G8 - BMENA Finance Ministerial

Sharm El Sheikh, Egypt

May 21, 2006

Summary of Initiatives

In June 2004, Leaders of the Group of Eight (G8) countries established a "Partnership for Progress and a Common Future" with countries of the broader Middle East and North Africa (BMENA). As part of this initiative, Finance Ministers from the G8 and BMENA launched the G8-BMENA Finance Ministerial process. Building on the momentum created at their first meeting as a group nearly a year earlier, these ministers have met every six months to discuss policy reforms and to launch specific initiatives to foster economic growth and job creation in the BMENA region.

Since its inception, the initiative has made concrete progress in five distinct areas: promoting access to capital for small and medium-sized enterprises; expanding microfinance; coordinating regional development projects; strengthening the financial sector; and improving the private sector investment climate.

Promoting Access to Capital: The **Private Enterprise Partnership for the Middle East and North Africa (PEP-MENA),** managed by the International Finance Corporation, supports comprehensive programs designed to stimulate private sector growth in the region. The PEP-MENA facility provides technical assistance to enhance the business environment, develop financial markets, strengthen the SME sector, and forge public-private partnerships. PEP-MENA has made significant progress since it was launched in October 2004, and now has a total of seventy-three projects completed or ongoing in sixteen countries in the region.

Expanding Microfinance: The **Microfinance Initiative,** managed by the Consultative Group to Assist the Poorest (CGAP), includes a specialized multi-donor facility dedicated to expanding sustainable microfinance in the BMENA region. Over the past two years, this initiative has helped double the number of microcredit clients in the region, launched a regional microfinance hub in Jordan, and established the Microfinance Consultative Group to provide strategic advice and serve as a forum for the exchange of best practices. These achievements provide a strong basis for further activities to build capacity among microfinance providers and stimulate policy development across the region.

Coordinating Regional Development: **The Network of Funds (NOF)** constitutes an unprecedented initiative to improve coordination of development policies and assistance in the region. Comprised of multilateral and regional development institutions, the NOF partnership coordinates current and upcoming development activities, encourages policy dialogue and institutional cooperation, and identifies joint regional initiatives where appropriate. The NOF has meet three times since the launch of BMENA. At its most recent meeting in March 2006, the group made significant progress identifying priority projects in private sector development, infrastructure, human development, and trade across the region.

Strengthening the Financial Sector: The **Partnership for Financial Excellence (PFE)** has brought together regulators and Central Bank staff from the US and thirteen regional countries for training in bank supervision, anti-money laundering, and other regulatory topics. The PFE has so far sponsored seven training sessions and will complete another six by the end of 2006.

Improving the Investment Climate: The **Investment Task Force** (ITF), managed by the Arab Business Council, provides a forum for discussion of barriers to investment in the Arab World. The group works closely with the OECD, which is helping countries in the region to develop concrete strategies to improve the domestic and regional investment climate. The ITF will establish a Secretariat and hold its first Executive Workshop in late 2006 or early 2007.

G8-BMENA Finance Ministerial
Sharm El Sheikh, Egypt
May 21, 2006

Discussion Papers

1. International Finance Corporation Private Enterprise Partnership for the Middle East and North Africa (PEP-MENA)
2. Consultative Group to Assist the Poorest (CGAP) Microfinance Initiative
3. Network of Funds
4. Partnership for Financial Excellence (PFE) Financial Regulators' Initiative
5. Arab Business Council Investment Task Force
6. International Monetary Fund, "MENA Capital Markets and Global Imbalances"
7. BMENA Finance Working Groups

DISCUSSION PAPER

Private Enterprise Partnership for the Middle East and North Africa (PEP-MENA)

Update for BMENA meeting, May 21, 2006

Introduction

1. This paper serves as an update on progress of activities for the period of October 1, 2005 to March 31, 2006. Activities in the period have been focused on implementing programs and projects designed in the previous period. A significant event was the approval, by the IFC Board in December 2005, of an extension of PEP-MENA till June 30, 2009. This will allow for implementation of longer term programs and ensure solid impact of the interventions.

