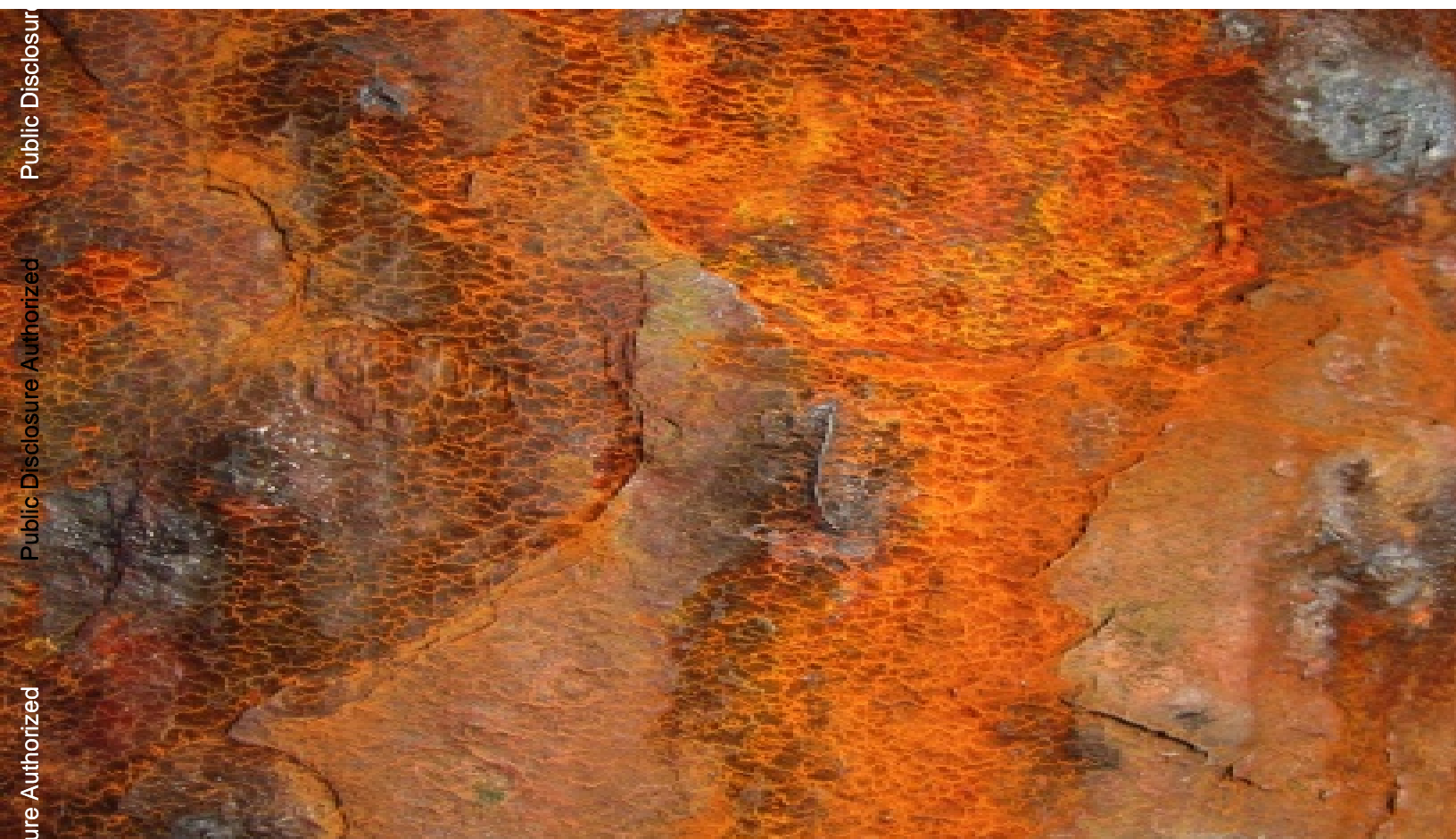


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WORLD BANK MIDDLE EAST AND NORTH AFRICA REGION
MENA ECONOMIC MONITOR

CORROSIVE SUBSIDIES



THE WORLD BANK



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WORLD BANK MIDDLE EAST AND NORTH AFRICA REGION

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Corrosive Subsidies

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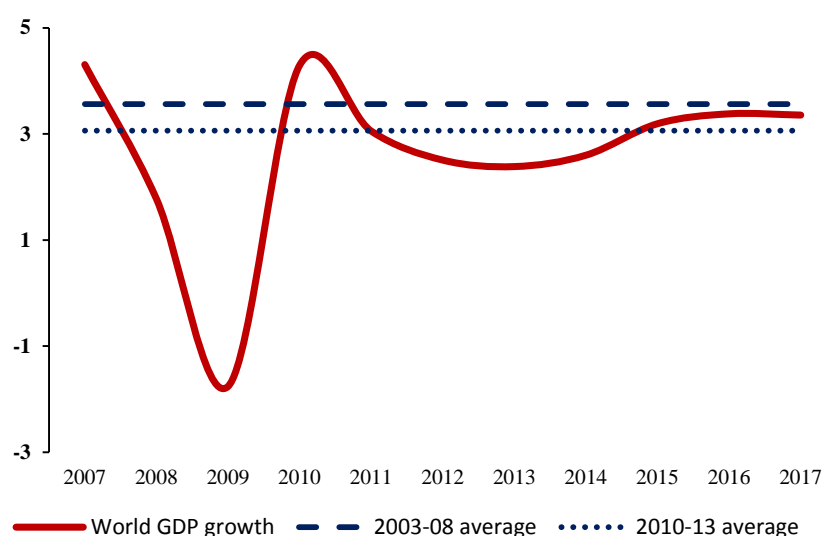
The MENA Economic Monitor is a product of the Chief Economist's Office of the Middle East and North Africa Region. The report was prepared by a team, led by Shanta Devarajan, and including Lili Mottaghi, Farrukh Iqbal, Gabriela Mundaca, Thomas Laursen, Maria Vagliasindi, Simon Commander and Isabelle Chaal-Dabi. The country notes are based on reports by the following country economists, led by Bernard Funck: Ibrahim Al-Ghelaiah, Dalia Al-Kadi, Sara Al-Nashar, Jean-Luc Bernasconi, Kevin Carey, Jean-Pierre Chauffour, Nada Choueri, Khalid El-Massnaoui, Shahrzad Mobasher Fard, Wissam Harake, Ahmed Kouchouk, Sibel Kulaksiz, Eric Le Borgne, Samer Naji Matta, Daniela Marotta, Nour Jalal Nasser-Eddin, Guido Rurangwa, and Abdoulaye Sy. We are grateful to MéliSe Jaud, Bob Rijkers and Inger Andersen for helpful comments.

Recent Developments and Prospects

The global economy

As of October 2014, the outlook for the global economy for the year 2014 is mixed, and disappointing relative to expectations earlier in the year. Global growth is projected to be around 2.5 percent, only slightly higher than last year's 2.4 percent (Figure 1). The upturn in the American and British economies is counterbalanced by renewed signs of weakness in the Euro Area and Japan. Developing countries are forecast to expand by 4.4 percent in 2014. India's economy is picking up, but China's is slowly moderating and Latin America and emerging Europe are facing stronger headwinds. The outlook for 2015 is for global growth to rise to 3.2 percent, and that of developing countries to 5 percent.

Figure 1.1 Global growth rate, percent



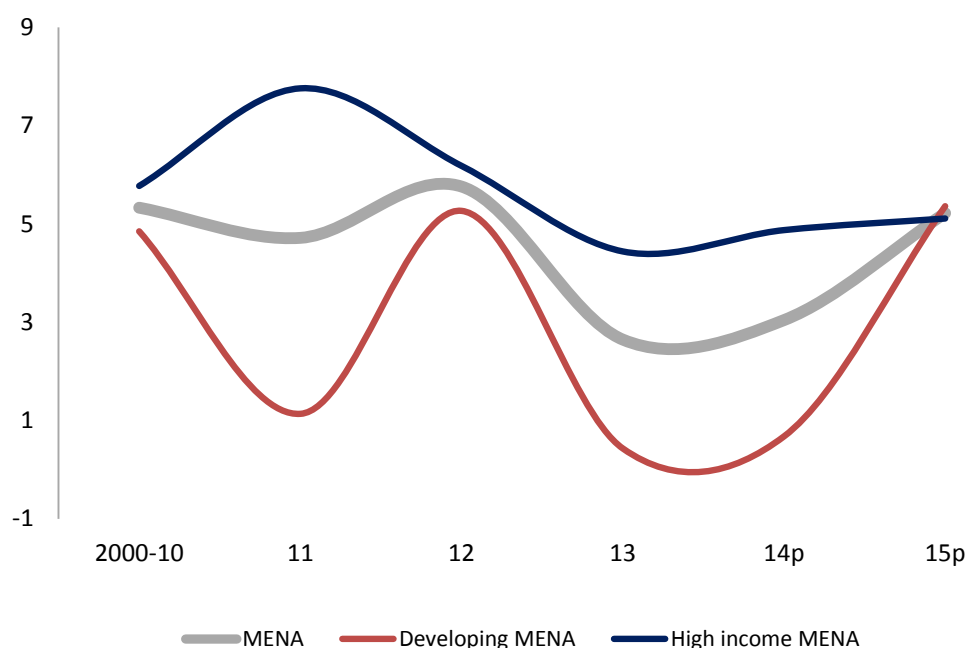
Source: World Bank, Development Prospects Group

The regional economy

Against this backdrop, the performance of the MENA region in 2014 is even more mixed, and in some cases, more disappointing. The region as a whole is expected to grow by 3 percent this year, but this average masks a big difference between the high-income and developing countries of MENA (Figure 2). The former has a projected growth rate of 4.9 percent, while the latter is expected to grow at 0.7 percent, a bit faster than last year's 0.4 percent (Table 1.1).

The forecast for 2015 is slightly more favorable. There is an optimistic scenario that growth will pick up to 5.2 percent, based on an increase in public and private consumption from expansionary fiscal policies, easing political tensions crowding-in investments in Egypt and Tunisia, continued subsidy reforms in Egypt, Jordan and Yemen, and, importantly, a resumption of oil production in Libya. Without the latter, overall MENA growth will be around 4.2 percent.

Figure 1.2 Real GDP growth in the MENA Region, percent



Source: World Bank, MENA Region

The weak performance of developing MENA this year is due to two, ongoing phenomena in the region. The first are the violent conflicts, including the civil war in Syria, now in its fourth year and its attendant effects on its neighbors such as Jordan and Lebanon; the recent spread of the Islamic State (ISIS), which now controls large swathes of Syria and Iraq; a devastating war in Gaza in June-July 2014; and ongoing insurgencies in Libya and Yemen. The second are the political transitions in Egypt and Tunisia, as well as political openings in Morocco and Jordan which, accompanied by large macroeconomic imbalances and a huge and unfinished reform agenda, have kept these economies' output well below potential.

The conflicts have affected more than ten million people across the region. A World Bank impact analysis estimated that the regional conflicts in Egypt, Tunisia, Syria, Yemen and Libya, with their spillovers into Jordan and Lebanon, cost roughly \$168 billion during 2011-3, the equivalent of 19 percent of the combined GDP of these countries. More than half of Syria's population is displaced, either internally or as refugees across borders. Syria's real output is 40 percent lower than its pre-crisis level in 2010, with contractions in all economic sectors. Around 75 percent of the population has fallen into poverty, with 54 percent in extreme poverty. The official unemployment rate reached 35 percent in

2013—unofficial numbers are believed to be higher—increasing fourfold since the start of the war in 2011. In Gaza, where half the population was already living in poverty, many more are believed to have fallen into poverty as food prices have increased sharply due to a halt in food production and lower food imports. While there is growing speculation that oil production in Libya can increase within the coming year, production recovery could take longer due to the extensive repairs and maintenance that would be needed. In Yemen, as a result of sabotage in the oil fields, crude oil production and export revenues continue to decline. The recent, Houthi-led uprising in the capital city, change in government, and partial reversal of subsidy reforms are likely to increase uncertainty about the economy going forward.

The spillovers of the conflicts, especially those of the Syrian war, are overwhelming. Lebanon is hosting about 1.6 million (official and unofficial) refugees (about a third of its population). It is estimated that the Syrian war cost Lebanon \$7 billion, or 23 percent of 2010 GDP, in 2011-13, and worsening public finances in a country suffering from double-digit fiscal deficits. The spread of ISIS has blocked trade between Iraq, Jordan and Lebanon. Iraq is the destination for about 20 percent of Jordanian exports. The number of trucks crossing the Iraq-Jordan border has fallen from an average of 500 per day to just 25. For Lebanon, Iraq is both a trading partner and a transit route to the Gulf; the ongoing Iraqi crisis has effectively blocked Lebanese exporters' access to Gulf markets. The breakdown of trade in the sub-region is doubly harmful since the countries of the greater Levant—Turkey, Syria, Iraq, Jordan, Lebanon and Egypt—were trying to deepen their trade relations in 2010. A modeling exercise shows that the combination of direct costs of trade disintegration and the forgone benefits of integration could add up to sizeable welfare losses for these countries (Box 1.1).

As to the transition countries not suffering from conflict—Egypt, Tunisia, Morocco, Jordan—their growth slowdown since 2011 continues this year. Egypt and Tunisia are expected to grow at 2.1 and 2.3 percent this year, the same as they did last year (Table 1.1). The decline in growth has been accompanied by a sizeable increase in fiscal deficits. Inasmuch as public spending in these countries is primarily devoted to subsidies (see section II) and the wage bill, there has been little fiscal space for growth-promoting investment. The reduction in fuel subsidies in Egypt and Morocco this year should create more space in the coming year. Growth is projected to pick up to 3.1 percent in Egypt, 2.7 percent in Tunisia and 4.6 percent in Morocco. In addition, all these countries suffer from a poor business climate, characterized by a few, large, slow-growing, capital-intensive firms and a very small, dynamic and competitive sector. There is evidence from Egypt and Tunisia that this structure was due to policies that favored politically-connected firms and to the energy subsidies that favored capital-intensive firms. Reforming these structural policies therefore will be key to resuming sustained growth in these countries.

Finally, it should be mentioned that the high-income countries in MENA (all hydrocarbon exporters in the Persian Gulf), while they have been growing at a rapid clip, also face structural problems that may constrain their growth in future. The level of energy subsidies in most of these countries is even higher than in developing MENA. While they have been running fiscal surpluses, the high levels of subsidies and public sector wage bill mean that the price of oil at which their budgets are balanced is quite high.

In fact, given current projections for the price of oil next year, budget surpluses are expected to disappear in Saudi Arabia and shrink in half in Qatar.

Box 1.1 Conflict in the Levant: The Economic Costs of Disintegration

On the eve of the Arab Spring, six countries in the greater Levant—Turkey, Syria, Iraq, Jordan, Lebanon, and Egypt—were considering deepening their trade ties to accelerate economic growth, diversification, and employment. By 2011, many of these countries embarked on political transitions that in some places turned into violent conflicts. In Syria, the civil war is wreaking widespread devastation. This war and the subsequent advance of the Islamic State of Iraq and the Levant (ISIL or ISIS) into Iraq are putting a halt to regional trade integration.

