Defining Moment

Only by opening up will the Arab countries in transition achieve the broad-based growth their societies so desperately need

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THE Arab Awakening, which started with the self-immolation of a street vendor in a rural town in Tunisia in December 2010, continues to dominate events in the region. The following month, the call in Egypt for "bread, freedom, and social justice" echoed across much of the Arab world. The mandate for change is not just political—it extends deep into the economic sphere. People are calling for a say in how their countries are governed and for greater opportunities for human fulfillment.

Two years later, the future of the Middle East and North Africa is unclear. Policymakers face the immediate challenge of satisfying people's high expectations and carrying out tough reforms to bring public finances under control and bolster weakened financial systems. And progressing on economic reform is proving difficult in the face of political wrangling over constitutional and governance issues and a debate over the role of religion in public life.

Some are warning darkly that the revolution in the region is failing. Rather, I believe it could take any one of three paths. We could see

- a tendency toward economic chaos, if squabbling over political power prevents stabilization, let alone reform;
- stabilization achieved by a reassertion of vested business interests, which would offer a respite from eroding economic conditions but would condemn the region to a return to economic stagnation, or tepid growth at best; or
- emergence of a new economy, as newly mandated governments gradually end economic disruptions and undertake reforms to open the way to greater economic opportunity for their people.

Needless to say, the first two paths are undesirable, but the third will be hard to attain. The current state of the world economy is not making it easier to undertake substantial reform. A slowing global economy, ongoing uncertainties in Europe, higher food and fuel prices, and the conflict in Syria, with its deplorable loss of life, all risk undermining the fragile gains that have been made in the region these past two years.

For leaders trying to manage difficult political transitions, pursuing both stabilization and transformation is daunting. What are the prospects for success? And what, if anything, can the international community do to affect the outcome?

Region in transition

The Middle East and North Africa is a diverse region, encompassing 20 countries with a population of more than 400 million people and $3 trillion in GDP—about 6 percent of the global population and 4 percent of global GDP. Country circumstances vary widely. Some countries in the region possess vast oil and gas reserves, while others must import both energy and food. The most telling economic statistic about the region, however, is that non-oil exports of the region, the whole region, are $365 billion, about the same as the exports of Belgium, a country of 11, not 400, million people. This region suffers from a lack of integration into the world economy.

Long before people took to the streets, the Arab countries in transition—Egypt, Jordan, Libya, Morocco, Tunisia, and Yemen—faced the challenge of employing rapidly growing, young populations. Despite several rounds of reforms, their economies were unable to generate enough jobs. There were three related problems.

First, there was a lack of openness and access to key export markets. Second, in some countries, energy and other subsidies were repeatedly increased to placate restive populations, which left budgets overstretched without room to invest in education, health care, and infrastructure. And third, where meaningful structural reforms were attempted, there was a widely held perception that the control over investments in new sectors remained in the hands of a select elite.

The result was a lack of economic vitality and high and rising unemployment, especially among well-educated young people.

To achieve broad-based and sustainable growth, the countries of the Middle East must move away from state-dominated to private investment and from protected industries to export-led growth. In short, the private sector must become the main source of growth.

Key areas of reform

To achieve this goal, I see four main areas where reforms are needed.

1. Stronger emphasis on trade: The overarching strategy to deliver growth on a scale and timetable that would create enough jobs and prosperity for the rapidly growing populations in these countries is economic integration. More trade integration would not only create growth and jobs, it would provide discipline and incentives to help get the reform strategy right. A country that opens up to international competition will inevitably find a greater logic in the other reforms listed below because they will help it compete.

2. Improving the business environment and facilitating access to finance: Complex regulations hold back job creation and growth in the region. Take Egypt, where no less than 36,000 regulations currently affect the private sector. And Egypt is by no means the only country afflicted by burdensome legislation. Indeed, many new political parties are grounded in support from people running small businesses who see improvement of the business climate as a key priority. Another major constraint on economic growth in the Arab countries in transition is companies' lack of access to finance. Now, private credit mainly benefits large established companies, and only 10 percent of firms use banks to finance investment. This is the lowest share of bank financing in the world.

3. Enhancing the labor market and improving education: Youth unemployment ranges from 18 to 30 percent in Egypt, Jordan, Morocco, and Tunisia. In Egypt, 650,000 people enter the labor force each year. Women face particular problems in finding jobs—only about a quarter of the female population in Egypt, Jordan, Morocco, and Libya is employed. The public sector dominates the job market, and labor laws are rigid. Governments should reduce disincentives to hiring, while still protecting workers. The labor force is also inadequately educated and lacks technical skills in engineering and science. The education system must shift its focus from training young people for entry into the civil service to preparing them to work in the private sector.

4. Replacing untargeted subsidies with a modern social safety net: Price subsidies in the Middle East and North Africa cost around $210 billion in 2011, more than 7 percent of regional GDP. Besides being very costly, such subsidies do a bad job of supporting the poor. Safety nets targeting people who really need them are more efficient and effective. To build public support, reforms must be clearly explained, with credible commitments that subsidy savings will be spent on investment and that vulnerable people will be protected.

Role of the international community

When one considers the potential costs of the two undesirable paths I described earlier, and the benefits for the region as well as the global economy of the third path, it is clear that the international community should provide adequate financing, trade access, and policy advice to support positive change.

At the IMF, we are trying to rise to the challenge. Throughout this difficult period, we have been advising countries on how to maintain economic stability by managing the shocks they have experienced, how to ensure that vulnerable households are protected during the transition, and how to lay the basis for job-creating growth.

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Our involvement has shifted from mainly providing advice to helping with financing. In the past year alone, we have provided $8½ billion in loans to Jordan, Morocco, and Yemen. A support package with the government of Egypt has also been mapped out, and we hope to help Yemen with a follow-up arrangement to supplement the emergency assistance we provided last year. We also stand ready to provide financial assistance for Tunisia. In Libya, which needs capacity building, not financing, we have stepped up our support to help the country rebuild its institutions and economy after the end of the conflict in 2011.

While the IMF can help countries stabilize and reform their economies, the task is so great that the entire international community must do more.

The Deauville Partnership, launched by the Group of Eight (G8) in 2011, has provided a useful coordinating framework but cannot by itself deliver on all that is needed. It will be critical for the international community, including the G8 countries, regional partners such as the Gulf Cooperation Council countries, and international and regional financial institutions, to provide adequate financing and capacity building. The European Union and the United States must grant better trade access for products and services from the region. The invaluable expertise of the European Bank for Reconstruction and Development and other financial institutions can increase the pace of investment in the private sector—as happened in eastern and central Europe.

Each country in the Middle East and North Africa must carve out its own path for change. The process must be truly participatory. Broad buy-in will be essential, and reform plans, no matter how technically sound, cannot be imposed from above.

Failure to agree on a compelling, shared vision is not an option. The risk of returning to the old status quo is all too real. But the reward of meaningful reform can be substantial. If the Arab countries in transition achieve growth that is 2 percentage points higher than projected, they could cut unemployment in half over a five-year period. That would be a major achievement. ■