WORLD BANK MIDDLE EAST AND NORTH AFRICA REGION

MENA ECONOMIC MONITOR

Economic Transformation

WORLD BANK GROUP

APRIL 2018

MIDDLE EAST AND NORTH AFRICA REGION

MENA Economic Monitor

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April 2018

1 2 3 4 21 20 19 18

ISBN (electronic): 978-1-4648-1288-0
DOI: 10.1596/978-1-4648-1288-0

Cover photo: © ZouZou/ Shutterstock.

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Acknowledgements

The MENA Economic Monitor is a product of the Chief Economist's Office of the Middle East and North Africa Region of the World Bank.

The report was prepared by a team led by Rabah Arezki, and including, Lili Mottaghi, Andrea Barone, Rachel Yuting Fan, Youssouf Kiendrebeogo, and Daniel Lederman.

We are grateful to Hideki Matsunaga, Omer Karasapan, and Piers E. Merrick for providing comments on the earlier version of the report, Isabelle Chaal-Dabi, Doris Chung, Nathalie Lenoble for excellent administrative support, James Lester Rowe Jr for editing the report, and Will Kemp for the cover design.

The country notes are based on reports by the following Country Economists, led by Kevin Carey: Sara B. Alnashar, Ibrahim Chowdhury, Hoda Youssef, Luca Bandiera, Ashwaq Maseeh, Bledi Celiku, Khalid El Massnaoui, Amina Iraqi, Nur Nasser Eddin, Wilfried Engelke, Amir Althibah, Christos Kostopoulos, Wissam Harake, Zeina Hasna, Kamer Karakurum-Ozdemir, Majid Kazemi, Tehmina Khan, Sahar Hussain, Harun Onder, Thaddeus Malesa, Julie Lohi, Emmanuel Pinto Moreira, Fulbert Tchana Tchana, Abdoulaye Sy, and Dalia Al Kadi.

Abbreviations

ADNOC	Abu Dhabi National Oil Corporation
AFR	Africa
b/d	Barrel/Day
bbl	Barrel
CDB	China Development Bank
COP	United Nations Conference on Climate Change
DPF	Development Policy Financing
EAP	East Asia and Pacific
ECA	Europe and Central Asia
EITI	Extractive Industry Transparency Initiative
EIU	The Economist Intelligence Unit
EU	European Union
FDI	Foreign Direct Investment
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
ICT	Information and Communication Technology
IEA	International Energy Agency
IFC	International Financial Corporation
IMF	International Monetary Fund
ISIS	Islamic State of Iraq and Syria
LAC	Latin America and Caribbean
MDBs	Multilateral Development Banks
MENA	Middle East and North Africa
MFD	Maximizing Finance for Development
MIGA	Multilateral Investment Guarantee Agency
MNA	Middle East and North Africa
OEC	Oil Exporting Countries
OECD	Organization for Economic Co-operation and Development
OIC	Oil Importing Countries
OPEC	Organization of Petroleum Exporting Countries
PPP	Public-Private Partnerships
R&D	Research and Development
RMB	Renminbi
SAR	South Asia Region
SMEs	Small and Medium Enterprises
SOE	State-Owned Enterprise
SSA	Sub Saharan Africa
U.S.	United States
UAE	United Arab Emirates
UDIC	Urban Development Investment Corporation
UK	United Kingdom
VAT	Value-Added Tax
WB	World Bank
WEF	World Economic Forum

Summary

Economic growth in MENA is projected to rebound in 2018, thanks to the positive global outlook, oil prices stabilizing at relatively higher levels, stabilization policies and reforms, and recovery and reconstruction as conflicts recede at least in the fighting against ISIS. Growth in MENA is expected to rebound to 3.1 percent in 2018, following a sharp decline to 2 percent in 2017 from 4.3 percent in 2016. The increase in growth is broad-based, and almost all countries will experience an uptick this year. On the back of a good performance by Gulf Cooperation Council countries, oil exporters could see growth reach 3 percent in 2018, double their rate in 2017. Growth in oil importers is also expected to improve, driven by a sharp rebound in Egypt. Stabilization policies, reforms, and a surge in foreign receipts are expected to lower MENA's fiscal and external imbalances in 2018 and beyond. In the short term, the outlook for MENA remains positive, and the growth rebound is expected to edge up to 3.3 percent in 2019, and then slightly moderate to 3.2 percent in 2020. However, geopolitical tensions, the challenges posed by forcibly displaced people, including refugees, and the rising levels of unemployment and debt in the region could cloud the positive outlook.

While stabilization policies have helped economies adjust in recent years, a second phase of reforms is needed that should be transformative if the region is to reach its potential. Indeed, the current growth trajectory is markedly below that potential and insufficient to absorb the hundred million young people who will enter the labor market in coming decades. In this report, we explore the role that public-private partnerships can play, not only in providing an alternative source of financing but in helping change the role of the state from the main provider of employment to an enabler of private sector activity.

Studies have shown that the gap between MENA economies and fast-growing ones is the performance of the services sector. Rapid technological change offers new opportunities for boosting private-sector-led growth through enhancement of high-tech jobs in the services sector. For each job created in the high-tech sector, approximately 4.3 jobs are created across all occupation and income groups. The MENA region has fast-growing pool of university graduates and a heavy penetration of social media and smartphones. Combining them could serve as the foundation for a digital sector that could create much-needed private sector jobs for the youth over the next decade. Several MENA countries have developed strategies to transform their economies and take advantage of disruptive technology, but more is needed to capture the opportunity.

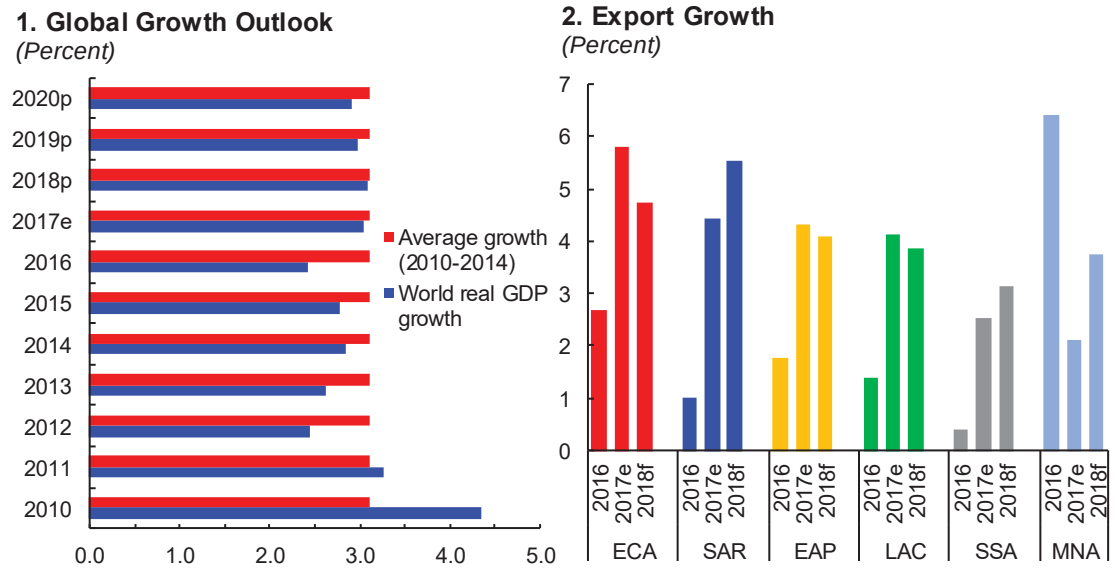
The report also shows how external forces are disrupting various markets, including those for energy, which exposes MENA countries to new risks, including of stranded assets.

1. The Global Outlook

The global recovery that started in mid-2016 is gaining momentum. Global growth for 2017 has been revised upward to 3.1 percent, about 0.2 percentage point higher than projected last Fall (Figure 1.1). For the first time since the global financial crisis, all countries except those in conflict are experiencing an increase in economic growth. The growth estimates for advanced economies in 2017—including the United States, the Euro Area, and Japan—are higher than the Fall projections by about 0.4 percentage point. Output in emerging and developing countries is estimated to have grown 0.2 percentage point faster in 2017 than was projected last Fall. The recovery in global output is demand driven and supported by a rebound in global investment and trade—the result of improved confidence and stability in commodity prices. Among advanced economies, economic activity in the United States is forecast to grow faster than earlier projected because of higher external demand which could carry on to 2018 as the expected macroeconomic impact of recent tax plan changes—mainly the reduction of the corporate income tax and associated fiscal stimulus materializes. Growth in the Euro Area in 2017 has been revised upward by 0.7 percentage point from the Fall forecast. Growth in many European economies—including Germany, Italy, and the Netherlands—is expected to exceed the Fall projections. Growth recovery in Europe and the United States has a strong correlation with recovery in emerging markets and developing economies, which will experience an increase in external demand. Estimates by the World Bank show that a one percentage point increase in the U.S. growth could lift growth in these countries by 0.6 percentage points after one year (World Bank 2017). Among them, growth is estimated to increase in Argentina, Brazil, Colombia, Iran, Nigeria, and Russia.

The global recovery is expected to continue into 2018 and 2019, with growth forecast to be about 3.1 percent, on average, for both years—0.2 percentage point faster than in the Fall forecasts. Economic activity in emerging and developing countries is expected to remain unchanged in 2018 and 2019, projected to grow 4.7 percent in both years. Although healthy, the global growth projection falls short of the average growth experienced between 2010 and 2014 (Figure 1.1). Moreover, risks to this positive outlook are high and could dampen the fragile recovery. These risks include inward-looking policies in some major advanced economies, the outcome of Britain's exit from the European Union, and increases in trade barriers, and, potentially, the rapid development of the digital economy, which could carry implications for financial stability. Geopolitical tensions and political uncertainty, particularly in East Asia and the Middle East, also could affect the global outlook. Climate change could increase humanitarian costs and economic losses in the affected regions. On a positive note, the current global recovery could prompt reforms in emerging and developing economies that could increase potential output in the medium term.

Figure 1.1 Global Growth Outlook

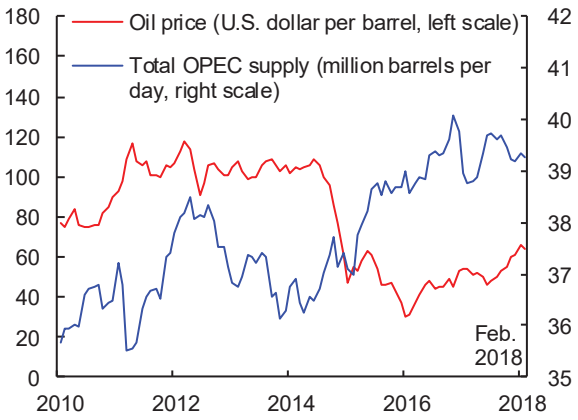


Source: World Bank.

Note: e = estimate; f = forecast.

Oil Price Outlook

Figure 1.2. Oil Price and Production



Sources: U.S. Energy Information Administration, Short Term Energy Outlook; and World Bank Commodity Price Data.

Stability is returning to the oil market at slightly higher prices than in 2014–15 but below the late 2016 high (Figure 1.2). An improved global growth outlook, an extension of OPEC cuts until the end of 2018, and geopolitical tensions in the Middle East have supported crude oil prices. The World Bank estimates oil prices will average $53 per barrel (bbl) in 2017, up from $43 bbl in 2016, and increase to $58 bbl in 2018. Oil prices are expected to stay around $60 bbl until the end of the decade (Mottaghi 2016). There are at least three major forces that will shape the outlook for oil prices over the next two years. First, while OPEC and a few non-OPEC oil producers agreed in November 2017 to extend their production cuts through the end of 2018, the deal is not expected to continue beyond then. Kuwait, at 200,000 barrels per day (b/d), Iran (100,000 b/d), and Iraq (250,000 b/d) have already signaled that they will raise oil production after the deal expires. If this happens, Saudi Arabia, Russia, Nigeria, and others will likely follow suit. This could push an additional 2 million b/d of crude oil into the market. Second, the boom in shale oil production will continue over the next two years, reaching around 11 million barrels per day—more than Saudi Arabia produces. According to the International

Energy Agency, the United States will become a net energy exporter by 2022. Should the U.S. production and inventories continue to build, oil prices could ease. In a pessimistic scenario, and the absence of a positive demand shock, the oversupplied market could push oil prices (as measured by Brent crude) back into the $50s. Third, rising geopolitical risks in major oil producers—including Iran, Iraq, Libya, Nigeria, and Venezuela—could bring back volatility to the market and increase oil prices temporarily.

There are substantial risks in each direction to the oil price forecast. Should oil prices drop sharply, that would not only have substantial consequences for oil-producing countries, but for oil importers, who would experience reductions in remittances, foreign direct investment (FDI), and tourism receipts. Any developments in the oil market could affect the global growth outlook.

Recent Economic Developments and Outlook in MENA

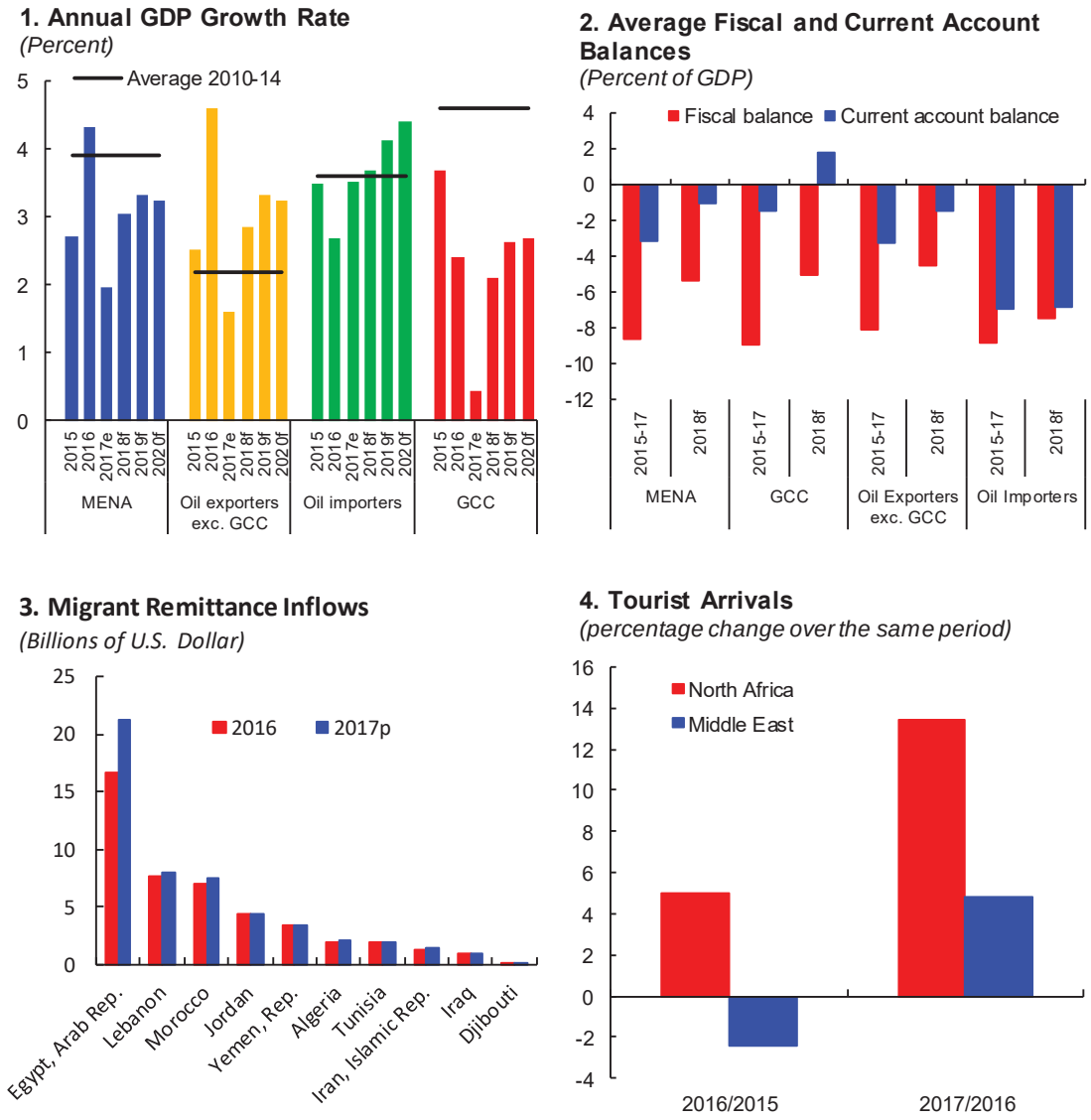
A favorable global economic environment, stability in the oil market at slightly higher prices, and resumption of construction activities in conflict-affected countries have helped economic growth return to the Middle East and North Africa (MENA) region (Figure 1.3 top left panel). Moreover, major economic and social reforms are occurring, albeit at a slow pace. Almost all countries are reducing or eliminating energy subsidies, considering increasing non-oil revenues, and taking on comprehensive social programs to shield the poor from the adverse effects of some reforms. Economic growth in MENA—which fell to 2 percent in 2017 from 4.3 percent in 2016 because of a sharp decline in economic activity among oil exporters—is expected to increase to 3.1 percent in 2018. The increase is broad-based; almost all countries will experience an uptick in growth this year (Table 1.1).

Table 1.1 MENA's Macroeconomic Outlook, 2015-20 Outlook

	Real GDP Growth, %						Fiscal Balance, % of GDP						Current Account Balance, % of GDP					
	2015	2016	2017e	2018f	2019f	2020f	2015	2016	2017e	2018f	2019f	2020f	2015	2016	2017e	2018f	2019f	2020f
MENA	**2.7**	**4.3**	**2.0**	**3.1**	**3.3**	**3.2**	**-9.2**	**-10.5**	**-6.2**	**-5.4**	**-3.8**	**-2.6**	**-3.6**	**-4.4**	**-1.4**	**-1.0**	**-0.6**	**-0.4**
Developing MENA	**1.4**	**6.6**	**3.8**	**4.1**	**4.1**	**3.8**	**-9.4**	**-9.6**	**-6.1**	**-5.8**	**-4.4**	**-3.4**	**-5.2**	**-5.2**	**-4.0**	**-3.8**	**-3.1**	**-2.7**
Oil Exporters	**2.5**	**4.6**	**1.6**	**2.9**	**3.1**	**2.9**	**-9.3**	**-10.8**	**-5.7**	**-4.8**	**-3.0**	**-1.6**	**-3.1**	**-3.6**	**0.3**	**0.6**	**1.1**	**1.3**
GCC	**3.7**	**2.4**	**0.4**	**2.1**	**2.6**	**2.7**	**-8.9**	**-11.5**	**-6.3**	**-5.0**	**-3.3**	**-1.7**	**-2.1**	**-3.6**	**1.2**	**1.8**	**2.0**	**2.1**
Bahrain	2.9	3.0	2.5	1.7	2.1	2.1	-18.4	-17.8	-13.2	-11.5	-10.2	-8.8	-2.4	-4.7	-4.5	-4.1	-3.5	-2.7
Kuwait	0.6	3.5	-1.0	1.9	3.5	3.0	5.8	0.5	3.5	3.7	2.9	2.2	7.5	-3.4	3.3	4.7	5.1	4.1
Oman	4.7	5.4	0.7	2.3	2.5	2.9	-17.5	-20.6	-13.3	-11.3	-10.1	-9.1	-15.5	-18.4	-11.7	-10.4	-9.2	-8.2
Qatar	4.0	2.2	2.2	2.8	3.2	2.8	1.4	-8.3	-5.0	-3.7	-2.0	-0.4	8.5	-7.5	2.6	3.8	3.3	3.2
Saudi Arabia	4.1	1.7	-0.6	1.8	2.1	2.3	-15.8	-16.9	-9.0	-7.6	-4.9	-2.4	-8.7	-4.3	1.7	2.1	2.3	2.4
United Arab Emirates	3.8	3.0	2.0	2.5	3.2	3.3	-3.4	-4.3	-3.1	-2.0	-1.0	-0.3	4.7	2.4	2.0	2.1	2.5	2.7
Developing Oil Exporters	**0.0**	**9.0**	**4.0**	**4.3**	**4.0**	**3.4**	**-9.9**	**-9.7**	**-4.6**	**-4.5**	**-2.6**	**-1.3**	**-4.9**	**-3.6**	**-1.2**	**-1.5**	**-0.5**	**-0.1**
Algeria	3.7	3.3	2.1	3.5	2.0	1.3	-17.5	-15.7	-8.2	-11.4	-5.2	-1.9	-16.5	-15.6	-14.7	-16.1	-12.7	-10.2
Iran, Islamic Rep.	-1.3	13.4	4.3	4.1	4.1	4.2	-1.7	-2.2	-2.4	-2.5	-2.7	-2.6	2.3	3.9	4.1	5.4	5.1	4.7
Iraq	4.8	11.0	-0.8	2.5	4.1	1.9	-12.3	-13.9	-2.2	0.9	1.7	1.4	-6.5	-8.6	0.7	-0.2	-0.1	-1.3
Libya	-8.9	-2.8	26.7	14.9	9.4	7.5	-76.9	-63.1	-26.0	-13.2	-7.1	0.2	-31.4	-14.6	-9.4	-7.2	-3.0	0.6
Syrian Arab Rep.	-15.8	1.7	…	…	…	…	-20.2	-18.2	…	…	…	…	-8.4	-9.9	…	…	…	…
Yemen, Rep.	-37.1	-34.3	-13.8	-0.5	17.9	16.3	-11.5	-16.5	-7.6	-14.0	-8.6	-2.7	-6.5	-5.2	-1.0	-6.5	-3.8	0.3
Developing Oil Importers	**3.5**	**2.7**	**3.5**	**3.7**	**4.1**	**4.4**	**-8.8**	**-9.4**	**-8.2**	**-7.6**	**-6.7**	**-6.0**	**-5.5**	**-7.5**	**-7.9**	**-6.9**	**-6.3**	**-5.8**
Djibouti	6.5	6.5	7.0	6.5	6.4	6.3	-20.7	-15.2	-3.1	-2.9	-1.4	-1.1	-30.4	-22.2	-5.5	-5.2	-4.6	-4.2
Egypt, Arab Rep.	4.4	4.3	4.2	5.0	5.5	5.8	-11.4	-12.5	-10.9	-9.8	-8.4	-7.3	-3.6	-6.0	-6.6	-4.9	-4.4	-4.1
Jordan	2.4	2.0	2.1	2.2	2.4	2.4	-3.6	-3.2	-3.4	-2.4	-1.9	-1.9	-9.1	-9.5	-8.8	-8.7	-8.6	-8.6
Lebanon	0.8	2.0	2.0	2.0	2.0	2.0	-7.8	-9.6	-6.6	-8.3	-8.9	-9.3	-16.3	-19.9	-21.2	-21.6	-20.4	-18.2
Morocco	4.5	1.2	4.0	3.0	3.5	3.7	-4.2	-4.0	-3.5	-3.3	-3.0	-3.0	-2.1	-4.4	-4.0	-4.2	-4.4	-4.5
Tunisia	1.1	1.0	2.0	2.7	3.3	3.7	-5.6	-6.0	-6.3	-5.6	-3.7	-2.7	-8.9	-8.8	-10.2	-9.5	-7.8	-7.2
West Bank & Gaza	3.4	4.7	2.7	2.5	2.3	2.3	-5.1	-4.0	-2.8	-2.8	-2.9	-2.9	-16.3	-10.4	-12.4	-12.6	-12.5	-12.0

Source: World Bank data. *Note:* e = estimate, and f=forecast. Data for Egypt correspond to the fiscal year (July-June). Due to lack of data for Syria, regional and subregional averages may not be comparable over time. Jordan data are from Jordan Economic Monitoring Note, Fall 2017.

Figure 1.3 MENA Outlook



Sources: World Bank, the World Tourism Organization, International Monetary Fund, and World Bank staff estimates.

The large fiscal and current account balances that followed the 2014 oil price collapse are expected to improve significantly in 2018 as a result of fiscal consolidation efforts by MENA governments and increases in remittances, tourism, and exports (Figure 1.3 top right panel). There has been a strong rebound in tourism in Egypt, and Tunisia, while Morocco, Bahrain, Jordan, Lebanon, Oman and the United Arab Emirate (Dubai) all continued their sustained growth in tourism (Figure 1.3 bottom right panel). Latest estimates show that remittance inflows to MENA have grown by around 12 percent in 2017, after two years of decline, driven by a rapid increase in remittances to Egypt (Figure 1.3 bottom left panel). Improving growth in Europe increased remittances to Maghreb in 2017 (Morocco by 5 percent until November 2017, Tunisia by 3 percent year-on-year). While remittances to Jordan grew by 1 percent in first three

quarters of 2017, remittances to Lebanon remained flat in the first part of 2017, as remittance outflows from Saudi Arabia declined but those from UAE increased.

Short-term economic prospects in MENA are brighter than they appeared a year ago. Fiscal and energy pricing reforms are gaining momentum as MENA governments consider new sources of revenues—including a value-added tax (VAT), other tax reforms, and consolidated public spending to reduce high fiscal deficits. Remittances and tourism are expected to grow in 2018 and beyond. War-torn and conflict-affected countries are slowly recovering from the war with ISIS while facing the challenges of funding reconstruction and maintaining growth recovery. People forcibly displaced by the conflicts, including refugees, however still face challenges to their wellbeing, and pose problems for the finances of their hosting communities (Devarajan and Mottaghi 2017). Against this backdrop, the economic recovery in MENA is expected to continue through 2020 (the end of the projection period), with regional growth exceeding 3 percent, as predicted in the October MENA Economic Monitor. The positive outlook reflects the improved prospects for the fiscal and external account positions, reconstruction efforts, structural reforms, and robust global economic growth. But job growth will remain weak. While reforms have started to bear fruit, the overall growth is still low, and the challenges posed by forcibly displaced people weigh on the short-term outlook. In the medium term, the prospects of reconstruction and reform are essential to sustaining growth and creating jobs, both of which depend significantly on how MENA countries seize the opportunity to advance growth.

Within MENA, the growth prospects for oil exporters as a whole could improve substantially in 2018-2020, as governments have started to take measures to diversify beyond oil. Growth in oil exporters is expected to average 3 percent from 2018 through 2020, twice the 2017 rate. Higher growth in Gulf Cooperation Council (GCC) countries is the main driver of an improved outlook for oil exporters. Growth in the GCC group will increase more than fivefold in 2018-2020 relative to 2017 (Table 1.1). Growth projections for 2018-2020 are higher for all countries except Bahrain. Low oil prices are expected to weigh on domestic demand in Bahrain, and market uncertainties prevent the economy from performing at its full potential. Saudi Arabia, which had a growth contraction in 2017, will return to positive growth; it will exceed 2 percent in 2020. In the United Arab Emirates, growth will reach 3.3 percent (up from 2 percent in 2017) by the end of the decade. The possible reversal of OPEC-mandated production cuts after 2018, a moderate increase in projected oil prices, improved oil production capacity, and recent stabilization policies and reforms are expected to contribute positively to the economic recovery. Fiscal reforms— including the introduction of the value added and other tax changes, reduction of fuel subsidies and further austerity measures—are expected to contribute to growth recovery in the medium term as the effects of short-term structural reforms dissipate. Notwithstanding, the overall growth in GCC countries will remain below the levels seen before the 2014 oil price shock (Figure 1.3 top left panel). The average growth rate for the GCC countries between 2010 and 2014 was around 4.6 percent, but oil-driven. The fiscal and current account deficits of the GCC group are expected to improve substantially. The fiscal deficit is projected to shrink to 1.6 percent of GDP in 2020 from 11.5 percent in 2016 (Table 1.1). Fuel subsidies in Bahrain were reduced significantly, leading to a 12 to 25 percent increase in gas prices. Saudi Arabia reduced gas subsidies, and prices increased by 80 percent in January 2018. Kuwait introduced new electricity tariffs for commercial buildings. These measures will contribute to improved fiscal finances, although public debt will remain elevated. Saudi Arabia increased its syndicated loans to creditors by $6 billion in March 2018 to $16 billion. Oman

raised $5 billion from international debt markets and $2 billion from sukuk to finance its fiscal needs in 2017.

Growth in oil-exporting countries, excluding those in the GCC, will remain unchanged at about 4 percent on average 2018-2020. Growth in Algeria is expected to slow to about 1.3 percent in 2020 from the 3.5 percent forecast for 2018. The main reasons are a slight decline in hydrocarbon production, lower growth in non-hydrocarbon sectors, and steps to reduce the fiscal deficit and debt that could recommence as early as next year following the presidential elections. The Iranian economy is expected to maintain its 4 percent growth by 2020 on the back of an imporvement in non-oil sectors and a recovery in consumption and investment demand. Signs of a pickup in the construction sector, historically a lead indicator of economic activity, confirm this trend. But high unemployment and increased inflation from a significant depreciation of the exchange rate combined with the uncertain future of the Joint Comprehensive Plan of Action (Iran nuclear deal) are likely to complicate the government's effort to advance economic reforms further. The rest of the countries in this group are dealing with the aftermath of war and conflict. Recovery and reconstruction efforts that are picking up in Iraq—and should later in Yemen, Libya, and Syria—could improve economic performance if necessary reforms are in place. Fiscal and current account balances in these countries are expected to substantially improve through 2020, the result of fiscal adjustments, slightly higher oil prices, and a rebound in foreign receipts (Figure 1.3 top right panel).

Growth among oil importers is expected to increase to 4 percent on average in 2018-2020, nearly half a percentage point higher than in 2017. The main contributor to the recovery in these countries—Djibouti, Egypt, Jordan, Lebanon, Morocco, Tunisia, and West Bank and Gaza—is Egypt's sharp rebound in growth. Egypt is the most populated country in MENA and has been beset by declining growth, rising debt, and widening fiscal and current account deficits. Recent reforms—including liberalizing the exchange rate, rationalizing subsidies and increasing social protections for the poor—have strengthened growth and helped attain adequate foreign reserves. Egypt's growth is projected to accelerate from 5 percent in 2018 to 5.8 percent in 2020, outperforming other oil importers. The burst in growth is mainly the result of a recovery in consumption and private investment and a rebound in merchandise exports and tourism. Among the other oil importers, growth in Morocco and Tunisia will remain subdued at around 3.4 and 3.2 percent, respectively, between 2018 and 2020. The Moroccan economy relies heavily on agricultural output and remains vulnerable to the risks of climate change. The Tunisian government must balance stability and the need for reform, which highlights the importance of promoting greater social and economic inclusion to create sufficient support for reform. Besides structural challenges, the protracted refugee crisis remains an impediment to the return to potential growth in Lebanon and Jordan. Both countries host more displaced Syrians per capita than any other country and the influx of refugees has put a significant strain on already weak public finances. Growth in Lebanon and Jordan is not expected to surpass 2 and 2.4 percent respectively over the next couple of years. The twin deficits for oil importers as a whole will remain elevated until the end of the decade, impeding their ability to tackle reforms and meet the challenges of chronically high unemployment rates.

Risks to the MENA's economic outlook are tilted to both sides. The recovery reconstruction program and rising infrastructure investment in war-torn countries, such as Iraq, could enhance the prospects of a sustained economic recovery and spillover effects could unlock the potential for higher growth and much-needed job creation among other countries in the region. A strong

rebound in MENA's main trading partners in the Euro Area—notably the United Kingdom, Spain, Italy, France, and Germany—as well as in the United States and China, could boost external demand and improve the prospects for the growth recovery. Conversely, loss of momentum in implementing economic reforms across MENA could adversely affect growth potential. Other downside risks include a worsening of the security situation in the region and elsewhere that could slow the rebound in tourism, remittances, and FDI, together with a possible increase in volatility in the global oil prices. Finally, MENA countries face high and unsustainable debt levels that could erode their economic prospects.

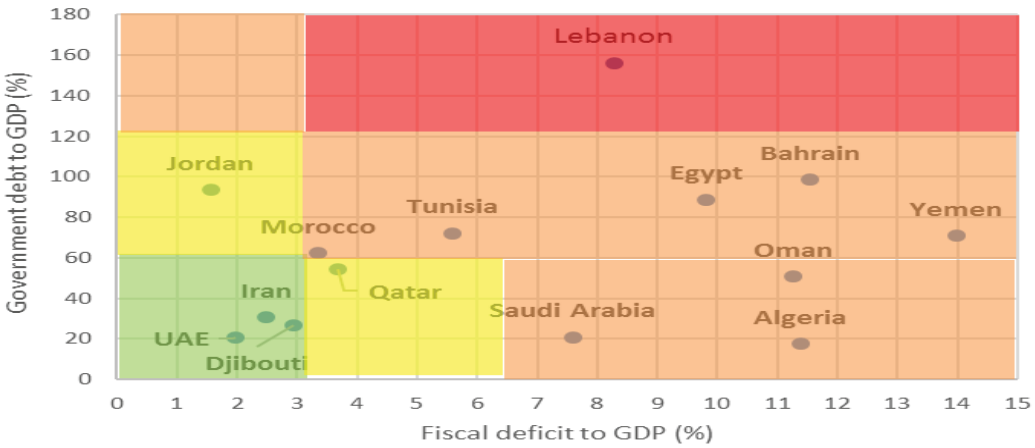
The Rising Debt Challenge

In fact, of all the economic challenges facing MENA countries[1], the most pressing may be the continuing rise in unemployment rates for the youth (see next section) and public debt levels to finance government deficits. Vulnerabilities to external shocks, including oil price volatility, are the genesis of that public borrowing, which has reached historically high levels in many countries in MENA. As noted above, both oil producers and oil importers have suffered. Producers rely heavily on oil revenue and have experienced a sharp fall in income since the price decline that began in 2014. Non-oil producers may have had a reduction in oil import expenses but they have also experienced a decline in grants, remittances, regional trade, financial services, and tourism. Rigidities in expenditure, a volatile revenue base, and weak fiscal institutions have added to regional woes, making a fiscal response to shocks difficult. Borrowing rather than adjusting spending has long been the dominant response in almost all countries in the region. But when debt rises sharply, its sustainability becomes a serious issue. The indebted governments must pay a large amount of interest, which ultimately increases the budget deficit forcing them to issue more debt.

Recent estimates by the IMF and the World Bank show that the already high ratio of debt to GDP will increase substantially across the region this year. In some GCC countries, such as Bahrain, the ratio will climb to close to 100 percent. The 2018 debt-to-GDP ratio in other GCC countries is expected to remain at levels high enough to be deemed critical under IMF criteria (Figure 1.4). The same is true of other indebted countries such as Egypt, Morocco, Algeria, Tunisia, and Yemen. The debt situation in Lebanon combined with its high fiscal deficit remain at unsustainable levels estimated at 153.4 percent of GDP. While the debt burden in Iran, UAE, and Djibouti is low (green area in Figure 1.4), it remains elevated in Jordan and Qatar leaving them in an unhealthy situation (yellow area in Figure 1.4) in the short term.

[1] Those challenges abound. There are considerable political and economic concerns regarding governments' fiscal and monetary policies, geopolitical uncertainty about raising adequate funding for reconstruction in conflict-affected countries, layered with uncertainty about the future of oil. The burden of coping with those forcibly displaced across the region have made it harder to deal with these challenges.

