

Toward New Horizons

Arab Economic Transformation Amid Political Transitions



Prepared by a staff team led by Harald Finger and Daniela Gressani, comprising Khaled Abdelkader, Khalid AlSaeed, Alberto Behar, Sami Ben Naceur, Christine Ebrahimzadeh, Asmaa El-Ganainy, Samar Maziad, Aiko Mineshima, Pritha Mitra, Preya Sharma, Charalambos Tsangarides, and Zeine Zeidane

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Cataloging-in-Publication Data
Joint Bank-Fund Library

Toward new horizons: Arab economic transformation amid political transitions / prepared by a staff team led by Harald Finger and Daniela Gressani comprising Khaled Abdelkader [and eleven others]. – Washington, D.C. : International Monetary Fund, c2014.

“Middle East and Central Asia Department.”

Includes bibliographical references.

ISBN 978-48431-146-2

1. Economic development—Arab countries. 2. Arab countries—Economic policy. 3. Fiscal policy—Arab countries. 4. Monetary policy—Arab countries. 5. Foreign exchange rates—Arab countries. I. Finger, Harald. II. Gressani, Daniela, 1956– III. Abdelkader, Khaled. IV. International Monetary Fund. V. International Monetary Fund. Middle East and Central Asia Department.

HC498.A73 2014

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Acknowledgments

The paper is the outcome of an interdepartmental project of the IMF's Middle East and Central Asia Department with the Communications, Fiscal Affairs, Monetary and Capital Markets, Research, and Strategy, Policy, and Review Departments.

The authors would like to thank Masood Ahmed, Director of the Middle East and Central Asia Department, for his guidance and comments. They are also thankful for advice and support in coordination from Prakash Loungani, David Marston, Marco Pinon, Christoph Rosenberg, and Abdel Senhadji; and for guidance on political economy issues from Raj Desai.

Thanks are also due to Yasser Abdih, Abdul Malik Al-Jaber, Nabil Ben Ltaifa, Ralph Chami, Jean-François Dauphin, Shantayanan Devarajan, Ishac Diwan, Gilda Fernandez, Edward Gemayel, Christopher Jarvis, Juha Kähkönen, Alfred Kammer, Kristina Kostial, Inutu Lukonga, Amine Mati, Tokhir Mirzoev, Eric Mottu, Galle Pierre, Bjoern Rother, Randa Sab, Nasser Saidi, Hossein Samiei, Carlo Sdravovich, Gazi Shbaikat, Natalia Tamirisa, Shahid Yusuf, and Younes Zouhar for providing comments at various stages of drafting the paper.

Special thanks are due to Gohar Abajyan and Jaime Espinosa-Bowen for their research assistance, Kia Penso for her editorial contributions, Cecilia Prado de Guzman for assistance with formatting and document preparation, and Joanne Johnson and Katy Whipple for editorial guidance and production support.

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Preface

The transformations in the Arab world that began three years ago had their roots not only in demands for more voice and participation but also in a growing frustration with the economic environment where job opportunities were few and connections seemed to be more important than merit in accessing the gains from economic growth. Since then, governments in these countries have been pursuing country-specific agendas of political and constitutional reform, but they have also had to grapple with heightened macroeconomic vulnerabilities, the effect, in part, of a worsening international, regional, and domestic environment on private sector confidence and growth. The near-term economic outlook continues to be challenging and subject to downside risk, and so the focus on maintaining macroeconomic stability will remain a key priority for the coming year.

However, it is also important for these governments to embark on the bold reform agendas that will make for more dynamic and inclusive economies, generate more jobs, and provide equal access to economic opportunity for all segments of society. Unless strong economic and financial reforms are implemented, a gradual economic recovery will not be enough to bring a meaningful reduction in the region's high rates of unemployment in coming years, particularly among women and youth.

Realizing the economic potential of the Arab Countries in Transition lies first and foremost in the hands of countries' governments. But the international community, including the IMF, can help. With the benefit of hindsight, it has become clear that in past years we paid insufficient attention to growing socioeconomic imbalances and unequal access to economic opportunity. The Arab transitions have thus prompted us to step back and rethink our approach to economic policy recommendations for the countries undergoing transition. While we have been actively engaged in all transitioning countries, with a focus on macroeconomic stabilization and policies in support of economic development, we have to date not laid out our comprehensive view on the macroeconomic and structural policies that we see as essential for safeguarding macroeconomic stability and putting in place the right conditions for high, sustainable, and inclusive growth. This publication attempts to fill that gap and to provide our intellectual contribution to the ongoing discussion on setting the right policies in the Arab Countries in Transition.

In this spirit, I hope that this publication will be of use for policymakers and other stakeholders in the countries undergoing transition, and for the international community that supports them, in order to enable an economic transformation that will respond to the hopes and aspirations of their young and dynamic population.

Masood Ahmed
Director, Middle East and Central Asia Department
International Monetary Fund

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Introduction and Summary

The political transitions in the Arab world have created an opportunity for economic transformation. The political landscape is changing and new stakeholders have become active, while old vested interests standing in the way of reform may have been weakened. This setting provides a historic opportunity to rethink the economic reform agenda and tackle longstanding economic issues that were previously difficult to approach.

Nevertheless, three years after the onset of political transition in the Arab world, managing the transitions and implementing necessary economic policies has proven to be challenging. The Arab Countries in Transition (ACTs), including countries that have undergone regime change (Egypt, Libya, Tunisia, Yemen) and those that have engaged in transformation under existing regimes (Jordan, Morocco), have progressed along their transition paths. Governments with limited horizons and mandates, institutional uncertainty, and socioeconomic tensions have been hindering, to varying degrees across countries, the focus on the economic transformation agenda. At the same time, challenges in economic management have intensified, as external and domestic economic conditions have been complex, policy buffers are running low, and economic growth is insufficient to bring down the ACTs' high unemployment. In this setting, countries are at a critical juncture: prudent economic management, paired with bold reform efforts to create an enabling environment for private sector-led growth, will be needed to safeguard the promise of the Arab transitions for better living conditions, higher and more inclusive growth, and job creation on a meaningful scale.

The ACTs have been facing a number of longstanding economic challenges. Well before the beginning of the transitions in 2011 in economic growth per capita and integration into the world economy they were lagging behind other emerging market and developing countries (EMDCs), and there was a perceived lack of competition in domestic markets. Unemployment in the ACTs was high, running at more than double the average rate of EMDCs, and youth unemployment was among the highest in the world. There was a

widespread perception that the benefits of growth were chiefly captured by the well-connected, while others felt marginalized. Many countries carried substantial public debt, and some were running high fiscal deficits. The ACTs' tendency to limit movements in their exchange rates helped provide an anchor for inflation but also constituted an important source of vulnerability.

The private sector has lacked the dynamism needed for sustained job-creating growth. It has been stifled by government intervention: complex and burdensome business regulation has constrained economic activity and enabled corruption; state-owned enterprises and public banks have often been dominant players in their sectors but have tended to operate inefficiently, leading to fiscal slippages and capital misallocation; and lack of a level playing field between public and private enterprises, as well as among private enterprises, has limited competition and innovation. Perceptions of government effectiveness and control of corruption have been deteriorating over time, and governments have been unable to create the infrastructure needed to support a dynamic economy. As a consequence, competitiveness has suffered. Where reforms were initiated, their top-down approach has often meant that the resulting economic benefits went largely to the well-connected without generating tangible benefits for most people—in particular, without creating formal sector jobs or improving living standards.

Shortcomings in access to finance, trade integration, infrastructure investment, and the labor market and education system have also hampered private sector-led growth. Access to finance by businesses has been among the lowest in the world, constraining private investment. A lack of trade integration (and supporting policies) has meant that the region's exports have been far below their potential. Inadequate labor regulations have been disincentives to private sector hiring, while the public sector has often taken the role of employer of first and last resort—a role that has distorted the labor market and education system, and one that governments can no longer afford to play. In addition, ACTs, like other countries in the MENA region more generally, have maintained large generalized subsidies as their main vehicle for social protection. These subsidies are inefficient—their benefits accrue disproportionately to the wealthy—and they tie up scarce resources that could be used for much-needed priority expenditure in areas like infrastructure investment, health, and education.

These problems have become more acute since the onset of transitions in 2011, as popular expectations for better living standards have risen. The ACTs have been faced with an economic downturn resulting from transition-related disruptions, regional conflict, an unclear political outlook, eroding competitiveness, a challenging external economic environment in the context of the European crisis, and declining confidence. This downturn has worsened the unemployment problem and led to stagnating living standards, and may have reduced the medium-term growth potential in some countries, putting

economic realities squarely at odds with the aspirations of the population for an economic transformation that would provide quick returns in the form of job creation and income generation. Demographic pressures suggest that, under current baseline projections for GDP growth through 2018 of around 4¼ percent in the oil-importing ACTs, unemployment is expected to continue rising. At the same time, fiscal deficits and public debt have further increased, and international reserve buffers have been run down, severely limiting the policy space for expansionary economic policies in the period ahead.

In this setting, the ACTs risk getting trapped in a vicious circle of economic stagnation and persistent sociopolitical strife. As economic realities fall behind populations' expectations, there is a risk of increased discontent, which could further complicate the political transitions, impairing governments' mandates and planning horizons and, consequently, their ability to implement the policies necessary to catalyze the much-needed economic improvement.

The political transitions have thus created not only new opportunities for economic transformation but also the necessity to accelerate economic reform. Strong economic management, and policies to bolster the business environment, are needed to avoid a vicious circle and create in its place a virtuous one where the right policies revive economic confidence and generate inclusive economic growth. Better economic conditions can then help reduce discontent and thereby smooth the political transitions.

The ACTs need a medium-term vision to set policies for their economic future. Goals will differ among countries, reflecting their citizens' aspirations; but in all countries they need to be framed in an economic model that provides a more level playing field, allows for greater integration into the global economy, and creates an environment in which a dynamic private sector can drive growth and create sufficient jobs for a growing labor force, while governments provide adequate infrastructure and regulation, along with basic services and targeted social protection.

At this critical juncture, three economic policy priorities are essential: enabling additional job creation in the near term to lessen the risk of a vicious circle; addressing macroeconomic vulnerabilities to safeguard economic stability; and setting in motion necessary reforms to generate higher potential growth and job creation in the coming years.

Near-term policies need to focus on quickly enabling job creation in order to lessen the adverse impact of the post-Arab-Spring economic downturns. Delays in the revival of private investment, in the context of impaired economic confidence, indicate a need for governments to shore up economic activity in the near term. Experience from other countries suggests that well-designed infrastructure projects can create jobs and lay a better foundation for private sector activity. With little room for further widening of fiscal deficits

in many countries, spending needs to be reoriented toward growth-enhancing and job-creating public investment that stimulates private sector activity, while protecting vulnerable groups through well-targeted social assistance. Expenditure-side reforms should include redirecting social protection from expensive and inefficient generalized subsidies to transfers that better target the poor and vulnerable. In addition, containing public wage bills would reduce expenditure rigidities and support fiscal strategies for sustainability and private sector job creation. Revenue measures should focus on broadening the tax base and improving the efficiency of tax collection. Some ACTs also have room for raising income tax progressivity and increasing excise and property tax rates. Together, these policies would enhance equity while freeing scarce resources for priority expenditure in infrastructure investment, health, and education.

At the same time, near-term policies need to be anchored in medium-term policy frameworks that maintain and strengthen economic stability. With concerns about debt sustainability rising and fiscal and external buffers eroding, countries need to anchor their fiscal policies in medium-term frameworks that safeguard macroeconomic stability and debt sustainability. In some cases, there may be room for scaling up deficits in the near term when adequate financing is available and in the context of medium-term adjustment programs. The slower the pace of fiscal adjustment, the larger the financing needs will be, underscoring the need to anchor policies in credible medium-term consolidation plans; these will help secure the continued willingness of creditors to provide the necessary financing.

Countries face trade-offs in monetary and exchange rate policy. Each country will need to weigh the pros and cons of pegging versus exchange rate flexibility on an individual basis. Inflation will need to be kept contained, and inflation expectations well anchored. At the same time, a key near-term challenge is to safeguard aggregate demand in the face of weak growth and necessary fiscal consolidation. In addition, capital flows must be restored so as to reverse the decline in reserves. This outcome would come from a credible monetary and exchange rate policy that reduces the impact of real shocks, supports measures to increase competitiveness, controls inflation, and thus lays out a path for stable and job-creating growth. For countries that opt for greater exchange rate flexibility, this would require the establishment of a new anchor for monetary policy and stepped up technical capacity at the central bank, while pegging implies the need to align fiscal policy closely with macroeconomic objectives.

Bolstering financial sector development will be essential to underpin the recovery and broaden access to finance for investment and growth. Limited bank competition, a concentration of lending to large, established companies, a generally poor financial infrastructure, and underdeveloped capital markets suggest that large benefits could be gained from strengthening

financial development and access to finance, and thereby bolstering investment, growth, and job creation. Reforms should focus on increasing competition among banks and strengthening their financial infrastructure, deepening capital markets and developing their investor base, and making available alternative financing instruments, Islamic finance, and microfinance.

A bold economic reform agenda will be essential for propelling private sector activity and fostering a more dynamic, competitive, innovation-driven, and inclusive economy. To achieve broad-based and sustainable growth, countries need to move gradually away from state-dominated to private investment, and from protected and rent-seeking enterprises to export-led growth and value creation. Policies should aim at strengthening the revival of private sector confidence and laying the foundations for higher potential growth. A key goal will be to engineer a transformation for the public sector, a shift from providing privileges such as public employment, subsidies, economic rents, and tax exemptions, to providing basic economic services, adequate social protection, better governance, a level playing field for all economic actors, and a competitive environment for the private sector. Countries will begin their efforts from different starting points and will have different reform objectives, but there are some common areas that should be covered: these include trade integration, business regulation and governance, labor market and education reform, improved access to finance, and better social safety nets (SSNs).

Deepening trade integration can offer significant benefits. In addition to the large potential direct gains of boosting exports and attracting productivity-enhancing FDI, trade integration can serve as catalyst for reforms in other areas that will help countries compete. Deeper trade integration will require better access to advanced economy markets. It will also involve carefully reducing further the ACTs' tariffs and non-tariff trade barriers, and focusing on the increasingly important areas of trade facilitation and export promotion.

Complex and burdensome business regulation needs to be tackled to unleash entrepreneurial activity and private investment. It is essential to improve the systems of checks and balances in domestic institutions to prevent the exercise of arbitrary discretion and nontransparent intervention, and to streamline business regulation with a view to cutting red tape and reducing informality and corruption. Institutional and regulatory reform should aim at reducing the scope for discretion, improving transparency, and strengthening institutional autonomy and accountability.

Labor market and education reforms can provide incentives for hiring and participation in the formal private sector labor market. Countries should review labor market regulations with a view to reducing distortions that discourage hiring and skills-building, while ensuring an adequate level of social protection. Governments need to revisit their recruitment and compensation policies to ensure that hiring does not exceed needs and salaries

do not bias job-seekers toward the public sector. Education systems should be improved and reoriented towards skills needed in the private sector. As these policies take time to yield tangible results, countries should consider employing active labor market policies to achieve quick improvements in labor market outcomes.

Countries need to create efficient SSNs to protect the poor and vulnerable in cost-effective ways. In transitioning from costly generalized subsidies to targeted forms of social protection, countries should increase their spending on existing safety net programs and improve their coverage; consolidate existing, fragmented SSNs; prioritize interventions such as conditional cash transfers that strengthen human capital; invest in SSN infrastructure such as unified registries for beneficiaries; increase the use of modern targeting techniques; strengthen governance and accountability in SSNs; and step up communication to potential beneficiaries about the programs available to them.

The complexity of all these tasks requires careful prioritization and sequencing. Although countries differ in their starting conditions and will need to tailor their individual reform plans, the scope for macroeconomic and structural policies to support growth and maintain stability is substantial in all of them. At the same time, the political transitions are at differing stages among the ACTs, and in some countries transitional governments with short horizons and limited mandates have less room to maneuver when setting in motion the necessary policy reforms. In addition, the administrative capacity to execute reforms differs among countries and is limited in some of them. Careful prioritization and sequencing of reforms is thus required to make efficient use of political capital and administrative capacity, and the complexity of the political transitions requires a flexible approach so that opportunities for reform can be seized as they arise. It will also be critical to identify those measures that can be taken quickly to produce strong effects, such as streamlining business regulation and improving the transparency of the budget process. Enacting this type of reform quickly would help strengthen confidence in the authorities' commitment to the reform process.

In an evolving sociopolitical environment, careful consideration of political economy has become crucial. Complex political processes, transition governments with short horizons, the emergence of new stakeholders, the growing importance of social media in the political process, increasing polarization of society, and a difficult security environment make for challenging and uncharted territory. To set in motion a virtuous circle where political transition and economic transformation reinforce one another to generate higher confidence and higher growth, policymakers need to employ a participatory approach, engaging with different segments of society, creating a sense of urgency for reform and showcasing its benefits, listening to stakeholders' views, and building coalitions for reform. Policy plans also

need to include effective communication plans. Governments must be able to explain persuasively the reasoning behind difficult decisions if people are to support them.

Stepped-up support from the international community will also be critical. Even as countries need to stay in the driver's seat and plan their policy programs through wide national consultation, there is a need for the international community to support the ACTs' policy efforts along four dimensions. Bilateral and multilateral partners will need to continue providing significant financing, increasing the scale in some cases, so that public spending can support growth and, where necessary, ease the pace of adjustment. Access for the ACTs' exports to advanced economies' markets is also important, to support the economic recovery and raise potential growth. The ACTs can also profit from policy advice from their international partners in many areas of economic policy. In addition, the international community can help in capacity-building efforts by providing technical assistance and training.

The IMF remains closely engaged with the ACTs. IMF staff are engaging with country authorities and their international partners in the areas of economic policies, financing, and capacity building. The IMF has committed about \$10 billion in financial arrangements with Jordan, Morocco, Tunisia, and Yemen. IMF staff are in discussions with Yemen toward a successor arrangement to the IMF support in 2012, and are supporting Egypt and Libya through policy dialogue and capacity-building efforts.

This paper lays out key elements of reform in the area of economic policy for the ACTs. While individual countries will design specific reform programs based on their starting positions and reform goals, a number of reform areas will be common for them. This paper discusses shared priorities and lessons. Chapter 2 highlights policies to address the fiscal challenges, while Chapter 3 discusses aspects of monetary and exchange rate policies to support near-term stabilization and stable medium-term growth. Chapter 4 raises issues related to financial sector policies for stability and development, including improving access to finance so as to catalyze inclusive growth. Chapter 5 emphasizes a broad range of areas where economic reform could generate higher potential growth and improved job creation in the medium term. Chapter 6 focuses on important supporting factors that need to fall in place to enhance the chances of successful policy outcomes. These include the crucial areas of political economy, communication, and support from the international community.

Tackling Fiscal Challenges

The ACTs faced significant medium-term fiscal challenges even before the onset of their transitions. In many cases, fiscal deficits and debt were higher than in other emerging market and developing countries, reflecting, to varying degrees, generalized food and fuel subsidies, high global commodities prices, low taxation, and countercyclical fiscal action in the context of the global financial crisis. Expenditures were dominated by rigid spending on wages and subsidies, consuming 40 percent or more of most ACTs' budgets and leaving too little space for capital expenditures, which in some cases ran at half the average of emerging and developing economies. Following the global financial crisis, all ACTs (except Libya) already had high or rising debt levels.

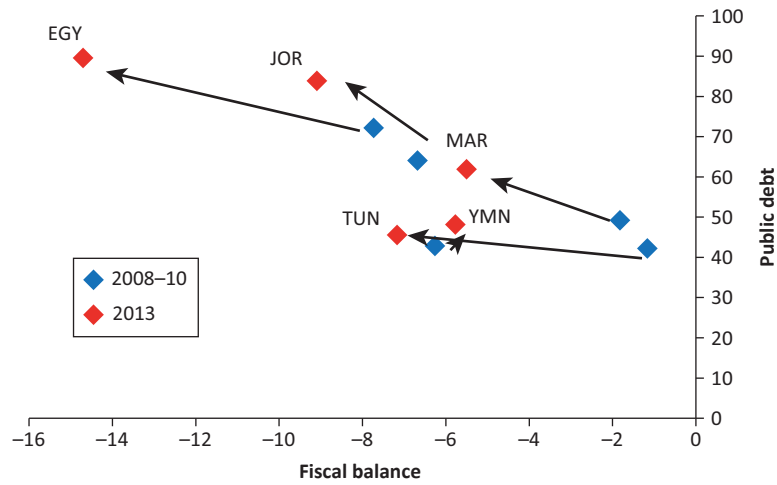
Spending hikes in the aftermath of the Arab Spring further raised fiscal deficits and public debt (Figure 2.1). ACT governments attempted to address pressing social needs and political tensions, and to sustain aggregate demand by further raising public wage bills and generalized subsidies (Figure 2.2).¹ In Egypt and Jordan, already sizeable deficits increased sharply, lifting debt above 80 percent of GDP by 2013. Despite moderate debt ratios in Morocco, Tunisia, and Yemen, fiscal vulnerabilities were heightened by elevated deficits. Libya's non-oil fiscal deficit is close to 170 percent of GDP, the fiscal breakeven oil price is \$118 per barrel,² and the overall fiscal position returned to a deficit in 2013 as a consequence of renewed oil supply disruptions, despite large oil reserves.

At the same time, these spending hikes failed to provide a lasting stimulus to private sector activity. Raising generalized subsidies and public sector wage bills provided a temporary boost to consumption but was ineffective at stimulating the private investment needed to generate jobs and improve living standards. Moreover, this new current spending was partially offset by reductions in already low capital spending, and sometimes, also, by reductions

¹ In Jordan, fiscal deficits also worsened because of quasi-fiscal activities and shortfalls in gas from Egypt, which necessitated expensive fuel imports for electricity generation.

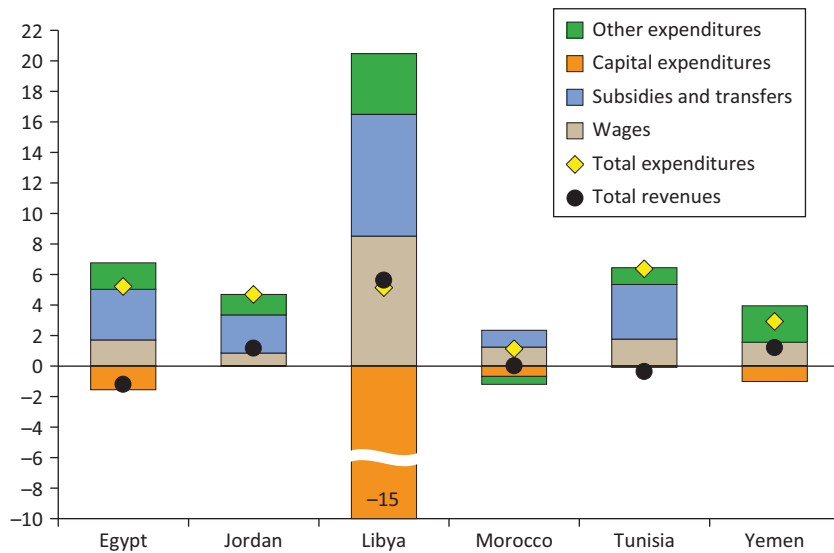
² The fiscal breakeven oil price is the hypothetical price of oil at which an oil-exporting country's budget would be balanced.

Figure 2.1. Fiscal Positions Have Deteriorated
(Gross public debt and overall fiscal balance, average; percent of GDP)



Sources: National authorities; and IMF staff estimates.

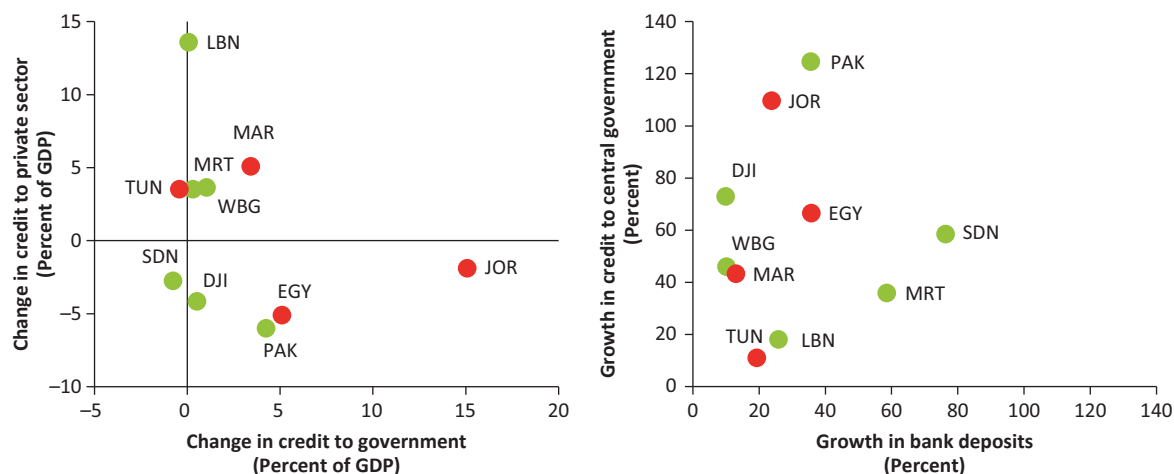
Figure 2.2. Subsidies, Transfers, and Wages Were Raised
(Changes in revenue and expenditure, 2010–13; percent of GDP)



Sources: National authorities; and IMF staff estimates.

in maintenance, education, and health spending—all of which are integral to sustained improvements in private sector activity. While weak demand has also been a factor in explaining subdued credit growth, financing of the resulting large fiscal deficits may be further hampering the recovery, by increasing the cost of credit available for private sector activities and creating inflationary pressures (Figure 2.3).

Figure 2.3. Crowding Out of Private Sector Credit, 2010–13



Source: National authorities; and IMF staff estimates.

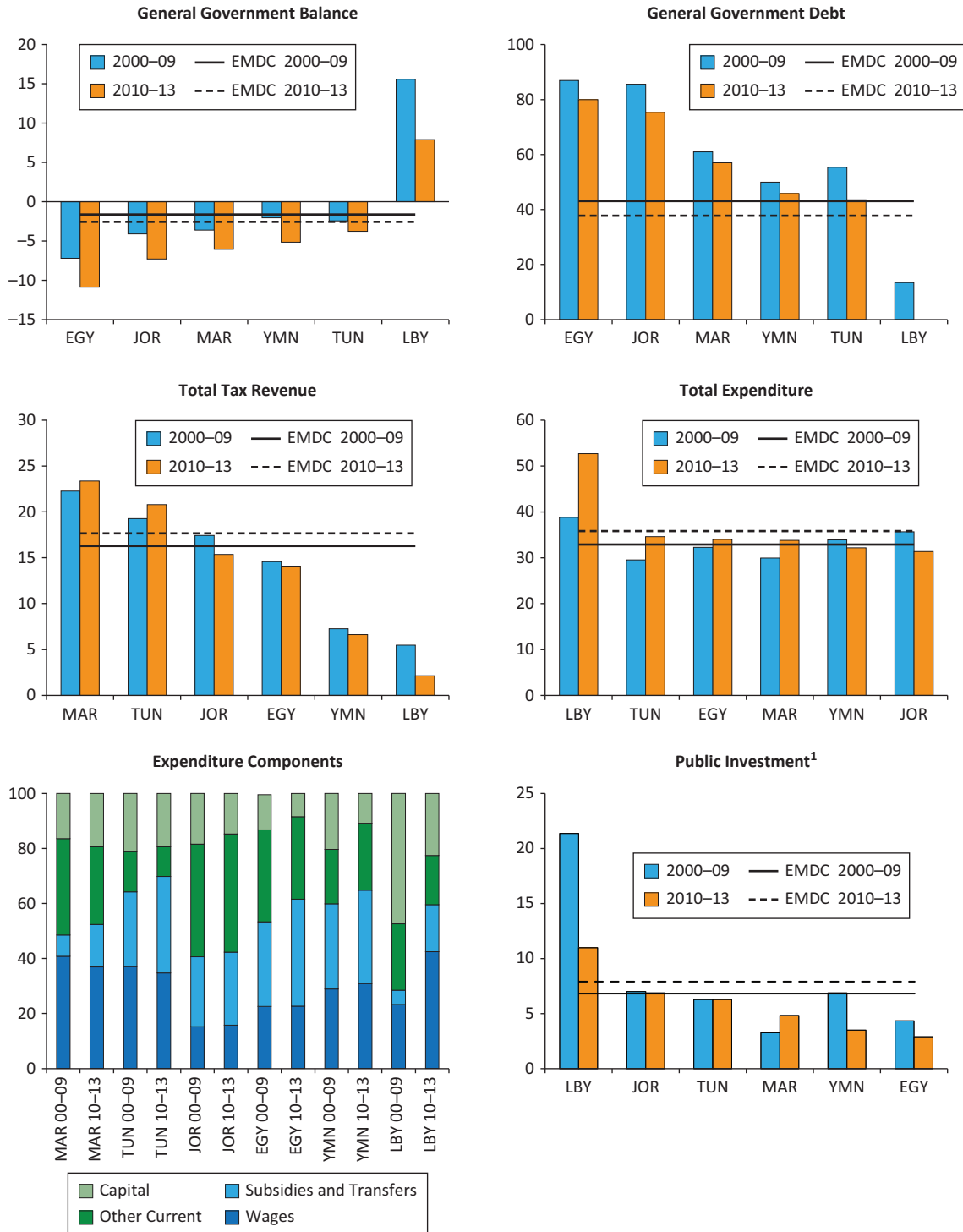
In this environment, the demands on near- and medium-term fiscal policy are substantial. Countries need to carefully reorient and sequence their near-term policies, so that they are aimed at supporting growth and job creation within binding resource constraints. Medium-term policies need to aim at clearly anchoring fiscal stability and strengthening efficiency.

