BOX 2.4.1 Potential growth in the Middle East and North Africa

The Middle East and North Africa's (MENA) potential growth has been held back by structural challenges over the past decade. These include low labor force participation (especially of women), low economic diversification outside of oil production, and weak private sector dynamism. Potential growth in the region is expected to strengthen somewhat in the coming years, supported by recovery in investment and productivity growth. Continued commitment to reforms, such as those aimed at encouraging diversification, improving governance and business climates, and strengthening fiscal management, has the potential to further improve potential growth.

Introduction

Growth has been uneven over the past decade in the Middle East and North Africa (MENA) region. Like other emerging market and developing economies (EMDEs), the region experienced high growth during 2003-07, which in MENA's case was supported by rising oil prices. However, growth slowed during 2010-14, mainly in response to the effects of political turmoil and military conflict, including Arab Spring revolutions in Egypt, Tunisia, Libya, and Yemen and associated conflict spillovers to neighboring countries, civil wars in Iraq and Syria, and the war on ISIS that halted economic activity and trade. Growth performance decelerated further after the oil price collapse of 2014 (Figure 2.4.1.1).

A key policy question for the region is whether this slowdown has been a temporary phenomenon or reflects deeper-seated structural impediments that will need to be tackled, especially in the context of subdued oil prices. Against this backdrop, this box will discuss the following questions:

- How has potential growth evolved in the MENA region and what were its main drivers?
- What are the prospects for potential growth?
- What are the policy options to lift potential growth?

The literature covering these issues is sparse, but has documented a broad-based decline in potential growth within the MENA region, including both oil exporters and oil importers. Moreover, relative to the EMDE average, this deterioration has been more severe, reflecting low total factor productivity growth and labor supply growth (Mitra et al. 2015; Alkhareif and Alsadoun 2016; IMF 2016e; IMF 2017g). These studies have underscored that reversing these trends requires policies to boost investment, especially in oil importers, as well as steps to improve the business environment, strengthen worker skills, and deepen financial markets (Mitra et al. 2016; World Bank 2017v).

The analysis here also highlights that the MENA region's poor growth performance in recent years has been largely driven by a slowdown in its potential growth, in turn driven by broad-based decelerations in capital stock growth, weak total factor productivity (TFP) growth relative to other regions, and slowing working-age population growth. It highlights, however, that a commitment to structural reforms would help improve potential growth and provide greater scope for improvements in living standards within the region.

Evolution of potential growth and its drivers

Growth in the MENA region declined sharply from 6 percent prior to the global financial crisis (2003-2007) to about 3 percent in 2013-17, and empirical analysis suggests that this was in large part the result of a deceleration of the region's potential growth, a slowdown that was more severe than those experienced by other EMDEs. A production function approach and an alternative estimate based on long-term (5-year-ahead) growth expectations suggest that potential growth during 2013-17 has fallen below its long-term average (1998-2017) rate of about 4 percent (Figure 2.4.1.2).

The recent decline in potential growth occurred against the backdrop of high geopolitical tensions, volatile oil prices, high structural imbalances, and conflict within the region, factors that have contributed to the region's relatively lackluster potential growth performance for at least two decades. However, an important factor behind the more recent slowdown has been investment growth, which more than halved in recent years. In fragile areas of the region, this was compounded by the outright destruction of capital (World Bank 2017w).[1] Also

