After the Arab spring

THE POLITICAL AND SOCIAL TURMOIL IN THE REGION HAS HUGE CONSEQUENCES FOR NATIONAL ECONOMIES AND GROWTH PROSPECTS, AS **BRIAN COULTON** REPORTS.

The political crisis that has engulfed the Middle East and North Africa (MENA) since the beginning of this year is a long way from subsiding fully. Egypt, by far the largest economy affected, has seen a political resolution and stabilisation, but serious social unrest is ongoing in Syria, Yemen and Bahrain, and the war in Libya shows no signs of nearing an end. Even in Egypt, strikes and sporadic violence continue as the post-Mubarak transition unfolds.

In addition to the direct disruption to activity from the unrest, a collapse in tourism, falling foreign investment and declining consumer and business confidence are harming MENA economies. Migration flows, particularly of oil sector workers leaving Libya, are further disrupting economies, while supply shortages and exchange rate weakness are pushing up inflation.

With the duration of political unrest unknown, it is impossible to forecast the economic fallout with any accuracy. But tourism, investment and consumer spending are all likely to be sharply reduced across the region in the first half of 2011. Tourism accounts for between 5% and 7% of GDP in Egypt, Tunisia, Morocco and Syria. The latest figures show Egypt's tourist arrivals down 80% in the year to April (see Figure 1) and Tunisia's tourism earnings down by nearly half. Tourism accounts for an even larger share of employment at 12-15% and so has a major impact on incomes and spending. Even if it bounces back in the second half of the year it is likely to be 20-30% lower over the year as a whole, knocking something like two percentage points off GDP growth.

Consumer spending is likely to be crimped further by the squeeze in real incomes from higher food prices (which make up 35-40% of the consumer spending basket in Egypt and Tunisia), declining consumer confidence in the face of political uncertainty and

personal security concerns, capital flight and weak equity prices. Domestic businesses are likely to shelve investment plans until the political outlook is clearer, while foreign direct investment inflows are falling. The latest figures for Egypt and Tunisia show industrial production down 24% and 11% respectively compared with a year ago. GDP growth in Egypt and Tunisia in 2011 as a whole is unlikely to be much better than 1%, compared with average annual rates of 6% and 4.7% respectively over the last five years.

MACRO POLICY AND POST-CRISIS RECOVERY A key factor shaping the path of post-crisis recoveries will be the macroeconomic policy responses. The scope for policy stimulus differs vastly between oil producers and oil importers. Oil exporters including Bahrain, Oman, Yemen and Algeria have seen their external and fiscal revenues improve sharply as global oil prices have moved higher on the back of regional unrest. This has offset any potential balance of payments pressures from capital flight during the unrest and, more importantly, has provided scope for expansionary fiscal policies.

As Figure 2 shows, fiscal measures announced over the course of 2011 among oil producers (excluding Saudi Arabia) have ranged from 0.5% to 4% of GDP. These have included direct cash transfers to households, job creation schemes, infrastructure programmes, wage increases for public sector workers and subsidies. Despite this substantial policy easing, fiscal surpluses across the oil-exporting countries are expected to improve sharply this year.

The biggest fiscal expansion by a huge margin has been announced by Saudi Arabia; it is equivalent to $125bn or 17% of Saudi GDP. Saudi Arabia has not suffered any serious social unrest, but with a young population, high youth unemployment and little democratic accountability it is not immune to the social tensions that have come to the surface elsewhere in the region. Aware of these vulnerabilities, King Abdullah, a popular and reformist monarch, has acted swiftly and aggressively to head off the risk of social protest. In addition to public wage increases, the fiscal expansion – which will be spread over several years – entails a huge public house-building programme and capital injections to credit institutions to bolster mortgage lending. Following the announcement of these measures, Saudi Arabia's non-oil GDP growth is expected to rise to 5.5% this year, the fastest rate since the middle of the last decade.