Figure 1.4 Debt Burden and Fiscal Balance in MENA



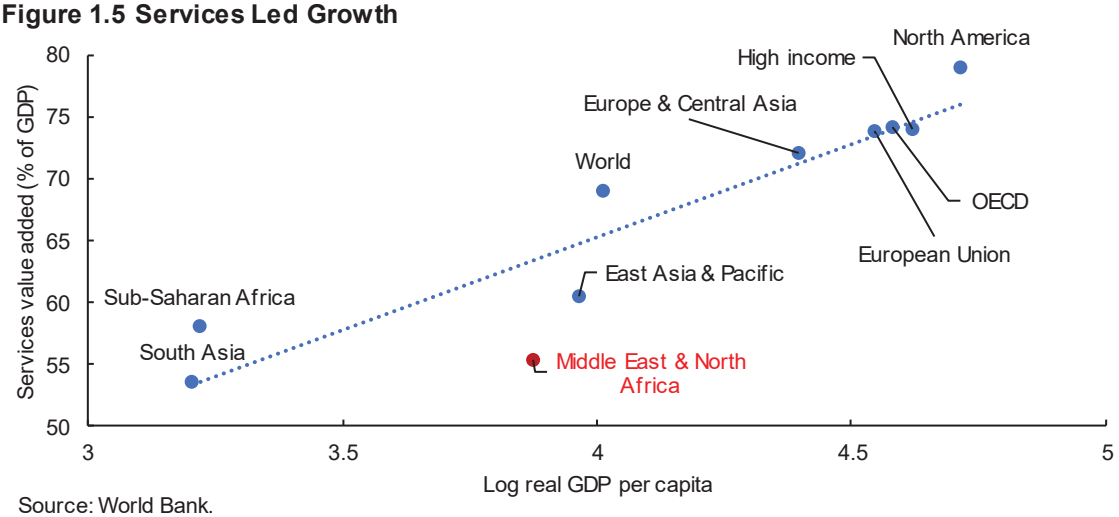
Source: World Bank.

Note: According to IMF guidelines: **Green** (max.60% debt-to-GDP and max.3% deficit). **Yellow** (60-120% debt-to-GDP if the deficit is below 3%, OR 0-60% debt-to-GDP with a 3-6% deficit), covers the area considered to be **unhealthy** in the long term. **Orange** (min.120% debt-to-GDP if the deficit is below 3%, OR 60-120% debt-to-GDP if the deficit is above 3%, OR 0-60% debt-to-GDP if the deficit is above 6%) covers the areas referred to as **critical** levels. **Red** (if the debt-to-GDP exceeds 120% in combination with having a deficit above 3%). In this area, the situation is **unsustainable**. As debt rises, countries may transition across zones.

A New Engine of Growth in MENA

To grow faster and significantly reduce chronic high unemployment rates, MENA governments must look to new sources of economic growth. Decades of efforts to diversify their economies away from oil have not worked. At about 14 percent, MENA has the world's lowest share of nonoil manufactured exports and the highest share of fuel exports—between 60 and 80 percent. The region's total nonoil exports are lower than Finland's, even though the region's population of above 300 million dwarfs Finland's 5 million people. MENA countries are the least integrated into the world economy. The region's 6 percent ratio of FDI to GDP is considered the world's lowest. The public sector has become a major provider of job opportunities but failed to create sufficient numbers of jobs due to government fiscal constraints while the private sector is weak and undeveloped. The growing numbers of young people—compounded by the low level of labor force participation, particularly among women—means that millions of additional jobs will be needed. Currently, unemployment rates in the MENA region exceed 11 percent—and youth unemployment is above 30 percent. Only one of every 30 new entrants can find a job. According to the most recent available data, the official unemployment rate in Djibouti was 39 percent (in 2015), with women at 49 percent and rural areas at 59 percent. In Gaza, unemployment reached 44 percent and 18 percent in West Bank in 2017. The dire situation in MENA is a result of the breakdown of the social contract, in which the state provided jobs and social and economic benefits to the citizens in exchange for limited public participation and official accountability (Devarajan and Mottaghi 2015). A new social contract must permit a more robust private sector, which can foster higher growth and create more jobs for the youth entering the labor market.

Figure 1.5 Services Led Growth



Source: World Bank.

Where might the future economic growth in MENA come from? Can that growth be inclusive and high enough to create more jobs for the youth bulge? The investment and growth in manufacturing that is the traditional path to diversification in developing countries has not happened in MENA. Studies have shown that the gap between MENA economies and fast-growing ones is the performance of the services sector (Figure 1.5). With advancement in technology, it is the right time for MENA governments to look into the "new normal" of promoting private sector-led growth and boosting jobs in the services sector.

High tech jobs are where the action is. High tech jobs in developed and developing countries have been more resilient to the economic downturns than any other private-sector industries. A recent study finds that employment growth in tech jobs outpaced gains in other professions by a ratio of 27 to 1 between 2001 and 2011. Moreover, demand from a larger digital sector could create jobs in other local goods and services sectors. This jobs multiplier effect is four times higher in the high tech sector than manufacturing sector. For each job created in the high tech sector, approximately 4.3 jobs are created across all income groups and occupations—including teachers, lawyers, doctors, among others. And a digital economy creates positive interlinked spillovers among economic and social sectors. E-health enables new forms of healthcare management and provision, increasing patient coverage and improving quality. E-education and online learning reach a large number of people, even in rural areas, at low cost and good quality. Poverty reduction experiences in Bolivia and India show that digital delivery can enhance inclusion and increase income among the disadvantaged.

Promoting digitalization in the services sector is a promising way to create millions of jobs in MENA. The region extensively uses social media and smart phones. That massive penetration of digital communication could provide the foudation for a broader tech-based economy that would create jobs for the fast-growing pool of university graduates. Estimates by McKinsey show that demand for high tech jobs will be higher than demand for other professions at least through 2020. The industries that best harness the digital experience will have the highest productivity increases and the small and medium enterprises that make better use of digital activities will grow faster (McKinsey 2016). The new engine of growth has important implication for how jobs, education, skills, and economic policy should be shaped.

Several MENA countries have developed strategies to revamp their economies and take advantage of disruptive technology to create more jobs. But effective policies are needed to capture the opportunity. Saudi Arabia's Vision 2030 seeks to raise the country's ranking in the E-government, prioritizing digital transformation as one of the top four Common National Goals. The program identified five digital platforms, 29 essential digital initiatives for key sectors, and several national digital assets to receive further investment to support the government's digital transformation. As part of the United Arab Emirates' Vision 2021, the National Innovation Strategy pinpointed digital technology as one of the top seven primary national sectors. The strategy focuses on the development of smart cities, software, and applications including advanced technology in areas of global interest such as artificial intelligence, semiconductors, nanotechnology, and 3D printing. Qatar's Vision 2030 prioritizes the creation of a knowledge-based economy characterized by innovation, entrepreneurship, excellence in education; a high quality infrastructure; efficient delivery of public services; and transparent and accountable government. Egypt's Vision 2030 foresees a competitive, balanced, and diversified economy, dependent on innovation and knowledge. New sources of growth are emerging in fintech and innovative financing instruments in Algeria and Bahrain. If MENA countries address the constraints to the growth in the services sector and improve digital adoption, they will not only create opportunities to move away from oil, increase new products, and boost labor productivity through skill development, they will also increase potential growth in the medium term.

Altogether, while stabilization policies have helped improve the prospects of a growth recovery in MENA, a second phase of reforms should be transformative if the region is to reach its potential. In the next section, we explore the role that public-private partnerships can play, not only in providing an alternative source of financing but in helping change the role of the state from the main provider of employment to an enabler of private sector activity.

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2. Developing Public Private Partnership Initiatives in the Middle East and North Africa: From Public Debt to Maximizing Finance for Development

This article argues for a novel approach to financing infrastructure needs in Arab countries. It first describes the context of rising public debt in the region contrasting it with the vast infrastructure needs. It then discusses the challenges in meeting these needs with traditional financing. The article then makes the case for "Maximizing Finance for Development (MFD)" using public private partnerships and presents a few successful examples in Arab countries. Finally, this article explores the way forward and concludes on the need for strong state capacity and integrity to promote the MFD approach.

Introduction

In March 2017, the World Bank Group set out a long-term vision of using development assistance and/or government spending to spur private sector investment–often called "crowding in." That document, produced for discussion at the Development Committee, introduced the "MFD" approach to infrastructure finance, which entails promoting private finance, wherever possible, to pay for the trillions of dollars of global infrastructure needed to support the sustainable development goals.[2]

The MFD approach argues for a changed role for multilateral development banks (MDBs) in which they would use their development assistance funds to encourage private finance, especially from largely untapped long-term institutional investors.

Specifically, to entice commercial financing, the MFD approach promotes reforms to address market failures and other constraints such as the improving the domestic legal and regulatory framework. Where risks remain high, the MFD approach calls for the use of guarantees and other risk-sharing instruments. Only when market solutions are not possible through reforms and risk mitigation does the MFD approach deem official development assistance appropriate. We aim to demonstrate why and how the MFD approach could help the Middle East and North Africa (MENA) region unleash its potential.

Indeed, when governments have limited or no ability to increase spending, the MENA region could leverage private finance to help build infrastructure—such as power plants and airports—and help enhance the quality of public service delivery. The vehicle to do just that is commonly known as public-private partnerships (PPP). While there is no one widely accepted definition, the World Bank's PPP Knowledge Lab defines a PPP as "a long-term contract between a private party and a government entity, for providing a public asset or service, in which the private party bears significant risk and management responsibility, and remuneration is linked

[2] See http://siteresources.worldbank.org/DEVCOMMINT/Documentation/23745169/DC2017-0002.pdf

to performance". PPPs typically do not include service contracts or construction contracts, which are categorized as public procurement projects, or the privatization of utilities where there is a limited ongoing role for the public sector.[3]

Scaling up PPPs is essential if MENA countries are to address the multifaceted set of challenges they face: moribund private sectors, low public-sector efficiency and the need to create millions of jobs for their young populations. Given their vast experience and knowledge, MDBs can help with the origination and the financing of PPP projects by providing technical assistance to governments, making government commitment to reforms credible, and mitigating risks by providing guarantees.

Conceptually, the matching of demand and supply of funds for infrastructure is hindered by both market and government failures, some of which are well understood and others somewhat less so:

- the public good nature of infrastructure projects, in which non-paying consumers cannot effectively be excluded from using them and their availability is not diminished by use—more formally known as non-excludability and non-rivalry in consumption;
- the market power of the operator of the infrastructure facilities; and
- the externalities (positive and negative)— including through trade, growth and network spillovers—associated with infrastructure investments.

Infrastructure projects often encounter obstacles because they are so complicated—they involve many agents (among them, construction companies, operators, insurers, government, owners, citizens), a complex chain of tasks (including building, maintenance, service delivery), and, inevitably, multiple informational asymmetries regarding quality, costs of service, and ultimate benefits. Informational asymmetries, in particular regarding quality—for example related to the inputs used for the infrastructure project by the private sector—lead to market failures. These failures call for a delicate balancing of public and private interests to ensure incentive compatibility—to limit opportunistic behavior on the part of both the public and private sector—and appropriate risk-sharing at various stages of the infrastructure project, as a large economics literature on PPPs has emphasized.

One of the central insights of the literature (see Lossa and Martimort, 2015 for an overview and Estache and Fay, 2007 for discussion of the evolution of the debate on infrastructure) is that it is generally incentive-efficient to structure concession contracts by bundling construction and service-provisions together with a single private operator. That provides a strong incentive to the builder to construct the facility in a way that minimizes future operating costs. While the literature has focused on incentives issues, researchers have paid little attention to origination and financing, including under PPPs, and to the role of MDBs.

One important exception is Arezki et al. (2017), who identify the main institutional obstacles that prevent the flow of savings towards infrastructure investment and propose a key institutional fix to unlock the current savings glut and reverse the recent trend of secular

[3] See PPP Knowledge Lab. An increasing number of countries are enshrining a definition of PPPs in their laws, each tailoring the definition to their institutional and legal particularities.

stagnation. They argue that the solution is to reshape PPPs in infrastructure and the classic model of MDBs.

Traditionally, PPPs have been bilateral contracts between a private concession operator and a government agency, while development banks offer financing to projects that could not attract private funding but have a high development impact.

Arezki et al. propose a model in which PPPs can involve three, or even four partners, with the additional partners being a development bank and long-term institutional investors. And the new model for development banks is to transform them into originate-and-distribute banks for PPP infrastructure projects. That is very much related to the so-called MFD approach that aims to maximize private sector financing.

In the rest of this article we look at the situation in the MENA region and its infrastructure needs and the challenges in meeting those needs with the traditional financing model. We make the case for MFD financing and present a few examples of successful examples in MENA. Finally, we look at the way forward.

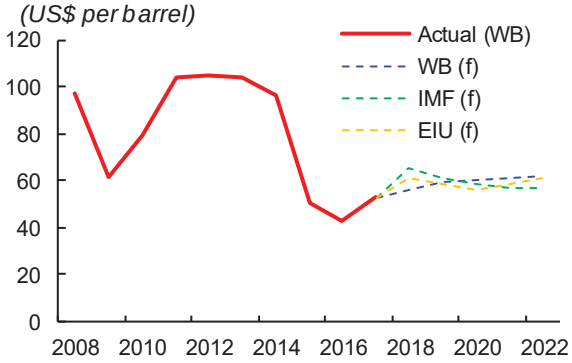
Context

Although there is a sustained global economic recovery, the MENA region is benefiting little because of myriad persistent shocks–including persistently low oil prices and escalating tensions and conflicts that are spilling over across borders. Those conflicts have created refugee crises.

Oil exporters in MENA have been severely hurt by low oil prices, which are about half the 2014 levels (see Figure 2.1). In oil-exporting countries, the oil price decline has turned fiscal and current account surpluses into deficits (see Figure 2.2). There are, however, important differences across countries in MENA. The effect of the decline in the price of oil on GDP, depends very much on a country's degree of dependence on oil exports, and on what proportion of oil revenues went to the state.

Figure 2.1 Crude Oil Price, Actual and Forecast

(US$ per barrel)

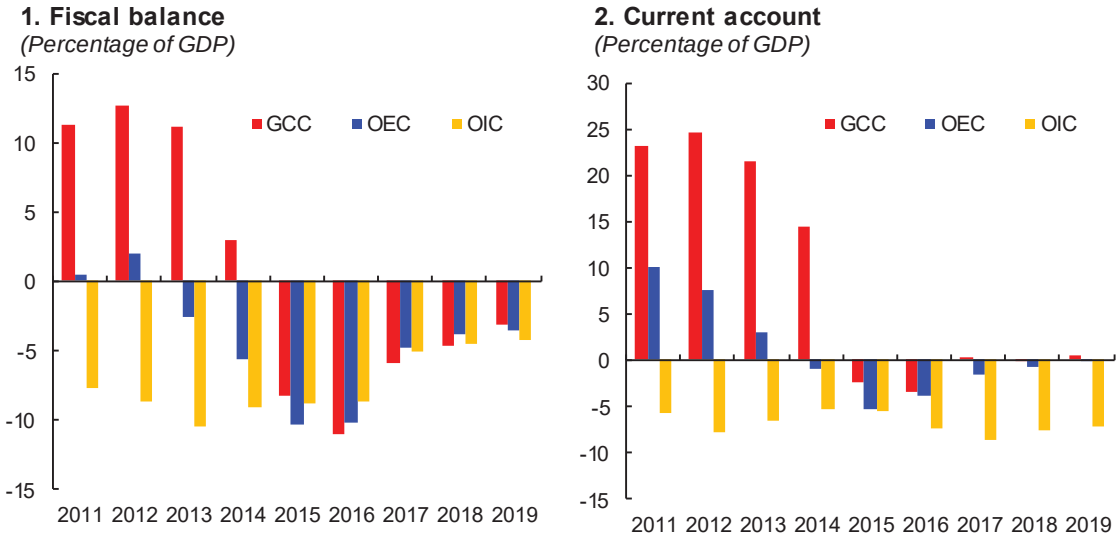


Sources: World Bank (WB), *Commodity Markets Outlook* October 2017; International Monetary Fund (IMF), *World Economic Outlook* January 2018 Update; The Economist Intelligence Unit (EIU), *World Commodity Forecasts*, March 2018 Edition; and WB staff calculations.

In response to this historical collapse, many MENA countries—especially those in the Gulf Cooperation Council (GCC), have undertaken bold reforms, such as eliminating fuel subsidies, cutting capital and current expenditures and introducing revenue-raising measures such as value-added taxes. These measures have helped stabilized their economies by reducing deficits and even moved some countries back to (small) surpluses. In the medium run, oil exporters in MENA need to transform their economies by creating the conditions to foster risk taking and entrepreneurship in private (and public) sector to absorb the fast-growing youth population entering the labor market.

Although MENA oil importers have realized an increase in real income from lower oil prices, they have also experienced severe adverse spillover effects because of lower income in their neighboring oil exporters, especially large GCC countries. These spillovers include a reduction in grants, remittances, and investments. On balance, oil importers in MENA have continued to run fiscal and current account deficits and to accumulate debt (see Figure 2.2).

Figure 2.2 From "Twin Surpluses" To "Twin Deficits" for Country Groups in MENA Region



Sources: International Monetary Fund, World Economic Outlook Database October 2017; and World Bank Staff calculations.
Note: Current account balance of country groups are average current account balance across member countries w eighted by gross domestic products. GCC: Gulf Cooperation Council countries. OEC: Oil exporting countries other than GCC countries. OIC: oil importing countries. Forecast Starting 2017.

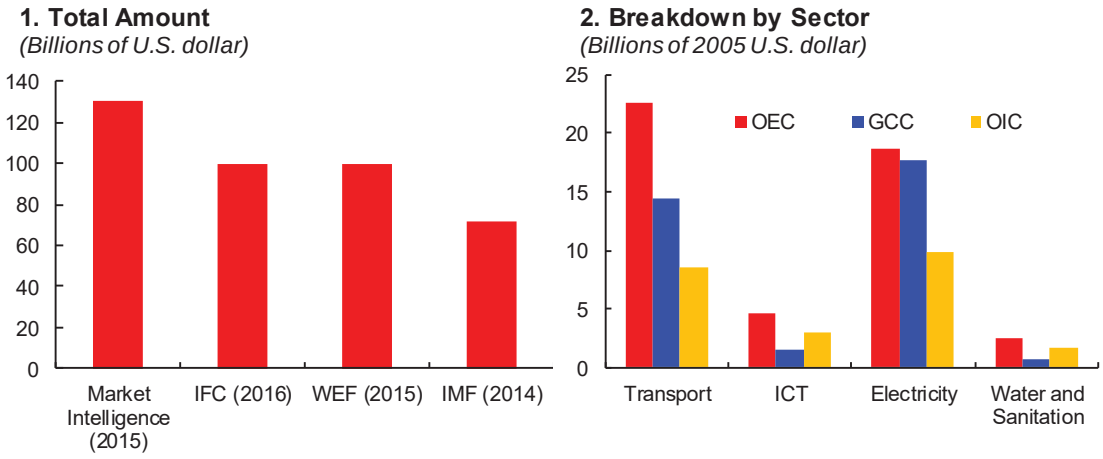
Even if many MENA countries, especially oil exporters, appear to have relatively low levels of debt, there are important contingent liabilities related to state-owned enterprises—such as non-performing loans—that suggest an escalation of public debt. With little ability to increase spending to embark on the kind of transformational agenda that is required to address the socio-economic challenges they face, MENA countries will have to mobilize private sector financing.

Infrastructure needs and challenges

The infrastructure needs in the region are large. They are estimated to be around 100 billion USD annually. Most of the needs are in electricity generation and transportation, followed by water and sanitation, and information and communication technologies.

Infrastructure traditionally has been financed, and managed, by governments with little private sector involvement. Because budgets are tighter, there will be underinvestment in maintenance of publicly owned and operated infrastructures. Interestingly, this is what led to the privatization of infrastructure in the United Kingdom in the 1980s, among other places (see Estache and Fay, 2007).

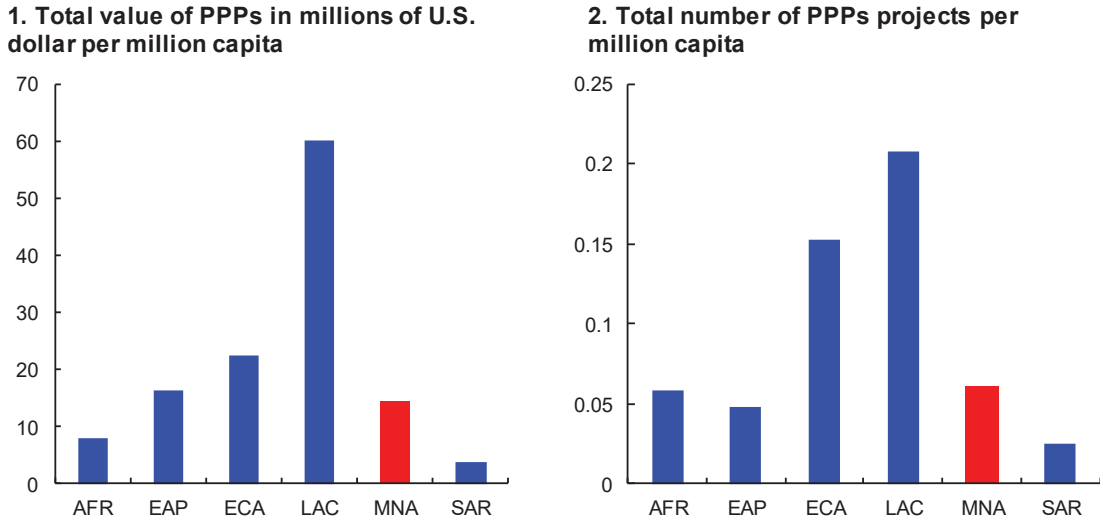
Figure 2.3. Annual Infrastructure Investment Needs in the MENA Region



Sources: World Bank and International Monetary Fund.

Source: Ianchovichina, et al. (2012)
Note: ICT = Information and Communication Technology.

Figure 2.4 Public - Private Partnerships in the Global Context

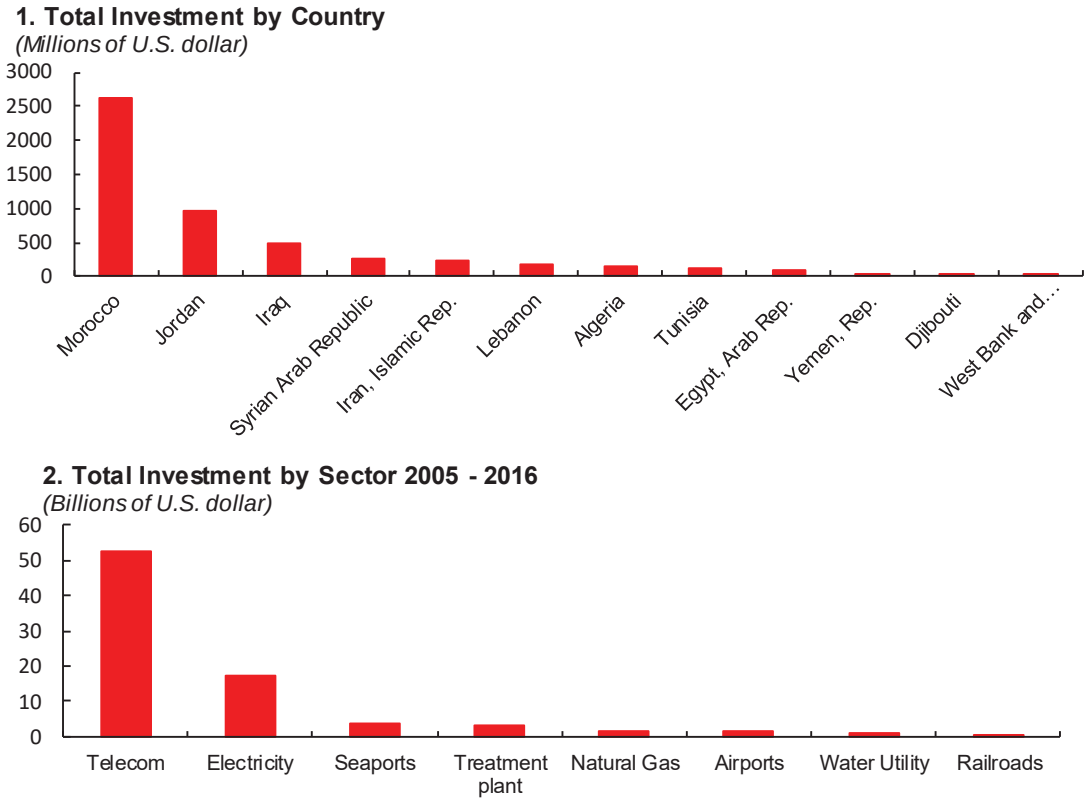


Sources: World Bank, Private Participation in Infrastructure Database; and World Bank staff calculations.
Note: Regional grouping follows the World Bank classification. High income countries are not included. Total value of investment and number of projects are in accordance to year 2016, or latest year available before that.

Existing PPPs in MENA are not large both in relation to what is needed (see Figure 2.3) and in comparison, to other regions[4] (see Figure 2.4). PPP investment in the region amounted to a few billion USD as of 2016. These PPPs are mainly in a few countries—Jordan, Iraq, and Morocco. They are concentrated in telecom, electricity and seaports (see Figure 2.5).

[4] Due to data availability of the source, only low- and middle-income countries are covered in the figure.

Figure 2.5 Breaking down PPPs in MENA



Sources: World Bank, Private Participation in Infrastructure Database; and World Bank staff calculations.

Note: Total value of investment and number of projects are in accordance to year 2016, or latest year available before that, unless otherwise noted.

The political economy of implementation and management in MENA

MENA states have had a poor track record in both the delivery and the management of public utilities. The are many reasons.

A primary factor is the so-called curse of financing. The excess profits from oil have turned governments into principals and citizens into agents. It is the reverse in economies in which taxpayer monies are the main sources of government revenue. As a result, there is little pressure on governments to do better. Moreover, the excessive reliance on traditional source of financing (entirely from public finance) also played a role in inducing inefficiency. Public financing of infrastructure without internal checks and balances does allow for overpricing and capture. It also prevents efficient pricing of risks and risk sharing with other partners such as private sector and MDBs.

Another factor in the poor track record of MENA countries is the concentrated nature of bureaucracies that make decisions from distant central states but have limited understanding of and pay little attention to local needs. The result often is poor implementation and delivery of services to citizens. That overconcentration of the state and the lack of information

accessible to citizens make it unlikely that states will achieve the dynamic adjustments needed to address the region's socio-economic challenges and in fact drive down efficiency. State capacity at the local level ends up being even weaker than in the center making it unlikely that subnational entities can borrow. Overconcentration is compounded by the lack of manager empowerment. Within overly concentrated bureaucracies, there are few incentives for managers to take initiatives and build new expertise. The lack of talent selection and retention reinforces poor state capacity.

The case for "MFD" finance: crowding in the private sector

With government coffers empty(ing), the needed transformation in the region should be largely financed by the private sector—an approach called "maximizing finance for development" or the "MFD"

There are three main advantages to the MFD approach.

The first is the potential efficiency gains that come from involving the private sector. Governments in the region have a poor track record of delivering and managing utilities, especially when compared with countries with similar income levels. The private sector can potentially better deliver and manage utilities provided the right incentive system is in place.

The second advantage is the ability of governments to shed some of the risk involved in building and maintaining infrastructure. The public sector can share risks with the private sector and MDBs. Depending on the nature of projects (whether building new or on an existing facility, for example), the balance between construction, demand, and regulatory risks differs. MDBs play a key monitoring role of both the service provider and the government agency, but also a fundamental role in structuring financing efficiently and providing optimal insurance or guarantees to private investors in PPPs.

The third advantage is a modulation in the cost of borrowing. For MENA countries, the borrowing costs are rising even though they are historically low globally. MENA countries are paying more because of lower oil prices, government inefficiency in building and managing infrastructure, and the interest rate premium associated with political risk. In some cases an exchange rate premium is in play because of potential overvaluation.

There region already has some successful PPPs that illustrate how a scaled-up MFD approach could bring about important the transformation in the delivery of public services in the MENA region.

Jordan: Queen Alia Airport. In 2007, the International Financial Corporation (IFC), which is part of the World Bank Group, advised the government of Jordan on structuring and awarding a 25-year concession for the Queen Alia International Airport in Amman following a competitive bidding process. The project includes rehabilitating existing facilities, constructing a new terminal to handle 12 million passengers per year, and operating the airport.

The concession was awarded to the Airport International Group, whose bid returned 54.58 percent of gross revenues to the government—the highest revenue-sharing percentage for similar projects anywhere in the world. This was the first successful airport PPP project in the Middle East and the largest private-sector investment of any type in Jordan to date. It is serving

Jordan as a model for launching a full-scale public-private partnership program in infrastructure.

West Bank and Gaza: Solid Waste Management. The provision of standard municipal public services, especially solid waste management, was of particular concern in West Bank and Gaza. Local capacity to manage a new solid waste facility was insufficient, so the Joint Services Council for Hebron and Bethlehem (JSC-H&B sought) IFC support in to finding an experienced private sector partner to manage the new facility through a PPP. The IFC provided an integrated solution that led to the first PPP in the West Bank. The Greek consortium that won the tender in 2013 is responsible for operating and maintaining the Al-Minya landfill and two transfer stations at Hebron and Tarqoumiya. The concession has contributed to improved quality of services, reduced health and environmental risks, and lower greenhouse gas emissions.

The nexus between reforms and PPPs: the Egyptian experience. Economic reforms have unlocked tens of billions of dollars of private investments in Egypt's energy sector. The reforms included a transition to bills that reflect the actual cost of providing energy and the introduction of market competition across energy sector. Between 2014 and 2016, the cost of subsidies in the electricity sector fell from 6.6 percent of GDP to 3 percent of GDP. In addition, competition and transparency are being promoted in the electricity, renewable energy, and gas sectors through private investment and newly established independent regulators. The World Bank Group has been working on reforms in Egypt that have unlocked more than $20 billion of private investments in oil and gas exploration, and $5 billion of investment in renewables. Similarly, the World Bank is supporting 1,500 megawatts of private renewable capacity through development policy financing (so-called DPF) which are being supported by the International Finance Corporation (IFC) with actual investments. IFC has been involved in parallel to the Bank to anchor the private aspects of the sectoral reform agenda from the start, which facilitated a seamless process.

Box 2.1 Value capture and urbanization: the case of China Development Bank

Value capture had been overlooked as way to finance greenfield investment, where China had decades of experiences in collaboration with the China Development Bank (CDB). The China Development Bank is both the leading bank in China for medium- and long-term funding and investment and the largest development finance institution in the world. At the end of 2016, its total assets were RMB 14.3 trillion (2.3 trillion USD), including loans of RMB 10.3 trillion (1.6 trillion USD). It had a net profit of RMB 109.7 billion (17.3 billion USD). The CDB's principal source of funding is through debt securities. Urbanization is an important goal of CDB financing and it has pioneered a partnership in financing urban-related project with local government. CDB has been playing a key role in funding China's massive urbanization. This box draws lessons from the CDB's leveraging value capture to help finance urbanization in China.

In 1998, CDB, along with the Wuhu Municipal Government in Anhui Province, created the "Wuhu Model" that established a bank-government cooperative approach to financing local infrastructure construction and overcame the legal prohibition on local governments borrowing directly from markets. The Wuhu government used some of its high-quality assets to set up the Urban Development Investment Corporation" (UDIC) for infrastructure investment and financing. CDB then provided 10-year loans of 1.08 billion RMB to the UDIC for a bundle of six Wuhu infrastructure projects, including road construction and water supply system refinement. Loan repayment was guaranteed by a "repayment reserve fund" set by Wuhu government. Recently the focus has been on a single project rather than many. The UDIC model—in which the CDB channels funds into local urbanization development, overcoming the financing difficulties faced by resource-strapped local governments—has been copied extensively throughout China.

In the UDIC approach, repayment of loans has been financed through three channels:

- revenue from the project(s),
- government budgets, and
- income from the increase in value of the land surround the projects.

The land income accrued from the value capture process that seeks to recover some of the increase in revenue or land value realized by businesses located near infrastructure projects. With monopoly power over the supply of land, local governments have been able to lease state-owned land use rights, that generate a significant volume of income. The revenue from the approach has grown rapidly—from less than 0.5 trillion RMB in 2003 to more than 4 trillion RMB in 2017. For two urban renewal projects in Shanxi Province funded by CDB, 10 percent of local government's land income was allocated to loan repayment.

CDB, among other Chinese banks, has been undoubtedly successful in supporting China's urbanization. And the fundamental base has been China's rapid economic growth—driven by the country's reform policy and integration into the world economy. The main risk to urban finance is the changing gears of the Chinese and world economy. Another comes from local governments' provision of collateral for the urbanization projects that brings themselves amounting debts, thus deleveraging has been the current policy direction.

Getting MFD right

Reinforcing state capacity and devising appropriate legal frameworks for PPPs are essential if the MFD is to succeed. The capacity of the state to negotiate PPPs must be reinforced to maximize job creation and government revenue.

At its core, success requires that the state move from being a "doer" to an "enabler." This relegates the state to a regulatory role and to promotion of markets that have few, if any, barriers to entry and exit. Governments in MENA should disengage from sectors where there is no rationale for public intervention and should be seen as honest brokers by providing a regulatory framework that improves markets. Many countries in the region have promotion policy on their books but enforcement is selective.

Rate regulation is a critical issue[5]. PPP operators are often local natural monopolies. The regulation of monopoly pricing is therefore key to protecting both customers and the PPP operator. Of course, rates are set during the bidding stage. But contingencies are likely to arise and require rate revisions. It is in this scenario that a regulatory commission including with representatives of consumer associations charged with setting or revising rates becomes important.

MDBs play a fundamental role in reducing both market and government failures and in helping governments identify and structure infrastructure projects. The impact studies they undertake and the strict due diligence standards they impose on the origination of new infrastructure projects are the best guarantees of the sustainability of these projects. Moreover, because of their international governance structure they also are ideally placed to help mitigate political risk. Indeed, MDBs' debt is senior to other commercial creditors according to existing conventions. Also, as repeat players and essential partners in infrastructure investments, MDBs are in a stronger position to be able to enforce repayment on their debt. MDBs can thus play a critical disciplining role, without which private lenders would not be willing to invest. MDBs could further leverage this disciplining role and act more as catalysts stimulating private investment in projects that are currently perceived as too risky, with too few protections for private investors. To fully play that role, however, MDBs must venture further in the direction of extending guarantees to private investors, so as to bring in more private capital (see Arezki et al. 2017). The Multilateral Investment Guarantee Agency (MIGA), part the World Bank Group, provides political risk insurance guarantees to private sector investors and lenders. MIGA's guarantees protect investments against-non-commercial risks and can help investors obtain access to funding sources with improved financial terms and conditions.

But MDBs have limited funds available for infrastructure investment. This is why MDBs should adopt the MFD approach—which would allow them to conserve their scarce capital and leverage their gate-keeping capabilities to give PPP infrastructure projects access to the vast pools of long-term institutional savings.

