipts and FDI. Consequently, the level of international reserves dropped from an average of over 6.4 months of imports during 2009-2010 to 4 months in 2011 (Figure 5). The overall weak economic performance combined with the return of a large numbers of Tunisians from Libya, resulted in a jump in the unemployment rate from an annual average of 13.2 percent during 2009-10 to nearly 19 percent by end-2011. The system of subsidized prices for food and oil counteracted external inflationary pressures and inflation declined to an average of 3.8 percent in 2011.

In 2012, the economy has embarked on a gradual recovery, but the situation remains difficult and the strength of the recovery depends on the government's ability to manage the social and political tensions, the extent of the European recession, and the execution of the fiscal stimulus.

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<sup>7</sup> On the fiscal front, the authorities approved a supplemental budget in June 2011 introducing additional spending of approximately 5 percent of GDP. On the monetary front, the Central Bank reduced reserve requirements in 2011 from 10.5 percent to 2 percent while providing a substantial amount of short-term loans to banks to increase their liquidity and encourage lending to businesses. The Central Bank also reduced its main interest rate from 4.5 to 3.5 percent to boost access to credit and investment.

Real GDP growth is projected to recover gradually to approximately 2.4 percent in 2012 (Figure 5). However, industrial production has been weakened by the Eurozone crisis, with textiles, mechanical and electrical production contracting in the second quarter of 2012. FDI is projected to recover from declines early in the year and reach 90 percent of its 2010 level, driven primarily by investments in the energy sector, and to some extent manufacturing. Tourism revenues are expected to bounce back, reaching about 80 percent of their 2010 levels. The unemployment rate has also started improving and is expected to decrease to an average of 17 percent in 2012.

The current account deficit is projected to widen to 7.7 percent of GDP in 2012 from 7.4 percent of GDP in 2011 due to a worsening trade deficit, as import growth outpaces overall export growth. The positive impact of FDI inflows and the expected pick up in the tourism sector will only partially offset the drop in net exports. The European economic slowdown is expected to continue affecting manufacturing exports over 2012-2013. Energy and phosphate exports are expected to recover slowly, supported by still relatively high international prices and assuming that production will not be disrupted as in 2011. International reserves are projected to remain at a low but still adequate level of 3.2 months of imports in 2012 and begin to rise again thereafter. The assumption is that Tunisia's external financing gap will be financed through official foreign inflows and financing from international capital markets with guarantees from external sources.

Fiscal policy will play a critical role in the next one to two years of transition. The government has decided to adopt a larger than planned fiscal stimulus and social protection package in 2012. The fiscal deficit is expected to deepen to 6.6 percent of GDP in 2012, driven mainly by an increase in public investment as some projects that stalled during 2011 are progressively implemented. The wage bill and the subsidy transfers have also increased by 13 and 12 percent, respectively.

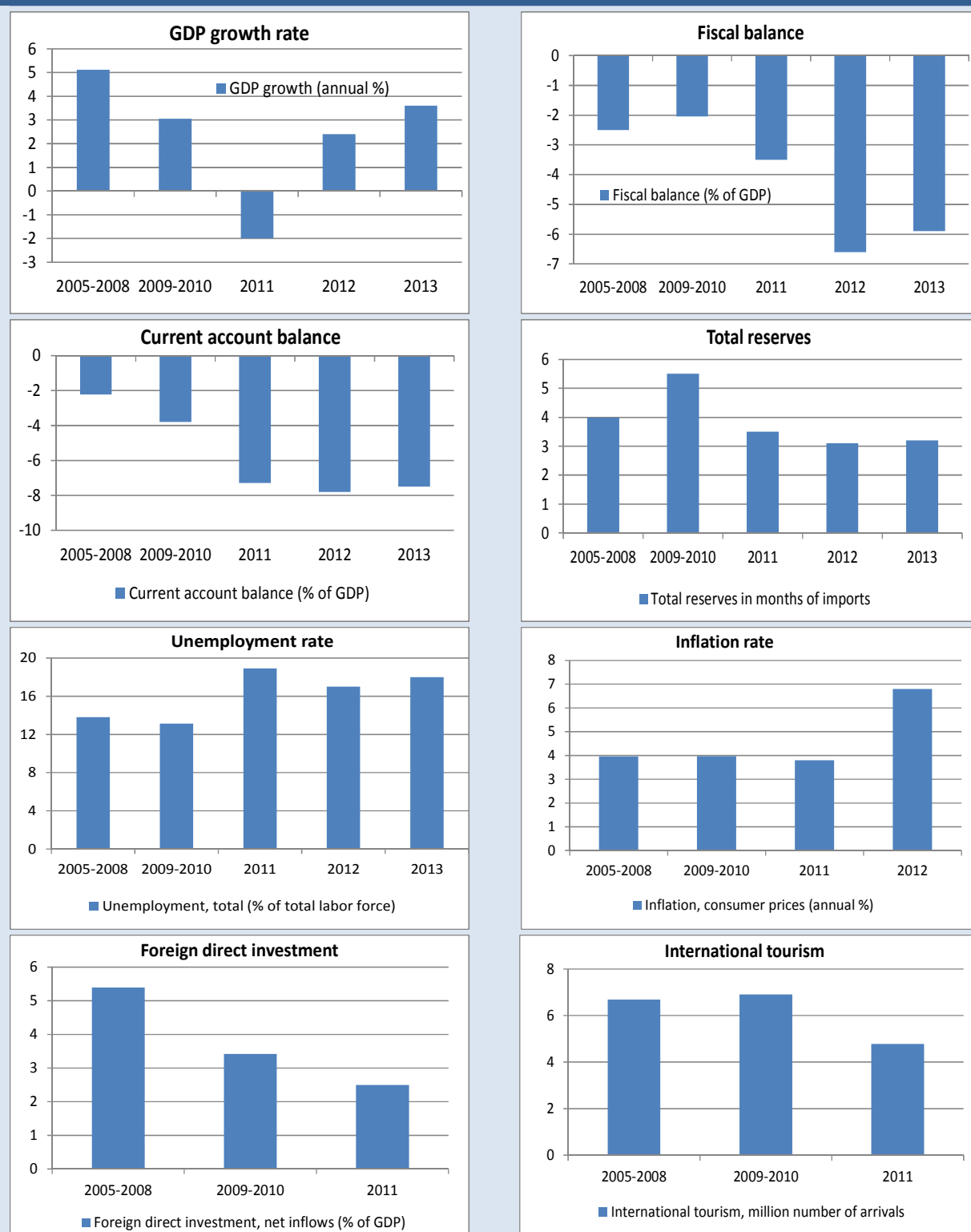
Inflationary pressures are expected to increase with both domestic and international commodity prices on the rise and the Tunisian dinar on a decline relative to the US dollar. With less room for monetary easing in 2012 compared with 2011, the risk exists that the banking system will start to tighten credit, making it difficult for businesses to operate and dampening the economic recovery.