Demands on near-term fiscal policy call for a reorientation of public spending toward growth-enhancing and job-creating public investment that stimulates private sector activity, and toward well-targeted social assistance that protects vulnerable groups. Room for expansionary fiscal policy is limited, given already high fiscal imbalances and financing limitations (Figure 2.4). Yet, with weak private sector confidence, governments have to take a lead role in shoring up economic activity in the near term. Achieving this objective without raising deficits and debt to unsustainable levels requires mobilizing revenues and cutting current spending, which, for most ACTs, means reducing spending on generalized subsidies and containing public sector wage bills.

Although this approach is politically difficult, the risks to near-term economic activity appear limited. In emerging and developing countries,³ including the ACTs, fiscal multipliers on current spending are smaller than those on capital spending; cuts to current spending, therefore, pose less risk to near-term economic activity. The pace of spending cuts should be designed to contain the negative effects on growth, as these effects are amplified when output

³ Ilzetki, Mendoza, and Vegh (2011).

Figure 2.4. Government Finances
(Percent of GDP)



Sources: National authorities; and IMF staff estimates.

Note: EMDC = emerging market and developing countries.

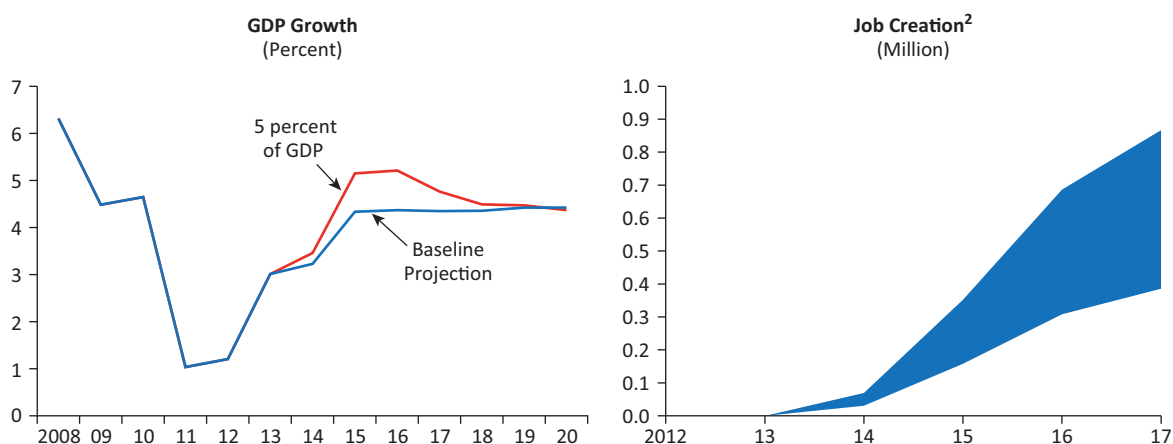
is below potential (the current cyclical position of the ACTs).⁴ In addition, low tax revenues (relative to GDP) in most ACTs, combined with revenue multipliers that tend to be lower than expenditure multipliers, support immediate revenue mobilization. Appropriately chosen near-term revenue measures—including broadening tax bases, raising income tax progressivity, and increasing excise and property tax rates—would also improve the redistributive impact of fiscal policy, which has so far been limited by weak taxation (see Section B below). This fiscal policy mix would need to be supported by adequate monetary policy, financial sector policies, and structural reforms (Chapters 3–5) to raise growth.

All ACTs need to anchor their short-term policies in strong and credible medium-term fiscal consolidation, with the speed of adjustment depending in part on the availability of financing. Medium-term consolidation will be needed to support confidence, turn unsustainable debt dynamics around, and reduce the susceptibility to shocks. The speed of adjustment will depend, among other factors, on the size of the fiscal imbalances and the availability of financing. By way of illustration, delaying subsidy reform in the ACTs by two years would entail a fiscal cost of \$8 billion. Raising public investment in the ACTs by 5 percent of GDP cumulatively over five years would require \$24 billion in financing, while significantly raising growth and employment (Figure 2.5). Stepped-up support from the international community, especially on budget support, would thus help smooth the adjustment (Chapter 6).

Fiscal consolidation will require significant effort over the medium term. While countries are at various stages of planning fiscal adjustment, an illustrative scenario can shed light on the scale of the challenge: if primary balances were to remain at their current levels, the public debt ratio would rise by about 17 percent of GDP on average over the next five years and reach 87 percent of GDP. Restoring debt to sustainable levels (assumed here, for purposes of illustration, at around 40–60 percent of GDP) over the medium term will require raising the primary fiscal balance by an average of 8 percent to 10 percent of GDP. Moreover, current account deficits and financing needs are substantial in many ACTs. For countries with low fiscal or external buffers, delays in consolidation could heighten concerns about the sustainability of macroeconomic policies, further eroding confidence and impairing growth. Even in Libya, fiscal vulnerabilities from high breakeven oil prices (highlighted by the renewed disruptions to oil output), and insufficient savings to support spending for future generations call for fiscal consolidation.

⁴ Fiscal multipliers are defined as the ratio of a change in output to an exogenous change in government spending or tax revenues. Several recent studies, including Auerbach and Gorodnichenko (2012) and Baum, Poplawski-Ribeiro, and Weber (2012) find that fiscal multipliers are magnified in advanced economies when output is below potential. This also holds for the ACTs, though revenue multipliers are estimated to be less sensitive to output gaps.

Figure 2.5. A 5 Percent of GDP Increase in Public Investment Would Significantly Impact Growth and Employment¹



Source: National authorities; and IMF staff estimates.

¹ ACTs, excluding Libya.

² Under various employment elasticities.

Medium-term consolidation plans need to center on lower current spending and higher revenue mobilization. Strategic spending reorientation should aim at eliminating generalized subsidies, undertaking comprehensive civil service reforms, and channeling part of these savings toward enhancing the coverage and amounts of targeted social assistance and strengthening public investment. The successful implementation of these reforms will also depend on improvements in key aspects of the budget process. On the revenue side, medium-term reforms should aim at improving the tax structure, and increasingly turn to tax and customs administration reforms, which would not only raise revenues but also improve governance and the business environment. These policies would improve equity, create jobs, and enhance long-term growth prospects by boosting productivity.

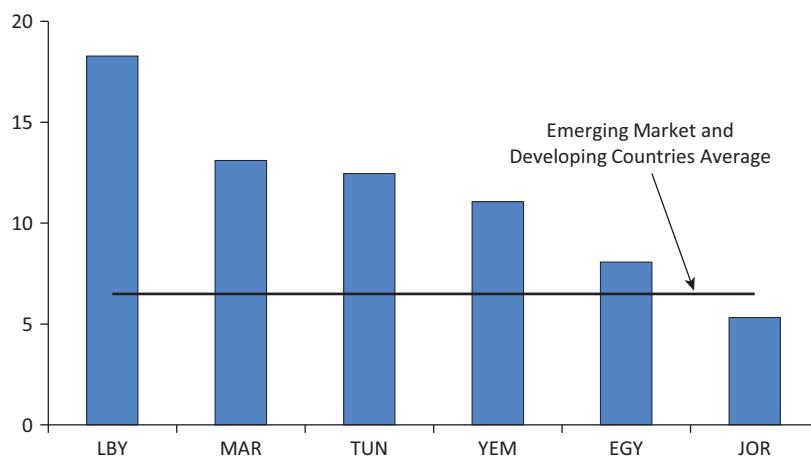
The success of such fiscal strategies will depend on getting the political economy right. Policymakers will need to gauge what reforms are possible and how best to sequence them under difficult sociopolitical circumstances. Success will depend on listening to all stakeholders' views when formulating policy agendas, and building the coalitions needed to implement them. To this end, the recent tax conference in Morocco and the ongoing national tax consultation process in Tunisia have been useful in building consensus for tax reforms. It will be important to know who stands to lose as a result of reform—whether in certain regions or economic sectors or along demographic or income lines. Such knowledge can help predict opposition to proposed plans and can inform strategies to address such opposition. A broad-based communication strategy, emphasizing that this form of consolidation will contain the negative impact on incomes and jobs while possibly improving income distribution, will be critical to building political consensus and gaining the public support needed to sustain the consolidation effort.

Reorienting Spending

Increased spending on public wage bills and generalized subsidies, in response to social pressures, stimulated near-term economic activity, but also widened external imbalances and worsened inequalities and expenditure rigidities. Broad-based subsidies, especially for energy, support imports more than they support demand for domestic goods and services, and they disproportionately benefit high-income segments of the population, who consume large amounts of fuel and electricity. Consequently, the bulk of subsidy increases was transferred to the wealthy and had limited effect in generating jobs or improving the living standards of the average household. Hikes in public wage bills were introduced in a difficult sociopolitical context; their continuation is not a sustainable policy option (Figure 2.6). They also tend to raise inequality (IMF, 2012c), especially where government employees hold an above-average position in the income distribution (Figure 2.7). Recognizing the limitations of cross-country comparisons in this area, among the ACTs, income inequality is highest in Tunisia and Morocco, where average civil service wages are three and four times per capita GDP, respectively. Expenditure rigidities stemming from the public wage bill and generalized subsidies, both above emerging and developing country averages, create additional challenges for fiscal policy.

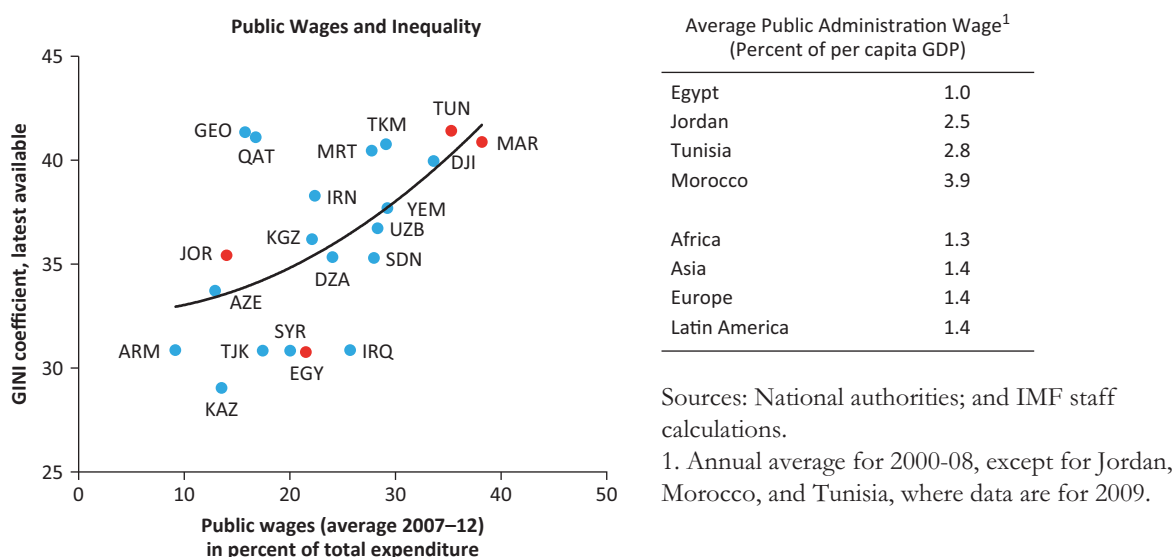
Carefully reorienting public spending away from generalized subsidies towards targeted social safety nets would support poorer households, reduce inequalities, and free resources for priority expenditure and deficit reduction. Stable or declining international energy prices have created a window of opportunity for reform of energy subsidies. Given the delicate sociopolitical environment, cuts in subsidies should be gradual and implemented concurrently with increased targeted social assistance (including

Figure 2.6. High Public Wage Bills
(Employee compensation, 2012; percent of GDP)



Sources: National authorities; and IMF staff estimates.

Figure 2.7. High Public Wages Tend to Raise Inequality



Sources: National authorities; World Bank World Development Indicators; and IMF staff calculations.

targeted cash transfers or vouchers) to mitigate the effects on poor and vulnerable households (see Chapter 5). To that end, Jordan is gradually raising electricity tariffs, has eliminated fuel subsidies, introduced a monthly fuel price adjustment mechanism, and reallocated some of the savings from these reforms to the bottom 70 percent of households via cash transfers (going well beyond compensation for the poor, also strengthening buy-in from the middle class, though the eligibility criteria are being fine-tuned with a view to better targeting the poor segments of the population). Energy price increases have also been implemented in Morocco, Tunisia, and Yemen. To a lesser extent, reforms have also begun in Egypt (IMF 2013d, Box 2.4 provides details).

Instituting energy subsidy reform is politically difficult, and country experiences provide key lessons for success.⁵ Important elements are a comprehensive energy sector reform plan that includes consultation with the main stakeholders; appropriately phased energy price increases; introduction of automatic pricing mechanisms⁶ to depoliticize energy pricing; a plan to improve the efficiency of state-owned enterprises and utilities to reduce producer subsidies; targeted measures to compensate and protect the poor and vulnerable; and an extensive communications strategy, including

⁵ See: IMF, 2013b for more details.

⁶ Automatic pricing should include price-smoothing measures to avoid potentially large fluctuations in domestic fuel prices.

publication of the magnitude of existing subsidies and planned use of prospective fiscal savings. Opinion polls have shown, for example, that citizens tend to support subsidy reform if they perceive that the proceeds are used for pro-poor, education, and health spending, and if they can be satisfied that these expenditures are done in an efficient way (Box 2.1).

Box 2.1. Mixed Public Views on Cutting Energy Subsidies

ACT populations are coming to terms with the need for subsidy reform, in recognition of rising fiscal pressures. Several ACT governments have recently taken steps toward cutting back costly generalized subsidies, especially for energy. Generally, populations have accepted these changes, but they do hold strong opinions on the types of subsidies that should be cut and where the savings should be allocated. A recent poll of ACT populations, conducted for the World Bank,⁷ provides more insight into their views.

Cuts in fuel subsidies are preferred over cuts to food subsidies (Table 2.1.1). In Tunisia 40 percent of respondents favored cutting energy subsidies. The response was not as strong in Egypt and Jordan, at 30 percent, but support for the removal of energy subsidies was several times stronger than for removal of food subsidies. This difference may reflect populations' awareness that fuel subsidies disproportionately benefit the wealthy. The poll results also indicate that Tunisians are least likely to oppose large-scale subsidy reform, while 60 percent of respondents in Egypt and nearly half of respondents in Jordan were not in favor of subsidy removal.

**Table 2.1.1. Subsidy Removal Preferences
(Percent of respondents)¹**

| | Egypt | Jordan | Tunisia |
|-------------|-------|--------|---------|
| Energy | 31 | 28 | 41 |
| Food | 6 | 13 | 25 |
| None | 60 | 47 | 27 |
| No response | 3 | 12 | 7 |

Source: World Bank MENA Development Report, "Inclusion and Resilience: The Way Forward for Social Safety Nets in the Middle East and North Africa."

¹ Response to the question, "If the government had to remove subsidies, which products would you prefer they target?"

Distributing savings to poor households and improving social services is favored, and can improve the public buy-in for reform. At least half the respondents in Egypt and Tunisia specified that the savings from energy subsidies should be distributed as cash transfers to the poor and as increased spending on healthcare and education

⁷ A Gallup poll of 4,000 interviews with adults, aged 15 and older, was conducted in Egypt, Jordan, Lebanon, and Tunisia during September–December 2012.

Box 2.1 (concluded)

(Table 2.1.2). Notably, more than two-thirds of Tunisians and nearly 60 percent of Egyptians who opposed any subsidy removal when originally asked indicated subsequently that they would support removing diesel subsidies if the savings were to be distributed to the poor and to education and healthcare spending.

**Table 2.1.2. Preferences for Distribution of Savings from Energy Subsidies
(Percent of respondents)¹**

| Distribute savings to . . . | Egypt | Jordan | Tunisia |
|--|-------|--------|---------|
| Poorest households | 32 | 50 | 38 |
| All except wealthy households | 3 | 19 | 6 |
| All households | 2 | 3 | 1 |
| Healthcare and education as well as poorest households | 57 | 10 | 50 |
| No response | 7 | 19 | 4 |

Source: World Bank MENA Development Report, “Inclusion and Resilience: The Way Forward for Social Safety Nets in the Middle East and North Africa.”

¹Response to the question, “Where should the government spend the savings from energy subsidies?”

Containing public wage bills would reduce expenditure rigidities and support fiscal strategies for sustainability and private sector job creation. Using the public sector as employer of first and last resort is no longer an option where fiscal buffers are running low. Moreover, in some cases inflated public sector salaries reduce the appeal of private sector jobs for the best workers. To kick-start reforms and facilitate private sector growth, further public sector hiring should be strictly limited and real wage growth should be reduced by restraining the growth of nominal wages and allowances, and by streamlining bonuses. Near-term consolidation efforts can be complemented by medium-term plans for comprehensive civil service reforms that review the size and structure (including regional and functional allocations) of the civil service to create a skilled and efficient government work force. This would entail reviewing existing civil service legislation and regulations to rationalize compensation policies, improve retention, and to create stronger performance incentives by tightening the link between pay and performance. At the same time, strengthening the payroll system would help eliminate ghost workers and double-dippers, especially in Libya and Yemen.⁸

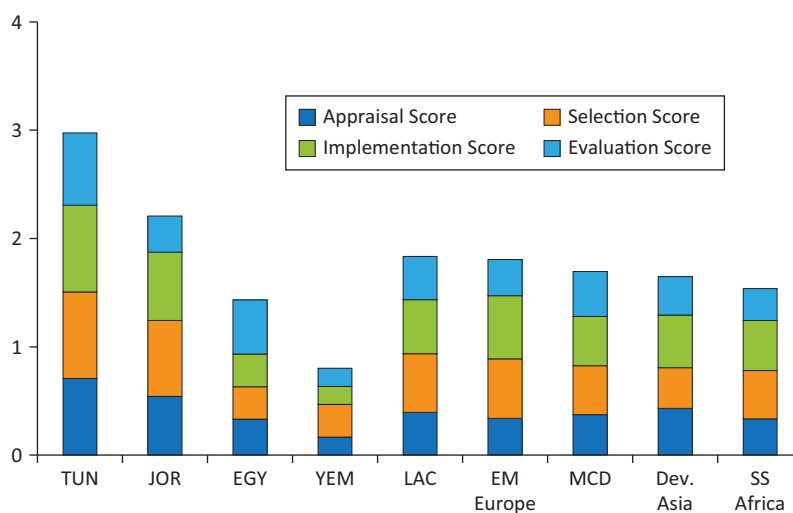
⁸ Morocco undertook successful reforms to downsize its public sector in 2005. However, further reforms are needed to raise the productivity of its civil service. In Yemen, the cabinet recently approved a plan to eliminate ghost workers and double-dippers in the civil service and military and security forces.

Increasing growth-enhancing capital expenditures will be important. Increasing outlays on efficient capital projects, healthcare, education, and training—particularly for low- and middle-income households—would create jobs and reduce inequalities⁹ in the near term, while strengthening long-term growth prospects.

The quality and efficiency of all growth-enhancing spending will need to be monitored, and implementation capacity strengthened (Figure 2.8). Public-private partnerships (PPPs) in a variety of areas can lessen the burden on public budgets, but only where the political environment supports them and where strong PPP legal frameworks and mechanisms can be established to mitigate the risk of large contingent liabilities. Strengthened reporting and monitoring mechanisms, as well as procurement systems, are essential for improvements in this phase, in both government and public enterprises, and would support a better business environment. Appropriate vetting and prioritization systems (i.e., choosing projects that relieve infrastructure bottlenecks, complement private investment, and enhance productivity), timely allocation of recurrent expenditures, and ex-post evaluations and internal audits would underpin improvements in the appraisal, selection, and project evaluation stages.

Broad public financial management reforms would bolster implementation of the plans above and instill confidence in ACT governments' commitment

Figure 2.8. Large Variation in the Quality of Public Investment Management
(Public investment management index; 0 (lowest) to 4 (highest))



Source: Dabla-Norris and others (2011).

⁹ Empirical literature finds that education is one of the main determinants of cross-country variations in inequality (De Gregorio and Lee, 2002; IMF, 2007; and Barro, 2008).

to fiscal sustainability and good governance. Improvements are needed across key aspects of the budget process, including, first and foremost, commitment controls and strengthened systems for budget preparation, as well as enhancements to budget coverage and audit:

- **Better commitment controls** are essential to limit the possibility of expenditure overruns, which is especially important for the ACTs in light of a history of overruns and substantial near- and medium-term consolidation needs. The first step toward addressing this challenge will be for all ACTs to move immediately toward exercising expenditure controls at the point of expenditure commitment rather than at the payment stage. Implementing efficient technological platforms such as Integrated Financial Management Information Systems (IFMIS) will be an important part of the process of improving cash and debt management. Allocating an appropriate level of contingency reserves would also help governments adjust to unexpected revenue declines or spending needs.
- **Sound budget preparation** is equally important: it enhances policy prioritization, which is key for the ACTs, given their need to prioritize spending in the context of limited resources. Approaches vary across the ACTs, from top-down in Jordan and Yemen to bottom-up in Egypt. International best practices indicate that all the ACTs would benefit from adopting a top-down approach that is complemented by strong ties between macro-fiscal projections and the budget, a unified budget process (that is, full integration of recurrent and capital budgets), and a closely linked medium-term fiscal framework. This approach should be complemented by bottom-up performance-based budgets at the sectoral level.
- **Comprehensive budget coverage and increased transparency** are needed to be able to adequately assess the fiscal stance and rein in extra-budgetary spending. Budget coverage in the ACTs tends to be narrower than in other regions (see IMF, 2013c, Box 2.5). Coverage that includes public enterprises, social security and pension funds, along with broad budget reporting that encompasses functional classifications, contingent liabilities, and arrears, would enhance transparency and risk assessment. This would rein in the use of third-party revenues and unused budget allocations for extra-budgetary expenditures, support the tracking of poverty-reducing expenditures, and facilitate the analysis of the allocation of resources across sectors. A statement of fiscal risks as part of the budget documents would also strengthen transparency. Disclosure of budget documents and outcomes would help strengthen accountability.
- **Strong internal and external audit procedures** are essential to implementing financial controls and risk management, thereby

strengthening governance. Morocco has made good progress in this area, but there is ample scope for strengthening such procedures in other ACTs. International best practices indicate that the ACTs should strive for independent auditors with clearly defined functional and institutional roles, sufficient access to information, and the power to report to the appropriate authorities.

For ACTs that have embarked on decentralization, potential fiscal risks should be limited with a sound intergovernmental fiscal relations framework. Efforts in most ACTs to embark on decentralization pre-date the political transitions that started in 2011, though decentralization endeavors are now influenced and shaped in part by the transitions. Except for Morocco, the ACTs are still in the early stages of decentralization (Box 2.2). Before moving forward, it will be important for these countries to strengthen their public financial management along the lines suggested above: clarify expenditure assignments, transfer and equalization systems, and build capacity at the level of sub-national governments. This includes appropriate sequencing of resources across sub-national governments (e.g., ex ante definition of the resource envelope for sub-nationals) in line with the assignment of spending responsibilities and limits on sub-national borrowing to avoid excessive borrowing and ensure fiscal discipline. The pace of decentralization should depend on the capacity of sub-national governments to carry out their assigned functions, which in turn relies on the strength of their public financial management. Finally, development of effective intergovernmental transfer systems should offset vertical and horizontal imbalances across various levels of government.

Mobilizing Revenues

Weak tax structures in many ACTs limit tax revenues and foster inequalities. In these cases, revenues have persistently suffered from weak collection, largely the result of high tax exemptions and compliance issues, and, in some countries, low income and corporate tax rates compared to those in other emerging and developing countries. The tax effort is generally well below 100 percent in the ACTs (except Morocco), implying that the gap between actual and potential tax revenue collection is substantial (Table 2.1).¹⁰ This finding is robust to various measures of potential revenue: these include comparing a country's tax receipts with: (i) the average of its peers, controlling

¹⁰The tax effort is measured as actual tax collection in percent of potential tax revenues, estimated by comparing a country's tax receipts with those of peers with similar characteristics.

Box 2.2. Progress on Decentralization

Jordan is in the initial stages of decentralization. A draft Local Councils Law, focused on administrative reforms, was prepared in 2010, but budgetary and financial management aspects of the law are relatively limited. Several parameters of reform have yet to be clarified: the link between governorates' and national priorities; mechanisms for deciding the allocation of resources to each governorate; the link between capital projects in the governorates and the recurrent expenditures needed to operate the projects (on line ministry budgets); and the link between new policies and governorates' development of financial management capacity.

In **Morocco**, regions already have some autonomy while also receiving transfers from the central government; however, resource distribution across regions involves a cumbersome process that generates regional disparities. In January 2010, to address these challenges, the King appointed the Consultative Commission for Regionalization (CCR), an advisory committee, to prepare a roadmap for a new model of decentralization. The CCR proposed a number of important reforms that are currently under discussion. Some key elements of the reforms include enhancing governance at the regional level, strengthening regional involvement in implementing development projects, and improving capacity at the sub-national level by transferring competencies from the central government to local councils.

Tunisia is moving toward decentralization; key principles have been enshrined in the recently approved constitution. Progress in decentralization so far has been slow: there have been no major changes in expenditure assignments; governorates continue to exercise tight control of municipalities; and governors (executive heads of the governorates, appointed by the President) are still reporting to the Ministry of the Interior. Devolution of public services is more advanced: in the education, health, and agricultural sectors, a growing share of the budget is implemented by legally autonomous entities (*Etablissements Publics Administratifs*). Nevertheless, their operational autonomy for personnel management and procurement can still be increased.

