OVERHAULING THE ARAB WORLD'S ECONOMIES

Illustrations by Magda Azab

The Middle East and North Africa can capitalize on a changing global environment

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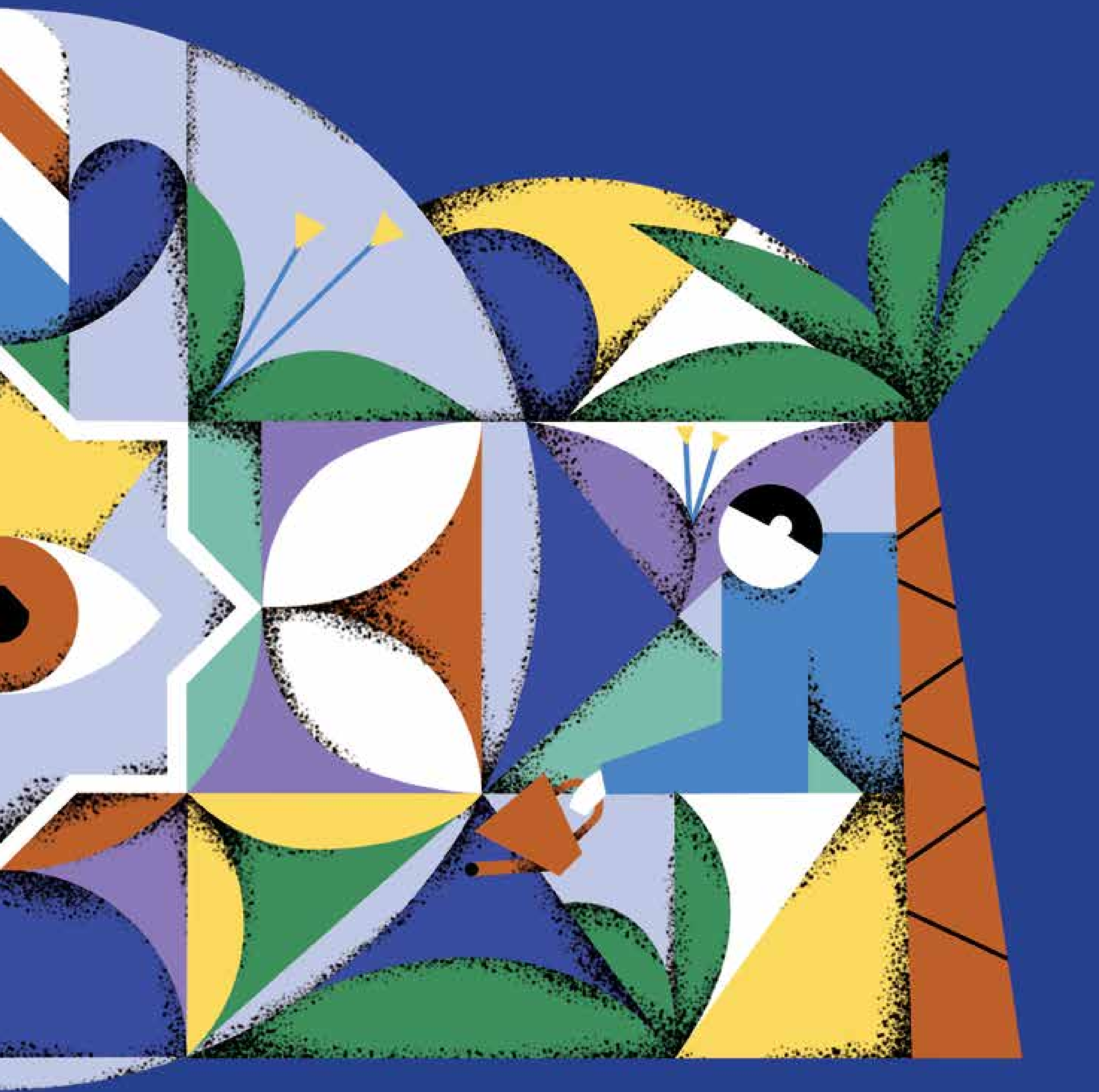

It's time to rethink the engines of economic growth across the Middle East and North Africa. In a rapidly changing world, the region's two dozen nations hold unprecedented opportunities to secure inclusive growth, create high-quality jobs, and better serve the aspirations of its 600 million people.