By stark contrast, crisis-affected oil importers face formidable macro policy challenges which will constrain the pace of recovery. Both Egypt and Tunisia have announced fiscal easing measures of around 1% of GDP, but they are expected to record substantial deficits this year (see Figure 3), particularly Egypt, where a near-10% deficit will add to an already high public debt stock that amounts to 74% of GDP. In addition to

Figure 1: Egypt tourist arrivals

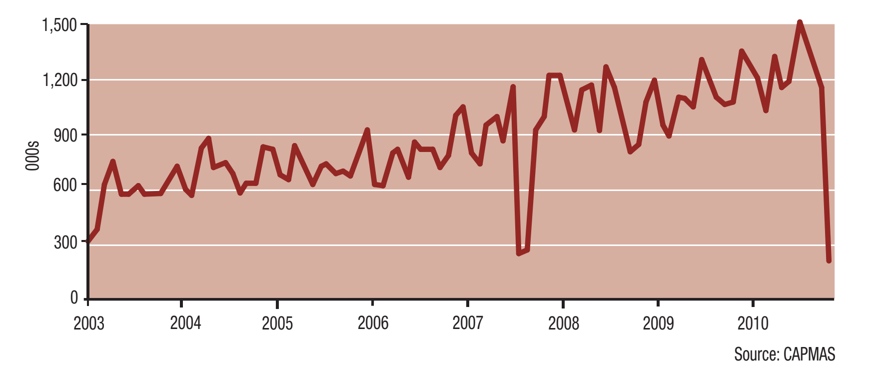


Figure 2: Middle East oil exporters – fiscal stimulus measures

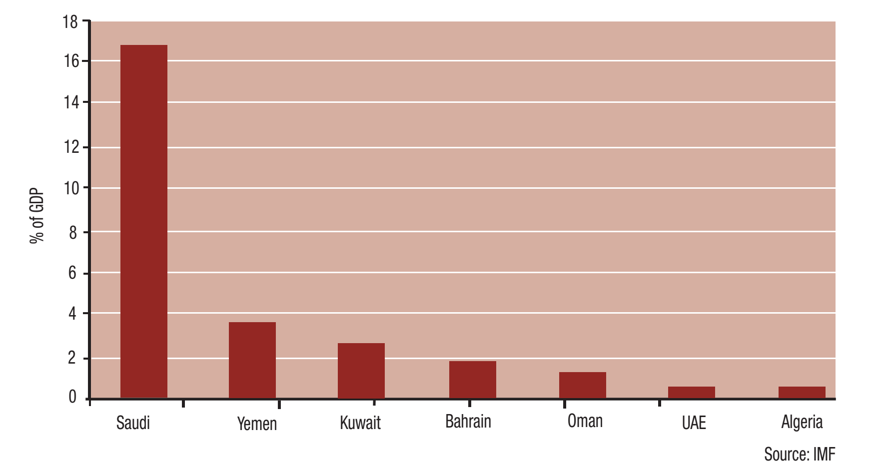


Figure 3: Fiscal balances - selected MENA countries

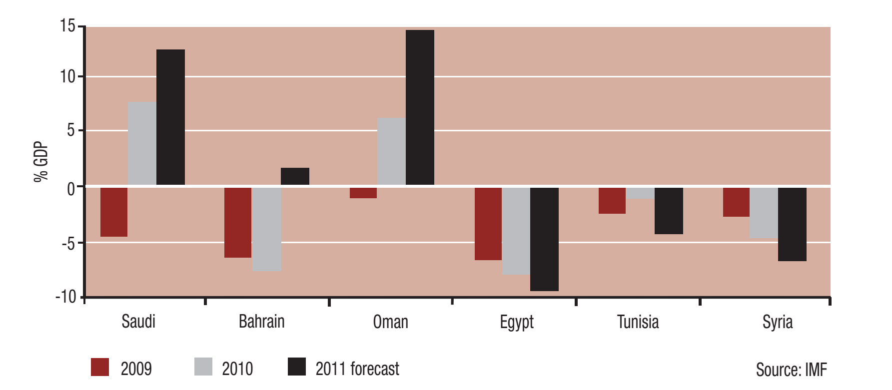
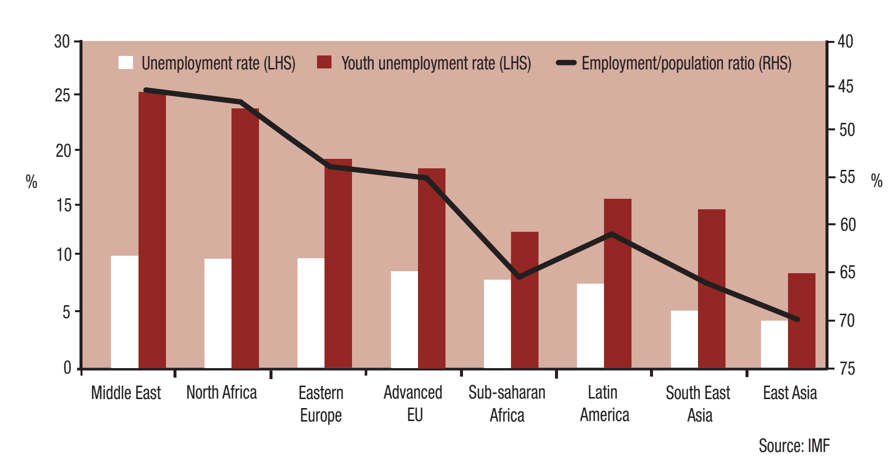