In **Yemen**, the Ministry of Local Administration (MOLA) paved the way for decentralization with amendments to the Decentralization Act and the Decentralization Strategy; however, progress has been held back by capacity constraints at the governorates and slow implementation of important public financial management reforms. The shape of future federal arrangements, including those related to decentralization issues, is currently under discussion.

for a range of characteristics likely to affect the ability to raise revenue, such as per capita income (see regression analysis in Box 2.3); or (ii) the maximum that others with similar characteristics have achieved (stochastic frontier

Table 2.1. Room for Improvement in Tax Effort and VAT Collection Efficiency¹

| | Tax Effort ¹ | | VAT Collection Efficiency ³ |
|---------|---------------------------------------|---|--|
| | Regression Analysis, Box ² | Stochastic Frontier Analysis ² | |
| Jordan | 51 | 64 | 74 |
| Egypt | 73 | 72 | ... |
| Morocco | 95 | 93 | 72 |
| Tunisia | 91 | ... | 53 |
| Yemen | ... | 73 | ... |

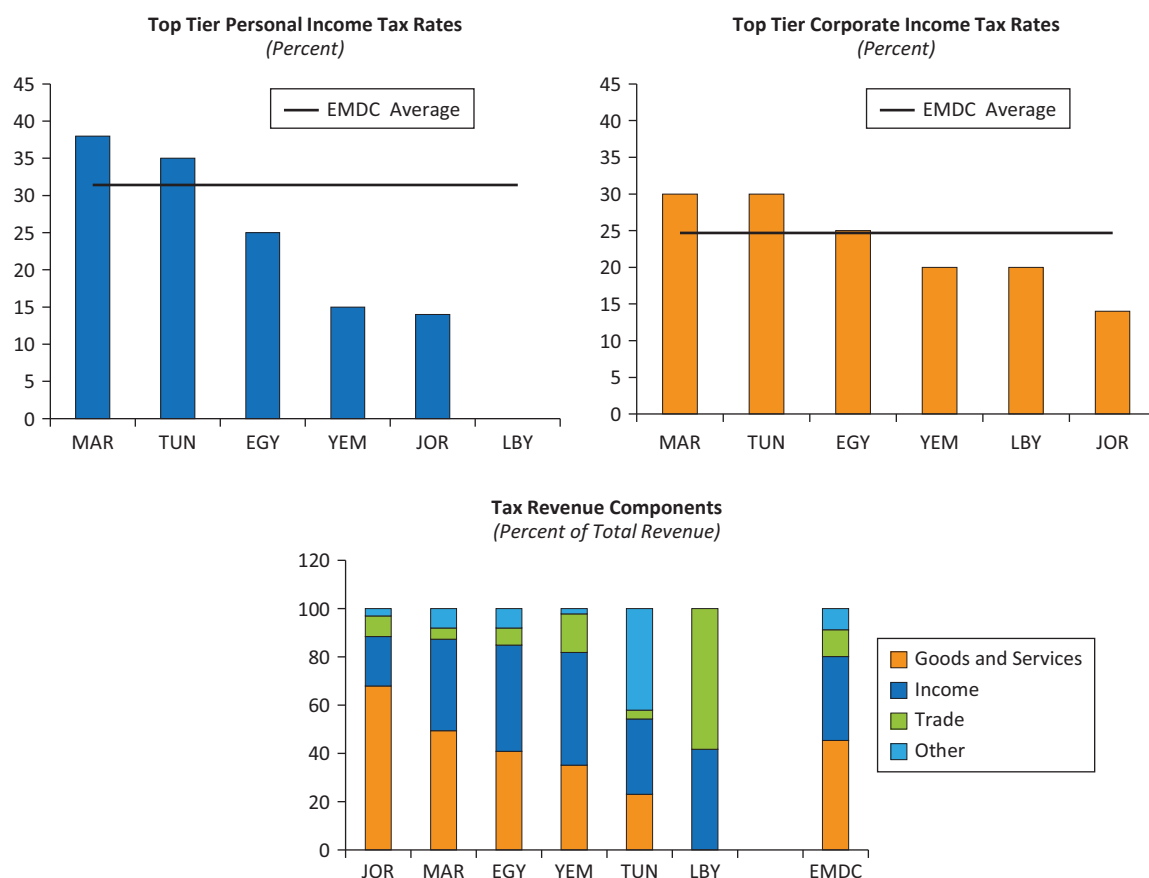
Sources: National authorities; IMF 2013c; and IMF staff estimates.

¹ 2012.

² Based on IMF 2013c, Appendix 2.

³ Average for emerging markets with most comparable characteristics to the ACTs.

**Figure 2.9. Scope for Additional Revenue Collection
(Tax rates and revenue, 2012¹)**



Sources: National authorities; KPMG; Deloitte; and IMF staff calculations.

¹Or latest available data.

analysis). Similarly, the ACTs' value-added (VAT) collection efficiency is low relative to the 80 percent average of emerging and developing economies. Tax progressivity is also low in most ACTs. In the non-oil ACTs the lack of progressivity largely reflects reliance on goods and services taxes and limited progressive income taxation. Absent change in the tax structure, these revenue challenges are expected to persist in the medium term in Egypt, Jordan, and Tunisia. In Yemen and Libya, the risk of declining oil prices underlines the importance of developing their non-oil sectors to create jobs, diversify growth, and develop a tax base that can supplement oil-related income over time.

Raising additional revenue is a priority for the ACTs (Figure 2.9). Low tax revenue intake suggests the potential for additional collection, while revenue multipliers that are smaller than the multipliers on the expenditure side imply that revenue generation is a less costly means—in terms of growth impact—of providing additional fiscal space than expenditure cuts. Collecting additional revenue can thus generate fiscal resources for priority expenditure and deficit reduction, without a high cost in growth and jobs.

Revenue gap analysis suggests country-specific areas where revenue measures can raise yields and support growth, equity, and competitiveness. Revenue gap analysis is applied to guide the focus of efforts to improve tax yields (Box 2.3). Egypt and Tunisia, in particular, have scope for measures that would improve yields from consumption taxes, the main area in which they fall short of their tax potential. Jordan could substantially raise its revenue potential by focusing on income tax collection; a draft income tax law, aiming to increase rates for individuals and corporates, was submitted to Parliament in February 2014. Even Morocco, with tax revenues close to potential, would benefit from greater efficiency in tax collection. To reduce their reliance on oil revenues, Yemen and Libya need to build their non-oil revenues across consumption, income, and other taxes. Some key initial tax policy measures that will help the ACTs raise revenues while meeting other macroeconomic and equity considerations include broadening the tax base, introducing greater income tax progressivity, and raising excise and property tax rates.

Broadening the tax base promotes several macroeconomic and equity objectives. It fosters equity, especially compared to across-the-board rate increases which can be both regressive (particularly for income and consumption taxes) and politically challenging to implement. New evidence confirms that base broadening is also better for growth—especially for VAT (Acosta-Ormachea and Yoo, 2013)—and for improving the business environment. Consequently, tax exemptions and deductions (except those protecting the poor) should be heavily reduced for all taxes and, whenever possible, multiple VAT rates consolidated into a single rate while raising registration thresholds (Table 2.2). Some progress has been made with the introduction of taxes on large agricultural firms in Morocco and moves toward harmonization of onshore and offshore taxation in Tunisia (including a reduction of the onshore income tax rate). More broadly, reducing tax exemptions would also reduce tax administration and compliance costs as well as tax evasion.

Box 2.3. Tax Potential and Revenue Gaps in Non-Oil ACTs

Revenue gaps, the difference between actual tax revenues and estimates of their potential, highlight areas where ACTs can garner further tax revenues.

In any country, tax potential depends on characteristics that are likely to affect its revenue-raising ability—economic (such as its level of development, or revenue from other sources), political (including constitutional), and even geographical (revenues can be harder to raise when borders are long and porous). Consequently, tax potential can be estimated by comparing a country’s tax receipts with the average of its peers, controlling for economic characteristics (Table 2.3.1). By construction, some countries will have revenue above this average, and others will have revenue below. Libya and Yemen are excluded from the analysis because they rely mainly on oil revenues.

**Table 2.3.1. Determinants of Tax Revenues
(Percent of GDP)**

| | Total domestic tax | Consumption tax ¹ |
|---------------------------|--------------------|------------------------------|
| Per capita GNI | 1.75*** | 0.82*** |
| VAT rate | 0.33* | 0.21* |
| Corporate Income tax rate | −0.04 | ... |
| Social spending | 0.70*** | 0.22*** |
| Growth gap | 0.51*** | 0.19* |
| Constant | 8.75** | 3.85*** |
| Number of countries | 64 | 66 |
| Adjusted R-squared | 0.69 | 0.42 |

***, **, *: statistically significant at 1, 5, and 10 percent.

Sources: National authorities; and IMF staff estimates.

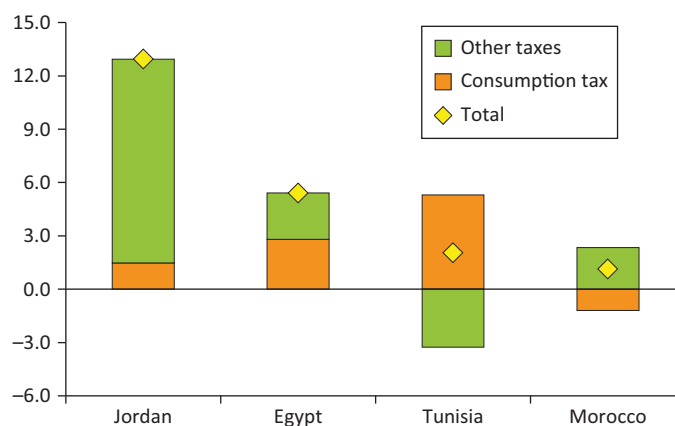
¹ Includes VAT and excises.

The domestic tax potential of non-oil ACTs varies greatly.¹¹ Applying a novel dataset of 66 middle-income and emerging economies from Torres (2014), tax potential is assessed separately for consumption and for other taxes. Controlling for differences in per capita gross national income, VAT or GST rates, top tier corporate income tax rate, the redistribution of tax revenues (proxied by social spending and direct subsidies),¹² and the current business cycle position (proxied by the gap between the current GDP growth rate and its potential), the following findings emerge (Figure 2.3.1):

¹¹ Because international trade taxes have experienced a declining trend in the ACTs with the lowering of international trade barriers, this analysis focuses on domestic taxes—defined as the total collection of taxes less international trade taxes.

¹² Per capita gross national income is highly correlated with the VAT, corporate income tax rates, and social spending. Consequently, the regression applies these variables after they have been purged of their correlation with per capita gross national income.

Box 2.3 (concluded)

Figure 2.3.1. Potential Tax Revenue Gains^{1,2}
(Percent of GDP)

Sources: National authorities; and IMF staff estimates.

¹ Model-based estimated tax revenues minus actual tax revenues; often referred to as tax gap.

² Other taxes include income, excise, and property taxes.

- **Jordan** is lagging behind its peers in raising tax revenues. Compared to countries with similar tax rates, its collection is especially low for income, property, and excise taxes.
- In **Egypt** there is some scope for improving collection of all taxes. In particular, GST collection is especially low because of numerous exemptions.
- **Tunisia** stands to gain from greater consumption tax revenues, which have also been eroded by exemptions; however, it exceeds its peers in the collection of other taxes.
- Overall, **Morocco's** tax collection is already comparable to its peers. It slightly outperforms peers in consumption taxes, but further gains could be achieved in other taxes.

In light of these results, broadening the tax base and improving tax administration will be key elements of reform across the non-oil ACTs. For those lagging in collection of non-consumption taxes, special attention should also be paid to increasing progressivity of income taxes and ramping up property taxes.

Table 2.2. Non-Oil ACTs: Base Broadening Recommendations

| | |
|---------|--|
| Egypt | Multiple general sales tax (GST) and corporate income tax (CIT) rates could be unified, GST extended to services, personal income tax (PIT) extended to all forms of capital income, and discretionary power over customs exemptions eliminated. |
| Jordan | GST thresholds could be harmonized, capital gains taxes instituted, and the exemption threshold under the PIT lowered. |
| Morocco | Numerous VAT rates could be reduced. |
| Tunisia | A single CIT rate could be applied for on- and off-shore activities, and corporate dividends taxed. |

Efforts to reduce the large informal sector (see Chapter 5) would also enlarge the tax base. A solid communication strategy—for example, Morocco’s current practice of publishing an annual tax expenditure review highlighting costs and benefits—would be critical to facilitate public buy-in for these efforts.

Greater income tax progressivity, in some ACTs, would improve equity, with little impact on growth. Except in Morocco and Tunisia, income tax progressivity in the ACTs is low (Table 2.3). Recently, progressivity has been increased in Egypt by the introduction of a new income tax bracket for high income earners and raising the rate applied to them. In Jordan, Libya, and Yemen, greater personal income tax progressivity could entail introducing a higher rate for the highest income earners, preserving the current rates for the majority of the population and lowering the rate for the lowest income segments of the population. In China, for example, greater progressivity was introduced by reducing the starting rate and widening the band over which the top rate applies (IMF 2013c). Greater tax progressivity is envisaged in Jordan’s draft income tax law, which proposes an increase in the top personal income tax rate (reversing a 2009 rate cut).

Multiple objectives could also be achieved by raising excise and property tax rates (Figure 2.10). In light of their currently low levels in a number of ACTs, higher rates on luxury goods’ excises, and on taxes on high-value properties, would improve revenues, efficiency, and fairness, with limited effects on growth; these taxes would mostly affect the wealthy, who typically have a relatively low consumption elasticity. Implementation of property taxes, however, would require substantial upfront investment in administrative infrastructure that would include establishing a comprehensive cadastre, valuation mechanisms, and effective enforcement.

These tax policy efforts should be complemented by reforms to tax and customs administration. Supporting administrative reforms would help generate additional revenue, help level the playing field by increasing transparency, compliance, and efficiency, garner public support for the overall reform package, and promote foreign direct investment and competitiveness, thus supporting higher medium-term growth. In light of the ACTs’ need to stimulate private sector confidence

**Table 2.3. Scope for More Income Tax Progressivity
(Personal income tax brackets in ACTs (local currency))¹**

| | Rate (Percent) | Income bracket |
|---------|----------------|--------------------|
| Egypt | 0 | EGP 0–5,000 |
| | 10 | EGP 5,000–30,000 |
| | 15 | EGP 30,000–45,000 |
| | 20 | EGP 45,000–250,000 |
| | 25 | EGP >250,000 |
| Jordan | 7 | JOD 0–12,000 |
| | 14 | JOD >12,000 |
| Libya | 5 | LYD 0–12,000 |
| | 10 | LYD >12,000 |
| Morocco | 0 | MAD 0–30,000 |
| | 10 | MAD 30,000–50,000 |
| | 20 | MAD 50,000–60,000 |
| | 30 | MAD 60,000–80,000 |
| | 34 | MAD 80,000–180,000 |
| | 38 | MAD >180,000 |
| Tunisia | 0 | TND 0–1,500 |
| | 15 | TND 1,500–5,000 |
| | 20 | TND 5,000–10,000 |
| | 25 | TND 10,000–20,000 |
| | 30 | TND 20,000–50,000 |
| | 35 | TND >50,000 |
| Yemen | 12 | YER 0–20,000 |
| | 15 | YER >20,000 |

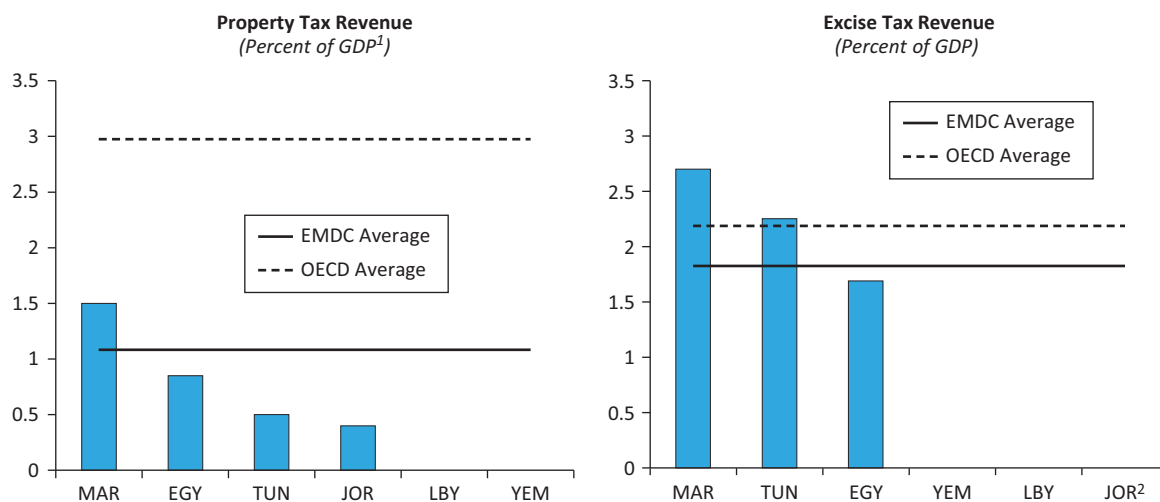
Sources: National authorities; and Deloitte and Touche, KPMG.

¹As of end-2012.

and activity, reforms should target strengthened administrative capacity and enhanced compliance, to address governance concerns. With these objectives in mind, it will be important to undertake the following reforms:

- **Simplifying tax systems** would improve their efficiency and business-friendliness. Streamlining procedures and simplifying tax codes, tax regulations, and small and medium-sized enterprise tax regimes are critical reforms in this area.
- **Enhancing tax compliance** is also an important component of reforms. In Jordan and Morocco, where VAT revenues are large, a risk-based compliance system (including an automated VAT refunds system) would raise tax yield, facilitate business operations, and reduce unequal

Figure 2.10. Scope for Raising Property and Excise Tax Rates
(Property and excise tax revenue, latest available; percent of GDP)



Source: National authorities; and IMF staff estimates.

¹Latest available data.

²Excise taxes are small and classified under GST or fees.

tax treatment across companies. International experience also suggests that a large tax payers' department, operating through a small number of offices, can lower tax evasion and improve administrative efficiency. For example, in Jordan, tax amnesties could be eliminated, penalties strengthened, and resources for the large taxpayers' office increased.

- **Strengthening the capacity of revenue administration** will be critical, and includes the retention of high-quality staff, who are necessary to successfully implement reforms in this area. In addition, more financial, technological, and human resources would raise yields and enhance governance. This is especially important for Yemen, where effective revenue administration is the key to reversing a culture of low tax compliance.
- **Advancing customs administration reforms** would substantially raise yields on import VAT, excise, and international trade taxes. A comprehensive reform package in this area should include (i) information sharing between the tax and customs administrations through valuation databases that are accessible to internal auditors and used by field declaration clearance officers to check declared customs values; (ii) replacing cumbersome customs codes with a simplified code pooling all customs laws, regulations, and orders; and (iii) reducing large physical examination requirements and clearance periods.

Monetary and Exchange Rate Policy for Stability, Growth, and Jobs

The ACTs' longstanding monetary and exchange rate policies have traditionally supported stability, but with pressures building up from time to time. Most ACTs have historically relied on stable exchange rates as a nominal anchor for monetary policy. While this generally supported a benign inflation environment and economic stability, some countries faced a gradual erosion of their competitiveness because they had persistently higher inflation than their main trading partners. Since the onset of the transitions in 2011, the setting in which monetary and exchange rate policy operates has faced further complexities. The transitions have left many ACTs with significant output gaps and current account deficits, reduced inflows of private capital, and much-diminished fiscal policy space and external buffers.

Limited exchange rate flexibility constrains monetary policy options. Stimulus for higher growth that would enable private sector job creation is urgently needed, but fiscal policy options are limited because of the need to focus on fiscal sustainability (Chapter 2). In addition, high fiscal deficits, largely financed domestically, have in some cases raised the cost of bank financing for the private sector. The outlook for higher global interest rates, resulting from a strengthening recovery in the United States, could further impair domestic financing conditions, especially in countries with fixed exchange rates.

The ongoing political transitions provide an opportunity to rethink monetary and exchange rate policies. Economic and political changes, in the context of the ongoing transitions, are providing a new setting for economic policies, with a view to identifying the right policies for short-term stabilization and stimulus, as well as for medium-term growth.

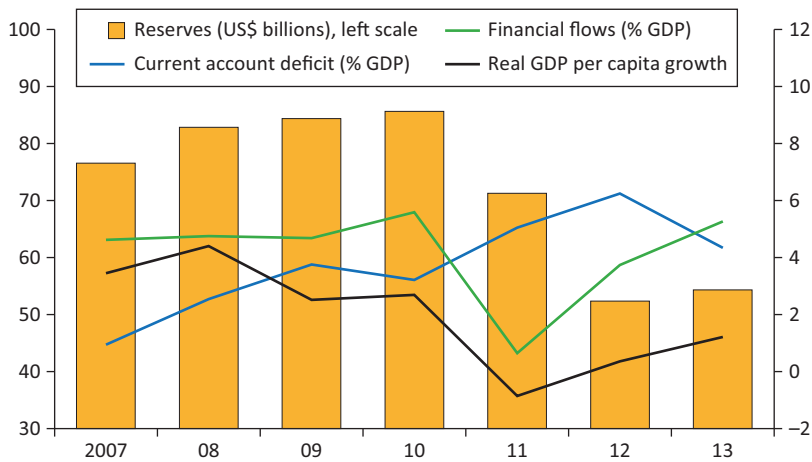
The Current Context for Monetary and Exchange Rate Policies

The ACTs are in a difficult cyclical and external position. The political transitions since 2011 have been accompanied by economic downturns, leading to—in some cases substantial—output gaps and deteriorating living standards, and further raising already high unemployment. External positions have also deteriorated (Figure 3.1, Figure 3.2). Chronically large trade and current account deficits have doubled since before the transition in some countries.

Rising food and energy import prices, and falling goods and services exports, owing to security concerns and weak global growth, including the recession in Europe, have contributed to these increases. At the same time, subdued confidence and sovereign credit downgrades reduced capital flows in 2011, and these have only partially recovered.

International reserves have declined substantially. In most cases (except Jordan and Libya), they now only cover a few months of imports and need to be increased to get comfortably in the range indicated by the IMF’s reserve adequacy metric, which calculates an adequate range for reserves for meeting vulnerabilities to export income, debt repayments, portfolio flows, and potential capital flight (Figure 3.3).¹

Figure 3.1. Significant Macroeconomic Impacts from the Political Transitions¹

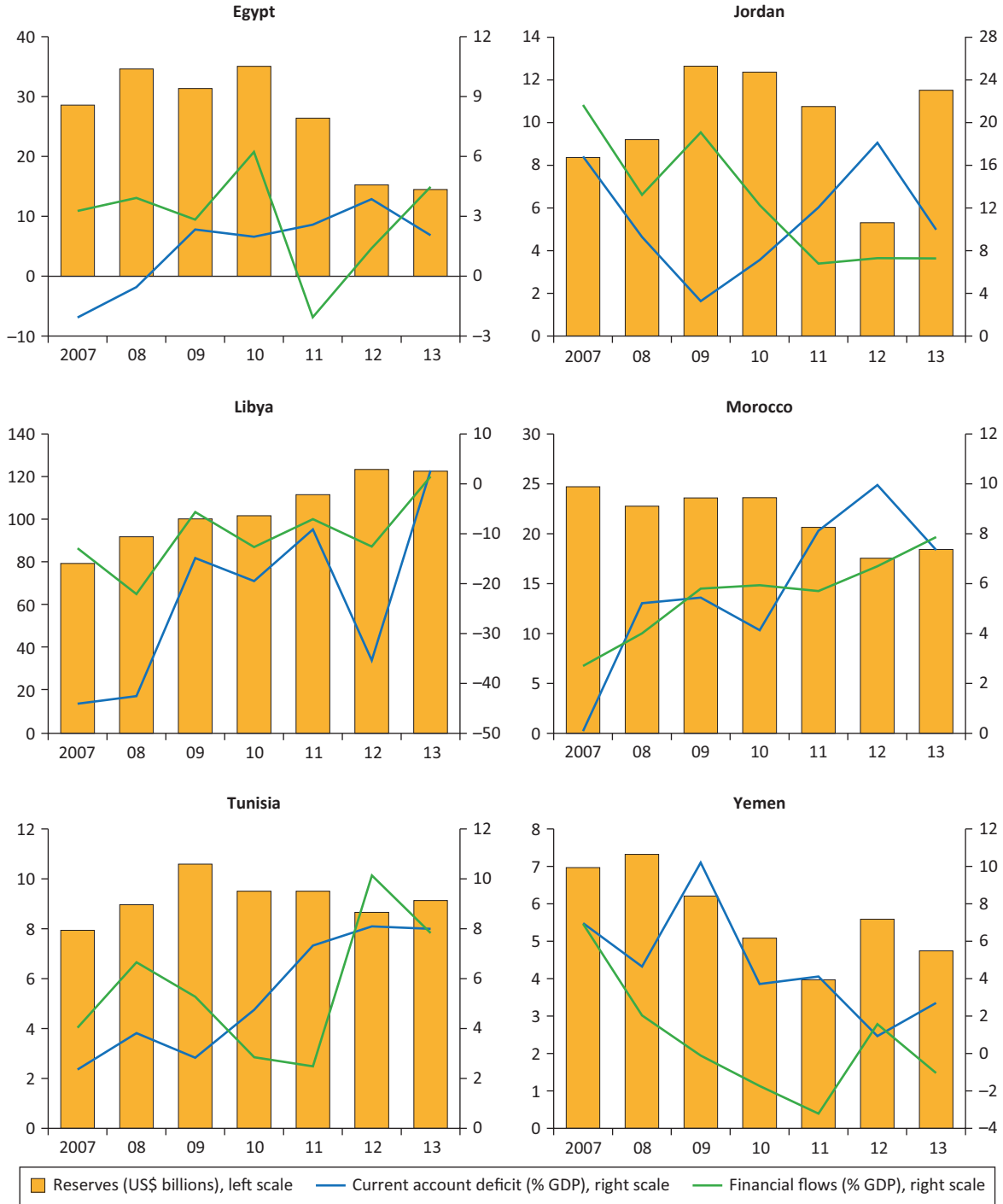


Sources: National authorities; and IMF staff calculations.

¹Excludes Libya.

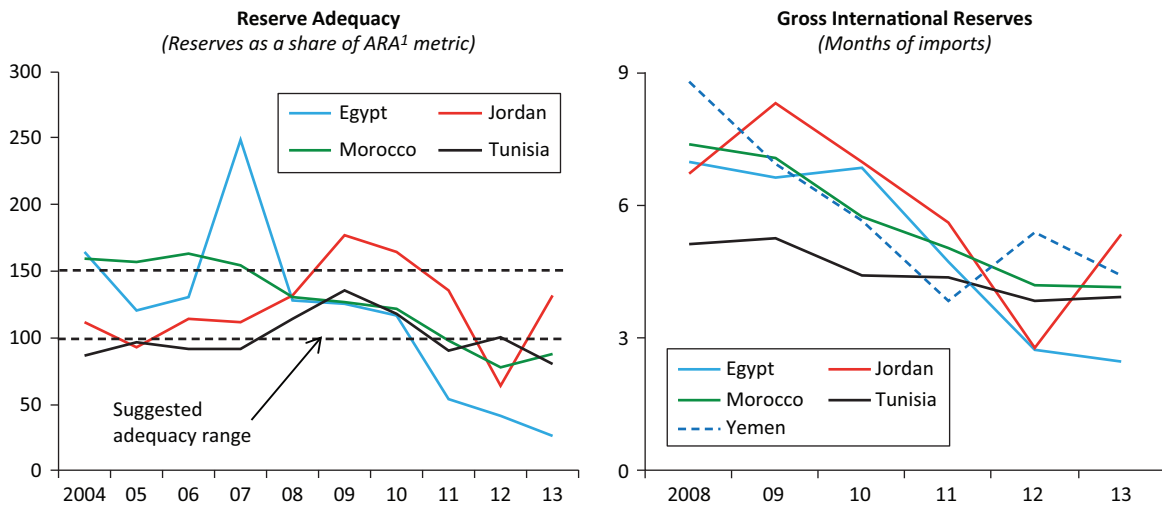
¹Libya maintains large foreign assets; reserve coverage is not a concern.

Figure 3.2. External Developments



Sources: National authorities; and IMF staff calculations.

Note: Financial flows are calculated as net direct investment + net portfolio investment + net other investments.

Figure 3.3. International Reserves Have Dropped Since the Onset of the Transition

Source: National authorities; and IMF staff calculations.

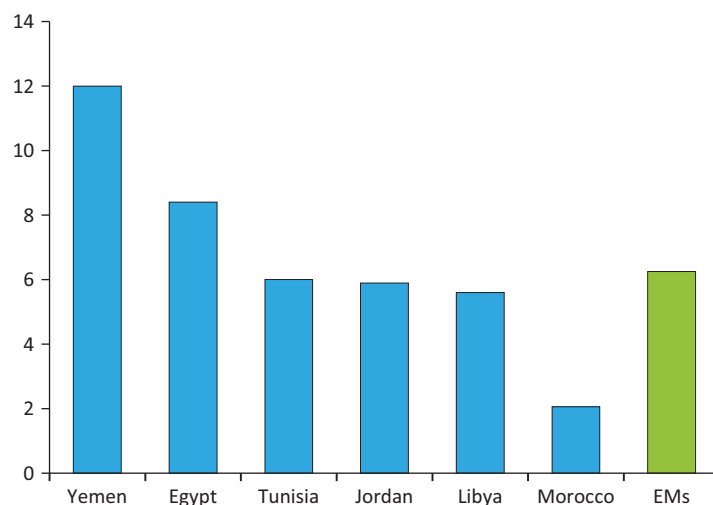
¹Assessing Reserve Adequacy metric as defined in (IMF, 2011a). 2013 estimates based on preliminary data.

Inflation outcomes have been, for the most part, benign. Substantial output gaps, subsidies on imported food and fuel products, and exchange rate stability relative to an appreciating U.S. dollar have helped keep inflation in most ACTs lower than in emerging markets, on average (Figure 3.4). However, in Egypt inflation has been structurally high and has risen over the past year as a result of pass-through from exchange rate depreciation, money expansion, supply shortages, and recurrent wage increases. Inflation in Yemen remains elevated but has declined in the context of the country's macroeconomic stabilization efforts following the 2011 crisis. In Jordan headline inflation has remained low despite liberalizing energy prices and a large influx of refugees.

ACTs have operated with limited exchange rate flexibility. Based on the IMF's de facto classification, ACT countries maintain pegged and intermediate exchange rate arrangements. In particular, three of the six ACT countries—Jordan, Libya and Morocco—maintain conventional pegs, while Egypt and Tunisia use crawl-like arrangements and Yemen operates under a managed float (Table 3.1). Pegs in Jordan, Libya, and Morocco have been in place for a long time, while Tunisia and Yemen have been making efforts to return to more flexible arrangements. Egypt maintained a crawl-like arrangement since 2010 and has recently allowed at times for increased flexibility.