Other commitments a country makes toward the international community can also be important. For instance, signing international arbitrage treaty can have an important signaling role. Indeed, signing such treaty could act as a commitment device to also encourage private sector investment and the establishment of PPPs.

[5] See http://ppp.worldbank.org/ppp/legislation-regulation/framework-assessment/legal-environment/dispute-resolution.

Box 2.2 Fiscal risks and Public Private Partnerships

A well-structured PPP brings private capital for investment, private-sector expertise, and management incentives needed for enhancing service provision to users. But is also entails potential fiscal risks for the government, which, if not foreseen, can exacerbate the already big constraints on MENA government spending. The fiscal risks PPPs pose are potentially large (World Bank 2017) and occur for at least three reasons.

First, the fiscal costs of PPPs tend to be deferred or contingent. Deferred and contingent costs aren't effectively controlled by traditional government budgets, which along with medium-term fiscal forecasts, can deal with predictable costs that will be incurred in the next few years. But traditional budgeting is largely ineffective in accounting for costs that will be incurred after the period of the forecasts. They are also ill-equipped to deal with the uncertain cost of guarantees—say for an off-take agreement, construction, and exchange rate risks. As a result, the fiscal commitments contained in PPPs–whether in the form of deferred costs or guarantees—that can escape proper scrutiny. Moreover, the deferred fiscal costs of PPPs may lead to move debt off balance sheet and create contingent and future liabilities, reducing fiscal place in the long term (IMF 2014).

Second, governments face an opportunity cost when they concede the right to collect tolls or user fees to a private company. There is a common, but incorrect, perception that procuring via a concession or toll-based arrangement shifts the responsibility for paying for the project from the government to users and therefore reduces government expenditure (OECD 2014). In fact, the government loses revenue it would have collected had it paid for the project. This opportunity cost is not usually included in government accounts but remains a cost.

Finally, almost all PPPs can create liabilities for future taxpayers and are onerous to prepare (OECD 2014). Even if a government is not contractually liable for a minimum stream of future cash flows, it will still incur costs. PPPs are complex to design and implement and involve high transaction costs. Moreover, structuring procurement, preparing the tender and negotiating the contract require substantial capacity and resources that governments facing spending constraints may not have. But in many, if not most, cases governments are also likely to have to guarantee some minimum revenue because it is unlikely that private investors or their lenders will be willing to face the project risks without one (OECD 2014). Any such guarantee creates additional liabilities and costs for the state.

A cash-strapped government under pressure to reduce its deficit in the short-term may prefer PPPs over public financing without taking into account that a PPP can cost more in the long run. This bias creates a risk of accumulating financial commitments that could prove unaffordable. Still a properly constructed PPP that takes account both of the potential costs to the government and any future stream of fees and payments to the private partner can be a win-win venture.

There are important complementarities among government, the private sector and MDBs which call for the following preconditions to participate in a PPP.

Preconditions for governments and the private sector include:

- **Political will and attractive returns.** The host government should be determined to involve the private sector in a competitive manner including through international bidding process and limit collusion. That is the government should be willing to enter into contracts (directly or through its subsidiaries) with the private sector. The risk allocation between the government and the private partner should be in line with market expectation and borne by the part best able to do so. The return on a project must be attractive enough to interest investors. This means, for instance, that in the power sector tariffs should provide a reasonable return to investors for the risk they are taking.

- **Enabling legislation.** The law, along with implementing regulations, should open the door to private participation and authorize various government agencies to engage the private sector. For example, in the case of power generation, the government bodies should facilitate the supply fuel, purchase power and transmit and distribute it and also enable the minister of finance to provide any guarantees that may be required. Government controlled contractual bodies should be solvent and able to pay, and in certain cases backstopped by the ministry of finance to ensure that these are arrangements in which private commercial lenders can participate. Other contractual arrangements should be clear with minimal uncertainty (regarding for example arbitration of disputes and termination. A transaction advisor is often hired by the Ministry of Finance to ensure the integrity of the PPP process. Specifically, the transaction advisor will provide the necessary technical, legal and financial advisory support for the procurement of a private partner involved in the PPP. The advisor should organize and run the procurement process–e.g. tender, feed in tariff… This must be in compliance with all elements of the legislation and all implementing regulations.

Preconditions on the side of MDBs include:

- **PPPs should be beneficial to the country.** In the electricity generation sector, for example, PPPs should reduce the average cost of generation, address production shortages, and lessen sector import dependence.

- **MDBs require a clean and reputable private sector 'sponsor' with the requisite expertise and financial strength.** The IFC will not finance more than 25 percent of a project's cost but can mobilize financing from other banks if a reputable firm is involved in the project. To attract private financing, MDBs also require a clear regulatory framework in which contractual arrangements are strong and the distribution of risks and rewards is equitable.

Conclusion

In sum, PPPs are institutional arrangements that if properly designed and implemented allow authorities to improve infrastructure procurement and management, while also reducing overall public expenditure. This is done by auctioning off to the private sector a contract for the construction and/or the operation of an infrastructure asset—say a toll road— for a specified

period (usually 20 years or more), after which full ownership is generally passed on to the public.

If a PPP is well structured, different risks associated with the project will be borne by the party that is better able to manage them—that is by the party that can control the risk through its behavior and that is in the best position to absorb a potential negative shock. Typically, PPPs allocate the risk of construction and operation to the private party, which therefore has an abiding interest in controlling costs and delivering on time because it will hence not receive any payment until the infrastructure project is ready to be used. Moreover, because the private party will manage the asset for many years there is no incentive to cut corners in ways that cannot be detected easily—a problem in many standard procurement procedures. Bundling construction and management also induces the private company to consider the overall life cost of the infrastructure, and thus choose the design that will best minimize construction and operating costs.

Once the infrastructure is in place, the private company will begin to receive remuneration for its investment either through regulated user fees or so-called “availability payments” from the public authority. Availability payments are based on achievement of predetermined performance targets. In some cases, remuneration comes from both user fees and availability payments. Because the infrastructure asset is monopolistic in nature, when user fees are involved appropriate safeguards must be put in place to prevent the private manager from exploiting its market power over users. Forward-looking incentive price regulation, like the so-called price cap, is usually preferred. That is because imposing limits on the tariffs that the regulated company can charge users–usually determined by an index that takes into account such factors as potential efficiency gains inflation—allows the company to appropriate any cost reductions it achieves during the period in which those limits are in place while setting a firm ceiling on potential charges to consumers. Availability payments are more conducive to generating efficiencies because they focus on output rather than input, and therefore can encourage the private party to adopt innovative solutions.

While these potential benefits can be significant, it must be recognized that PPPs can have serious drawbacks. Probably the most important is their low level of flexibility when unforeseen circumstances occur. This is the result of the need for very detailed contracts to cement trust between both the public and private parties, which are each exposed to the risk of an opportunistic behavior of the other. These detailed contracts make it very difficult to change the core characteristics of the project once a contract has been awarded. That, in turn, makes PPPs particularly unsuitable in sectors in which technological change is so rapid and disruptive that the future is very hard to predict making the associated risks too high.

Finally, the need for strong state capacity and integrity cannot be underestimated. Indeed, designing effective PPPs is a complex task that requires substantial technical expertise in all phases —which include feasibility analysis, bidding process, contract writing, setting performance targets, and monitoring, among other things. Moreover, commitment to the common good is essential for establishing the right balance of risks and rewards with the private counterpart. This commitment will avoid the political backlash that would be associated with arrangements that place an excessive burden on the public sector, while allowing easy profits to the private sector.

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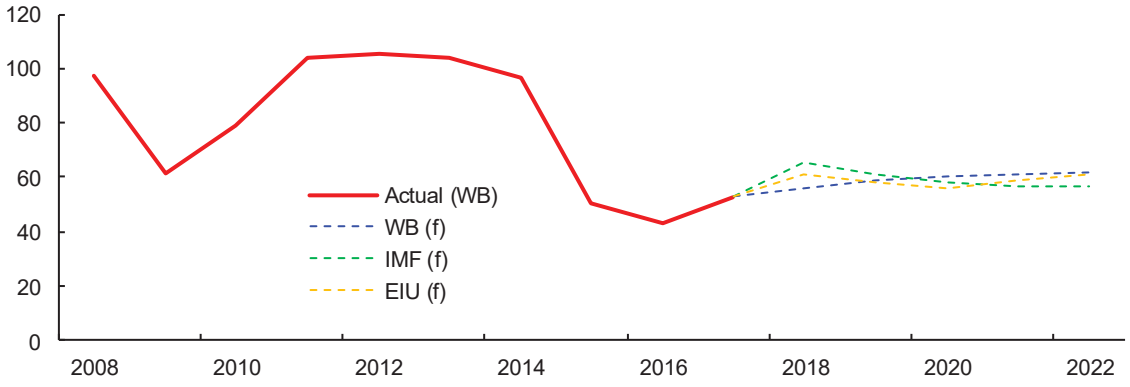
3. Transformation, Not Diversification?

Introduction

The collapse in oil prices that started in 2014 has put diversification at the forefront of the policy debate in many nations that have been dependent on fossil fuel production. Many oil rich countries have indeed either announced or already put in place policies to help transform their economies and move away from the dependence on oil. Diversification strategies have been pursued in the past and historically those managed by the state have not worked. That's because top-down management almost inevitably obstructs the economic diversification process because it does not empower managers of the companies (and their teams) who are best able to guide the process and adapt to new circumstances. In other words, states should not concentrate on the end goal—namely diversification—and focus instead on what is required to get there, no matter how disruptive that transformation process might be to traditional production.

Energy markets are subject to changes in technologies that affect producers and consumers alike. These changes—such as certain innovations in oil drilling techniques or in battery technology for automobiles—can be risky for oil companies and national economies that depend on fossil fuel production.[6] But technological change can also offer new opportunities for growth.

Figure 3.1 Crude Oil Price, Actual and Forecast
(US$ per barrel)



Sources: World Bank (WB), *Commodity Markets Outlook* October 2017; International Monetary Fund (IMF), *World Economic Outlook* January 2018 Update; The Economist Intelligence Unit (EIU), *World Commodity Forecasts*, March 2018 Edition; and WB staff calculations.

[6] Oil and fossil fuels are used interchangeably thereafter.

The biggest risk for oil producers and oil-dependent economies comes from changes that cause oil price collapses followed by a protracted period of low prices, as is occurring now (see Figure 3.1). What is more is that low prices could strand oil reserves—which will be left in the ground because they are no longer economical to extract—a sharp blow to economies whose national wealth is heavily bound up with fossil fuel reserves.

The opportunities associated with technological change include potential improvements in extraction efficiency that permit profitable production of oil at lower prices. Other changes not directly associated with oil, such as the development of technologies around renewable energies, can allow economies that have say a high potential for solar irradiation to limit the risks of trying to develop non- fossil fuel industries and better align with the goals set by the 2015 Paris Climate Accord. The accord, if adhered to, will reduce the burning of oil, natural gas and coal and further depress their prices (if global production does not decline).

Policies geared toward "behavioral change," such as changes in attitude toward innovation and risk-taking by managers and employees—especially as they relate to how firms govern themselves, can complement policies that have so far focused almost exclusively on improving the business environment outside the firm. Specifically, to induce behaviora1 change, policies should aim at turning state owned enterprises (SOEs) in the oil sector into publicly listed corporations. That would enhance their transparency and efficiency and make them more accountable to investors. The result should be that instead of timidly approaching diversification, SOEs would be sitting at the technological frontier in the energy sector and exert positive spillovers to the rest of the economy that would drive overall development. That is, of course, a tall order but a goal worth pursuing for its long-term socioeconomic gains.

The focus on transformation—rather than on the objective of diversification—also has important policy implications for the energy (-producing and -using) industry and the ever-growing number of countries that are dependent on the exploitation of energy resources. This new focus has also broader relevance for the global community as it relates to the economic consequences of the needed transformation of energy markets to support the goal of limiting global warming by reducing greenhouse gas emissions.

The remainder of this paper is organized as follows. The second section explores the role of technological change in shaping energy markets. The third section discusses the nature of the risks and opportunities associated with the changes occurring in energy markets. The fourth section argues for the need for economic transformation of oil dependent economies and SOEs. The fifth section concludes on the modalities for the shifting landscape for "big state oil."

Box 3.1 Economic Diversification

Economies diversify when they increase the types of good and services they produce. Diversification mitigates risks an economy faces by making it less dependent on a narrow product base and by expanding the number of trading partners. The typical example of an economy ripe for diversification is one in an early stage of development that is excessively reliant on one or more primary commodities.

The need for economic diversification has become more urgent in oil-dependent countries since the persistent decline in oil prices that began in 2014. Prices, which briefly fell to the $20 per barrel range, now hovers around $65 per barrel as of early April and the advent of shale oil production will contain prices in the foreseeable future and make it unlikely prices will ever come close to the $120-per-barrel that prevailed before the slump.

Facing large fiscal and external deficits, oil-producing countries have set diversification goals and announced ambitious efforts to diversify. But medium-term growth prospects remain low. The IMF (2016) emphasizes that to support economic diversification, the public sector should enable, not compete with, the private sector, and provide needed macroeconomic stability and a supportive regulatory and institutional framework.

There are several other aspects that must be considered. First, economic diversification has several dimensions—including trade diversification, product diversification, fiscal-revenue diversification, and employment diversification. It is possible that some countries become diversified in one dimension but not in others. For example, Mexico is highly diversified in trade and production, but an outsized 20 percent of its government revenues come from state-run oil company, PEMEX. That figure was much higher before the slump.

Furthermore, commonly used indicators of “diversification” do not explicitly consider “risk diversification.” Often prices in different industries move in the same direction. For example, developing a refining industry may not represent true diversification if refined gasoline prices co-move with the price of crude.

Moreover, diversification experiences vary significantly across countries. Morocco, for example, had been highly reliant on agriculture and phosphates. In 2008 the government launched an effort to widen its export base. As a result, the agriculture sector now contributes only 14 percent of GDP, but it still employs about 33 percent of the labor force. The unemployment rate remains high, especially for the youth, meaning further transformation in the labor force may be needed.

On the other hand, Oman’s diversification established special economic zones, privatized management, and strengthened academic and professional training. Oil’s contribution to Oman’s GDP dropped from 46 percent in 2011 to 20 percent in 2015, and both its employment rate and labor force participation rate have both steadily increased during the past five years. Such differing outcomes should be explored further to inform decisions on future policy directions.

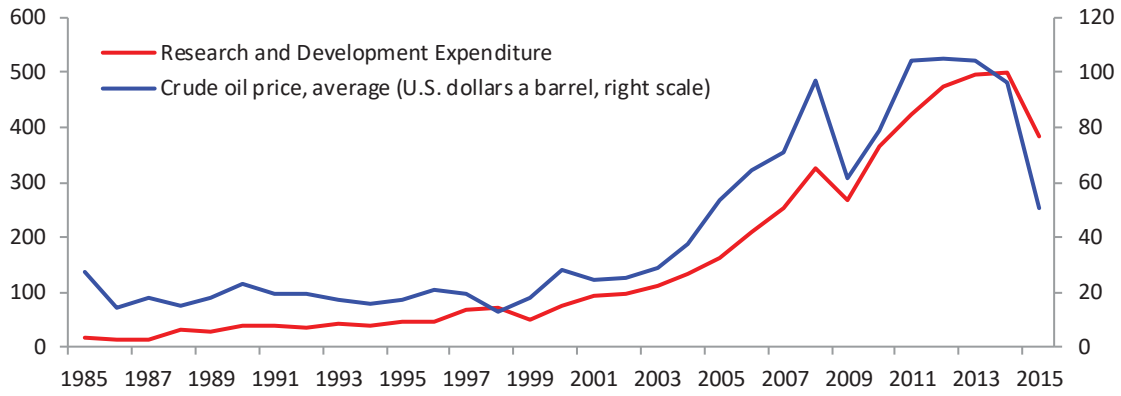
The role of technological change in shaping energy markets

The literature on understanding energy and more broadly economic cycles can be interpreted as entertaining two views–one narrow, the other broad.

The narrow view emphasizes short term factors as key determinants of energy and more specifically oil market fluctuations. It emphasizes that relatively small shocks such as a disruption of production can have outsized effects on prices. The underlying assumption is that supply and demand cannot change very much in the short term, regardless of what happens to prices. People cannot easily shift their commutes or change their vehicles. Oil producers cannot turn a production spigot on and off (Blanchard and Gali, 2009; Hamilton, 2003). In fact, the long lead time between first investment and first production in the oil sector is often used to explain the boom and bust cycles in prices.[7] Or as many in the industry put it, "the best cure for low oil prices is low oil prices." That's because low oil prices discourage investment in production capacity, which eventually causes prices to rise as existing oil fields that can be tapped at relatively low marginal cost are depleted.

Figure 3.2 Evolution of Research and Development Expenditure in Select Integrated Oil and Service Companies

(Billions of US Dollars; unless otherwise noted)



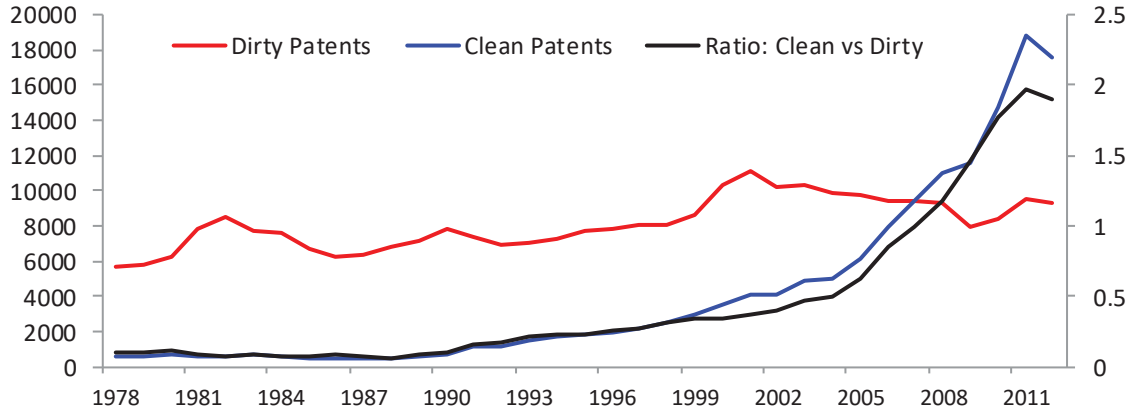
Source: World Bank; Bloomberg LP.; and WB staff calculation.

But the adage gained its currency before the advent of shale oil production, which can be turned on and off much faster than conventional production. The new shale oil production—made possible by new technologies such as hydraulic fracturing ("fracking") and horizontal drilling—will lead to shorter and more limited oil-price cycles. In the narrow view, however, technological innovation--both among producers and users, are results from exogenous (i.e. independent and external) forces. The data seem to suggest otherwise—that technological change is, in economic parlance, endogenous to market developments. As shown in Figures

[7] The anticipated nature of lead times for conventional oil raises concerns as to whether lead times are valid explanations for boom and bust cycles especially if agents are forward-looking and/or that they learn.

3.2 and 3.3, periods of high oil prices tend to stimulate expenditure in research and development and subsequently innovation.

Figure 3.3 Clean vs Dirty Patents



Source: Aghion, Dechezlepretre, Hemous, Martin and Van Reenen (2012), calculations based on the PATSTAT database.

The "broad" view emphasizes "medium run" factors, specifically endogenous technological change. The insights from that literature date at least back to Kondratiev and Schumpeter. The economics literature has paid little attention to the role that technological changes play in shaping the dynamics of energy markets. Nevertheless, research on medium term business cycles (Gertler and Comin, 2005) can help us understand oil and energy market developments. Among other things, this research emphasizes the endogenous nature of technology adoption in explaining economic cycles (Anzoategui et al. 2016). A key mechanism is the so-called market size effect that drives entry and (process) innovation in the sectors affected (Acemoglu et al. 2004).

Nonetheless, an analytical challenge faced by the broad view is that the precise timing at which technological changes affect expectations—and hence energy prices—is hard to determine empirically. Moreover, the potential consequences of these technology changes on supply and demand for energy are uncertain. In determining the impact on prices one needs to be cognizant about the importance of "learning" associated with new technologies including in relation to the pace of their adoption and diffusion, which can differ widely over time and space.

Rethinking the 2014 oil price collapse

Regarding the 2014 oil price collapse, most studies have emphasized excess supply (Arezki and Blanchard, 2014) as the dominant factor. Because a sudden increase in supply is a seemingly exogenous development, there should have been a strong positive impact on the global economy.[8] Yet there has not been one (Obstfeld, Arezki and Milesi-Ferretti 2016).

[8] In contrast with the (seemingly exogenous) supply component, the demand driven component of the oil price decline is a symptom of slowing global economic activity rather than a cause.

One potential explanation of the muted response of the global economy to the decline in the price of oil could be that the increase in supply was not an independent shock but rather one due to powerful technological changes. Innovation and the subsequent adoption of new recovery techniques—including for drilling and processing—have given rise to new sources of "unconventional oil." For example, oil produced from shale (also known as tight oil) has become a major contributor to the global oil supply. Provided they are effective and widely adopted, improvements in recovery techniques increase the size of technically recoverable oil reserves. This increase, in turn, changes the outlook for oil supply—with potentially large and immediate implications for oil prices—by changing expectations about the future path of oil production. Increased supply lowers oil prices, but even if this has the effect of reducing investment, and hence production, the industry is nonetheless forced to become more efficient to compete with unconventional production, unleashing automatic stabilizing forces.

Innovations in recovery techniques typically follow periods of prolonged high prices or changes in regulations that render the new techniques more economical. New oil sources often come on stream in times of need—because of, say, the depletion of existing conventional sources—and in places like the United States and Canada that have economic and institutional systems more favorable to both innovation and the adoption of new recovery techniques. Innovation has led to significant improvements in drilling techniques such as 3D imaging and fracking. Fracking, in which water is injected to free up petroleum trapped in layers of rock, gave rise to the production of shale oil in the 2000s. In the wake of the two oil crises of the 1970s, which dramatically increased oil prices, successive improvements in techniques for deep-water drilling spurred production in the North Sea and the Gulf of Mexico. In both instances, innovation paved the way for new oil sources in relatively high-cost producing locales and gave rise to tensions with the lower-cost producers from the Organization of Petroleum Exporting Countries (OPEC), which in the 1980s and again more recently responded strategically by adjusting their production levels.

Risks and opportunities associated with the oil price collapse and technological changes

Technological changes on oil and energy markets can both threaten and enhance the outlook for economies and companies that depend on oil.

Risks

From surpluses to deficits

The protracted low oil prices have had dramatic, if divergent, effects on oil exporters. The fall in oil prices led to decreases in real income. But the severity of the effect of the decline in the price of oil on GDP depends very much on how dependent a country is on oil exports, and on what proportion of oil revenue goes to the state.

According to the International Monetary Fund, for example, before the 2014 decline, energy accounted for 25 percent of Russia's GDP, 70 percent of its exports, and 50 percent of federal revenues. In the Gulf Cooperation Council countries in the Middle East, the share of oil in

federal government revenue is 22.5 percent of GDP and 63.6 percent of exports. In Africa, oil exports accounts for 40-50 percent of GDP for Gabon, Angola and the Republic of Congo, and 80 percent of GDP for Equatorial Guinea. Oil also accounts for 75 percent of government revenues in Angola, Republic of Congo and Equatorial Guinea. In Latin America, oil contributes, respectively, about 30 percent and 46.6 percent to public sector revenues, and about 55 percent and 94 percent of exports for Ecuador and Venezuela.

In most oil-dependent economies, the oil price decline led to fiscal deficit and an associated current account deficit. Some countries were better-equipped than in previous episodes to manage that adjustment. A few, such as Norway, have put in place policy cushions—such as fiscal rules that constrain overspending in good times and saving funds— and have more credible monetary frameworks. These policies have helped countries stave off or moderate recessions even when they have a sharp increase in their current account deficit. That said, oil dependent economies have to look beyond the stabilization of their economies and worry about new risks because they rely so heavily on fossil fuels for development.

Stranded assets

The historical COP21 agreement to keep global warming below 2 degrees Celsius and the technological innovation (such as declining cost of renewable energy sources and electric cars) have accelerated the global energy transition away from oil and more generally fossil fuels. That means that many fossil fuel reserves will remain underground, unexploited. Indeed, to keep mean global surface temperature below 2 degrees Celsius, only 300 to 400 gigatonnes of carbon can still be burned–a third of the reserves of major private oil and gas companies. To abide by international commitments to limit global warming, a third of oil, half of gas, and 80 percent of coal reserves should be kept in the ground forever (McGlade and Ekins, 2015). This would mean keeping unburned one third of oil reserves in Canada and the Arctic, 50 percent of gas and 80 percent of coal (mainly China, Russia, US). In the Middle East, reserves are three times larger than their “carbon budget”. In other words, 260 billion barrels of oil in Middle East cannot be burnt. In addition to stranded reserves, the structures and capital used in extraction and in exploitation of fossil fuel can also become stranded.

One implication of the potential stranded assets is that it could lead to a race to burn the last ton of carbon. That could in turn lead to the so-called green paradox whereby regulation aiming to limit carbon emissions end up raising the latter at least in the short run (van der Ploeg, 2011). Some commentators have argued that the collapse in oil prices and the attempt on the part of major oil exporters with low marginal cost of production to crowd out higher marginal cost producers could delay the energy transition (Arezki and Obstfeld, 2015; Aghion and al. 2016).

While the risk of stranded assets for fossil fuel exporters appears to be remote, it does pose an existential threat that dependent economies cannot afford to ignore.

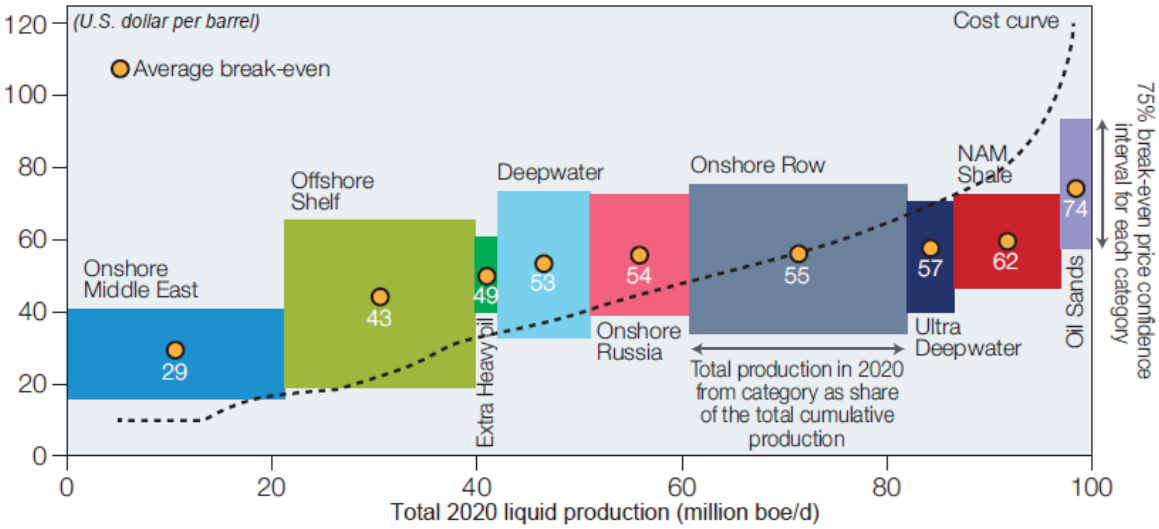
Opportunities

Efficiency gains

Although the abrupt decline in prices led in turn to a reduction in investment and expenditure, there is a silver lining for corporations as the reduced spending leads to large operational

efficiency gains.[9] This benefit is generally not recognized because the commonly held belief is that that the cost structure—which is often proxied by the lowest price at which it is economical to produce a barrel of oil—is constant and driven by immutable factors, such as the nature of the oil extracted and the associated geology (see Figure 3.4). In practice, the cost structure depends on many factors, including technological improvements and the extent of "learning by doing," which both permanently reduce costs. In some instances, breakeven prices have fallen in sync with oil prices. That type of shift is explained by operational efficiency gains that help the service industries that support oil production (infrastructure, drilling supplies, transportation, storage, and the like) significantly reduce their costs. For shale oil production, the extraordinary resilience to the decline in oil prices can be explained by important efficiency gains and also by the fact that shale production came online at the onset of an investment cycle in which learning by doing was important. The shale cost structure is likely to increase somewhat because expanded oil production will require an increase in investment and the cost of capital is likely to increase if U.S. interest rates rise as expected.[10]

Figure 3.4 - Global Liquid Supply Cost Curve



Source: Rystad Energy research and analysis.

Renewables

The technological changes driving the energy transition from fossil fuels to renewable sources present economic opportunities—including for those countries that risk stranded assets. One of the most notable trends in energy consumption is the increased use of renewable energy resources as the cost of renewables such as solar and wind have declined. These cost reductions are the result of research and development efforts to promote clean energy and energy efficiency ("grey" technology). Research and development (R&D) investment dates back to the 1970s, when fossil fuels reached record-high prices. Unsurprisingly R&D was then mostly government funded because the private sector typically does not internalize the positive

[9] There are two main sources associated with the reduction in the aggregate cost structure following the oil price collapse. The first is the reduction in exploration and investment in higher cost fields which mechanically drives down aggregate costs. Second, the operational efficiency gains in the form of optimizing the use of entrants also cause a downward shift in the aggregate cost structure. The downward shifts are thus partly temporary.

[10] The shift in the cost structure has not been uniform across unconventional sources. Oil sands production costs have continued to grow at high rates, in part because of the high costs of decommissioning processing plants.

externalities associated with an increase in R&D especially at the early stage of development of the technology. Public R&D spending early on, however, paved the way for corporate R&D spending during the 2000s, another period of high fossil fuel prices. The result has been a flow of technological innovations across sectors, including the development of electric and natural-gas-powered vehicles.[11] The International Energy Agency forecasts that the share of renewables in global total primary energy consumption will increase from 14 percent in 2013 to 19 percent in 2040 as a result of expected energy policy changes. Electricity generation is set to change dramatically: renewables are expected to be used to generate about 34 percent of all electricity by 2040, up from 22 percent in 2013.[12]

Many Middle East and North African economies are investing in renewables. According to the U.S. National Aeronautics and Space Administration, solar power concentration is highest in the Middle East and Africa and parts of Asia and the United States. The United Arab Emirates—an oil-exporting country—and oil-importer Morocco, have both embarked on ambitious efforts to develop renewable energy resources. The United Arab Emirates wants to draw 24 percent of its primary energy consumption from renewable sources by 2021. Morocco, the host of the 2016 United Nations Conference on Climate Change (COP22), has unveiled the first phase of a massive solar power plant in the Sahara Desert that is expected to have a combined capacity of two gigawatts by 2020, making it the world's largest solar power production facility. But even if an economy has the natural endowment of renewable resources, developing them can be difficult unless the economy has the needed infrastructure, human capital, and soft capital—the right enabling environment (Collier and Venables, 2012).

The need for transformation

Focus on the process

A change in approach is needed. Many fossil fuel exporters feel the need to diversify their economies, but very few have (Venables, 2016). The regulatory and technological change sweeping energy markets make diversification more urgent, but potentially easier since the price of oil has fallen and it is unlikely to recover to the highs seen before 2014.

In the past, diversification efforts have been often stymied by the top-down approach of the state, which has not allowed managers and other economic agents to feel empowered enough to innovate and take risks. For example, the incentive structure of state-owned companies in many countries have failed to consistently encourage managers and employees to achieve their full potential and adapt to the technological changes rapidly affecting their industry. Indeed, instead of concentrating on core issues, many state-owned companies often embark

[11] The outlook for alternative fuel vehicles is somewhat mixed. There has been an increase in use of compressed natural gas for transportation, particularly commercial fleets and buses. But sales of electric cars, notably plug-in hybrid vehicles, still have a low penetration rate, accounting for less than 1 percent of car sales in the United States. Unsurprisingly, electric car sales in the United States have decreased with the recent drop in gasoline prices.

[12] One obstacle to increased use of renewable energy in power generation is intermittency and hence reliability. Unstable supplies of wind, sun, and rainfall can trigger a mismatch between supply and demand. Addressing this will require ramping up of supply during daily peaks to achieve load balancing. In other words, the intermittencies associated with the increased usage of renewables trigger spikes in demand for "controllable" power, for example power generated from natural gas. To overcome this problem, the power sector needs to develop economical battery backup technology and foster electricity exchange. Battery technology has shown steady progress, suggesting that electricity storage technology eventually will facilitate a more widespread reliance on renewables.

on missions outside their core activities and competencies, innovate very little and struggle to keep talented employees.

But if countries were to shift their focus from the end goal, namely diversification, to how to get there—that is, on the transformation process—they may find it easier to diversify. By embracing transformation, countries will focus on getting incentives right for economic agents and turn into friends the technology and innovation that energy markets now see as disruptive enemies. They are less likely to stumble or to resist changes.

Indeed, adapting to technological changes in energy markets can help the sustainability of economies that depend on oil revenues. More agile economic systems with the appropriate corporate governance structures can more easily leverage existing technological innovation to mitigate risks associated with potential disruptions in energy markets and even create opportunities, including in renewables.

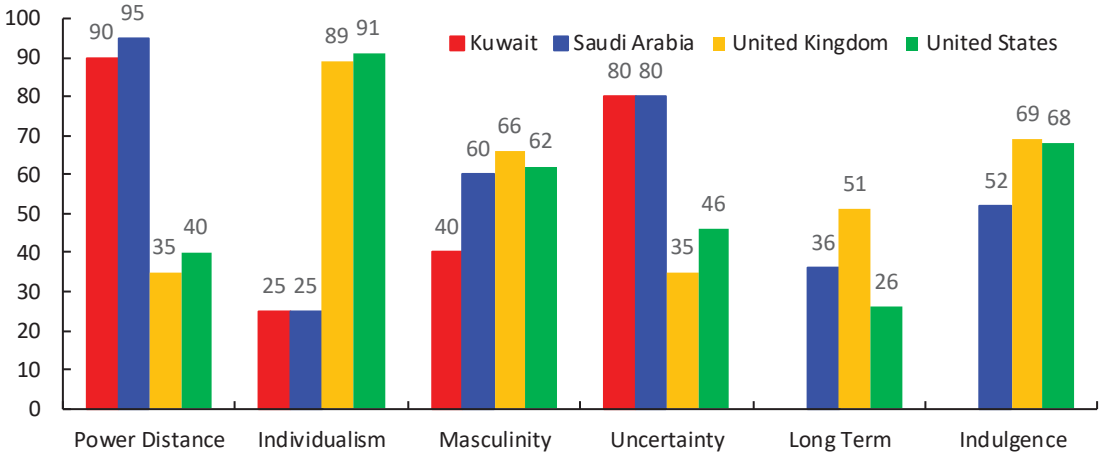
Transformation as behavioral change

The literature on the so-called resource curse has long emphasized the role of strong institutions in alleviating the challenges faced by resource rich countries such as the Dutch disease (loss in competitiveness), volatility, excessive spending and indebtedness, and conflicts (Frankel, 2012). What has been less explored is the role of attitudes, especially toward innovation and risks. Societal attitudes toward innovation and risks affect how governments, firms, and citizens react to market disruptions, including those that originate from technological change. Attitudes toward innovation vary considerably across countries. The most relevant psychological traits that can affect the ability of some oil-dependent economies to innovate are power distance (the way in which power is distributed), avoidance of uncertainty, and individualism (as identified by Hofstede Insights, a Dutch social psychologist. Oil-dependent economies tend to be subject to more power distance, avoidance of uncertainty and less individualism than diversified economies (see Figure 3.5).