The region spans 4,000 miles and four time zones from Morocco to the Islamic Republic of Iran. It includes some of the world's wealthiest nations—Qatar, the United Arab Emirates, Saudi Arabia—and some of the poorest—Somalia, Sudan, Yemen. While the nations of the Arab world have diverse economies and populations, they share many characteristics, including history, language, and profound cultural ties.

In the past two decades, the Middle East and North Africa have experienced both significant change, including the Arab Spring uprisings of 2010–11, and not enough forward-looking transformation—persistently lackluster growth, low female labor force participation, and high youth unemployment. Some countries face intensifying pressures related to debt, high inflation, demographics, and equity.

Nonetheless, amid these challenges lie new opportunities to secure inclusive growth and create sustainable jobs on the back of the pandemic, climate change, and the digital revolution. These include digitalization, green investment, new economic markets, the energy transition, and the changing nature of work. Already, countries including Egypt, Mauritania, Morocco, and the United Arab Emirates are moving to tap into green energy. The region could also grasp the potential to benefit from expanded intraregional trade as global supply chains undergo realignment.

The status quo of state-dominated economic activity will be hard to sustain, especially for heavily indebted countries facing high financing costs. Already swamped with high levels of youth unemployment and gender inequality, these countries won't be able to absorb the more than 100 million people who are projected to enter the workforce in the next 10 years unless they change their growth model. No-change policy will severely threaten vulnerable social cohesion—on top of the strains caused by the rapid warming of the planet and the dramatically evolving global economy.

A "new deal" for the region will be to deliver for its people on well-known and long-standing goals: more jobs, better education, greater dignity, better governance, and a broader, fairer distribution of economic opportunities and resources. How can the nations of North Africa and the Middle East achieve transformation, reduce vulnerabilities, and build resilience to future shocks? How can they drive change while promoting greater global cooperation?

Economic stability

Focusing on macroeconomic and financial stability is a start. While many governments rightly increased spending and provided social support to confront the COVID-19 pandemic and the cost-of-living crisis, such measures did not come without cost and often required borrowing. Higher debt servicing costs mean less room for fiscal maneuver as governments continue to face risks from future shocks, contingent liabilities, and worsening climate stress.

As they pay down debt, governments should mobilize revenue, withdrawing ineffective exemptions and improving tax equity; limit spending on untargeted subsidies; and control the public sector wage bill. Such outlays are rigid and constrain governments' ability to respond to shocks or finance education, health care, and social protection. For example, in Tunisia that kind of spending accounts for four-fifths of revenues.

On the monetary policy side, central banks should continue to be forward-looking, with a clear focus on price stability while maintaining financial stability as needed. Policy needs to be adjusted in line with new data, developments in global conditions, and the policy posture of major central banks.

Simply preserving macroeconomic stability, however, will not deliver the intended transformational change. Stability is the foundation, not the house. Achieving truly inclusive growth will also require structural reforms.

A strong and well-designed social safety net is essential for maintaining social cohesion. Most of the region's social spending goes to untargeted, broad subsidies. While these help ensure affordable access to food and fuel for the poor, they entail enormous waste, as most of the benefits accrue to the wealthy, and they limit governments' ability to invest in better-targeted programs.

Replacing generalized price subsidies with targeted support would mean that those most in need could experience an immediate and visible improvement. Along these lines, Morocco removed fuel subsidies in 2016, Egypt introduced an automatic fuel price index mechanism in 2019, and Mauritania substantially reduced untargeted fuel subsidies while progressively increasing cash transfers to the most vulnerable.