Some ACTs have been experiencing appreciation in their real effective exchange rates (REERs). The evolution of the individual country REERs reflects patterns in the anchor currencies (for countries with pegs), movements of the price of oil, domestic price and wage developments, and inflation differentials with trading partners. Compared to their 2005 levels, the REERs of Yemen and Libya appreciated by about

**Figure 3.4. Inflation in Most ACTs Has Remained below the Emerging Market Average
(Consumer price inflation, 2013; year average, percent)**



Sources: National authorities; and IMF staff calculations.

Table 3.1. Structural and Exchange Rate Characteristics

| | Egypt | Jordan | Libya | Morocco | Tunisia | Yemen |
|--|--------------------------------|----------------------------------|------------------------------|------------------------------|---------------------------------|---------------------|
| Resource-based economies | No | No | Yes | No | No | Yes |
| De facto exchange rate policy | Crawl-like arrangement | Conventional peg | Conventional peg | Conventional peg | Crawl-like arrangement | Other managed float |
| Output gap 2013 (percent) | -2.7 | -1.3 | - | -1.3 | -2.7 | -9.0 |
| Current account deficit, 2013 | 2.1 | 9.9 | 2.7 | 7.4 | 8.0 | 2.7 |
| Exchange rate assessment | 2.6 to 14 percent ¹ | -4.1 to 6.9 percent ² | 0 to 15 percent ³ | 5 to 15 percent ⁴ | 0.9 to 6.7 percent ⁵ | -8.5 to 2.3 percent |
| Labor market efficiency rank (1 = best; 144 = worst) | 142 | 101 | 137 | 122 | ... | 138 |
| Product market efficiency rank (1 = best; 144 = worst) | 125 | 44 | 137 | 69 | ... | 131 |
| Food imports as a share of total merchandise imports, 2010 | 19.2 | 15.9 | ... | 11.9 | 8.9 | 34.0 |

Sources: IMF staff estimates; and World Economic Forum Global Competitiveness Index.

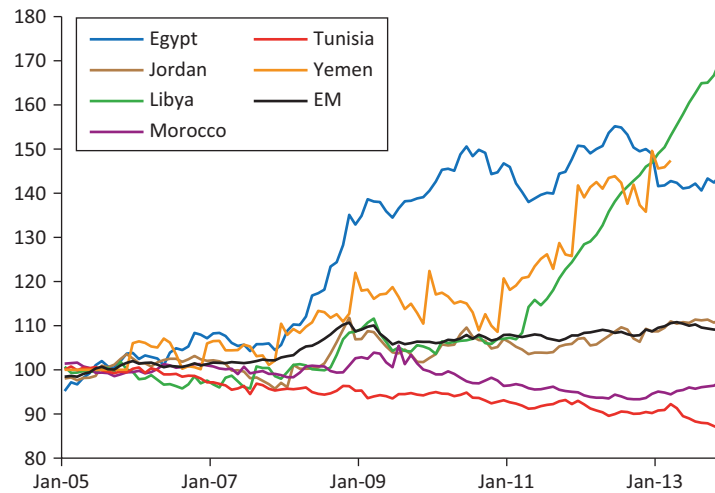
¹IMF Country Report 10/94.

²IMF Country Report 12/119.

³IMF Country Report No. 13/150.

⁴IMF Country Report 13/69.

⁵IMF Country Report 12/255.

Figure 3.5. Real Effective Exchange Rates Have Appreciated in Some ACTs

Sources: National authorities; and IMF staff calculations.

50 percent. In both cases, these increases were related to increased inflation in the wake of higher oil-based spending, and subsequently to high inflation in the context of Yemen's economic crisis and stabilization (2011–13) and Libya's 2011 civil war. Egypt's REER has been appreciating since 2007 because of high inflation, though that trend has recently halted, partly owing to depreciation of the nominal exchange rate. Jordan experienced a milder REER appreciation driven by the appreciation of the U.S. dollar since mid-2010, and by inflation differentials with trading partners. In contrast, Morocco and Tunisia's REERs have been following a declining trend and are currently below their 2005 levels (Figure 3.5).

Monetary and Exchange Rate Policies in Support of High and Sustainable Growth

The choice of an exchange rate regime depends on the structure of the economy. Important factors include the size of the economy, the degree of openness and financial development, the diversification of the economy's production and exports, its exposure to shocks, concerns about domestic inflation, the degree of labor and capital mobility, the extent of price flexibility in product and labor markets, and the quality of institutions. In addition, the degree to which existing regimes provide a well-functioning inflation anchor and economic stability will be an important factor. Short-term considerations may also include a need to maintain adequate levels of international reserves and avoid any significant misalignment of the exchange rate with fundamentals.

The empirical literature offers no consensus on the effect of exchange rate regimes on macroeconomic performance.² Recent IMF empirical work on the choice of exchange rate regime brings more balance to the debate over which regime is appropriate, and suggests that there is no “single prescription.” It also identifies important tradeoffs in the choice of exchange rate regimes among the goals of economic performance (inflation and growth), the vulnerability to real or nominal shocks, and the ease of external adjustment.³

Inflation and growth

Pegging the exchange rate provides a useful commitment device to anchor inflation expectations. A well-established finding in the literature is that pegs are associated with lower inflation than more flexible arrangements because they can anchor inflation expectations and provide macroeconomic stability.⁴ Indeed, conventional pegs in Jordan, Morocco, and Libya have, on average, yielded inflation rates 4 percentage points lower than in the other ACTs since 2000.

International evidence associates faster growth with intermediate regimes. Recent empirical evidence (Ghosh, Ostry, and Tsangarides, 2010) suggests that intermediate exchange rate regimes are associated with the highest average growth performance by capturing some of the benefits of pegs (low nominal and real exchange rate volatility, and trade integration) while avoiding the main drawback (risk of exchange rate overvaluation). Countries that allow for exchange rate flexibility also experience smaller GDP losses in response to negative terms of trade shocks (Broda, 2004). In the ACTs, average per capita growth performance since 2000 has been similar across regimes.

Real and nominal shocks

The nature and magnitude of shocks facing the economy are important considerations in choosing an exchange rate regime. Real external shocks (such as terms of trade shocks) or nominal external shocks (such as increases in trading partner inflation) are better accommodated with flexible exchange rate regimes. In contrast, a fixed exchange rate regime may be more

² See Ghosh, Gulde, and Wolf (2003), Levy-Yeyati and Sturzenegger (2003), and Reinhart and Rogoff (2004).

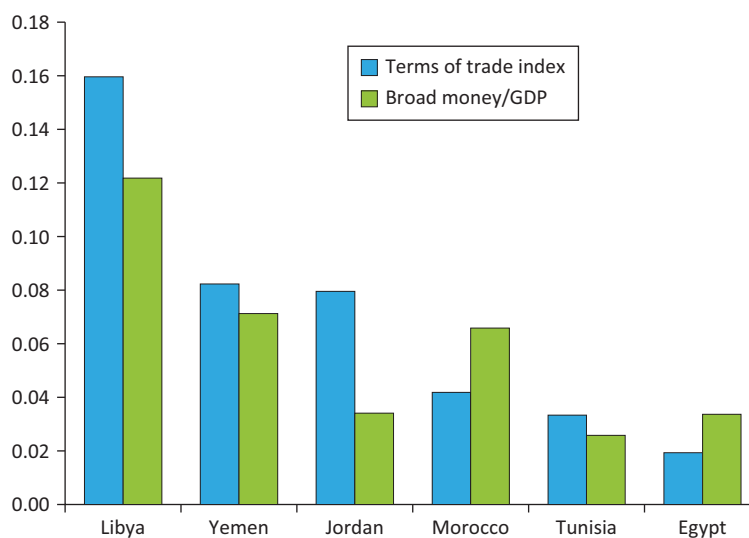
³ See Ghosh, Ostry, and Tsangarides (2010). Previous Fund work on exchange rate regimes includes Mussa and others (2000) and Rogoff and others (2004).

⁴ See Ghosh Gude, and Wolf (2003), Rogoff and others (2004), and Klein and Shambaugh (2010).

suitable when the economy faces domestic nominal shocks, such as those originating from fluctuations in money demand.⁵ The ACTs are subject to significant real economic shocks including volatile terms of trade (Figure 3.6) and their exposure to prices of imported goods, for example food prices, is high. Some countries have also experienced money volatility, but this has not necessarily translated into inflation volatility.

An important characteristic of more flexible exchange rates is that they facilitate external adjustment. Recent empirical work using data from the past three decades shows that floating exchange rate regimes are associated with smoother and faster external adjustment, while less flexible regimes are associated with larger deficits, which can cease abruptly.⁶ It appears that this pattern broadly holds among the ACTs: Egypt, Tunisia, and Yemen—countries with more flexible exchange rate arrangements—have, on average, lower imbalances than those with pegs.

Figure 3.6. Real and Nominal Volatility, 2000–12¹



Sources: National authorities; and IMF staff calculations.

¹Calculated as the average three-year rolling coefficient of variation for the corresponding period of time.

⁵ See Friedman (1953), Broda (2004), and Jbili and Kramarenko (2003).

⁶ See Ghosh, Ostry, and Tsangarides (2010), and Ghosh, Qureishi, and Tsangarides (2013).

Structure of the economy

Undiversified resource-based economies benefit less from exchange rate flexibility than non-resource economies do. As argued above, in an environment where the scope for expenditure switching between traded and non-traded goods is limited, exchange rate changes have only a small effect on external positions and growth. By contrast, the undiversified export structure implies that export earnings may be volatile and may fluctuate with international commodity prices, which, under a flexible exchange rate regime, would lead to large swings in the exchange rate. In the upswing of the commodity price cycle, this would lead to significant exchange rate appreciation hindering countries' efforts at economic diversification, and would suggest that commodity windfalls would be spent rather than invested abroad for future generations.

Recommendations

Based on these criteria, each country will need to weigh the pros and cons of pegging versus exchange rate flexibility on an individual basis. Inflation will need to be kept contained, and inflation expectations well anchored. At the same time, a key near-term challenge is to safeguard aggregate demand in the face of weak growth and necessary fiscal consolidation. In addition, capital flows must be restored so as to reverse the decline in reserves. This outcome would come from a credible monetary and exchange rate policy that reduces the impact of real shocks, supports measures to increase competitiveness, controls inflation, and thus lays out a path for stable and job-creating growth. For countries that opt for greater exchange rate flexibility, this would require the establishment of a new anchor for monetary policy and stepped-up technical capacity at the central bank, while pegging runs the risk of a continued gradual buildup of vulnerabilities (including exchange rate overvaluation and potentially increasing dollarization and balance sheet risks) and implies the need to align fiscal policy more closely with macroeconomic objectives.

Countries that opt to allow more exchange rate flexibility may need to prepare the ground. Central banks may need to build additional capacity, particularly if they want to pursue inflation targeting (see below). Moreover, the presence of adequate mechanisms for hedging foreign exchange risk for companies and households would lessen the potentially negative impact of exchange rate volatility, and sufficiently deep local capital markets could provide firms with an alternative to debt issuance in foreign exchange.

Monetary policy under exchange rate flexibility

More flexibility in exchange rates brings with it the opportunity for more proactive monetary policy but requires a strong monetary anchor. For example, during times when demand is cyclically weak, job creation and economic activity can be boosted through monetary policy easing. For this approach to be effective, however, a strong monetary policy framework is needed to anchor inflation expectations.

Under a set of preconditions, inflation-targeting regimes would be best suited to addressing monetary policy challenges. Although there has been a general trend towards adopting inflation-targeting regimes, including in emerging markets, such regimes also require more developed monetary policy institutions and instruments. Indeed, Egypt, Morocco, and Tunisia have announced their intention to move toward inflation-targeting regimes once the required institutional environment is complete. From the standpoint of their varying degrees of progress, the ACTs would need to focus on four main areas:

- *Central bank capacity and independence.* In some countries, central bank independence should be strengthened through amendments in the legal framework: requiring the appointment of independent Board members, and specifying adequate rules for central bank lending to government and financial institutions. In countries where the operational capacity of the central bank is strong and independence is well established, there is greater scope to move towards inflation targeting. This move will require a solid understanding of the monetary policy transmission mechanism and the ability of the central bank to pursue its inflation target consistently. Inflation targeting cannot operate effectively in cases where fiscal dominance constrains monetary policy options.
- *Political support.* There is often a tradeoff between output and inflation goals, which may undermine the extent to which the central bank can credibly achieve inflation targets. Broader political support for central bank independence and the inflation target is essential.
- *Stable/low initial inflation.* There are few situations where inflation targeting has been successful when it was started in a high-inflation environment.
- *Policy transparency and communication.* Improvements in communication—through regular monetary policy reports, public statements and, possibly, publication of the minutes of policymaking meetings—can help provide policy transparency and support public accountability, which underpins operational independence.

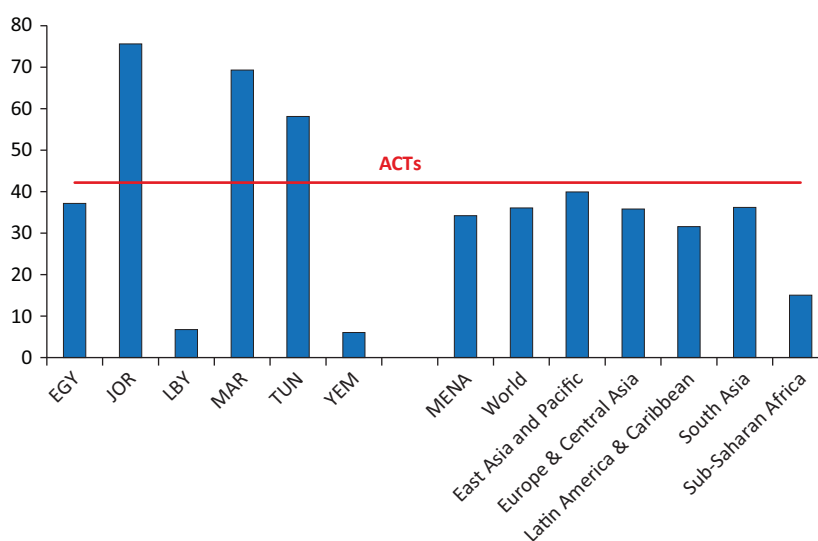
During the transitional phase, countries could adopt a monetary aggregate as a target. Given the institutional and policy requirements, ACTs are not yet in a position to adopt full-fledged inflation-targeting regimes, though some, like Morocco, are making significant progress in strengthening their capacity. In the interim, countries could consider adopting a monetary aggregate target (such as broad money) as the monetary anchor. Conventional monetary targeting can be a useful disciplining tool for achieving monetary/fiscal restraint and managing inflation in the early stages of stabilization under a flexible exchange rate. Countries that have or can gain higher policy credibility, eliminate fiscal dominance, deepen financial markets, and enhance the analytical capabilities of central banks can transition towards more flexible regimes that supplement monetary targeting with some forward-looking aspects needed for inflation targeting—but without necessarily publishing an explicit inflation target in the initial stages.

For countries that opt for increased exchange rate flexibility, policymakers can address stakeholders' resistance by empowering beneficiaries and compensating losers. In addition to concerns about adverse macroeconomic consequences, obstacles to increased exchange rate flexibility may arise from interest groups that have divergent views on the exchange rate regime, level, and distributional effects, and from the governments' institutional and political strength to identify and tackle vocal interest groups. For example, if food and energy are a large component of imports and the consumption basket, consumers may be resistant to increased flexibility because of the uncertainty this would imply for their purchasing power. Addressing these and other concerns requires a concerted effort by the authorities to empower beneficiaries of reform, build coalitions, consider ways to compensate groups that stand to lose, and sequence reforms with realistic timing (Chapter 6).

Bolstering Financial Stability and Development

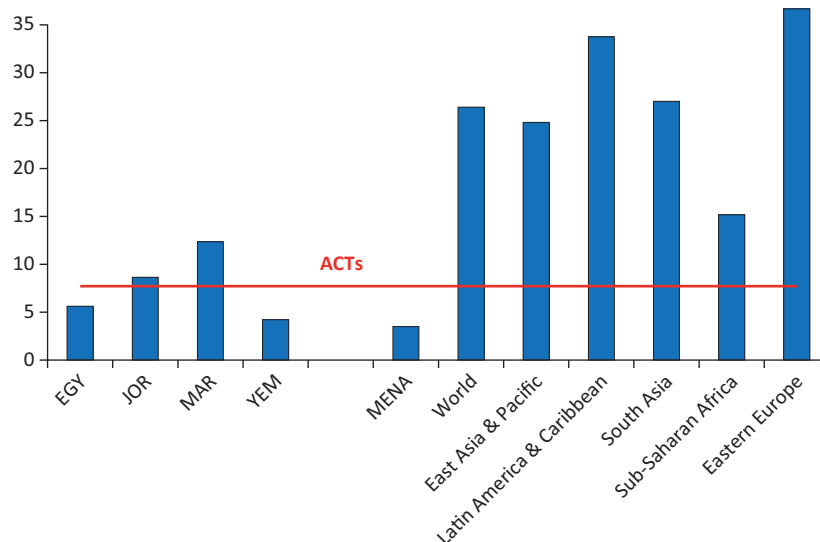
Financial systems in the ACTs could gain significantly from reforms that foster financial stability and development. Although banks are sizeable, competition remains limited, with significant state ownership in many cases, and credit is highly concentrated in a few large, well-connected borrowers. The nonbank financial sector remains underdeveloped. In consequence, access to finance for most people and firms remains very limited, highlighting the large potential gains from fostering inclusive financial development. At the same time, elevated levels of nonperforming loans (NPLs) in many banking systems point to a needed focus on policy areas that help reinforce financial stability.

Figure 4.1. Bank Credit is Large in Most ACTs
(Bank private credit to GDP, 2007–11 average; percent)



Source: World Bank Global Financial Development database.

Figure 4.2. Few Firms Use Bank Credit to Finance Investments
(Percent of firms using banks to finance investments, latest year available)



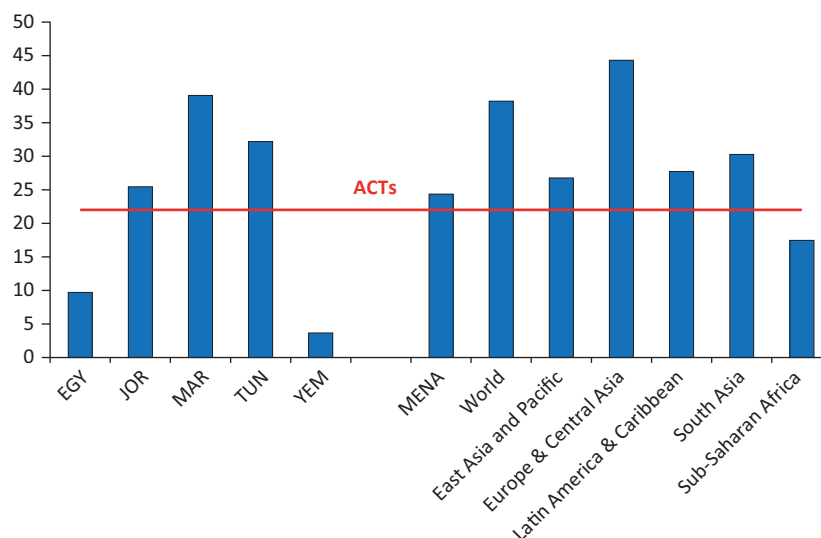
Source: World Bank Enterprise Surveys.

Banking systems are relatively large compared to other regions, with credit concentrated in large, established companies. The ACTs compare well with other countries in the world in the size of financial intermediation, as measured by credit to the private sector over GDP, except for Libya and Yemen (Figure 4.1). The average ratio of private sector credit to GDP is higher than in other regions, and bank credit overshadows other sources of finance. This finding is not surprising, given the large deposit bases and loan-to-deposit ratios in general in the MENA region. However, credit remains very concentrated in many countries, and its benefits disproportionately go to large companies (Barajas and others, 2013.)

Lack of access to finance is a major constraint for firms and households. Only 7 percent of firms use banks to finance investment, by far the lowest share among the world's regions (Figure 4.2); and more than 30 percent of firms identify access to finance as a major constraint, a higher percentage than in all other regions except sub-Saharan Africa (Figure 4.3). In some ACTs only a small share of adults have bank accounts (Figure 4.4); this low access to finance has been the result of a variety of factors, including poor financial infrastructure, weak banking competition, connected lending, and underdevelopment of the nonbank financial sector.

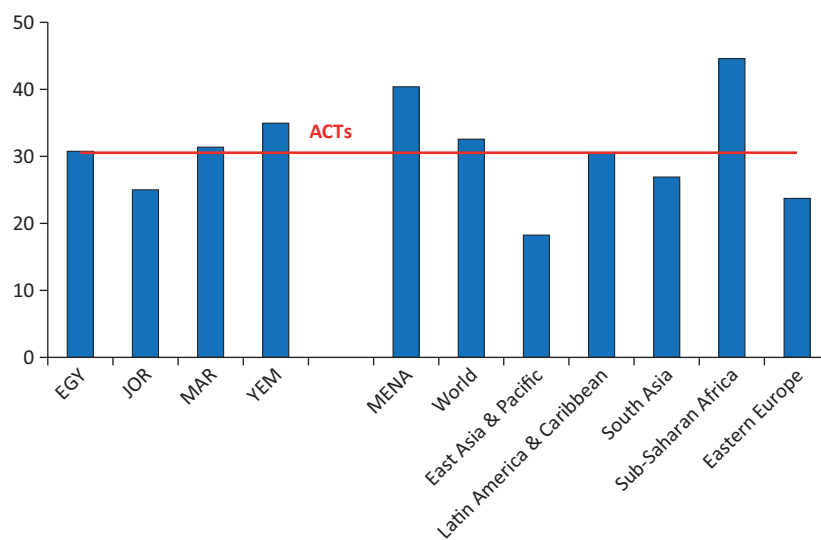
Many ACT banking systems suffer from elevated NPLs. Poor risk management in banks, combined with weak financial infrastructures, have resulted in a higher ratio of NPLs compared to other regions; in some countries it is also the result of a history of connected lending between

Figure 4.3. Relatively Few People in the ACTs Maintain Bank Accounts
(Adults with an account at a formal financial institution to total adults, 2011; percent)



Source: The World Bank Global Financial Development database.

Figure 4.4. Access to Finance is a Major Constraint
(Percent of firms identifying access to finance as a major constraint, latest year available)

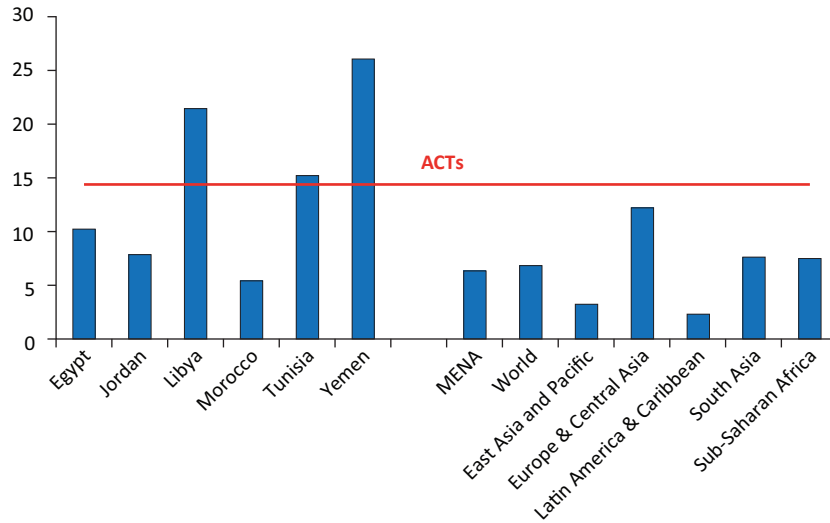


Source: World Bank Enterprise Surveys.

state-owned banks and state-owned enterprises, and of the economic downturn in the context of political transitions (Figure 4.5).

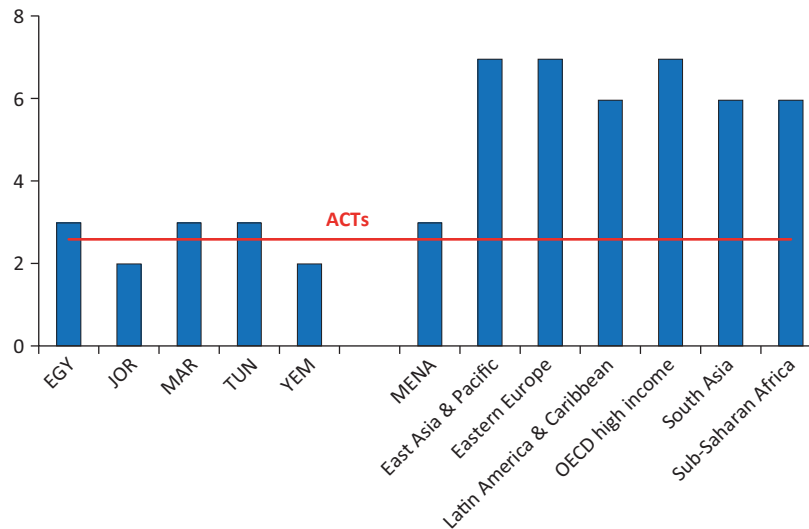
The financial infrastructure in the ACTs is weak. The ACTs still depend on traditional public credit registries, and even the countries that have introduced private credit bureaus are lagging behind other regions in coverage and

Figure 4.5. Nonperforming Loans are High
(Nonperforming loans, 2013 or latest month or year available; percent)



Sources: IMF Financial Soundness Indicators database; World Bank Global Financial Development database; and MCD high-frequency database.

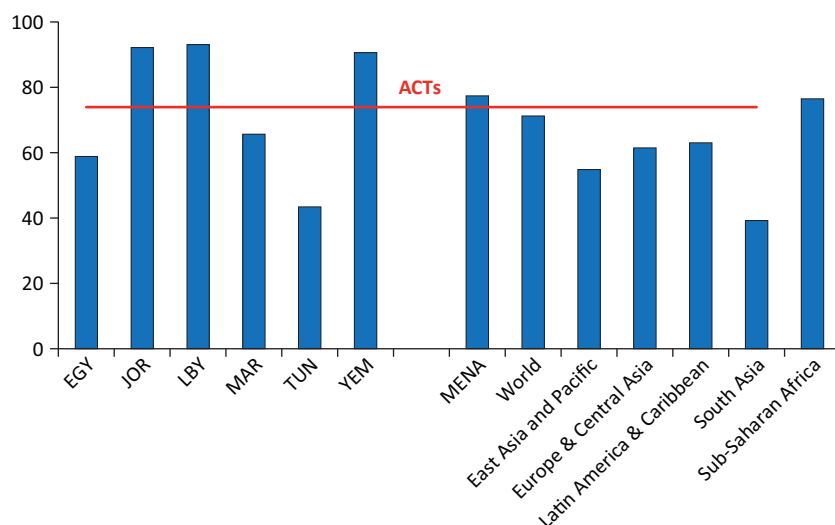
Figure 4.6. ACTs Rank Last in Legal Rights
(Strength of legal rights, latest year available; 0–10)



Source: World Bank, Doing Business.

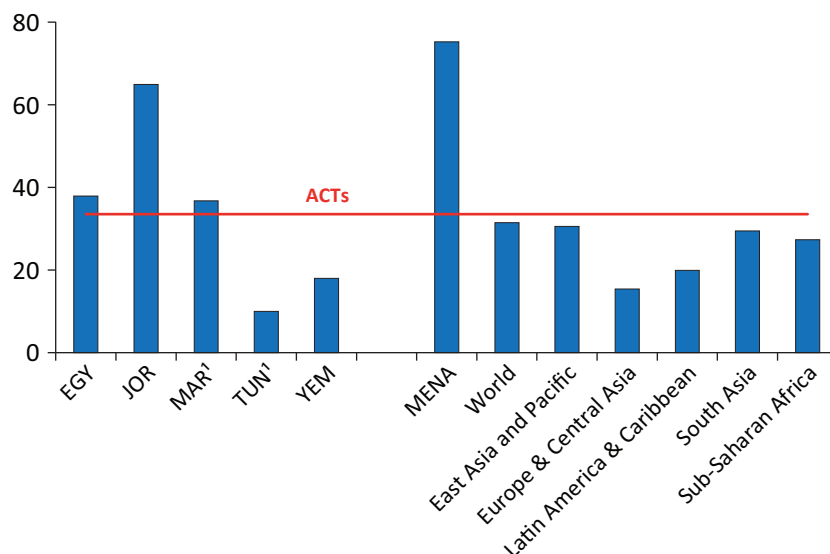
quality of information (Madeddu, 2010). In addition, the ACTs have severe weaknesses in almost all components of collateral regimes: the region ranks last in the area of credit rights as measured by the legal rights index of the World Bank’s Doing Business indicators (Figure 4.6). Insolvency regimes suffer from the lack of efficient exit mechanisms and protection for secured creditors (Rocha and others, 2011b).