The medium-term growth outlook remains positive due to an expected growth acceleration after the 2013 elections, but downside risks persist. The pace of growth can be expected to increase to approximately 3.6 percent in 2013 (Figure 5 and Table 1) as a result of the combined effect of the recovery in exports, tourism and FDI, the continuation of major public investments, and the package of reforms adopted by the interim government which is expected to lead to growing consumption and investment. Notably, domestic private investment is projected to expand in 2013 and beyond, as a result of the expected completion of the political transition by mid-2013 and progress on structural reforms. The current account deficit however is expected to remain large at 7.5 percent of GDP as imports are likely to outpace exports with recovery in progress.

The fiscal balance is projected to improve somewhat relative to 2012, but will remain high due to an increase in current expenditures, progressive implementation of public investment, and spending related to the planned 2013 elections. The composition of public expenditures is of particular concern, as the rising current expenditures on wages and broad-based food and fuel subsidies could leave little room for growth promoting investments.

The main short term risks facing Tunisia are domestic political uncertainty and persistent social tensions as well as developments in the Eurozone, which could severely impact Tunisia's recovery. While the number of strikes has diminished substantially compared to 2011, such incidents persist due to high unemployment and economic hardship. Furthermore, political risks could increase in the run up to elections, dampening FDI and tourism growth and constraining the economic recovery. Tunisia's exports will remain subdued due to sluggish Eurozone growth, preventing the country's external position from strengthening, and uncertainty about the stabilization process in Libya could dampen economic and political developments in Tunisia.

Figure 5. Select economic indicators for Tunisia



Sources: World Bank, IMF and UNWTO.

## THE REPUBLIC OF YEMEN

In the years leading to the Arab Spring, the Republic of Yemen maintained a stable, albeit modest, growth pattern with annual GDP growth averaging 4 percent during 2005-08 and just under 6 percent during 2009-10 (Figure 6). Growth spikes occurred during the second half of the 2000s but these were associated mainly with increases in the international oil price and the initiation of production at a large liquefied natural gas investment in 2010. Services also expanded but moderately, while growth in the agricultural sector has been on a decline and growth in the non-oil industrial sectors stagnated.

The political crisis of 2011 resulted in a sharp drop in economic growth in 2011, with GDP contracting by 10.5 percent due to disruptions to normal economic activity in all sectors (Figure 6). The current account deficit narrowed significantly from almost 7 percent of GDP in 2009-10 to nearly 3 percent of GDP in 2011 as the value of fuel exports increased and imports decreased reflecting depressed domestic demand. Nonoil exports however contracted and their share in GDP fell from 5.7 percent of GDP in 2009 to 1.9 percent in 2011. Inflation rose sharply, from an average of 7.4 percent in 2009-10 to 19.5 percent in 2011 (Figure 6), with food inflation rising significantly mainly due to disruptions in domestic supply and imports, further exacerbated by transport and distribution interruptions as a result of the civil strife. Rising fuel costs led to steep increases in transport costs, at times reaching 100 percent in urban areas and twice as much in rural areas.

The fiscal deficit fell to 4.4 percent of GDP in 2011 as public investment stalled. Revenues from oil and non-oil sources alike declined as the economy contracted deeply despite increases in the global oil price. Tax evasion exacerbated shortfalls in non-oil taxes, while foreign grants and loans plummeted by close to 60 percent and 70 percent, respectively. On the expenditure side, even though total expenditures and net lending fell in 2011 compared with 2010, public wages and salaries rose by close to 20 percent.

The 2011 economic contraction triggered a setback in poverty outcomes. The poverty rate, measured at the US\$1 a day poverty line, rose to an estimated 54.4 percent. The conflict has sharply driven down real household income through higher unemployment and inflation. Household expenditure also declined sharply, contracting by nearly 17 percent in 2011 with urban households suffering steeper losses than rural households. In terms of poverty impact, urban households also suffered more than rural households in relative and absolute sense. Urban poverty rose sharply from 30 percent in 2009 to 42.4 in 2011, whereas rural poverty rose from its very high pre-crisis level of 47.6 percent further to 59 percent in 2011.<sup>8</sup> The large poverty impact

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<sup>8</sup> Source: "Yemen: Joint Social and Economic Assessment," June 2012. The poverty analysis is based on the 2005 Household Budget Survey, which established the annual income lines of Yemen Riyal (YR) 66,000 for the urban poor and YR 63,900 for the rural poor, equivalent to about 94 cents for the urban poor and 91 cents for the rural poor. The income lines were adjusted for inflation to estimate the poverty incidence for 2009 and 2011.

in urban areas may reflect the fact that much of the uprisings took place in urban areas while many rural areas have been affected only indirectly.

Although in 2012 the economic situation in the Republic of Yemen is expected to improve relative to 2011, the economy will remain in recession, contracting on average by an estimated 1.9 percent (Figure 6). The weakness will affect all sectors, including oil due to disruptions in a key pipeline. Inflation is projected to remain high due to the protracted political crisis, rising international food prices and supply chain imperfections. The 2012 fiscal deficit is projected to reach 12.7 percent of GDP, excluding grants (Figure 6). Total expenditures are expected to increase by nearly 6 percent of GDP in 2012, with a noticeable increase in the wage bill. Revenues remain constrained by declining oil revenues and weak tax collection rates in a depressed economic environment. Capital expenditures are picking up but are still far too low to give a significant boost to growth. Aid from the country's financial partners, especially Saudi Arabia, is critical for maintaining the fiscal balance at a moderate level in 2012, closing the balance of payment gap,<sup>9</sup> and keeping international reserves at safe levels (Figure 6).