Figure 4: Labour market attachment rates



the latest crisis measures, high global food and fuel prices are swelling subsidy bills. The scope for further fiscal populism looks limited: foreign investors are reducing exposures to Egyptian government debt, sovereign ratings are under pressure and the fiscal financing burden is heavy.

On the monetary policy front, Egypt has seen its foreign exchange (FX) reserves fall by $8bn, or 22% since the start of the year as the central bank has sought to limit the exchange rate depreciation in the face of capital outflows. Tunisia and Bahrain have also seen a 15% decline in FX reserves. In Bahrain's case this is in spite of higher oil revenues and reflects its pegged exchange rate regime.

The need to limit the degree of exchange rate depreciation in Egypt reflects inflation concerns. Annual consumer price index inflation increased to over 12% in April and the monthly core rate accelerated sharply. Food prices in particular – up by over 20% annually in April – were a contributory factor in the earlier outbreak of social unrest in the country.

Recent public sector wage increases will add to cost pressures in Egypt and food price shocks have historically had powerful knock-on effects to non-food inflation, underscoring the need for the central bank to maintain a relatively tight monetary stance. Cognisant of the risks of funding large fiscal deficits in a climate of capital outflows, current account deficits, inflation worries and limited FX reserves, Egypt has recently requested external financial support from the International Monetary Fund to the tune of $12bn for this year and next. Tunisia is also looking to multilateral financing.

MEDIUM-TERM PROSPECTS – THE QUEST FOR INCLUSIVE GROWTH Although the scope for near-term macro policy support differs sharply between oil exporters and importers, both face similar challenges in re-orienting their economies over the medium term. One of the clearest stand-out economic features of the Middle East and North Africa is a very poor rate of labour market attachment (see Figure 4). Measured by either the unemployment rate or the employment to population ratio (which captures low labour force participation rates), the MENA region scores the worst, while youth unemployment is also the highest in the world.

These labour market outcomes reflect relatively poor growth performance. GDP per capita grew by 3% over the last decade compared with 5% for emerging markets as a whole. Labour market rigidities include high firing costs and skill mismatches, while the large public sectors limit both growth and job creation in the private sector. A high rate of labour force growth, as reflected in the high share of young people in the population, has compounded youth unemployment.

Policymakers across the region are faced with the challenge of re-orienting economic growth to generate better employment and income opportunities across the wider population. Achieving more inclusive growth on a sustained basis is likely to require structural reforms to improve the business climate, to deregulate labour and product markets, to reduce the role of the public sector in commercial activity and to liberalise international trade. But with expectations for social change high, there will be strong incentives in the near term to expand labour-intensive infrastructure investment and construction in order to foster job creation.

The fiscal space for oil importers to deliver on this is limited, placing greater emphasis on budget restructuring – including reforms of inefficient subsidy schemes – to avoid jeopardising fiscal and macroeconomic stability. And while oil exporters are much better resourced, thanks to current high global oil prices, the vulnerability of medium-term fiscal positions to future declines in oil prices is increasing sharply. Break-even oil prices for the Saudi Arabia budget have risen to $90 from $30 in the middle of the last decade.

Box: Middle East outlook in a nutshell

Few countries in the Middle East and North Africa have been untouched by the political turmoil that began in Tunisia in January and is still ongoing. The near-term economic impact is hugely uncertain but is sure to differ greatly between those countries that have oil resources and are able to deliver aggressively policy easing, and those that don't. Strong non-oil growth in Saudi Arabia and other Gulf Co-operation Council (GCC) members is likely to drag average GDP growth in the region up to relatively robust rates, but Egypt's economy will struggle badly in the face of inflation and fiscal financing constraints.

Job creation is a key challenge across the entire region and an expansion in labour-intensive public infrastructure and construction spending across the region seems highly likely. But the task of delivering more inclusive economic growth on a sustained basis will require deep structural reforms.

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