Figure 4.7. Bank Concentration is High
(Three largest banks, 2007–11, average; percent)



Sources: World Bank Global Financial Development database.

Figure 4.8. Government Debt Markets Remain Underdeveloped
(Outstanding public debt securities to GDP, 2007–11 average; percent)



Sources: National authorities; and World Bank Global Financial Development database.

¹Average for 2008–11.

Bank competition is lower than in most emerging market regions (Anzoategui, Martinez Peria, and Rocha, 2010). The ACTs have the largest bank concentration in the world (as measured by the share in total assets of the three largest banks in each country), stifling competition (Figure 4.7). Weak

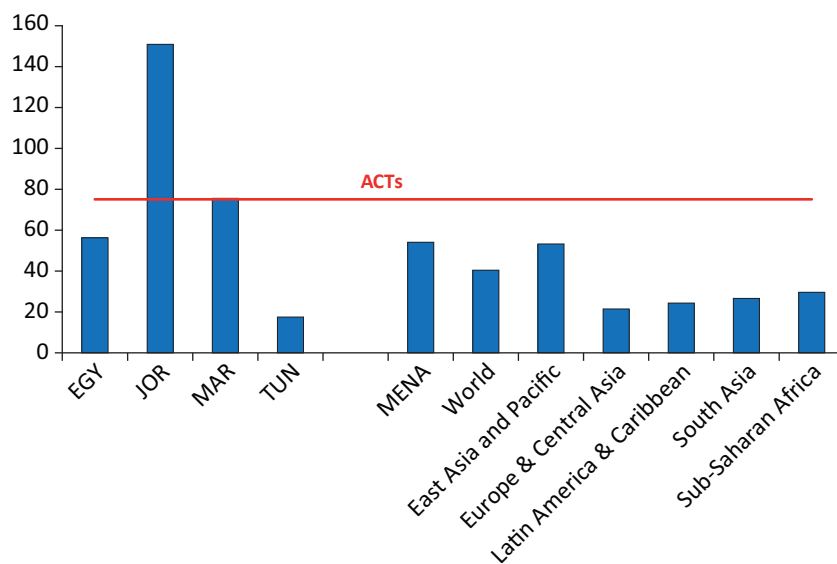
competition is also explained by a weak credit culture, complicated licensing requirements, and the dominant role of state-owned banks.

Nonbank financial sectors remain underdeveloped in most ACTs. The financial landscape is dominated by the banking sector. The nonbank financial sector consists mainly of government bond markets and equities, with little presence of private fixed-income market or corporate issuers. The stock of traded public bonds is sizable and constitutes an important instrument for domestic portfolios (Figure 4.8); however, government debt markets remain underdeveloped, with scope for further deepening and improving market liquidity and broadening the investor base. The stock of private fixed-income instruments is negligible; there is very little issuance of corporate bonds, mortgage-backed securities, or other asset-backed securities. Thus there are few alternatives to bank financing for corporations and small and medium-sized enterprises (SMEs).

Stock markets in some ACTs are large but have limited trading volume. The average stock market size is large, as measured by the ratio of market capitalization to GDP (Figure 4.9). However, the amount of stocks available for portfolio investment is small in many countries, as indicated by the low free float compared to international average, and reflects the large number of family-controlled companies and concentrated ownership structures in the region.

Capital markets are not supported by a solid domestic private institutional investor base. The lack of private institutional investors (insurance companies,

Figure 4.9. Stock Markets are Large in Some ACTs
(*Stock market capitalization to GDP, 2007–11, average; percent*)



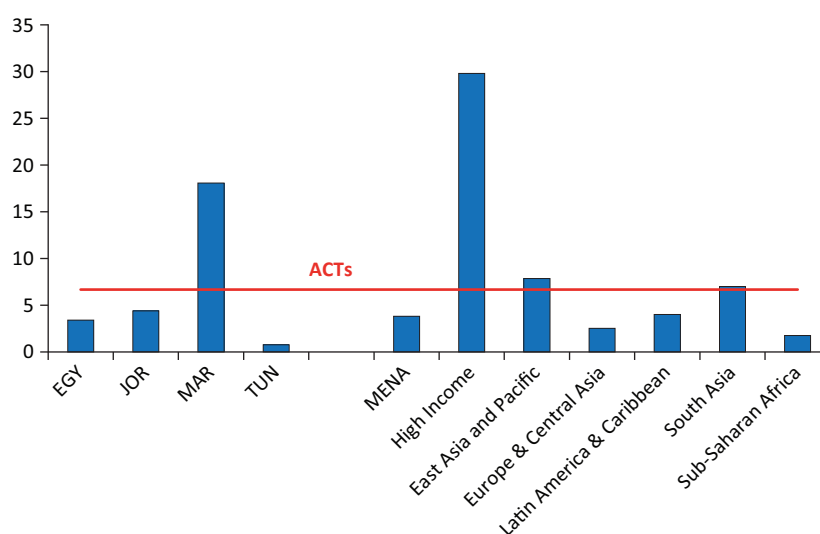
Sources: World Bank Global Financial Development database.

mutual funds, and private pension funds) operating in capital markets is one of the main hindrances to promoting the role of the capital market in supporting growth (Figure 4.10) and, combined with a large number of uninformed small individual investors, a few high net worth individual investors, and large state investors, raises questions about the quality of price discovery (Rocha and others, 2011a).

In light of these trends and structural impediments, the ACTs need a bold agenda for financial access and stability. Starting points and reform needs vary across countries, but there are a number of common areas for reform. There is a clear need to expand access to finance, particularly for SMEs, to enable entrepreneurial activity and spur job-creating growth. Countries also need to develop alternatives to bank finance, including private bond issuance. This will further their economic development and, in countries where bank financing for the public sector limits the availability of private sector credit (see Chapter 2), can help address a key bottleneck. Fostering Islamic finance will contribute to the inclusion of wider segments of the population in the financial system, and thus help to build a more inclusive economic model. Finally, continued improvements to financial stability are needed to ensure stable economic conditions for growth and job creation. The wide range of potential reform areas suggests a need for careful prioritization and sequencing, and for a flexible approach so that reform opportunities can be seized as they arise.

The rewards of successful reform can be significant. Empirical estimates show that raising access to finance to the world average could increase per

Figure 4.10. Private Institutional Investors are Lacking in Some Countries
(*Insurance company assets to GDP, 2007–2011 average; percent*)



Source: World Bank Global Financial Development Database.

capita GDP growth by over 0.1 percent per annum on average for the MENA region, and by substantially more in countries with high access constraints (Bhattacharya and Wolde, 2010). Moreover, financial development and stability can significantly reduce income inequality and poverty, and potential gains in these areas are much larger in the ACTs than in other regions in the world (Ben Naceur and Zhang, forthcoming).

Expanding Access to Finance Through the Banking System

Strategies to enhance access to finance need to address shortcomings in the banking system, which is expected to continue dominating the financial landscape in the coming years. The financial infrastructure in the ACTs is much weaker than in other regions, and bank competition is low. Addressing these two priority areas could substantially improve access to finance and lending for SMEs, strengthening equality of economic opportunity, and supporting job-creating growth.

Strengthening the financial infrastructure should include improving credit information systems, enhancing collateral regimes, and reforming insolvency regimes. There have already been improvements in credit information with the introduction of private credit bureaus (PCBs) in Egypt and Morocco, the enacting of a customized credit reporting law in Jordan (in preparation for creation of a PCB in 2014), and the upgrade of the public credit registry (PCR) in Tunisia. Nevertheless, more needs to be done to improve the coverage and depth of credit information, especially for SMEs: data contribution in credit reporting should be mandatory and should include all loans; positive and negative data should be available; utilities and telecommunications providers should be included; inquiry to the PCR or PCB should be mandatory before granting credit; a National Identification Number (NID) system should be created for credit reporting purposes; and PCBs should be given incentives to develop value-added services (such as credit scores and ratings of SMEs) (see Maddedu, 2010).

Collateral regimes should be strengthened to improve creditor protection. The legal and regulatory frameworks for secured transactions need to be improved by allowing broad pools of assets to be accepted as collateral (e.g., receivables and inventories), by simplifying the procedure for creating security interests on movable assets, by developing modern electronic collateral registries, and by strengthening enforcement mechanisms including the introduction of effective out-of-court enforcement mechanisms (Alvarez de la Campa, 2011).

While considerable progress has been made on the legal front, insolvency regimes in the ACTs remain underdeveloped. Only a few countries (such as Morocco) have introduced an insolvency regime that gives priority to corporate restructuring (Tahari and others, 2007). Considerable room

remains for modernizing bankruptcy and foreclosure proceedings. More specifically, bankruptcy should be decriminalized, liquidation and reorganization procedures should be made more efficient through improved court functioning, and bankruptcy professionals need to be better trained in the economics of distressed firms and commercial matters (Uttamchandani, 2011).

Strengthening competition among banks will also be important, to create better incentives for them to expand their lending. Strict entry requirements, a weak credit information system, and lack of competition from capital markets and the nonbank financial system are among the main impediments to stronger bank competition in the ACTs (Anzoategui and others, 2010). Enhancing competition in the banking sector may require the review of licensing requirements to ease bank entry (though without undermining the quality of entrants), the removal of remaining barriers to entry for reputable foreign financial institutions (for example, greenfield bank licenses have generally not been granted (see the World Bank/IMF Tunisia Financial Sector Assessment Program, 2012)); the development of nonbanking finance institutions and capital markets (see below); the elimination of any preferential treatment in the regulatory, supervisory, and tax treatment of public and private banks; the reduction of loan concentration and connected lending through enhanced prudential measures and additional capital requirements; a continuous effort to promote financial instrument transparency; and the creation of a competition agency with the mandate of ensuring competition in the financial sector.

The steady growth in Islamic banking during the past decade suggests that it has started to move into the mainstream of the banking system. The participatory nature of the Islamic banking business model helped to minimize the adverse impact of the global financial crisis on Islamic banks (Hasan and Dridi, 2010). The prospects for Islamic banking are favorable, with further growth expected, and Islamic banks are evolving rapidly in the variety, distribution, and operational complexity of their products, to meet the challenges of Shari'a compliance and competition. Some jurisdictions have amended their regulatory systems to incorporate Islamic banking-related legislation, to increase consumer confidence, and to create an environment conducive to expansion and economic growth. Weaknesses persist in the risk management framework for Islamic financial institutions, however, and their risk management capacities are in need of comprehensive overhaul (Hasan and Dridi, 2010). Policymakers are advised to adopt Islamic banking guidelines issued by industry associations, such as the Islamic Financial Services Board (IFSB), International Islamic Financial Market, and the Basel Committee on Banking Supervision, on quality and regulatory capitalization, risk oversight, leverage ratios, and macro prudential buffers (IFSB, 2013).

Adopting new technologies, improving financial literacy, and ensuring consumer protection will also boost financial inclusion. Introducing new

technologies in the financial sector, such as mobile payment, mobile banking, electronic credit information systems, and biometric identification systems, can help lower the barriers to accessing financial services. Improving financial literacy for the young and for those with lower levels of financial education can have measurable effects (Miller and others, 2013). Consumers will also need to be protected, through more transparency and disclosure by lenders, and through effective recourse mechanisms.

Beyond Banks: Diversifying the Financial System

Diversifying the financial sector should focus on creating alternative sources of financing, particularly for SMEs, and improving the functioning and liquidity of local capital markets. Towards that end, ACTs should develop medium-term strategies for (i) deepening local bond markets and catalyzing private issuance; (ii) expanding the institutional investor base, including the pension and insurance industries; (iii) developing alternative instruments to bank financing, such as leasing and factoring, and promoting microfinance; (iv) fostering the development of Sukuk (Islamic fixed-income securities) markets to meet the growing demand for new asset classes for diversification purposes, with rigorous regulatory and supervisory frameworks in place. Over the longer term, improving corporate governance and investor education will contribute to attracting corporate issuers to the local bond and equity markets.

Deepening local bond markets and catalyzing private issuance

There is large potential for developing private bond issuance as an alternative to bank financing. Private fixed-income markets are largely underdeveloped within the ACTs, limiting the options of financing and investment channels (Rocha and others, 2011a). Corporate bond issuances within ACTs remain small and, for the most part, limited to banks in countries like Morocco and Tunisia, where they are used mainly to build up Tier 2 capital or for compliance with regulations limiting maturity mismatches. Fixed-income funds are very small, amounting to approximately US\$15 billion, or 25 percent of total assets under management (Morocco and Tunisia). Private fixed-income instruments such as corporate bonds, corporate Sukuk, asset-backed securities, mortgage-backed bonds, and covered-mortgage bonds can be essential pillars, providing long-term financing to the private sector and diversifying the financial sector.

Strategies to catalyze bond issuance should take a dual approach, pursuing both domestic and regional market development initiatives. The limited pool of savings and the underdeveloped institutional investor class (see above) pose structural constraints for the market's potential scale, liquidity, and efficiency. Because it takes time for institutional investors to develop, the strategy for

boosting private domestic bond issuance could be expanded or adapted to include a regional dimension.

Near-term policies to strengthen domestic issuance of fixed-income instruments should focus on creating an enabling environment. A sustainable macroeconomic environment, and stronger confidence in the ACT economies, as discussed in previous chapters, will be necessary preconditions. In addition, policymakers should identify priority areas for encouraging corporate bond issuance, including (i) creating a benchmark yield curve for government securities so as to improve pricing of corporate bonds; (ii) increasing market efficiency by setting up solid corporate governance structures, including adopting global sound transparency and disclosure practices to monitor risk; (iii) improving market infrastructure by aligning primary market structures (for example, issuing process and listing conditions) with the needs for efficient secondary market operations (volume, regular issuance, allocation) and building efficient electronic platforms for smoother market functions such as clearing and settlement; (iv) fostering a skilled human resources and knowledge base for regulatory, supervisory, and operational purposes by providing the necessary educational and technical training; and (v) developing capacity-building programs for corporate issuers, to strengthen the professional and competitive environment (Rocha and others, 2011a). Improving the supervision of large bank exposures and connected lending, as well as adding capital requirements for banks with high credit concentration, can help encourage large firms to issue bonds.

The ACTs should focus on putting in place the foundations for an active government bond market as a catalyst for private issuance. Some countries (Egypt, Jordan, Morocco) with large outstanding government securities and regular issuance can build on good initial conditions. Further action is required to improve market structure and secondary market liquidity, including monetary policy implementation and liquidity management to improve money market functioning; enhancements to the debt management strategy and issuance practices; and measures to diversify the investor base, including foreign participation. Key market shortcomings are found in the maturity structure, auction calendars, concentration of demand, and lack of liability management techniques. The maturity structure is generally unbalanced and does not always cover key points on the yield curve. With the exception of Egypt, countries do not comply with a predictable auction calendar, resulting in irregular supply of instruments. The authorities in other ACTs should prioritize building a reliable benchmark yield curve with a regular issuance calendar.

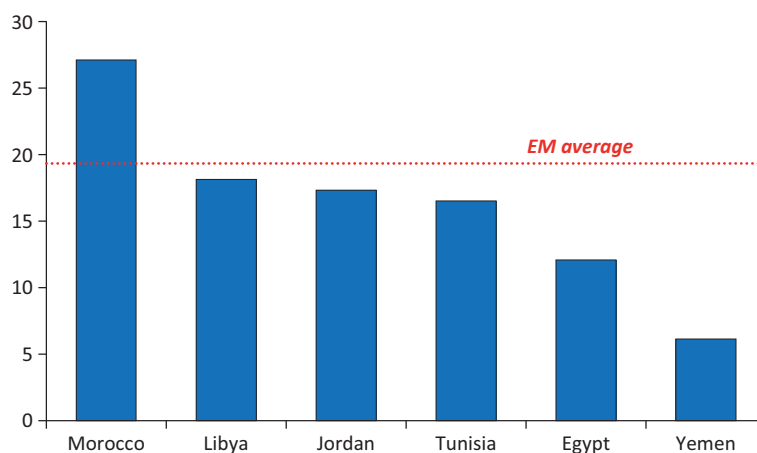
A large and diversified investor base is important for ensuring high liquidity and stable demand in the fixed-income market. A heterogeneous investor base, with different time horizons, risk preferences, and trading motives,

ensures active trading and stimulates liquidity, enabling the government to execute its funding strategy under a wide range of market conditions. Similarly, a diversified investor base will provide demand for privately issued financial instruments such as bonds and equities. Egypt and Jordan have the least diversified investor bases, with banks and state-owned entities holding more than 75 percent of issued debt (Rocha and others, 2011a). Secondary markets are generally shallow, as a result of excess liquidity and an undiversified investor base. Efforts to encourage the development of insurance, pension, and mutual funds industries over the medium term are necessary to diversify and improve the resilience of the financial sector and to make the best use of the significant amount of national saving in the region (Figure 4.11). State insurance companies and pension funds dominate the industries and limit competition and innovation.

Developing the insurance sector so it can play a role as institutional investor can help to broaden the investor base. Egypt has made progress towards allowing the entry of private companies and restructuring state insurers. Upgrading the regulatory framework for insurance sectors is a priority, because insurance supervisors lack adequate legal, administrative, or budgetary independence. Financial Sector Assessment Programs have identified several common weaknesses in supervisory practices, including weak financial reporting; weak corporate governance; problems with illegal and excessive payments to agents and brokers; lack of consumer protection mechanisms; and limited information available to the public (Egypt, Jordan, and Morocco are notable exceptions).

Promoting the development of private pension funds will also help strengthen the domestic investor base. Some countries have recently taken

Figure 4.11. Potential for Developing the Investor Base
(National savings rate, 2013; percent of GDP)



Sources: National authorities; and IMF staff calculations.

steps toward this goal, including Egypt and Jordan; however, pension schemes remain small and under-regulated. By contrast, public pension funds have accumulated large reserves as a result of the young demographic profile of their populations. Accumulated reserves exceed 20 percent of GDP in Egypt, Jordan, and Morocco. In many cases, asset management is not outsourced to independent investment managers, and assets are largely held in nontradable government bonds, resulting in their effective assimilation into unfunded pension schemes (Egypt). In other countries, public pension funds adopt conservative investment policies that include large holdings of government securities and bank deposits, and restrict holdings of foreign assets. In Jordan and Morocco, public pension funds seem to be adopting more modern asset allocation strategies and have expanded their allocations to equities, though investments in foreign assets are subject to low limits.

Over the medium term, a number of additional policy steps can be taken toward development of an active fixed-income market. These include:¹

- **Strengthening investor protection** (e.g., financial and nonfinancial institutions, pension funds, and mutual funds etc.) by building the necessary comprehensive legal, regulatory, and supervisory framework, in addition to developing a flexible collateral system, is critical to mobilizing resources and ensuring the development of a broader and deeper private bond market (only Morocco and Tunisia have securitization laws).
- **Promoting investor awareness** by launching public awareness campaigns to encourage investors to diversify their investment portfolios.
- **Building a strong asset management industry** to offer retail investors the opportunity to penetrate the bond market at low cost.
- **Developing new investment products** such as mortgage-backed securities, along with parallel development of derivative markets for risk management purposes.
- **Gradually liberalizing capital account restrictions** to enable foreign investors to enter and diversify the investor base and improve liquidity.

Exploring the potential for a regional bond market initiative could overcome constraints to bond market growth in individual countries. Individual markets are small, and a regional initiative could have the advantage of presenting foreign investors with a unified set of rules, lowering their cost for market entry. To support such an initiative, governments should consider introducing standardized market rules and regulations and tax codes across the

¹ See: Rocha and others, 2011a.

region; creating regional credit guarantee schemes; and allowing for regional credit rating services and clearing and settlement associations (Parreñas and Waller, 2006). Governments should also continue to relax the remaining capital controls to support the regional capital market initiative. These steps should be pursued in partnership with the private sector and in collaboration with regional bodies and oil-exporting countries' funds.

Strengthening alternative financing instruments

Developing the leasing industry can help overcome some obstacles that hold back bank lending and help SMEs gain access to finance. Leasing offers some potential advantages over bank lending: leasing companies retain ownership of the leased asset, overcoming some of the effects of weak creditor rights that hinder commercial bank lending to SMEs; and leasing companies are often established as joint ventures between equipment manufacturers and financial institutions, and benefit from the technical support of their founders. Leasing should be particularly attractive for SMEs in ACTs, because these firms do not have long credit histories or significant collateral. In addition, as an asset-based financing operation, leasing is inherently a Shari'a-compliant product. Despite these potential advantages, the leasing industry is very small in the region. In Tunisia, it accounts for about 10 percent of gross capital formation, followed by Jordan and Morocco at less than 5 percent. That said, markets are growing quickly in the ACTs, revealing strong demand for the product and potential for further growth. The dominant types of lessors are banks and bank-related institutions, because of their easier access to funding. Policies to promote leasing should focus on strengthening the legal framework, including the enforcement of contractual and proprietary rights, and improving the tax framework to establish clear and neutral tax treatment.

Supporting venture capital and private equity can help innovation. Private equity investment in MENA is very low at 0.05 percent of GDP (2012), well below world averages (MENA Private Equity Association, 2013). To support development of private equity and venture capital, ACT governments can consider guarantee schemes for venture capital investment in startups; foster collaboration between incubators, research and venture capital companies; streamline the legal and tax systems to remove complications; reinforce the protection of property rights; allow foreign investment in the industry; and consider the creation of special public funds to alleviate the lack of funding in the industry (OECD, 2006).

Bolstering microfinance

Strengthening microfinance could spur inclusive growth by providing economic opportunity for the smallest businesses and the poor. Microfinance is still limited in scale, reaching only 1.8 percent of the adult population

in the ACTs, about half the proportion in South Asia or Latin America. It continues to be constrained by the absence of a clear regulatory and supervisory framework, inadequate institutional models, and poor financial infrastructure (Pearce, 2011). Most microfinance institutions (MFIs) in the ACTs are non-deposit-taking NGOs. In some countries, including Tunisia, banks are restricted by interest caps that make microloans unprofitable. In most countries, MFIs are not included in the formal credit information system. Reforms to promote microfinance should focus on developing a finance company model for microfinance (allowing microcredit NGOs to evolve into finance companies), increasing flexibility for interest rate setting for microcredit, moving microfinance under the umbrella of the financial regulator, strengthening consumer protections, and integrating microfinance borrower information into credit bureaus (Rocha and others, 2011a).

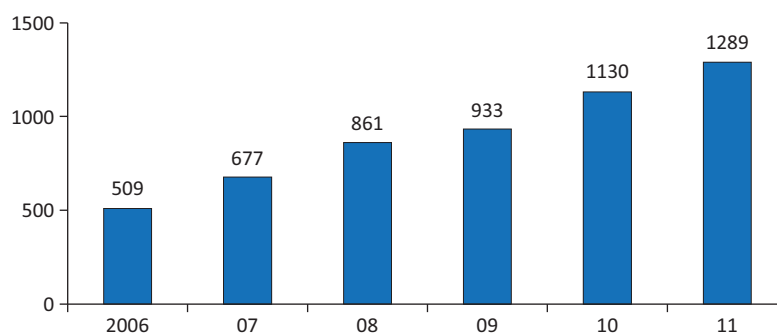
Islamic Finance for Financial Deepening and Access

Some ACTs have signaled interest in developing Islamic finance.² These countries face increased investor demand and rapid growth of Shari'a-compliant products (Figure 4.12). Developing financial products along Islamic principles encourages financial intermediation for groups of society that would otherwise not participate in the formal financial system, thereby fostering access to finance and an inclusive economic model. ACTs have recently amended their existing financial legal and regulatory systems to incorporate a suitable legislative environment for Islamic finance, including Sukuk capital markets. Libya is taking a different approach by requiring the complete conversion to a full-fledged Islamic finance system by 2015.

Integrating Islamic finance instruments into the existing financial system remains a challenge. Developing additional dynamic investment products requires concerted efforts over a period of time to create sufficient depth and liquidity for the new instruments, and to educate investors about the associated risks. Most Islamic finance contracts like Sukuk securities share some operational similarities to these of conventional bonds. Such resemblance is embedded in the characteristics of issuance, coupon payments, redemption procedures, and default clauses. It is important to guard against market fragmentation with too many instruments, given the thin instrument liquidity and narrow investor base in most ACTs. The Islamic finance industry is becoming a mainstream asset class: its regulatory and supervisory

² Based on Shari'a laws, in Islamic finance, transactions are based on the principle of profit and loss sharing; interest payment (*Riba*) and trading in financial risk products (*Gharar*) such as derivative products are prohibited.

**Figure 4.12. Global Assets of Islamic Finance Have Grown
(Billions of U.S. dollars)**



Source: *The Banker*, Ernst & Young, 2013.

frameworks in areas such as regulation, accounting, governance, and infrastructure are still being developed, including ensuring that the investment products are actually Shari'a-compliant and only mimic conventional products to target financial institutional investors.

A number of policies can help provide investors with a stable asset class. Over time, it is advisable to develop a comprehensive regulatory and supervisory framework for Islamic finance products, to support sound market growth and guard against risks to financial stability. Improving the transparency of the underlying asset structure and clarifying the legal framework and investors' rights would facilitate accurate valuation, pricing, and credit rating mechanisms in case of liquidation or restructuring. In addition, policymakers should focus on boosting supervisory capacity and introducing supporting policies such as: (i) standardizing products and unifying specialized Shari'a committee rulings on the compliance of Islamic finance contracts with Shari'a law, to minimize legal uncertainty among investors; (ii) considering how Shari'a-compliant products would be integrated into the existing financial system and operations of financial institutions; (iii) reviewing existing tax codes to ensure equal treatment of Islamic finance products and conventional finance; (iv) integrating Islamic finance into dealership systems and electronic clearing for speedy and cost-efficient operation, to reduce cost and risk; (v) developing a robust and efficient liquidity management framework to help Islamic financial institutions in performing funding and investment activities; and (vi) cultivating skilled human resources and the knowledge base, as Islamic finance involves a mixture of specialized qualification in legal, Shari'a, and financial expertise.

Safeguarding the Stability of the Financial System

Reinforcing systems to safeguard financial stability is a high priority. Promoting financial development and access to finance will strengthen growth

potential and promote equal economic opportunity, but the economic woes that have followed in the wake of the Arab Spring have highlighted the need to remain vigilant and support financial stability. There are four main areas in which the ACTs can enact improvements: macroprudential regulation and supervision, financial safety nets and crisis management systems, microprudential regulation and supervision, and bank governance rules.

Macroprudential regulation and supervision

Macroprudential policy must deploy a range of tools to address aggregate weakness and mitigate systemic risk. The authorities should tailor specific macroprudential instruments to their particular vulnerabilities. Some tools can address the buildup of aggregate risks over time: these include dynamic capital buffers that require banks to set aside money to cover loan losses in good times; varying sectoral risk weights to cover new loans in sectors that are building up excessive risks; loan-to-value ratios to reduce systemic risk from boom-bust episodes in real estate markets; and measures to limit exposure to foreign currency lending.

Effective macroprudential policies require adequate institutional underpinnings. These need to take into account country-specific circumstances and differences in institutional capacity. The arrangements should foster effective identification of developing risks; provide strong incentives to take timely and effective action to counter those risks; and facilitate coordination across policies that affect systemic risk (Nier and others, 2011). To achieve these goals, complex and excessively fragmented structures should be avoided.

Financial safety nets and crisis management

Refining the current model of financial safety nets and crisis management would help reduce moral hazard. By effectively not allowing banks to fail, the current approach has guaranteed the stability of the financial system, but it has reduced the incentives for private monitoring of the health of financial institutions. The framework would therefore benefit from a number of enhancements to strengthen market discipline.

Modernizing deposit insurance will be an important element. A well-designed, explicit limited-coverage deposit insurance system (DIS) can promote market discipline and protect small depositors from losses. There are four DISs in the ACTs: a pure pay-box system³ under central bank management in Morocco

³ A pure pay-box system has three basic roles: premium collection, fund management, and depositor reimbursement. This system assumes no significant role in bank resolution and the disposition of failed insured institutions (IADI, 2007).

and Libya, and operationally independent systems in Jordan and Yemen. Although the essential design of the explicit DISs in the ACTs is largely in line with the International Association of Deposit Insurers (IADI) core principles, there are some divergences that need to be addressed. Tunisia and Egypt need to transition from blanket government guarantees to a properly designed explicit limited-coverage DIS, preferably at a time when the macroeconomic environment is stable and the banking sector is sound. The reform of existing DISs should mainly focus on transforming the pure pay-box system into an effective tool for resolution, reinforcing the legal protection of those working in DISs, providing backup funding for the DIS (for example, a credit line with the government), adequately covering the large majority of small depositors, and moving from a flat-rate premium system to a risk-based one.