Progress Summary

2. During this period, PEP-MENA rapidly expanded its level of activities. It now has a total of 73 completed or ongoing projects in 16 of the 19 countries in the region. Financial intermediaries make up most of the PEP-MENA direct beneficiaries at 41% of expenditures, followed by other intermediaries such as business membership organizations and non-financial institutions at 39% and direct assistance to SMEs and governments the remaining 20%.

3. During the period, PEP-MENA engaged in a number of new technical assistance activities:

- In the Business Enabling Environment pillar technical assistance agreements were signed for projects on business start-up simplification in Alexandria, Egypt, business registration simplification in Lebanon, and alternative dispute resolution in Pakistan. Conferences and workshops were held on the World Bank Group's *Doing Business* report in Algeria, Jordan, Lebanon and Morocco as well as on the policy framework for mining investments in Egypt and Yemen.
- In the Financial Markets pillar two advisory agreements on corporate governance were signed: with the Association of Banks in Jordan to draft a charter of corporate governance best practices; and in the UAE to assist the Central Bank in developing a handbook of corporate governance for bank directors. Under IFC's credit bureau program, an advisory agreement was signed to help establish the first private credit bureau in Egypt. IFC also entered into an advisory agreement to assist a start-up microfinance bank in Pakistan in the design and procurement of its management information systems. Finally, IFC signed an advisory agreement with BCP Bank in Morocco to help promote SME banking by advising the Bank on how to improve its credit underwriting and risk management systems.
- In the SME Development pillar three projects were developed in conflict-affected frontier countries. A technical assistance agreement was signed with Kabul

- University to establish a sustainable business training program in Afghanistan; a Memorandum of Understanding was signed with PalTrade to strengthen firms in the olive oil cluster in West Bank and Gaza, and a project was launched to strengthen firms in pomegranate and green raisin clusters in Afghanistan; both aim to improve product quality and enhance export earnings by developing supply chains. Under IFC's SME Management training program, a memorandum of understanding was signed with the 'Skills Development Project' – a partnership between the World Bank and the Ministry of Foreign Trade and Industry in Egypt - to provide managerial training to local entrepreneurs in the construction, manufacturing, and tourism sectors.
- In the Privatization and Public-Private Partnership pillar two new mandates were signed to provide transaction support to increase private sector participation in infrastructure services: (i) Queen Alia International Airport in Amman, Jordan; and (ii) reactivation of an expired mandate with the Pakistani government for the privatization of an electricity distribution company. In Lebanon, Banque Libanaise pour le Commerce (BLC) was successfully sold to a Qatari group in October 2005; PEP-MENA had provided support to the Lebanese Government in preparing the bank for privatization.

4. In March of 2006, PEP-MENA's hub operations in Cairo, Egypt moved to its new premises together with IFC's regional investment operations. This co-location of investment and technical assistance staff forms part of the strategy to fully integrate IFC's two main instruments and thereby maximize its developmental impact.

Program Expenditures

5. Total net spending since the inception of PEP-MENA is US$15.1 million. Management & Administration (M&A) expenditures accounted for 47% of total net expenditures to date, reflecting the initial setup costs of the facility. During the reporting period, M&A expenditures dropped to 32% despite the one-time costs associated with the office move, reflecting the rapid expansion of operational activities. This trend is expected to continue.

6. PEP-MENA's operational expenditures have a heavy emphasis on the Financial Markets and SME Development pillars, both representing over 40% of total expenditures. Over time, this distribution will change with new project activities expanding rapidly in the areas of Business Enabling Environment (currently 11% of expenditures) and Public-Private Partnership/Privatization (currently 5%).

Staffing

7. In line with the expansion of operational activities, PEP-MENA continues to hire staff, increasingly now in field locations throughout the region. Total staff for the facility has reached 90, with about 40% located outside of the Cairo hub in various field offices. PEP-MENA currently has staff presence in Afghanistan, Algeria, Egypt, Jordan, Lebanon, Morocco, Pakistan, United Arab Emirates, West Bank & Gaza, and Yemen.