Overall, oil-dependent economies tend to innovate much less than non-dependent economies. Indeed, a casual look suggests that natural resource dependent economies, not just those dependent on oil, spend far less on R&D spending (see Figure 3.6 and Figure 3.7). There is however substantial heterogeneity across economies.

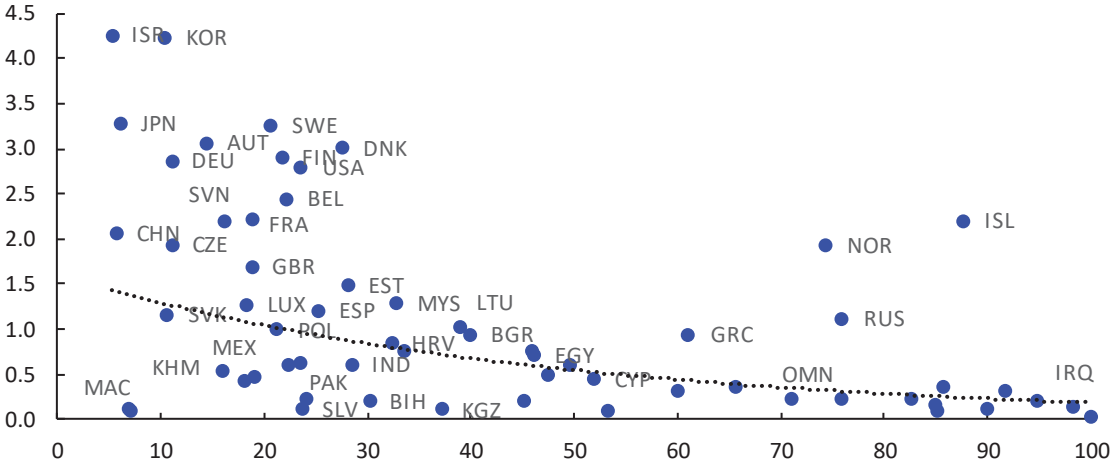
But it is not only external factors (institutions that mediate interaction “between firms”) that explain differences in performance across resource economies, factors that relate to “within firm” governance are also important and have received little attention.

Figure 3.5 Attitude toward innovation



Source: Hofstede Insights.

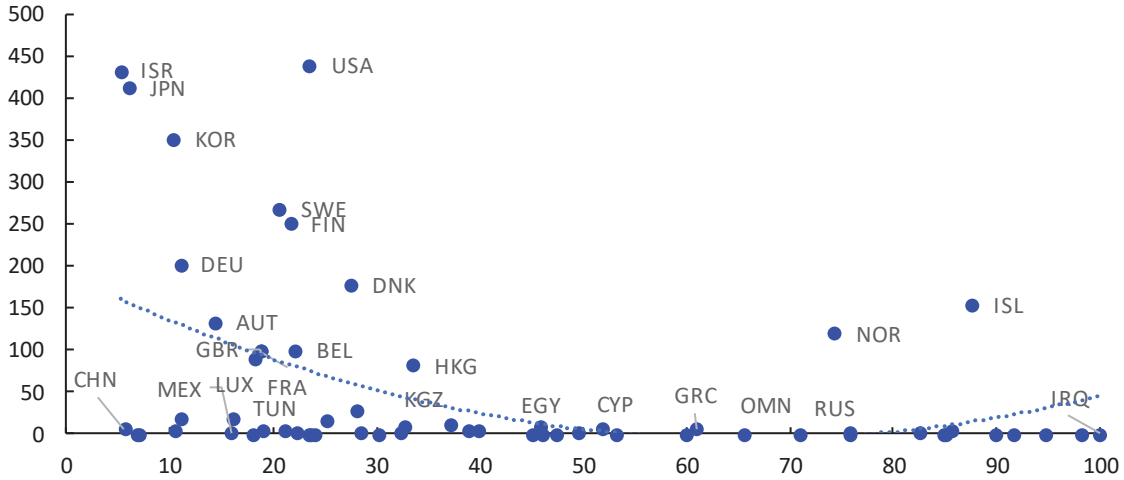
Figure 3.6 Share of Resource Exports in Merchandise Exports and Share of Research and Development Expenditure in GDP in 2015



Source: World Bank, *World Development Indicators.*

Note: Share of resource exports in merchandise exports in horizontal axis; and share of research and development expenditure in GDP in vertical axis.

Figure 3.7 Share of Resource Exports in Merchandise Exports and Patent Counts Per Capita in 2015



Source: World Bank, *World Development Indicators*; IP5 Offices; and World Bank staff calculations.
Note: Share of resource exports in merchandise exports in horizontal axis; and patent counts per capita in vertical axis.

Such within-firm factors as corporate governance are important determinants of whether the oil sector can transform and adapt to the changing reality of global energy markets. The data suggest that there are important differences in the level of innovation when comparing corporations—private versus state-owned. State-owned enterprises lag behind when it comes to the propensity to innovate. Indeed, to the extent that the abundance of resources tends to direct the technological change toward capital-intensive activities such as exploration and extraction, it furthers the specialization of these economies (see Acemoglu, 2002). So, it is all the more important to design the incentive structure to further enhance attitudes toward innovation within the oil sector, also considering the potential synergies between the production of different sources of energy.

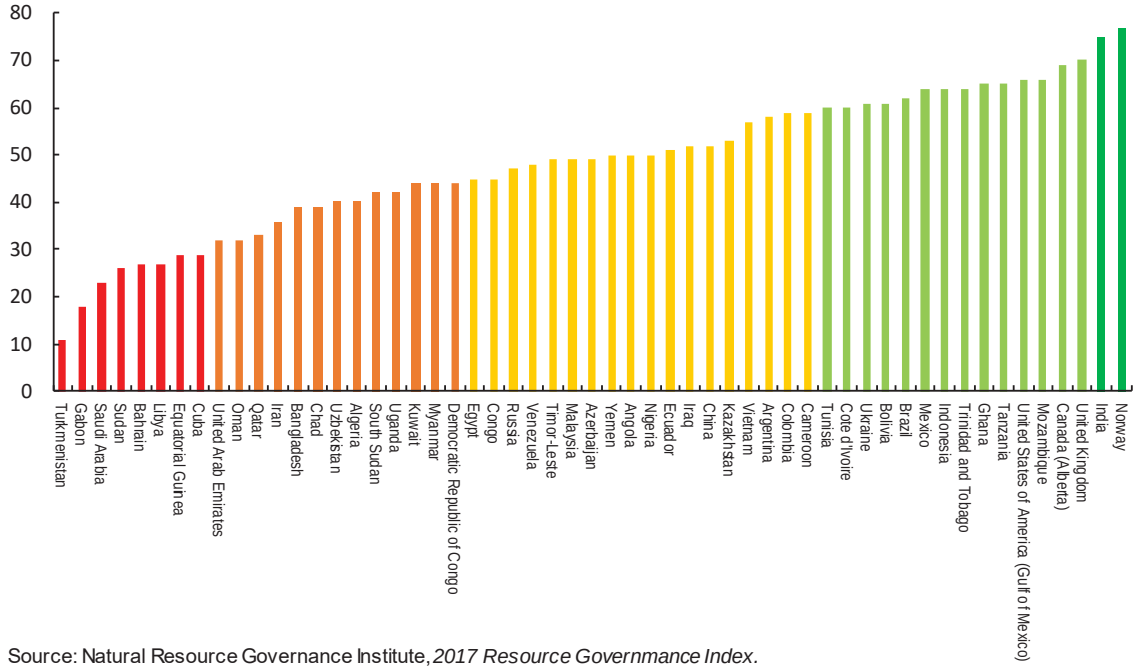
Shifting landscape for "big state oil"?

The adage that "necessity is the mother of invention" seems to have a particular resonance when considering the need to develop economic systems and corporations that are resilient to the transformation facing energy markets. The ability or willingness of corporations to innovate is influenced by their structure of ownership. This is clear when contemplating the challenges faced by large state oil corporations. Embracing the "letter and spirit" of modern corporate governance (that is a function of ownership, organizational structure and manager empowerment) is key to achieving transparency and efficiency.

Indeed, while many state-owned enterprises sit on the largest and cheapest to extract oil reserves, many are heavily indebted (Venezuela, for example). The status quo is not sustainable as they risk becoming stranded firms. Considering the low oil price environment and the need for large investment and technological upgrade, opening up their capital to foreign investors seem to be inevitable. Indeed one key difference between state-owned and publicly

listed companies (and private corporations) is that the former typically have soft as opposed to strict budget constraints. Exclusively state- owned enterprises are typically less transparent and less innovative than those with foreign or private participation. Transparency is the best disinfectant. According to the Natural Resource Governance Institute, Norway's state-owned oil sector is among the most transparent when it comes to the disclosure of the flow of funds between corporations and the budget while Saudi Arabia's oil sector is amongst the least transparent (see Figure 3.8).

Figure 3.8 Governance of Extractive Resources



Source: Natural Resource Governance Institute, *2017 Resource Governmance Index.*
Note: Governance of Extractive Resources covers the governance of allocating extraction rights, exploration, production, environmental protection, revenue collection and state-ow ned enterprises. Score 0-100 where 100=best. If a country scores "No data / Not applicable" it w ill not show in the bar chart.

Exclusively state-owned corporations tend to not separate control from management. That typically limits the empowerment of managers, who are key not only to the success of the firm but to economic development in general. In fact, several developing countries have in the past criminalized business mistakes, especially for top executives of state owned enterprises, which discourages employees from risk-taking and economic initiative.

In the past decades, there has been an important shift in opening the capital of state-owned oil corporations, including in China, Brazil and Mexico. In December 2017, Abu Dhabi National Oil Corporation (ADNOC) successfully launched an initial public offering (IPO) one of the first among large Middle East oil exporters. Saudi Arabia, as part of its ambitious plan to transform its economy, has announced that it would sell 5 percent of the state-owned oil company, ARAMCO, in an IPO. That appears to be a step toward emulating publicly owned Western companies such as Exxon, ENI, and BP that once concentrated on oil and gas, but have broadened their focus to become energy companies—balancing their oil and gas assets with other forms of energy.

But can IPO help diversification and spill over to the rest of the economy? How should they be structured?

Publicly listed companies (also to a lesser extent privately owned firms) are typically more transparent. Also, because publicly listed companies have a more diffused ownership and hard budget constraints, management is typically more accountable (to shareholders). Publicly listed firms perform better and are more innovative (Gilje et al. 2016). Indeed, as mentioned earlier, many of these firms were able to significantly increase efficiency after the collapse in oil prices and continue producing at lower prices.

It also matter where the public shares of these companies are traded. Indeed, different stock exchanges are associated with different disclosure rules (in contrast to when a SOE is subject to a private placement). There is a pecking order of stock exchanges in terms of disclosure rules. Choosing the stock exchange where disclosure rules are stricter could thus be seen as a commitment device for SOEs and the associated government to enhance transparency. Indeed, in the United States, the 2010 Dodd-Frank Act requires petroleum and mining companies listed on the Securities and Exchange Commission to disclose how much they pay to governments (Heuty, 2011). The Europe Union followed suit in 2011 when the European Union (EU) required EU-based companies to disclose their payments to governments for oil, gas, minerals, and logging on a country-by-country and per-project basis. The US and EU rules are more stringent that the Extractive Industry Transparency Initiative, known as EITI, which is voluntary reporting system for payments.

IPOs can also help raise corporate efficiency through enhanced “innovatedness”. Indeed, IPOs are typically associated with a significant rise in the number of patents filed (Acharya et. al. forthcoming). Interestingly, R&D significantly increased in the oil sectors of China and Brazil after IPOs by PetroChina and Petrobras.

More broadly, the access to the cheapest oil reserves by major Western corporations has been limited for decades and has hence influenced the direction of technological change (away from an oil-centered global energy mix). As mentioned earlier, these Western corporations have moved from exclusively oil to broader energy companies. If these multinational corporations were to gain greater “access” to the cheapest source of oil, including that in the Middle East at the same time that corporate governance was improving in SOEs, important progress could be made toward promoting cleaner oil technology and facilitating the movement toward renewables among SOEs.

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4. Country Pages

ALGERIA

Table 1	2017
Population, million	41.1
GDP, current US$ billion	173.2
GDP per capita, current US$	4218
National poverty line[a]	5.5
International poverty rate ($1.9)[a]	0.5
Upper middle-income poverty rate ($5.5)[a]	29.2
Gini coefficient[b]	27.6
School enrollment, primary (% gross)[c]	116.2
Life expectancy at birth, years[c]	75.9

Source: WDI, Macro Poverty Outlook, and official data.
Notes:
(a) Most recent value (2011), 2011 PPPs.
(b) Most recent value (2011).
(c) Most recent WDI value (2015)

A slight decline in hydrocarbon production, which was not offset by higher than expected public spending, underpinned the growth slowdown in 2017. Additionally, structural challenges constrain growth for the non-hydrocarbon sector and inflation continues to rise. Substantial twin deficits remain, depleting official reserves. In the medium term, both growth and the twin deficits are expected to decline, as the government implements fiscal consolidation. However, in the short term, the exclusive use of seignorage to finance the fiscal deficit will need careful management.

Recent developments

Algeria's economic growth decelerated in 2017 due to a slight decline in hydrocarbon production and the continued modest non-hydrocarbon growth. Real GDP growth in 2017 is estimated at 2.1 percent, a slowdown from 3.3 percent in 2016. This slowdown was mainly driven by weak growth in hydrocarbon production, which is estimated to have decreased by 1.4 percent in 2017; a sharp contrast from the dynamic start in the first quarter of the year. Meanwhile, growth in the non-hydrocarbon sector remains modest, despite the slight upturn from 2.3 in 2016 to 2.5 percent in 2017. This upturn is mainly attributed to the reversal of fiscal consolidation in the second half of 2017. Inflation remained high (5.5 percent in 2017) down from 6.4 percent in 2016.

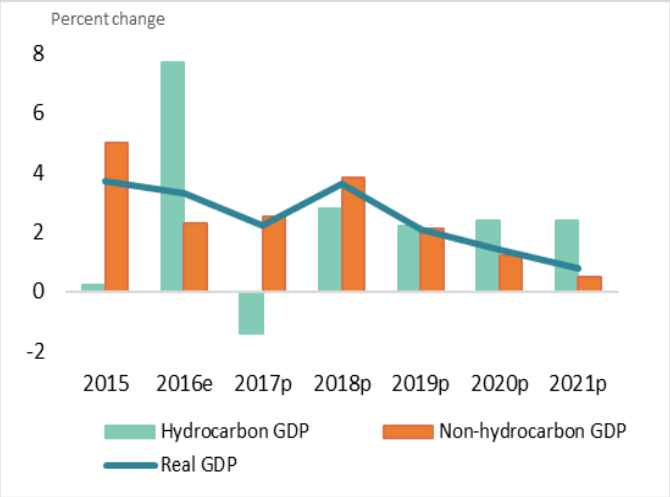
Substantial fiscal deficits as well as double-digit external current account deficits remain, depleting fiscal savings and reserves. Public spending decreased by less than expected due to difficulties in pursuing the 2017 budget target. In fact, a new government, appointed in May 2017, put an end to fiscal consolidation and reverted to the previous, high levels of public spending, specifically in housing. As a result, fiscal deficit is estimated at 8.2 percent in 2017. Regarding the external current accounts, preliminary data indicates that imports increased slightly, by 2.7 percent (0.5 in real terms) in 2017, signaling that the imposition of licenses failed to curb the volume of imports. Meanwhile exports have increased significantly, by 16.5 percent (0.7 in real terms). As a result of continued deficits and limited capital inflows, the country's international reserves declined sharply. Nonetheless, external debt remains very low. Overall, the current account balance (-14.7 percent of GDP) is indicative of the lack of adjustment of imports to the large reduction in export revenues since 2014.

The unemployment rate increased by almost 1.5 percentage points, reflecting the sluggish non-hydrocarbon growth. It stood at 11.7 percent in September 2017, an increase from 10.5 percent in September 2016. Unemployment is particularly high among educated, youth, and women, some of which likely reflects a preference to wait for formal sector employment. The rise in unemployment undermines poverty reduction. 10 percent of the population is considered vulnerable to fall back into poverty and important regional disparities persist with some regions featuring double (Sahara) or triple (Steppe) the national rate. The most recent official calculations (2011) placed the national poverty rate at 5.5 percent, with a mere 0.5 percent of the population living in extreme poverty. Official calculations are based on a poverty line estimated to be 3.57 (3.18) USD/day in 2011 PPP in urban (rural) areas, which could be perceived as low for an upper middle country

Outlook

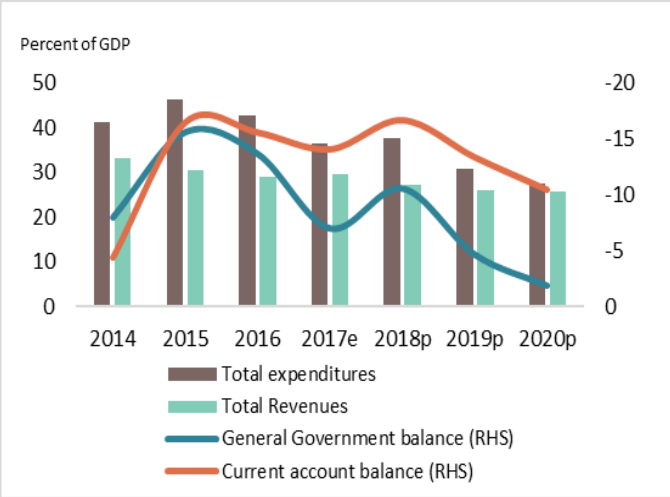
Growth is expected to recover sharply in 2018 as fiscal expansion takes hold. As

FIGURE 1 **Algeria** / Real GDP growth



Sources: World Bank Staff estimates and projections.

FIGURE 2 **Algeria** / Algeria's twin deficits



Sources: World Bank Staff estimates and projections.

new public investments announced in the 2018 budget are carried out, headline growth and inflation will increase. As a result, GDP growth is expected to stand at 3.5 percent, inflation at 7.5 percent for 2018. Yet, GDP growth will struggle to surpass the 2 percent threshold for 2019-20 (Figure 1), constituting anemic growth for a middle-income country with a large youth bulge. While continued strong production from new oil wells will provide a growth boost, non-hydrocarbon growth would bear the brunt of fiscal consolidation that the government says could recommence in mid-2019.

The twin deficits will further deteriorate in 2018, and the intended reliance on monetary financing is a major concern. In the current fiscal framework (2018-2020), adopted in the 2018 Budget Law, public spending will remain very high, and will not be offset by a potential increase of government revenues due to an expected upturn in oil price and production. While the fiscal deficit will increase in 2018 (11.4 percent of GDP), it is expected to decline rapidly in 2019-2020 (Figure 2). However, the persistence of fiscal deficit is expected to entail substantial monetary creation, as the government has so far refused to finance its deficit with external borrowing. The current account deficit is projected to decline slightly to 10.2 percent in 2020. This level of current account deficit is considered manageable, given the level of reserves (17 months of imports at end 2017). However, by 2020 this reserves level could stand at only 5 months of imports, drawing close to the emerging market 3 months threshold. The government is aware that potential reforms to the subsidy system need to be evaluated for poverty and vulnerability impacts.

Risks and challenges

The economy is confronted with social challenges, and the management of the newly adopted, non-conventional, monetary policy. Firstly, high youth unemployment levels constitutes a substantial risk to the outlook discussed above. The adoption of non-conventional monetary policy has reduced public finance constraints in the short run but sends the wrong signals about the intended reorientation of the economy to be less dependent on hydrocarbons.

TABLE 2 **Algeria** / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2015	2016	2017 e	2018 f	2019 f	2020 f
Real GDP growth, at constant market prices	3.7	3.3	2.1	3.5	2.0	1.3
Private Consumption	3.9	3.3	3.6	3.7	2.5	1.5
Government Consumption	3.1	1.3	0.9	1.2	-4.5	-2.5
Gross Fixed Capital Investment	5.7	3.5	0.5	10.5	-6.9	-5.6
Exports, Goods and Services	0.6	7.9	0.7	1.8	2.3	2.2
Imports, Goods and Services	6.4	-3.0	0.5	6.5	-8.2	-6.0
Real GDP growth, at constant factor prices	3.7	3.4	1.9	3.4	2.0	1.4
Agriculture	6.0	1.8	2.5	2.5	2.7	2.3
Industry	1.8	6.2	3.4	4.2	1.8	1.0
Services	4.3	2.3	0.9	3.1	2.0	1.4
Inflation (Consumer Price Index)	4.8	6.4	5.5	7.5	8.1	9.0
Current Account Balance (% of GDP)	-16.5	-15.6	-14.7	-16.1	-12.7	-10.2
Fiscal Balance (% of GDP)	-17.5	-15.7	-8.2	-11.4	-5.2	-1.9
Debt (% of GDP)	19.1	32.5	26.9	39.4	42.1	41.3
Primary Balance (% of GDP)	-16.8	-14.9	-6.9	-10.3	-3.6	-0.2

Source: World Bank, Poverty & Equity and Macroeconomics, Trade & Investment Global Practices.
Notes: e = estimate, f = forecast.

BAHRAIN

Table 1	2017
Population, million	1.5
GDP, current US$ billion	34.5
GDP per capita, current US$	23565
School enrollment, primary (% gross)[a]	101.2
Life expectancy at birth, years[a]	76.9

Source: WDI, Macro Poverty Outlook, and official data.
Notes:

(a) Most recent WDI value (2015)

Continued economic growth has been achieved despite low oil prices, but it has come at the expense of fiscal and external stability. The exchange rate peg is a regular feature of debate given the perceived structural weaknesses. Despite recently enacted austerity measures, Bahrain remains the most vulnerable Gulf country in the face of lower oil and commodity prices due to its limited savings and sharply rising debt levels, leaving it exposed to financing risks.

Recent developments

The consequences of lower hydrocarbon prices continued to weigh heavily on the economy. Bahrain sustained an expansionary fiscal stance in 2017, resulting in a double-digit deficit for the third year in a row (down to an estimated 13.2 percent of GDP). Fortunately, due to slightly elevated global oil prices and lower spending on domestic subsidies, the budget deficit narrowed markedly. Although deficit spending helped maintain economic growth within a range of 2-3 percent, it also drew down international reserves to a low level of 1.2 months' worth of imports and increased general government debt to over 90 percent of GDP.

Bahrain has introduced a series of initiatives aimed at fiscal consolidation. Revenue enhancing measures such as higher tobacco and alcohol taxes, removal of subsidies on housing utilities, and government services fees were initiated. The introduction of VAT was postponed in the wake of public opposition, but is expected later this year when there is greater assurance about mitigation measures. Inflation has risen in tandem with the lifting of subsidies and imposition of new taxes but this is expected to be temporary.

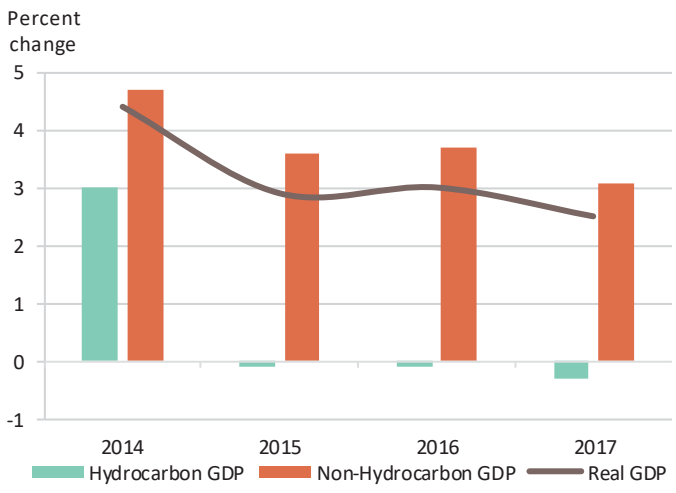
Financial sector assessments by the IMF and rating agencies indicate that the banking sector has remained resilient with adequate capitalization and liquidity levels as regulation and supervision of the sector were strengthened by the Central Bank. Growth in the balance sheet of the international financial center has been muted since the political climate tightened in 2011, but new sources of growth are emerging in fintech and innovative financing instruments.

The economy grew by an estimated 2.5 percent in 2017, which was driven by an expansion of non-hydrocarbon GDP at a rate of 3.1 percent. A raft of project spending, ranging from an airport expansion to social housing developments, has lifted activity in the wider economy. The downside of relying on fiscal stimulus to generate growth, however, has been manifested in persistently high financing needs met via debt issuances, despite the sovereign credit rating being well below investment grade.

Recently, infrastructure spending has been bolstered by the allocation of funds under the Gulf Development Program – a pledge by Bahrain's neighbors in 2011 to provide some US$10 billion in grants over 10 years to boost investment in infrastructure and housing. The government's investment program is linked to an industrial strategy based on downstream energy-intensive sectors and digital development, and hence is focused on aluminum sector, utilities, roads, renewable energy and telecommunications.

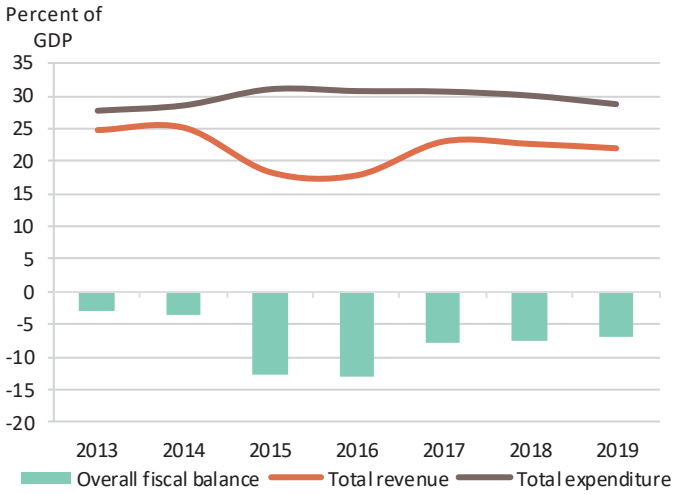
Bahrain's external position faces acute vulnerabilities which are mitigated by implicit backstops from regional partners. Due to the drop in global oil prices since late 2014, Bahrain has run continual current account deficits averaging nearly 4 percent of GDP through the end of 2017. As a consequence of this, paired with large draws on its international reserves,

FIGURE 1 **Bahrain** / Growth in GDP and its components



Sources: Bahraini Authorities and World Bank staff estimates.

FIGURE 2 **Bahrain** / Government balances



Sources: Bahraini Authorities and World Bank staff estimates.

the exchange rate peg has come under significant pressure (visible in the 12-month forward foreign exchange rate). Proceeds from the US$3 billion bond from September 2017 were important to replenish reserves, which subsequently rose to a more than two-year high of US$3.4 billion (from US$1.4 billion in August).

Absolute poverty is believed not to exist in Bahrain, at least for Bahraini nationals. Little comprehensive welfare analysis is available due to restricted access to household survey data and limited capacity. Existing and planned measures on subsidy reform and taxation are likely to require more attention to mitigation of household level impacts.

Outlook

Economic growth is expected to moderate over the forecast period. Real GDP growth projections have been revised down to 1.7 percent in 2018 and 2.1 percent 2019, as low oil prices weigh on domestic demand and market uncertainties prevent the economy from performing at its full potential. However, project spending is foreseen to increase thanks to multilateral and private sector commitments. In addition, oil GDP is expected to expand again over the forecast horizon once the OPEC+ deal terminates at the end of 2018 and the new 350,000 b/d offshore oil pipeline connecting to Saudi Arabia is completed.

Average inflation is expected to increase to 3.4 percent in 2018 due to a raft of one-off measures including the institution of new tax measures and reduction of subsidies, and then moderate to 2.4 percent in 2019. The current account deficit will partially narrow to 4.1 percent of GDP in 2018 and then again to 3.5 percent of GDP in 2019, driven by improved export performance. General government debt is projected to near 100 percent of GDP in 2018 and reach nearly 107 percent of GDP in 2019, as debt issuances are foreseen to continue.

Risks and challenges

Despite efforts to diversify and boost non-oil fiscal revenues, hydrocarbons account for approximately 75 percent of government revenues in Bahrain. Delays in implementing proposed fiscal consolidation and structural reforms, or an unexpected decline in oil prices or wider market uncertainties could trigger additional sovereign rating downgrades making access to external financing harder and intensifying pressure on international reserves and the currency peg. Fiscal solvency and liquidity risks remain high, despite the recent successful public debt issuance in September 2017. Key elements of the social contract—public employment and subsidies—are unaffordable in this context. Yet a key component of Saudi Arabia Vision 2030—the liberalization of the entertainment sector—will undermine Bahrain's appeal as a weekend destination for Saudis. Meanwhile, Brexit is likely to intensify competition among international financial centers. Some combination of more radical structural reform (which will need more political consensus than exists at present) and explicit GCC financial support is likely to be needed.

TABLE 2 **Bahrain** / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2015	2016	2017 e	2018 f	2019 f	2020 f
Real GDP growth, at constant market prices	2.9	3.0	2.5	1.7	2.1	2.1
Private Consumption	1.9	1.8	1.7	1.6	2.0	2.2
Government Consumption	0.3	-1.0	-1.9	-1.4	0.4	0.4
Gross Fixed Capital Investment	-12.1	5.0	4.7	1.2	4.8	5.1
Exports, Goods and Services	1.3	2.5	3.0	3.1	2.0	2.2
Imports, Goods and Services	-5.6	0.2	2.4	2.6	2.5	2.6
Real GDP growth, at constant factor prices	..	..	..	..	..	..
Agriculture	..	..	..	..	..	..
Industry	..	..	..	..	..	..
Services	..	..	..	..	..	..
Inflation (Consumer Price Index)	1.8	2.8	0.9	3.4	2.4	2.4
Current Account Balance (% of GDP)	-2.4	-4.7	-4.5	-4.1	-3.5	-2.7
Fiscal Balance (% of GDP)	-18.4	-17.8	-13.2	-11.5	-10.2	-8.8

Source: World Bank, Poverty & Equity and Macroeconomics, Trade & Investment Global Practices.
Notes: e = estimate, f = forecast.

DJIBOUTI

Table 1	2017
Population, million	1.0
GDP, current US$ billion	2.3
GDP per capita, current US$	2405
International poverty rate ($ 1.9)[a]	22.5
National poverty line[a]	23.0
Gini coefficient[a]	44.1
School enrollment, primary (% gross)[b]	66.3
Life expectancy at birth, years[b]	62.2

Source: WDI, Macro Poverty Outlook, and official data.
Notes:
(a) Most recent value (2013), 2011 PPPs.
(b) Most recent WDI value (2015)

Growth is projected to decline to 6.5 percent in 2018, from an estimated 7 percent in 2017, given the low level of investments while the pickup in net exports remains slow. Fiscal and external balances are expected to improve owing to reduced capital expenditure and imports. Elevated public debt and foreign investor uncertainty associated with the recent termination of DP World's contract for Doraleh port are key risks. Meanwhile, more than a fifth of the population lives in extreme poverty and nearly 40 percent of the labor force unemployed.

Recent developments

GDP growth is projected to decline to 6.5 percent in 2018, down from an estimated 7 percent in 2017, due to lower investments while the pickup in net exports is weak. Growth in 2017 was mainly driven by the combined effects of strong improvement in net exports as percent of GDP, private consumption, and investment that were still relatively high. Inflation is expected to remain at 3.5 percent, given the relatively high oil price and housing and services driven demand. The latest official unemployment rates show weak links between growth and employment generation: the rate was 39 percent in 2015, with women (49 percent) and rural areas (59 percent) showing higher rates. Meanwhile, the employment-to-population ratio is less than 25 percent.

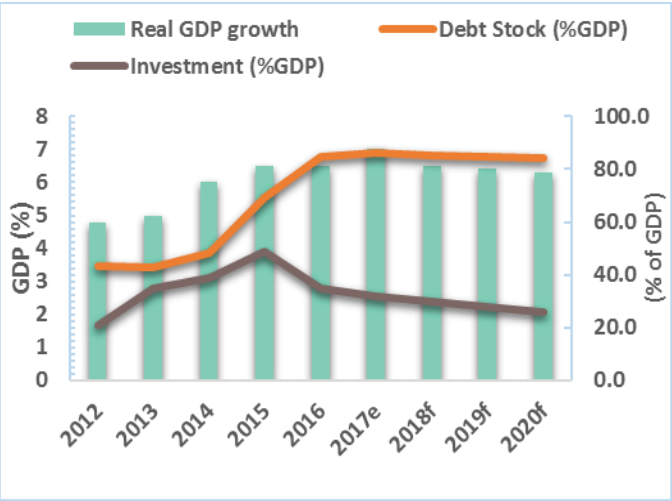
The fiscal deficit is projected to narrow to 2.9 percent of GDP in 2018, from an estimated 3.1 percent in 2017, given the continued decline in capital expenditure. The external deficit is projected to narrow as well, down to 5.2 percent of GDP in 2018 as large capital imports ended and re-export slowly picks up with improved transport and port facilities. FDI is expected to rise to 11.5 percent of GDP in 2018 from 10.8 in 2017, stimulated by ongoing constructions of new export-processing zones and operations of the newly constructed Djibouti-Addis railway. Foreign exchange reserves are projected to remain strong in 2018 at US$435 million, sufficient for coverage of broad money and currency board at 3.6 months of import. The banking sector remains weak with deteriorating loan portfolio of commercial banks and nonperforming loans (NPLs).

Monitoring of welfare and poverty in the country has been somewhat limited due to lack of reliable statistics. The most recent official national extreme poverty rate was 23 percent in 2013, with rural areas showing rates twice as high (44 percent).

Outlook

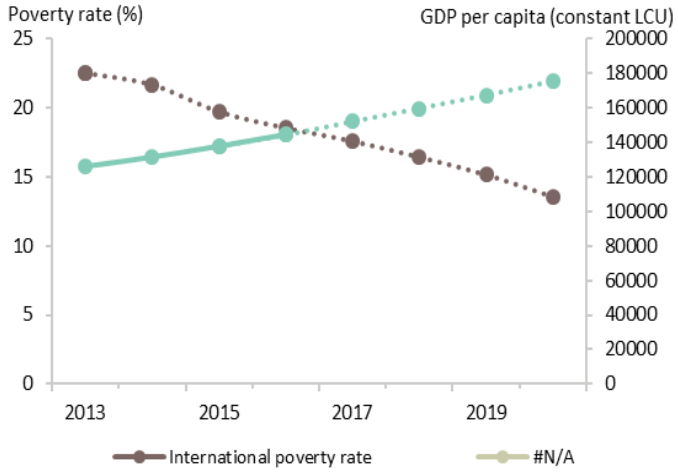
The near-term outlook suggests that while investment-driven growth has slowed as expected, an alternative source of renewed growth acceleration has yet to be found. The fiscal imbalance is projected to further narrow to low single digits in 2018-2020, with ending of large capital expenditures combined with expectation that new revenues will be generated from the completed infrastructures. External imbalance is expected to narrow to 4 percent of GDP by 2020, owing to reduced capital imports combined with re-export capacity from new railway and port facilities. Nonetheless, the debt level will remain high, around 85 percent of GDP over the forecast period and its servicing burden will continue to pressure fiscal space. Government revenues are expected to further decline given the delayed tax system reform. FDI inflows and more restrained borrowing will continue to finance the deficit. Inflation is projected to be modest but persistent, driven by a relatively high

FIGURE 1 Djibouti / Growth and Public Debt



Sources: Djibouti authorities and World Bank staff calculation.

