MENA economic and development prospects 2013: Investing in Turbulent times

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Introduction: The political and social upheavals that followed the Arab Spring of 2011 continue to dominate economic activity and near term prospects in the Middle East and North Africa (MENA). Although political transitions bring promises of greater political and economic freedom, in MENA the process remains far from complete and has been accompanied by increased political and macroeconomic instability in 2013. In Egypt, rising social and political tensions weighed heavily on confidence. In Syria, a marked escalation of the civil war exacted a heavy economic and human toll, with spillovers to neighboring Lebanon, Jordan, and Iraq. Oil production in developing MENA oil exporters has fallen because of security setbacks, infrastructure problems, strikes, and in the case of Iran, economic sanctions. Meanwhile, the GCC oil exporters continue to make up the loss in oil production, while providing financial support to the region’s transition economies.

The 2013 Regional Outlook: The outlook for 2013—and more so for 2014—is uncertain and subject to a variety of risks, mostly domestic in nature and linked to political instability, while global economic conditions have become more favorable. In 2013, economic growth is expected to remain weak or weaken relative to 2012 across MENA and average 2.8%, down from the estimated 5.6% in 2012. Growth has been most volatile in the MENA’s developing oil exporting countries, and is projected to slow down considerably due to unfavorable developments, especially in Libya, Iran, and Syria. Growth of MENA’s oil importing countries is expected to remain weak and below potential, but performance will strengthen slightly relative to 2012 (see Figure 1). The economic expansion of the GCC economies will slow down relative to

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1This Quick Note is based on the Executive Summary of the October 2013 MENA Economic Development and Prospects (EDP) report. This MNA K&L Quick Note was cleared by Shantayanan Devarajan, Chief Economist of the MENA Region, the World Bank. Elena Ianchovichina is Lead Economist in the Office of the Chief Economist of the MENA Region, the World Bank. Martijn Burger is Assistant Professor at Erasmus University, Rotterdam, the Netherlands.
2012, but their pace will still be strongest in the region. Assuming the political situation evolves toward greater stability and clarity, economic growth is expected to pick up and average 4% in 2014.

Oil importing countries will continue to face external financing difficulties and fiscal pressures, but macroeconomic vulnerabilities have also been growing in developing oil exporting countries. The absence of significant economic reforms, combined with persistent political and macroeconomic instability, is likely to keep investment and growth below potential in developing MENA not only in the short run, but in coming years, unless there is a break with past practices.

**Figure 1 - Post Arab Spring Regional Growth Record and Outlook (annual % change)**

A more disparate picture of FDI in MENA shows some differences from the rest of the world and over time. Although the region attracted more FDI in the 2000s relative to the 1990s, reflecting improvements in the business environment in many economies, the majority of countries performed below potential. In addition, FDI was concentrated in the resource-intensive and services sectors, while nonoil manufacturing FDI remained weak. Developing oil importing countries received just 30 percent of the region’s FDI inflows and a large amount of it came from the GCC economies. As oil prices rose in the 2000s, source countries shifted investments toward the oil exporting countries in the region. After 2010, FDI inflows declined across the region, public investment declined in developing MENA, while domestic private investment remained relatively unaffected.

**Figure 2 - Net FDI Inflows to MENA and Other Developing Countries (% of GDP)**

Whether the post-2011 decline in FDI has been due to political instability is not clear-cut, just as it is not in the literature. Some aspects of instability, including the quality and stability of government institutions and policies, did play a role, but others, such as democratic accountability, did not. Furthermore, FDI flows to the resource-intensive and nontradable sectors appear immune to political instability, but FDI flows to the tradable sectors exhibit a clear negative response. Overall, the rise in political instability associated with the Arab Spring events (Figure 3) has had a significant,
negative effect on FDI flows to the region (Figure 4). Finally, economic conditions have continued to play an important role in attracting FDI.

Figure 3 - Political Instability Index, 2000-2012

Source: ICRG database. *Note: An increase in the index reflects an increase in political instability. MENA=Middle East and North Africa; GCC = Gulf Cooperation Council; OECD=Organization for Economic Co-operation and Development.

Policy Challenges and Priorities in MENA: The findings of the EDP outline several policy challenges and priorities. The report argues that MENA countries may find themselves in a resource trap unless they strengthen institutions and improve the investment climate, especially political and macroeconomic stability. Protecting the property rights, and committing to stable and transparent policies will encourage investment, especially foreign investment in the labor-intensive nonoil manufacturing and service sectors of MENA, and thus job creation, growth, and structural transformation. Achieving consensus on political reforms is a necessary pre-requisite for sustainable, high growth in developing MENA. But so are structural reforms that address long-standing challenges, including distortionary and unevenly enforced regulations, favoring of privileged businesses, macroeconomic imbalances and expensive subsidies, inadequate and irregular provision of electricity and other infrastructure services, problems with education quality and skills, and poorly functioning markets for labor, goods, and finance. These structural issues constrain growth, with grim consequences for the structural unemployment problem, especially among youth and women.

More broadly, political turbulence since the early 2000s has affected not only the level of FDI in MENA, but also its composition; it has skewed it towards activities that create the least jobs or that create jobs in non-tradable sectors. At the same time, it has discouraged the high quality FDI in non-resource tradable manufacturing and services needed for export upgrading and diversification. By hurting these efficiency-seeking investments, shocks to political stability exacerbate the clustering of FDI in the extractive industries and non-tradable sectors – a problem associated with policy distortions and political capture that predate the Arab Spring.

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