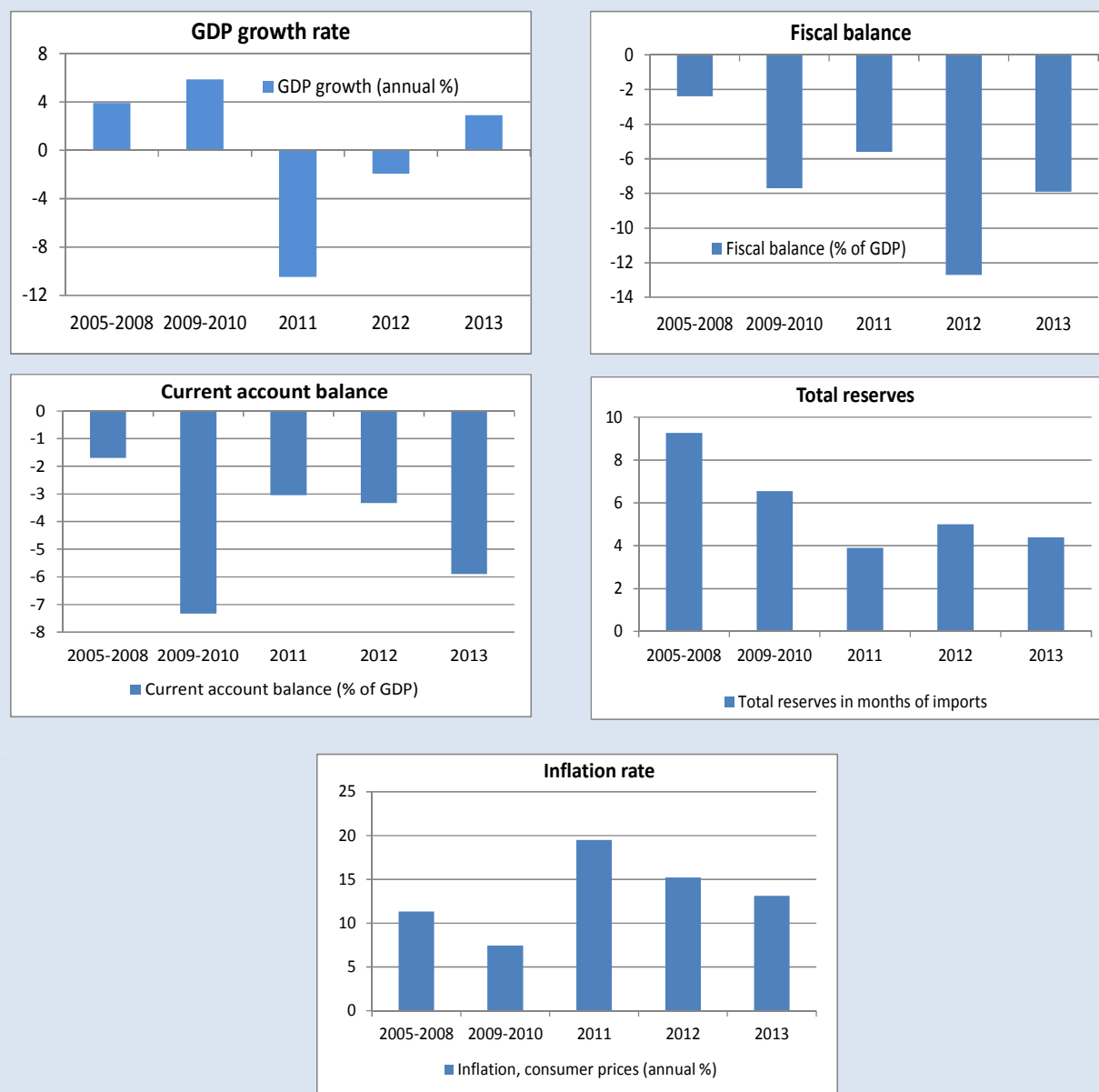
While the economy is projected to recover in 2013, GDP growth will average 2.9 percent in 2013 (Figure 6) and remain low as the country's underlying weaknesses emerge. Authorities will need to work on the key priorities of stabilizing the security situation, improving governance and accountability and pressing ahead with reforms to strengthen the private, nonoil economy. New sources of growth and fiscal revenues, which could generate employment and substitute for the loss of oil production, are currently not in sight. Improving the private investment climate and the public financial management system in the Republic of Yemen would be a first step toward tackling the country's structural problems. Proposing and implementing reforms which break privileged access and create a competitive private sector is needed to address the social and political demands for jobs and inclusion in the Republic of Yemen.

The macroeconomic outlook for 2013 is subject to a number of serious risks, including uncertainty about the political and security situation and weak commitment and ability to implement structural reforms. Addressing the structural issues undermining the country's economic development and sustainable growth will require successful conclusion of the transition process.

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<sup>9</sup> The current account deficit is projected to widen only slightly in 2012.

Figure 6. Select economic indicators for Yemen, Rep.



Sources: World Bank, and IMF.

## LIBYA

Prior to the revolution of 2011, Libya's economy was expanding at a moderate pace supported by the lifting of UN sanctions in 2003. GDP growth averaged over 6 percent per year during the period 2005-08 and 3 percent a year during the two years following the global financial and economic crisis of 2008 (Figure 7). Growth in the later period was generated in the non-oil economy, led by retail and wholesale trade, public services, construction, and financial services.

Expenditure policies were expansionary prior to 2011, buoyed by comfortable oil revenues and ample international reserves.

In 2011, real GDP growth plunged by 61 percent due to the conflict as oil production plummeted (Figure 2) and nonoil output contracted by 50 percent. Consequently, all other macroeconomic indicators deteriorated markedly (Table 1). Large fiscal and current account surpluses turned into large deficits (Figure 7), reflecting the drop in economic activity, exports and oil revenues; international reserves declined; and the national currency depreciated against the US dollar. Inflation increased to 16 percent due to constraints on imports, domestic supply limitations, and monetary expansion. Unemployment, estimated to be just above 20 percent pre-transition,<sup>10</sup> jumped to an estimated 33 percent in 2011.<sup>11</sup>

After a tumultuous 2011, Libya's economy is expected to rebound in 2012 and stabilize in the near term. Real growth is estimated to average 87 percent in 2012 and 6 percent in 2013, as oil production recovers and non-oil economic activity benefits from economic reconstruction and the return of economic stability. Oil output will jump up by an estimated 178 percent in 2012, reaching 80 percent of its pre-transition level, and 6.8 percent in 2013. Non-oil output is projected to rebound by around 30 percent in 2012 and continue its recovery by 5 percent in 2013. Key prices such as the general consumer price index and the exchange rate vis-à-vis the US dollar are also stabilizing as activity returns to normal and monetary conditions stabilize.

The 2012 budget will help stimulate the non-oil sector and continue to bridge the gap in social spending. Further increases in salaries and a rise in capital spending, half of which designated for housing and infrastructure, will be counterbalanced by increases in oil revenues. These developments will yield a slight fiscal deficit of 1.4 percent of GDP for the year, whereas the current account balance is projected to turn into a surplus as exports normalize.

Risks to the outlook include delays in normalizing the security situation and lower international prices for oil and gas. Uncertainties in the security environment will constrain the economic recovery and impede foreign investment and the return of much needed expatriate workers. Intensifying strains in the euro area and fragilities elsewhere have resulted in deteriorating financial conditions and escalated downside risks to global growth. Although hydrocarbon prices have remained high in 2012, the risk of a widespread economic slowdown could lower petroleum prices in 2013 and present additional challenges to Libya's oil-dependent economy. Therefore, the government should stay focused on exercising budget discipline, resuscitating the banking system and maintaining macroeconomic stability.