Staff now represents over 21 nationalities, with about 70% from the region. Forty-nine percent of staff is female.

Funding Status

8. PEPMENA was established with a target budget of US$ 100 million, of which the IFC has approved a contribution of US$ 20 million. Another US$44.5 million has been committed by other donors, including the Islamic Development Bank and Kuwait representing as first contributors from the region. During this period, agreements were signed with Canada, France and the United Kingdom to allow for disbursement of their commitments. Currently, the funding gap therefore stands at US$ 35.5 million.

Country	(US $ Millions)	Status
G 8/BMENA target	**100**	
IFC	20	Approved, partially disbursed
United States	15	Approved, partially disbursed
Japan	10	Disbursed
United Kingdom	5.4	Approved, partially disbursed
Islamic Development Bank	5	Committed, agreement in progress
France	2.6	Approved, partially disbursed
Canada	2.5	Approved, partially disbursed
Kuwait	2	Committed, agreement in progress
Netherlands	2	Disbursed
Total	**64.5**	
Outstanding Balance	**35.5**	

Operational Strategy

Low growth and high unemployment – especially for the young and female entrants into the labor market – tend to be a serious problem across the MENA region. The private sector simply is not strong and competitive enough to effectively address these concerns. Overly complex legal and regulatory frameworks, insufficient access to finance, a lack of entrepreneurial skills and expertise, and crowding out through an often still dominant public sector tend to present the most critical impediments. PEP-MENA's technical assistance work therefore focuses on four key pillars: improving the business enabling environment, strengthening financial markets, supporting the development of small and medium-sized enterprises (SMEs) and fostering privatizations and public-private partnerships.

In the Business Enabling Environment (BEE) pillar, PEP-MENA engages governments in the region in policy reform initiatives that deliver rapid and tangible results for the private sector. Assistance projects aim for positive impact within a short time-frame by taking a "demonstration" or pilot approach, while supporting the longer-term goals of ongoing reform processes undertaken by the World Bank and other donors. The BEE pillar concentrates on the following programs:

- *"Doing Business Better"*: public awareness raising events to motivate policy reform
- *Business Start-up Simplification*: Simplifying procedures for business registration, licensing and permitting
- *Business Regulation Reform*: streamlining operating rules and procedures
- *Alternative Dispute Resolution*: introducing mediation as an alternative tool to settle commercial disputes (see Box)
- *Industry Specific Policy Reform*: targeted policy interventions to support specific industries

IFC Launches a Pilot Project for Commercial Dispute Resolution in Pakistan

In September 2006, IFC will open a new pilot commercial mediation centre in Karachi, the first of its kind in the Sindh province. At the center, a pipe-line of commercial cases referred by the courts will be mediated by mediators, trained and certified to international standards. The centre is expected to serve as a model for Pakistan and the MENA region.

This innovative initiative has been enthusiastically welcomed by the private sector, especially SMEs, to help extricate them from lengthy and arduous court procedures which can take up to ten years to resolve. Currently, businesses have little alternative recourse in the event of a contract breach, and lengthy and burdensome court procedures often cost more than the amount of the dispute.

In collaboration with the Sindh High Court, the pilot will help to relieve the massive backlog of commercial cases stuck in overburdened courts. In parallel, IFC is also actively assisting the Ministry of Law, Justice and Human rights to enhance the legislative framework for mediation as an alternative dispute resolution mechanism.