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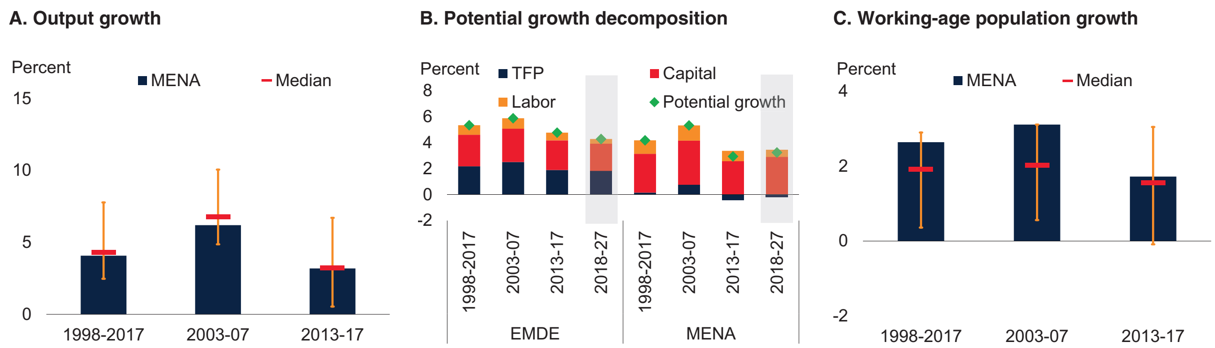
[1] In the fragile areas, prolonged crises impose large negative impact on potential output in the short run, followed by a prolonged period of slow growth as economies adjust to their post-crisis growth paths. These countries face a "permanent level loss" in the potential output meaning that the economy eventually would return to its pre-crisis potential growth rate but would fail to recoup all of the lost output.

BOX 2.4.1 Potential growth in the Middle East and North Africa *(continued)*

FIGURE 2.4.1.1 MENA potential growth

The slowdown of MENA's regional output growth in recent years has partly resulted from a decline in its potential growth rate. A wide range of factors have underpinned this slowdown, including weak investment, persistently low productivity growth, and slowing working-age population growth.



Sources: International Monetary Fund, Penn World Tables, United Nations, World Bank estimates.
Notes: GDP-weighted averages.
A. C. Red markers show median GDP-weighted averages of the six EMDE regions and whiskers denote range of regional GDP-weighted averages.
B. Estimates based on the production function approach for 50 EMDEs and 7 MENA economies. See Annex 3.1 for more details.
C. Working-age population refers to population of ages 15-64.

contributing were a continued slowdown in labor supply growth and stagnant TFP, the latter related to the region's high reliance on oil production and corresponding lack of economic dynamism.

While the slowdown in potential growth is broad-based across oil exporters and importers, the relative importance of contributing factors varies. In oil exporters, TFP growth has been negative (partly reflecting low labor market efficiency and subsidized energy), capital growth is weak, and employment growth is declining. In oil importers, while TFP, labor supply, and capital growth are all slowing, low investment growth is especially a concern.

However, common to the entire region are female labor force participation rates that are among the lowest in the world. For example, women make up half the population in the GCC and yet represent only about one-fourth of the labor force (Constant 2016). Overall labor force participation rates are also very low outside of the GCC. Moreover, while educational attainment has risen during the post-crisis period, the quality of education, such as measured by primary school proficiency tests, remains low compared to most other regions (World Bank 2017j).