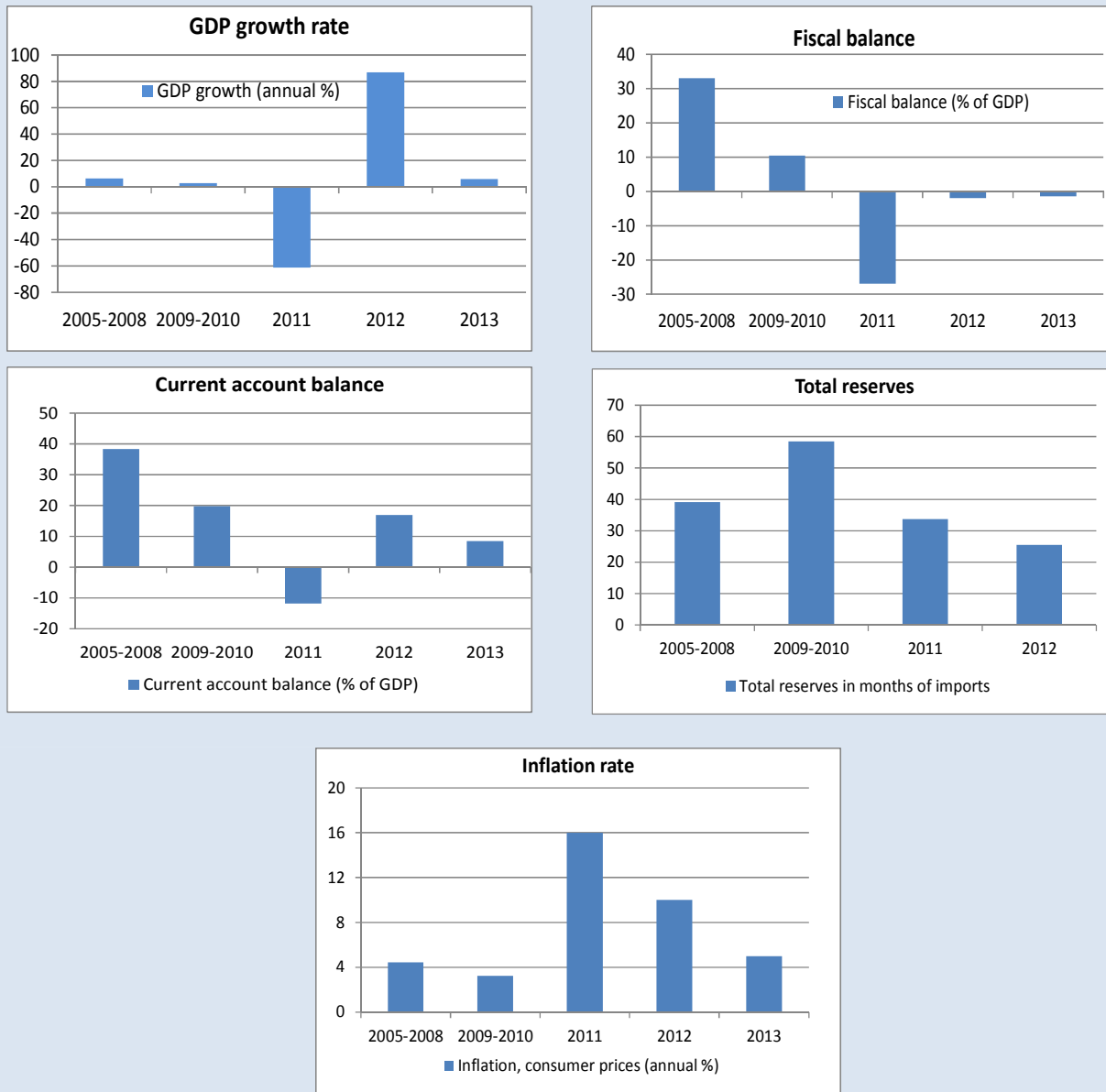
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<sup>10</sup> This estimate reflects data from a Labor Force Survey (LFS), adjusted to take into account hidden unemployment due to discouragement (the "inactive"). LFS data alone points to unemployment of only 13.5 percent.

<sup>11</sup> This estimate is based on rapid assessment of the labor market prepared by the World Bank in 2012.



Figure 7. Select economic indicators for Libya



Sources: World Bank, and IMF



## MULTI-SPEED GROWTH IN OTHER MENA COUNTRIES

High oil prices in 2012 have supported GCC oil exporters' economic growth for the year to an average of 5.1 percent (Figure 8 and Table 1). Developing oil exporters other than the Republic of Yemen, Libya and Syria are expected to grow at a much weaker pace, reflecting weakness in the Islamic Republic of Iran.<sup>12</sup> Oil importers other than Egypt and Tunisia will register moderate growth of 3.3 percent in 2012, although high oil prices during the year have exacerbated their fiscal and current account imbalances (Figure 8). Growth in GCC oil exporters is projected to decelerate in 2013 on account of moderating oil prices and oil production partly due to weaker global economic activity, while growth in oil importers is expected to strengthen.

Figure 8. Macroeconomic outlook in rest of MENA



Source: World Bank. Note: Developing oil exporters exclude Libya, the Republic of Yemen and Syrian Arab Republic (2011) and oil importers exclude Egypt and Tunisia.

<sup>12</sup> The pace of growth will be lower if we include Syria's growth forecast. Syria was excluded in this report because of lack of accurate information in a rapidly evolving situation.

## GCC COUNTRIES

Economic growth in the GCC countries is expected to be strong at 5.1 percent in 2012 (Figure 8). Several factors are supporting growth of this sub-region in 2012. Many of the GCC countries increased oil production in an effort to offset the impact of restrictions on exports from the Islamic Republic of Iran and stabilize global markets. Elevated oil prices, expected to average \$115 in 2012<sup>13</sup> have boosted government revenues whereas an expansionary fiscal policy and an accommodating monetary policy have stimulated the non-oil economy. Real GDP growth in the GCC countries is expected to remain robust but decline to an average of 4.4 percent in 2013 as oil and gas production remains flat and the stimulus measures of 2011 wear off.

The growth average for the group of GCC countries masks wide variations in growth prospects for individual countries. Saudi Arabia, Qatar and Kuwait continue to be the main growth engines in the sub region. Buoyed by strong domestic demand, Saudi Arabia's economic growth is expected to average 6 percent in 2012 (Table 1). Continuation of the government's massive investment program – planned to run through 2014 – has stimulated private sector growth. Despite rising global food prices, credit expansion and strong domestic demand growth, inflation has remained subdued, averaging 3.8 percent (yoy) in August, its lowest annual level since 2009. Real growth in Saudi Arabia will be slightly lower in 2013 relative to 2012 because of lower oil sector growth as the country's role in replenishing global oil supply will likely involve lower increase in oil production in 2012 relative to 2011. Non-oil growth will stay at 6.5 percent – slightly above the average of the previous 3 years, owing mostly to solid performance of the construction, trade and manufacturing sectors.

Economic activity in Qatar is expected to remain strong at 6 percent in 2012 due to rising government spending and high levels of infrastructure investments, especially on World Cup related projects. Growth in Kuwait is expected to remain robust at 5.5 percent in 2012 as oil production has increased by more than 0.6 million barrels per day to offset Iranian sanctions and has nearly reached full capacity of 3 million barrels per day. By contrast, growth has slowed sharply in Bahrain but high oil prices and economic growth in Asia have supported the key pillars of Bahrain's energy sector – crude oil production, oil refining, petrochemicals, and aluminum. Bahrain is vulnerable to external conditions because of financial sector exposures and the political climate.

The twin effects of higher oil prices and large oil export volumes have allowed GCC fiscal balances to improve in 2012 and enabled the financing of a higher government spending. Expenditure growth has remained high in the GCC countries particularly after the beginning of the Arab Spring, and much of the increased spending has been in the form of wage increases and other current spending measures.

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<sup>13</sup> Source: World Economic Outlook, International Monetary Fund, 2012 F.

Rising spending however has increased considerably the fiscal breakeven price of oil,<sup>14</sup> leaving the GCC economies' fiscal positions vulnerable to varying degrees to a negative oil price shock. For the period of 2010-12 the breakeven oil prices have risen between US\$5-20 per barrel on average, with Bahrain and the United Arab Emirates (UAE) having the highest breakeven oil price ranging between US\$100 and US\$140, followed by Saudi Arabia with an estimated 2012 breakeven oil price of around US\$80 per barrel. Though in most cases the average breakeven oil prices remain below the current spot oil prices, in the absence of diversification of budget revenues and in the event of a prolonged global recession coupled with a fall in oil prices, the GCC governments' fiscal position could be adversely affected.