In the Financial Markets pillar, programs are designed to generate and leverage investment opportunities, both for IFC and other private investors, while they seek to promote innovative financial products, new delivery mechanisms and greater outreach. Where IFC has a clear comparative advantage, program areas are selected based on an analysis of country needs, potential developmental impact and the degree of commitment demonstrated by our counterparties. The programs are:

- *SME Bank Advisory Service*: assist commercial banks to expand lending to SMEs
- *Microfinance*: expand access to finance for micro-enterprises
- *Leasing*: Introduce leasing as a financing tool for firms

- *Credit Information Services*: Promotes the sharing of credit information through private credit bureaus
- *Corporate Governance*: Improves governance and transparency practices for companies and banks
- *Housing Finance*: Promotes affordable housing finance/long-term lending by banks

Helping Bank Misr to Lend Small

It is estimated that only 12% of Egypt's micro-enterprises have any access to bank credit. IFC proactively approached the second largest bank in the country, Banque Misr, to make a compelling business case for breaking into the microfinance segment. The Board and management of the bank bought into the huge potential and asked IFC to design and implement a technical assistance program to help Banque Misr pilot a microfinance window in a limited number of branches.

IFC designed a program to facilitate a rapid and smooth scaling up: a thorough market survey, careful product design, and a complete business plan. The IFC team then helped the bank draft credit policy, procedures, and operating manuals for the microfinance operation, implement a loan tracking system, train loan officers, and organize workshops in target communities. By the end of the program, five pilot branches were operational and, within one year of operations, the bank had disbursed 13,000 micro loans grossing about USD6 million with a repayment rate approximating 100%. IFC was asked to help the bank roll-out the program to more branches and continues to work with Banque Misr to increase the quality and outreach of its microfinance program. The project is having a considerable demonstration effect which is attracting the interest of other banks in the country and the region.

To maximize the impact of its assistance on the performance of small and medium enterprises, the SME Development Pillar follows an integrated approach that builds on synergies among PEP-MENA programs and pillars, customizing existing programs in the SME, Business Enabling Environment or Financial Markets pillars and providing specific new services. The pillar comprises the following Programs:

- *SME Management Training*: Advances management skills and productivity, and improves capacity in local training markets
- *Access to Business Services*: Strengthens business associations as service providers and advocates for policy reform
- *Industry Development*: Enhances competitiveness in key industries through targeted interventions with multiple firms
- *Entrepreneurship Institutional Development*: Supports entrepreneurship development through education and training institutions
- *Gender Entrepreneurship Markets*: Support to women entrepreneurs to expand their participation in the private economy

Business Edge: Meeting the Challenges of Management Training for SMEs

SMEs in Egypt face numerous challenges that are directly related to available management skills. Still, they are reluctant to invest in management training. Constrained by limited time, staff, and financial resources, smaller companies consider training costly and are not convinced that it will have a tangible impact on the bottom line. Meanwhile, training agencies have focused on the "big fish" (multinationals and larger companies) that have structural training budgets. As a result, training agencies do not tap into a potentially very large market constituting the bulk of the private sector. PEP-MENA has seized this strategic opportunity to play a key role in enhancing the management capacity of SMEs through its Business Edge Management Training Program.

Training partners use the 36 *Business Edge* management workbooks (in Marketing, Human Resources, Production & Operations, Finance & Accounting, and Productivity Skills) as a core in designing their unique and innovative training programs for SMEs. IFC/PEP-MENA certifies training providers, provides their trainers with TOT sessions, and monitors their performance. Through such support, IFC ensures that consistent quality standards are upheld.

Since its launch in October 2004, 11 training partners in Egypt were certified and 2,522 SME managers/owners were trained. Trainees have given *Business Edge* training courses an average satisfaction rate of 86%. During the same period, 190 trainers and 20 Master Trainers from across the region were trained and certified in TOT sessions. In order to further expand its reach and impact, PEP-MENA is partnering with large corporations such as MobiNil, (the leading Egyptian telecommunications operator) to provide training on key business management skills to small enterprises operating in their value chains. The Business Edge program is currently being implemented in Egypt, Jordan., Oman Palestine, UAE, and Yemen.