Potential growth: prospects and policy options

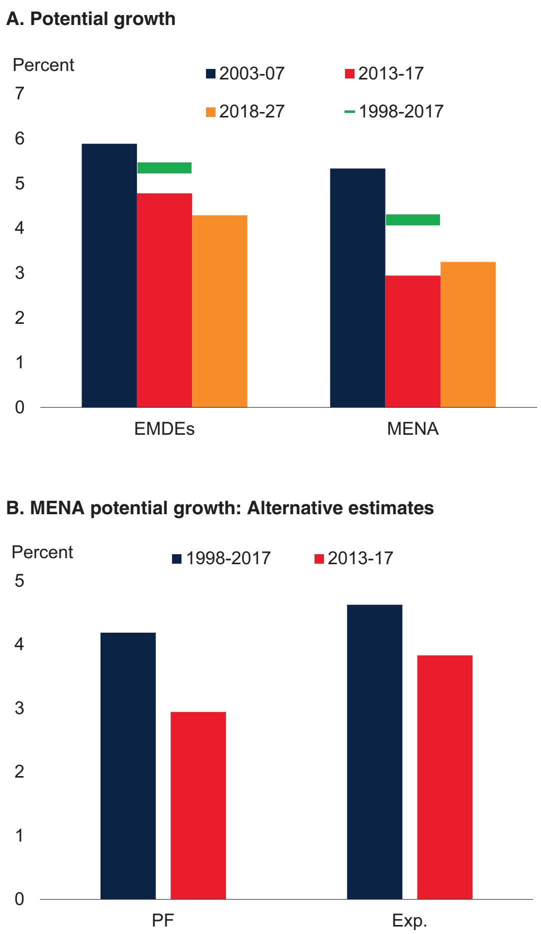
Over the coming years, potential growth in the region is expected to strengthen somewhat from its 2013-17 average rate of 2.9 percent. This is predicated upon trend improvements in educational and health outcomes, median fertility projections in population dynamics (as in the UN Population Projections), and continued investment growth at its long-term average rate (Annex 3.1). While projected change in demographic structure is expected to weigh on potential growth, the long-term trajectory of potential growth is marked by considerable uncertainty. For example, unlike many other EMDEs, the youth share of population is currently high (more than a third of the region's population is under the age of 25). This generates a large potential pool of new entrants into the labor force as well as a large consumer base for innovative activity, despite an aging population structure. But such capacity can only be realized to boost potential growth if the private sector is sufficiently vibrant, such as having a flexible labor market and more educated workforce, to create new jobs.

Raising private-sector participation. Looking ahead, the challenge for the region is to tackle the deep-seated structural impediments to sustained and private sector-led growth, the type of growth that allows job creation to support higher per-capita living standards. This will require policies to promote economic diversification; measures to improve the business climate (e.g., the recent introduction of the investment law and industrial licensing act in Egypt and a bankruptcy protection law in the United Arab

BOX 2.4.1 Potential growth in the Middle East and North Africa *(continued)*

FIGURE 2.4.1.2 MENA potential growth

The slowdown in MENA's potential growth coincided with that of other EMDEs. Both production function and expectations-based measures suggest that post-crisis potential growth was substantially weaker than long-term average potential growth.



Sources: International Monetary Fund, World Bank estimates.
Notes: GDP-weighted averages.
A. Production function approach based on 50 EMDEs and 7 MENA economies. See Annex 3.1 for more details.
B. "PF" refers to production function approach (7 economies). "Exp." refers to potential growth based on long-term IMF WEO (5-year-ahead) growth expectations (16 economies).

Emirates); financial sector deepening; and policies to promote education and skills development.

Reconstruction investment. In fragile economies of the region, reconstruction investment that maintains adequate provision of health, education, electricity, water and sanitation services, remains a high priority (World Bank 2017w). In host countries of refugees, these efforts require adapting to the structural changes that the refugee crisis has brought to their economies, such as adopting more innovative financing mechanisms to fund higher demands for health service delivery (World Bank 2017u).

Improving public sector efficiency. Improving the quality and effectiveness of government will have to be an important part of the reform effort, especially in an environment where fiscal space is limited, public sector employment is excessive, revenue systems are over reliant on oil revenues, and energy subsidies are high. This will require measures to improve the efficiency of public investment, ensuring that broader spending programs deliver "value for money," and a careful review of revenue systems to enhance tax administrations, improve compliance, and cut wasteful and ineffective tax incentives.

Improving governance. Strengthening potential growth also relies on improving the governance environment, as weak governance in the MENA region has been found to crowd-out private investment and discourage private-sector growth (Nabli 2007; Benhassine et al. 2009). Improved governance, such as more structured measurement of results in training and educational programs, enhances the match of skills across workers and employers and may provide more quality jobs in the private sector (Gatti et al. 2013). Weak governance may also be reflected in perceived corruption, which is among a highly-cited constraint to business activity in MENA based on the World Bank's Enterprise Surveys. Higher levels of corruption are associated with lower employment and productivity and may discourage interactions between private firms and public authorities, subsequently deterring allocative efficiency (World Bank 2016k). Strengthening the legal framework, including in areas such as corporate governance and bankruptcy resolution, can alleviate these constraints and facilitate market transactions.