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<sup>14</sup> The breakeven price is the price of oil at which fiscal balance is attained.

Table 1. Macroeconomic Outlook

	Real GDP Growth						Fiscal balance						Current account balance					
	2010	2011	2012e	2013p	2000	2011	2012e	2013p	2000	2011	2012e	2013p	2000	2011	2012e	2013p		
	(Annual percentage change)						(in percentage of GDP)						(in percentage of GDP)					
<b>MENA</b>	5.0	3.5	5.5	3.5	0.1	2.3	2.6	1.4	7.9	10.8	9.9	8.9	7.9	10.8	9.9	8.9		
Excluding Post-Revolutionary Economies	5.0	5.3	3.7	3.5	0.7	4.7	5.1	3.4	9.0	13.4	11.9	10.8	9.0	13.4	11.9	10.8		
Developing MENA	4.7	0.1	6.0	2.6	-3.4	-5.3	-6.6	-5.5	1.7	0.3	-1.7	-0.3	1.7	0.3	-1.7	-0.3		
Developing Post-Revolutionary Economies	4.8	-4.4	13.2	3.5	-3.1	-10.7	-8.6	-9.1	2.5	-3.5	1.0	-1.1	2.5	-3.5	1.0	-1.1		
Other Developing MENA	4.7	2.5	1.4	2.1	-3.5	-3.1	-5.6	-4.0	1.3	1.8	-3.0	0.1	1.3	1.8	-3.0	0.1		
<b>Oil Exporters</b>	5.1	3.9	6.5	3.4	1.8	5.0	5.6	3.8	11.2	15.2	14.4	12.4	11.2	15.2	14.4	12.4		
Excluding Post-Revolutionary Economies	5.1	5.4	3.7	3.3	1.5	6.0	6.5	4.3	11.0	16.3	14.7	12.9	11.0	16.3	14.7	12.9		
<b>GCC</b>	5.3	7.2	5.1	4.4	4.2	11.2	13.3	8.7	15.2	23.1	23.3	18.5	15.2	23.1	23.3	18.5		
Bahrain	4.1	1.8	2.0	2.8	-6.6	-2.3	-4.7	-5.1	3.4	4.2	4.4	7.0	3.4	4.2	4.4	7.0		
Kuwait	2.3	6.0	5.5	3.0	16.5	30.6	31.0	25.1	29.4	41.4	44.2	39.5	29.4	41.4	44.2	39.5		
Oman	4.8	3.8	5.0	4.0	6.9	7.6	6.5	5.0	7.9	16.8	14.0	10.0	7.9	16.8	14.0	10.0		
Qatar	16.6	18.8	6.0	4.6	2.7	7.2	8.6	5.4	26.3	28.1	26.3	25.0	26.3	28.1	26.3	25.0		
Saudi Arabia	5.1	7.1	6.0	5.0	5.1	13.0	16.5	6.8	14.6	26.5	26.5	16.8	14.6	26.5	26.5	16.8		
United Arab Emirates	3.2	4.9	3.5	4.0	-2.1	2.9	5.0	7.0	7.7	9.2	10.3	10.4	7.7	9.2	10.3	10.4		
<b>Developing Oil Exporters</b>	4.8	-2.1	9.3	1.6	-1.5	-3.5	-5.1	-3.3	6.0	4.5	2.1	3.4	6.0	4.5	2.1	3.4		
Post-Revolutionary Economies	4.7	-36.7	57.9	5.0	5.6	-17.1	-5.1	-3.2	14.4	-7.8	10.9	4.6	14.4	-7.8	10.9	4.6		
Libya	3.5	-61.1	87.0	6.0	10.3	-26.9	-2.0	-1.4	22.6	-11.8	16.9	8.5	22.6	-11.8	16.9	8.5		
Yemen, Rep	7.7	-10.5	-1.9	2.9	-5.2	-5.6	-22.7	-7.9	-4.4	-3.0	-3.3	-5.9	-4.4	-3.0	-3.3	-5.9		
<b>Rest of Developing Oil Exporters</b>	4.8	1.8	0.5	0.9	-2.7	-1.9	-5.1	-3.3	4.6	5.9	0.2	3.2	4.6	5.9	0.2	3.2		
Algeria	3.3	2.5	3.1	3.0	-1.9	-4.0	-6.0	2.0	7.5	9.5	5.4	11.4	7.5	9.5	5.4	11.4		
Iran, Islamic Rep.	5.9	1.7	-1.4	-1.1	-1.8	-2.6	-5.1	-5.9	5.9	5.2	-1.7	-0.5	5.9	5.2	-1.7	-0.5		
Iraq	0.8	9.9	11.1	13.5	-9.1	7.4	-3.1	-1.2	-1.8	7.9	0.1	5.8	-1.8	7.9	0.1	5.8		
Syrian Arab Republic	3.2	-3.0	...	...	-1.3	-3.5	...	...	-5.1	-2.2	...	...	-5.1	-2.2	...	...		
<b>Oil Importers</b>	4.7	2.4	2.6	3.7	-6.7	-8.5	-9.1	-9.8	-5.8	-7.0	-7.9	-7.3	-5.8	-7.0	-7.9	-7.3		
Post-Revolutionary Economies	4.8	1.2	2.2	3.2	-6.8	-8.7	-10.3	-11.8	-2.5	-2.2	-3.9	-3.7	-2.5	-2.2	-3.9	-3.7		
Egypt, Arab Rep	5.1	1.8	2.2	3.1	-8.1	-9.8	-11.0	-13.0	-2.0	-1.2	-3.1	-2.9	-2.0	-1.2	-3.1	-2.9		
Tunisia	3.0	-2.0	2.4	3.6	-1.1	-3.5	-6.6	-5.9	-4.8	-7.3	-7.8	-7.5	-4.8	-7.3	-7.8	-7.5		
<b>Rest of Oil Importers</b>	4.6	4.4	3.3	4.6	-6.5	-8.1	-7.4	-6.6	-10.7	-14.2	-14.2	-12.8	-10.7	-14.2	-14.2	-12.8		
Djibouti	3.5	4.5	4.8	4.5	-0.5	-0.7	0.5	0.9	-5.8	-12.6	-12.1	-11.9	-5.8	-12.6	-12.1	-11.9		
Jordan	2.3	2.6	3.0	3.5	-7.7	-12.7	-10.7	-9.3	-11.3	-19.0	-18.9	-14.2	-11.3	-19.0	-18.9	-14.2		
Lebanon	7.0	3.0	3.5	4.2	-8.2	-6.5	-6.9	-6.9	-22.8	-21.9	-20.1	-19.2	-22.8	-21.9	-20.1	-19.2		
Monrocco	3.6	5.0	3.0	4.9	-4.7	-6.9	-6.1	-5.1	-4.5	-8.0	-9.0	-8.4	-4.5	-8.0	-9.0	-8.4		
West Bank & Gaza	9.8	9.9	6.2	5.6	-17.6	-16.5	-14.5	-13.3	-25.9	-36.7	-30.7	-26.8	-25.9	-36.7	-30.7	-26.8		

Source: World Bank. Fiscal year data are reported for Egypt and 2011 data for Lebanon are estimates.