More efficient targeting mechanisms can also be implemented quickly. During the pandemic, Morocco was able to swiftly reach informal workers with a cash transfer program using digital payments. Similarly, Jordan improved the targeting of its cash transfer system, greatly broadening its reach.

Expanding the private sector

Ensuring a more inclusive role for the private sector will be key for job creation. The private sector generates more than 90 percent of jobs in developing economies. As the public sector works on delivering an enabling environment, private enterprise should take on the responsibility of increasing investment, productivity, and competitiveness while training the workforce to take advantage of a changing technological world.

Hence, the private sector needs to be in the driver's seat for expanding economic activity, supported by a strong and efficient public sector. In turn, governments' role in developing institutions, correcting market failures, and providing public goods is key. Educational improvements will be essential to ensure the formalization of the labor force—improving people's income security and access to social protections—and the development of adequate skills for people to perform

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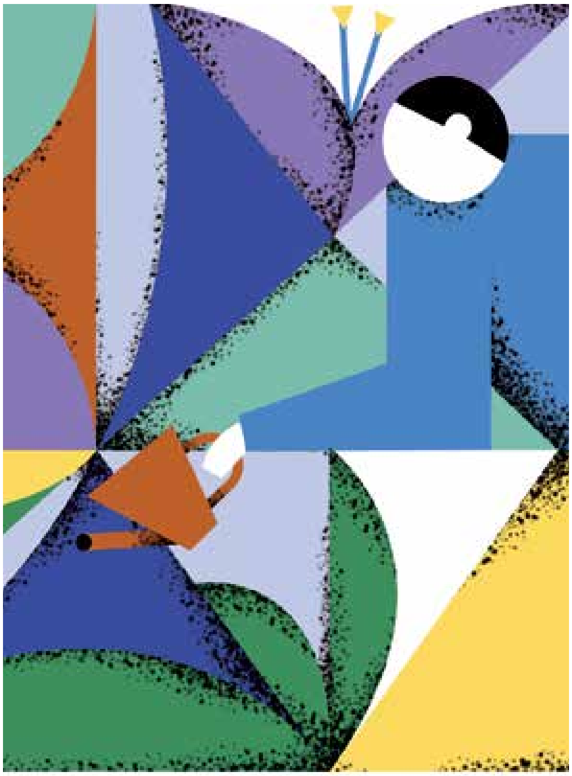

in the private sector. Removing legal barriers and discriminatory practices would help bolster female labor force participation.

Currently, the region's state-owned enterprises are sprinkled across the economic spectrum, ranging from tobacco, textiles, foodstuffs, and furniture manufacturing to communications and electricity production. This outsize presence of the public sector in commercial activities and as an employer of first resort creates inefficiencies and distortions, weighing heavily on overall productivity growth.

Stronger economic governance and decisive anti-corruption policies are key to fostering faster and more inclusive growth while ensuring that everyone has a voice. Political and economic participation safeguards accountability in the use of public resources and the provision of services. It also strengthens social cohesion and trust and ensures that the benefits of growth can be spread across society. As reforms progress, it will be important that governments provide supporting evidence for decisions and outcomes and hold themselves accountable. Transparent institutions with strong accountability ensure that the rules of the game are fair and clear.

Emphasis on resilience

The energy transition and climate resilience have become even more urgent. In a region with significant water and food needs, climate change will further exacerbate record levels of hunger. These are likely to deepen economic upheaval, conflict, and human displacement. Tunisia's tourism and fishing sectors face the threat of beach erosion, with significant implications for activity and employment. In Mauritania, growth could fall by as much as 1 percentage point as drought intensifies, but expanding access to electricity could cut the losses in half.

Clearly, proactively bolstering resilience to climate change is an urgent priority. Some countries have already begun investing in renewable energy and climate-resilient infrastructure while enacting measures that raise the effective cost of carbon emissions, including the phaseout of subsidies. Morocco in recent years built the world's largest concentrated solar plant, which uses reflected heat to drive power generation even after the sun sets. Egypt pioneered green bonds in the region and has accelerated the integration of renewable energy over the past decade.