FIGURE 2 Djibouti / Poverty ratio at US$ 1.9 2011 PPP



Sources: World Bank. Note: See Table 2.

oil price and demand in the housing and services sectors.

Macroeconomic stability remains subject to downside risks, considering the rapidly grown public debt, declining revenues, and Djibouti's heavy external dependence that increase its vulnerability to external shocks. The recent termination of DP World's contract for the Doraleh port by the Djiboutian government, is perceived as a risk for investors and could affect FDI. Moreover, Ethiopia's engagement along-side with DP World to develop Berbera port in Somaliland could divert a portion of its trade flow from Djibouti in the long run. Social discontent is a concern given poverty, unemployment, inequality, regional instability and acute climate challenges. Such social discontent poses additional risks to the growth prospect.

The poverty rate (at $1.9 USD 2011 PPP) is expected to be around 16.5 percent in 2018, with small reductions in the medium term if economic growth is not mirrored by increased dynamism in the private sector. However, the country's monitoring of welfare is expected to take a significant step forward in 2018. A new National Strategy for Development of Statistics is being prepared and expected to be released this year. Also, the first results of the 2017 household consumption survey are expected to be available in spring 2018, with further studies released by summer.

Risks and challenges

Costs for backbone services, maintaining macroeconomic stability and investing in human capital to improve labor productivity remain the main challenges of the government of Djibouti. Addressing these challenges would require: (1) strengthening institutional capacity for more accountable public service delivery; (2) reforming the tax system for domestic resource mobilization that are needed for investment and servicing the rapidly grown public debt; and (3) easing the business regulatory system and addressing structural constraint of high costs of production factors to improve competitiveness and job creation.

TABLE 2 **Djibouti** / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2015	2016	2017 e	2018 f	2019 f	2020 f
Real GDP growth, at constant market prices	6.5	6.5	7.0	6.5	6.4	6.3
Private Consumption	7.1	6.0	7.1	8.1	7.9	7.9
Government Consumption	5.7	5.8	9.4	7.7	9.6	8.2
Gross Fixed Capital Investment	33.0	-24.0	-2.7	-0.3	-1.8	-0.3
Exports, Goods and Services	17.6	4.5	5.9	6.8	8.1	8.1
Imports, Goods and Services	28.9	-5.0	-1.6	5.2	6.3	7.0
Real GDP growth, at constant factor prices	6.5	6.5	7.2	6.5	6.4	6.3
Agriculture	3.0	2.1	2.5	3.0	3.0	3.0
Industry	5.4	5.5	5.8	6.0	6.1	6.1
Services	6.9	6.9	7.7	6.7	6.6	6.4
Inflation (Consumer Price Index)	2.2	3.5	3.5	3.5	3.1	3.1
Current Account Balance (% of GDP)	-30.4	-22.2	-5.5	-5.2	-4.6	-4.2
Fiscal Balance (% of GDP)	-20.7	-15.2	-3.1	-2.9	-1.4	-1.1
Debt (% of GDP)	69.4	84.8	86.0	85.4	84.9	84.2
Primary Balance (% of GDP)	-19.1	-13.4	-1.2	-0.7	0.9	1.3
International poverty rate ($1.9 in 2011 PPP)[a,b]	19.7	18.6	17.6	16.5	15.2	13.6

Source: World Bank, Poverty & Equity and Macroeconomics, Trade & Investment Global Practices.
Notes: e = estimate, f = forecast.
(a) Calculations based on 2013-EDAM. Nowcast: 2015 - 2017. Forecast are from 2018 to 2020.
(b) Projection using neutral distribution (2013) with pass-through = 0.7 based on GDP per capita in constant LCU.

ARAB REPUBLIC OF EGYPT

Table 1	2017
Population, million	95.2
GDP, current US$ billion	235.7
GDP per capita, current US$	2475
Lower middle-income poverty rate ($3.2)[a]	16.1
National poverty line[a]	27.8
Gini coefficient[a]	30.0
Life expectancy at birth, years[b]	71.3

Source: WDI, Macro Poverty Outlook, and official data.
Notes:
(a) Most recent value (2015), 2011 PPPs.
(b) Most recent WDI value (2015)

Macroeconomic conditions are improving, as Egypt's twin deficits are narrowing and inflation has receded sharply in recent months. The Central Bank has cut key policy rates for the first time since the tightening cycle that accompanied the exchange rate flotation in November 2016. Economic activity is picking up, and unemployment rate has fallen below 12% for the first time since 2011. Socio-economic conditions remain challenging with the erosion of real incomes over the past year. The impact of key business environment reforms will depend on effective implementation.

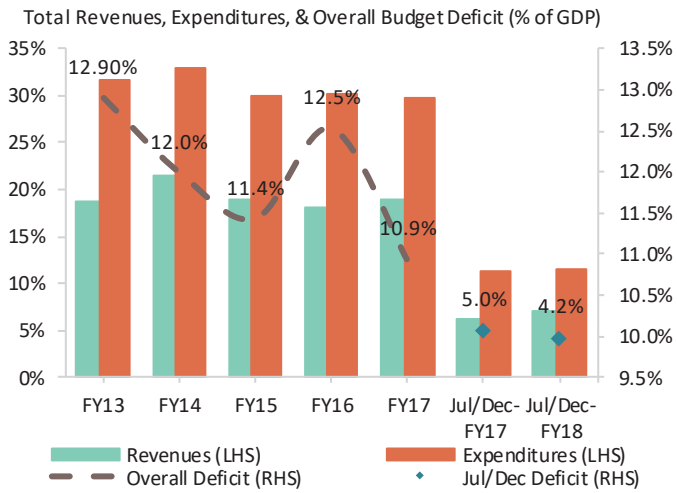
Recent developments

Egypt's economy grew by 5.2% in H1-FY18 (July/June), compared to 3.7% a year earlier, mainly driven by investment, exports and consumption. On the sectoral side, the gas extractives sector has been a main contributor to growth, notably since the recent operationalization of the large Zohr gas field. The improvement in energy supply is also starting to have positive spill-overs on other sectors, especially manufacturing. The tourism sector is rebounding gradually, helped by the effect of local currency depreciation. The nascent economic recovery has been accompanied by a steady decline in unemployment, which dropped to its lowest level since mid-FY10 to reach 11.3% in Q2-FY18. Annual headline and core inflation rates continued to decline for the sixth consecutive month in January 2018, reaching 17.1% and 14.4%, down from peaks of 33% and 35%, respectively in July 2017. This decline was supported by tighter monetary conditions, easing food inflation, in addition to the favorable base effect, as the impact of the exchange rate depreciation in November 2016 and the one-off energy price hikes are fading. The CBE has thus started to ease policy rates by 100 basis points in mid-February 2018. While nominal interest rates are still 600 basis points above their pre-exchange rate flotation levels, declining inflation has helped turn real interest rates positive in end-February 2018.

Macroeconomic imbalances are narrowing. The primary budget balance is close to surplus (-0.3% of GDP) for the first half of FY18. Tax revenues increased to 6.8% of GDP in H1-FY18, up from 4.8% during the first half of the previous year, driven mainly by the increase in revenues from the VAT, but also from corporate and personal income tax. Efforts continue to contain the civil servants' wage bill and energy subsidies, savings from the latter allowing the government to scale up the allocations to the food subsidy as well as the cash transfer programs. On the external side, the current account deficit narrowed to 0.7% of GDP in Q1-FY18, down from 2% a year before. This was supported by an increase in merchandise exports, tourism revenues, Suez Canal dues and remittances. Those, in addition to large portfolio inflows, contributed to an overall balance of payments surplus of 2.3% of GDP in Q1-FY18, up from a 0.8% in the same quarter of the previous year. Net international reserves achieved a new record high of US$42.5 billion in end-February 2018 (covering 9 months of FY18 merchandise imports), more than double its level prior to the exchange rate flotation in end-October 2016.

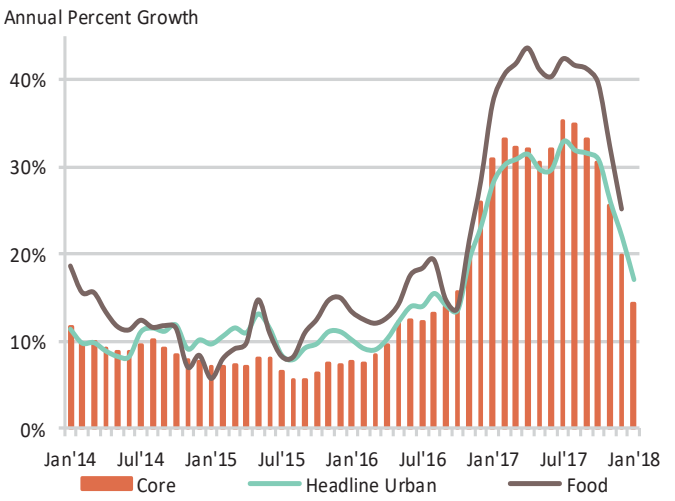
FDI remains weak (0.7% of GDP in Q1-FY18, down from 0.8% of GDP a year earlier), reflecting continuing concerns about business climate and the growing role of the State in economic activity. To enhance the business environment, the government has introduced a series of key legislative reforms, including a new industrial licensing law, investment law, bankruptcy law, and amendments to the companies law.

FIGURE 1 Arab Republic of Egypt / Real GDP growth, demand-side, FY2014Q1-FY2018Q1



Source: Authors' calculations based on Ministry of Planning data.

FIGURE 2 Arab Republic of Egypt / Inflation rates, January 2014 – January 2018



Source: Central Bank of Egypt.

Extreme poverty in Egypt is practically eradicated. Using the national poverty threshold, about a third (27.8%) of the population was below the poverty line in 2015. Moreover, the high inflation accumulated over the course of FY15-FY17 has lowered the purchasing power of households across the distribution, reducing the positive spillovers of economic growth; taking a toll on social and economic conditions. Regional disparities continue to be part of the country's landscape, with Upper Rural Egypt showing poverty rates three times as high as Metropolitan Egypt. Recent increases in allowances of the main social programs have helped weather the effects of inflation, but imperfect coverage and targeting leave some groups unprotected.

Outlook

As reform momentum is sustained, economic activity is expected to improve and imbalances are projected to narrow further. Real GDP is forecast to grow by 5% in FY18, and to increase gradually to 5.8% by FY20. Growth is expected to be driven by resilient private consumption and investment, in addition to a gradual pickup in exports (notably from tourism and gas).

The budget deficit is expected to narrow to 9.8% of GDP in FY18. This is slightly higher than initially-budgeted, due to larger interest payments, higher international oil prices, and larger-than-budgeted exchange rate. The fiscal consolidation program is expected to rely on revenue mobilization, in particular the increase in VAT receipts, in addition to energy subsidy reforms. The current account deficit is expected to narrow to 4.9% of GDP in FY18, from 6.6% of GDP in FY17.

Consistent with the macro picture of resilient growth in private consumption, poverty rate based on the $3.2/day (2011 PPP) is projected to decline modestly to 15.21% in 2019 from an estimated 15.63% in 2017. However, the ongoing reforms, although beneficial in the long term, could reduce households' welfare in the short-term due to energy price increases and overall high inflation. The government's strategy to shift expenditures away from universal subsidies to targeted transfers and food smart cards is key in mitigating the effects and will help support private consumption. Social protection measures must be complemented with efforts to improve service delivery. Negative impacts on the vulnerable and the middle class may only be mitigated by ability of the private sector to create jobs, especially for the youth and women.

Risks and challenges

The absence of a level-playing field, especially in sectors where there are State-led activities, might stifle the private sector and job-creation. Additionally, regional and domestic security risks threaten the recovery of foreign investments and tourism.

Fiscal reforms slippage or unfavorable external conditions, for example in the form of sustained increases in global oil prices, pose risks that may negatively impact the consolidation trajectory. With a government debt ratio of 108.8 % of GDP in end-FY17, a combined macro-fiscal shock can threaten Egypt's debt sustainability.

Social conditions remain difficult with double-digit unemployment rate and the absence of a notable acceleration in employment. A better understanding of the impact on the population and their coping mechanisms will come from the results of the ongoing Household Consumption Survey 2017 which was launched in October.

TABLE 2 **Arab Republic of Egypt** / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2015	2016	2017 e	2018 f	2019 f	2020 f
Real GDP growth, at constant market prices	4.4	4.3	4.2	5.0	5.5	5.8
Private Consumption	3.1	4.7	4.2	3.9	4.1	4.2
Government Consumption	7.0	3.9	2.3	2.0	2.9	1.9
Gross Fixed Capital Investment	13.8	12.0	12.4	8.0	8.2	12.1
Exports, Goods and Services	0.0	-15.0	86.0	4.0	9.0	8.0
Imports, Goods and Services	1.0	-2.2	52.5	2.0	4.5	5.0
Real GDP growth, at constant factor prices	3.4	2.3	3.6	5.0	5.5	5.8
Agriculture	3.1	3.1	3.2	3.8	3.5	3.8
Industry	1.1	0.2	3.1	3.8	4.1	3.7
Services	5.0	3.6	4.0	6.1	6.8	7.5
Inflation (Consumer Price Index)	11.1	10.2	23.3	22.1	14.0	12.0
Current Account Balance (% of GDP)	-3.6	-6.0	-6.6	-4.9	-4.4	-4.1
Financial and Capital Account (% of GDP)	4.3	7.2	6.5	4.9	4.4	4.1
Net Foreign Direct Investment (% of GDP)	1.9	2.0	3.3	3.3	3.5	3.7
Fiscal Balance (% of GDP)	-11.4	-12.5	-10.9	-9.8	-8.4	-7.3
Debt (% of GDP)	93.3	103.0	108.8	99.8	96.4	91.3
Primary Balance (% of GDP)	-3.5	-3.5	-1.8	-0.6	0.8	1.2
Lower middle-income poverty rate ($3.2 in 2011 PPP)[a,b]	16.1	15.9	15.6	15.4	15.2	15.0

Source: World Bank, Poverty & Equity and Macroeconomics, Trade & Investment Global Practices.
Notes: e = estimate, f = forecast.
(a) Calculations based on 2004-HIECS and 2015-HIECS. Actual data: 2015. Nowcast: 2016 - 2017. Forecast are from 2018 to 2020.
(b) Projection using point-to-point elasticity (2004-2015) with pass-through = 0.5 based on private consumption per capita in constant LCU.

IRAN, ISLAMIC REPUBLIC

Table 1	2017
Population, million	80.6
GDP, current US$ billion	439.5
GDP per capita, current US$	5452
Upper middle-income poverty rate ($5.5)[a]	10.5
Gini coefficient[a]	38.8
School enrollment, primary (% gross)[b]	108.9
Life expectancy at birth, years[b]	75.7

Source: WDI, Macro Poverty Outlook, and official data.
Notes:
(a) Most recent value (2014), 2011 PPPs.
(b) Most recent WDI value (2015)

As the impact of the previous year's boost in oil production and exports dissipates, overall growth rate is expected to stabilize at around 4.2 percent, with a larger contribution from the non-oil sector. Yet, continued high unemployment rate and an expected upward trend in prices are likely to put pressure on household incomes and complicate the space to implement further economic reforms, particularly in the aftermath of widespread protests in January 2018.

Recent developments

Real GDP growth at factor prices is expected to moderate from 12.5 percent in 2016/17 to 4.3 percent in 2017/18 as oil production stabilizes. Unlike in 2016/17, the non-oil sector was the main contributor to the overall growth in the first half of 2017/18 (by 3.2 percentage points of the overall 4.5 percent). Gross fixed capital formation recorded a positive growth rate for the first time since the second half of 2014/15, driven mainly by a pickup in investments in the construction sector. This was supported by a 20 percent growth in outstanding loans as of December 2017, compared to December 2016.

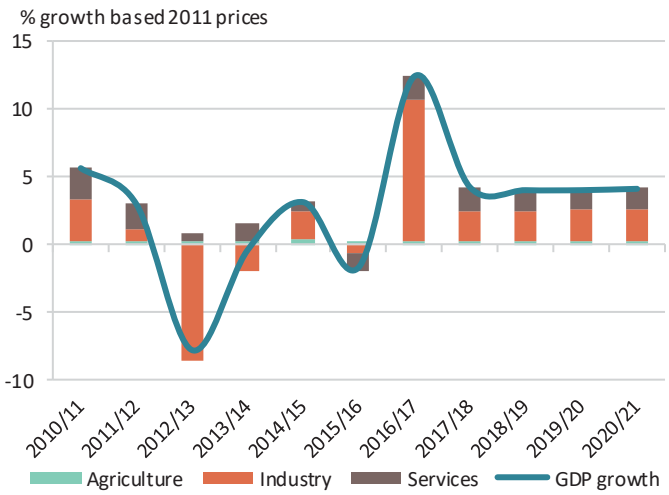
The fiscal deficit is estimated to slightly widen to 2.4 percent as government expenditures growth outpaces the increase in revenues. In the first nine months of 2017/18 tax revenues increased by only 4.4 percent and oil exports receipts surged by 52 percent compared to 25 percent and -6.7 percent respectively in the same period in 2016/17. On the expenditures side, current expenditures increased by 16.8, while capital expenditures surged by 91 percent on the back of a considerably low base and two subsequent years of contraction.

The current account surplus is estimated to slightly improve to 4.1 percent of GDP in 2017/18 (up from 3.9 percent in 2016/17) as oil prices increase while export volumes remain stable around the country's 2.4 million barrels per day and production remains at the amount agreed under the OPEC production cut and 2011/12 daily production level. However, data for the first 10 months of the current year regarding non-oil trade balance indicate a considerable deficit of around US$5.7 billion as imports increased by 22 percent and exports by 1.7 percent on an annual basis.

Following the street protests in Tehran and a number of other cities at the end of December 2017 and early January 2018, sparked by economic concerns, the exchange rate depreciated significantly as uncertainty increased speculative demand for foreign currency. By mid-February Rial's parallel market exchange rate against the US dollar was around 16 percent lower than end-December 2017. In response, CBI announced a temporary increase on bank deposit return rate ceiling to 20 percent (up from 15 percent). As of end-February Rial stood at 6.4 percent lower than its end-December value against the US dollar in the parallel markets. As the gap between the parallel and official exchange rate widened, some critics argued that the government, as the largest supplier of foreign exchange, benefitted from this rate premium as a quasi-fiscal tool to cover the mounting cost of problems with pension funds and cash handouts. Despite the exchange rate turmoil, pass-through remained limited and CPI inflation stayed just below 10 percent in the 12-months prior to February 20th.

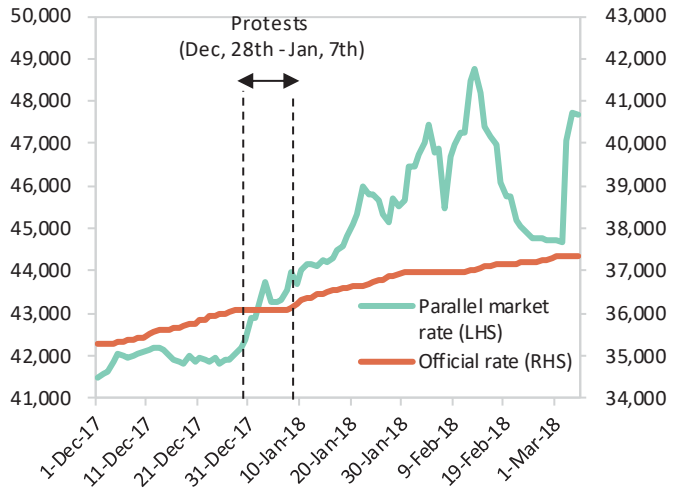
Recent Statistical Center of Iran data puts the unemployment rate for the third quarter of the year (October-December 2017) at 11.9 percent and the labor force participation at 41 percent, which marks a moderate improvement compared to the same quarter a year earlier (12.3 and 38.9 per-

FIGURE 1 Islamic Republic of Iran / Supply side contribution to GDP



Sources: CBI and World Bank staff calculations.

FIGURE 2 Islamic Republic of Iran / Recent Rial to US dollar exchange rates



Sources: CBI, Donya-e-Eqtesad and World Bank staff calculations.

cent respectively). This is in line with a gradual improvement in non-oil sector production.

Poverty is estimated to have fallen from about 13 percent to 8 percent between 2009 and 2013 (US$5.5 a day line in 2011 PPP). This was likely due to the introduction of the universal cash transfer program in late 2010, contributing to positive consumption growth of the bottom 40 percent of the population, with overall consumption growth between 2009 and 2013 being negative. Poverty increased in 2014 to 10.5 percent though and this may be associated with a declining social assistance in real terms.

Outlook

The economy is expected to maintain a steady growth of slightly over 4 percent, increasingly based on non-oil sectors, and fueled by a recovery in consumption and investment demand and overtaking the contribution of net exports. Some signs of pick up in construction sector, historically a lead indicator of economic activity, also appear to confirm this trend.

The fiscal deficit is estimated to remain above 2.5 percent of GDP through 2020 as expenditures increase due to the postponement by the Parliament of some reform measures (such as the initially envisioned cash transfer targeting under the initial draft of the 2018/19 budget). Furthermore, increased leveraging of government budget through bonds and other financial instruments and the subsequent higher servicing of debt are likely to add upward pressure on expenditures.

The current account surplus is expected to further strengthen and hover around 5 percent of GDP, mainly due to the steady increase in global energy prices based on current projections and gradual improvement in non-oil trade balance.

In the medium term, inflationary pressures are likely to increase due to widening output gap and further currency depreciation, pushing CPI inflation into double-digit territory again.

Given political and economic uncertainty Iran has been facing since 2009, poverty has been volatile, making forecasts less precise. Nevertheless, falling real value of cash transfers may continue to have negative impact on poverty, while moderate economic growth and planned improved targeting of benefits may contribute to lower poverty after 2017.

Risks and challenges

The lack of job creating growth will continue to be an important challenge. As the unrest in early January 2018 demonstrated there is widespread concern about poverty, corruption and lack of jobs, particularly for the youth. In the aftermath of events and the presence of continued yet more scattered demonstrations, the policy environment in the county has become more challenging for the government's reform agenda, with significantly different views regarding the country's development model. Banking sector reforms are largely pending, which, combined with uncertainties around global banks re-engagement with Iranian banks put pressure on inward investment. The unification of the official and market exchange rates has been further postponed and the gap between the two rates currently stands higher at close to 28 percent. The increasing reliance on issuance of debt instruments for financing government arrears and current expenditures can put additional pressure for rollover of maturing debt, increase borrowing costs and undermine the sustainability of government finances in the coming years.

TABLE 2 **Islamic Republic of Iran** / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2015/16	2016/17	2017/18 e	2018/19 f	2019/20 f	2020/21 f
Real GDP growth, at constant market prices	-1.3	13.4	4.3	4.1	4.1	4.2
Private Consumption	-3.5	3.8	5.3	5.0	5.1	4.9
Government Consumption	4.8	3.7	4.0	4.4	3.8	3.6
Gross Fixed Capital Investment	-12.0	-3.7	2.2	1.9	2.4	3.2
Exports, Goods and Services	12.1	41.3	7.3	7.0	6.7	6.9
Imports, Goods and Services	-20.2	6.1	7.8	8.1	8.3	8.5
Real GDP growth, at constant factor prices	-1.6	12.5	4.3	4.1	4.1	4.2
Agriculture	4.6	4.2	4.0	4.0	3.9	3.9
Industry	-1.4	24.7	4.7	4.7	4.8	4.9
Services	-2.5	3.7	3.9	3.5	3.4	3.6
Inflation (Consumer Price Index)	11.9	9.0	9.8	11.4	11.0	10.8
Current Account Balance (% of GDP)	2.3	3.9	4.1	5.4	5.1	4.7
Fiscal Balance (% of GDP)	-1.7	-2.2	-2.4	-2.5	-2.7	-2.6
Gross Public Debt (% of GDP)	41.2	49.0	40.9	53.9	49.2	45.6
Primary Balance (% of GDP)	-1.6	-2.1	-2.3	-0.6	0.0	-0.1

Source: World Bank, Poverty & Equity and Macroeconomics, Trade & Investment Global Practices.
Notes: e = estimate, f = forecast.

REPUBLIC OF IRAQ

Table 1	2017
Population, million	38.7
GDP, current US$ billion	197.7
GDP per capita, current US$	5115
Lower middle-income poverty rate ($3.2)[a]	17.9
Upper middle-income poverty rate ($5.5)[a]	57.3
National poverty line[b]	22.5
Gini coefficient[a]	29.5
Life expectancy at birth, years[c]	69.6

Source: WDI, Macro Poverty Outlook, and official data.
Notes:
(a) Most recent value (2012), 2011 PPPs.
(b) Most recent WDI value (2014)
(c) Most recent WDI value (2015)

Reconstruction is slowly replacing oil production as a driver of growth in the wake of the twin shocks of the ISIS war and oil revenue decline which caused a deep recession in the non-oil economy. OPEC+ production restraint resulted in negative growth in 2017, despite a strong recovery of the non-oil sector. Growth will accelerate in 2018, thanks to a more favorable security environment, but sustaining growth during reconstruction would depend on structural reforms. Poverty reached 22.5 % in 2014 and 10 % of Iraqis remain displaced.

Recent developments

Following the complete liberation from ISIS in December 2017, the Government of Iraq (GoI) is designing a comprehensive reconstruction package linking immediate stabilization to a long-term vision. The recent Iraq Damage and Needs Assessment estimates the reconstruction and recovery needs at US$88 billion. In February 2018, Kuwait hosted a reconstruction and recovery conference which identified pledges amounting to US$30 billion. Supported by the World Bank, the GoI is considering a financing facility to mobilize significant resources from the private sector.

Strong oil production has sustained economic growth in 2015-16, but overall GDP growth is estimated to have turned negative at 0.8 percent in 2017, due to a 3.5 percent reduction in oil production to fulfill OPEC+ agreement and further reduction from areas that returned under the GoI's control. Due to the ISIS war and fiscal consolidation to adjust to lower oil prices, non-oil growth has been negative in 2014-16. At the end of 2017, the cumulative real losses due to the conflict stood at 72 percent of the 2013 GDP and 142 percent of the 2013 non-oil GDP. Improved security situation and initial reconstruction effort have sustained non-oil growth at 4.4 percent in 2017. The pegged exchange rate and subdued demand have kept inflation low at around 0.1 percent in 2017.

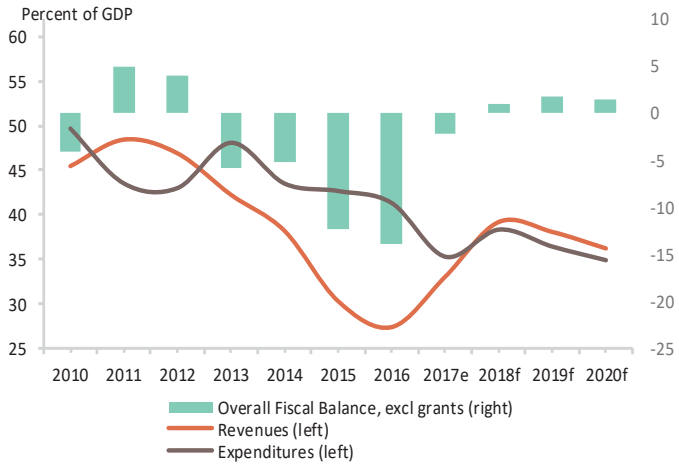
In 2017, the GoI's overall fiscal deficit is estimated to have narrowed to 2.2 percent of GDP due to higher oil prices and measures to contain current expenditures. In 2015-16, low oil prices, higher security and humanitarian outlays and weak controls rapidly deteriorated the fiscal balance, with the adjustment falling mainly on non-oil investment expenditure. KRG expenditure control measures decreased its fiscal deficit by 80 percent from 2014 to 2016, while spending pressures remained high to assist IDPs and refugees from Syria. In October 2017, following a referendum on KRG independence, which was considered illegal by GoI, federal forces regained control of disputed areas controlled by KRG, including oil-rich areas. As a result, KRG lost half of its oil revenue.

The GoI's reform program is supported by a large financing package from bilaterals and multilaterals which avoided a much deeper economic and social crisis that could have been triggered by the large fiscal shock. GoI also tapped the sovereign bond market in August 2017, first independent issuance since 2006, with a US$1 billion bond.

A better fiscal outturn has stabilized public debt in 2017 after large borrowing and issuance of debt guarantees increased the public debt-to-GDP ratio from 32 percent in 2014 to 64.4 percent in 2016. In 2017, the government has made progress to reduce a large stock of guarantees and improve their management.

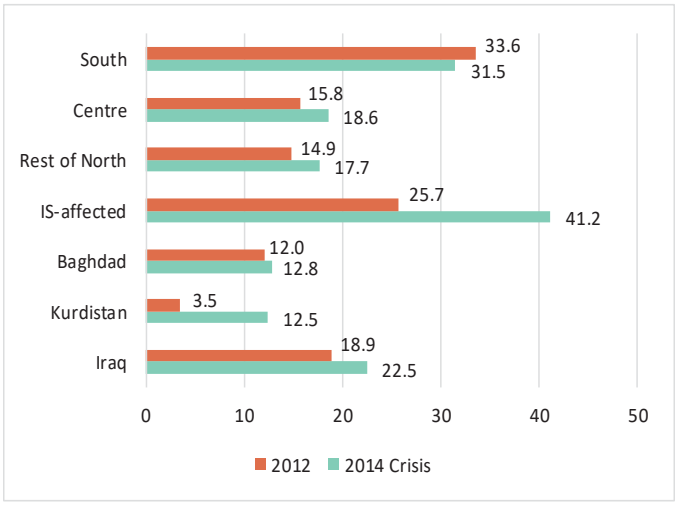
In 2017, the current account is estimated to have returned to a surplus of 0.7 percent of GDP. The strong reserve accumulation in 2010–2013 smoothed the impact

FIGURE 1 Republic of Iraq / Fiscal Accounts (percent of GDP)



Sources: Ministry of Finance; and World Bank staff projections.

FIGURE 2 Republic of Iraq / Poverty Head Count Rate (% change)



Sources: World Bank staff microsimulation estimates.

of the fiscal policy adjustment required to maintain external sustainability. Thanks to higher oil prices, international reserves started increasing in 2017, rebuilding buffers to external shocks.

The poverty rate increased from 18.9 percent in 2012 to an estimated 22.5 percent in 2014. Recent labor market statistics suggest further deterioration of the poverty situation. Labor force participation rate of the youth (ages 15-24) has dropped markedly since the onset of the crisis, from 32.5 percent to 27.4 percent. Unemployment increased particularly for individuals from the poorest households, youth, and those in the prime working age (ages 25-49). Unemployment rate is about twice as high in the governorates most affected by ISIS-related violence and displacement compared to the rest of the country (21.1 percent versus 11.2 percent), especially among the young and the uneducated. Among the three million IDPs, unemployment is 55 percent higher than that of host communities. The Public Distribution System (PDS) provides the only safety net for most poor, and is currently stretched to its limits. Almost all IDPs and residents of ISIS-affected governorates have experienced some form of negative shock and many lost access to food rations through the PDS.

Outlook

Iraq's growth outlook is expected to improve thanks to a more favorable security environment, and the gradual pick up of investment for reconstruction. Overall GDP growth is projected to return positive in 2018 despite the extension of OPEC+ agreement till end-2018 and further increase in 2019 as the agreement expires. From 2020, oil production is expected to increase only marginally, reducing overall growth, as GoI cannot afford to significantly increase investments in the oil sector. Non-oil economic growth is expected to benefit from increased investment for reconstruction, but absent structural reforms, higher non-oil growth would be short-lived. In 2018, a step up of government investment, with a large import component, is expected to stimulate growth over the projection period in agriculture, manufacturing, construction, transport and supporting services. Private sector activity is subsequently projected to pick up, as public investments decreases. Projected fiscal surpluses should be seen in the context of continued oil price volatility and creating fiscal space for financing for reconstruction. The current account deficit is expected to remain limited thanks to higher oil prices. Thanks to fiscal consolidation, public debt is expected to remain sustainable in the medium term.

Risks and challenges

Downside risks include oil price volatility, failure to improve the security environment and failure to implement the expected large fiscal adjustment to contain current expenditure and prioritize investment for reconstruction. In the short-term, escalating political tensions and the probability of terrorist attacks ahead of the elections in mid-May 2018 add further risk to the outlook. The external debt remains highly vulnerable to a reduction in oil prices or a real exchange rate depreciation. Risks are also related to the capacity of the GoI to provide public services and start reconstruction. Effective delivery of basic services and creation of income-generating opportunities, particularly for youths in recently-liberated areas, is also crucial to ameliorate the underlying fragility and prevent another cycle of violence and conflict in the country.

TABLE 2 **Republic of Iraq** / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2015	2016	2017 e	2018 f	2019 f	2020 f
Real GDP growth, at constant market prices	4.8	11.0	-0.8	2.5	4.1	1.9
Private Consumption	20.0	13.0	2.1	1.1	3.3	3.5
Government Consumption	29.1	6.3	-1.2	10.4	-3.6	-4.0
Gross Fixed Capital Investment	-2.1	-30.2	-7.8	5.9	-1.7	-2.3
Exports, Goods and Services	28.3	13.1	-0.1	2.2	5.0	1.2
Imports, Goods and Services	11.2	-5.3	0.8	11.2	-1.7	-1.7
Real GDP growth, at constant factor prices	4.8	11.0	-0.8	2.5	4.1	1.9
Agriculture	-49.3	59.6	-3.0	7.0	7.0	7.0
Industry	9.3	18.6	-3.3	2.1	4.2	0.9
Services	2.4	-7.2	5.9	3.0	3.5	3.7
Inflation (Consumer Price Index)	1.4	0.4	0.1	2.0	2.0	2.0
Current Account Balance (% of GDP)	-6.5	-8.6	0.7	-0.2	-0.1	-1.3
Fiscal Balance (% of GDP)	-12.3	-13.9	-2.2	0.9	1.7	1.4
Debt (% of GDP)	55.1	64.3	57.8	55.2	53.5	50.7
Primary Balance (% of GDP)	-11.7	-13.2	-1.0	2.5	3.0	2.6

Source: World Bank, Poverty & Equity and Macroeconomics, Trade & Investment Global Practices.
Notes: e = estimate, f = forecast.

KUWAIT

Table 1	2017
Population, million	4.1
GDP, current US$ billion	120.1
GDP per capita, current US$	29031
Life expectancy at birth, years[a]	74.7

Source: WDI, Macro Poverty Outlook, and official data.
Notes:

(a) Most recent WDI value (2015)

Kuwait's economy contracted by an estimated 1 percent in 2017 as OPEC-related oil production cuts weighed on growth. However, growth should gradually recover to about 3 percent in the medium term, supported by infrastructure spending, and as oil production cuts are phased out. External and fiscal balances are improving. Key challenges include hydrocarbon dependence and parliamentary opposition to deep structural reforms. Poverty incidence among Kuwaitis is low.