Ianchovichina and Ivanic (2014) model both the direct economic effects of the Levant conflict and its indirect impact through foregone trade integration. Syria and Iraq, which have borne the brunt of the direct war costs, are estimated to have lost 11% and 16%, respectively, in per capita welfare terms. The embargo on trade with Syria has been a major factor. The output contraction in Syria, estimated at 32%, is much larger than its per-capita GDP decline of 14%, due to the large number of Syrian refugees and war casualties. All other Levant countries lose in per-capita terms, but not in aggregate terms, because the influx of refugees has increased the size of these economies through their effect on consumption, investment, and the labor market.

The direct effects of war understate the real costs of disintegration in the Levant. If one includes the foregone benefits of integration, especially those associated with failed services liberalization, the total costs of war are sizable for all Levant countries. The per-capita welfare losses approximately double for Syria and Iraq, reaching 23% and 28%, respectively, and escalate to 10% in Egypt, 7% in Jordan, and 2% in Turkey. In Lebanon, they are 13%.

The average effects hide shifts within countries. In Syria, all economic agents have been hurt but landowners have lost the most as people fled their homes and farms. Real land prices in Syria are estimated to have dropped by 64% compared to a drop of around 25% in real wages. By contrast, in Lebanon, land and capital owners have benefited while workers have lost because the inflow of refugees put pressure on housing demand and augmented labor supply. The conflict has boosted real land prices in Lebanon by an estimated 35% and depressed real wages by 12%.

As political circumstances in the Levant change, so will the magnitude of these effects. Further escalation of the conflict in Syria and Iraq would increase the economic costs of war there, and if the war were to spread into neighboring countries, the costs to Turkey, Jordan, and Lebanon would rise too.

Reference: Ianchovichina, E. and M. Ivanic. 2014. "Missed Economic Opportunities in the Levant: Costs of Disintegration." Mimeo, World Bank.

Table 1.1 Macroeconomic outlook

	Real GDP growth (percent)						Fiscal Balance (percent of GDP)					Current Account Balance (percent of GDP)				
	2000-10	2011	2012	2013	2014p	2015p	2011	2012	2013	2014p	2015p	2011	2012	2013	2014p	2015p
MENA	5.3	4.7	5.8	2.6	3.0	5.2	2.9	5.1	2.5	1.3	0.1	12.3	12.9	10.1	7.8	5.6
Developing MENA	4.8	1.1	5.3	0.4	0.7	5.4	-3.6	-3.1	-6.3	-5.9	-4.7	4.4	2.5	-0.8	-1.4	-1.5
Oil Exporters	5.4	5.2	6.4	2.6	3.2	5.6	5.0	7.7	5.1	3.6	1.9	15.8	16.5	13.2	10.4	7.9
High income MENA	5.8	7.8	6.2	4.4	4.9	5.1	9.6	13.2	10.4	8.4	5.3	20.6	23.3	20.0	17.0	13.2
Bahrain	4.2	2.1	3.4	4.9	4.0	3.0	-0.1	-3.2	-4.4	-4.8	-6.0	11.2	7.3	8.0	7.0	5.5
Kuwait	3.7	6.3	8.3	-0.4	1.4	1.8	36.0	34.6	31.6	29.1	27.1	41.7	45.5	40.5	41.9	39.7
Oman	9.1	5.4	3.4	5.2	5.5	5.6	7.4	0.5	1.6	-1.3	-1.6	15.4	11.7	8.9	6.7	4.1
Qatar	11.9	13.0	6.2	6.1	5.9	7.1	6.4	9.5	11.1	7.6	4.9	30.3	32.4	29.2	25.4	20.5
Saudi Arabia	5.6	8.5	6.8	4.5	5.3	5.5	8.3	13.2	8.7	5.7	0.5	19.9	19.9	16.2	12.4	6.5
United Arab Emirates	5.0	4.9	4.7	5.2	4.7	4.5	2.9	8.9	6.5	7.2	6.3	9.2	18.5	16.1	12.1	11.8
Developing Oil Exporters	4.8	0.4	6.7	-0.9	-0.3	6.5	-1.4	-0.3	-3.9	-3.8	-2.7	9.0	6.6	1.7	0.4	0.6
Algeria	3.8	2.8	3.3	2.8	3.0	3.3	-1.5	-5.0	-1.5	-3.4	-4.8	9.9	6.0	0.3	-0.5	-2.2
Iran	4.4	3.0	-5.8	-1.7	1.5	2.3	-1.4	-2.0	-2.2	-2.5	-2.5	11.0	6.6	8.0	5.0	2.7
Iraq	5.7	10.2	10.3	4.2	-2.7	1.5	4.7	4.1	-5.9	-3.0	-0.6	12.0	6.7	-0.8	3.0	2.4
Libya	5.8	-62.1	104.5	-10.9	-27.8	54.3	-15.4	27.8	-3.6	-11.1	0.9	3.2	29.1	-3.5	-29.6	-0.5
Syrian Arab Republic	5.8	-3.4	-18.9	-18.7	1.8	2.4	-12.1	-16.7	-12.4	-8.9	-7.5	-14.7	-15.2	-12.2	-11.0	-11.1
Yemen	3.8	-12.7	2.4	4.8	1.9	4.6	-5.7	-12.4	-7.8	-6.8	-6.0	-3.0	-1.7	-3.1	-1.3	-1.1
Oil Importers	4.8	2.4	2.7	2.7	2.3	3.4	-8.5	-9.4	-11.0	-9.9	-8.9	-6.1	-6.8	-5.5	-5.0	-6.0
Djibouti	1.6	4.5	4.8	5.0	5.5	5.5	-0.7	-2.7	-5.8	-8.8	-12.1	-14.1	-18.4	-23.7	-33.0	-36.6
Jordan	5.9	2.6	2.7	2.8	3.0	3.4	-12.7	-10.5	-14.1	-14.7	-8.9	-10.2	-15.2	-10.0	-11.3	-9.4
Lebanon	4.8	2.0	2.2	0.9	1.5	2.0	-6.4	-8.7	-9.4	-10.2	-11.2	-10.9	-8.1	-8.5	-8.3	-8.0
Egypt	4.9	1.8	2.2	2.1	2.1	3.1	-9.8	-10.6	-13.7	-11.8	-10.5	-2.6	-3.1	-2.1	-0.8	-3.5
Morocco	4.5	5.0	2.7	4.4	3.0	4.6	-15.4	27.8	-3.6	-11.1	0.9	-8.0	-9.7	-7.6	-6.7	-5.8
Tunisia	4.9	-1.9	3.7	2.3	2.3	2.7	-3.3	-5.5	-6.9	-5.9	-5.8	-7.4	-8.2	-8.4	-9.1	-8.6
West Bank and Gaza	6.5	12.4	6.3	1.9	-3.7	4.4	-15.0	-14.9	-12.3	-13.5	-12.7	-32.0	-36.4	-29.1	-37.5	-39.7
Source: World Bank, MENA Region																

Corrosive Subsidies

The Middle East and North Africa (MENA) Region is home to 5.5 percent of the world's population, 3.3 percent of its GDP—and 48 percent¹ of its energy subsidies. Covering petroleum products, natural gas and electricity, these subsidies are prevalent in oil-importing and oil-exporting countries. Introduced in the 1970s to protect the population from spikes in world oil prices, energy subsidies in MENA have grown to become significant proportions of countries' economies. After the recent round of reforms, energy subsidies in Egypt, Tunisia and Yemen still account for more than 5 percent of GDP. Subsidies are even higher among hydrocarbon exporters: in Algeria, Iran, Iraq and Saudi Arabia, they exceed 10 percent of GDP.

Energy subsidies have been criticized on two grounds. First, that they are a drain on government budgets. Inasmuch as a number of MENA countries are running large fiscal deficits—to the tune of 13 percent of GDP in Egypt and Jordan, and 7 percent in Tunisia, Yemen and Lebanon—these subsidies are crowding out public spending on health, education and investment and possibly threatening sustainability of public debt. Egypt spends seven times more on fuel subsidies than on health.

Secondly, the allocation of these subsidies is heavily skewed towards the rich, who consume more fuel and energy than the poor. In Yemen, the portion of fuel subsidies going to the richest quintile was 40 percent; the comparable figure in Jordan was 45 percent and in Egypt, 60 percent.

Yet, there is political resistance to reforming energy subsidies. One reason could be that each of these criticisms has a rejoinder. While fuel subsidies contribute to the fiscal deficit in high-deficit countries, they are also found in oil-exporting countries with fiscal surpluses². It is difficult to claim that energy subsidies are crowding out public expenditures in Saudi Arabia, which has a fiscal surplus of 8.7 percent of GDP. Moreover, the statement that government can save a lot of money by removing subsidies begs the question of what it will do with the savings. In some countries, citizens may not trust government to use the savings in their interest—which may explain the resistance to subsidy reform, even from people who do not benefit much from the subsidies³. Furthermore, in oil-rich countries, energy subsidies are often seen as a way of distributing oil revenues to the population.

Similarly, the fact that the lion's share of energy subsidies goes to the rich misses the point that the poor spend a higher fraction of their income on energy than do the rich. In Jordan in 2010, the poorest decile spent 4.6 percent of their income on electricity, while the richest spent only 2 percent of their income.

¹ Clements and others (2013). The calculation is based on pre-tax subsidies, or the price paid by firms and households relative to supply and distribution costs.

² To be sure, generous subsidies have pushed up the breakeven oil prices to unprecedented levels in these countries. Should oil prices fall significantly, their fiscal space will become limited.

³ There is some evidence that cuts in fuel subsidies are associated with increases in health expenditures (Mundaca, 2014).

An across-the-board cut in electricity subsidies will hurt the poor (as a proportion of their income) more than the rich, even if the latter consume much more electricity than the former. Again, this may explain the political resistance to energy subsidy reform, especially among the middle class, who both spend a high share of their income on energy, and are quite vocal.

The real problem with energy subsidies

The real problem with energy subsidies is that they have contributed to some of the biggest development challenges facing the MENA region. The region is currently experiencing slow growth (average growth has declined from 5 percent a year in 2000-10 to a little over 2 percent since 2011), high unemployment, urban air pollution and congestion, and severe water scarcity that is undermining agriculture. There is emerging evidence that energy subsidies are associated with these problems. Reform of energy subsidies, therefore, is not just a way of saving cash-strapped governments money or redistributing public resources more equitably. It is central to creating a dynamic, employment-intensive economy supported by managed urbanization and a productive agricultural sector.

Growth. On the one hand, raising energy prices—that is, cutting energy subsidies—can be growth-reducing. Higher energy prices will increase costs to producers, including exporters, who will then be less competitive in world markets. The reduction in exports, in turn, will lower growth. On the other hand, the countervailing effects of greater energy efficiency from more rational pricing of energy could stimulate growth in the medium-run. The sheer magnitude of energy subsidies in MENA suggests that these efficiency gains could be sizeable.

Some recent analysis (Mundaca, 2014) sheds light on this question by estimating a nonlinear relationship between energy subsidies and per-capita GDP growth on a global sample of countries. On average, she finds a positive and statistically significant relationship between fuel prices and per-capita GDP growth. That is, the higher the fuel price (the lower the fuel subsidy), the faster was the growth rate during 1998-2012. At the average subsidy, a 20-cents per liter increase in the diesel and gasoline price is associated with an average increase in GDP per capita growth rate of about 0.45 percent and 0.55 percent, respectively.

Since Mundaca estimates an inverted U-shaped relationship between fuel prices and per-capita growth, the global estimates also shed light on the particular circumstances of the MENA region. With the highest fuel subsidies in the world, MENA countries could be in the part of the curve where a reduction in subsidies is associated with an increase in per-capita growth. By contrast, in the Europe and Central Asia (ECA) region, where fuel is hardly subsidized (and in many cases taxed), a further reduction in subsidies or increase in taxation could undermine growth. That this is indeed the case can be seen by comparing the correlation between fuel prices and per-capita growth in the two regions: in MENA, the relationship is positive, whereas in ECA it is negative (Figures 2.1 and 2.2).

Figure 2.1 MENA: Correlation between GDP per capita growth and gasoline price gap: subsidies (-) taxes (+) (\$ cents/liter)

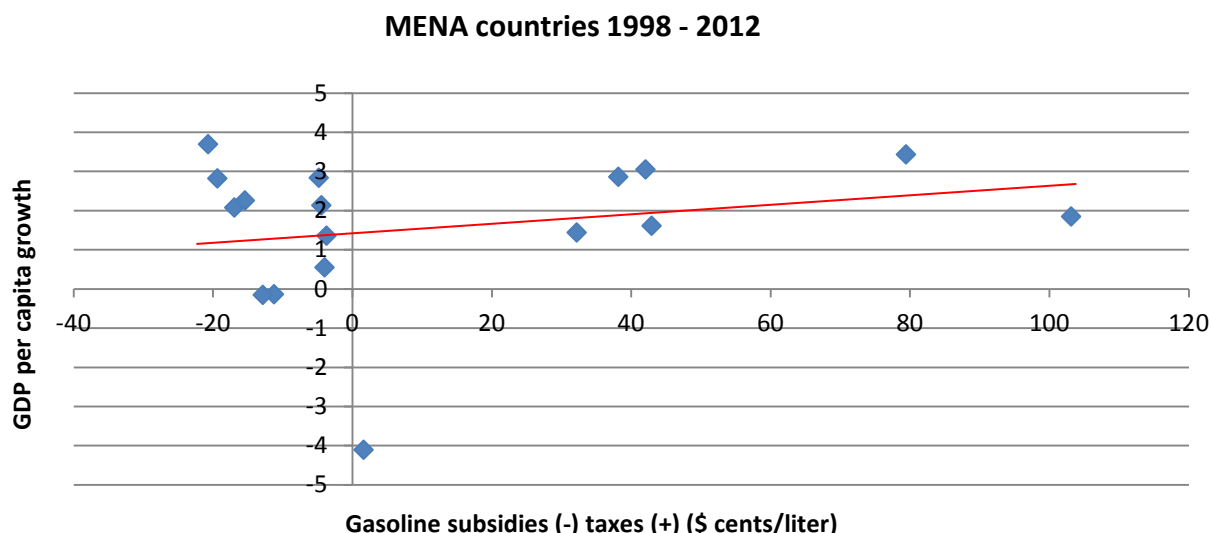
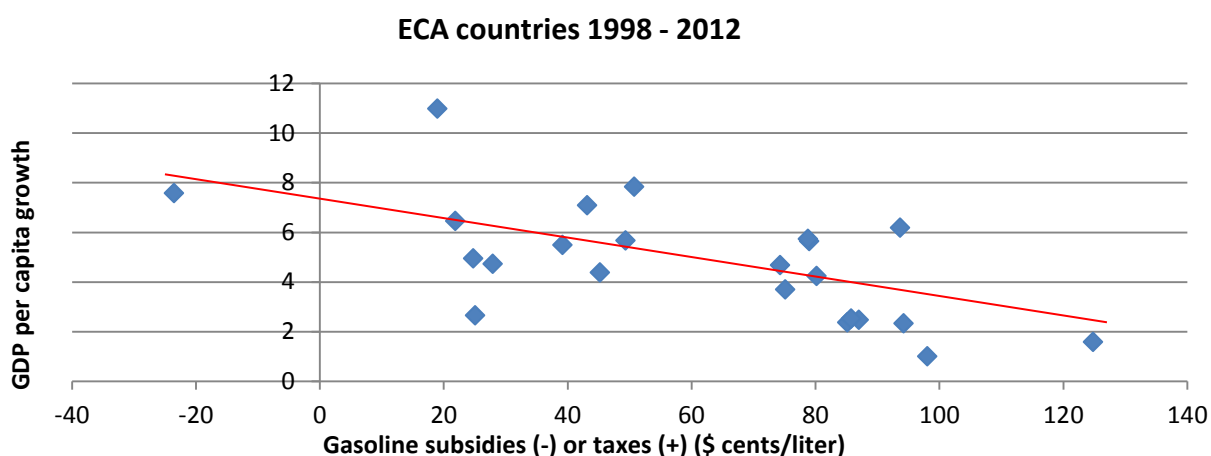


Figure 2.2 ECA: Correlation between GDP per capita growth and gasoline price gap: subsidies (-) taxes (+) (\$ cents/liter)



Sources: Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ); IMF; World Bank and Penn World Tables.