## OTHER DEVELOPING OIL EXPORTERS

The economic prospects for the Islamic Republic of Iran are expected to remain weak. Crude oil production has declined by 20 percent between November 2011 and July 2012 (Figure 9). Consequently, real GDP growth is expected to contract by 1.4 and 1.1 percent, respectively, in 2012 and 2013. Its fiscal and external positions are expected to stretch further in 2012 as lower oil production and oil receipts are expected to adversely affect the government's budget and the external sector (Table 1).<sup>15</sup> The International Energy Agency estimates that the country's oil exports will fall to 1.5 million barrels per day (mbd) in 2012, down from 2.8 mbd in July 2012 which will further lower oil receipts and revenue.

Inflation is expected to remain high and peak at about 24 percent in 2012-13, driven by a confluence of factors, including the temporary effects of subsidy reform, planned to be completed in phases through 2014, the international sanctions, and any further weakening of the Iranian currency (Figure 9).

In Iraq, real GDP growth is expected to increase relative to 2011 and average just above 11 percent in 2012, on account of oil production and government spending increases.<sup>16</sup> The current account balance is expected to remain in surplus and small fiscal deficits are projected for 2012-13 (Table 1), although it is likely that fiscal surpluses will be recorded in both years as the budget assumes an average oil price of US\$85 per barrel and capacity constraints might result in under-execution of the capital budget. Inflation has been subdued at 6 percent in 2011 and 7 percent during the first half of 2012. High food prices have a strong fiscal impact but do not translate into food inflation because most food products are imported, subsidized and distributed by the Government of Iraq.

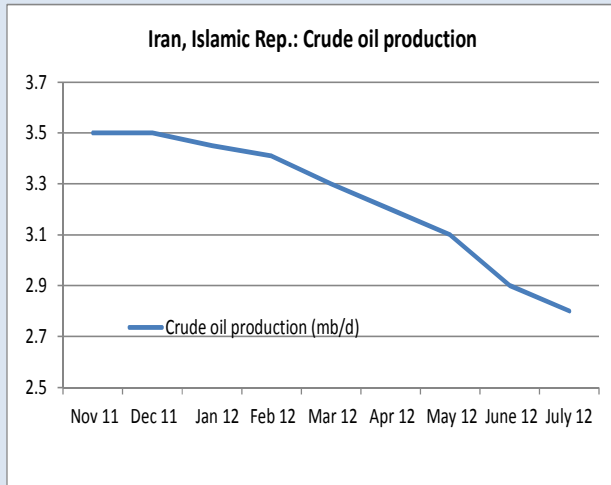
Despite a slight decline of 2.4 percent in the volume of oil exports, real GDP growth in Algeria is expected to recover to 3.1 percent in 2012 from 2.5 percent in 2011 as capital expenditures and wages grow (Table 1). High oil prices and government's large stimulus spending through increase in capital expenditure and wages are expected to support growth in 2012 and 2013. High oil and gas prices are expected to keep the external balance in surplus in 2012 and reserves at high levels, recorded at 95 percent of GDP in September 2012. The fiscal deficit is expected to deteriorate in 2012 in line with continued expansionary fiscal policy. Public spending has grown during the last five years due to Algeria's Public Investment Program (PIP) and increases in salaries for public employees. In 2011, public employees' salaries increased by 46 percent and government spending for the agricultural price support and the youth employment support fund grew by 92 percent.

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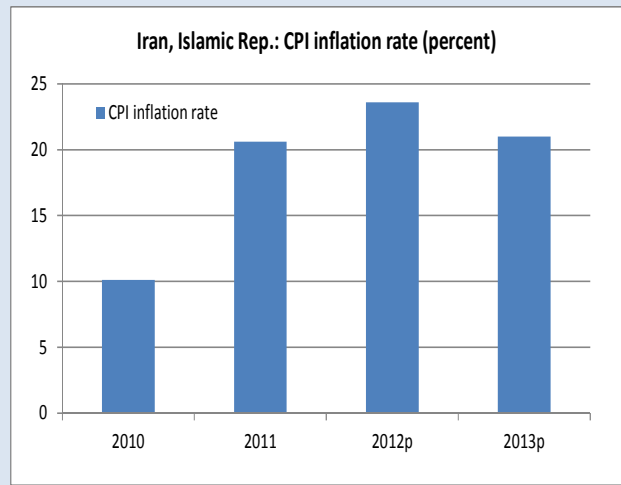
<sup>15</sup> Oil constitutes over 80 percent of Iran's government revenue.

<sup>16</sup> Oil production is expected to increase by 15 percent and government spending is projected to rise by about 5 percent of GDP in 2012.

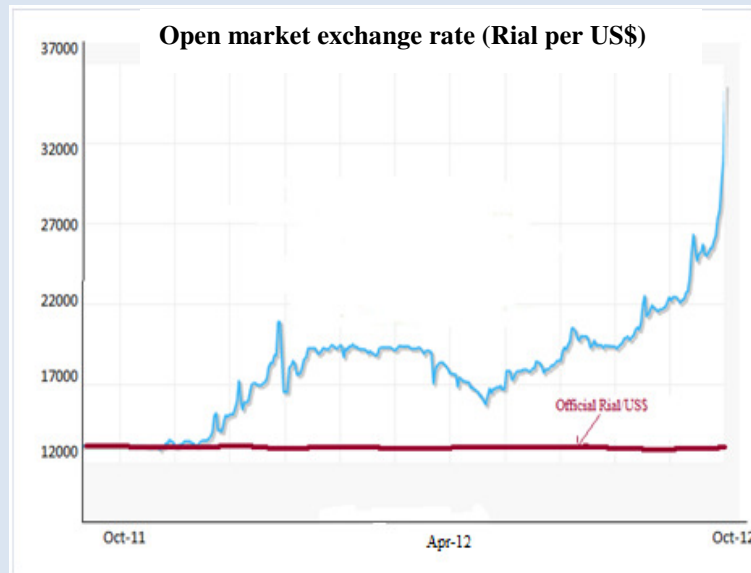
**Figure 9. Economic indicators for Iran, Islamic Rep.**



Source: Organization of the Petroleum Exporting Countries (OPEC).



Source: Economist Intelligence Unit (EIU).



Source: [www.eranico.com](http://www.eranico.com) (Tehran market rate).



Inflationary pressures have emerged in the last trimester of 2011 and reached 9 percent in the first half of 2012, almost double the rates in 2010 and 2011, as a result of rising food prices and heavy government spending while the government's efforts to soak up excess liquidity and restrict lending, including by increasing reserve requirements, have had little impact. Algeria is a major importer of agricultural products, particularly wheat, and the consumer price index is heavily weighed by food (43 percent), leaving it vulnerable to shifts in international prices. Moreover, the import sector is heavily restricted, which creates bottlenecks and can lead to price spikes.