Cross-country experience suggests that education, health, and labor market reforms can yield significant benefits in terms of higher potential growth (Chapter 3). A scenario analysis applied to the MENA region suggests that labor market policies to raise the female labor force participation rates by its largest 10-year improvement historically could

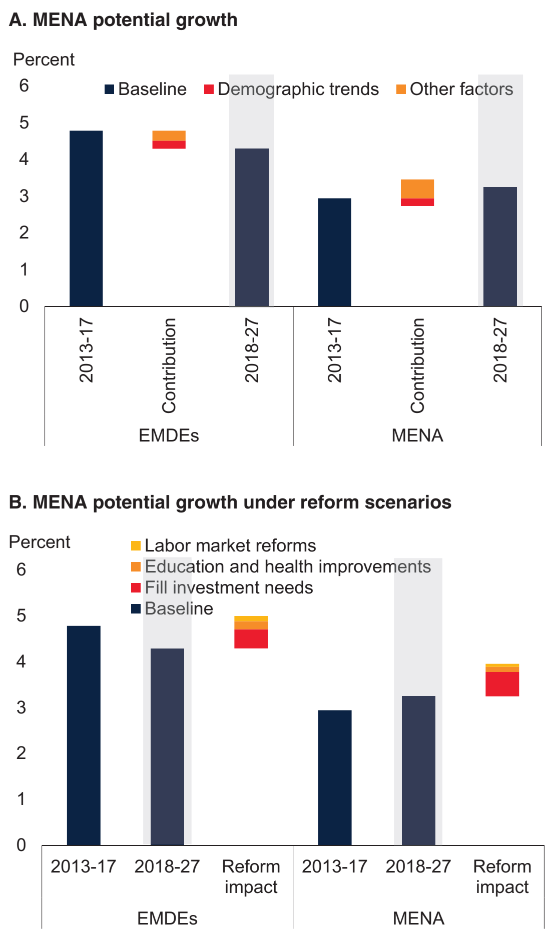
BOX 2.4.1 Potential growth in the Middle East and North Africa *(concluded)*

lift potential growth by 0.1 percentage point, while similar steps to address gaps in investment could yield a further 0.5 percentage point (Figure 2.4.1.3). If policy reforms were stronger than historical improvements, the gains realized from these policies could be substantially greater.

The MENA region has made substantial progress in structural reforms in recent years, including the formulation of national development plans to encourage inclusion of women in the workforce (Constant 2016).[2] Multi-pronged approaches through diagnostics, investment climate assessment, value-chain analysis, and labor skills review in areas like North Lebanon may also help lay the foundation for job creation (World Bank 2017x). Early childhood education programs in Morocco are expected to help boost educational attainment. The continued commitment to implementing these reforms will be critical for realizing higher potential growth dividends in the coming years.

FIGURE 2.4.1.3 Policies to stem weakness in potential growth

Potential growth in MENA is expected to strengthen somewhat over the coming years, partly reflecting improvements in investment and productivity. However, reforms that boost investment, labor market participation, or educational and health outcomes have the capability to further improve potential growth.



Source: World Bank estimates.

Notes: GDP-weighted averages. Derived using the production function-based estimates of potential growth (see Annex 3.1).

A. "Other factors" reflects changes unrelated to population structure. See Annex 3.1. for methodology.

B. Policy scenarios are described in methodological Annex 3.1.

[2] The World Bank and other international financial institutions have also participated in these efforts, such as by adopting the Women Entrepreneurs Finance (We-Fi) initiative, a multilateral financing facility; the Tunisia Youth Economic Inclusion Project to boost young workers' prospects; the Jordan Innovative Startups Fund Project to boost entrepreneurship; or the Concessional Financing Facility (WB-UN-Islamic Development Bank) to facilitate refugee host country development.