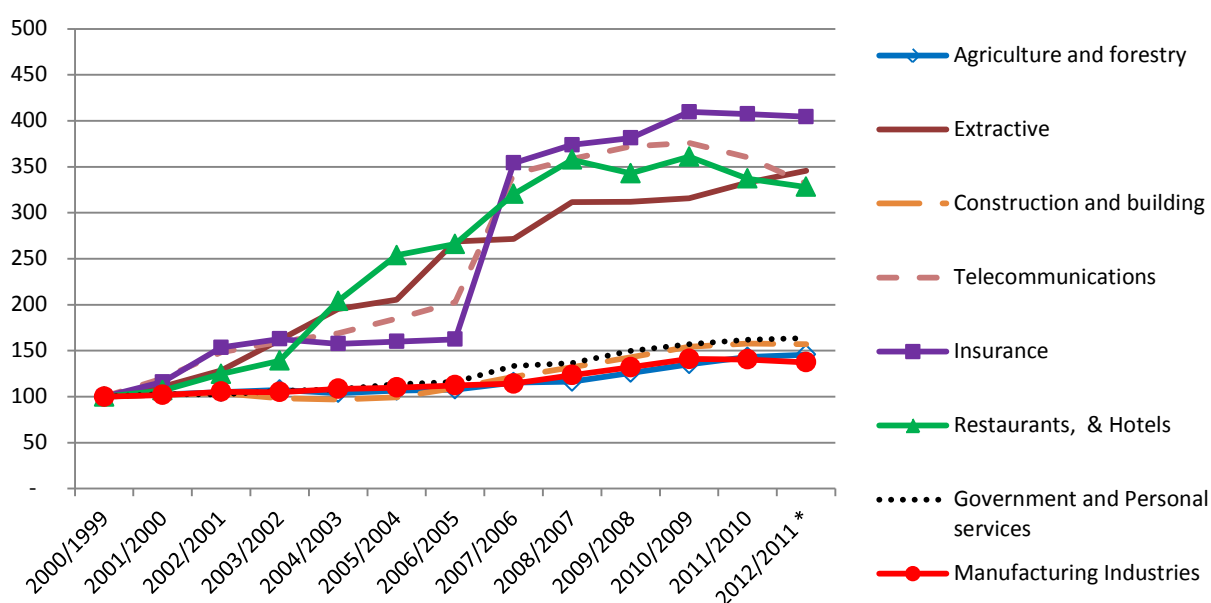
Cross-section estimates such as the ones shown above are capturing a long-run relationship between fuel prices and growth. Even if this is positive, there might be concerns that, in the short-run, an increase in fuel prices can reduce growth. The dislocations in the economy from the price increase could undermine growth even if, eventually, the efficiency gains stimulate growth. Mundaca assesses this possibility by undertaking a panel analysis, where fuel price changes in a particular year are linked with contemporaneous changes in per-capita growth, as well as with changes two years later. For diesel fuel, she finds that in MENA (and all regions except ECA), a price increase is associated with both a contemporaneous and a later increase in per-capita growth. For gasoline prices, there is an initial drop in per-capita growth, but the gains one and two years later are sufficient to register an overall increase

in growth. Controlling for other, institutional determinants of growth, such as corruption and the quality of the regulation framework, do not change the statistically significant relationship between higher fuel prices and economic growth.

Taken together, these results indicate that high fuel subsidies in MENA are a drag on growth. Reducing fuel subsidies will likely help MENA countries resume the growth that is sorely needed.

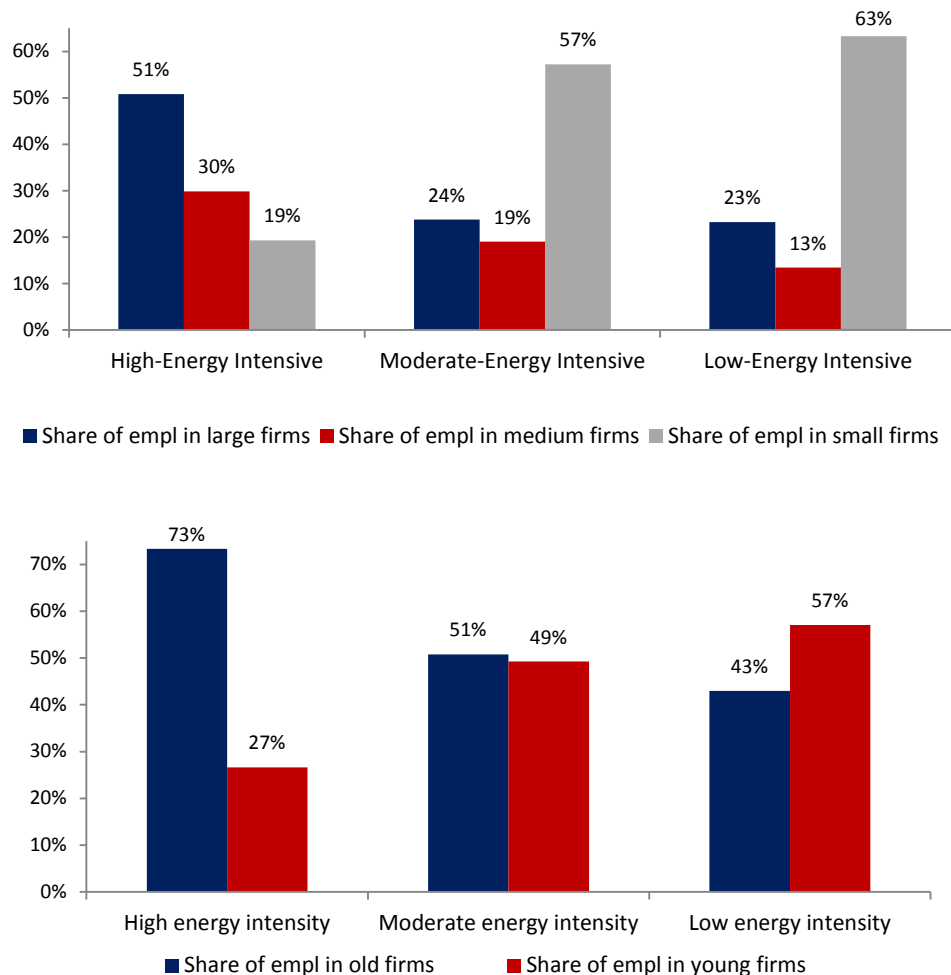
Employment. Energy subsidies encourage energy-intensive production, which also tends to be relatively capital-intensive, thus discouraging labor and employment and contributing to the high unemployment in the region. In Egypt, for example, the main sectors driving growth have been the extractive and heavy manufacturing industries (in addition to certain service sectors), while light manufacturing and construction—which are relatively labor-intensive—have stagnated (Figure 2.3). This being said, the correlation between energy and capital use outside of the energy sector is relatively limited in Egypt at 0.2 as many services like transport and tourism are quite energy-intensive but rather less capital-intensive.

Figure 2.3 Egypt: Sector Value Added 2000-2012.



Furthermore, energy subsidies bias production within sectors towards larger, older and less employment-generating firms. Entry into energy-intensive industries typically requires large upfront fixed investments, which in turn demand access to land and credit. In Egypt, a government license is required to legally operate in energy-intensive heavy industries, such as steel and cement, thereby limiting free entry and competition. As a result, most of the energy-intensive firms are old, established firms. Yet, employment growth typically comes from younger firms, whose share among high-energy intensity firms is small (Figure 2.4).

Figure 2.4 Egypt: Distribution of employment by energy intensity and size (upper panel) and age (lower panel)



Notes: Authors' calculations based on establishment census. Large: at least 200 employees, medium: at least 10 but less than 200, small: less than 10. Young establishments are less than 10 years in operation and old establishments at least 10 years.
Source: Schiffbauer and others (2014).

Finally, simulation results using a general-equilibrium model developed for Egypt suggest that a reduction in energy subsidies would lead to higher employment or wages (or both).⁴ With higher energy prices, resources would shift towards light manufacturing and construction and sectors producing investment rather than consumption goods (Table 2.1). Specifically, a 25 percent reduction in all energy subsidies would raise employment by about 1 percent (lowering the capital-labor ratio in the economy by about 1½ percent) (Tables 2.2 and 2.3). If subsidies were eliminated, the impact would be fourfold (given that the model is approximately linear). A dynamic version of the model is currently being developed, in which the sharp increase in investment (driven by higher government savings from lower fuel subsidies) would raise potential output growth thus further stimulating employment.

⁴ The model has 56 production sectors, including 11 energy sectors spanning the range of energy products. It also includes a household module in order to analyze distributional impacts of energy subsidy reform.

Table 2.1 Change in structure of market supply – scenario 1 (25% reduction in all subsidies)

	Intermediate Energy Inputs	Other Intermediate Inputs	Value added	Output	Import
	<i>% Change in real magnitudes</i>				
All sectors	-5.0%	1.3%	0.0%	0.2%	1.4%
Crude Oil	0.0%	0.0%	0.0%	0.0%	-6.2%
Natural Gas	0.0%	0.0%	0.0%	0.0%	
LPG	-3.4%	-3.4%	-3.4%	-3.4%	-3.4%
Petroleum Refining	-6.1%	-3.0%	-2.2%	-5.8%	-3.7%
Electricity	-1.6%	-1.6%	-1.6%	-1.6%	5.1%
Agriculture and Fishing	-1.5%	-1.7%	-1.7%	-1.7%	-1.6%
Food, Beverages & Tobacco	-2.0%	-1.9%	-1.9%	-1.9%	-1.0%
High Energy Manufacturing	-2.8%	-0.1%	-0.6%	-0.4%	3.4%
Glass, Tiles and Cement	5.4%	5.4%	5.4%	5.4%	8.1%
Other Manufacturing and Mining	3.4%	2.4%	2.9%	2.6%	3.6%
Water and Sewage	-3.4%	-2.8%	-2.9%	-3.0%	
Construction	17.8%	17.8%	17.8%	17.8%	20.2%
Transportation	-10.8%	-3.5%	-4.5%	-5.1%	-0.4%
Tourism	0.2%	0.2%	0.2%	0.2%	
Other Services	-0.5%	-0.6%	-0.3%	-0.4%	1.00%

Table 2.2 change in factor employment – scenario 1 (25% reduction in all subsidies)

	Labor			Capital		
	2013/14	Scenario 1	Scenario 1	2013/14	Scenario 1	Scenario 1
	% Share of total		% Change	% Share of total		% Change
Total	100.0%	100.0%	0.0%	100.0%	100.0%	0.0%
Crude Oil	0.5%	0.5%	0.0%	11.0%	11.0%	0.0%
Natural Gas	0.2%	0.2%	0.0%	3.7%	3.7%	0.0%
LPG	0.0%	0.0%	-3.4%	0.0%	0.0%	-3.4%
Petroleum Refining	0.2%	0.2%	-2.2%	0.3%	0.2%	-2.2%
Electricity	0.8%	0.8%	-1.6%	0.4%	0.4%	-1.6%
Agriculture and Fishing	9.7%	9.5%	-2.1%	18.2%	17.9%	-1.6%
Food, Beverages & Tobacco	3.8%	3.8%	-2.1%	4.5%	4.4%	-1.9%
High Energy Manufacturing	6.2%	6.2%	-0.6%	8.5%	8.5%	-0.6%
Glass, Tiles and Cement	0.7%	0.8%	5.1%	1.8%	1.9%	5.4%
Other Manufacturing and Mining	3.6%	3.7%	2.7%	3.1%	3.2%	3.0%
Water and Sewage	0.7%	0.7%	-3.0%	0.3%	0.3%	-2.8%
Construction	5.3%	6.3%	17.6%	3.2%	3.7%	17.9%
Transportation	5.0%	4.7%	-7.5%	8.0%	7.7%	-3.8%
Tourism	2.3%	2.3%	-0.1%	3.3%	3.3%	0.3%
Other Services	60.7%	60.4%	-0.5%	33.7%	33.7%	-0.1%

Table 2.3 Capital/Labor Ratio – Scenario 1 (25% reduction in all subsidies)

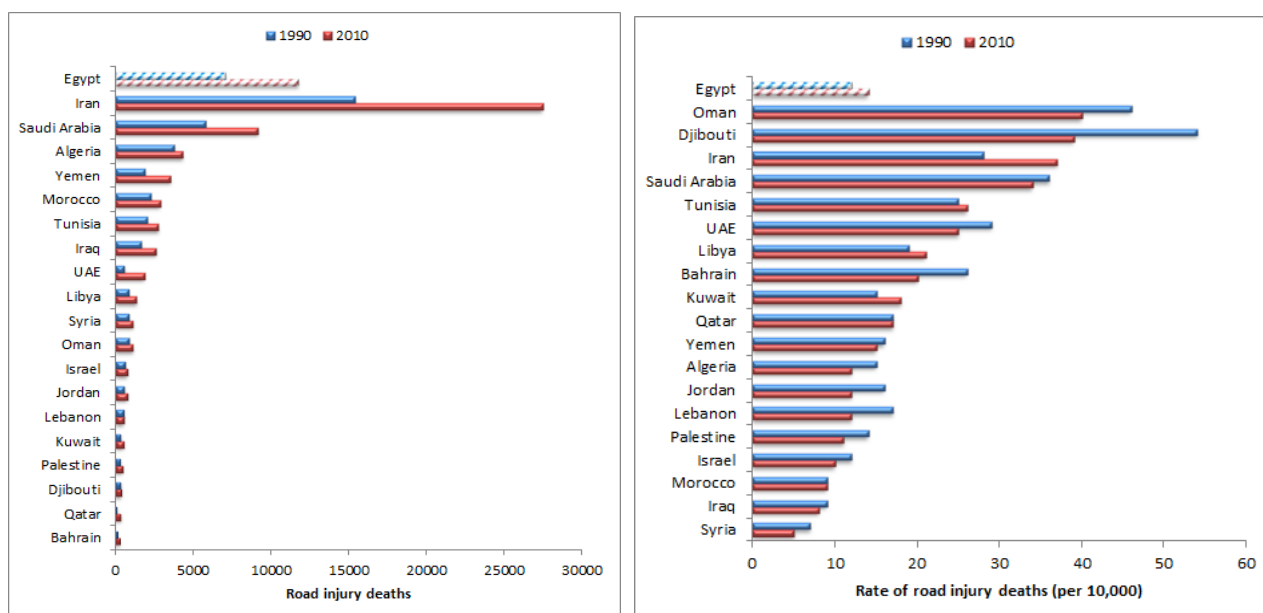
	2013/14	Scenario 1	Scenario 1
	Capital/Labor Ratio		% Changes
Total	2.85	2.82	-1.40%
Crude Oil	59.24	58.9	-0.60%
Natural Gas	59.84	59.51	-0.60%
LPG	4.58	4.54	-1.00%
Petroleum Refining	4.26	5.36	25.80%
Electricity	1.32	1.31	-1.00%
Agriculture and Fishing	5.36	5.31	-1.00%
Food, Beverages & Tobacco	3.34	3.30	-1.30%
High Energy Manufacturing	3.9	3.84	-1.50%
Glass, Tiles and Cement	7.18	7.09	-1.20%
Other Manufacturing and Mining	2.42	2.39	-1.20%
Water and Sewage	1.26	1.24	-1.40%
Construction	1.69	1.66	-1.30%
Transportation	4.54	4.64	2.30%
Tourism	3.98	3.93	-1.20%
Other Services	1.58	1.56	-1.10%

Note: A number of sectors – electricity, high energy manufacturing, and water and sewage would be expected to have higher capital stocks or K/L ratios – however, the capital in the model is not based on the installation cost value, but rather on the value of the return to capital, which is lower than expected in these sectors. In addition, we are not only looking at the production/generation of the commodities, but production is combined with distribution expenses, which tends to lower capital/labor ratios.