Governments should give priority to measures that are beneficial under all plausible climate-change scenarios and build adaptation capacity. World Bank simulations for Morocco show that investment in water infrastructure would improve resilience to drought, reducing GDP losses by almost 60 percent and capping the rise in public debt. For lower-income, fragile, and conflict-affected countries, the immediate priority should be strengthening disaster preparedness, water resource management, and climate-adapted infrastructure. These countries should also upgrade the capacity of institutions to address climate change and the ability of communities to respond to shocks.

Embracing new technologies could fuel a dramatic transformation. According to the World Bank, GDP per capita in the region could rise by more than 40 percent as digitalization elevates efficiency, inclusion, and resilience. There remains, however, much untapped potential. Smartphones are widely used, but e-commerce is still nascent. Disparities in digital adoption also remain between low-income and high-income nations.

To promote digitalization, governments need to create a strong enabling environment. This means enhancing digital infrastructure, upgrading digital literacy, and developing skills in the workforce. Such measures would alleviate adoption costs, especially for small and medium enterprises. Tunisia, for example, began this shift in 2018 with its Startup Act, which simplifies administrative procedures to encourage entrepreneurship and innovation in the digital sector.

Change is a journey

Reforms will take time to bear fruit, but to ensure their success some basic yet critical ingredients must be in place. Based on past experiences across countries, governments' full ownership is key for the success and durability of reforms. Such ownership will help governments overcome resistance to change. The second ingredient is transparent communication to inform the public of the necessity of change and to build support for difficult choices. This requires a real two-way dialogue, in which governments receive and incorporate feedback from key stakeholders. People should feel that they have the power to influence outcomes and not be subject to policies that benefit only a few.

Progress in structural transformation is not linear. Many governments have attempted to deliver sustained and broad change only to be confronted with unfavorable external shocks, difficult domestic conditions, and internal and external conflicts. In addition, any perception that "reforms" are rigged to benefit a privileged few can hinder momentum. For these reasons, sequencing is key: starting with measures that deliver broad gains and capitalizing on quick wins to overcome skepticism and build a track record. There will be times of rapid progress and times when changes stall. Original plans should be ambitious and flexible enough to adjust to changing circumstances. As former US President Dwight D. Eisenhower once said, "Plans are nothing; planning is everything."

In sum, macroeconomic stability is an important outcome, but it isn't enough in itself. As the Arab upris-