The introduction of special resolution regimes could be useful for the prompt and orderly resolution of failed banks. These regimes should allow banking authorities to take control of a bank at an early stage of its financial difficulties, to use a wide array of instruments to deal with a failing bank without the consent of shareholders (e.g., acquisition by a sound financial institution; creation of a bridge bank; partial transfer of deposits and assets to a “good bank”); specifying a regulatory threshold for initiating the resolution process; and establishing financial stability as its main objective (Cihak and Nier, 2009). Steps also need to be taken to introduce an effective crisis management framework in which a memorandum of understanding should define the respective roles of the Ministry of Finance and the supervisory authorities during a systemic crisis. Conducting periodic simulation exercises would help prepare all stakeholders to intervene coherently during an unexpected crisis. It can be also helpful to put in place a coordinating committee that will be in charge of crisis preparedness activities during normal times and in charge of crisis management during a crisis.

Modalities for emergency liquidity assistance should be strengthened and separated from monetary operations. The central bank should stand ready to promptly provide funds to solvent but illiquid banks secured by acceptable collateral. A haircut system should be introduced for loans to be used as collateral in the central bank refinancing operation. Emergency liquidity assistance should be more expensive than other instruments, to encourage banks to first look for funding from other sources (IMF Staff Report for the 2013 Article IV Consultation with Tunisia).

Microprudential regulation and supervision

Implementing effective risk-based supervision and enhancing the capacity and resources of supervisors remain a priority and a challenge. Capital requirements should better reflect individual institutions’ risk profiles as

well as macroeconomic risks. This requires progress towards risk-based supervision to define additional capital requirements. Supervisors should work towards adopting relevant Basel standards in a timely manner, and consider introducing a capital conservation buffer in line with Basel III.

Several countries, among them Egypt, Jordan, and Morocco, have made progress in bringing supervision into line with international standards. Risk-based supervision requires a transition from focusing on regulatory compliance to understanding and assessing banking groups' risk profiles and strategies, and taking appropriate supervisory actions in response. This transition generally calls for new supervisory methodologies, allowing for risk prioritization of on-site inspections and structured off-site risk analyses; a better understanding of the environment in which banks operate; adequate resources and staff able to understand, identify, and quantify risk; and effective coordination between offsite and onsite supervision.

Policies should aim at reducing credit concentration. Credit concentration is a shared characteristic that to some extent reflects economic structures, but it should be gradually reduced to ensure banks' stability and encourage competition and access to finance for SMEs. Supervisors should aim to reduce the concentration of credit portfolios by gradually tightening limits on credit concentration, and by subjecting banks that are exposed to high credit concentration risk to additional capital requirements. Banks should also be required to improve their risk management frameworks and apply international best practices for loss reporting, collateral valuation, and provision for NPLs.

Extension of the perimeter of prudential regulation will be increasingly important. As financial systems become more diverse and complex, the current focus on banking sector regulation and supervision will need to be broadened. International experience shows that focusing on bank regulation is not a sufficient instrument to capture systemic risks (Carvajal and others, 2009). These considerations argue for the allocation of more resources for regulatory authorities of nonbank financial institutions, and for enhancing coordination among supervisors. Coordination is also essential to prevent regulatory arbitrage as financial systems become more diverse and complex.

Bank corporate governance

Building on recent progress, improving bank corporate governance is an essential component of the financial sector reform program. Deficiencies in bank corporate governance arrangements can pose systemic risks to the real economy. ACT banks have made substantial progress in corporate governance

over the past decade: setting up board committees (audit, accounting, and risk management); separating the CEO and the chairman positions; diversifying the composition of boards; setting up banking-sector-specific corporate governance (Egypt, Morocco, Yemen); and introducing guidelines and regulation by supervisors (on the composition of the board, disclosure, risk management, and connected lending).

There is still ample room for improvement, and significant challenges arise for the implementation of reforms. Legislation and regulation on corporate governance exist in most countries but their implementation is lagging because supervisory authorities are weak. Audit committees are created by banks, but they lack an adequate proportion of independent directors. Risk committees are generally in place, but only at the management level.

Bank boards should be strengthened to include independent directors and members experienced in banking and finance issues. Results of an OECD-Hawkamah survey suggest that boards in the ACTs should have a majority of well-qualified independent or non-executive directors. Banking supervisors need to define directors' duties concretely and make sure that directors fulfill their functions properly. The performance of board members should be regularly evaluated. Board committees should receive adequate information within the bank and be conducted by independent directors with clearly defined duties.

Improvements are needed in risk management and disclosure. Risk management needs to be improved in most ACT banks, and requires creating the position of chief risk officer (CRO), with adequate powers, who reports directly to the board and alerts it to existing or emerging risks. Boards should have a committee that establishes the salary structure for all bank employees and board members. Although financial disclosure in the ACTs is largely of good quality, nonfinancial disclosure remains weak and needs to be improved, particularly in areas of basic ownership structure, the qualifications of board members and their attendance at board and board committees, and related-party transactions.

ACTs need a strategy for governance of state-owned banks. Although during the past two decades the ACTs implemented comprehensive privatization programs that included banks, during the past two decades, state-owned banks still maintain a large share of total banking assets in most ACT countries (Egypt, Libya, Tunisia). Countries should develop a vision for the role of public banks and reduce ownership where government participation has no clear and justifiable objective. In this context, privatization should not be the only option for state-owned bank reform, and ACT countries should consider developing and implementing corporate governance standards for their state-owned banks. Above all, state-owned banks should have clear objectives and

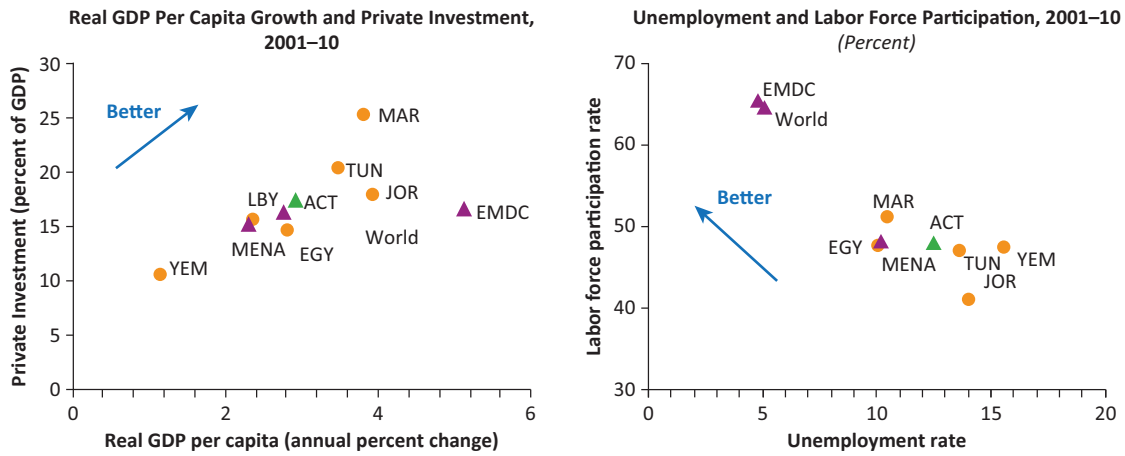
performance criteria to allow for greater political autonomy and for enhanced monitoring. Boards should include independent members with relevant skills to approve and oversee the bank's strategic decisions and the choice of senior executives. Finally, to reinforce competition, bank supervisors should regulate and supervise state-owned banks just as they regulate and supervise private banks.

Reform for Sustainable, Job-Creating, Private Sector-led Growth

The ACTs have contended for years with structural economic challenges. Many have moved over time from state-led economies to systems relying more on private sector-led growth. Nonetheless, competition in domestic markets and economic integration with the rest of the world remained limited, public sector employment stayed much larger than in other regions in the world, and the ACTs were unable to unleash the same economic dynamism that helped to raise productivity growth and lead the economic transformation in emerging markets and developing countries in other regions (Lipton, 2004, 2012). As a result, per capita growth was lagging behind other regions even before the onset of transitions in 2011 (Figure 5.1). In addition, there was a growing sense that the benefits of economic growth were largely captured by the well-connected, while large groups of people felt marginalized. Not enough jobs were created for a growing population, leading to high unemployment and low labor force participation (Figure 5.1) (IMF, 2010).

Current demographic trends in the ACTs require a heightened focus on growth and job creation. Demographic pressures suggest that unemployment will remain high in the oil-importing ACTs unless growth accelerates above 6 percent. Under current baseline projections for GDP growth of around 4¼ percent in these countries through 2018, fewer than 5 million jobs will be created, compared with about 7 million jobs needed to reduce the unemployment rate halfway to the average of emerging markets (that is, to about 8½ percent). To close this gap of 2¼ million jobs would require an average annual growth rate of 6¼ percent, considering the currently insufficient responsiveness of employment to growth. Because generating such high growth will be difficult, a focus on increasing the responsiveness of employment to growth is also needed. A strong commitment to creating an environment where the private sector can generate high, sustainable, and more job-creating growth will thus be required to improve labor market outcomes and unlock the ACTs' economic potential.

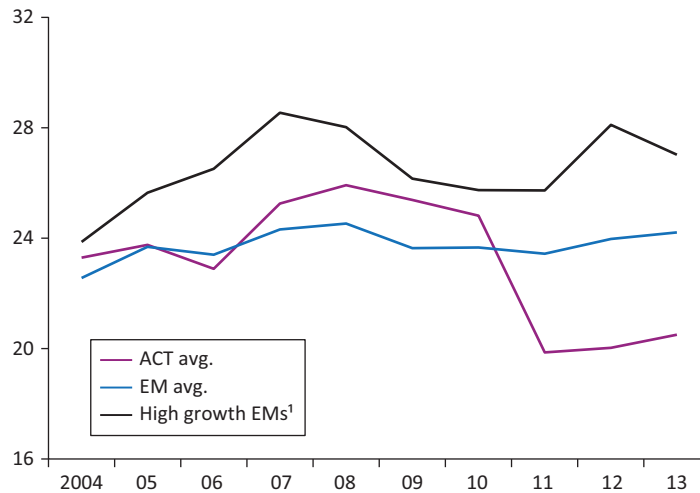
Figure 5.1. Lagging Growth and High Unemployment



Source: IMF World Economic Outlook; World Bank World Development Indicators; and United Nations International Labor Organization.

As the political transitions are progressing, countries need to focus on laying out plans for structural economic reform that will provide a vision for revitalizing the economy. Strategies will vary with each country’s different starting points and goals; and many countries, including Jordan, Morocco, and Tunisia, can build on earlier successful economic reform programs. All need to aim for higher, sustained, private sector–led growth, which requires more private investment (Figure 5.2) and higher productivity. Governments should strive to engineer an environment conducive to private sector–led growth, while ensuring adequate regulation for its

Figure 5.2. More Investment is Needed to Support Growth
(National investment rate; percent of GDP)



Sources: National authorities; and IMF staff calculations.

¹Highest real GDP growth quartile among EMs.

efficient functioning, so that the economy can move from rent-seeking to the creation of economic value and jobs. The ACTs themselves must drive these transition agendas, but it is crucial that the international community support them with adequate financing, improved access to key export markets, and policy advice.

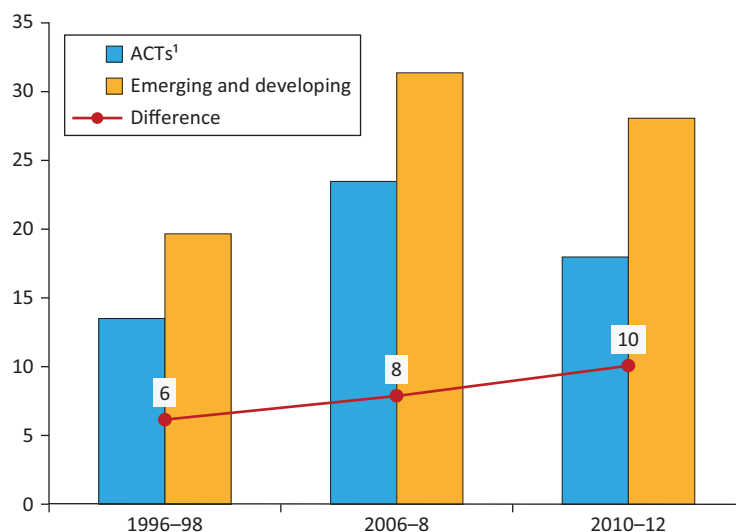
Bold reform agendas are needed to propel private sector activity and foster a more dynamic, competitive, and inclusive economy. Taking into account different country circumstances, reforms will broadly need to focus on four areas: greater global and regional trade integration; business and investment climate reforms to simplify doing business and enhance governance; labor market and education system reform to ensure productive employment and generation of human capital; and efficient safety nets to protect the poor and vulnerable. These efforts need to be supported by a strong statistical base that allows for efficient policymaking and monitoring. With a wide field for potential reforms and limited implementation capacity, countries will need to prioritize their reform efforts. Full implementation will take a number of years, and early steps in areas with high payoffs are needed to build momentum and signal governments' commitment to reform, thereby improving confidence (Yusuf, 2014). Country reform agendas will also need to consider sectoral priorities for targeted growth strategies, while being mindful of the perils of attempting to pick winners.

Boosting Trade

In recent decades, trade has not been a significant engine of growth for ACTs. Merchandise exports as a share of GDP are significantly below the average of emerging market and developing countries, and the gap has widened over time (Figure 5.3). As global growth has shifted toward emerging markets, longstanding close links with Europe—particularly among North African countries (Figure 5.4)—have meant that the region has benefitted relatively little from the high growth of emerging markets, particularly in Asia. Exports have also been inhibited in some cases by overvalued exchange rates (Chapter 3). Although countries (especially Morocco and Tunisia) have streamlined and lowered their tariffs, these remain high, and there are also significant non-tariff barriers (Figure 5.5). Partly because of high trade barriers between the ACTs, intraregional trade is very low (Figure 5.6). Vested interests from monopolistic or oligopolistic structures that provide rents to influential beneficiaries have often led to a political economy that has not been conducive to comprehensive trade liberalization.

Progress toward transitioning into knowledge-intensive business services and other higher-value-added areas has remained limited. The share of more technologically advanced and higher-value-added capital goods in total exports is small and remains below the average for low-income countries. This mirrors

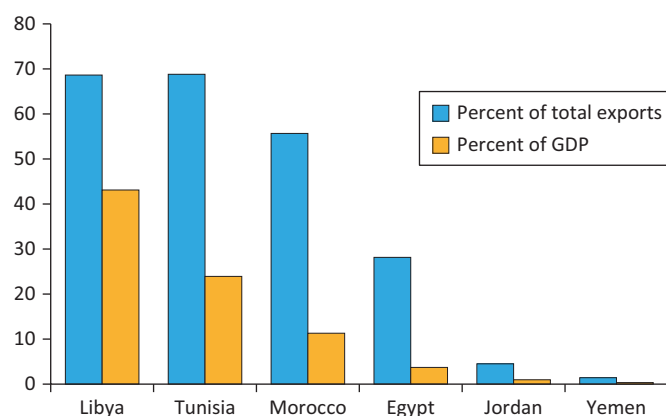
Figure 5.3. Large Potential for Higher Exports
(Merchandise exports; percent of GDP)



Sources: National authorities; and IMF staff calculations.

¹ Excluding Libya.

Figure 5.4. Strong Trade Links with Europe
(Exports to Europe, 2012)

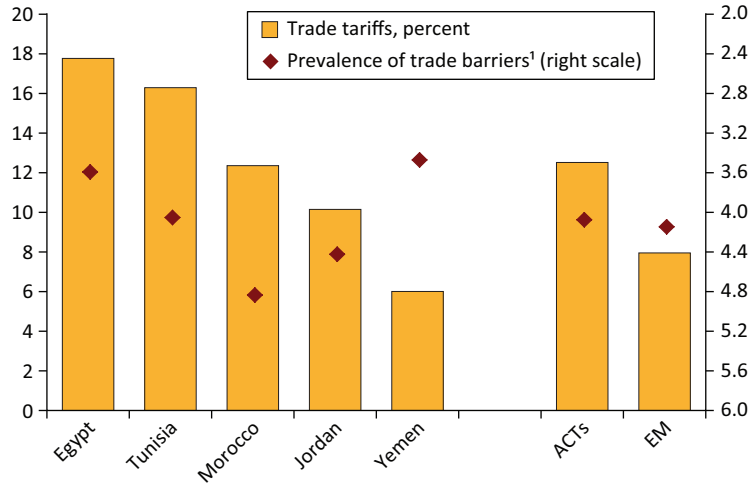


Sources: National authorities; and IMF staff calculations.

trends in the broader MENA region, where, according to recent estimates, exports are only a third of their potential, and aggregate intra-industry trade, an indicator of trade in differentiated goods and participation in supply chains, is lower than in Africa and all other regions (Behar and Freund, 2011).

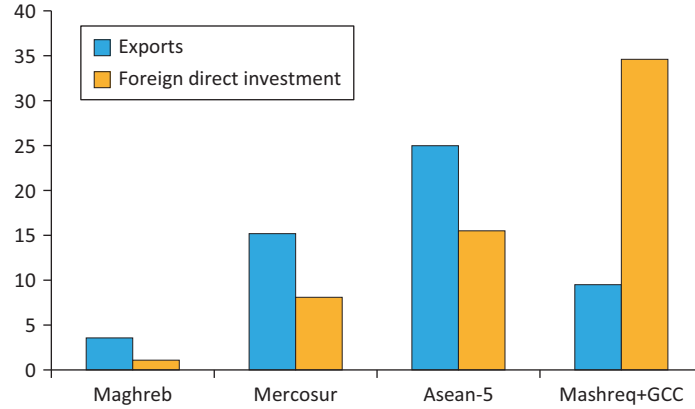
Deeper trade integration could provide a significant boost to the region's economies. Empirical evidence suggests that raising the MENA region's openness to the level of emerging Asian countries could increase GDP growth by as much as a full percentage point (IMF, 2010). Deeper trade

**Figure 5.5. Significant Trade Barriers
(Trade barriers, 2013)**



Source: World Economic Forum, Global Competitiveness Report 2013–14.
 ¹Scaled from 1–7, with 7 being the least restrictive.

**Figure 5.6. Intraregional Share of Exports and Stock of Foreign Direct Investment
(2011 or latest available, percent)**



Sources: ASEAN; MERCOSUR; IsDB; UNCTAD; Arab Investment and Export Credit Guarantee Corporation; and national sources.

integration would not only create growth and jobs through direct effects on exports; it could also catalyze productivity-enhancing inward FDI. Experience from Central Europe, for example, underscores that integration into international supply chains can generate significant greenfield investment. In addition, empirical studies show that larger markets are more successful in attracting FDI; this would be another benefit of regional integration (IMF, 2013a). The drive toward deeper trade integration can also help catalyze

reform efforts in other areas (such as business regulation and labor market reform) that are important for successful trade integration. The move toward greater integration into the global economy could thus help provide discipline and incentives to enact broader reforms aimed at strengthening competitiveness.

Deeper trade integration will require better access to advanced economy markets. For instance, the EU's high tariffs, quota restrictions, and farm subsidies remain a significant impediment to agricultural exports to the EU, and substantial non-tariff barriers to trade with the EU persist in the area of standards and conformity assessments. Existing agreements with the EU also do not provide for liberalization in trade in services. The EU could deepen its trade relationships with the ACTs through effective implementation of the proposed Deep and Comprehensive Free Trade Areas (DCFTA). As this process will take time, immediate steps should include providing better access for agricultural products (the EU has already adopted an agreement with Morocco to that end) and dismantling non-tariff barriers. The United States could deepen its existing trade agreements with Jordan and Morocco, and enter into free trade agreements with the remaining ACTs.

More trade integration with the EU and the United States will become especially important in the period ahead in light of the planned Transatlantic Trade and Investment Partnership (TTIP). The TTIP, a planned agreement between the United States and the EU, is expected to generate strong economic benefits overall but could have negative effects on ACT exports and jobs because of expected trade diversion to countries inside the TTIP (Felbermayr and others, 2013), unless accompanied by better access for ACTs to EU and U.S. markets.

To fully reap the benefits of integrating into global trade, a broader opening to trade will be required. Many countries, including Morocco and Tunisia, are strongly committed to further opening their trade regimes. All ACTs should strive to reduce their non-tariff barriers and, building on past efforts, consider further liberalizing their tariffs. They should also aim to diversify trade toward fast-growing emerging markets and higher-value-added goods. They could also better exploit the opportunities presented by global value chains, by removing import barriers for their exporting industries. Increased regional integration that would result from lowering non-tariff barriers and harmonizing policies would also help the ACTs' prospects for integration into global value chains. The removal of import barriers will need to be implemented in a well-planned manner, as the risk of negative short-term effects on affected industries underscores the need for adequate social protection. Losses in budgetary revenues stemming from lower tariffs would also need to be compensated by increases in other revenues or expenditure cuts.

Trade facilitation policies also play an important role. Trade facilitation measures can include the simplification of customs requirements, rules and

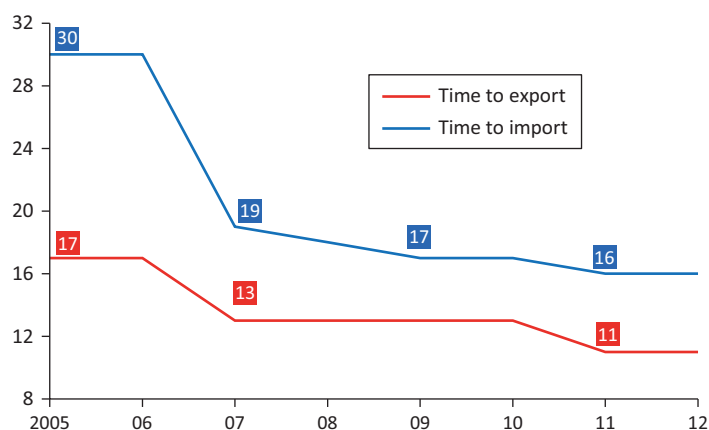
procedures, and upgrading logistics. These measures, which would also be supported by the EU in the context of DCFTAs, are gaining importance in a world of global value chains. Better logistics, in particular, have been shown to promote exports. By one estimate, an improvement in Egypt’s logistics quality to Tunisia’s level could increase Egypt’s exports by 12 percent (Behar, Manners, and Nelson, 2013). Morocco has shown a large improvement in this respect through investment in port infrastructure (including the expansion of Tanger-Med to become the largest port in Africa) and in thinning out obstructive procedures (Figure 5.7). ACTs could also provide training for small exporters and new entrants on navigating the variety and complexity of rules governing trade, including standards and certification procedures. Increased assistance from state overseas marketing agencies in identifying export market opportunities and gathering relevant market intelligence would be a considerable asset, especially for smaller companies.

A number of other export-promotion policy options can be considered. These include export credits and insurance/guarantee schemes at below-market rates (within the boundaries of existing trade agreements), transparent tax concessions on earnings and profits, targeted subsidies for nontraditional exports, duty drawback provisions on imported inputs, and subsidies for freight and transshipment fees to export markets. While these can help support exports, they would need to be implemented in a transparent way in order to preempt possible governance issues.

Recalibrating Business Regulation

The ACTs are encumbered with a legacy of complex and burdensome business regulations. Egypt, for example, has catalogued 36,000 regulations

Figure 5.7. Improvements from Trade Facilitation in Morocco
(Time to export and import; days)



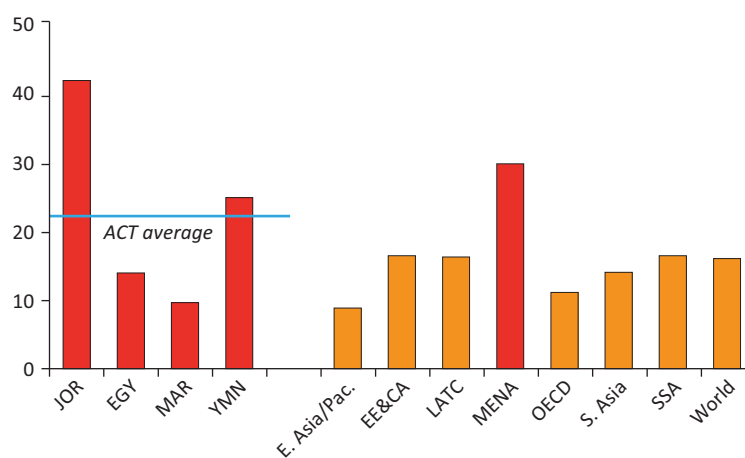
Source: World Bank *Doing Business* indicators.

affecting the private sector, many of which overlap, originating from—and implemented by—different parts of government (Amin and others, 2012). The results are often lengthy, expensive, and complicated procedures for starting and operating businesses: an average of 22 percent of firms in the ACTs perceive business licensing and permits as a major constraint to their activities, by far the highest share among the world's regions, though the share is substantially lower in Morocco (Figure 5.8).¹

In addition to constraining entrepreneurial activity and private investment, complex and burdensome regulation is also conducive to informality and corruption. The informal sector is larger than in other middle-income countries, with estimates ranging from 26 percent to 44 percent (IMF, 2011d). Opportunities for business growth and investment are more limited in the informal sector, and many workers have little or no social protection or employment benefits. Most countries in the region fare poorly on global governance rankings—increasingly so over the past decade (Figure 5.9). Corruption is a major concern, with more than half of firms in the MENA region having experienced bribe payment requests, a much higher share than in any other region in the world.²

Unclear rules and discretion in business regulation have also limited enterprise creation and turnover. Firms in the MENA region tend to be substantially older than in other emerging market and developing countries, and only the

**Figure 5.8. Business Licensing and Permits are Major Constraints¹
(Percent)**



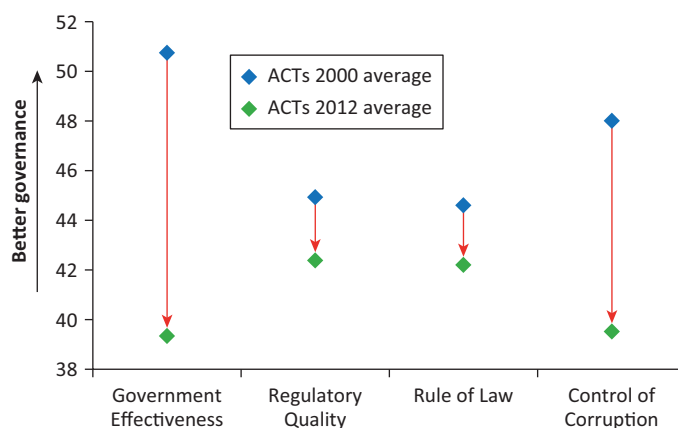
Source: World Bank Enterprise Surveys 2006–11.

¹Percent of firms identifying business licensing and permits as a major constraint.

¹ World Bank Enterprise Surveys (<http://www.enterprisesurveys.org>).

² Ibid.

**Figure 5.9. Governance and Corruption are Increasingly Serious Concerns
(Percentile, 2000 and 2012)**



Source: World Bank, Worldwide Governance Indicators.

East Asia/Pacific region has fewer registered firms per capita (World Bank, 2009). High barriers to entry and protected markets constrain competition and, consequently, growth and employment.

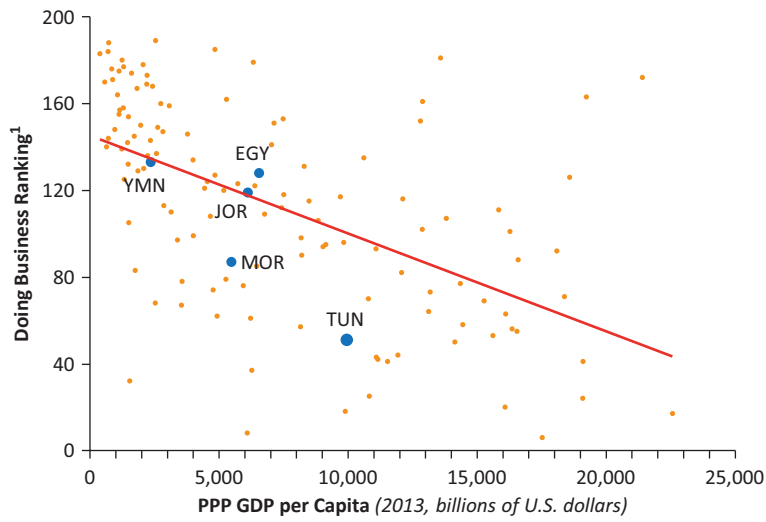
There is a widespread perception in the region that the private sector is rent-seeking and corrupt. In addition, officials are often perceived as being selective in improving the investment climate for the benefit of a few well-connected firms, families, and institutions (World Bank, 2009).