Transport. The MENA region is characterized by high rates of road accidents and, especially in large cities such as Cairo, urban air pollution and congestion. All of these are externalities associated with road transport, which has been growing substantially in the region. The textbook prescription for externalities is to tax the activity. By subsidizing transport fuels such as gasoline and diesel, therefore, the countries of the MENA region are exacerbating the social costs due to these urban externalities.

In the case of road accidents, the MENA region's rate of fatal road accidents is surpassed only by South Asia and Sub-Saharan Africa; the rate of non-fatal accidents is second to South Asia. Within the MENA region there is also substantial variation across countries. Egypt and Iran are the countries most affected by road injury deaths in absolute terms. Further, both countries have seen an increase in road injury deaths (Figure 2.5).

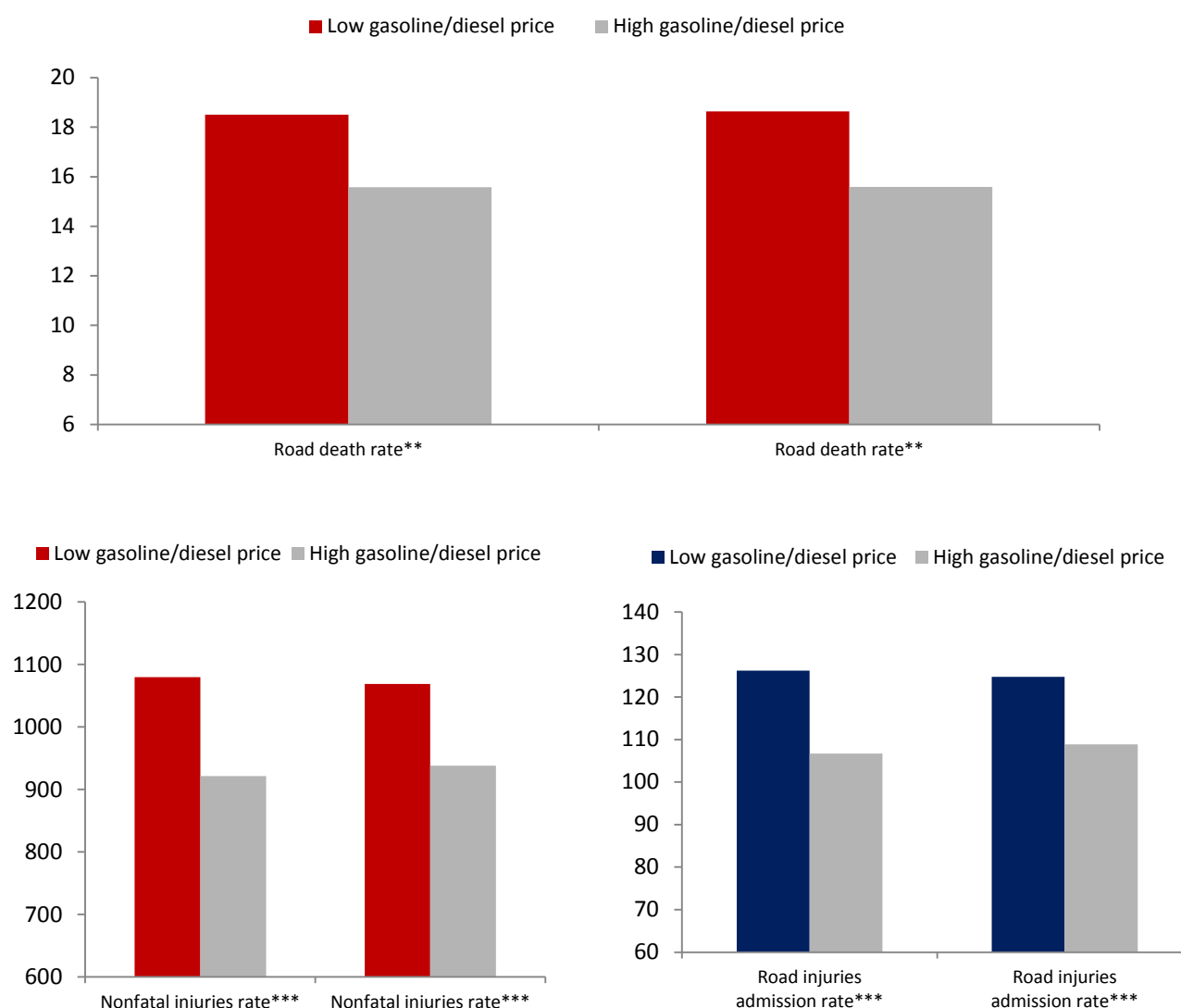
Figure 2.5 Road deaths, 1990-2010 (absolute number and per 10,000 people)



Source: Commander, Nikoloski and Vagliasindi (2014)'s' elaboration based on Institute for Health Metrics and Evaluation's Global Burden of Disease (GBD) dataset

The data also show a significant difference in the rate of fatal and non-fatal road accidents between countries with below and above average fuel transport prices (both gasoline and diesel) (Figure 2.6). While this may well be explained by a combination of factors, it is possible that reducing subsidies may contribute to reducing the social costs associated with road accidents.

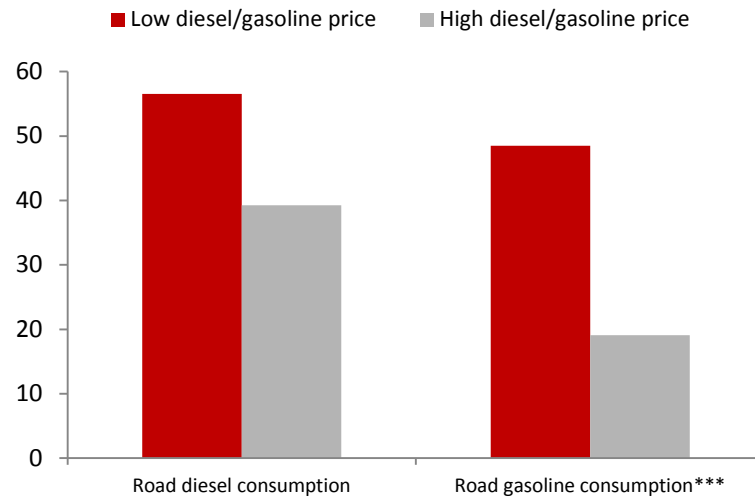
Figure 2.6 Difference in average road death rates, non-fatal injuries rates and road injuries between countries with above and below average gasoline/diesel prices



Note: *** denote significance of t-test between the average groups at 1% confidence level ** denote significance of t-test between the average groups at 5% confidence level. Source: Commander, Nikoloski and Vagliasindi (2014)'s' elaboration based on Institute for Health Metrics and Evaluation's Global Burden of Disease (GBD) dataset

The MENA region had among the highest rates of air pollution in 1990. While the rate has come down in some countries (notably Saudi Arabia), pollution continues to be associated with high rates of motor vehicle ownership. Furthermore, in lower-middle-income countries (which is the majority of MENA countries), lower fuel prices are associated with higher fuel consumption (Figure 2.7).

Figure 2.7 Difference in road fuel (diesel/gasoline) consumption between countries with above and below average fuel prices

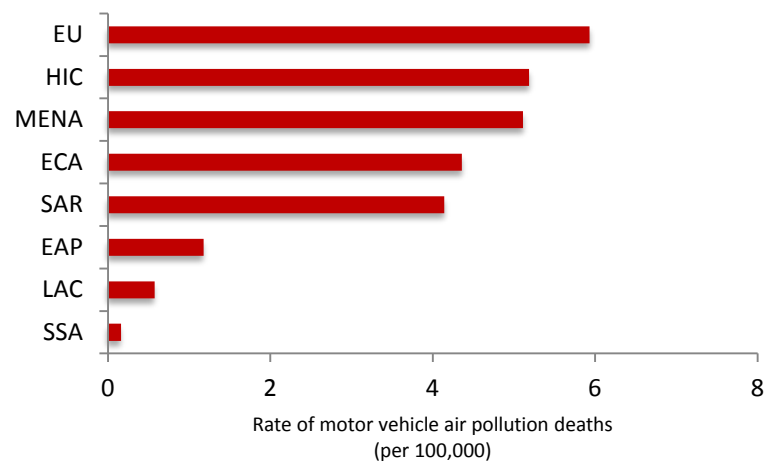


Note: *** denote significance of t-test between the average groups at 1% confidence level

Source: Commander, Nikoloski and Vagliasindi (2014)'s' elaboration based on WDI data

As a result, the MENA region has the highest rate of air pollution deaths in the developing world (Figure 2.8).

Figure 2.8 Motor vehicle air pollution deaths (per 100,000 people) by regions

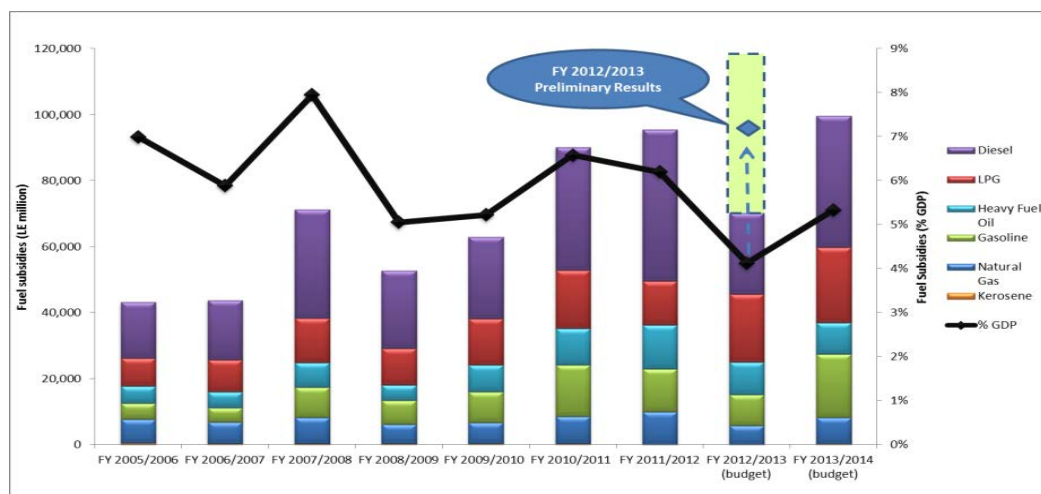


Source: Commander, Nikoloski and Vagliasindi (2014)'s' elaboration based on Institute for Health Metrics and Evaluation's Global Burden of Disease (GBD) dataset

To capture the contribution of fuel subsidies on traffic congestion, we focus on the MENA region's largest metropolis, Cairo. Egypt subsidizes several sources of energy, of which transport fuels—gasoline and diesel—make up about half (Figure 2.9). Both common sense and measured elasticities of demand

indicate that these subsidies contribute to more vehicle-kilometers traveled, more trips, and less use of alternate modes, such as walking, cycling or public transport.

Figure 2.9 Egypt energy subsidies (by fuel), Fiscal year 2005/2006-2012/2013



Source: Egypt Ministry of Finance

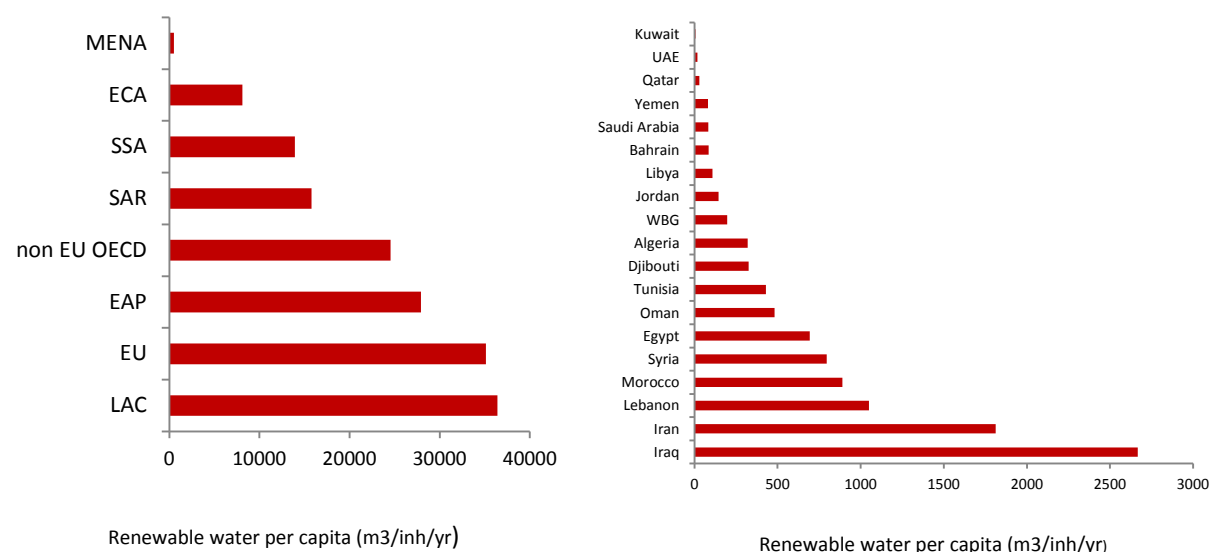
The result is the recurrent phenomenon of traffic congestion in Cairo. To estimate the costs of this congestion, World Bank (2013) used data on 11 major corridors in the Greater Cairo area. The study uses the following indicators:

- cost of travel time delay imposed on users (passengers as well as freight). The study estimates these costs to be in the region of 2.4 to 2.6 billion Egyptian pounds (LE).
- cost of travel time unreliability in passenger transportation – estimated at 1.7 billion LE for passengers and 13.5 million LE for freight transport.
- cost of excess fuel consumption in vehicular transportation (diesel and gasoline) – estimated at 2.38 - 2.85 billion LE.
- associated cost of Carbon Dioxide (CO₂) emissions due to excess fuel consumption – 86 - 97 million LE.