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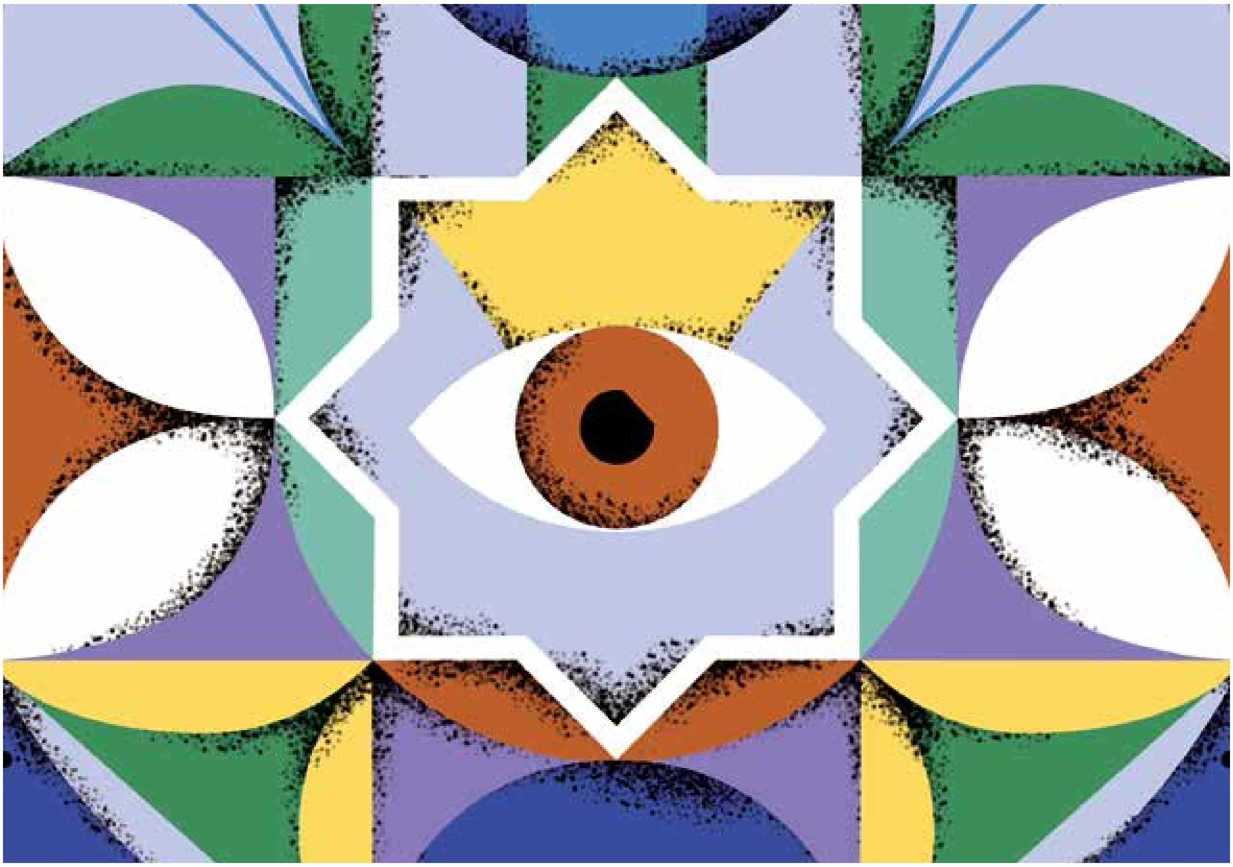

ings and protests in Latin America have shown, stability without jobs, shared prosperity, and voice will go only so far. Stability matters because it allows governments to make structural transformations, which in turn reinforce a country's resilience and ability to preserve stability.

A renewed regional partnership

Today's fragmented global landscape calls for a reboot of regional partnerships in the Middle East and North Africa. Less trade integration would do the most harm to low-income countries in a highly fragile region, and reduced capital flows and foreign direct investment would further constrain these countries' financing, technology diffusion, and growth prospects. As global links weaken, it will be more important than ever to strengthen regional ties in trade and investment.

In this context, members of the 42-year-old Gulf Cooperation Council—Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates—have taken steps to support regional investments. But despite multiple trade agreements across the Middle East and North Africa, trade within the region remains weak.

As more advanced economies engage in "friend-shoring," it will be essential for nations in this region to diversify their economies and develop greater regional self-sufficiency. This would help improve resilience to exogenous shocks and market volatility.

As the world shifts, the international community will also need to learn from what has worked in the past and what has not. As this region undergoes a fundamental rethinking, the rest of the world should also reconsider how to address global existential threats such as climate change and pandemics and how to avoid runaway fragmentation. Multilateral institutions should upgrade rules to ensure cooperation on global public goods, fair competition, and adequate protection of the most vulnerable.

One unavoidable lesson from the past is that nothing that is forced from outside a country can work if there is no buy-in within the country. Jordanian authorities, who sought support from the IMF in 2019, have consistently shown strong ownership in the implementation of their IMF-supported program. Morocco's successful transformation over the past decade was supported by IMF credit facilities. These countries are a testimony to how a homegrown economic overhaul can be effective in transforming a country. In turn, multilateral institutions must play their role in opening dialogue, seeking consensus, and promoting careful and consistent implementation. F&D

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