Recent developments

With hydrocarbons accounting for nearly half of GDP, oil production cuts by OPEC and some non-OPEC countries ("OPEC+") until the end of 2018 has weighed on GDP growth, with the economy estimated to have contracted by 1 percent in 2017. Outside the oil sector, activity has been supported by the implementation of large infrastructure, transport and refinery projects contained in the five-year Development Plan (2015/16-2019/20). In 2017, the government released the *New Kuwait* 2035 Strategic Plan, the latest iteration of ambitions to transform the country into a regional, financial and commercial hub.

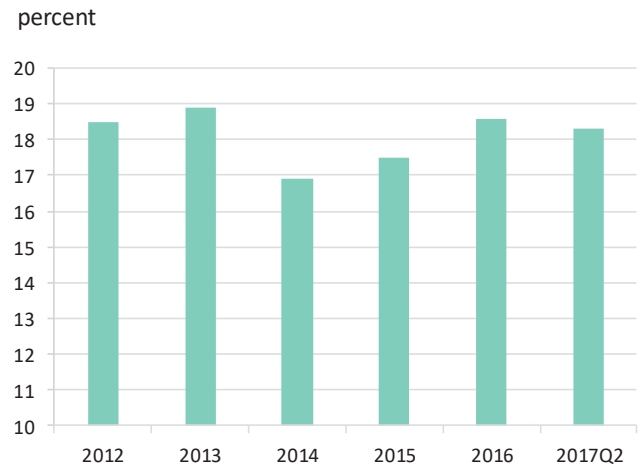
Household spending and confidence are improving. Consumer confidence and spending rebounded over the past year following a marked slowdown in late 2016. In part this reflects the recovery in oil prices and steady hiring by the government, which have boosted sentiment and supported spending. The correction in real estate prices, which had been softening in recent years, also appears to have run its course: real estate prices have stabilized while residential sector sales and related household borrowing are expanding at a robust pace. Bank lending to firms slowed during 2017; the banking sector remains generally healthy and, at 18.3 percent, bank capital adequacy ratios are above the Central Bank's required 13 percent.

External positions are strong and supportive of Kuwait's currency peg. Financial buffers held by the Kuwait Investment Authority are estimated at close to US$530 billion (approximately US$380 billion in the Future Generations Fund, and US$148 billion in the General Reserve Fund (GRF) which aims to support the budget). The recovery in oil prices over the past year has boosted export receipts (despite the oil production cuts), with Kuwait estimated to post a current account surplus of over 3 percent of GDP in 2017, a marked improvement from a deficit of –3.4 percent of GDP in 2016. Import growth has remained robust reflecting healthy domestic demand related to government infrastructure projects.

Fiscal pressures lessened in 2017, but financing needs will remain over the medium term. The recovery in global energy prices – from an average of US$45/bbl (Brent) in 2016 to US$66/bbl in 2017 – has boosted oil receipts, which account for nearly 90 percent of total government receipts. As a result, the government is anticipated to post a deficit of 3.5 percent of GDP in FY2017/18, an improvement from 17 percent shortfall the previous year. Deficits have been financed by a mix of drawdowns from fiscal savings in the GRF, and from domestic and international debt financing. Kuwait issued an inaugural US$10 billion international bond in 2017, but gross public debt remains low at less than 20 percent of GDP in end-2017.

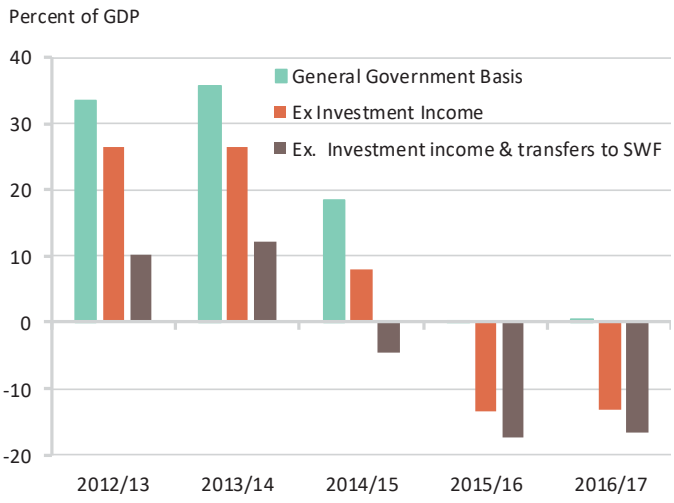
Fiscal reforms are proceeding slowly. The government began raising utility prices in September 2016; however subsequent tariff increases during 2017 have been slower than initially proposed in part due to strong opposition in Parliament. The government remains committed to intro-

FIGURE 1 **Kuwait** / Banking sector capital adequacy ratios



Sources: Central Bank of Kuwait, Haver, World Bank.

FIGURE 2 **Kuwait** / Public sector balances



Sources: Central Bank of Kuwait, Haver, World Bank.

ducing a VAT. Inflation has remained muted, averaging 1.6 percent during 2017 due to declining housing costs and persistently weak food inflation. The peg to an undisclosed basket of currencies, in which the US Dollar has a heavy weighting means that monetary policy is closely tied to that in the US. The Central Bank has opted to raise policy rates more slowly than the US Fed, in order to support activity in the non-oil sector, and held off from raising its key rate after the Fed rate increase in December 2017. Absolute poverty and involuntary unemployment are virtually nonexistent. Eighty percent of employed Kuwaiti nationals work in the public sector. In contrast, expatriates, who make up two-thirds of the population, constitute the bulk of lower-income residents. Additional concerns for immigrant workers include unpaid or delayed wages, difficult working condi-tions and fear of a crackdown. A relative concept of living standards may be more appropriate for a rich country, like Kuwait. In that respect, about 18 percent of the total population lives on less than half the median income level—this number is 1.5 percent for Kuwaiti nationals and 34 percent for others. The Gini index of per capita consumption in Kuwait, at 36.5, is not extreme, with higher inequality amongst expatriates. A more detailed analysis is hindered by restrictions on access to household data.

Outlook

Growth is projected to rebound to 3.5 percent in 2019 as OPEC+ production cuts are tapered off, and oil output and exports increase. Plans to invest US$115 billion in the oil sector over the next five years should also boost oil production. With additional support coming from public investment spending, growth should rise to about 2.7 percent over the medium term. Current account and budgetary pressures are expected to continue easing on the back of a partial recovery in oil revenues, and as government spending is gradually trimmed. The baseline assumes gradual implementation of spending and revenue reforms including the introduction of a VAT in the second half of 2018 as part of efforts to diversify revenues. Inflation is expected to rise moderately to 3 percent during the implementation of the VAT, before easing to 2.5 percent in the medium term.

Risks and challenges

Key external risks include spillovers from geo-political tensions and conflict. A strong resurgence of US hydrocarbon output could weigh on global oil prices, particularly if the US sustains its emergence as a major energy exporter. Bouts of global financial volatility as G3 central banks tighten monetary policy could affect the costs of funding given large financing needs in the country.

Longer-term challenges relate to oil dependence. The public sector is one of the largest in the world, with a spending to GDP ratio of 53 percent. Oil rents are distributed through subsidies, transfers and public employment, with 80 percent of employed Kuwaiti nationals working in the public sector. A poor business environment and onerous regulations – Kuwait is ranked 96th out of 190 countries in the Doing Business rankings – have hampered the development of the private non-oil sector. Comprehensive reforms are needed to rebalance the economy away from the energy sector to a more diversified growth path underpinned by innovation, private sector entrepreneurship and job creation, and the quality of its labor force.

TABLE 2 **Kuwait** / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2015	2016	2017 e	2018 f	2019 f	2020 f
Real GDP growth, at constant market prices	0.6	3.5	-1.0	1.9	3.5	3.0
Private Consumption	3.4	5.9	2.2	2.6	3.0	3.0
Government Consumption	-1.5	2.9	4.0	-4.2	-0.4	3.2
Gross Fixed Capital Investment	15.3	14.8	10.3	11.0	8.5	7.1
Exports, Goods and Services	-0.8	-2.1	-5.6	1.5	3.6	2.3
Imports, Goods and Services	6.8	1.1	4.0	5.0	5.0	5.0
Real GDP growth, at constant factor prices	-0.9	2.2	-1.0	1.9	3.5	3.0
Agriculture	-5.3	3.6	0.7	2.3	3.4	3.4
Industry	-1.7	-5.3	-4.4	0.2	4.9	0.6
Services	0.6	14.9	3.7	4.1	1.7	6.0
Inflation (Consumer Price Index)	3.3	3.2	1.6	3.0	2.4	2.5
Current Account Balance (% of GDP)	7.5	-3.4	3.3	4.7	5.1	4.1
Financial and Capital Account (% of GDP)	-8.1	4.9	-4.0	-4.8	-5.3	-4.5
Net Foreign Direct Investment (% of GDP)	-12.8	-5.1	-3.1	-2.1	-2.1	-1.9
Fiscal Balance (% of GDP)	5.8	0.5	3.5	3.7	2.9	2.2
Debt (% of GDP)	11.0	10.2	19.0	27.3	33.2	38.1
Primary Balance (% of GDP)	5.9	0.5	3.7	3.9	3.3	2.7

Source: World Bank, Poverty & Equity and Macroeconomics, Trade & Investment Global Practices.
Notes: e = estimate, f = forecast.

LEBANON

Table 1	2017
Population, million	6.1
GDP, current US$ billion	518
GDP per capita, current US$	8524
National poverty line[a]	27.4
Gini coefficient[a]	318
School enrollment, primary (%gross)[b]	92.4
Life expectancy at birth, years[b]	79.5

Source: WDI, Macro Poverty Outlook, and official data.
Notes:
(a) Most recent value (2011).
(b) Most recent WDI value (2015)

2017 was a politically capricious year, commencing with much optimism emanating from the election of President Aoun and the passage of a series of long-disputed reform measures. The Hariri-Saudi Arabia crisis in November brought anxiety and exchange market pressures, followed by rediscovered unity among the political class. As elections scheduled for May 2018 get closer, domestic political tensions re-emerge. The Paris Investor Conference planned for early April is a rare opportunity for Lebanon to emerge from its economic conundrums, with success hinging on the implementation of a structural reform program.

Recent developments

In 2017, real GDP growth rate is estimated at 2 percent, unchanged from 2016, with the main driver being services and tourism in particular. Over the first 11 months of 2017 (11M-2017), tourist arrivals rose by 10.9 percent (yoy), while hotel occupancy rates averaged 64.4 percent (10M-2017), with the latter registering an increase of 6.9 percentage points (pp) over 2016 and the highest rate since 2010. From the demand side, private consumption is once again driving growth and reversing a three-year (2014-2016) decline in the contribution to GDP growth. On the other hand, both gross fixed capital formation and net exports dragged growth, with the former held by a stagnant real-estate sector (Figure 1). Structurally, the economy remains heavily based on real estate, retail and financial services and oriented towards the region, rendering it vulnerable to security perceptions.

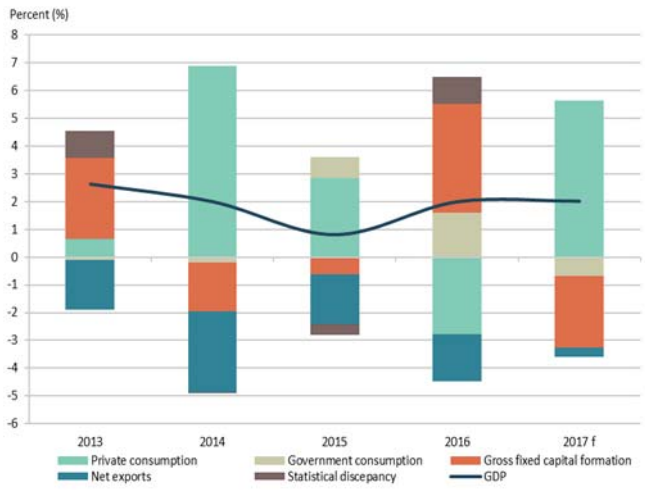
A one-off tax windfall in 2017 generated from large banking sector profits reaped from financial engineering in 2016, boosted tax revenues by an estimated 3 pp to reach 17 percent of GDP. This improvement is reflected on the overall fiscal deficit, which is estimated to have narrowed to 6.6 percent of GDP from 9.6 percent in 2016, along with a larger primary surplus. However, subdued GDP growth and high interest payments mean that the debt-to-GDP ratio persisted in an unsustainable path toward an estimated 153.4 percent by end-2017.

The Hariri-Saudi Arabia crisis on November 4th constituted a significant negative shock for financial markets leading to substantial exchange market pressures. The deposit dollarization rate increased by 288 basis points (bp) in 2017, 145 of which occurred in November and December, to reach 68.72 percent. While outright capital outflows remained inconsequential, dollarization did put pressure on foreign exchange reserves at the Central Bank, Banque Du Liban (BdL).

Slowing deposit inflows combined with large external financing needs has been steadily draining foreign assets from the economy since 2011 (except for 2016 due to large financial engineering operations). In 2017, the net foreign assets (NFA) position accumulated a loss of US$156 million, led by a worsened trade in goods deficit. However, increasingly challenging measures continue to be undertaken by BdL to replenish its reserves, overcoming pressures from the November Crisis; by end-2017, foreign exchange reserves were back at US$42 billion, compared to US$43 billion before the crisis and US$39.6 billion end-2016.

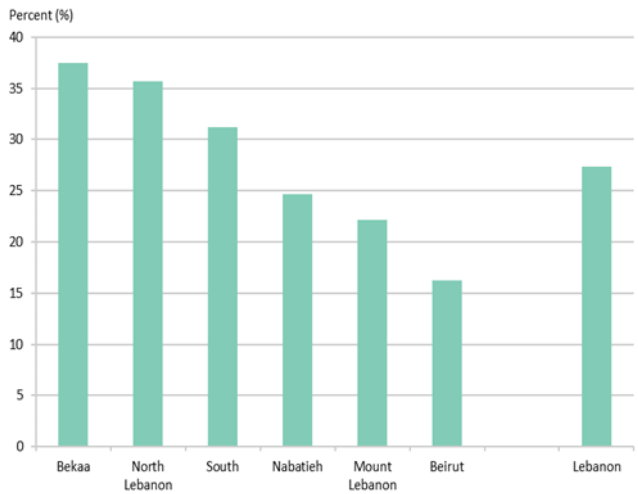
According to the most recent household budget survey in 2011/12, about 27 percent of the population was classified as poor. The highest poverty rates were recorded in the North Lebanon and Bekaa regions, while the largest poverty count was observed in the most populous Mount Lebanon (Figure 2). Poverty rates were significantly higher for workers employed in the agricultural and construction sectors who are paid on a weekly or daily basis. Given the large refugee influx

FIGURE 1 Lebanon / Volatile economic activity reflects frequent shocks.



Sources: Lebanese authorities and WB staff calculations.

FIGURE 2 Lebanon / Poverty rate highest in the Bekaa and North 2011/12.



Sources: Lebanese authorities and WB staff calculations.

after 2011, the poverty rate for 2011/12 most probably does not adequately reflect the current situation.

Outlook

Medium-term economic prospects remain sluggish and macro-financial risks high. Projections of annual growth persist to be around 2 percent over the medium term. In 2018, expected boost to spending motivated by the forthcoming parliamentary elections scheduled in May, will be offset by tightened lending provisions imposed by BdL (as NPL ratios are reportedly significantly higher following a reclassification exercise). Moreover, with imports rising further, net exports of goods and services are projected to continue being a drag.

On the fiscal side, the absence of a tax windfall in 2018 and the persistent rise in interest payments on the public debt will widen the fiscal deficit to a projected 8.3 percent of GDP. Externally, a growing trade deficit along with increasing difficulty in attracting capital inflows are expected to reflect on the foreign exchange position. The November crisis along with more long-term financing challenges and rising FED rates are translating into tightening of liquidity conditions; average deposit rates on LBP and US$ has increased by 850 and 370 bps to reach 6.41 and 3.89 percent, respectively.

The Paris Investor Conference in early April 2018 presents a unique opportunity for Lebanon to effect a sustained boost to the economy, attract much needed capital inflows, help stabilize financial and foreign exchange markets, and catalyze job creation. An essential component of this process is the adoption and implementation of a structural reform program, including a strategy to lower the public debt -to-GDP ratio toward a more sustainable trajectory.

The latest official poverty rate is based on data from 2011/12 and cannot be used for poverty projections due to the substantial structural changes that the country has been undergoing in large part due to the large refugee influx.

Risks and challenges

Security and political challenges continue to be Lebanon's primary concern. A frail macro-fiscal framework, underpinned by unsustainable debt ratios and persistent and sizable twin deficits, within the context of the dollar peg, exposes the country to significant foreign exchange and refinancing risks. The reliance on deposits to finance these imbalances could prove challenging based on recent commercial banks' deposit growth data.

Critical structural reforms in public finances, energy, safety nets and the business environment still elude the government, though some important decisions have recently been made. The draft 2018 budget uses a combination of revenue measures and non-wage recurrent spending restraint to aim for further deficit reduction. But reform is ever more urgent as BdL's solo activism is facing macro-financial risks. The expected increases in global interest rates will make it harder to attract hard currency deposits unless domestic interest rates also rise. Higher NPLs for banks suggest that BdL subsidized loans, in effect now for several years, have run into diminishing returns.

One of the key challenges to improving empirically informed policy is to strengthen the data and analytical base of the government, especially in the Central Administration of Statistics for poverty measurement and monitoring. An improved data system would better inform understanding of the micro-implications of the refugee crisis.

TABLE 2 **Lebanon** / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2015	2016	2017 e	2018 f	2019 f	2020 f
Real GDP growth, at constant market prices	0.8	2.0	2.0	2.0	2.0	2.0
Private Consumption	3.1	-3.0	6.6	2.0	1.1	0.1
Government Consumption	6.0	12.1	-4.8	5.1	3.6	2.0
Gross Fixed Capital Investment	-2.6	17.3	-10.2	9.1	4.8	2.9
Exports, Goods and Services	7.2	-5.0	0.9	7.2	5.6	2.8
Imports, Goods and Services	6.9	0.2	1.1	8.1	4.3	0.3
Real GDP growth, at constant factor prices	0.3	4.6	1.7	1.0	1.9	2.1
Agriculture	-14.0	1.5	3.4	2.5	0.0	2.6
Industry	-5.5	-2.8	-21.1	3.4	2.5	2.6
Services	2.2	6.1	5.3	0.6	1.9	2.1
Inflation (Private Consumption Deflator)	-3.1	-0.8	4.5	4.5	3.5	3.0
Current Account Balance (% of GDP)	-16.3	-19.9	-21.2	-21.6	-20.4	-18.2
Financial and Capital Account (% of GDP)	22.3	18.8	16.7	17.4	15.5	14.2
Net Foreign Direct Investment (% of GDP)	3.4	4.0	3.3	3.2	3.1	3.0
Fiscal Balance (% of GDP)	-7.8	-9.6	-6.6	-8.3	-8.9	-9.3
Debt (% of GDP)	142.2	151.0	151.1	149.3	149.6	150.6
Primary Balance (% of GDP)	1.2	0.0	3.2	2.1	2.0	2.1

Source: World Bank, Poverty & Equity and Macroeconomics, Trade & Investment Global Practices.
Notes: e = estimate, f = forecast.

LIBYA

Table 1	2017
Population, million	
GDP, current US$ billion	
GDP per capita, current US$	
Life expectancy at birth, years[a]	

Source: WDI, Macro Poverty Outlook, and official data.
Notes:

(a) Most recent WDI value (2015)

The relative economic improvement in 2017 remains fragile, as sustaining this dynamic depends crucially on a political resolution that in the current context seems hard to reach. The macroeconomic framework is unstable. It is characterized by record inflation and unsustainable twin deficits, mostly driven by rising budget expenditures. Dwindling savings are keeping pressure on foreign reserves and the LYD continued to lose its value in the parallel markets. To stabilize the macroeconomic framework, Libya needs to launch budget reforms and diversify the economy for growth and job creation.

Recent developments

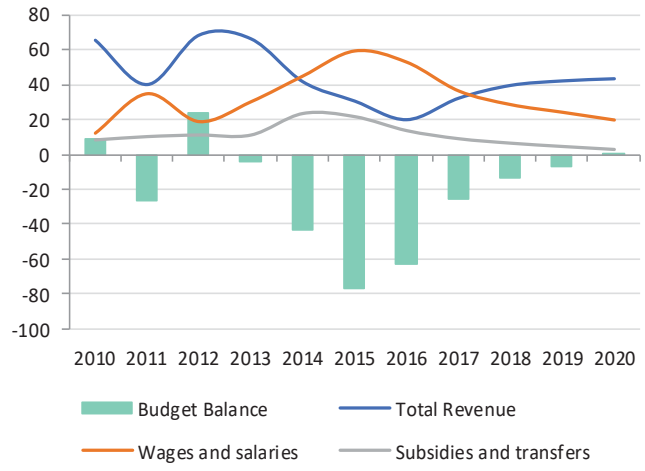
Following four years of recession, the Libyan economy grew strongly in 2017, driven by a welcome recovery in oil production. However, sustaining this dynamic to reach economic potential depends on the resolve of the political strife. Exceptional but fragile implicit arrangements between the parties in conflict allowed the oil sector to more than double its production to an average 0.820 million barrels per day (bpd) in 2017, compared to only 0.380 million in 2016. The non-hydrocarbon sectors remained sluggish inhibited by lack of liquidity and security. GDP is estimated to have increased by almost 27 percent in 2017 allowing income per capita to substantially improve to 63 percent of its 2010 level after losing more than half of its value.

Inflation accelerated, exacerbating further the hardship of the population. Prices of all commodities continued to increase, mainly driven by acute shortages in the supply chains of basic commodities, speculation in the expanding black markets, and the strong devaluation of the LYD in the parallel markets. Consequently, inflation hit a record level of 28.4 percent in 2017 following the 25.9 percent in 2016. High inflation coupled with weak basic service delivery are likely to have increased poverty and exacerbated socio-economic exclusion.

Despite higher hydrocarbon revenues, public finances remained under stress, given the high and rigid current expenditures driven by political motives. Budget revenues almost tripled in 2017 (31.8 percent of GDP) compared to 2016, but remained at half of potential. However, revenues were not even enough to cover public wages (36.4 percent of GDP), which increased due to political hires and higher salaries. Inefficient subsidies (9.2 percent of GDP) continued to absorb a significant amount of budget resources while capital expenditures remained weak (4.8 percent of GDP). Consequently, a high budget deficit persisted at 26 percent of GDP in 2017 (63.1 percent of GDP in 2016). The deficit is being financed mainly through cash advances from the Central Bank of Libya. The domestic debt has quickly increased to reach LYD 59 billion end September 2017, up from LYD 1 billion in 2010.

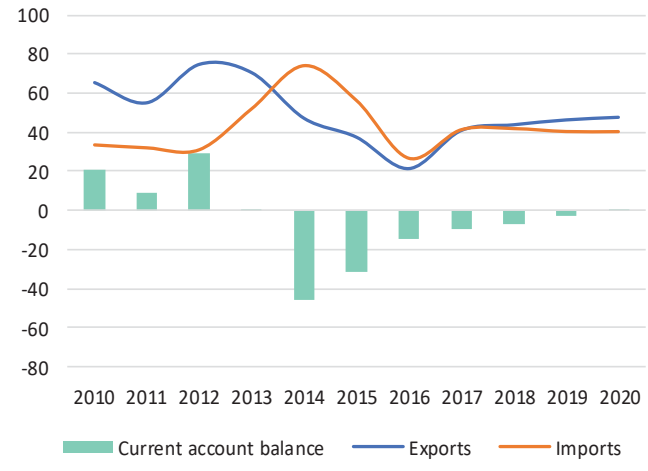
Although improving, the balance of payments continues to suffer from politically-constrained production and export of oil and high consumption-induced imports. Libya managed to substantially increase oil export in 2017 (0.7 million bpd), but remained at half of potential. This relative performance is not enough for a sustainable current account considering the high dependence of Libya on imports to meet consumption and intermediate goods requirements. As a result, the current account deficit remained high at an estimated 9.4 percent of GDP. This deficit was fully financed by net foreign financial inflow, allowing foreign reserves to remain unchanged in 2017 at around US$ 72.6 billion. While the pegged official exchange rate was kept stable, the Libyan Dinar lost around 85 percent of its value in the paral-

FIGURE 1 Libya / High Wage bill and subsidies are still straining public finances



Sources: Government of Libya and World Bank staff estimates.

FIGURE 2 Libya / Although improving, the balance of payments remains unsustainable



Sources: Government of Libya and World Bank staff estimates.

lel market due to the weak macroeconomic fundamentals and an illiquid banking system.

Outlook

At the current pace of spending in a context of conflict and insecurity, Libya will either exhaust foreign exchange reserves or be forced into ad hoc adjustments necessary to stave off crisis, but far from sufficient to reestablish growth foundations. The economic and social outlook assumes that political strife is resolved and a unified government can ensure macrostability and launch a comprehensive program to rebuild the economic and social infrastructures. In this context, it is expected that oil production will progressively increase to reach its potential (around 1.5 million bpd) by 2020, which is the time necessary to restore the heavily damaged oil infrastructure. Growth is projected to rebound at around 15 percent in 2018 and an average 7.6 percent in 2019 -20. Both the fiscal and current account balances will significantly improve, with the budget and the current account running surpluses expected from 2020 onwards. Foreign reserves will start building up by 2020. They will average US$72.5 billion during 2018-2020, representing the equivalent of 27.5 months of imports.

Risks and challenges

The baseline macroeconomic scenario presented above is very fragile because it requires upholding the implicit agreement between the parties in conflict to ensure minimum security around oil infrastructure. Moreover, an improved macroeconomic outlook is unlikely to be sustained and is not sufficient to bring about significant change, unless immediate and targeted actions are taken to address the humanitarian crisis. The country needs humanitarian aid and specific programs to address the destruction and lack of basic services that a large part of the population faces.

Immediate challenges are to restore peace that would lead to macroeconomic stability and to improve basic public services. This calls for immediate actions to bring current expenditures under control, especially the wage bill and subsidies, and improve governance of the financial sector, which will also contribute to price stability. Over the medium term, the country needs broader and deeper structural reforms to stabilize the macroeconomic framework and promote private sector-led job generation. Other medium-term priorities should focus on promoting the development and diversification of the private sector for job creation through policies to reorient the economy away from hydrocarbon dependence, reforming the financial sector, and improving the business environment.

Libya's economic fragility has important consequences for the people's well-being. Although there is no systematic study on poverty and very little evidence on the current well-being of Libyan households, it is not unrealistic to think that for most of Libyans living conditions are dire. Since hydrocarbons account for a large share of GDP and government revenues (40 and 86 percent respectively), the sharp decline in oil exports started in 2011 has severely impacted public services. The erratic power supply and the recurrent food shortages also contribute to worsening conditions for people. In the current situation, large share of the population is either vulnerable to poverty or has fallen into poverty.

TABLE 2 **Libya** / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2015	2016	2017 e	2018 f	2019 f	2020 f
Real GDP growth, at constant market prices	-8.9	-2.8	26.7	14.9	9.4	7.5
Private Consumption	-22.5	-12.0	16.3	7.5	4.3	4.2
Government Consumption	-19.5	-34.1	32.5	2.3	-0.9	-0.9
Gross Fixed Capital Investment	-42.2	-19.4	86.4	42.0	8.3	11.6
Exports, Goods and Services	9.0	-27.0	143.9	22.2	17.1	12.0
Imports, Goods and Services	-37.1	-42.4	114.8	25.0	7.1	9.1
Real GDP growth, at constant factor prices	..	..	..	..	..	..
Hydrocarbon	-15.8	-5.4	116.7	30.2	17.5	12.4
Non-hydrocarbon	-6.5	-2.0	0.0	5.0	3.0	3.0
	..	..	..	..	..	..
Inflation (Consumer Price Index)	9.8	25.9	28.4	10.0	5.0	5.0
Current Account Balance (% of GDP)	-31.4	-14.6	-9.4	-7.2	-3.0	0.6
Fiscal Balance (% of GDP)	-76.9	-63.1	-26.0	-13.2	-7.1	0.2

Source: World Bank, Poverty & Equity and Macroeconomics, Trade & Investment Global Practices.
Notes: e = estimate, f = forecast.

MOROCCO

Table 1	2017
Population, million	35.7
GDP, current US$ billion	110.2
GDP per capita, current US$	3083
National poverty line[a]	4.8
Gini coefficient[a]	39.5
School enrollment, primary (% gross)[b]	114.7
Life expectancy at birth, years[b]	75.5

Source: WDI, Macro Poverty Outlook, and official data.
Notes:
(a) Most recent value (2014).
(b) Most recent WDI value (2015)

Economic growth has recovered in 2017, while non-agricultural activity remained subdued, reflecting an economy, which the production still depends on rain-fed agriculture. Thanks to prudent fiscal policy, the fiscal deficit was reduced to 3.5 percent of GDP. Although, Morocco's current account deficit declined, the trade deficit widened due to high energy prices. Job creation has improved, but unemployment remained high especially for the young. Over the medium term, the challenges include broadening the middle class and catalyzing the private sector.

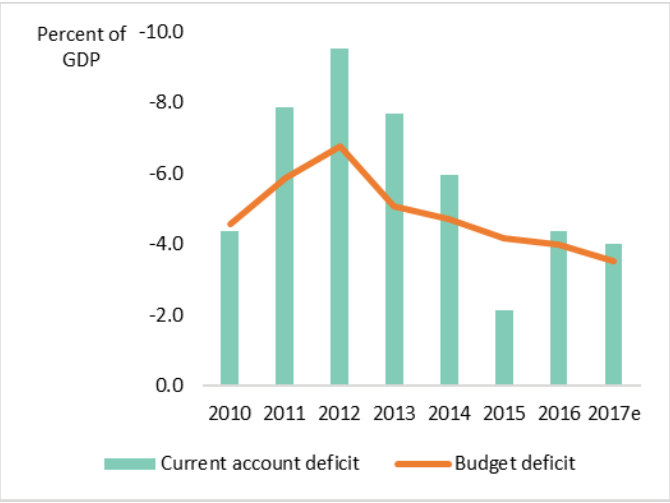
Recent developments

Following a sharp slowdown in 2016, real GDP growth rate reached 4 percent in 2017 (from 1.2 percent in 2016), boosted by a strong rebound in agricultural output. Driven by better than average cereal production, the agricultural sector has experienced a strong recovery, with a growth rate of 15.1 percent. However, non-agricultural GDP remained sluggish at around 2.8 percent. Mining activities contributed the most to growth outside agriculture, mostly driven by the recovery in phosphates. Inflation remained low at 0.7 percent. Unemployment remained on an upward trend, rising from 9.9 in 2016 to 10.2 percent in 2017, especially prevalent among the young and the educated, as well as women (26.5 percent 17.9 percent and 14.7 percent respectively), reflecting the weak capacity of the economy to generate inclusive growth. International poverty estimates for Morocco are expected to be available in June 2018. Results based on the national poverty line indicate a sharp decline in poverty between 2001 and 2014. Poverty was at 15.3% in 2001 and declined to 8.9% in 2007 before dropping to 4.8% in 2014.

The fiscal deficit declined in 2017, while the slight improvement of exports was not enough to reduce the trade deficit as imports increased. Thanks to prudent fiscal policy, the fiscal deficit was reduced to 3.5 percent of GDP in 2017 and the central government debt ratio has been stabilized at around 65.1 percent. Regarding the current account deficit, it is estimated to have declined to 4 percent of GDP in 2017 (compared with 4.4 percent in 2016). The trade deficit widened by 2.8 percent despite the surge in phosphates exports. In fact, exports picked up by 9.4 percent, while imports increased by 6.4 percent (from a larger base), reflecting a sharp rise in oil prices. Tourism receipts and remittances remained steady.

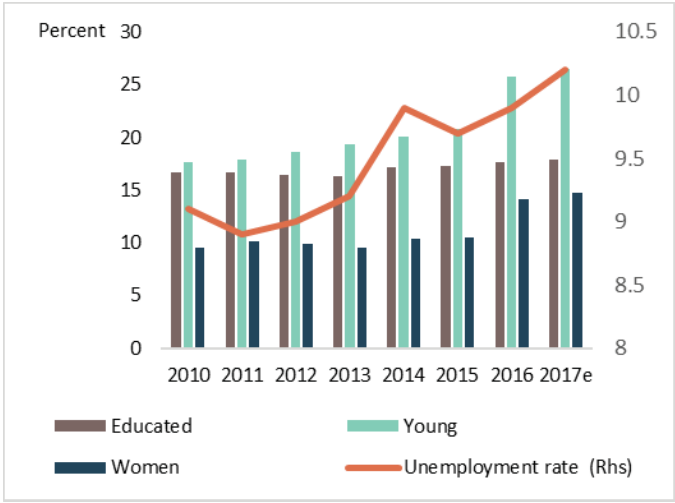
Morocco's Central Bank finally adopted the reform towards a more flexible exchange regime, allowing the currency to fluctuate within a wider band of ± 2.5 percent, compared with the previous band of 0.3 percent. The reform was delayed given expectations that it would start last July, but the government appears to have strong ownership of the reform since its introduction in mid-January 2018. Two reasons could explain this shift: first, the shock absorption capacity of the economy had been weak, particularly given current constraints on fiscal space, and exchange rate flexibility will help; secondly, the uncertainty in which the global economy is evolving which involves strong external risks and again more ability to adjust. While this reform could increase vulnerability to increases in the price of imported goods, the benefits of greater competitiveness and less exposure to other forms of economic shock would more than outweigh the costs of the move. In addition, this reform will allow the country to be better-positioned for a flexible credit line arrangement with the IMF.

FIGURE 1 **Morocco** / Morocco's twin deficits



Sources: Ministry of economy and finance, World Bank staff estimates.

FIGURE 2 **Morocco** / Young, women, educated



Source: High-Commission of Planning.

Outlook

GDP growth is projected to decline to 3 percent in 2018. Cereal production is projected to return to its historical average and non-agricultural GDP growth is expected to remain around 3 percent in the absence of more decisive structural reforms.

The fiscal deficit is expected to decline to 3.3 percent of GDP in 2018 in line with the government's commitment to bring down the deficit to 3 percent of GDP by 2019-2021 and to reduce public debt to 60 percent of GDP by 2021. To achieve this target, it would be appropriate for the government to ensure a comprehensive tax reform including measures to reduce tax exemptions, lower corporate tax rates, and better enforce tax payments by the self-employed and liberal professions and improved public investment management. In line with this fiscal consolidation and oil price projections, the current account deficit is projected to remain below 4.5 percent of GDP in 2018.

Over the medium term, Morocco's economic outlook should improve provided the government remains committed to implement deep and comprehensive reforms. The outlook remains linked to continued fiscal consolidation, flexibly managed exchange rate regime and to the implementation of structural reforms in key areas such as education and the labor market in order to reduce unemployment, especially among the young, improve the business environment, and enhance human capital for higher and inclusive growth.