The total direct traffic congestion cost for these 11 corridors is consequently estimated to be in the range of 6.6 - 7.0 billion LE, which was equivalent to around 0.6 percent of 2010 Egyptian GDP. A simulation analysis of a 50 percent increase in fuel prices shows that it could lower congestion costs by 350 million LE in the short-run, and by 1.09 billion LE, or 0.09 percent of GDP in the medium-run.

Water. At 500 cubic meters per capita per annum of renewable water, MENA is the most water scarce region in the world. Renewable water resource availability is below 30 cubic meters per capita per annum in Kuwait, UAE and Qatar, followed by Yemen. Only a few countries in MENA, such as Iraq, Iran and Lebanon, have more than 1,000 cubic meters per capita (Figure 2.10).

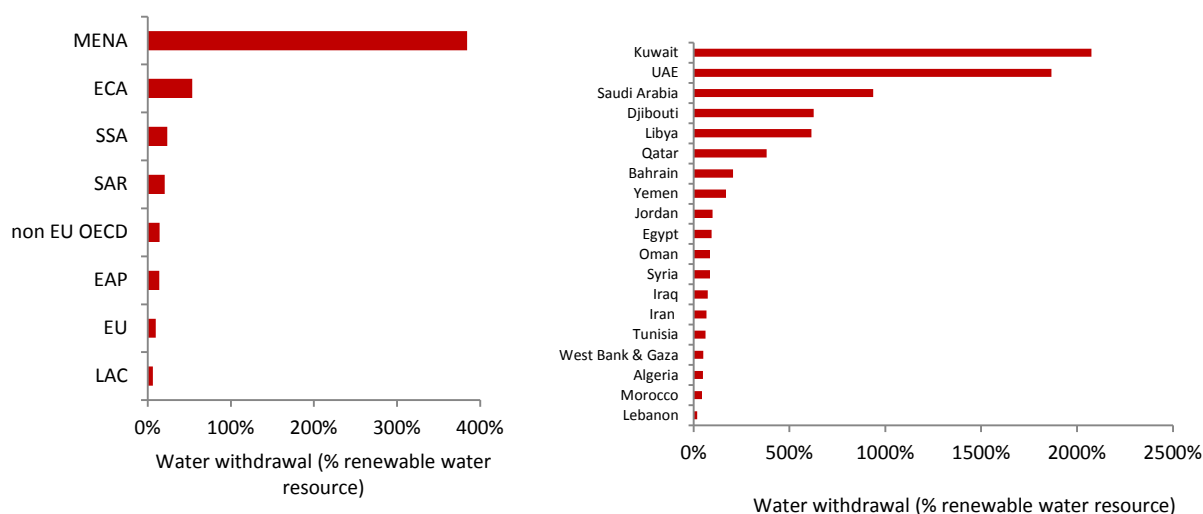
Figure 2.10 Renewable water resource availability (m3/per inhabitant/year) by region and by MENA countries



Source: Commander, Nikoloski and Vagliasindi (2014)'s elaboration based on Aquastat's database.

Renewable water availability has also been declining over time, with a rate of decrease of 35 percent over the last decade. For some countries, the rate of decrease has been as high as 75 percent, for example in UAE and Qatar. Even more troubling, the ratio of water withdrawn to availability is highest in MENA, amounting on average to just below 400 percent. In other regions they range from 6 to 54 percent (Figure 2.11). Countries such as Egypt and Jordan are reaching the 100 percent threshold. Lebanon, Morocco and Algeria are the only countries where water withdrawal is less than 50 per cent of availability.

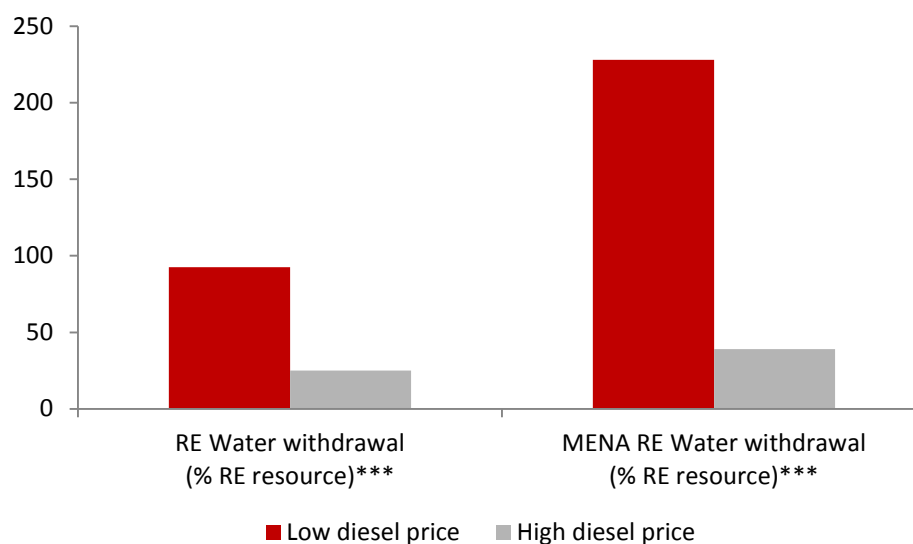
Figure 2.11 Water withdrawal (% renewable water resources) by region and by MENA countries



Source: Commander, Nikoloski and Vagliasindi (2014)'s elaboration based on Aquastat's database

By making it cheaper to pump water out of the ground, fuel subsidies contribute to this water depletion. The evidence suggests that, globally, countries with lower than average diesel prices are characterized by higher (and statistically significant) water depletion than those that have increased diesel prices. In MENA, the gap is much higher (Figure 2.12).

Figure 2.12 Difference in water withdrawal (% renewable water resources) between countries with above and below average fuel prices



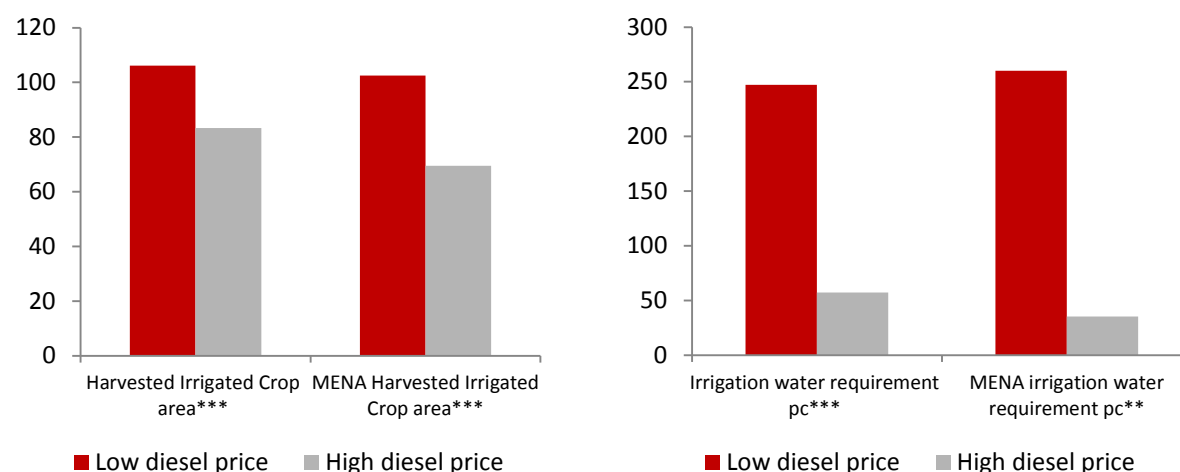
Note: *** denote significance of t-test between the average groups at 1% confidence level

Source: Commander, Nikoloski and Vagliasindi (2014)'s elaboration based on Aquastat's database

Most water is used for agriculture, a sector whose productivity is low compared to other countries as well as other sectors in the region. MENA countries use groundwater for irrigation to a greater extent than any other region. The evidence suggests that countries with lower than average diesel prices are characterized by much higher (and statistically significant) harvested irrigated crop area and irrigation water requirements than those that have increased diesel prices. The between-group difference is slightly higher in MENA countries in terms of harvested irrigated crop areas, but is much higher in terms of irrigation water requirement per capita, pointing at the wasteful use of water for irrigation due to low price signals (Figure 2.13).

The main impact of fuel subsidies is to shift the crop mix towards water-intensive crops. A study of Syria showed that although subsidized fuel had a significant positive impact on cereal production, it was also associated with intensive groundwater use and aquifer depletion in water-scarce areas. The intensity of groundwater use had been associated with the expansion in areas of high water-consuming crops. The study also suggested that higher fuel costs led farmers to shift production to crops with higher water-productivity. The study also emphasized that fuel subsidies directly contributed to low water productivity (gross margin per cubic meter), particularly in cotton production.

Figure 2.13 Difference in harvested irrigated crop areas and irrigation water requirement per capita globally and in the MENA region between countries with above and below average fuel prices



Note: *** denote significance of t-test between the average groups at 1% confidence level ** denote significance of t-test between the average groups at 5% confidence level.

Source: Commander, Nikoloski and Vagliasindi (2014)'s elaboration based on Aquastat's database

In Yemen, energy subsidies account for 9 percent of GDP, most of which is for diesel to power electric generators. Although Yemen is one of the most water-scarce countries in the world, pumping for irrigation and drainage accounts for 28 percent of the total electricity and diesel consumption, a share much higher than the 6 percent average for the MENA region. The ground waters on which more than half of agricultural output now depends are almost fully exploited and reserves are being rapidly depleted. Behind this depletion lies specific crop selection. In particular, *qat* - a stimulant widely chewed by Yemenis – accounts for around 40 percent of total water resource use. While profitable at current relative prices, *qat* crowds out production of food or export crops, and its consumption creates both social and health problems.

Concluding remarks

The MENA region suffers from low growth, high unemployment, traffic congestion and pollution and low agricultural productivity from a depleted water table. Energy subsidies contribute to all of these problems. Reforming them should be the highest priority. Otherwise, these problems will likely get worse.

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Country Notes

Algeria

Overall economic growth has been slow due to falling hydrocarbon output. While non-hydrocarbon growth has been robust, exceeding 6.5 percent on average since 2010, overall growth has averaged only around 3% because hydrocarbon output has been falling. This has also had a sharp effect on the current account balance causing it to decline from a 6% surplus in 2012 to a projected deficit of 0.5% in 2014. On the positive side, the high inflation of 8.9% witnessed in 2012 has been brought down to 3.3% as the fiscal deficit has been cut from 5% in 2012 to 1.5% in 2013.

Economic prospects are poor both because of falling hydrocarbon output and a difficult business environment for the private sector. The economy remains highly dependent on the hydrocarbon sector which, despite declining production since 2006, still accounts for about a third of GDP and 98 percent of exports. Moreover, in the non-oil economy, a difficult business climate is holding back private sector development, jeopardizing the chances of achieving strong, sustainable growth and rapid job creation. The key challenges that face the economy—improving governance and the business environment, reducing subsidies, diversifying the economy, and creating private sector jobs—remain substantively unaddressed.

The political status-quo has recently been strengthened. President Bouteflika was re-elected to a 4th five-year term in April, 2014. Though the government includes some new members, it is generally acknowledged that the political status-quo has been firmly reasserted and the context for policymaking will remain as before. Mr. Bouteflika's fragile health, and disagreements within his ruling FLN party, as well as apparent tensions between the President's allies and the powerful military establishment cast some uncertainty over the next few years. However, despite significant popular resentment—rooted in high youth unemployment, limited political freedom and perception of pervasive corruption, and often expressed in unpublicized protests—analysts believe that Algeria is unlikely to witness the upheaval seen in “Arab Spring” countries, largely because of the still vivid memories of the brutal civil war of the 1990s. To preserve stability, the government has managed simmering discontent through minor political reforms, and amendments to the constitution are underway (but are not expected to be substantial).

Key Economic Indicators

	2013e	2014f	2015f
Real GDP Growth (%)	2.8	3.0	3.3
Inflation Rate (%)	3.3	3.3	3.5
Fiscal Balance (% of GDP)	-1.5	-3.4	-4.8
Current Account Balance (% of GDP)	0.3	-0.5	-2.2

Bahrain

Despite protracted political uncertainty, GDP growth in Bahrain has increased to the 4-5 percent range, driven by hydrocarbons. As expected, the return to full capacity of the Abu Saafa field, shared with Saudi Arabia, was a major contributor to this growth, as was an increase in production at Bahrain's indigenous Awali field, through the use of enhanced oil recovery techniques. Real growth in some key non-hydrocarbon sectors, however, continues to be weak. The financial sector has lagged as international financial corporations shift their activities away from Bahrain, in favor of Dubai, Doha, and Riyadh. Construction is also sluggish, as limited progress has been made on affordable housing and infrastructure projects despite the availability of substantial GCC funding. On the positive side, growth in hotels and restaurants has been resilient, indicating that tourists, especially from Saudi Arabia's Eastern Province, are returning.

Relatively strong growth is coming at the expense of the public finances, which continue to deteriorate. The government has increased subsidies and public sector wages in recent years, leading to fiscal deficits and a rising public debt (with the latter reaching 44 percent of GNP in 2013). Recently, however, some parts of the government have warned that food and energy subsidies are too high and should be better targeted and that public debt levels are becoming too high. Implementing fiscal reforms, however, could face stiff resistance by vested interests – as indicated by the protests made by several MPs in Parliament to a proposed 20 percent rise in the price of diesel fuel, which ultimately led the Prime Minister to delay the increase.

Going forward, growth will ease somewhat but downside risks remain due to lack of diversification. Future growth will come mostly as the hydrocarbon sector continues to rebound, an oil-refining upgrade comes online, and construction of a new aluminum plant starts. On the negative side, Bahrain is running out of domestically-produced natural gas and soon may need to import gas at market prices – which could reduce the profitability and competitiveness of its energy-intensive industries, such as aluminum manufacturing. Moreover, the ongoing political stasis continues to hurt Bahrain. Without a political solution, which would facilitate steps to cut expenditures and broaden the private sector, government debt as a percent of GDP is forecast to increase to 60 percent in 2018, which would be extremely high by GCC standards.