The Public-Private Partnership and Privatization (PPP/P) pillar of PEP-MENA provides advisory, technical assistance and capacity building services to governments in order to enable them to involve the private sector in the delivery of services which thus far have been handled by the state itself. PEP-MENA focuses on opportunities where Governments' interests can be properly safeguarded, where risks associated with a failed PPP are minimized, and where bidding processes are implemented in an efficient and transparent manner. The work under this pillar comprises a number of specific advisory mandates. Below presents a few of the mandates currently signed.

- *Queen Alia International Airport, Jordan*
- *Electricity Distribution company, Pakistan*

In all these technical assistance activities, PEP-MENA works closely with its colleagues from IFC and the World Bank through joint engagements wherever possible to maximize synergies and effectiveness. In addition, PEP-MENA is keen on collaborating with other multilateral and bilateral donors by working together in individual projects and programs, because this significantly enhances the chances of success and positive developmental impact.

CGAP MICROFINANCE INITIATIVE
Update for the G8 BMENA meeting
Sharm el-Sheikh, May 2006

Overview. For the G8 Summit at Sea Island in June 2004, CGAP, a consortium of 33 donors to promote microfinance, helped to design a specialized multi-donor facility for promoting and improving microfinance in the Middle East and North Africa region. The G8 and several governments of the region endorsed the microfinance initiative in its Plan of Support for Reform by specifying that it is committed to establishing a Microfinance Consultative Group, managed by CGAP.
CGAP has since built a consortium to dramatically scale up microfinance in the Middle East and North Africa by: (1) building the capacity of microfinance providers; (2) stimulating improvements in policy; (3) improving aid effectiveness; (4) funding innovations and new institutions in new markets; (5) building awareness of microfinance best practices.

Outreach: Market update. Since its launch less than two years ago, the CGAP initiative has seen the number of microcredit beneficiaries increase dramatically, with microfinance institutions growing in equal measure. As of December 2005, we count 1.5 million microcredit clients in the region against 750,000 at the beginning of the initiative in December 2003. A milestone of 2 million clients is set to be reached in 2006

Key institutional achievements. CGAP established the Microfinance Consultative Group (MCG), composed of leading donors (including the World Bank, USAID, KfW, the United Nations, the Islamic Development Bank, and Agfund), practitioners, and policy makers from the region. The MCG held its first meeting in Cairo in December 2004; the second meeting took place in November 2005 during the third annual conference of Sanabel, the Arab microfinance network. The role of the MCG is to provide strategic advice and serve as a forum for the exchange of best practices in microfinance.

CGAP also agreed with the government of Jordan to establish its regional technical hub in Amman to implement and manage project activities. A director, Rula Dababneh, who has over ten years of banking and microfinance experience, was hired, and the hub was launched in August 2005.

In addition, CGAP has established an Executive Council, made up of ministers and other high-level officials from the MENA region and chaired by Her Majesty, Queen Rania Al Abdullah of Jordan, to champion the initiative's vision of building pro-poor financial sectors. The members of the Council include H.E. Driss Jettou, Prime Minister of the Kingdom of Morocco; H.E. Abdulkarim Al Arhaby, Yemen's Minister of Social Affairs; H.E. Dr. Mahmoud Mohieldin, Egypt's Minister of Investment; H.E. Suhair Al Ali, Jordan's Minister of Planning and International Cooperation; and former IMF head Michel Camdessus. The Executive Council had its inaugural meeting on May 21, 2005 during the World Economic Forum at the Dead Sea, and Her Majesty Queen Rania Al Abdullah endorsed the CGAP Key Principles of Microfinance on behalf of the council.

Update on project outcomes. A number of activities such as the country-specific national microfinance strategies, training partnerships, the legal framework diagnostics, and the survey of regional and national donors are already underway.

Building the capacity of microfinance providers. Through the technical hub and in partnership with regional or national organizations, the initiative has launched several major initiatives for microfinance institution (MFI) managers, including training, translation and dissemination of best practice documents, and technical assistance to microfinance providers:
- Four training of trainers' workshops have been organized through Sanabel, one of CGAP's key partners in the region. To date, Sanabel has a pool

CGAP MICROFINANCE INITIATIVE
Update for the G8 BMENA meeting
Sharm el-Sheikh, May 2006

of 24 trainers; these trainers have provided training courses for over 326 microfinance managers in seven Arab countries.