### **OTHER OIL IMPORTING COUNTRIES**

Domestic pressures coupled with a challenging global environment and spillovers from regional events influenced the 2011 economic performance of some oil importers such as Jordan, Lebanon, and Morocco. Sluggish global growth, particularly in the Euro area, adversely affected export receipts, tourism revenue and FDI flows, and coupled with rising international oil prices weakened their external balances. Jordan and Lebanon have also been affected by the conflict in Syria. As a result, growth of other oil importers slowed from 4.6 percent in 2010 to 4.4 percent in 2011, and just 3.3 percent in 2012 (Figure 8).

Different pressures are observed in individual oil importing countries. The short term outlook in Morocco is expected to be affected by developments in the European Union – Morocco's main trading partner, and the weak harvest season. The agricultural sector – accounting for about 15 percent of GDP on average – is expected to contract by 9 percent in 2012, and drag down the overall GDP performance to 3 percent in 2012 (Table 1). A recovery is expected in 2013 when GDP growth is projected to average 4.9 percent. Economic weakness in Europe and a slow expected recovery thereafter will adversely affect Moroccan exports and growth. Partially compensating the sluggish external demand is the fiscal stimulus programs implemented over the last few years and continued into 2012.

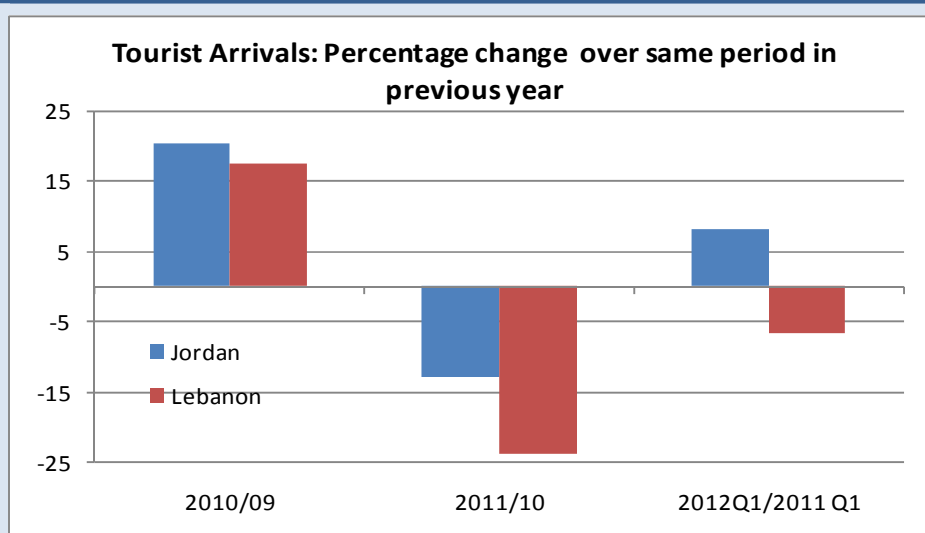
Extensive social measures, a rising public wage bill, and persistent pressure from the subsidy system, especially for fuel (Table 2), will keep the budget deficit above 6 percent of GDP in 2012 and above 5 percent in 2013 (Table 1). Inflation is expected to remain contained as a result of the government's food and fuel subsidy program, which has nearly doubled since 2010 and reached 6 percent of GDP in 2011 (Table 2). A potential deterioration in economic activity in the European Union, would negatively impact the short term economic outlook of Morocco through lower exports receipts, including tourism, as well as remittances and FDI flows. Sustained, high commodity prices, deterioration in the regional context, and prolonged global financial uncertainties are also risks to Morocco's economic prospects.

**Table 2. Subsidies in Morocco (percent of GDP)**

	2007	2008	2009	2010	2011
Food	1.0	1.1	0.7	0.7	0.9
Fuel	1.7	3.5	1.1	2.9	5.1
Total Subsidies	2.7	4.6	1.7	3.6	6.0

Source: Morocco DPL (Moroccan Authorities and Bank staff estimates).

Economic activity in Jordan and Lebanon has been hindered by domestic pressures, regional political turmoil, particularly in Syria, and spillovers from a challenging external environment. Domestic political uncertainty and sporadic security incidents in Lebanon have had an adverse impact on its economic growth which is not expected to exceed 3.5 percent in 2012 and 4.2 percent in 2013 (Table 1). The ongoing political conflict in Syria has weighed heavily on Lebanon's service-oriented economy through lower trade, tourism receipts and foreign direct investment. In 2011 tourist arrivals declined by close to 25 percent relative to 2010, and data for 2012 shows that tourist arrivals have slowed down in the first quarter of 2012, relative to the same period in 2011 (Figure 10). Also, a significant portion of Lebanese exports are routed through transit routes in Syria so continued unrest there will limit the growth of the Lebanese economy in 2013.

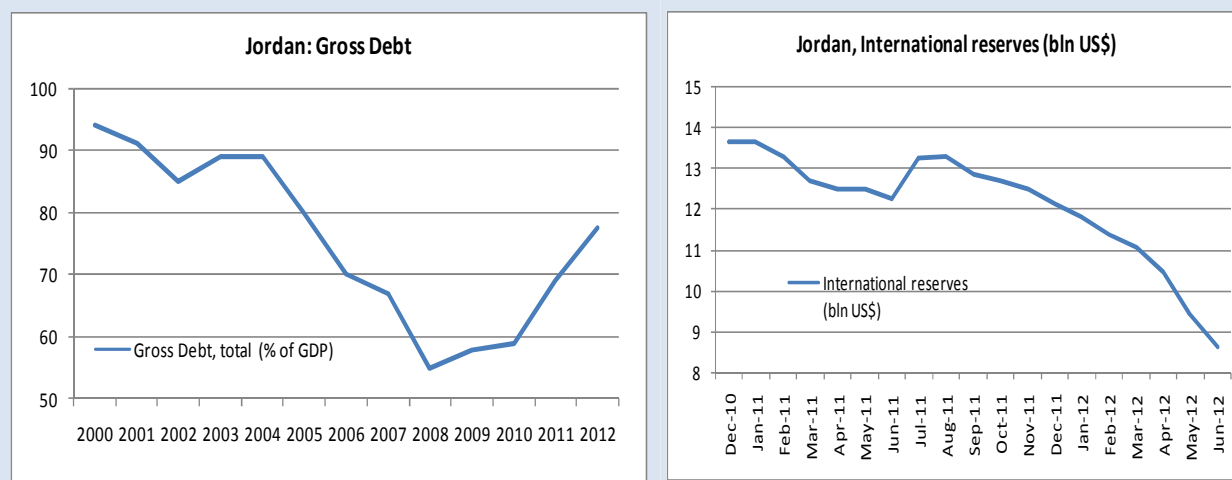
**Figure 10. Tourist arrivals in Lebanon and Jordan**

Source: UNWTO.

Economic activity in Jordan is expected to recover slightly but will remain constrained in 2012 and 2013. Real GDP growth is projected to reach 3 percent in 2012 (Table 1) as domestic consumption picks up. A boost in government current spending is a major growth driver offsetting a fall in foreign demand and investment. External imbalances are expected to remain sizable in 2012 (Table 1) because of high international food and fuel prices and the use of expensive imported fuels for power generation to compensate for the interruption in Egyptian gas supply. Data for the first six months of 2012 show that foreign exchange reserves have declined by more than 35 percent since the end of 2010 (Figure 11) as a result of external imbalances during 2011-12.