Key Economic Indicators

	2013e	2014f	2015f
Real GDP Growth (%)	4.9	4.0	3.0
Inflation Rate (%)	3.3	2.5	2.4
Fiscal Balance (% of GDP)	-4.4	-4.8	-6.0
Current Account Balance (% of GDP)	8.0	7.0	5.5

Djibouti

Djibouti is experiencing rising economic growth due in part to high inflows of foreign investment.

Growth is estimated to reach 5.5 percent in 2014 up from 5 percent and 4.8 percent in 2013 and 2012 respectively. This is due in part to the expansion of port-related activities such as the transit trade with Ethiopia and transshipment activities which have been attracting large FDI inflows. Such inflows jumped from 6.3% of GDP in 2011 to 19.6% in 2013 and are expected to remain at an average of 15% of GDP over the next four years. Despite these inflows, the current account deficit has been very high, at 24.7 percent of GDP in 2013 and an expected 33.3 percent in 2014.

The fiscal deficit is expected to worsen sharply in 2014 and beyond due to the non-concessional financing of two major projects.

In November 2013 the government contracted two non-concessional loans, equivalent to 60 percent of GDP, to finance two major water and railway investment projects. The two loans are expected to be disbursed during the period 2014-2018 and will push the national debt up from 48 percent of GDP in 2013 to over 82 percent in 2017. Non-tax revenues are expected to increase with the signing of a ten-year lease extension for the sole official military base of the United States in Africa, Camp Lemonier. Under the new lease agreement Djibouti will receive 63 million US\$ per year (up from 38 million US\$ per year) over 10 years. Despite this increase of non-tax revenues the fiscal deficit is projected to rise above 10 percent of GDP in 2014-2017 stemming from higher debt service arising from the non-concessional loans.

The decision to cancel the MIGA-guaranteed concession of the main port facility is increasing business uncertainty.

On July 2014 the government announced that it had cancelled the concession of its main container terminal to Dubai Port World. While Dubai Port World is continuing to operate the terminal during the arbitration phase, the commercial dispute has increased business uncertainty. This may ultimately affect the perceived quality of the business environment, reduce investor confidence in Djibouti and undermine the economic progress of the previous years led by better management and higher investment in port activities.

The medium-term outlook is favorable but significant risks to growth exist. The medium-term outlook is favorable with real GDP growth in 2014-2016 projected to reach 6.3 percent per year while inflation would remain at about 2.5 percent per year. The main risks to growth and macroeconomic stability come from the sharply rising public debt which hampers the ability to respond to possible fuel and food price shocks for a country that is so heavily dependent on imported fuel and food. Adverse security developments in neighboring countries are also a source of risk as are domestic security events such as the May 24th suicide bomb attack in the capital city. Finally, as already mentioned, the commercial dispute with Dubai Port World could lower investor confidence in Djibouti with a detrimental impact on investment inflow and growth.

Key Economic Indicators

	2013e	2014f	2015f
Real GDP Growth (%)	5.0	5.5	5.5
Inflation Rate (%)	3.5	3.5	4.0
Fiscal Balance (% of GDP)	-5.8	-8.8	-12.1
Current Account Balance (% of GDP)	-23.7	-33.3	-36.6

Egypt

Key political and economic steps have been undertaken recently. On the political front, key recent steps include ratification of an amended constitution in January 2014 and the swearing in of a new president (Abdel Fattah El-Sisi) on June 8, 2014. On the economic front, the new government has, in a bold move, raised taxes and reduced energy subsidies and also initiated a mega-project to develop the Suez Canal and surrounding regions. The security situation remains fragile as sporadic attacks on the police and the military continue along with reports of repression of the opposition.

Early signs of an economic recovery are emerging. Economic activity started to pick up in the third quarter of FY14, with growth up at 2.5 percent, more than double the rate recorded in the first half. However, growth for the whole fiscal year is expected to remain subdued at 2.1 percent. Unemployment has been stable during FY14, but remains elevated at 13.3 percent, and the latest poverty data (for FY13) indicate a national poverty rate of 26.3 percent of the population.

Capital inflows from the Gulf have helped to stabilize Egypt's external accounts. Net international reserves have risen from \$14.9 billion at the end of FY13 to around US\$16.8 billion as of end August 2014, largely as a result of inflows from selected Gulf countries. The reserves position is expected to come under pressure in the short term with debt repayments coming due to Qatar (worth US\$2.5 billion) and with the need to clear the arrears already due to foreign oil companies.

The authorities have recently announced decisions to reduce future fiscal deficits and gradually tilt public spending in favor of development needs. Early in July 2014, the newly elected president approved long-awaited structural reforms, including increasing and/or enacting new taxes and streamlining electricity and fuel subsidies. This would bring the deficit down to 10.5 percent of GDP in FY15, compared to an expected outturn of 12 percent of GDP in FY14. At the same time, some EGP27 billion will be directed to enhance spending on health, education, scientific research and social safety nets and in pursuit of an ambitious capital spending program.

Medium term economic prospects hinge on both political stability and sustained reforms. On the assumption that political tensions abate, the security situation improves, and government continues to implement announced reforms, economic activity is likely to pick up as confidence improves and higher social and capital spending provide an additional boost. Real GDP growth could increase gradually from the 2.1 percent expected in FY14 to 4.1 percent by FY17. Net international reserves should stabilize around current levels, but external financing gaps are likely to reemerge starting FY16 as exceptional financing inflows decline.

Key Economic Indicators

	2013e	2014f	2015f
Real GDP Growth (%)	2.1	2.1	3.1
Inflation Rate (%)	6.9	10.2	14.2
Fiscal Balance (% of GDP)	-13.7	-11.8	-10.5
Current Account Balance (% of GDP)	-2.1	-0.8	-3.5

Iran

Negotiations continue on a potential nuclear agreement while interim measures have been extended into November 2014. Under the interim agreement, Iran is curbing the development of its nuclear program while the international community enacts a temporary and partial easing of sanctions relating in particular to Iran's oil exports and financial assets held abroad. New attempts to reach a comprehensive deal began on September 4, 2014—with bilateral meetings between Iran and the United States as well as with the European Union - and are expected to reach results no later than November 24, 2014.

The economy has continued to contract in 2013-14, albeit at a slowing pace. The sanctions imposed on Iran's oil exports, on the supply chain in key sectors of the economy – such as in the automobiles industry – and on transactions of international and domestic banks resulted in a real GDP contraction of 5.8 percent in 2012-13. For 2013-14 (i.e., March 2013 - March 2014), the economy is estimated to have contracted at an annual rate of 1.7 percent in line with the easing of sanctions as well as the rise in consumer and business confidence that a comprehensive agreement is within reach. Growth is expected to enter positive territory at the modest rate of 1.5 percent in 2014-15. Meanwhile, inflation has continued at a very high rate, reaching 35.2 percent in 2013/14.

Government has been running modest fiscal deficits in recent years. Oil revenues declined by more than 4% of GDP between 2011/12 and 2013/14 (from 10.8% to 6.2%) and are expected to fall by another 2.7% of GDP (to 3.7%) by 2015/16. Tax revenues have also declined as the economy has decelerated. Government expenditures have been cut sharply as well but not by the same amount as the decline in total revenues. As a result, Iran has experienced fiscal deficits in recent years, amounting to 2% of GDP in 2012-13 and 2.2% in 2013-14.

The current account surplus is estimated to have increased from 6.6 percent of GDP in 2012-13 to 8.0 percent in 2013-14. This came amid a real exchange rate depreciation and higher costs of conducting international business, which led to a decline in imports, partially offset by a decline in exports of goods and services. Notwithstanding this improvement, the current account remains markedly lower than the 11 percent of GDP recorded in 2011-12 when oil export receipts were twice their current level.

The outlook calls for a modest recovery of the Iranian economy. The baseline scenario suggests that Iran's economy would expand by 1.5 percent in 2014-15 (March 2014-March 2015) and 2.3 percent in 2015-16. The key risks to the economic outlook are: (i) Iran's failure to reach a comprehensive agreement with the P5+1 and a consequent tightening of international sanctions on the country; (ii) an intensification of regional conflicts in Iraq and Syria; and (iii) the government being unable to implement the reforms needed to spur growth and job creation.

Key Economic Indicators

	2013e	2014f	2015f
Real GDP Growth (%)	-5.8	-1.7	1.5
Inflation Rate (%)	30.5	35.2	23.0
Fiscal Balance (% of GDP)	-2.0	-2.2	-2.5
Current Account Balance (% of GDP)	6.6	8.0	5.0

Iraq

An escalating insurgency has generated great civilian misery and poses a fundamental challenge to the territorial integrity of Iraq. Recent advances by an insurgent group, the Islamic State of Iraq and Syria (ISIS), have thrown Iraq into violent chaos. ISIS seized control of the city of Falluja, as well as part of nearby Ramadi in Anbar province in early January 2014. The militants then launched an offensive in June that has brought a huge swath of northern and western Iraq under their control, including Mosul, Iraq's second largest city. ISIS made significant advances in August into Kurdish-controlled positions to the east, north and west of Mosul. According to Iraq Body Count, the death toll in Iraq continued to climb in 2014; where violence has killed 11,190 civilians, including 2,534 civilians killed in June 2014, the highest since the crisis intensified. Another 1.2 million have been driven from their homes by the violence since fighting erupted in Anbar Province at the start of the year. This already complex political, social, and security context is exacerbated by regional dynamics, especially the Syrian conflict and resulting flow of refugees and armed groups in and out of the country.

Disputes and disruption were already taking a toll in the northern oil sector well before June, shutting off official exports and reducing fiscal revenue. The Kirkuk-Ceyhan pipeline, which has a capacity of 1.6 million bpd, has been shut down due to frequent attacks since March and exports from the northern oil fields have been sharply curtailed, making the shipments of Basra light crude from the south the federal government's sole source of exports. Southern production and exports have not been affected yet and remain at about 2.5 mbd of exports. On the other hand, the uncertainty concerning the political future of Iraq may cause international oil companies to slow expansion plans, which will disrupt the economy and make gains in production fall short of government targets. Given the prevailing context of insurgency and disruption, it is inevitable that Iraq's real GDP will decline in 2014.

Food security is under threat. Food shortages are in prospect as the conflict with ISIS has disrupted key food production and transit trade areas. The governorates most affected by the current conflict, Nineveh and Salahaddin, contribute nearly a third of Iraq's wheat production and about 38 percent of the its barley. Recent UN reports indicate that in Nineveh and Salahaddin governorates, grain reserves are being depleted and levels of available food to households via the Public Distribution System are deteriorating.

Tensions over the disposition of oil revenues have delayed the budget. A dispute between Baghdad and the KRG has held up the approval of the federal budget. The KRG demands the payment of eight months of the region's 2014 budget and an agreement about a new law for oil exports and revenue distribution. Baghdad does not recognize the right of the KRG to the exploitation and sale of oil and gas resources from Kurdistan. Meanwhile, KRG has attempted to export oil via tanker from Ceyhan and, while details are lacking, it is believed that it has been successful in selling 4 cargoes of around 1 million barrels each.

Key Economic Indicators

	2013e	2014f	2015f
Real GDP Growth (%)	4.2	-2.7	1.5
Inflation Rate (%)	1.9	4.7	6.2
Fiscal Balance (% of GDP)	-5.9	-3.0	-0.6
Current Account Balance (% of GDP)	-0.8	3.0	2.4

Jordan

Regional tensions are affecting the Jordanian economy adversely. The political and military crisis in neighboring Iraq and Syria is affecting the Jordanian economy adversely. While the full impact is difficult to estimate at this point when so much is in flux, it is unlikely that economic growth will advance beyond 3 percent in 2014, thereby extending a run of moderate growth rates since 2011. All indications are that investor and exporter confidence is falling while uncertainty is rising.

Macroeconomic vulnerabilities persist due to high fiscal deficits and a large public debt. Excluding grants, Jordan has been running high fiscal deficits in recent years, reaching a level of 14.1 percent of GDP in 2013. This is expected to widen to 14.7 percent of GDP in 2014 mostly due to a rise in the losses of the National Electric Power Company which faced a severe shortfall in gas supplies from Egypt this year and had to run its power stations on more expensive diesel oil. As a result, the already high gross public debt is projected to increase further to 90.6 percent of GDP in 2014. The current account deficit is also projected to widen to 11.3 percent of GDP in 2014 due to rising energy imports and a slowdown in export growth.

Monetary policy has also been expansionary. The central bank lowered its key policy rates by 125 basis points in August 2013 following a drop in headline inflation and a substantial increase in foreign reserves. This monetary policy easing has not yet translated into higher lending as credit to the private sector remained subdued, possibly on account of the uncertain regional political climate.

The medium term outlook is positive though much will depend on ongoing energy sector reforms and how the upsurge of military activity in the region plays out. Assuming that the ongoing military actions in Syria and Iraq lead to regional political stability, it is possible that the Jordanian economy will benefit from: (i) higher capital spending based on the utilization of previous grants from the GCC (e.g., funding large development projects such as LNG terminals), and (ii) a drop in energy imports as Egyptian gas supplies resume and energy sources become more diverse. Consumption spending is also expected to rise, not least because the country continues to host a large Syrian refugee population of 618,000 people (around 9.5 percent of Jordan's total population). The upside economic forecast is for growth to rise to 3.4 percent in 2015 and further to 3.9 percent in 2016.

Key Economic Indicators

	2013e	2014f	2015f
Real GDP Growth (%)	2.8	3.0	3.4
Inflation Rate (%)	5.6	3.1	2.8
Fiscal Balance (% of GDP; excluding grants)	-14.1	-14.7	-8.9
Current Account Balance (% of GDP)	-10.0	-11.3	-9.4

Kuwait

With little upside in the oil sector, growth prospects hinge on the non-oil sector —historically, not Kuwait’s strong point. Real GDP growth decelerated to negative territory in 2013, as oil production eased off its 3 million barrels per day capacity. But spending was buoyant as geopolitical factors have kept oil prices high despite global weakness. Given its chronic difficulties in scaling up capital spending, revenue recycling takes the form of higher current spending predominantly.

Concerns about medium-term fiscal sustainability remain, but public complacency presents a formidable obstacle. Fiscal space has been in decline due to the ratcheting up of salaries and allowances with each increase in nominal oil revenues. Salary “standardization” is the latest solution for the problems of leapfrogging in public sector wage determination, but it increasingly seems that this will occur without any reforms to performance incentives or management practices. Reflecting momentum from 2013, a significant amount of technical work was done, led by the Ministry of Finance, on energy subsidy reform. However, the discussions became bogged down on the issue of minimizing impact on “average” Kuwaitis and shifting costs onto expatriates. It appears that diesel subsidy removal may proceed to implementation, but the economic role of diesel in the economy is small.