Risks and challenges

Morocco's growth model shows signs of weaknesses as it is confronted with a series of sustainability issues that risk, with varying degrees of intensity, impeding further progress. The economic model based on domestic demand, especially public investment, risks petering out without a significant increase in investment spillovers and productivity. Growth in the past two decades has been mainly based on public capital accumulation, sometimes through FDI joint ventures with SOEs, that will be difficult to maintain without higher total factor productivity gains in the future. This calls for a shift toward a more export-led model, where the private sector is playing a greater role as an engine of growth and employment.

Slow job creation and entry barriers generate high unemployment among the young and educated. With the working age population increasing by 300,000 a year, job creation, at 129,000 per year, has been insufficient. Youth unemployment is twice the rate of total population. This rate among urban youth has been worsening since the financial crisis, growing from 31.3 percent in 2010 to 41 percent in 2016. Furthermore, unemployment spells tend to be long: more than 70 percent are unemployed for more than a year, and this share is higher among those with tertiary education.

The persistence of vulnerabilities and the lack of inclusion remain the main challenges for Morocco's economy. These are closely related to the lack of inclusive and contestable market institutions, public governance, human capital formation, and opportunities for productive jobs or entrepreneurship in urban areas. Climate change adaptation is increasingly urgent, and will require policy reforms and investment.

TABLE 2 **Morocco** / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2015	2016	2017 e	2018 f	2019 f	2020 f
Real GDP growth, at constant market prices	4.5	1.2	4.0	3.0	3.5	3.7
Private Consumption	2.3	3.4	4.0	3.1	3.7	3.4
Government Consumption	2.4	2.1	0.8	1.7	1.3	1.1
Gross Fixed Capital Investment	0.2	9.3	3.4	3.9	4.4	4.6
Exports, Goods and Services	5.5	5.1	8.8	6.1	7.3	7.5
Imports, Goods and Services	-1.1	15.4	5.9	5.6	5.1	5.6
Real GDP growth, at constant factor prices	3.2	0.0	4.4	2.3	4.5	3.8
Agriculture	11.6	-11.3	13.6	-1.8	10.5	3.6
Industry	1.8	1.2	2.9	2.9	3.1	3.3
Services	1.7	2.7	2.7	3.1	3.6	4.1
Inflation (Consumer Price Index)	1.6	1.6	0.7	1.5	1.2	1.2
Current Account Balance (% of GDP)	-2.1	-4.4	-4.0	-4.2	-4.4	-4.5
Fiscal Balance (% of GDP)	-4.2	-4.0	-3.5	-3.3	-3.0	-3.0
Debt (% of GDP)	63.7	64.7	65.1	65.0	65.0	65.0
Primary Balance (% of GDP)	-1.4	-1.3	-1.0	-1.0	-0.7	-1.0

Source: World Bank, Poverty & Equity and Macroeconomics, Trade & Investment Global Practices.
Notes: e = estimate, f = forecast.

OMAN

Table 1	2017
Population, million	4.9
GDP, current US$ billion	73.7
GDP per capita, current US$	15121
School enrollment, primary (% gross)[a]	109.3
Life expectancy at birth, years[a]	77.1

Source: WDI, Macro Poverty Outlook, and official data.
Notes:

(a) Most recent WDI value (2015)

Real GDP growth in 2017 remained broadly flat due to Oman's participation in the OPEC+ oil production cuts and fiscal austerity. The current account deficit has narrowed but remains large. Similarly, the fiscal account deficit is estimated to have narrowed in 2017, and partially financed through external borrowing—leading to rapidly rising debt. The outlook is set to improve as growth picks up following a boost in oil and gas and from expected gains in the non-oil sector resulting from the government's economic diversification plan.

Recent developments

Growth in Oman was subdued in 2017 due to lower oil production and weaker consumption and investment. Real GDP growth is estimated to have slowed down to 0.7 percent in 2017, compared with 5.4 percent in 2016, which was driven by record high oil production levels (1 million bd). In 2017, Oman joined most OPEC non-members in oil production cuts, leading to a contraction of the hydrocarbon sector by 3 percent. Private consumption, although dampened due to fiscal austerity, is estimated to be the main driver of growth in 2017. The current account deficit is estimated to have improved to 11.7 percent in 2017 from 18.4 percent of GDP in 2016 on the back of higher oil prices. Oman has also benefitted from the ongoing Gulf sanctions on Qatar through the re-routing of trade by Qatar away from Saudi Arabia and the UAE [to Oman]. Given its peg to the US Dollar the Central Bank of Oman implemented a gradual rate increase to match the US Fed hikes. Inflation increased slightly from 1.1 percent in 2016 to 1.5 percent in 2017 reflecting the ongoing subsidy reform.

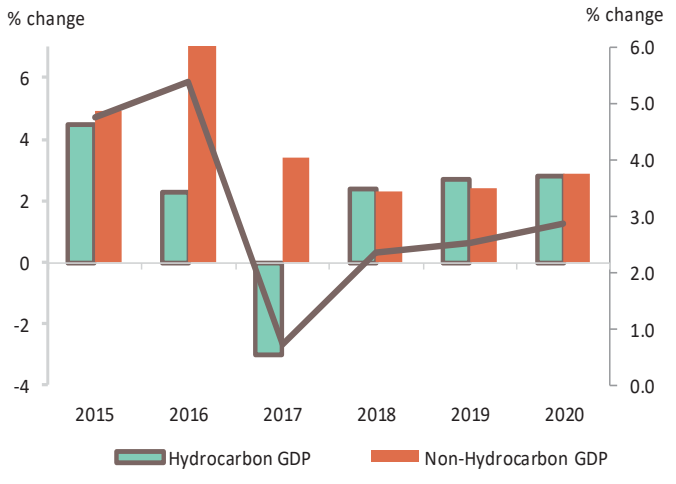
Fiscal outturns indicate that Oman is on course to narrow its fiscal deficit in 2017 on the back of stronger oil revenue and lower expenditure. Savings came from higher utility tariffs on large customers and lower defense spending. Overall, the government, which has had the biggest fiscal deficit in the GCC in the past two years, managed to cut the budget deficit by 30 percent to an estimated 13.3 percent of GDP in 2017 (from 20.6 percent of GDP in 2016). Oman raised US$5 billion from international debt markets and US$2 billion from sukuk to finance its fiscal needs in 2017. Foreign borrowing has been critical in easing the strain on reserves given the structural large negative items on the current account.

The main social concern for Oman is the lack of jobs and the adverse effects of subsidy reform on vulnerable households. The most recent ILO estimate of unemployment was 17 percent in 2017, while youth unemployment is approximately 49 percent—a pressing challenge in Oman where over 40 percent of the population is under the age of 25. In January 2018 the authorities launched an initiative to provide 25,000 new jobs in the private sector and stopped issuing visas to expats for certain professions. The government announced mitigation measures to support the vulnerable population in 2018; (1) it will allocate 100 million rials (US$260 million) to support needy households, (2) a new fuel subsidy scheme where households with an income below 600 rials will receive 200 liters of petrol per month at a subsidized rate.

Outlook

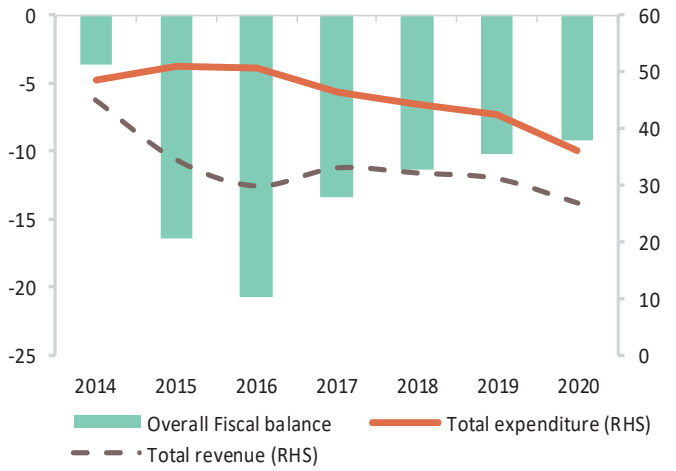
Economic growth is set to modestly recover over the medium term. In 2018, a boost in the hydrocarbon sector is expected to drive the recovery as the Khazzan gas production expands. In the outer years, as

FIGURE 1 **Oman** / Real Annual GDP growth



Sources: Omani Authorities, World Bank Staff estimates.

FIGURE 2 **Oman** / General Government Operations (in percent of GDP)



Sources: Omani Authorities, World Bank Staff estimates.

the "OPEC plus" restrictions on oil supply are lifted and as the gradual recovery of oil prices improves confidence and encourages private sector investment, GDP growth is projected to rebound to 2.9 percent by 2020. Over the longer term, probusiness reforms such as foreign ownership, FDI, SME support and PPP laws are expected to increase trade and investment. A further impetus to growth will be provided by rising natural gas exports from the seven-year natural gas supply deal signed between BP and Oman LNG. Monetary policy will remain tight as interest rates continue to rise. Owing to the hike in electricity tariffs and the VAT, inflation is expected to inch up to 3 percent in 2019 before moderating in 2020 as cost push pressures from subsidy reform dissipate.

The approved budget for 2018— deficit of OMR3 billion (US$7.8 billion) and 10 percent of projected GDP— indicates an expansionary fiscal policy. The introduction of the GCC-wide 5 percent VAT has been postponed to 2019, so higher revenues in 2018 will come from, in addition to higher oil revenues, higher corporate income tax, excises and the privatization of public companies. In January 2018, Oman issued US$6.5 billion in a triple-tranche of sovereign bonds, its largest issuance ever, to plug 2018 financing needs. Over the medium term, the recovery in oil prices, VAT and higher corporate income tax, propelled by higher economic growth are expected to narrow the fiscal deficit to 9.1 percent by 2020. Oman's sovereign wealth funds, partially used to finance fiscal deficits since 2014, are estimated at US$24 billion. However greater reliance on foreign borrowing will raise public debt to over 50 percent of GDP by 2020 from 34 percent in 2016. The current account deficit is projected to improve to 8.2 percent by 2020 as oil prices rise, non-oil exports grow, and as both the Miraah solar plant and the construction of a new US$600m oil terminal in Sohar make more crude oil available for export.

Risks and challenges

Inclusive economic growth hinges on the timely implementation of diversification reforms, but fiscal strain continues to delay development spending envisaged under the 9th Development Plan. The government is looking towards increasing PPPs which are currently hampered by falling investor confidence in the region. Moreover, with a rapidly rising population, social pressures will continue to mount if the private sector fails to provide enough jobs and fiscal constraints limit the government's ability to create jobs. The long-term solution needs to be based on a more fluid labor market and improvements in business climate and education system tailored for the needs of the economy.

The overall economic outlook is vulnerable to several risks. If the planned consolidation does not materialize, the government's fiscal policy risks losing credibility with negative consequences for financing. External risks include a collapse in the OPEC deal which could send oil prices back down, and US interest rate hikes. The possible weakening of the US Dollar could raise import costs and deteriorate the external balance. A continued slowdown in China, Oman's main trading partner, would add to downside risks. Financing conditions may become more challenging given the expansion in debt, especially if, with higher U.S. rates, investor sentiment shifts away from emerging markets. These stresses are already evident in several ratings downgrades, most recently by Moody's.

TABLE 2 **Oman** / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2015	2016	2017 e	2018 f	2019 f	2020 f
Real GDP growth, at constant market prices	4.7	5.4	0.7	2.3	2.5	2.9
Private Consumption	2.9	1.9	1.5	2.5	3.0	3.0
Government Consumption	0.8	-2.2	-3.2	0.9	1.7	2.3
Gross Fixed Capital Investment	-0.4	9.4	4.4	3.0	3.4	3.9
Exports, Goods and Services	-9.4	2.3	-1.6	2.5	3.0	3.2
Imports, Goods and Services	-3.2	-1.5	-1.1	2.3	3.5	3.5
Real GDP growth, at constant factor prices	..	..	..	..	..	..
Agriculture	..	..	..	..	..	..
Industry	..	..	..	..	..	..
Services	..	..	..	..	..	..
Inflation (Consumer Price Index)	0.1	1.1	1.5	2.2	3.0	2.8
Current Account Balance (% of GDP)	-15.5	-18.4	-11.7	-10.4	-9.2	-8.2
Fiscal Balance (% of GDP)	-17.5	-20.6	-13.3	-11.3	-10.1	-9.1

Source: World Bank, Poverty & Equity and Macroeconomics, Trade & Investment Global Practices.
Notes: e = estimate, f = forecast.

PALESTINIAN TERRITORIES

Table 1	2017
Population, million	4.7
GDP, current US$ billion	14.9
GDP per capita, current US$	3182
Upper middle-income poverty rate ($5.5)[a]	20.7
Gini coefficient[a]	34.4
School enrollment, primary (% gross)[b]	94.3
Life expectancy at birth, years[b]	73.3

Source: WDI, Macro Poverty Outlook, and official data.
Notes:
(a) Most recent value (2011), 2011 PPPs.
(b) Most recent WDI value (2015)

The impetus to growth from the initial recovery following the 2014 war has ended resulting in growth dropping to 2.4 percent in Palestine in Q32017. At 27 percent, unemployment continues to be stubbornly high and about 21 percent of the population lives below US$5.5 2011 PPP a day. Given the ongoing constraints to economic competitiveness, medium term growth is projected at 2.3 percent. Further reductions in transfers to Gaza, lower aid and the possibility of conflict pose downside risks to growth and employment.

Recent developments

Economic conditions in the Palestinian territories deteriorated with growth dropping to 2.4 percent in the first three quarters of 2017, down from 4.7 percent in 2016. The decline was mainly driven by a deterioration in Gaza where the economy is estimated to have grown by a mere 0.5 percent following a large drop in aid for reconstruction and a severe liquidity squeeze as almost a quarter of Gazans have seen their income significantly drop since mid-2017. Meanwhile, growth in the West Bank reached 3 percent in the first three quarters of 2017 - only slightly below its rate in the previous year, and was concentrated in activities less impacted by the Israeli restrictions including construction, wholesale and retail trade in addition to services.

Unemployment in the Palestinian territories continued to be high at 27 percent in 2017. In Gaza, it reached 44 percent compared to 18 percent in the West Bank. In 2017, only 41 percent of those aged between 15 and 29 were active in the labor market, reflecting high pessimism regarding employment prospects. Despite a low participation rate, unemployment amongst this category reached a staggering 60 percent in Gaza. There are also dramatic differences in labor force participation by gender. Male participation rates reached 71 percent in 2017 while women have recent participation rates of 19 percent.

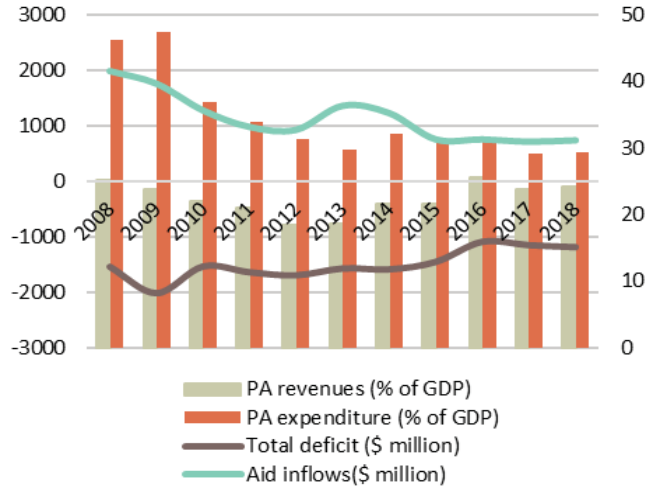
The latest poverty numbers for 2011 suggest that about 21 percent of the Palestinian population lives below the US$5.5 a day poverty line. Poverty is expected to have been volatile in the following years witnessing a strong increase after the war in 2014 before gradually declining to pre-crises levels and then increasing again in 2017 due to the recent decline in incomes in Gaza. Inflation continued to be subdued in 2017 with overall prices increasing by a mere 0.2 percent. The Israeli Shekel, which is the main currency in circulation in the Palestinian territories, continued its appreciation in 2017 and this had a deflationary effect on the prices of imported goods. In addition, the prices of food products (most of which are produced domestically or in Israel) remained low in 2017.

The Palestinian Authority's (PA) fiscal performance improved in 2017 but the fiscal stance remained tight due to lower than needed aid. The total deficit (before grants) amounted to US$1.14 billion in 2017 or 7.7 percent of GDP – down from 8 percent in the previous year. Aid received amounted to US$719 million and was 11 percent lower than in 2016, resulting in a financing gap of about US$420 million. To fill the gap, the PA resorted to domestic sources of financing. It increased its net domestic bank financing by US$85 million resulting in its total domestic debt reaching US$1.5 billion, as of December 2017.

The PA also resorted to arrears accumulation and despite repaying some dues from previous years, net accumulation in 2017 reached US$338 million.

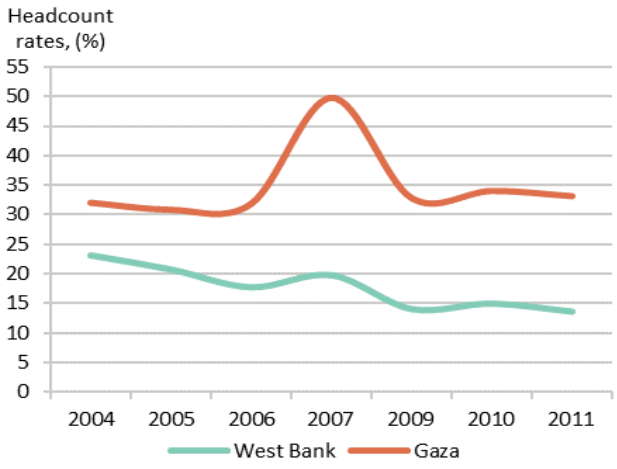
Despite a decline in the trade deficit, the external current account deficit (including

FIGURE 1 Palestinian territories / Estimates and outlook: public finances



Sources: Palestinian MoF and staff estimates.

FIGURE 2 Palestinian territories / 2011 PPP poverty line in the West Bank and Gaza



Source: Palestinian Bureau of Statistics.

official transfers) is estimated to have widened in 2017 to 12 percent of GDP due to a drop-in transfers. The trade deficit stood at 37 percent of GDP in 2017 – 2 percentage points lower than in 2016 following a drop-in imports from Israel. Exports continue to be constrained by the ongoing trade restrictions and have remained low and stagnant at around 18 percent of GDP. Current transfers as a share of GDP dropped from 17 percent in 2016 to 13 percent due to a decline in both private and official transfers.

Outlook

The economic outlook for the Palestinian territories is worrying. Under a baseline scenario that assumes persistence of the Israeli restrictions and the internal divide between the West Bank and Gaza, real GDP growth of the Palestinian economy is projected to decline to 2.3 percent in the medium term. This modest growth implies a decline in real per capita income and an increase in unemployment.

Given the low growth projections, poverty rates are not likely to decline. If the flow of aid revenues is lower than projected or another episode of conflict erupts, poverty will increase sharply in Gaza. New data from the 2016/2017 Expenditure and Consumption Survey will be available shortly and will clarify the picture.

The fiscal deficit (before grants) is expected to remain constant as a share of GDP in 2018, at 7.7 percent, and amount to US$1.18 billion. At the same time, foreign aid is expected to reach US$745 million, leaving a financing gap in excess of US$0.4 billion. If ongoing reconciliation talks between the PA and the *de facto* authority in Gaza progress and result in higher public spending in Gaza, the financing gap could hover around US$0.9 billion. PA actions alone will not be enough to fully close the gap, even prior to reconciliation. Unless donor aid is significantly stepped up, the PA will be forced to exhaust domestic sources of financing including debt from local banks and arrears to the private sector and the pension fund. This would eventually choke the economies of both the West Bank and Gaza and impose large negative consequences on suppliers, banks and ultimately growth and tax generation.

The Palestinian territories' current account is expected to remain unfavorable in the coming years due to the persistently large trade deficit. The share of Palestinian exports in the economy is expected to remain stagnant at 18-19 percent in the medium term due to the ongoing Israeli restrictions on trade. The Palestinian territories will continue to heavily depend on imports to meet even some of their basic needs, and hence the share of imports in the economy will hover around 56 percent. Consequently, the current account deficit is expected to remain high in the coming years at about 12-13 percent of GDP.

Risks and challenges

A sustainable economic recovery in the Palestinian territories is not possible given the stalemate in the peace process, ongoing restrictions imposed by Israel alongside internal political divisions. As a result, downside risks to growth and employment remain significant. In Gaza, if the United Nations Refugee and Works Agency's (UNRWA) funding gap is not offset, this will have a severe impact on its ability to provide education, health services and food parcels to more than one million Gazans and will result in cuts to the income of around 13 thousand UNRWA employees. Consequently, economic and social conditions in the Strip will further deteriorate, significantly raising the potential for unrest. There are also significant downside risks on the West Bank, including if donor support declines faster than expected.

TABLE 2 **Palestinian territories** / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2015	2016	2017 e	2018 f	2019 f	2020 f
Real GDP growth, at constant market prices	3.4	4.7	2.7	2.5	2.3	2.3
Private Consumption	6.2	3.3	4.3	3.8	3.2	3.0
Government Consumption	5.8	1.8	3.5	3.5	3.0	2.8
Gross Fixed Capital Investment	9.0	-0.9	1.6	-1.1	-1.3	-1.1
Exports, Goods and Services	2.6	1.9	6.8	5.0	3.0	3.0
Imports, Goods and Services	9.5	0.2	6.5	4.5	3.0	2.6
Real GDP growth, at constant factor prices	1.5	4.3	2.7	2.5	2.3	2.2
Agriculture	-7.2	-8.1	0.0	0.7	1.0	1.2
Industry	-3.0	7.5	3.5	3.8	4.0	4.0
Services	3.5	4.0	2.6	2.1	1.7	1.7
Inflation (Consumer Price Index)	1.4	-1.0	0.2	1.2	2.5	2.5
Current Account Balance (% of GDP)	-16.3	-10.4	-12.4	-12.6	-12.5	-12.0
Financial and Capital Account (% of GDP)	19.4	8.7	10.3	10.7	10.7	9.4
Net Foreign Direct Investment (% of GDP)	0.2	1.2	1.1	1.1	1.1	1.2
Fiscal Balance (% of GDP)	-5.1	-4.0	-2.8	-2.8	-2.9	-2.9

Source: World Bank, Poverty & Equity and Macroeconomics, Trade & Investment Global Practices.
Notes: e = estimate, f = forecast.

QATAR

Table 1	2017
Population, million	2.4
GDP, current US$ billion	164.0
GDP per capita, current US$	69705
School enrollment, primary (% gross)[a]	103.0
Life expectancy at birth, years[a]	78.5

Source: WDI, Macro Poverty Outlook, and official data.
Notes:

(a) Most recent WDI value (2015)

GDP growth is estimated to have remained flat at 2.2 percent in 2017, in part reflecting the effects of the ongoing rift with its neighbors. However, growth is expected to strengthen in the medium term to close to 3 percent, supported by rising oil and gas output and 2022 FIFA World Cup related spending. Reforms protecting foreign workers and introducing permanent residency rights for expats will help with longer-term diversification efforts.

Recent developments

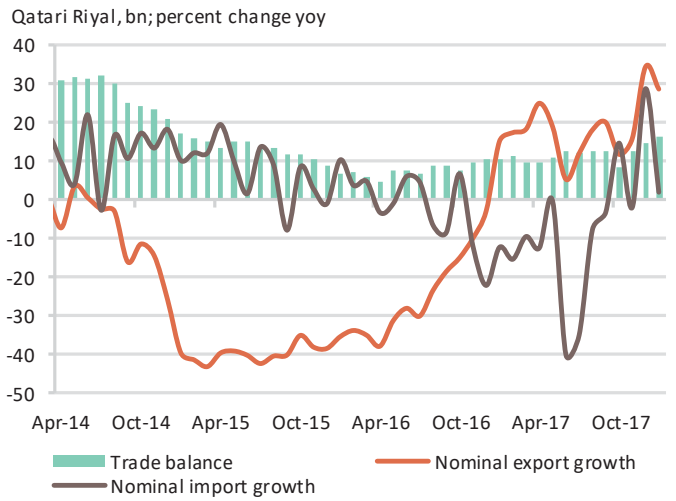
Qatar has been affected by, but is successfully adjusting to, the diplomatic rift with its Arab neighbors that started in mid-2017. The severing of diplomatic ties and freezing of trade flows by Saudi Arabia, the UAE, Bahrain, and Egypt in June 2017 led to an initial sharp drop in imports of 40 percent yoy in June 2017, and contributed to an increase in food inflation. It also dented investor sentiment, visible in a sell-off in equities, squeezed commercial bank access to foreign funds as non-resident deposits at Qatari banks dropped sharply, rising interbank rates and falling foreign exchange reserves.

However, the impact has been short-lived. A re-routing of trade (using Iranian airspace and Omani ports, and opening the new US$7.4 billion Hamad Port), and a diversification of sources of imports (purchasing food through Iran, Oman, Turkey and China) and enhancing domestic food processing. As a result, food inflation has decelerated, while goods imports are back to pre-dispute levels. The banking system remains well capitalized, and asset quality strong, and the liquidity pressures that emerged mid-2017, have waned. While non-resident deposits remain down 25 percent relative to mid-2017 levels, nevertheless, they have been more than fully offset by an influx of government deposits into the domestic banking system of US$43 billion (26 percent of GDP) in public sector–mostly Qatar Investment Authority (QIA)–assets, previously held abroad. The economy rebounded in the third quarter, and growth for the year as a whole is anticipated at 2.2 percent, the same as in 2016. Headline inflation remained muted at 0.5 percent yoy in December.

Qatar's gas exports have also continued despite the diplomatic rift and its LNG market share remains around 30 percent, mainly supplying Japan and other customers in Asia. The steep fall in imports mid-2017 and rising export earnings due to the partial recovery in global energy prices helped to shift the current account back into surplus in the first 3 quarters of 2017, after posting a deficit of 5.5 percent in 2016 (the first in 17 years). Foreign exchange reserves are recovering, rising from a low of US$35.6 billion in September 2017 to US$37.6 billion by end-year.

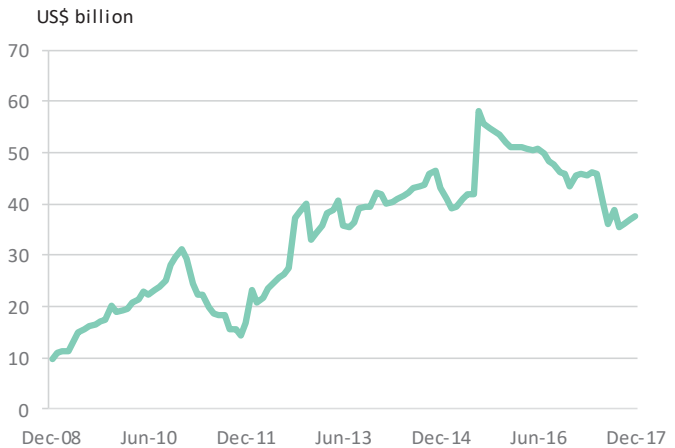
Fiscal consolidation, and the recovery in energy receipts more recently, has placed the fiscal deficit on a narrowing trajectory. In response to the fall in international oil and gas prices, the government had cut back current spending and embarked on energy subsidy reform. Notably it had also pared back a substantial public investment program for 2014-2024 to US$130 billion from US$180 billion, prioritizing projects related to the FIFA 2022 World Cup. As a result, the fiscal deficit is estimated to have declined to 5.0 percent of GDP in 2017 from over 8.3 percent in 2016. The fiscal costs of dealing with the blockade will not pose a substantial risk to fiscal stability given huge financial buffers held by the sovereign wealth fund, the Qatar Investment Authority (QIA).

FIGURE 1 **Qatar** / Goods Trade Balances



Source: Haver.

FIGURE 2 **Qatar** / International Reserves, US$ billion



Sources: Qatar Central Bank, Haver.

Absolute poverty is not an issue for citizens. In the context of the National Development Strategy 2011-16 the authorities have adopted a national relative poverty line and a welfare measurement methodology to track living standards of the population and identify vulnerable households. This threshold is equal to the half of the median household's income, and about 8 percent of Qataris in 2013 lived on an income less than that—a share broadly unchanged from 2007. Lower incomes correlated with household dependency ratio, job market status, educational attainment, female headship and disability.

Spatial differences in welfare exist, both for monetary and non-monetary measures, notably between more urbanized and less urbanized areas. Expatriate workers face additional challenges, from delays or withholding of wages, poor working conditions, substandard employer-provided accommodation, irregular recruitment practices and lack of information on how to enforce their rights.

Outlook

Growth is expected to recover to 2.8 percent in 2018, and rise further to an average of 3 percent in 2019/20, as rising energy receipts help ease fiscal constraints, spending on the multi-year infrastructure upgrade ahead of the FIFA World Cup continues and as the US$10 billion Barzan natural gas facility comes onstream in 2020. Qatar's peg to the US Dollar means that monetary policy will gradually tighten in tandem with the US. Government efforts to ease the costs and to lighten the effects of the blockade on the population will likely limit the scope for cutting spending sharply. Nevertheless, key tax policy and administration measures, including the introduction of a VAT and excises during 2018 are expected to further contain the fiscal deficit over the medium term, although inflation should also rise to close to 2.4 percent as a result in 2018. A recovery in imports, in particular capital goods related to infrastructure spending, should keep the current account surplus modest in the near term.

Risks and challenges

In the near term, downside risks stem from the ongoing diplomatic crisis. Over the medium term, the emergence of new suppliers in the United States, East Asia and Africa and rising global gas supply (including from Qatar's North Field) poses downside risks to global LNG prices. Other external risks include regional instability risks, and global financial volatility that affects capital flows and cost of funding although these are mitigated by narrowing fiscal deficits and the return to current account surplus. On the domestic front, delays in the implementation of the VAT and other taxes will reinforce dependence of public sector finances on hydrocarbons sector, which accounts for nearly 90 percent of government revenues (directly and indirectly).

Qatar's investment-driven growth strategy over the past decade has helped to transform standards of living for citizens, but has also given rise to concerns including sustainability with persistently low energy prices, signs of excess capacity and demographic imbalances. Given the uncertain medium-term outlook for the gas sector, the development of the non-hydrocarbon sector is critical. Recent permanent residency reforms are an important step, and a first among GCC countries, to help attract and retain highly skilled foreign workers needed to achieve long term objectives become a knowledge economy. In addition, Qatar will also need to raise the productivity of its human and physical capital, and undertake structural reforms to improve the business environment.

TABLE 2 **Qatar** / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2015	2016	2017 e	2018 f	2019 f	2020 f
Real GDP growth, at constant market prices	4.0	2.2	2.2	2.8	3.2	2.8
Private Consumption	8.1	3.5	1.2	2.5	2.5	2.0
Government Consumption	1.1	-21.0	-2.5	0.2	0.0	-0.1
Gross Fixed Capital Investment	1.4	8.0	2.2	5.4	6.4	3.8
Exports, Goods and Services	-0.8	1.7	0.5	2.5	3.0	3.4
Imports, Goods and Services	-8.9	-3.9	-5.0	4.0	5.0	4.0
Real GDP growth, at constant factor prices	4.0	2.1	2.2	2.8	3.2	2.8
Agriculture	8.7	4.0	0.4	1.5	1.9	1.9
Industry	2.0	2.0	0.5	1.9	2.4	2.4
Services	8.6	2.2	6.1	4.7	4.8	3.6
Inflation (Consumer Price Index)	1.9	2.9	0.4	2.4	2.0	1.5
Current Account Balance (% of GDP)	8.5	-7.5	2.6	3.8	3.3	3.2
Financial and Capital Account (% of GDP)	-7.7	6.4	-3.7	-4.9	-4.2	-4.4
Net Foreign Direct Investment (% of GDP)	-2.8	-3.0	-2.8	-3.1	-3.3	-3.1
Fiscal Balance (% of GDP)	1.4	-8.3	-5.0	-3.7	-2.0	-0.4

Source: World Bank, Poverty & Equity and Macroeconomics, Trade & Investment Global Practices.
Notes: e = estimate, f = forecast.

SAUDI ARABIA

Table 1	2017
Population, million	32.8
GDP, current US$ billion	685.2
GDP per capita, current US$	20878
School enrollment, primary (% gross)[a]	109.5
Life expectancy at birth, years[a]	74.6

Source: WDI, Macro Poverty Outlook, and official data.
Notes:

(a) Most recent WDI value (2015)

The Kingdom of Saudi Arabia is proceeding swiftly on its ambitious multifaceted reform agenda. In 2018, authorities are continuing their commitment to the OPEC+ deal, which is in place through the end of the year, by restricting oil production and implementing major reform initiatives to counter the pervasive problems in its oil-dependent economy. With subdued oil production, and a private sector still adapting to fiscal consolidation, growth is likely to be dependent on the trajectory of new public spending that has been recently announced.

Recent developments

The Saudi Arabian economy contracted moderately at 0.6 percent in 2017, as oil production was restrained based on the OPEC+ deal, and non-oil sector growth slowed in the wake of reduced public spending. Early data for 2018 suggests that non-oil GDP in the first quarter may have deteriorated further, given the January PMI level of 53.0, which fell noticeably from 57.3 in December 2017, and is the slowest recorded since August 2009. More promisingly for the future however, hiring picked up to its strongest level since August 2016 and business optimism reached an eight-month high, according to the Emirates NBD Saudi Arabia Purchasing Managers' Index survey.

The fiscal deficit markedly improved to 9.0 percent of GDP in 2017, compared to the 16.9 percent a year earlier. This substantial progress increased space to mitigate household impacts of fiscal reforms. Upon the completion of its recent crackdown on corruption, during which purportedly over US$100 billion in assets were garnered, authorities announced new allowances for state employees over 2018 to compensate for the higher costs of living. Authorities have acknowledged that they ought to slow down the pace of austerity so as not to imperil the burgeoning economic recovery led by the private sector.

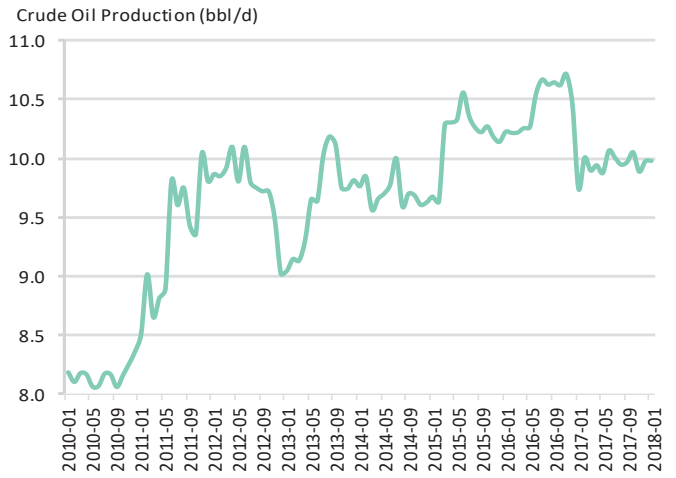
Deflation was evident in the economy through October 2017, and the annual inflation average registered by SAMA stood at -0.23 percent over the course of calendar year 2017. Although the deflationary trend has seemingly reversed, it could still spell a weaker demand environment in light of recent reforms and an uncertain political environment. The Kingdom has continued to peg its currency to US$, which given recent depreciation could help rebalance pressures on non-oil exports and rein in imports.