Countries have already taken action. A drive for regulatory reform in the ACTs, that had begun prior to the transitions, has helped raise business entry rates, private investment and FDI; many ACTs are now relatively well-positioned in the World Bank's Doing Business rankings, considering their levels of per capita income (Figure 5.10).³ There is, however, much room for improvement. Since the onset of the transitions, reform efforts have been mixed, with some countries falling back in the rankings, and others renewing efforts at reviewing regulations (Figure 5.11). Morocco, in part through the efforts of its *Comité National de l'Environnement des Affaires* (CNEA), was named the country with the most improved business regulations in the World Bank's 2012 Doing Business rankings. Reforms since 2011 have included, for example, a reduction in the minimum capital requirement and fees for starting a business in Jordan and Morocco, and enhanced electronic filing options for tax documents in Morocco.

Sustained and intensified efforts are needed. There is an urgent need to accelerate the reform process, which is key to job creation in the medium

³World Bank *Doing Business* Indicators.

Figure 5.10. Doing Business Rankings Improve with Income

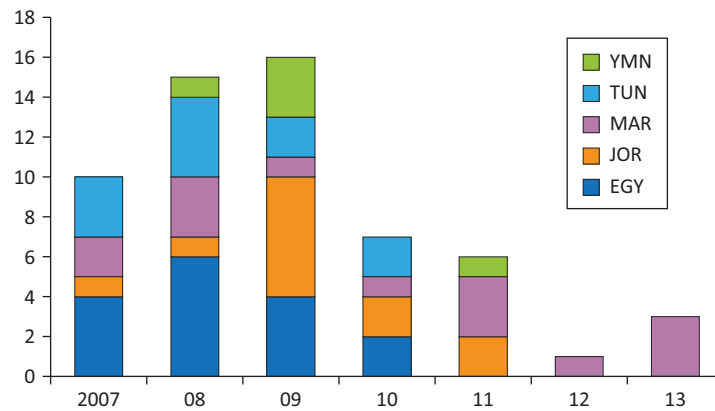


Sources: IMF World Economic Outlook; World Bank *Doing Business 2014*; and IMF staff calculations.

¹ 2013.

Note: Countries with PPP GDP pc above \$25,000 have been excluded.

Figure 5.11. Doing Business Reform Efforts Have Been Set Back (Number of Doing Business reforms)



Source: World Bank *Doing Business 2008–14*.

term. In particular, it is essential to create systems of checks and balances in national and regional institutions to prevent the exercise of excessive discretion and nontransparent intervention. The experience of East Asia, for example, shows that countries that were effective in creating accountable, rules-based institutions were significantly more successful at generating economic growth than countries where institutions remained subject to arbitrary intervention by political leaders and public officials (World Bank,

2009). Moreover, policymakers will need to strengthen incentives for the large informal sector to integrate with the formal economy. However, despite such efforts, the informal economy will remain large over the medium term, and policymakers should also increasingly focus on raising productivity in the informal sector as such.

Institutional and regulatory reforms should aim at:

- ***Reducing the scope for discretion***, by, for example, reducing the number of administrative steps in interactions with businesses and orienting interactions toward electronic processes.
- ***Improving transparency and access to information***, to promote accountability of public institutions.
- ***Strengthening the autonomy of institutions from the executive and political leaders***, to help reduce undue interference.
- ***Putting in place independent evaluation of the performance of institutions***.

Strategies to reform business regulation should focus on removing the barriers to entry and exit. Entry requirements—such as sector-ministry approval, that give officials substantial discretion over which investors to favor or exclude—should be reviewed and based on clear and transparent rules. Similarly, high minimum capital requirements and restrictions on foreign ownership should be relaxed, unless they reflect a particular regulatory concern. In addition, the focus of reform efforts should be on removing difficulties to exit, including modern bankruptcy codes that decriminalize business failure.

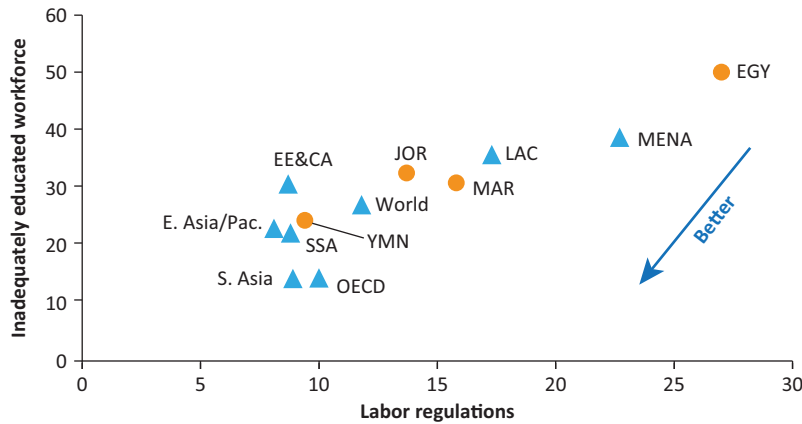
Countries should place special emphasis on providing an enabling environment for SMEs and startups. Given the importance of SMEs' contribution to output and employment in the ACTs, special focus on providing an enabling environment for them will be needed. For startups, in addition to an enhanced emphasis on access to finance (Chapter 4), countries should aim at building a broader ecosystem that helps young entrepreneurs progress and gain a foothold in the economy.

Improving Labor Markets and Education

Labor markets face substantial problems. The ACTs' high rates of unemployment are compounded by significant demographic pressures as more of the young population enters the labor market (Ahmed, Guillaume,

and Furceri, 2012) (Figure 5.12). Youth unemployment is high, ranging from 18 percent to 30 percent in Egypt, Jordan, Morocco, and Tunisia. In Egypt, the share of first-time job seekers finding employment in a formal job dropped from 80 percent in the 1970s to 30 percent in the mid-2000s, and those entering the labor force in a public sector job do so after having spent an average 2.3 years in unemployment (Amin and others, 2012).

Figure 5.12. Excess Labor Regulations and Education Mismatches¹ (Percent)

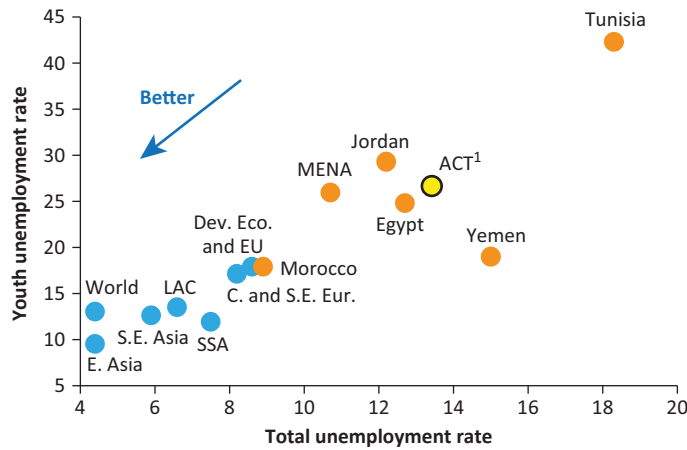


Sources: International Labor Organization; national authorities; and IMF staff calculations.

¹Egypt, Jordan, Morocco, Tunisia, and Yemen.

Note: EE&CA = Eastern Europe and Central Asia; SSA = Sub-Saharan Africa.

Figure 5.13. Large Total and Youth Unemployment (Rates by region, 2012; percent)



Source: World Bank Enterprise Surveys 2006–11.

¹Percent of firms identifying each item as a major constraint.

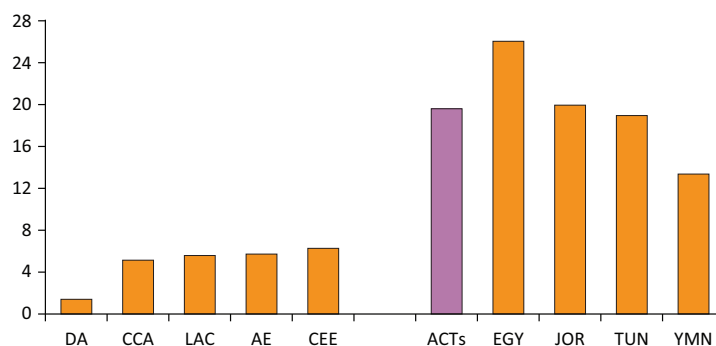
Women face particular problems entering the formal labor market and securing employment. In Egypt, Jordan, Libya, Morocco, and Tunisia, only about a quarter of adult women are in the labor force compared to 70–80 percent labor participation rates among men (AfDB, 2012b).⁴ Recent analysis shows that, for the broader MENA region, if the gap in female labor participation during the last decade had been double instead of triple the average gap in emerging markets, the region could have gained \$1 trillion in cumulative output, doubling GDP growth (IMF, 2013d).

The roots of the problems vary across countries, but a number of common critical factors have been identified in labor markets and education. These include: stifling labor market regulations; the dominance of the public sector as employer of first and last resort; and education systems that do not deliver an adequate skill mix.

- **Rigid labor market regulations** discourage firms from hiring. Enterprise surveys show that 23 percent of firms in the MENA region perceive labor regulations as a major constraint, by far the highest share among the world's regions (Figure 5.13). A survey of manufacturing firms in Egypt found that 24 percent would increase their hiring in the absence of restrictions, while only 3 percent would fire workers (AfDB, 2012b). Regulations affecting layoffs of workers are particularly restrictive in the region. In Tunisia, for example, rules and procedures for laying off workers for economic and technological reasons are complex and rarely used (AfDB, 2012a). As a result, economic activity is diverted to the informal sector, where workers do not enjoy the same level of protection. Empirical estimates show that labor market rigidities can explain nearly 30 percent of the size of the informal economy in the ACTs (IMF, 2011d).
- **The dominance of the public sector in the labor market** (Figure 5.14) has introduced distortions by affecting the structure of unemployment and the supply of skills through the education system. The (implicit and explicit) employment guarantees in government hiring, and mismatched salary expectations resulting from generous civil service pay scales and benefits, have led to market segmentation and excess demand for public sector jobs (Figure 5.15).
- **The education system's strong focus on formal qualifications for entry into the civil service** has meant that job market entrants often do not have the right skills mix for the private sector. Enterprise surveys show that the share of firms in MENA identifying an inadequately educated workforce as a major constraint (39 percent) is the highest among the world's regions (Figure 5.13). In Egypt, for example, a study found that 34 percent of jobs require a technical education, but only 11 percent

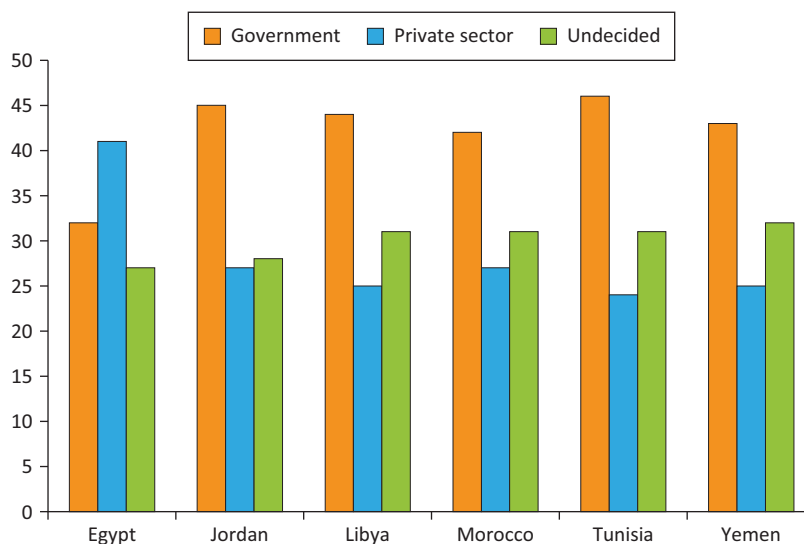
⁴Data for male and female participation in the informal sector, such as traditional agriculture, are not available.

Figure 5.14. The Public Sector is a Large Employer in MENA
(Public sector employment as a share of total employment, 2008–11; percent)¹



Sources: National authorities; International Labor Organization; IMF World Economic Outlook database; and IMF staff calculations.
¹ AE: Advanced economies; CCA: Caucasus and Central Asia; CEE: Central and Eastern Europe; DA: Developing Asia; LAC: Latin America and the Caribbean.

Figure 5.15. Government is the Preferred Employer for Arab Youth
(Arab youth employment preferences; percent)



Source: Burson-Marsteller, 2013.

of graduates have this level of qualification (Kandil, 2012). University education, meanwhile, is skewed away from technical subjects. Across North Africa, only 18 percent of university graduates are in the fields of science and engineering (AfDB, 2012b). In addition, while public spending on education as a percent of GDP has been higher in the MENA region

than in comparable East Asian and Latin American countries, the return in terms of the quality of education have been disappointing: MENA country rankings in international educational achievement tests remain low (Amin and others, 2012). Primary education is also an area in need of improvement, underscored by low literacy rates, for example, in Egypt, Morocco, and Yemen, and undermining labor productivity.

Solutions to these problems will vary among countries. Bearing in mind countries' different problems and starting conditions, solutions should generally be centered on five areas: reviewing labor market regulation to reduce disincentives for hiring, while maintaining adequate worker protection; revisiting public sector hiring practices and compensation policies to reduce the public sector's labor market dominance and bias; reforming the education system, aligning it better with the needs of private employers; pursuing active labor market policies to make quicker inroads in lowering unemployment; and placing particular emphasis on policies promoting youth and female employment.⁵ Many of these reforms are complex and will require considerable efforts at consensus-building and implementation.

- **Reviewing labor market regulation** with a view to reducing distortions—particularly those that discourage hiring and skill building—while ensuring adequate social protection. Regulations should continue to provide appropriate protection against discrimination and arbitrary decisions by employers, thereby promoting efficiency by providing incentives for employers and employees to invest in firm-specific training. By contrast, undue protection, including cumbersome processes for layoffs and excessive severance payments, should be reduced or phased out, to relieve firms of excessive rigidities in a constantly changing economy, and the associated negative effects on labor demand and economic growth. Minimum wages should also be reviewed under a transparent mechanism, setting them low enough to support demand for low-skilled workers, but high enough to support the bargaining position of workers and limit discrimination.
- **Revisiting public sector hiring policies** to ensure that hiring does not exceed the needs and/or means of the public sector. At the same time, compensation policies may need to be revised to reflect worker productivity and comparable salaries in the private sector. As the model of the state as employer of first and last resort is phased out, prospective job market entrants will have an incentive to position themselves increasingly toward the private job market.

⁵ See also work on this issue in IMF *Regional Economic Outlook* for the Middle East and Central Asia (IMF 2010, 2011b, and 2011d).

- ***Improving and reorienting the education system*** will also help address labor market mismatches. There is scope to align curricula better with the needs of the private sector, including through an increased focus on writing skills, critical thinking, and problem solving. This can be approached by partnering with the business community to reform the curricula, and further catalyzed by increasing school's public accountability by giving citizens adequate mechanisms to influence education objectives, priorities, and resource allocation (World Bank, 2008b). In addition, relating the hiring of government employees more to individual productivity and skills than to credentials would create incentives to reorient the education system toward more productive and demanding curricula.
- ***Focusing on short-term policies to improve labor market outcomes*** will be equally important, as many of the other reforms take time to implement and yield results. Such policies notably include active labor market policies, such as job intermediation and placement services, apprenticeship and training programs (including entrepreneurship training), employability training, and support for on-the-job training. Egypt, Jordan, and Tunisia, for example, have government-funded active labor market programs, though so far these reach only a limited number of beneficiaries.
- ***Promoting employment of women and youth.*** Female employment can be supported by offering more flexible work schedules, accommodating needs such as reduced ability to travel and child care responsibilities, improving girls' access to education, and by offering programs specifically for women (IMF, 2013d). Programs for youth can include training and counseling for labor market entry, and internship schemes to smooth the transition from school to work.

Creating More Efficient Safety Nets

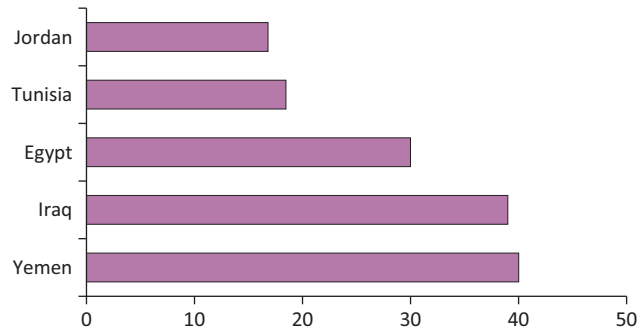
Despite progress over the past two decades, poverty remains an important concern, particularly among children and in rural areas (Table 5.1) (World Bank, 2012c). Early childhood malnutrition rates are high, and children in poor households are more likely to drop out of school and thus bring limited skills to the job market. Rural poverty rates (Figure 5.16) are in some countries more than twice those of urban areas. Limited access to basic services, including health and education, restricts opportunities for many of the poor. In addition, in some countries, a significant share of the population is vulnerable to falling into poverty (Figure 5.17); with incomes just above the poverty line, these households cannot adjust their expenditures when

**Table 5.1. Poverty Remains an Important Concern
(Overall and child poverty rates; percent)**

| | Overall | Child (0–14) |
|-----------------|---------|--------------|
| Egypt 2013/2011 | 26.3 | 26.4 |
| Jordan 2010 | 14.4 | 20.1 |
| Morocco 2010 | 20.0 | 25.0 |
| Yemen 2006 | 34.8 | 36.0 |

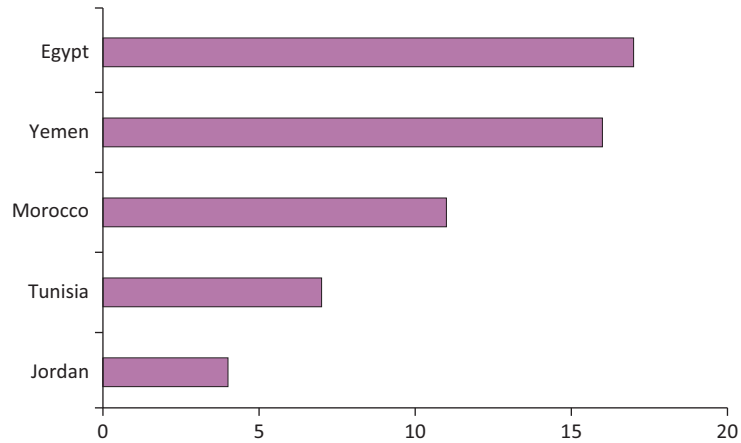
Sources: National authorities; UNICEF; and World Bank (2012c).

**Figure 5.16. Rural Poverty is Significant
(Poverty rate of rural population; percent)**



Source: World Bank (2012c).

**Figure 5.17. Many People are Vulnerable to Falling into Poverty
(Share of population living between \$2–\$2.5 a day; percent)**



Source: World Bank (2012c).

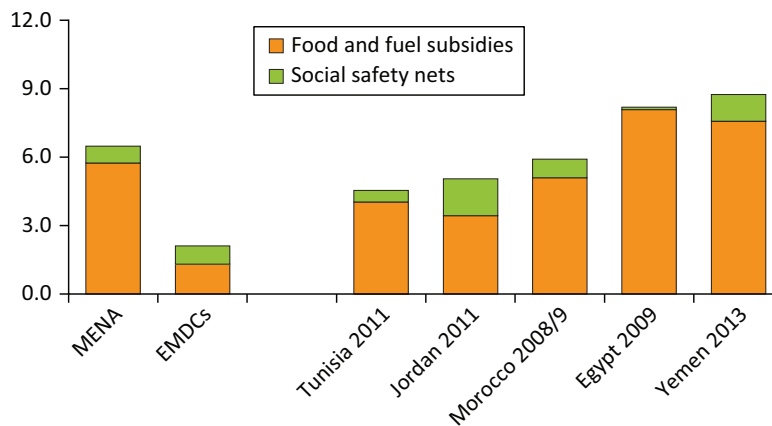
necessary. Yet few have access to formal safety nets, and those without access face a higher risk of moving into poverty.

Spending on subsidies for food and fuel is a costly and inefficient means of social protection. The ACTs have been relying heavily on subsidies as their main tool for providing social protection. Generalized energy price subsidies, in particular, are large, and though they provide support for poor consumers, they disproportionately benefit the well-off. Energy subsidies are appealing to governments because they are easier to administer than other means of social protection; however, they weigh heavily on public finances in an environment of high deficits and debt, and crowd out resources for targeted social programs. In all ACTs, energy subsidies take a larger share of the resource envelope than, for example, public spending on education.

In contrast to subsidies, social safety net (SSN) programs are small. They account for only about one-tenth of spending on subsidies in the ACTs (Figure 5.18), and reach less than one-third of the population in the lowest income quintile (Figure 5.19), significantly below the world average.

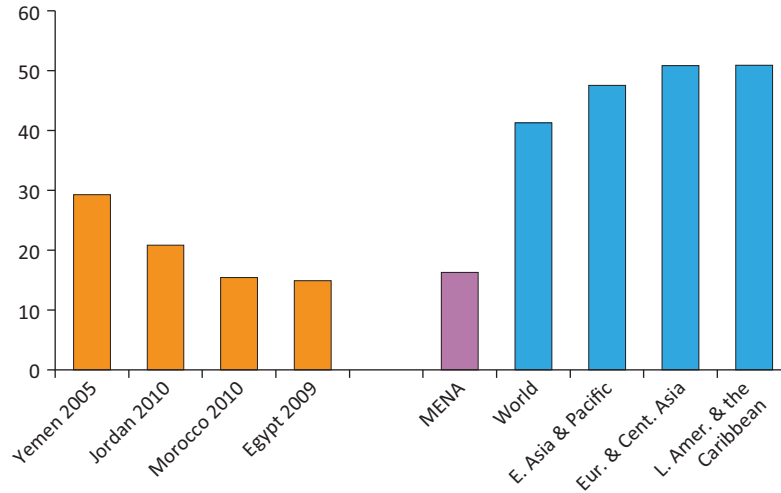
SSN spending is poorly targeted. The ACTs' tendency to rely on geographical and categorical targeting does not work well in environments where poverty is less concentrated in certain regions or demographic groups. As a consequence, only a quarter of recipients of SSN benefits are in the lowest income quintile, far below the world average. Nonetheless, there are also notable improvements under way in the ACTs: Jordan and Yemen have

Figure 5.18. Social Safety Nets are Small
(Spending on social safety nets and subsidies; percent of GDP)



Sources: World Bank (2012c); IMF Fiscal Affairs Department database; IMF staff reports, various publications; and IMF staff estimates.

Figure 5.19. Social Safety Net Coverage is Limited
(Percentage covered in bottom income quintile)

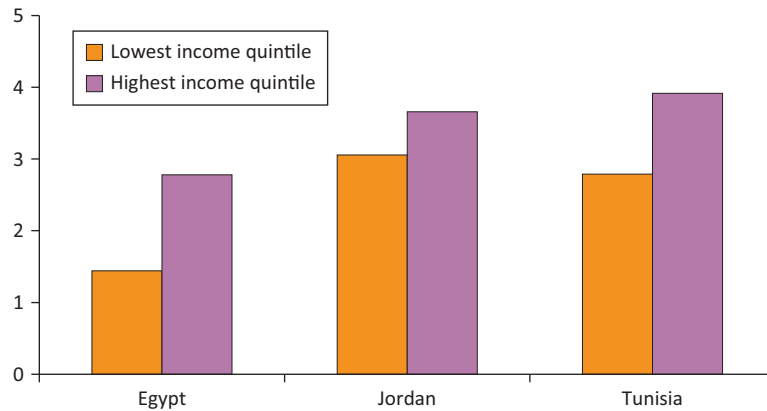


Source: World Bank (2012c).

introduced SSN programs with elements of means testing or proxy means testing—i.e., based on attributes that correlate with poverty—which are expected to yield better results.

There is limited awareness of SSNs among the groups that should benefit the most from them. People in the bottom income quintile are much less aware of SSN programs than people in the top quintile (Figure 5.20). According to surveys, almost a quarter of Egyptians are not aware of any SSN programs, while in Tunisia, people in the top and middle income quintiles are much more likely than the poor to personally know SSN beneficiaries.

Figure 5.20. Limited Awareness of Social Safety Nets in the Lowest Income Quintile
(Average number of SSN programs recognized by respondents, 2012)



Source: World Bank (2012c).

As a result, SSNs have little impact on poverty and inequality. The small size, low coverage, poor targeting, and limited awareness among those in need mean that the impact of these programs on poverty and inequality is small. Except in Jordan, the impact of SSNs on reducing poverty is well below the world average.

A roadmap for reform

The strategy for reform should be centered on phasing out generalized subsidies and replacing them with more efficient SSNs. In light of their inefficiencies as means of social protection, there is a strong case for phasing out generalized subsidies. Scaled-up and appropriately targeted SSNs have the potential to deliver much more cost-effective social protection, freeing scarce resources for other priority expenditure and debt reduction.

International experience shows that subsidy reform is often difficult to implement. Countries attempting reform have often faced obstacles (IMF, 2013a): these include a lack of public information and understanding of the magnitude and ineffectiveness of subsidies; opposition from specific groups benefiting from subsidies (for example, transport sector, energy-intensive manufacturing); lack of public trust that governments will use the savings from subsidy reform efficiently for alternative means of social protection, other priority expenditure, or debt reduction; concerns regarding a possible net adverse impact on the poor; concerns about effects on inflation and volatility of prices, beyond energy products; loss of competitiveness, especially in energy-intensive sectors; and weak macroeconomic conditions at the outset of reforms exacerbating many of the above concerns.

In that light, it will be important to plan subsidy reform well. Country experience highlights six factors that heighten the chances for success (IMF, 2013b, 2014):

- ***Targeted mitigating measures for the poor***, which are discussed below;
- ***A comprehensive energy sector reform plan***, drawn up in consultation with stakeholders;
- ***A comprehensive communications strategy***, including consultation with stakeholders, provision of information on the costs of subsidies and benefits of reform, and heightened transparency in reporting subsidies in the budget;
- ***Appropriately phased in and sequenced price increases*** that avoid sudden and sharp increases;

- **Improved efficiency of state-owned enterprises** to reduce producer subsidies; and
- **Depoliticized price setting** through price liberalization or rules-based price-setting mechanisms.

The substantial incidence of poverty, the limited scope and efficiency of existing SSNs, and the need to reform generalized price subsidies suggest a need to expand SSNs and make them more efficient, by:⁶

- **Increasing spending on SSNs and improving their coverage**, creating new programs, and expanding existing ones that are effective.
- **Simplifying the SSN landscape by consolidating fragmented SSN programs** into a few comprehensive programs specifically designed to reach different segments of the poor and vulnerable populations.
- **Investing in SSN infrastructure** by creating unified registries of beneficiaries that can be used across multiple programs, and by using modern service delivery mechanisms such as smart cards, mobile payments, and over-the-counter payments in bank branches.
- **Prioritizing interventions that strengthen human capital**, including conditional cash transfer programs and workfare programs.
- **Increasing the use of proxy means testing in targeting social assistance** (where feasible in light of administrative capacity issues and possible political sensitivities), which has been shown to be more effective at targeting the poor and vulnerable than geographic or categorical criteria.
- **Focusing on strong governance and accountability in SSNs** to improve their efficiency and minimize corruption.
- **Reaching out and informing the poor and vulnerable** about the safety net programs available to them.

Several ACTs are already making progress in these areas. Morocco has started to consolidate its SSN programs and has scaled up its successful Tayssir program, a conditional cash transfer program for families with school-aged children. Yemen reformed its Social Welfare Fund by scaling it up, introducing

⁶ See World Bank, 2012c for more details.

a proxy means test formula, and strengthening capacity in service delivery. Jordan is moving in the direction of poverty-based targeting and, in the context of the 2012 fuel subsidy reform, implemented a cash transfer system to compensate a large part of the population.

Most ACTs are currently considering new programs or reforms in their existing SSNs. Egypt intends to expand priority social programs and implement targeted cash transfer programs. Morocco continues to expand the coverage of the Tayssir program and the RAMED program (basic health coverage for the poor). Tunisia also plans increased cash transfers to targeted households. Yemen plans to further increase its support to the poor through the Social Welfare Fund.

Further efforts are needed to improve social outcomes and support the economic transitions. While countries have begun to reform their safety nets, substantially more efforts are needed to improve and modernize them, and, by making them more efficient, free scarce resources for priority expenditures and deficit reduction.