Mobilization of the private sector – whether domestic or foreign – has failed to take hold. There is awareness in government of the need to enable the private sector, but specific solutions, such as privatization, business environment reform, and liberalization of key services markets such as telecom and key markets such as land, have stalled in implementation. Younger Kuwaitis repeatedly cite frustration that connections are needed to expedite even simple administrative transactions, while experienced contractors and foreign investors express exasperation at the way politics and lobbying undermine seemingly secure deals.

The modest growth outlook assumes that faltering steps towards reform are revitalized. Growth in the range of 2 percent is expected for 2014-15 and fiscal and current account balances will remain large even if oil prices ease. Government-Assembly tensions remain high and so fiscal discipline and growth-enhancing reforms will continue to be a delicate political balancing act.

Key Economic Indicators

	2013e	2014f	2015f
Real GDP Growth (%)	-0.4	1.4	1.8
Inflation Rate (%)	2.7	3.0	3.5
Fiscal Balance (% of GDP)	31.6	29.1	27.1
Current Account Balance (% of GDP)	40.5	41.9	39.7

Lebanon

Lebanon's economy continues to be affected adversely by regional political and military developments. The intensification of the civil war in Syria and the continued influx of refugees (now at 1.2 million) have adversely affected Lebanon's economy. While a mid-year lull in the security environment led to some improvement in tourism and commercial activities, the economy is not expected to grow by more than 1.5 percent in 2014. Meanwhile, a state of deadlock continues in domestic politics. This has blocked the election of a president and could eventually lead to an unprecedented political vacuum in the three branches of government simultaneously.

The fiscal position continues to deteriorate in 2014. The central government's overall fiscal deficit is forecast to widen to 10.2 percent of GDP in 2014, compared to 9.4 percent last year. Moreover, Lebanon's primary balance in 2014 will register a deficit for the third consecutive year, increasing by a projected 0.7 percentage points to 1.2 percent of GDP. As a result, gross public debt will rise to a forecast 149 percent of GDP in 2014, compared to 143.1 percent of GDP at end-2013. The government financed the widening fiscal deficit by issuing Treasury bills and Eurobonds.

The current account deficit remains elevated. The current account deficit is forecast to reach 8.3 percent of GDP in 2014, in line with the previous two years. To meet its balance of payments, Lebanon remains dependent on capital inflows, which continue to be robust, supported by remittances and international aid for refugees. As a result, the stock of international reserves (excluding gold) at the central bank reached US\$31.7 billion by end-2013 (equivalent to 12.1 months of imports), increasing by 5.8 percent compared to end-2012.

The banking sector remains stable as does the currency. Conservatism in both financial sector regulations and approach to private sector banking has helped maintain a well-capitalized and resilient domestic banking sector, despite sluggish growth and downgrades by international rating agencies. High spreads between domestic and international rates of return have induced sufficient inflows of deposits to Lebanese banks to maintain solid liquidity buffers.

An expansion in regional turmoil is Lebanon's primary risk. In addition, internal political paralysis prevents Lebanon from effectively facing this challenge. As a result, the balance of risks is tilted to the downside. Spillovers from the Syrian conflict will also continue to be a drag on growth, which is expected to remain below potential for the near term. The balance of risks to our growth projection is similarly tilted to the downside.

Key Economic Indicators

	2013e	2014f	2015f
Real GDP Growth (%)	0.9	1.5	2.0
Inflation Rate (%)	2.7	1.5	3.4
Fiscal Balance (% of GDP)	-9.4	-10.2	-11.2
Current Account Balance (% of GDP)	-8.5	-8.3	-8.0

Libya

Three years after the fall of Gaddafi, Libya is at a political impasse amidst renewed internal strife.

Political instability reached new heights at the end of August when the “Islamists”-dominated parliament called the General National Council, whose term had expired earlier in 2014, refused to recognize the legitimacy of its successor, the House of Representatives, elected at end-June 2014. Each of these “parliamentary” bodies has now appointed Prime Ministers who have in turn formed new governments. Meanwhile armed conflict persists in both the Tripoli and eastern regions. In Tripoli, various militias have coalesced in two loosely defined groups which have been battling for control of the capital and adjacent airport. An intense armed conflict has also been going on in the eastern part of the country, with extremist “Islamist” groups pitted against a coalition led by a retired army general whom many view as operating outside the law.

Civil strife is taking a huge toll on the economy. Oil production and exports, which had recovered in 2012, collapsed again in the first half of 2014 due to a blockade imposed by various militias on the main oil terminals starting July 2013. As a result, Libya’s oil-dependent economy shrank by over 10 percent last year and is expected to contract further by almost 28% in 2014. Fiscal and current account deficits re-emerged in 2013 (estimated at 3.6 and 3.5 percent of GDP respectively) and are expected to worsen substantially in 2014. Liquidity shortages surfaced, and the parallel market exchange rate depreciated by about 10 percent vis-à-vis the official rate. At the time of writing, the government remains cash strapped, although the blockade began to be lifted in June 2014 following a deal struck between the militias and the government. Oil production and exports have resumed but remain significantly below pre-revolution levels because of continued security problems and technical difficulties caused by the extended shutdown of all equipment and pipelines.

Libya faces formidable political and economic challenges. Immediate priorities are to convince all parties to lay down their arms and negotiate the basis for a united polity. Only when security is restored can there be sustainable progress towards political and economic stability. If these conditions are met, the next priorities will be to begin restoring and improving basic services and infrastructure while rebuilding (or, in some cases, simply *building*) government institutions. Political negotiations must also be accompanied by a dialogue on the economic and social reforms that would need to be put in place to rebuild a country damaged by 40 years of autocratic rule and recent civil conflict. Medium-term priorities include reorienting the economy away from hydrocarbon dependence and setting up a governance framework that promotes private sector development, job creation and inclusive growth.

Key Economic Indicators

	2013e	2014f	2015f
Real GDP Growth (%)	-10.9	-27.8	54.3
Inflation Rate (%)	2.6	5.0	5.0
Fiscal Balance (% of GDP)	-3.6	-22.3	-5.0
Current Account Balance (% of GDP)	-3.5	-29.6	-0.5

Morocco

Economic growth has declined recently and unemployment remains a challenge. During the first half of 2014, GDP growth decelerated to 2 percent due to a decline in agricultural output and continued lackluster performance in other sectors. As a result, overall growth is not expected to rise above 3 percent for the full year in 2014. Inflation has remained under control thank to lower world prices of imported basic commodities. Unemployment worsened to 9.8 percent in 2014-H1 (up from 9.2 percent in 2013-H1) as the economy could not create enough jobs to absorb all the new job seekers, especially the urban young and educated, whose unemployment rates reached 36.6 percent and 19.5 percent, respectively.

Measures taken to cut subsidies and improve revenues have reduced the fiscal deficit. Though still high in absolute terms, during January-June 2014, subsidies dropped by 0.6 percent of GDP and the public wage bill also declined by 0.3 percent of GDP. On the revenue side, efforts to improve tax collection through the extension of the tax base, the harmonization of tax rates, and the fight against tax evasion have begun to pay off and fiscal revenues increased faster (4.8 percent) than non-agricultural nominal GDP during the first half of the year. As a result, the budget deficit declined by 0.7 percent of GDP. Given the ongoing implementation of the fuel subsidy and tax reforms, the government should be able to reduce the budget deficit by half a percentage point and reach its deficit target of 5 percent of GDP in 2014. This would help curtail government debt at around 65 percent of GDP in 2014.

Morocco's external position has recently strengthened. Exports of goods and services jumped by 7.8 percent over the period, while imports increased by only 2.5 percent. Tourism also performed well in the first half of the year with tourism receipts growing by 4.3 percent. However, remittances continued to suffer from the sluggish economic recovery in Europe. Overall, the current account deficit is projected to improve to 6.7 percent of GDP in 2014. On the capital account side, Morocco has received large foreign exchange inflows during the first half of the year—including 1 billion Eurobonds raised by the government and US\$1.85 billion raised by the state-owned phosphate company. Net FDI inflows declined by 15 percent but from an outstanding performance in 2013. Net foreign reserves increased to US\$20.6 billion at end July 2014 or the equivalent of 4.6 months of imports.

Government plans to achieve higher growth over the medium term through fiscal consolidation and structural reforms. Government aims to achieve a budget deficit of no more than 3 percent of GDP and a current account deficit of less than 5 percent of GDP over the medium term. Foreign exchange reserves should become more comfortable, especially if Morocco retains the confidence of investors and the financial support of the Gulf countries. On July 28, 2014, the IMF approved a new 24-month arrangement for Morocco in an amount equivalent to SDR 3.2 billion (about US\$5 billion).

Key Economic Indicators

	2013e	2014f	2015f
Real GDP Growth (%)	4.4	3.0	4.6
Inflation Rate (%)	1.9	1.5	2.5
Fiscal Balance (% of GDP)	-5.5	-4.9	-4.3
Current Account Balance (% of GDP)	-7.6	-6.7	-5.8

Oman

The macro-economy continues to be robust, supported by the oil sector and high government spending. Real GDP grew by an estimated 5.2% in 2013 and is expected to pick up further to 5.5% in 2014. Oil production is currently at a medium-term peak of around 0.94 million barrels per day. The non-hydrocarbon sector has been driven mainly by petrochemicals, large-scale infrastructure projects, social infrastructure, and financial services. Non-oil GDP growth is estimated to have increased by 5.6 percent in 2013 and may rise to 7.4% in 2014. The current account balance was at 8.9 percent in 2013 and is expected to decline to 6.7 percent in 2014. Inflation has stayed low at under 3%. The present configuration of oil output and domestic demand support a growth rate forecast of 5.6% for 2015.

The fiscal position has tightened. One recent spending initiative relating to government wage scales has increased the total wage bill by more than 50 percent. The Ministry of Finance estimates the cost to be OMR 900 million (7 percent of total budget expenditure). Together with a declining trend of revenues this is expected to lead to a deficit of 1.3 percent of GDP in 2014. Because of the spending trend in place, the deficit is projected to deteriorate further in 2015 even though the revenue position will improve due to higher oil production at 0.99 million barrels per day.

Capital spending is seen as critical to meeting public expectations. Capital and development spending were increased substantially in recent years in response to concerns arising from public disturbances in 2010-11. The 8th 5-year development plan includes investment of some \$44 billion over 2011–15 (about 20 percent of GDP a year). This provides for major economic infrastructure projects (airport, port, water systems, roads, housing and tourism), and a strong emphasis on education, housing and social infrastructure. With fiscal space tightening, realizing the productivity benefits of this spending surge will be critical.

Lack of jobs for youth is a major economic and social concern. With the working age population growing at over 3 percent a year the economy will have to generate some 45,000 new positions for Omanis each year in order to make a significant dent in the already high unemployment rate, estimated in 2010 to be around 24%. This pace of absorption has only been reached in the past by direct hiring into the public sector workforce. This is not considered a sustainable strategy for the future. Moreover, increases in public sector employment, pay and benefits make it more difficult for the private sector, especially the SME sector, to compete.

Key Economic Indicators

	2013e	2014f	2015f
Real GDP Growth (%)	5.2	5.5	5.6
Inflation Rate (%)	2.8	2.1	2.5
Fiscal Balance (% of GDP)	1.6	-1.3	-1.6
Current Account Balance (% of GDP)	8.9	6.7	4.1

Qatar

Growth continues to be robust, though slower than in previous years as liquefied natural gas (LNG) investment and production level off. For most of the last decade, LNG production expansion, elevated oil prices, and non-oil growth resulted in double-digit annual growth rates. More recently, the plateauing of LNG production levels has resulted in a deceleration in growth to a projected 6 percent in 2014. Strong hydrocarbon prices will continue to benefit Qatar's fiscal and external balances, and surpluses are expected to accumulate in 2014 and 2015.

A pause on further LNG production expansion is in effect, but the hydrocarbon sector will continue to be the mainstay of the economy in the coming years. A moratorium on further tapping (beyond existing flows and confirmed projects) of the giant off-shore North field (shared with Iran) took effect in 2013 and will continue at least until the end of 2014 or later, when further study of its reserve capacity is completed. Nevertheless, a substantial hydrocarbon revenue flow is locked-in for the foreseeable future through existing LNG contracts and ongoing crude oil production. Furthermore, the country is investing in redeveloping some of its mature oil fields and in finding new oil fields. It has also established footholds in downstream petrochemicals, aluminum, and shipping industries. Most recently, Qatar started production at its second helium plant in the summer of 2013, making it the largest exporter and second-largest producer of helium globally.

Medium-term prospects in the gas market are unclear. The most prominent issue is the emergence of shale gas as a potentially major supply source in Europe and the United States. Additionally, Australia is expected to triple its exports of LNG by the end of the decade while Russia, Canada and others ramp up exports as well. At the same time, geopolitical considerations could make Qatar's access to additional gas sources from the North field questionable. On the other hand, the Ukraine crisis is only the latest of a series of major shocks that have boosted the economics of LNG for incumbent players like Qatar.

The Government aims to accelerate the development of the country's non-hydrocarbon sector. The National Development Strategy 2011-2016 (NDS) and the broader Qatar National Vision 2030 prioritize economic diversification. Plans call for spending over a US\$100 billion until 2019 on infrastructure projects that include preparations for the 2022 World Cup, as well as infrastructure for manufacturing and financial services.

Qatar has announced measures to reform its labor policies and ensure better treatment of expatriate workers. An international outcry over the treatment of expatriate workers involved in construction projects related to the 2022 World Cup in Qatar has galvanized government action to reform labor policies. In May 2014, Qatar announced a set of reforms to its sponsorship system to allow expatriate workers more freedom to switch between employers and to exit the country. It also announced measures to ensure workers' wage payments through an electronic system and to prevent employers from forcing employees to work outdoors during the hottest hours of the day.

Key Economic Indicators

	2013e	2014f	2015f
Real GDP Growth (%)	6.1	5.9	7.1
Inflation Rate (%)	3.1	3.5	3.5
Fiscal Balance (% of GDP)	11.1	7.6	4.9
Current Account Balance (% of GDP)	29.2	25.4	20.5

Saudi Arabia

Saudi Arabia is enjoying a period of sustained high growth despite the difficult global and regional environment. Buoyant oil prices and high levels of public spending have enabled Saudi Arabia to register several years of high growth despite difficult global and regional conditions. This has also been the case so far in 2014 with real GDP growth expected at around 5.3% after a dip to 4.5% last year. Non-oil sector growth, while ultimately linked to the oil engine, has been comfortably above 6% for many years now, and is expected to register 6.1% in 2014. Oil production has stayed close to 10 million barrels per day, sustained by a variety of geopolitical factors including the country's important role in the OPEC cartel. Inflation has been in the range of 4-5% for several years and is not expected to deviate from this level in 2014.

The macroeconomic position is strong with the fiscal and current accounts in surplus and reserves at historical highs. High oil prices and stable production levels have enabled surpluses on both fiscal and external accounts for several years now. In 2013, the fiscal surplus was 8.7% and the current account surplus was 16.2% of GDP. Both surpluses are expected to decline in 2014 but will remain positive at 5.7% and 12.4% respectively thereby contributing further to external reserves which are now at a historical peak level of around \$750 billion. The composition of fiscal spending is tilted towards human development (with health and education accounting for 38%) as well as towards transport and urban services.