The gross domestic debt has also been on the rise as a share of GDP since 2010 and the ongoing fragile political backdrop and lingering social tensions are expected to require concessions that will further stretch current expenditures and continue to push debt levels higher (Figure 11). Fiscal pressures have been mounting since 2011 not only due to rising government spending but also lower fiscal revenue in an environment of sluggish economic activity. Despite loose monetary and fiscal policies and high commodity prices, inflation remained subdued at 4 percent largely due to the government's extensive subsidy system which kept food and fuel prices stable.

**Figure 11. Select economic indicators, Jordan**

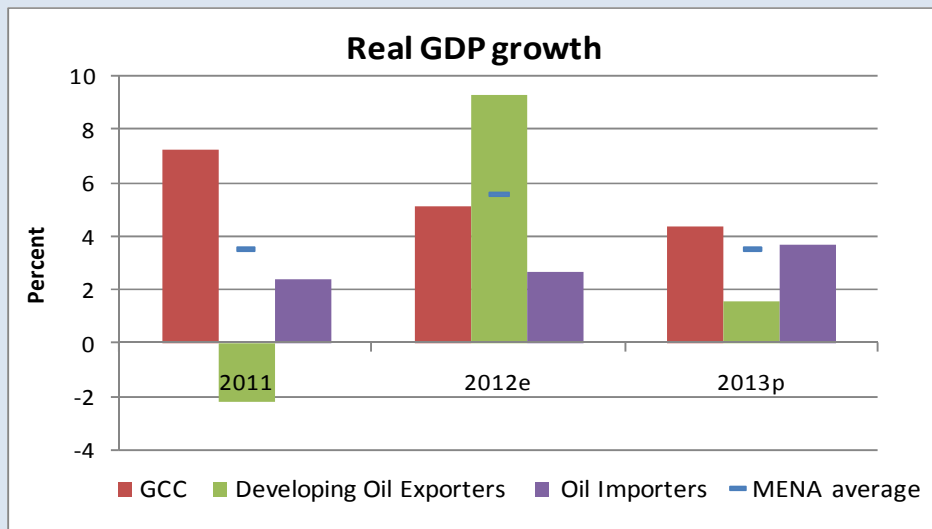


Source: World Bank, and IMF.

Jordan's and Lebanon's near-term challenge is to maintain prudent macroeconomic management and address serious fiscal challenges. In Jordan, macroeconomic stability depends on the implementation of fiscal consolidation to avoid liquidity and fiscal crises. In Lebanon, careful fiscal management to preserve the confidence of all (domestic and foreign) depositors and investors is crucial, particularly given the exposure of commercial banks to sovereign risk.

Growth of Djibouti's economy has been relatively strong since 2010 and is expected to inch up to 4.8 percent in 2012 from 4.5 in 2011, supported by strong growth in transport, telecommunications, tourism and construction (Table 1). The fiscal accounts are projected to register a slight surplus, whereas the current account deficit will be financed by increases in FDI and capital flows to the public sector. Inflation is expected to continue its gradual upward trend throughout 2012, in line with the world food price cycle. Inflation is expected to average around 5 percent in 2012 and a bit lower in 2013. The main risk to the growth outlook in Djibouti is a global economic slowdown that threatens technical and financial assistance from donors, especially the GCC economies. Risks associated with developments in neighboring countries should not be ignored and include the situation in Somalia, the drought in the Horn of Africa, and a slowdown in economic growth in Ethiopia.

**Figure 12. Regional growth outlook**



Source: World Bank staff.

In summary, the regional growth prospects reflect mainly regional dynamics, but also weaker expected global economic activity, especially in the EU, and moderating oil prices in 2013. Regional real economic growth is expected to average 5.5 percent in 2012 and decelerate to 3.5 percent in 2013 (Figure 12 and Table 1). Oil exporting countries will grow at an estimated average of 6.5 percent in 2012 and only 3.4 percent in 2013. The growth deceleration largely reflects a return to a more normal growth pace in Libya after a year of strong rebound in 2012, but also a weaker activity in the GCC economies. By contrast, oil importers will grow at an estimated 2.6 percent in 2012 and 3.7 percent in 2013, but Egypt and Tunisia will be growing slower than the average for the group. Prolonged political and policy uncertainty and political and social unrest are serious downside risks to this macroeconomic outlook, while elevated international food commodity prices are a threat to vulnerable populations in the region.

## KEY MESSAGES

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- The post-revolutionary economies in MENA – Egypt, Tunisia, Libya and the Republic of Yemen – are recovering after a period of growth decelerations accompanying the Arab Spring turmoil. Recovery was relatively quick, with industrial production recovering in a matter of months, and in some cases the growth dips in 2011 were less dramatic than the average declines observed around the year of transition during previous transition episodes. However, the growth decelerations and recovery have taken place in a weak global environment, with events in the Eurozone posing particular challenges for exporters in the Maghreb.
- The transition process in these countries is far from complete and uncertainty about the reform process and outcomes remains a binding constraint to private investment. In Egypt, Tunisia and the Republic of Yemen post-transition growth is below potential and is lower than growth during the period immediately preceding the Arab Spring, with negative consequences for unemployment and the poor and vulnerable in these countries.
- Macroeconomic fundamentals weakened in most MENA countries in 2011-12 as growth slowed and governments responded to social pressures with expansionary fiscal policies. Consequently, fiscal deficits widened, in some cases to unsustainable levels, governments' debt burden rose, and real interest rates increased. Official reserves declined, in some cases steeply, in a move by governments to avoid currency depreciations. High oil prices helped oil exporters, but have exacerbated current account and fiscal deficits in oil importing countries, especially in places where governments subsidize energy use.
- The regional growth outlook for 2013 reflects weaker expected global economic activity, especially in the EU, and moderating oil prices. Regional real economic growth is expected to average 5.5 percent in 2012 and decelerate to 3.5 percent in 2013. The growth deceleration largely reflects much weaker activity in oil exporting countries, which will grow at an estimated average of 6.5 percent in 2012 and only 3.4 percent in 2013. Post-revolutionary oil exporters such as Libya are expected to grow faster than the average for the oil exporting group but their growth will also decelerate in 2013. By contrast, oil importers will grow at an estimated 2.6 percent in 2012 and 3.7 percent in 2013, but Egypt and Tunisia will be growing slower than the average for the group.
- Prolonged political and policy uncertainty and political and social unrest are serious downside risks to this macroeconomic outlook. Uncertainty is a key obstacle to investment and trade, particularly trade in services. Services exports have been an area of relative strength for MENA and the sector was booming prior to 2011 but concerns about security has triggered a major contraction in tourism to the region, leading to a jump in unemployment in countries such as Egypt and Tunisia. Unemployment has also increased in these countries as migrant workers returned home from places in unrest, notably Libya. Strengthening macroeconomic fundamentals will also be crucial to growth throughout

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developing MENA, whereas elevated international food commodity prices are a threat to vulnerable populations.

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