On the external side, the pace of contraction in exports, registering at 4.7 percent as the OPEC+ deal slowed Saudi oil production, was outpaced by the discernable slowdown in imports by 8.3 percent. Together, this translated into a swing of the current account into surplus of 1.7 percent of GDP.

Regarding labor market issues, the latest available data suggests an improvement. The pace of job creation improved in the second half of 2017 as the unemployment rate decreased to 5.8 percent in the third quarter. Latest available survey data from Emirates NBD suggests that hiring levels are picking up strongly. However, the unemployment rate remained broadly unchanged in 2017 at approximately 5.8 percent for the overall population and increased to slightly above 12 percent for Saudi nationals (up from 11.5 percent a year earlier) given the structural labor market issues, including high reservation wages for Saudi nationals.

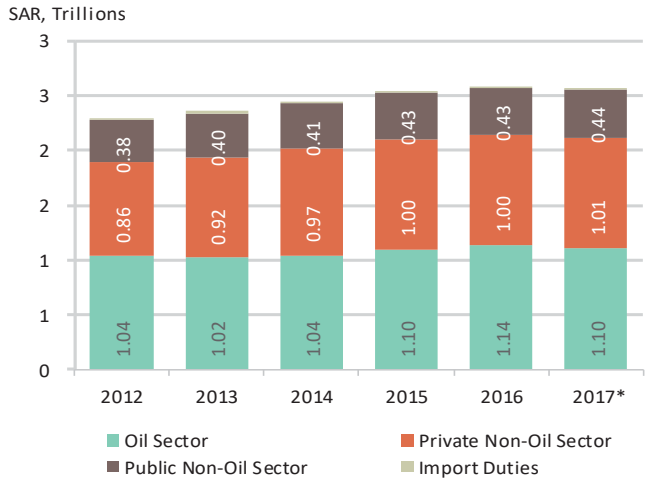
While no official information is available, the Kingdom likely faces a looming poverty problem. As in other GCC countries, the bulk of low-income residents are migrant workers, but as the citizen population crosses the 20 million-mark, inade-

FIGURE 1 Saudi Arabia / Crude oil production in the KSA



Source: Joint Organizations Data Initiative (JODI).

FIGURE 2 Saudi Arabia / Institutional composition of the GDP (constant prices)



Source: KSA General Authority for Statistics.

quate access to economic opportunities is also an issue for nationals. With the prospect of low oil prices for longer, the old social contract—one based on government employment, generous subsidies, and free public services—is no longer sustainable. A reform agenda contained in the Vision 2030 document envisages deep structural changes that will profoundly impact the population in all aspects of their livelihoods.

The authorities are serious about mitigating the negative impact of reforms, as seen in public pronouncements and actions. Yet targeted support is still a new concept in the country. Identifying the most poor and vulnerable groups has been difficult, and little evidence exists to inform policies about the level of support to be provided to them. In that respect, the authorities are currently building capacity and institutions for welfare measurement and analysis.

Outlook

The economy is projected to expand again in 2018 mainly due to a moderate recovery in oil production levels (vis-à-vis last year's sharp cuts) and marginally higher public spending. However, as the negative short-term effects of structural reforms dissipates and government balances improve, it is projected that growth will rise to over 2 percent in 2019. As NTP-related reforms and direct government initiatives aimed at the private sector are implemented, while capital spending is simultaneously ramped up, further domestic growth opportunities are foreseen to open up. Crown Prince Mohammed bin Salman continues to have strong popularity, providing a strong signal to investors and the wider public of a longer-term commitment to continue the path of reforms despite the negative perceptions generated by specific initiatives.

With improved economic conditions, and an announcement by authorities of fewer fiscal constraints in 2018, the fiscal deficit is expected to narrow only slightly in 2018 to 7.6 percent, as a share of GDP. The fiscal outlook incorporates a continued strong commitment to reform efforts.

Recovering oil prices are expected to further strengthen the current account from its estimated surplus of 1.7 percent of GDP in 2017. Inflation is projected to be considerably more volatile in the coming years, rising to nearly 5 percent in 2018 and then dropping to below 2 percent in 2019 as the VAT introduction is absorbed.

Risks and challenges

Over the medium-term the main challenge to the economy is an ability to translate general strategic directions into specific policies, at which point opposition tends to materialize. In practice this means that reforms with broad "middle class" negative impacts are more prone to reversal, such as subsidy reform and taxation. To stave off such opposition to the social contract, credibility that alternative sources of job creation will emerge is critical. In addition, while the government has tended to downplay fears of capital flight, net foreign assets held by SAMA had fallen steeply in recent years until late 2017. Buffers are still ample, but depleted relative to 2014. The clear intention to engage in more directive investments with foreign assets raises risks that foreign assets could be less liquid, inhibiting the country's ability to cope with oil price volatility.

TABLE 2 **Saudi Arabia** / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2015	2016	2017 e	2018 f	2019 f	2020 f
Real GDP growth, at constant market prices	4.1	1.7	-0.6	1.8	2.1	2.3
Private Consumption	6.8	2.3	1.8	2.6	2.5	2.9
Government Consumption	-1.8	-18.8	2.0	1.1	1.4	1.4
Gross Fixed Capital Investment	3.6	-15.9	1.7	2.0	3.8	4.1
Exports, Goods and Services	0.7	1.4	-0.5	1.9	1.7	1.8
Imports, Goods and Services	1.5	-24.3	2.2	2.6	2.8	3.0
Real GDP growth, at constant factor prices	3.5	1.8	-0.6	1.8	2.1	2.3
Agriculture	0.6	0.6	0.0	0.2	0.6	0.6
Industry	5.0	2.5	-0.3	1.4	2.0	2.0
Services	1.4	0.9	-1.1	2.5	2.4	2.9
Inflation (Consumer Price Index)	2.2	3.5	-0.1	4.9	1.9	2.3
Current Account Balance (% of GDP)	-8.7	-4.3	1.7	2.1	2.3	2.4
Fiscal Balance (% of GDP)	-15.8	-16.9	-9.0	-7.6	-4.9	-2.4

Source: World Bank, Poverty & Equity and Macroeconomics, Trade & Investment Global Practices.
Notes: e = estimate, f = forecast.

TUNISIA

Table 1	2017
Population, million	11.4
GDP, current US$ billion	39.7
GDP per capita, current US$	3469
National poverty line[a]	15.2
Gini coefficient[a]	30.9
School enrollment, primary (% gross)[b]	114.2
Life expectancy at birth, years[b]	75.5

Source: WDI, Macro Poverty Outlook, and official data.
Notes:
(a) Most recent value (2015).
(b) Most recent WDI value (2015)

Tunisia has made important strides to advance its democratic transition, but the country remains fragile to economic, security and social shocks. Growth has been too low to make a significant dent in unemployment, fiscal and current account deficits are elevated, inflation has risen and popular discontent about economic conditions is high, particularly among youth and in interior regions. The national unity government—a coalition of the main political parties, worker and trade unions—has adopted a consensus-building reform approach.

Recent developments

In 2017, the economy grew by 2 percent following 1 percent and 1.1 percent in 2016 and 2015, respectively, driven by robust private consumption and a rebound in investment. However, the contribution of exports and investment to growth remain significantly below their levels before the 2011 Revolution. On the production side, growth in 2017 was driven mainly by agriculture and services, while industrial and non-manufacturing industries (i.e., phosphate, oil) have not fully recovered despite the Dinar depreciation, due to social movements in mining regions, low oil prices and reduced investment in prospection.

Inflation has accelerated to a record 7.1 percent in February 2018, from 4.2 percent in December 2016 fueled by the depreciation of the Dinar, administered energy price increases and wage inflation. In the face of these rising inflationary pressures, the Central Bank has increased its policy rate three times between April 2017 and March 2018 to 5.75 percent from 4.25 percent, and is expected to continue to gradually tighten monetary policy in 2018.

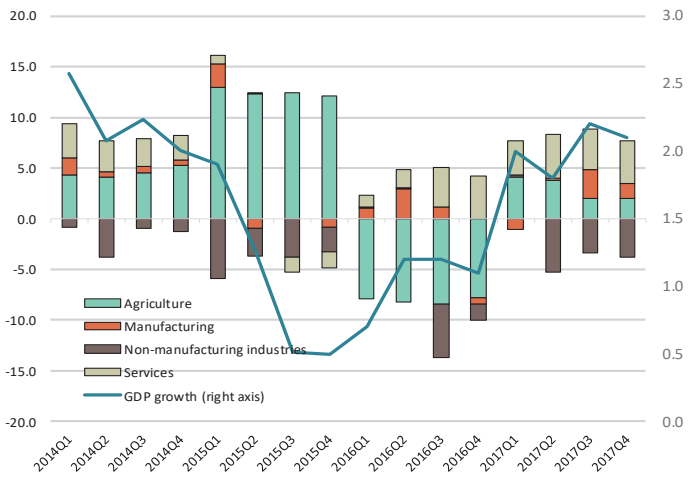
Tunisia faces large fiscal and external deficits. The fiscal deficit (including grants) reached 6.1 percent of GDP in 2017, compared to 6 percent of GDP in the initial budget, mainly due to higher wage bill spending. The current account deficit reached a record 10.2 percent of GDP in 2017, reflecting a weak supply response to the gradual depreciation of the Dinar and rising energy prices. Consequently, public and external debt reached respectively 73 and 80 percent of GDP (compared to 40 and 52 percent of GDP in 2010). With a widening current account deficit, depressed FDI and large Central Bank interventions in the forex market, foreign reserves have continued to decrease, dropping below 80 days in early March 2018.

The 2018 Budget Law aims to keep the deficit within 5 percent of GDP mainly through higher tax revenues (total expected yield of tax measures: 1.7 percent of GDP) and by containing energy subsidy costs and lowering wage bill growth.

Unemployment remains high at 15.5 percent in 2017 despite a low labor force participation, at about 50 percent, mainly due to weak participation of women (28 percent). Most of the unemployed are low-skilled but university graduates have the highest unemployment rate, which increased from 15 percent in 2005 to 23 percent in 2010 and 31 percent in 2017. Unemployment rates are also much higher among women and in interior regions.

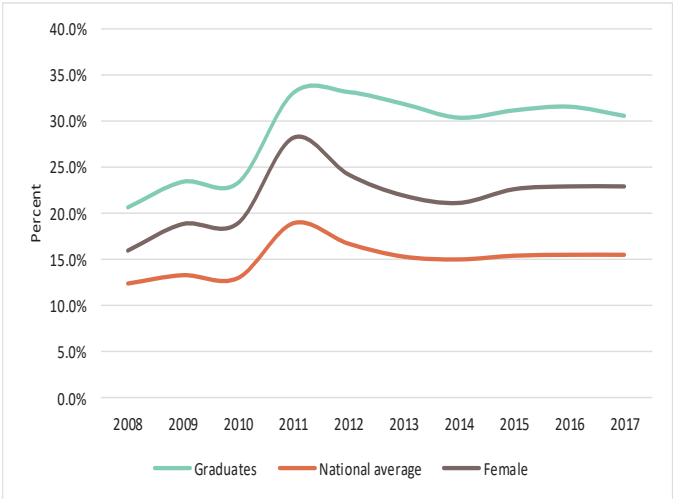
The methodology to measure poverty was recently updated by the National Institute of Statistics to better reflect current living conditions. The official poverty rate estimate for 2015 was 15.2 percent, down from 20.5 percent in 2010 and 23.1 percent in 2005. Regional disparities are an enduring feature, with the North West and Center West showing rates almost twice the national average. Inequality, as measured by the Gini index, is estimated at 30.9, down from 36 in 2005. The dynamics of monetary indicators of welfare appear to be at odds with the perception of lower

FIGURE 1 **Tunisia** / Sectoral value added and GGDP Growth (y-o-y)



Sources: Institut national de statistiques, Banque centrale de Tunisie and staff computation.

FIGURE 2 **Tunisia** / Unemployment rate



Sources: Institut national de statistiques, Banque centrale de Tunisie and staff computation.

standards of living in household surveys.
The national unity government—a coalition of the main political parties, the largest workers' and trade union formed almost two years ago—has set its priority as strengthening the security environment, improving the business environment, ensuring macroeconomic stability, fiscal sustainability and restarting growth. It has so far adopted a gradual and consensus-building approach to reform in a fragile transition phase and in the presence of strong workers' unions and private sector organizations.

Outlook

Economic growth is projected to expand modestly by 2.7 percent in 2018 through sustained agricultural and services growth, continued strengthening of tourism, and gradual recovery of tourism, phosphate and manufacturing. In the medium term, economic growth is projected to pick up gradually to 3.5 percent in 2019/20 against a backdrop of improved business climate through structural reforms and greater security and social stability.
Inflation is projected to increase to 6.7 percent in 2018, driven by the Dinar depreciation, the VAT rate increase, and the increase in prices of certain products (e.g., fuels, tobacco, telecom) while monetary tightening and fiscal consolidation will partly counteract inflationary pressures.
The fiscal deficit (including grants) is expected to remain significant at 5.2 percent of GDP in 2018 but with upward pressure from increasing oil prices in the absence of reform. Fiscal sustainability will require reining in the public wage bill and the growing subsidy bill while expanding the tax base. Pension reform and improved design of cash transfer programs would also create space for increased investment and social spending.
On the external side, the current account deficit is projected to slightly narrow to 9.5 percent of GDP in 2018. In the medium term, the current account is likely to benefit from the gradual recovery of industry and services trade, slightly lower energy imports and competitiveness gains from the depreciation of the Dinar.
The World Bank does not prepare poverty projections due to unavailability of recent microdata. It would be informative to understand the drivers of the large drop observed between 2010 and 2015 in official poverty rates. In particular, it would be important to understand how this drop in official poverty rate was related to GDP per capita (private consumption) growth averaging 0.6 (2.4) percent per annum in the same period.

Risks and challenges

While the government is deploying resources to improve the security situation, the high level of youth unemployment notably in the lagging regions as well as rising inflation may reignite social tensions. The government also faces the challenge of balancing between social stability and the need for reform, which highlights the importance of promoting greater social and economic inclusion to create sufficient support for reform. Moreover, reforms to stimulate private sector growth, job creation and entrepreneurship are key to creating opportunities and hope for the future. Wage negotiations with unions which are imminent and rising oil prices are substantial risks of upward pressure on spending and the deficit.

TABLE 2 **Tunisia** / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2015	2016	2017	2018 f	2019 f	2020 f
Real GDP growth, at constant market prices	1.1	1.0	2.0	2.7	3.3	3.7
Private Consumption	1.6	1.6	1.5	0.6	1.4	4.6
Government Consumption	4.8	3.8	-2.4	-8.3	2.3	-6.1
Gross Fixed Capital Investment	-2.5	2.8	4.4	4.4	4.9	6.2
Exports, Goods and Services	-2.8	0.2	4.2	4.7	4.5	3.6
Imports, Goods and Services	-2.5	2.0	2.2	-1.1	2.3	2.6
Real GDP growth, at constant factor prices	1.0	0.8	1.7	2.7	3.3	3.7
Agriculture	12.3	-8.5	2.5	5.0	1.9	3.0
Industry	-1.5	-0.5	-0.9	3.9	4.6	4.6
Services	0.6	2.9	2.7	1.9	3.0	3.4
Inflation (Consumer Price Index)	4.9	3.7	5.3	6.7	5.6	4.6
Current Account Balance (% of GDP)	-8.9	-8.8	-10.2	-9.5	-7.8	-7.2
Fiscal Balance (% of GDP)[a]	-5.6	-6.0	-6.3	-5.6	-3.7	-2.7
Debt (% of GDP)	54.8	61.2	72.9	77.8	77.2	76.2
Primary Balance (% of GDP)	-3.7	-3.8	-4.0	-2.9	-1.1	-0.7

Source: World Bank, Poverty & Equity and Macroeconomics, Trade & Investment Global Practices.
Notes: e = estimate, f = forecast.
(a) Fiscal balance excludes grants.

UNITED ARAB EMIRATES

Table 1	2017
Population, million	9.4
GDP, current US$ billion	378.4
GDP per capita, current US$	40266
School enrollment, primary (% gross)[a]	116.3
Life expectancy at birth, years[a]	77.5

Source: WDI, Macro Poverty Outlook, and official data.
Notes:

(a) Most recent WDI value (2015)

Non-hydrocarbon growth is estimated to have remained resilient in 2017 while OPEC-mandated oil production cuts limited hydrocarbon growth. Economic performance is likely to improve in 2018 with firming oil prices, an improvement in global trade, and the expected easing pace of fiscal adjustment, especially as investments ramp up ahead of Dubai's Expo 2020. However, this rebound is faced with several downside risks including lower oil prices and tighter global financial conditions.

Recent developments

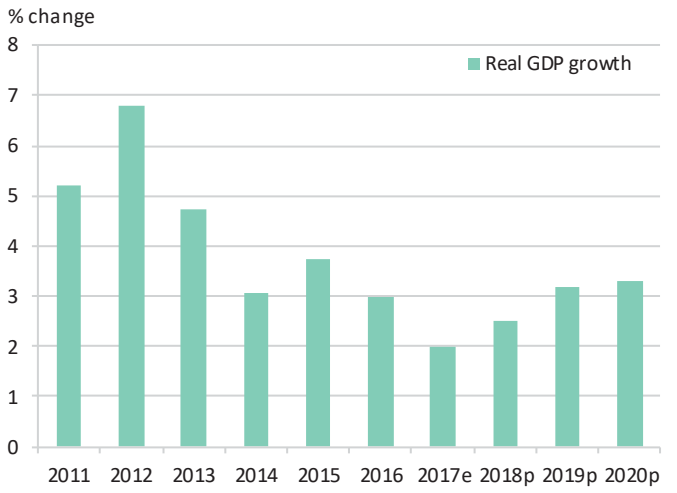
Although the non-oil economy is showing signs of recovery, OPEC+ oil production cuts continued to restrain the UAE's overall economic growth in 2017 which is estimated to have moderated to 2 percent in 2017 down from 3 percent in 2016. Hydrocarbon GDP growth is estimated to have contracted by 3 percent in 2017 from 5.4 percent growth in 2016. The non-hydrocarbon sector is estimated to have driven growth in 2017 reflecting higher public investment and a pickup in tourism and global trade. According to the PMI, private sector activity increased in late 2017 reaching the highest level since 2015. Consumers and firms brought forward planned consumption before the introduction of the VAT in 2018. Inflation increased by only 0.3 percentage points in 2017 reflecting a significant decline in rents, which has mitigated higher import and gasoline prices. The current account surplus is expected to deteriorate only slightly to 2 percent of GDP in 2017 owing to subdued oil exports.

Fiscal consolidation efforts that began in 2015 with subsidy reform (fuel, electricity and water) continue, but at a slower pace. The decline in oil prices in 2014 had pushed the consolidated fiscal balance down from a surplus of 10.4 percent of GDP in 2013 to a 4.3 percent deficit in 2016. However, in 2017, despite higher capital spending, the recovery of oil prices and some revenue measures are expected to improve the fiscal deficit to 3.1 percent of GDP. The Federal Tax Authority introduced excises on tobacco and sugary drinks, Abu Dhabi increased municipality fees and Dubai increased hotel, airport and parking fees. The fiscal deficit was financed through withdrawals from the sovereign wealth funds (total assets estimated at US$1.3 trillion), bank borrowing and, increasingly, by foreign capital raising. Abu Dhabi raised US$10 billion in October from a series of bond offerings, with maturities ranging up to 30 years. A further issuance is expected in Q1 2018, as yields remain very attractive given the strong liquidity profile of UAE entities.

The Central Bank has mirrored the US Federal Reserve movements to maintain the peg—interest rates were raised four times by a total of 75 basis points. The consolidated growth in credit slowed to 1.7 percent in December (y-oy), due to weak demand for credit in Abu Dhabi. Annual growth in deposits remained stable at 4.1 percent in December.

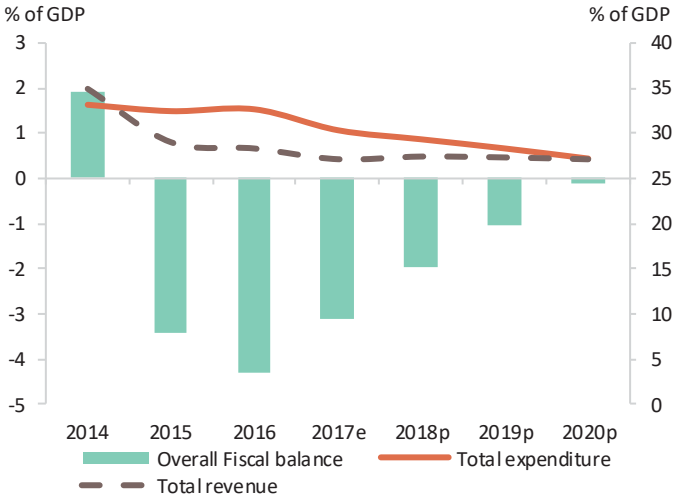
The 2014 oil price shock and its impact on government finances and regional liquidity prompted substantial reconsideration of UAE's policy direction – but the recent upward trend in oil prices may reduce reform momentum. Excise duties on drinks and tobacco were introduced and VAT became effective this year, albeit at a low rate of 5 percent and with several exemptions. The VAT is being used to develop a system of intergovernmental fiscal transfers through a revenue sharing formula across emirates, which was previously ad hoc. Abu Dhabi has initiated oil sector and financial management reforms. Focus on diversification continues as the

FIGURE 1 United Arab Emirates / GDP growth rate (percent per annum)



Sources: UAE authorities and IMF/World Bank Staff estimates.

FIGURE 2 United Arab Emirates / Government Operations (as share of GDP)



Sources: UAE authorities and IMF/World Bank Staff estimates.

government targets an 80 percent contribution to UAE GDP from non-oil sectors by 2021 (currently 70 percent). The authorities are seeking to boost private-sector engagement, including through equity participation in some GREs. Dubai will also focus on improving financial, real estate and internet regulations and infrastructure, to boost its appeal to foreign investors. The UAE is stepping up efforts to pioneer the use of modern technologies; with plans to develop smart cities, use blockchain technology for government transactions, and undertake financial technology projects.

Each Emirate has an independent statistics agency, and while the federal-level statistical bureau was established in 2009, the harmonization of statistical agendas for a country-level welfare measurement is yet to be accomplished. Poverty is not seen as a serious issue among the national population. Information on living standards is infrequent, lagged and of unknown quality. Results from the 2014/15 household survey show the average consumption for Emirati household in Dubai was US$1,477 per-capita per month (US$1,293 for non-Emirati households, US$734 for collective households and US$511 for labor camps). Family expenditure is lower in the northern Emirates. However, the authorities recognize the potential for economic dissatisfaction in the middle class and have increased social allocations to improve welfare, housing affordability, education and healthcare provision for nationals. Moreover, the government plans to allocate 70 percent of VAT revenue to local services, as officials seek to build public support for the tax.

Outlook

Beyond 2017, overall GDP growth is expected to recover to above 3 percent in the medium term. Oil production capacity is expected to increase and the strength of the non-oil economy will boost prospects particularly later in the forecast period as megaproject implementation ramps up ahead of Dubai's hosting of Expo 2020—expected to draw in 25 million visitors, boosting private consumption and services exports. Export earnings will pick up gradually, with non-oil goods trade and services outpacing oil export growth, although the current account will remain in modest surplus. The 2018 budgets presented by different emirates and the federal government over the last few months are expansionary, with Dubai's budget containing a notable uptick in infrastructure spending. However, on the back of higher oil prices, improved oil production capacity and higher non-oil revenues, the fiscal deficit is projected to reverse by 2020. Inflation is projected to rise to 2.9 percent in 2018 due to the VAT but is projected to moderate thereafter.

Risks and challenges

Risks to the outlook are skewed towards the downside. The remission in oil price volatility may not last, for instance, due to a faster recovery of the US shale production or reduced compliance with OPECs oil production cuts, which could reduce fiscal revenues, and consequently investment, and confidence. A faster rise in US interest rates or higher financial market volatility could increase borrowing costs, potentially affecting liquidity in the domestic banking system. Contingent liabilities continue to be a risk and if megaprojects, including for Expo 2020, are mismanaged, risks for GREs, banks, and sovereigns would rise. More difficult to quantify are risks related to the UAE's protracted role in conflict countries in the region, notably Yemen and Libya. Upside risks include increased international economic engagement with Iran, for which the UAE functions as the key offshore hub.

TABLE 2 United Arab Emirates / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2015	2016	2017 e	2018 f	2019 f	2020 f
Real GDP growth, at constant market prices	3.8	3.0	2.0	2.5	3.2	3.3
Private Consumption	-12.0	2.1	1.0	3.2	3.5	3.7
Government Consumption	16.6	-0.9	-0.5	2.0	2.2	2.3
Gross Fixed Capital Investment	10.6	3.0	2.8	6.0	5.9	5.8
Exports, Goods and Services	3.4	1.3	2.5	3.5	3.8	3.8
Imports, Goods and Services	-1.2	2.5	2.1	3.1	3.3	3.7
Real GDP growth, at constant factor prices	3.8	3.0	2.0	2.5	3.2	3.3
Agriculture	3.1	3.0	2.0	3.0	3.2	3.2
Industry	4.6	2.3	2.1	2.3	3.0	5.2
Services	2.8	3.8	1.9	2.7	3.4	1.2
Inflation (Consumer Price Index)	4.1	1.6	2.0	2.9	2.3	2.4
Current Account Balance (% of GDP)	4.7	2.4	2.0	2.1	2.5	2.7
Fiscal Balance (% of GDP)	-3.4	-4.3	-3.1	-2.0	-1.0	-0.3

Source: World Bank, Poverty & Equity and Macroeconomics, Trade & Investment Global Practices.
Notes: e = estimate, f = forecast.

YEMEN

Table 1	2017
Population, million	28.3
GDP, current US$ billion	16.5
GDP per capita, current US$	583
International poverty rate ($1.9)[a]	82.9
Lower middle-income poverty rate ($3.2)[a]	94.7
National poverty line[a]	
Gini coefficient[a]	
Life expectancy at birth, years[b]	

Source: WDI, Macro Poverty Outlook, and official data.
Notes:
(a) Most recent value (2014), 2011 PPPs.
(b) Most recent WDI value (2015)

The violent conflict has caused a dramatic deterioration of the economic and social conditions in the country. Output has contracted sharply, household incomes are declining, and poverty has dramatically increased with nearly four-fifths of the population living below US$3.20 a day PPP. Even beyond the increase in poverty, UNOCHA estimates that almost 9 million Yemenis are facing various forms of food insecurity at level 3 or 4 of the internationally agreed standard for measuring food security. Cholera, diphtheria, and other communicable diseases have been ravaging the country.

Recent developments

Since the escalation of violent conflict in March 2015, Yemen's economy has deteriorated sharply. Although official statistics are no longer available, evidence suggests that Yemen's GDP contracted by more than 50 percent cumulatively since 2015 while employment opportunities in the private sector have significantly diminished. Economic activity in agriculture services, and oil and gas production—the largest components of GDP, remains limited due to the ongoing conflict. Furthermore, the commensurate dramatic decrease in government revenues, especially due to the much-reduced oil and gas production, have contributed to the implosion of the formal social safety net and infrequent payment of public salaries. In addition, the conflict has led to increasing inflation and pressure on the exchange rate, which further undermined household income at a time when approximately 40 percent of households reported to have lost their primary income source (according to the 2016 Gallup World Poll). For many, joining a militia or other conflict related economic activities remain the only gainful opportunities.

Imports have greatly contracted given the dwindled foreign reserves available to the Central Bank system of Yemen (CBY). Critical food and energy imports are facilitated exclusively through private channels without support from financial trade services offered earlier by the CBY. In addition, limited access to and the turnover capacity of Yemen's key ports further undermines the flow of key commodities - including food, fuel, and medical supplies - to parts of the country. These hurdles are particularly challenging given that Yemen had previously imported approximately 90 percent of its food.

While it is reported that food is available in markets, many Yemenis do not have the purchasing power to buy the required quantities. UN-OCHA estimates that 22 million Yemenis are in need of humanitarian assistance, of which about 9 million are in acute need of assistance to sustain their lives and avoid famine. The advent of cholera, diphtheria, and other infectious diseases in a context of prevailing poor health and malnutrition, has further diminished peoples' welfare and eroded their ability to lead productive lives. The ability of many households to cope is at a breaking point.

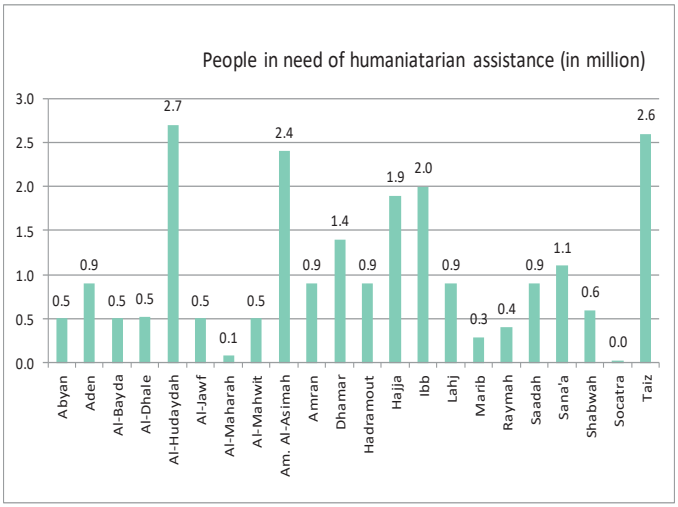
The dramatic worsening of conditions has translated into a significant worsening of the incidence of poverty. The poverty rate (with the poverty line at a US$3.20 PPP) is estimated to have increased since 2014 by nearly 30 percentage points to approximately 80 percent today. Poverty was already on the rise in Yemen prior to the recent conflict, rising nearly 14 percent between 2005 and 2014.

However, the deteriorating socio-economic conditions and worsening poverty rate do not fully describe the suffering of the Yemeni population. Significant damage to vital infrastructure and private residences has contributed to a decline in access to basic services (like water), crippled civilian health and education facili-

FIGURE 1 **Yemen** / Republic of Yemen/Public Finances

Sources: Yemen Ministry of Finance, Yemen Statistical Office; staff of the IMF and the World Bank.

FIGURE 2 **Yemen** / People in need of humanitarian assistance (in million)



Sources: 2018 United Nations Humanitarian Response Plan.

ties, and has led to an internal displacement of over 10 percent of the population. The humanitarian response in Yemen continues to support the basic needs of a significant share of the population in difficult circumstances. There are approximately 153 humanitarian partners on the ground-109 national non-government organization (NGOs), 36 international NGOs, and 8 UN agencies. The World Bank supports the most vulnerable groups with approximately US$1.2 billion through five large emergency operations providing critical health and other services, complementary income opportunities and cash transfers. These programs serve to combat famine and impoverishment while maintaining critical institutional capacity.

However, coverage by humanitarian partners is not uniform across the country, where only 200 out of 322 districts in the country are classified as "relatively accessible" by the humanitarian response. Approximately 51 districts are classified as having "high or extremely high access constraints." Thus, there are pockets where people in need cannot be reached. Out of the 22 million Yemeni targeted by the humanitarian response, 1.5 million live in districts with high access constraints.

Outlook

Economic prospects in 2018 and beyond will critically depend on rapid improvements of the political and security situation, and ultimately whether an end to the on-going conflict will allow for rebuilding the economy and Yemen's social fabric. Macroeconomic stabilization is impossible in the current context of fragmented control of key economic institutions between the recognized government in Aden and the *de facto* authority in Sanaa. If violence can be contained by mid-2018, with accompanying improvements in functioning of budgetary and monetary institutions, GDP is projected to begin to recover in 2019, with a projected double-digit GDP recovery growth rate. Restoration of more peaceful conditions will likely allow for resumption of hydrocarbon production, which will help restore government revenues. However, even in this scenario, little of this projected growth is to translate into a substantial poverty reduction. Rather, poverty is projected to remain high at approximately 75 percent in 2018 and 73 percent in 2019. Given the bleak outlook in Yemen, massive foreign assistance would continue to be required for recovery and reconstruction in a post-conflict period. In particular, foreign assistance would be needed to help restore basic services and rebuild confidence in Yemen's institutions.

Risks and challenges

The estimated massive increase in absolute poverty in Yemen since 2014 poses a tremendous challenge for peace building. Making peace sustainable in Yemen will require diversifying the economy, making employment more productive, designing fiscal and other policies, which will support investment to create jobs and income for the large share of Yemenis who were unemployed and excluded even before the conflict. The war has severely aggravated centrifugal forces in Yemen, and an inclusive governance model will be essential to mitigate these forces. Leveraging support for recovery and reconstruction to improve economic and social inclusiveness could help with the prevention of relapse after a period of reduced conflict.

TABLE 2 **Yemen** / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2015	2016	2017 e	2018 f	2019 f	2020 f
Real GDP growth, at constant market prices	-37.1	-34.3	-13.8	-0.5	17.9	16.3
Private Consumption	-29.3	-27.5	-8.9	-0.8	6.6	3.4
Government Consumption	-26.0	-23.0	-37.1	26.1	0.7	12.7
Gross Fixed Capital Investment	-85.2	-39.6	9.3	220.2	33.8	15.2
Exports, Goods and Services	-68.1	-78.5	43.2	196.8	81.4	55.4
Imports, Goods and Services	-45.1	-20.5	-1.1	55.9	12.1	10.1
Real GDP growth, at constant factor prices	-37.6	-35.0	-13.6	0.5	19.4	17.8
Agriculture	-34.9	-31.4	-15.0	-5.0	11.0	9.0
Industry	-43.1	-43.4	-9.6	1.0	22.1	25.8
Services	-34.9	-31.4	-15.0	3.3	22.2	17.3
Inflation (Consumer Price Index)	61.4	-20.3	4.9	23.0	20.0	7.5
Current Account Balance (% of GDP)	-6.5	-5.2	-1.0	-6.5	-3.8	0.3
Fiscal Balance (% of GDP)	-11.5	-16.5	-7.6	-14.0	-8.6	-2.7
Debt (% of GDP)	72.7	128.0	141.8	130.9	98.5	84.7
Primary Balance (% of GDP)	-3.4	-7.3	-7.2	-7.7	-1.9	1.7
International poverty rate ($1.9 in 2011 PPP)[a,b]	50.0	76.3	82.9	83.9	78.9	73.6
Lower middle-income poverty rate ($3.2 in 2011 PPP)[a,b]	79.7	92.2	94.7	95.1	92.9	90.5
Upper middle-income poverty rate ($5.5 in 2011 PPP)[a,b]	93.5	98.2	99.0	99.1	98.4	97.8

Source: World Bank, Poverty & Equity and Macroeconomics, Trade & Investment Global Practices.
Notes: e = estimate, f = forecast.
(a) Calculations based on 2014-HBS. Nowcast: 2015 - 2017. Forecast are from 2018 to 2020.
(b) Projection using neutral distribution (2014) with pass-through = 1 based on GDP per capita in constant LCU.

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Economic Transformation