- CGAP in collaboration with various players and stakeholders in the region developed a concept paper to explore various options to establish a best practice training center in Amman to serve the capacity building needs of MFIs in the sub-region, with a particular focus on Jordan, West Bank and Gaza, and Iraq. The goal of this training center is to offer high-quality microfinance training services and serve as a hub for the dissemination of best practices.
- The Arabic version of the Microfinance Gateway was launched. The Gateway is a key tool to exchange information, capitalize knowledge, and disseminate best-practice documents in Arabic. Over 100 documents have been translated into Arabic and are available on line.
- In Jordan CGAP is providing support to the newly created National Microfinance Bank in its effort to become a major microfinance provider in Jordan.

Stimulating improvements in policy frameworks. CGAP legal experts are carrying out diagnostics of legal and regulatory frameworks in several countries to provide recommendations to policy makers, donors and practitioners on how to improve the business climate for microfinance. Workshops to engage government officials in relevant discussions and a specialized helpdesk manned by legal experts to help policy makers are also planned.

- Policy diagnostic missions have been carried out in Algeria, Egypt, Jordan, Morocco, Tunisia, Yemen and West bank and Gaza
- Governments and Donors implemented CGAP recommendations in Yemen, Jordan, West bank and Gaza, and Morocco. Following up on the Jordanian mission, CGAP has helped the government develop a National Microfinance Strategy that was approved by the cabinet on March 30, 2005.
- CGAP conducted a microfinance country assessment for West Bank/Gaza in July and September of 2005 at the request of James Wolfensohn, special envoy for the quartet. The assessment aims to scale up microfinance in West Bank/Gaza to reach 100,000 clients over the next three years and has been well received by the Palestinian Authority and donors.

Improving aid effectiveness. The initiative is setting up in-country working groups, conducting donor training and surveying regional and national donors.

- After an initial regional donor coordination meeting in December 2004, CGAP has conducted a mapping exercise of donor activity in the region as a first step towards better donor coordination.
- The donor guidelines for microfinance programs have been translated in Arabic for better dissemination.
- CGAP engaged and visited several Arab Donors involved in microfinance, notably the Islamic Development Bank and the Abdullatif Jameel initiative.

Transparency. By promoting greater transparency and consistent reporting standards, the initiative will also help link MFIs to domestic capital markets.

- CGAP is working with the World Bank to roll out its new financial access survey program
- CGAP is working with the MIX (the Microfinance Information Exchange) to improve transparency of MFIs in the region. Twenty-seven MFIs are now reporting their financial and outreach information to the public.

The budget. The total budget for five years is approximately US$20 million. The budget for the first two years is estimated at $3.39 million, of which the U.S State Department is considering committing $2 million and CGAP donor members $1.39 million. No other G8 donors have committed to fund the initiative at this time.

NOF

UPDATE ON NETWORK OF FUNDS INITIATIVE FOR THE G8/BMENA MEETING IN SHARM AL SHEIKH – 21 MAY, 2006.

Four technical working groups in the areas of private sector development, infrastructure, human development and trade, were created last year under the NOF Initiative. These working groups met at the AMF premises on March 21-22, 2006, which were attended by representatives from the Arab Monetary Fund, EIB, Kuwait Fund, Islamic Development Bank, IMF, World Bank, OPEC Fund and Arab Trade Financing Program. Following two days of discussion, including information sharing on ongoing activities, identification of challenges and sharing of experience, the groups suggested a number of opportunities for further collaboration. All participants noted the presence of significant existing programs in all of these areas, particularly bilateral assistance and the importance of not interfering with ongoing efforts. To this end a number of initiatives were identified in the four principal areas with the aim of leveraging the potential value added of the NOF-as a forum for dialogue and cooperation between regional and global financial institutions which could work together informally on a number of regional activities. Participants discussed the possibility of using the Arab Payments System initiative as a prototype for collaboration, to the extent that is demand driven, based on a detailed stock taking undertaken on a joint basis among participating institutions in each Arab country and identifies follow-up actions to be implemented at the country and individual institution level.