Strengthening Economic Statistics

The global financial crisis has shown the importance of preemptively identifying sources of fiscal and financial sector risks to support macroeconomic stability and inclusive growth. The ACTs have made significant progress in strengthening their statistical systems, and Egypt, Jordan, Morocco, and Tunisia subscribe to the IMF's Special Data Dissemination Standard (SDDS). Nonetheless, the ACTs need further development of national accounts, government finance, balance of payments, monetary, and financial statistics to improve their availability, coverage, periodicity, and timeliness. On the positive side, ACTs have begun adopting the methodologies of the IMF's *Government Finance Statistics Manual 2001*; however, the official coverage of fiscal statistics could be expanded beyond central government statistics to the social security system, other extra-budgetary funds, and sub-national government accounts (Chapter 2). The coverage of state-owned enterprises and government financial institutions also remains limited, except in Morocco and Egypt. Balance of payments statistics could generally benefit from greater details on the financial accounts. Addressing the challenges in banking supervision information systems and database management would help increase accuracy and reduce the significant lags in reporting financial indicators. On national accounts, additional efforts are needed to develop national accounts from the expenditure approach, and to produce high-frequency data on employment, unemployment, and wages, as well as the coverage of informal activities.

Managing Economic Change During The Transitions

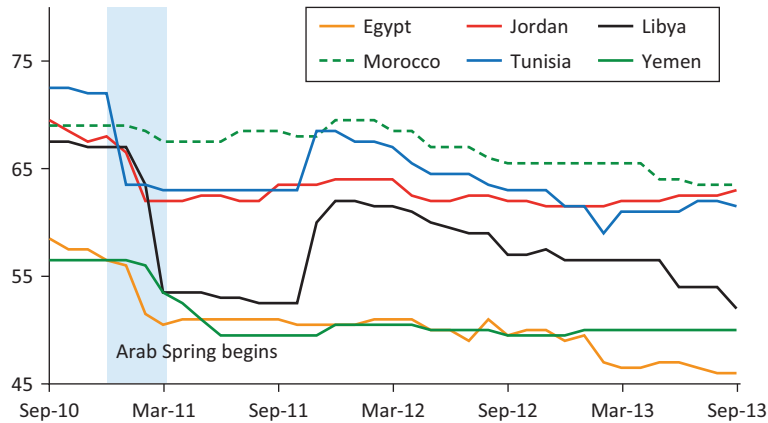
Generating success in economic transformation requires a coordinated effort. The complexity of the task under adverse conditions necessitates a heightened focus on navigating the political economy and a strong communication strategy. Careful sequencing of reforms will be required, with emphasis on early steps in areas with high payoffs, and countries need to employ a flexible approach so they can seize reform opportunities as they arise. Well-coordinated and stepped-up support from the international community is also essential.

Political economy and communications

The ACTs are embarking on difficult macroeconomic and structural reforms in a challenging socio-political environment (Figure 6.1). Policymakers across the ACTs are facing a difficult economic situation that is making the need for reforms urgent in a broad range of areas, even as the socio-political environment challenges policymakers' ability to deliver them:

- **The political transitions are complex**, with a number of countries yet to adopt new constitutions and elect governments with more than transitional terms.
- **Institutional uncertainty adds to political risks.** Lack of clear relationships between different institutions, together with weak or even absent institutions, hinders the reform process and delays the economic transformation agenda.
- **Governments with short horizons and looming elections have limited mandates or incentives to undertake reforms that have short-term political costs—irrespective of their future benefits.** For example, transitional governments may find it difficult to implement subsidy reform or allow for exchange rate depreciation that would have

Figure 6.1. Political Risk Has Increased
(Ranges from 100 (least risk) to 0 (highest risk))

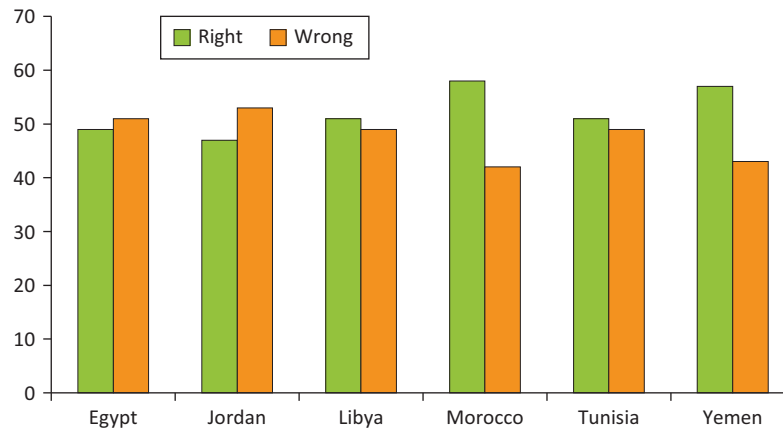


Source: The PRS Group.

negative income or balance sheet effects for some groups in the short term, even though these measures are necessary to strengthen inclusive growth in the future.

- **Many reforms have important distributional impact, which can trigger early resistance.** Some vested interests have been weakened in the context of the transitions, but other interest groups may be in a better position to influence economic policy than newcomers. Moreover, the struggle for power and rents between the former elite and vested interests on the one hand, and the newcomers on the other, increases political uncertainty and may also discourage reform efforts.
- **Although coalition governments are in place in a number of ACTs, parties within the coalition may have conflicting agendas.** This conflict can jeopardize reforms that have important distributional effects. In addition, a lack of experience among those new to government often poses obstacles to the design and implementation of reforms.
- **Youth interests can no longer be treated as an “add-on.”** The demographic situation in the MENA region, where youth make up the majority of the population, needs to be factored into the decision-making process, and youth interests need to be explicitly addressed. According to a recent survey, a large share of youth in the ACTs is dissatisfied with the direction of the economy (Figure 6.2) (Burson-Marsteller, 2013). Moreover, Arab youth have traditionally borne a disproportionate share of the costs of economic adjustment during previous decades.

Figure 6.2. Perception of Arab Youth about Direction of the Economy (Percent)



Source: Burson-Marsteller, Arab Youth Survey, 2013.

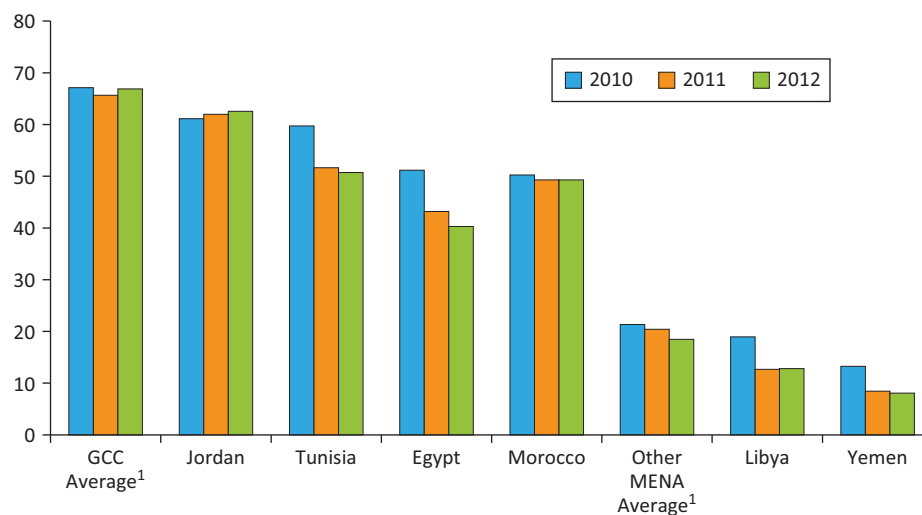
- **The security situation has deteriorated in most ACTs.** Polarization has increased among different groups—political, ethnic, religious, and economic. Sources of discontent—most notably high youth unemployment—are still unresolved and have in many cases grown worse. Spillovers from regional conflicts are aggravating polarization and security challenges.

In addition, governments have inherited economic institutions that require strengthening.

- **The rule of law is the overarching prerequisite for institutions and governments to gain the trust of investors and citizens alike,** and there remains considerable room for improvement in this area (Figure 6.3). This problem is exacerbated by a considerable gap between the establishment of rules and their application following a long period of institutional stagnation or even decay in some ACTs. International experience shows that, in countries undergoing political transition, the process of establishing the rule of law is often at risk, because emphasis tends to be placed on the most pressing, immediate requirements of a functioning democracy: enacting a constitution and holding periodic elections.¹
- **A merit-based civil service** is required to step up government effectiveness and enable change. The ACTs lag in this respect, because the civil service in many cases has lacked the incentives and training to manage increasingly complex public policy decisions. In addition, in

¹ See International Crisis Group (2012).

Figure 6.3. Rule of Law Ranking Shows Room for Improvement
(Percentile ranking among 215 countries; ranges from 100 (highest) to 0 (lowest))



Source: World Bank World Governance Indicators, 2013.

¹ Includes Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

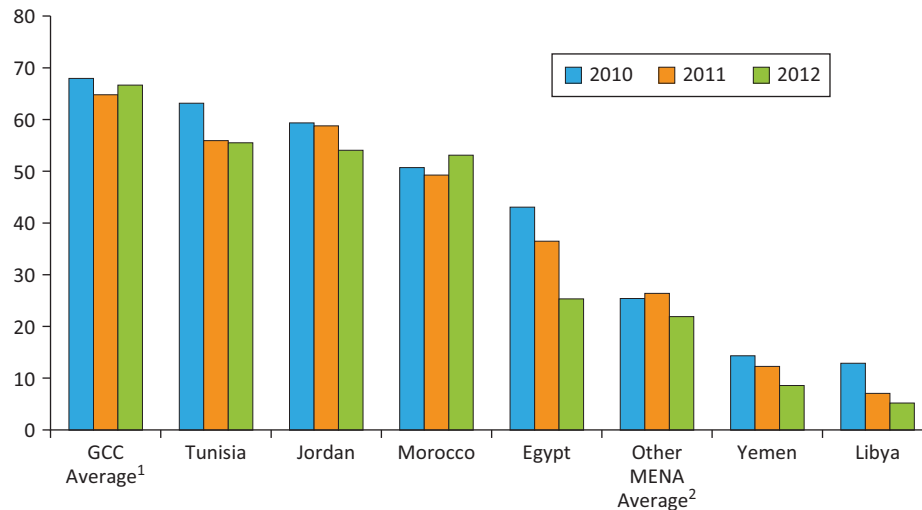
² Includes Algeria, Djibouti, Iran, Iraq, Kuwait, Lebanon, and Mauritania.

several ACTs, the perception of government effectiveness—the reach and quality of public services, the professionalism and independence of the civil service, the quality of policy formulation and implementation, and the credibility of the government’s commitment to such policies—has declined over time (Figure 6.4).

- **Budgetary institutions** with rules that govern budget formulation, execution, reporting, and disclosure, along with capable external oversight bodies, are necessary to support sound fiscal policy and financial accountability (Chapter 2); but countries, including those that have undergone a Public Expenditure and Financial Accountability (PEFA) assessment, show significant shortcomings.²
- **Central bank independence** is critical for the credibility of monetary policy, but few countries in the region have achieved it, partly because of fiscal dominance (Chapter 3).
- **An independent competition body** is also needed to facilitate business entry and operation in all sectors of the economy, contain monopolistic tendencies, and foster economic efficiency.

²The percentage of indicators with low ratings (C and D) is 25 percent for Tunisia (June 2010), 39 percent for Morocco (May 2009) and 56 percent for Yemen (June 2008).

Figure 6.4. Government Effectiveness Has Suffered in Most ACTs
(Percentile ranking among 215 countries; ranges from 100 (highest) to 0 (lowest))



Source: World Bank World Governance Indicators, 2013.

¹ Includes Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

² Includes Algeria, Djibouti, Iran, Iraq, Kuwait, Lebanon, and Mauritania.

- **Informal institutions** need to be taken into account. Informal networks—for example, those driven by personal relations or patronage—are still prevalent, especially in countries lacking efficient social safety nets, and can affect the reform process in unforeseen ways.

The feasibility of reforms may also be constrained by limited administrative capacity to design and administer them. Agents of change who are needed to champion reform could be at risk of becoming overloaded and losing the ability to focus on delivering on priority items. Complex reforms may therefore not be feasible in the short term, and would require careful sequencing that includes investment in building the capacity to implement them.

The strategy for undertaking reforms must be tailored to the particular circumstances of each country as well as to the specific nature of the reforms. There is no one-size-fits-all approach; nonetheless experience gleaned from the work of the IMF and other institutions, as well as the political economy literature, points to a number of considerations that policymakers in the ACTs may find useful when designing and implementing reforms.³

³ See OECD (2010); Fritz and others (2008); and Haggard and Webb (1993).

Creating a sense of urgency for reform can boost the chances of success. A strong case must be made for the benefits of reform. Gathering data and undertaking analytical work to explain poor outcomes, and identifying policies to improve them, are the first steps in a well-designed reform process. Highlighting the costs of the status quo and providing evidence of the benefits of reform across the different segments of the population can provide a compelling case for change. For example, recent analytical work has shown that generalized energy subsidies are fiscally unsustainable and socially unfair, supporting the case for change (Chapter 2).

Reform plans should be anchored in clear and measurable performance goals. By increasing transparency and holding policymakers accountable for reform implementation, one can lessen the risk of reform paralysis in which reform is much discussed but never implemented.

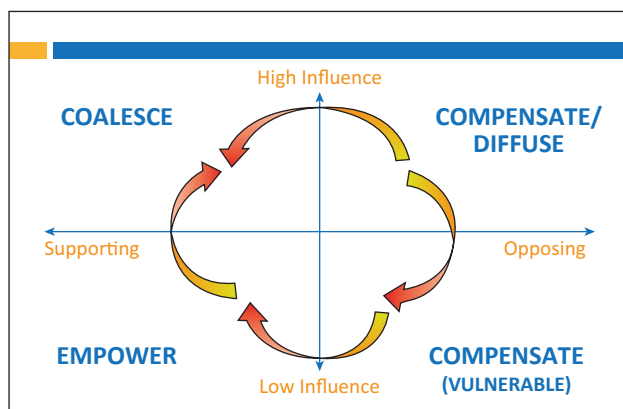
A participatory approach can reduce resistance to change. As policymakers across the ACTs formulate and embark on their reform agendas, different stakeholders—new and emerging political actors, parliamentarians, academics, businesses, organized labor, civil society, youth activists, think tanks, and policymakers themselves—will have varying perspectives on the way forward. To build momentum for reform, transparency about the whole reform process is essential. Policymakers' success will depend on listening to all stakeholders' views when formulating policy agendas. This will require legal reforms to permit independent organizations to form without state approval. A more participatory process will help identify areas of resistance or support for change. Experience shows that involving a broader spectrum of society in the design of reform—along with a readiness to respond to concerns to the extent of modifying reform proposals—also fosters a sense of ownership for reform and can help hold back future opposition. Moreover, reform experiences in OECD countries indicate that, although consultative processes are no insurance against conflict, they can generate greater trust among parties involved, which “may make expected losers more willing to rely on commitments to measures that will mitigate the cost of reform to them” (OECD, 2010).

Building coalitions is imperative for successful reform. Economic reform inevitably entails distributional consequences: losses for some—particularly those with vested interest in the status quo—in the short term, while generating broad benefits to the wider population only in the longer term. Gaining traction for reform—and ultimately succeeding in implementing it—depends to a great extent on a government's ability to build coalitions in support of change while addressing opponents' concerns about its distributional impact (Box 6.1).

Box 6.1. A Stylized Approach to Building Coalitions

This approach entails coalescing with champions (high-influence groups that support the measure), empowering winners (low-influence groups that benefit from the reform) and helping them voice their support, compensating or defusing influential groups that would lose as result of the reform, and compensating the most vulnerable that would lose and have little influence. Well-targeted measures for protecting the latter are imperative for adequate social protection, and are often also vital for building public support for reform. In the case of subsidy reform, for example, it is crucial that those who are hardest hit by the removal of subsidies be compensated from the beginning through more targeted social protection. When feasible, bundling reforms as a package of measures that remove distortions while spreading benefits and adjustment costs broadly can also be useful: it can create more winners, allow the losers by certain measures to be beneficiaries by others, and defuse the sense that a particular group is being singled out.

Figure 6.1.1. Building Coalitions



Careful timing and sequencing are also required. In a challenging socio-political environment, it may be necessary to move ahead with those measures that can garner sufficient support and to postpone others: some progress is better than none at all. In this sense, it will be important to accept deviations in timing and sequencing from technically or economically “optimal” reform paths, subject to considerations of macroeconomic stability. Policymakers may focus on low-hanging fruit or use small-step approaches, such as launching reforms on a limited scale and assessing them before expanding them. Examples include accepting a gradual approach to a tax increase, or linking electricity tariff increases to improvements in service provision coverage. In the case of particularly difficult reforms, such as the introduction of exchange rate flexibility, for example, success is more likely to be secured when a government’s political mandate is strong and the potential loss of political capital is manageable, which in many instances is after elections (Rother, 2009).

Sequencing must include initiatives that create visible immediate benefits. In ACTs, it is clear that a strong economic rationale drives political support for the transitions, which are expected to improve economic opportunities for the majority of the population. The sustainability of any reform—and support for the whole reform process—could be jeopardized by the lack of early and visible economic improvements. To counter this risk, show commitment to reform, and improve confidence, policymakers should include in their reform programs initiatives that will have a rapid impact (Chapter 5), and consider compensating in advance those vulnerable groups that stand to lose from the reforms. Policymakers will need to focus on building mechanisms for such compensation where none are readily available.

Reform champions, together with well-functioning and credible institutions, are needed to sustain change. Reform-minded individuals are indispensable for the reform effort, but without strong institutions policies cannot be implemented; or they can be quickly reversed. For example, in the case of energy subsidies, successful and durable reforms typically require the introduction of a depoliticized and rules-based mechanism for setting energy prices, which can help reduce the chances of reversal. Similarly, strong institutions, such as an independent central bank and a well-functioning, well-supervised banking system, are essential for a successful transition from a managed exchange rate regime to a more flexible one. However, these considerations should not prevent policymakers from implementing the technical measures that are often less contentious but critical in laying the ground for the success of reforms. In addition, increasing the organizational resources of groups that owe their wealth not to privileges, spoils, or rents but to independent activity in a competitive setting, will also increase the political weight of pro-reform constituencies. Without institutionalized groups capable of making broadly credible commitments and delivering on them, the only policies that citizens can directly connect to government performance are the subsidies and transfers that became a mainstay of the old social contract (Amin and others, 2012).

As governments embark on economic transformation, the role of communications will be critical. Governments now need to operate in a multi-stakeholder environment, where civil society has become more empowered, and where the unprecedented diffusion of social media (Table 6.1) adds to both challenges and opportunities. Young people in the ACTs, who were to a large extent marginalized before the Arab Spring, have formed interest groups and are voicing their views and demands. Governments also face business interests and organized labor, which have shown a willingness to protest if their economic and political demands are not met. In this setting, it will be important to devote adequate attention to engaging with these groups through appropriate consultation and communication.

**Table 6.1. Strong Use of Social Networks for Political and Community Views
(Use of social networking in the ACTs; percent)**

| | Use of social networks ¹ | Use social networks to express views about ² | |
|---------------------------|-------------------------------------|---|------------------|
| | | Politics | Community issues |
| Tunisia | 34 | 67 | 82 |
| Egypt | 30 | 63 | 74 |
| Jordan | 29 | 60 | 80 |
| Global³ | 34 | 34 | 46 |

Source: Pew Research Center, 2013.

¹ Percent of respondents from a survey among 1000 people in each country.

² Percent of social network users who use networks to express views about politics/
community issues.

³ Median of 21 advanced and emerging economies.

Effective communication needs to be an integral part of the economic reform process. Public communication campaigns should aim at increasing awareness of the planned policy changes, explaining the rationale and building buy-in for the proposed reforms, highlighting their benefits for society at large and for specific groups, and establishing realistic expectations about what can be achieved. Given the emergence of social media and the connectivity across media networks, it is ever more important for governments to embark on effective communications to make a case for reform. For example, when reforming subsidies, policymakers should explain how expensive and inefficient existing subsidies are and the costs they impose on the economy and the environment. In any reform involving revenue increases or expenditure cuts, it is important to demonstrate that savings are being used to good effect. In addition, the communication strategy should also clarify the role of international financial institutions and the international community at large in supporting the reform process.

A number of lessons from policymakers' experiences in other regions can help increase the chances for successful reform. Policymakers need to explain what they do, and choose their media strategically for different messages and audiences. Given the connectivity across media networks, it is even more important for government officials to speak with one voice, coordinating with others to make sure that their messages are aligned and mutually reinforcing. Inspiring messages that are personal and practical tend to be most effective. Communication efforts should include examples of successful reforms in other countries, and how obstacles were overcome. To stimulate demand for reform, it can also be helpful to focus on the missed opportunities

from lack of reform—that is, the costs of doing nothing. At the same time, communications efforts should not be about “selling” reforms: true engagement often calls for modification of reform proposals, while keeping the main goal in view.

Support from the international community

Stepped-up support from the international community is critical for successful reform. Even as countries need to stay in the driver’s seat and plan their policy programs through wide national consultation, there is a need for the international community to support the ACTs’ reform efforts along four dimensions.

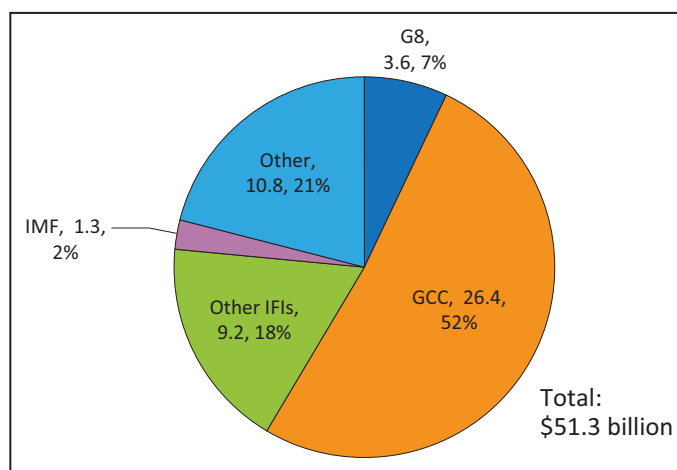
- Bilateral and multilateral partners will need to continue providing significant financing, increasing its scale in some cases, so that public spending can support growth and ease the pace of adjustment (Box 6.2). The significant support from donors in GCC countries to some ACTs, in particular, has helped cushion the immediate adjustment needs at a time of reduced trade and capital flows. Greater predictability and stronger coordination of donor efforts with the ACTs’ macroeconomic plans could further enhance the effectiveness of donor support.
- Improved access for the ACTs’ exports to advanced economies’ markets is also important to support the economic recovery and raise potential growth, complementing their efforts at trade reform.
- The ACTs can also profit from policy advice from their international partners in many areas of economic policy.
- The international community can help in capacity-building efforts by providing technical assistance and training.

Donors also have a critical role to play in helping to overcome obstacles to reform. Close coordination among donors should ensure that they do not inadvertently provide disincentives for change by supporting divergent policies. Initiatives such as the Deauville Partnership can play an important role in this context. Donors should also avoid overburdening the few agents of change and instead should support them with technical assistance that is aligned with their needs and delivered on time. For example, it is important to act promptly to develop the registries required for cash transfer mechanisms; delays could jeopardize safety net reform. Donors should also recognize the potential challenges they face in the region stemming from the stigma attached to previous stabilization measures and structural reform programs.

Box 6.2. Continuing Need for Stepped-Up Donor Support

Since the onset of the transitions in 2011, the ACTs have received significant financial support from the international community, more than half from the GCC countries (Figure 6.2.1). Their external financing needs will remain high under baseline projections in 2014–15, at around \$50–60 billion per year. Yet, even with sufficient external support to cover these needs, the baseline projection of economic growth will not be sufficient to tackle the ACTs’ main economic challenge of high unemployment.

Figure 6.2.1. External Official Financing for ACTs (2011–13, USD billions, percent)



Source: National authorities and IMF staff estimates.

Short-term growth and employment could be boosted by a carefully designed job-creating public investment initiative, but would require additional external support (US\$24 billion over the next five years in the example of Figure 2.5). This additional financing would need to be on sufficiently concessional terms to preserve debt sustainability, especially in those countries with high debt, and consistent with the countries’ absorptive capacity. Therefore it is critical for the international community to do more in mobilizing financial support for the ACTs.

Over the medium term, financing needs are expected to remain substantial but with private financing—both FDI and private capital markets—playing a bigger role. These expectations are predicated not only on externally financed public investment initiatives but also, importantly, on the successful implementation of a comprehensive package of structural reforms aimed at ensuring sufficient job creation by the private sector to maintain employment in the medium term.

The IMF remains closely engaged with the ACTs. IMF staff are engaging with country authorities and their international partners in the areas of economic policies and financing. The IMF's advice to the ACTs has been adapting to changing external and domestic economic conditions (Box 6.3). Since the onset of the political transitions, its focus has been on striking the right balance between measures needed to maintain macroeconomic stability and protect the poor during the transition, on the one hand, and those laying the groundwork for faster growth and job creation, on the other. In this context, the IMF has advised countries to adjust large fiscal deficits gradually so as to put fiscal balances on a sustainable path while limiting the adverse short-term effects on growth and unemployment under the presently difficult socio-political conditions. The IMF has committed about \$10 billion in financial arrangements with Jordan, Morocco, Tunisia, and Yemen. IMF staff are in advanced discussions with Yemen toward a successor arrangement to the IMF support provided in 2012, are supporting Libya through policy dialogue and capacity-building efforts, and are ready to engage with Egypt on a possible financial arrangement when requested. The IMF is active in all ACTs on policy advice and capacity building, and, in coordination with ACT governments, has increased its communications with stakeholders, including civil society organizations, academics, and parliamentarians.

Box 6.3. Lessons from the Arab Transitions for the IMF

While IMF advice prior to the onset of the transitions in 2011 centered on sound macroeconomic policies for stability and growth, insufficient attention was paid to growing socioeconomic imbalances. Efforts centered on helping countries build sound macroeconomic foundations, liberalize economic activity, and introduce market-based reforms that would generate higher economic growth. In addition to advice on sound fiscal and monetary policies, the IMF recommended strengthening monetary policy instruments, enhancing the liquidity of government bond markets, strengthening the soundness and competition of the banking sector, maintaining the momentum of privatization, improving public finance management, lowering the cost of doing business, enhancing labor market flexibility, and increasing regional cooperation and trade liberalization. While the focus was mainly on strengthening macroeconomic stability and medium-term growth, with hindsight it has become clear that not enough emphasis was placed on the need to ensure equal access to economic and employment opportunities.

IMF advice since 2011 has adapted to the challenges of the transitions. Following the onset of political transitions in 2011, and in light of challenging socio-political conditions, high public debt, and large fiscal and external imbalances, IMF advice has focused primarily on bolstering macro stability while strengthening the focus

Box 6.3 (concluded)

on employment generation and measures to boost inclusive growth. The IMF has particularly recommended that fiscal consolidation be pursued at a gradual pace to put fiscal balances on a sustainable path while limiting the adverse short-term effects on growth and unemployment. In ACT program countries (Jordan, Morocco, Tunisia, Yemen), external shocks have been partially accommodated by loosening the targeted fiscal deficits. The IMF has put emphasis on subsidy reform, recommending that generalized subsidies should gradually be replaced by more cost-effective ways of social protection. The IMF has also recommended an accommodative monetary policy stance, in light of subdued inflation and weak recovery in the region.

The IMF has increased its focus on inclusive growth and political economy.

Realizing that the popular uprisings in the ACTs were born in part of a desire for more widespread and fairer distribution of economic opportunities, the IMF has increasingly focused on issues pertaining to inclusive growth. In particular, the IMF has recommended important economic reforms to reduce high structural unemployment and deliver a more equitable distribution of income, including enhancing business and investment conditions, increasing trade openness, improving the stability and access of the financial system, and improving social safety nets. It has also developed an analytical tool to better understand the linkages between growth and employment. Recognizing that countries are operating under difficult socio-political conditions, the IMF has increased its focus on the political economy aspects of reform, strengthening the emphasis on national dialogue and ownership of economic programs and improved communication of policy intentions.

The way ahead

The political transitions present a historic opportunity to set in motion needed economic transformations. The transitions have created a unique opportunity to challenge the status quo and the vested interests that have supported it in the past. This is the hub of the virtuous circle where economic transformation and political transition mutually reinforce one another to deliver on the aspirations of the ACTs. The ACTs have strong underlying potential for a dynamic economy, including a young workforce, increasing access to technology, a unique geographic location linking several continents, and rich tourist destinations. The right combination of policies, enacted with a clear view of the political economy and with the support of the international community, can help realize this potential and deliver on the aspirations of the people of the ACTs.

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