Longer term challenges include generating jobs for nationals. High economic growth has not led to adequate absorption of Saudi nationals into the private sector work force. Over the years, labor policies have generated a big gap between public and private sector wages as well as between wages for nationals and those for expatriates. This has led to private sector employers preferring to hire expatriates rather than Saudi nationals and the latter preferring to join the public sector rather than the private sector. In recent years, government has attempted to expand jobs for nationals by redesigning the quotas that apply to expatriate employment in different sectors. Under the redesigned system (called Nitaqat) more incentives are available to employers who achieve their quotas. Some reduction in national unemployment has been observed recently, from 12.2 percent in 2012 to 11.5 percent in 2013. However, this tendency may have been partly offset by new hiring and pay increases in the public sector that have likely enhanced the preference of job seekers to wait, remaining unemployed, until a public sector job arises.

Key Economic Indicators

	2013e	2014f	2015f
Real GDP Growth (%)	4.5	5.3	5.5
Inflation Rate (%)	4.0	4.1	4.0
Fiscal Balance (% of GDP)	8.7	5.7	0.5
Current Account Balance (% of GDP)	16.2	12.4	6.5

Syria

The ongoing conflict in Syria is having an enormous human and economic impact. More than 190,000 Syrians have been killed and almost half the population has been displaced. This includes about 6.5 million internally displaced persons, 2.9 million refugees registered or awaiting registration with UNHCR in neighboring countries, and more than 1.5 million non-refugee migrants. More than 10.8 million Syrians within the country are in need of humanitarian aid. The lack of access to health care services and a scarcity of medicine have led to a catastrophic health situation in several regions. Hunger and nutrition are also matters of concern as food has become scarce in some areas. School attendance has declined dramatically with 52% of school-age children not attending in the 2013/2014 academic year. Unemployment is estimated to have reached almost 54 percent of the labor force by the end of 2013. Overall poverty incidence may have reached 75 percent at end-2013, with large differences across governorates, while extreme poverty affected 54 percent of the population.

Available estimates suggest substantial economic contraction in 2012 and 2013 followed by a milder contraction in 2014. The Economist Intelligence Unit (EIU) estimates that the economy shrank by more than 19 percent per annum in 2012 and 2013 respectively. The Syrian Center for Policy Research (SCPR) estimates a more dramatic contraction of 31 percent in 2012 and 38 percent in 2013. The EIU expects that the Syrian economy will grow at a modest 1.8 percent rate in 2014, driven by the economy's adjustment to the military stalemate in addition to the considerable migration of businesses to the more stable coastal areas including the industrial zone near Tartous. Inflation seems to be slowing down, with the EIU projecting a CPI growth rate of 35 percent for end-2014 compared to 90 percent in 2013.

The fiscal situation continues to deteriorate. The EIU estimates a budget deficit of around 17 and 12 percent of GDP in 2012 and 2013 respectively, and projects a deficit of around 9 percent of GDP in 2014. SCPR estimates are even higher, at 34 and 54 percent of GDP in 2012 and 2013 respectively. The latter estimates are consistent with public debt reaching 126 percent of GDP at end-2013, with domestic debt accounting for 74 percent of GDP and foreign debt reaching 53 percent of GDP.

The currency continues to be under pressure. Following significant depreciation over the past two years, the exchange rate is expected to reach around 161 Syrian pounds per USD by the end of 2014. Pressure is likely to continue in 2015 due to depressed export revenues and international sanctions. While the gap between the official and unofficial rate is currently narrow, at one point in July 2013 the unofficial rate had reached a level of 221 Syrian pounds to the dollar.

Key Economic Indicators

	2013e	2014f
Real GDP Growth (%)	-18.7	1.8
Inflation Rate (%)	89.6	34.8
Fiscal Balance (% of GDP)	-12.4	-8.9
Current Account Balance (% of GDP)	-12.2	-11.0

Note: Compiled from Economist Intelligence Unit sources.

Tunisia

The post-revolution political transition is on track in Tunisia. Following the resolution of the political crisis at the end of 2013, agreed steps are being implemented on schedule. A new Constitution was promulgated in early 2014 and a non-partisan technocratic government was appointed in parallel. Legislative elections are to be held on October 26, followed by Presidential elections on November 23. Despite government efforts, the security situation remains volatile, especially on the border with Algeria, where scattered terrorist attacks have occurred, and Libya, where refugee pressure is high.

Economic growth has been weak recently and unemployment remains a challenge. Growth of only 2.3 percent was registered in 2013 (compared to 3.7 percent in 2012) because of the political and security tensions during the year. Despite the recent improvement in the political context, the economy has remained weak, growing at only 2.1% in the first half of 2014, on account of slow manufacturing production, low investment (public and private) and sluggish tourism activity. Inflation has been relatively high at around 5.7 percent in 2013 and up to 6 percent so far in 2014, reflecting rising food and energy prices as well as the depreciation of the exchange rate. While unemployment declined to 15.2 percent (first quarter 2014) from a high of 18.9 percent in 2011, this reflects hiring in the public and parastatal sectors, which cannot be sustained in the medium run.

The fiscal deficit remains high though within IMF target limits. Large wage and subsidies expenditures increased the fiscal deficit to 6.2 percent of GDP in 2013. The deficit was financed domestically, mainly by drawing down the stock of government deposits at the Central Bank. For 2014, preliminary figures show lower spending on subsidies and improved tax collection but the deficit is still expected to reach 6.5 percent of GDP, higher than in 2013 but in line with the target agreed with the IMF. The main fiscal consolidation effort is expected to take place in 2015 when the deficit is to be brought down to around 5 percent of GDP.

A high current account deficit has maintained pressure on the currency. The current account deficit is expected to rise to 9.1% of GDP in 2014 from 8.4% in 2013, due to weak exports, increased energy imports and low tourism receipts. With limited access to capital markets and low FDI inflows (US\$190 million in the first quarter of 2014, 20 percent below 2013 levels), Tunisia's external financing options rely heavily on official sources. The currency has remained under pressure, with the exchange rate losing about 10 percent of its value vs. both the US dollar and the Euro in recent months.

Medium term prospects depend on the continuation of an orderly political transition and the return of sound macroeconomic policies and structural reforms. The government and the National Constituent Assembly are considering adopting reforms relating to the investment climate and the financial sector. These reforms would send important positive signals and counter some of the uncertainty arising from the political transition, the sporadic social and security tensions, the slow recovery in Europe and the renewed crisis in Libya. In this context, growth of 2.2% is projected for 2014 and 2.7% for 2015.

Key Economic Indicators

	2013e	2014f	2015f
Real GDP Growth (%)	2.3	2.2	2.7
Inflation Rate (%)	5.7	5.7	4.9
Fiscal Balance (% of GDP)	-6.2	-6.5	-5.0
Current Account Balance (% of GDP)	-8.4	-9.1	-8.6

United Arab Emirates

The UAE economy is performing well on the back of a resurgent non-oil sector. Oil production is now near capacity but a revitalized non-oil sector has sustained real GDP growth in the neighborhood of 5% since 2013. Some of the bravado of pre-2008 Dubai has returned (home prices rose by 35 percent in 2013) and its services and logistics business model has been resilient. Nevertheless, lessons have been learned: in both Abu Dhabi and Dubai, the local governments have moved to gain direct control over commercial property development entities and to ring-fence those from the government balance sheet.

Dubai's successful debt restructuring of government-related enterprises (GREs) is being tested in 2014 as some extended repayments come due. A common element to the restructurings was extensions of bank debt maturities with terms depending on creditor priority (i.e. secured creditors got better terms than unsecured). Cash to meet immediate GRE needs was supplied by a US\$20 billion loan backstopped by Abu Dhabi in 2009. This loan was due for repayment this year, but has now been extended to 2019 with an interest rate of 1 percent (in contrast to 4 percent on the original loan).

Commercial banks and the government continue to broker the practical lessons of the 2008 crash. Although banks are well managed, they have high loan concentrations including working capital exposures to major property developers. Initial attempts to put in place stronger prudential measures saw some pushback from influential commercial banks with demands to exclude commercial bank holdings of GRE bonds from exposure limits, while allowing them to count favorably in liquidity ratios. While tighter consumer and mortgage lending regulations have been introduced, banks have gained some concessions regarding loan-to-value ratios for mortgages and the ability of expatriates to hold multiple mortgages.

Abu Dhabi is completing existing development initiatives, though there is some uncertainty about oil sector policy. The tourism/culture megaprojects remain on their revised track, and various sovereign development entities continue their mix of strategic investments at home (e.g., Masdar solar) and abroad (European and East Asian energy and finance). The government has struggled to maintain a fully arms-length relationship from public commercial companies: Etihad (the airline) and Etisalat (telecom) were both revealed to be in receipt of large albeit one-off financial transfers. Regarding the oil sector, the Abu Dhabi National Oil Company allowed the 75 year old onshore oil concession to lapse, and for now is operating the fields itself. However, it is generally believed that financing and technical needs to expand or even maintain oil production will necessitate a new deal with international oil companies.

Growth should remain in the 4-5 percent range for 2014-15. The UAE remains the pre-eminent GCC hub. Dubai's port and free zone has a strong logistics and trade facilitation advantage. Dubai remains a crucial commercial window for Iran and is well positioned as a platform for Iranian investment in a post-sanctions era. Abu Dhabi's non-oil growth remains investment-driven, but in the medium-term, realizing the benefits of these projects will be critical.

Key Economic Indicators

	2013e	2014f	2015f
Real GDP Growth (%)	5.2	4.7	4.5
Inflation Rate (%)	1.1	2.5	2.8
Fiscal Balance (% of GDP)	6.5	7.2	6.3
Current Account Balance (% of GDP)	16.1	12.1	11.8

West Bank and Gaza

The political outlook in the Palestinian territories remains highly uncertain despite the achievement of a ceasefire between Israel and Hamas in Gaza. Following President Abbas's announcement of the formation of a consensus government with Hamas in mid-2014, Israeli-Palestinian relations began deteriorating, leading to a military conflict in Gaza during July-August 2014. The human and physical toll of the 7-week conflict was devastating with more than 2,130 Palestinians killed and more than 100,000 left homeless. Even though an Egyptian-brokered ceasefire came into effect on the 26th of August 2014, the outlook remains highly uncertain. A recent UN facilitated agreement between the Palestinian Authority and the Government of Israel may allow easier movement of people and materials into Gaza for reconstruction; however, no progress has been made on ending the blockade that has been imposed on Gaza since 2006-7. Meanwhile, the Government of Israel has announced a decision to appropriate about 1000 acres of Palestinian land for the building of yet more settlements. Internally, the Palestinian Authority and Hamas have recently agreed to transfer control over Gaza to the Authority. Details of governance arrangements under this agreement and a timeline for national elections are yet to be worked out.

The Palestinian economy was slowing even before the recent Gaza conflict. Growth dropped from 6.3 percent in 2012 to 1.9 percent in 2013 as a result of political uncertainty, a reduction in aid, ongoing restrictions on the movement of goods and people into the Palestinian territories and the collapse of tunnel activity between Gaza and Egypt, which had a severe impact on economic conditions in Gaza. The deterioration continued in 2014 and preliminary estimates by the Palestine Central Bureau of Statistics (PCBS) indicate that the economy fell into recession in the first quarter of the year with growth amounting to -1 percent: 0.5 percent in the West Bank and -4 percent in Gaza. It is expected that the economy will shrink by at least 3.7% overall in 2014. In addition, unemployment has surged, reaching 45 percent in Gaza (Q2 2014), which is almost three times higher than that in the West Bank at 16 percent.

An already difficult fiscal position has been made worse by the recent conflict. Even prior to the conflict, the fiscal position of the Palestinian Authority was challenging for a number of reasons. First, budget support has declined compared to its peak in 2008, and even though there has been a substantial fiscal adjustment in response, it has not been commensurate with the reduction in aid flows. Furthermore, even though the PA's revenue performance has been improving, it remains weak particularly due to the low amount of revenues collected from Gaza compared to expenditures there. The tax base in the West Bank also remains narrow. Additional spending for reconstruction efforts in Gaza will add significant pressures to an already tight budget. This means that additional recourse to external budget support will be necessary in 2014, perhaps even more than the \$1.5 billion currently forecast.

Key Economic Indicators

	2013e	2014f	2015f
Real GDP Growth (%)	1.9	-3.7	4.4
Inflation Rate (%)	1.7	2.6	2.8
Fiscal Balance (% of GDP)	-12.3	-13.5	-12.7
Current Account Balance (% of GDP)	-29.1	-37.5	-39.7

Notes: Fiscal and current account balance data do not include external financing and transfers.

Yemen

Yemen's economy deteriorated in the first half of 2014, mostly due to the sabotage of oil pipelines. In 2013, non-hydrocarbon growth was steady at about 4 percent, while hydrocarbon growth picked up strongly, reversing part of the oil output decline in 2012 and 2011. As a result, real GDP growth increased to 4.8 percent from 2.4 percent in 2012. At the same time, average inflation edged up slightly to reach 11 percent—up from about 10 percent a year earlier—and the exchange rate remained stable. During the first half of 2014, the frequent sabotage of oil pipelines resulted in a significant decline in oil production and exports. Severe fuel and electricity shortages have adversely affected economic activity, with real GDP growth expected to decelerate to less than 2 percent in 2014. Declining oil production and exports have caused oil revenues to drop by about 19 percent so far compared to the first half of 2013, thereby reversing the improvement in the fiscal deficit that had occurred between 2012 and 2013.

A reform program was launched in July 2014 only to be overtaken by major political developments, such as the recent capture of Sana'a by Houthi rebels. The reform program aimed to reduce the fiscal deficit, reorient public expenditure to pro-growth/pro-poor outlays, enhance governance and the business environment, and promote inclusive growth and job creation. The program is supported by a \$553 million three-year IMF Enhanced Credit Facility (ECF) approved early in September. Other donors who have confirmed financial assistance to the program include the World Bank (\$100 million), the Kingdom of Saudi Arabia (\$435 million budget support and \$807 million in fuel products) and the United States of America (\$30 million grant). As a first step, the government ended fuel subsidies in July, boosting prices by 60-90 percent. However, following protests over the reduction of subsidies and a dramatic take-over of Sana'a in September 2014 by Houthi rebels, the full implementation of the program is now uncertain.

Yemen's medium-term outlook hinges on successful resolution of the Houthi rebellion and takeover and a quick return to normalcy and security. If political stability is restored and the program agreed with international donors is followed, the economy is expected to recover in 2015, growing by 4.6 percent. The fiscal and external positions will improve gradually over the medium term as a result of reforms and the recovery of hydrocarbon exports and upward revisions in the contracted low LNG export prices.

Key Economic Indicators

	2013e	2014f	2015f
Real GDP Growth (%)	4.8	1.9	4.6
Inflation Rate (%)	11.0	9.0	11.4
Fiscal Balance (% of GDP)	-7.8	6.8	6.0
Current Account Balance (% of GDP)	-3.1	-1.3	-1.1

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