A. **Private and financial Sector Development: (Co-chaired by: AMF, EIB)**

Participants noted the presence of significant existing programs in this area, particularly bilateral assistance and the importance of not superseding ongoing efforts. To this end, two initiatives were identified.

- **Arab Bond Market Development Initiatives.** The outcome is a stronger capital market in the region, an area generally recognized as needing significant strengthening. The project will be demand driven and consist of a detailed stocktaking undertaken on a joint basis for each Arab country. This will identify follow up actions which will be allocated to individual institutions for follow up.

- **Arab Housing Finance promotion Initiative.** The outcome will be a stronger housing finance market which will have a positive impact on the capital markets as well as SME development – Housing finance being the key way entrepreneurs finance start up and initial investment. The project will follow the Bond Market process.

B. **Infrastructure: (Chaired by IDB)**

Participants noted the importance increasing project and sector financing in infrastructure, encouraging regional projects and programs such as subregional transport infrastructure among interested countries, enhancing public private partnerships and the use of structured finance and associated technical assistance as well as innovations needed to enhance sustainability of current activities such as the increased used of road funds, beneficiary surveys and public involvement in the transport sector. It was agreed, however, that there was one high priority activity for infrastructure, which is **water initiative.**

Ensure achievement of the Water Millennium Development Goal. Given the rapid deterioration of available water for people in the MENA region, concerted efforts would be needed to ensure adequate water availability by 2015. Participants noted the presence of many ongoing water programs but agreed that there would be value in a joint exercise to take stock of existing programs on a joint basis for interested countries to determine the best way of meeting the Water MDG target.

C. **Human Development: (Chaired by World Bank)**

Participants identified activities which would enhance the development impact and results orientation of education projects in the MENA region including:

- **Fostering a Regional Network of Education Research and Policy Institutes** to enhance the basis of information and research tools and capacities in the are of education. This would entail strengthening existing institutes to carry out policy research on impact and establish a results-orientation of projects at the country level. The regional network will also twin with reputable institutions outside the region to enhance its capacity.

- **Regional Capacity Building Activities in Education,** This activity would address the fact that there are few training courses on education sector reform that are region-specific, in Arabic and carried out in the region for middle level policy makers in the education sector. It will establish a series of training modules on education sector reform for the region to be carried out by local institutions on a regular basis. It will also include staff exchange between other countries to share experience.

- **Enhancing the quality of Math and Science Education** at the Secondary Level-strengthening the quality of math and science education is a challenge for all countries seeking to compete in a globalized economic system. This proposal will support a series of regional activities to enhance the quality of the math and science curriculum at the secondary level including teacher training, curriculum reforms, twinning with countries strong in math and science education, etc. It will also work with interested countries to improve ranking in international exams in math and science (TIMSS).

D. **Trade (Co-chaired by: AMF & IMF)**

Participants discussed the importance of supporting ongoing progress on tariff and nontariff barrier reduction as well as accelerating integration with the global economy and promoting exports. Three initiatives which could support these aims were identified and include

- **JITAP (Joint Integrated Technical Assistance Program In International Trade)** aims at helping MENA countries integrate into the multilateral trade system and would support MENA country accession to the WTO.

- **Strengthen GAFTA as a source of regional integration** which could help to accelerate domestic reforms to underpin efforts at multilateral liberalization. Immediate efforts. This would include giving technical support to the Arab League Secretariat which monitors implementation of the GAFTA agreement.

- **Enhance access of SME exporters to trade finance** by ensuring appropriate insurance and guarantees needed to gain access to export credit. The suggestion was also made to invite MENA Export Credit Guarantee Agencies to participate in the working group.

Appendix I.

General Principles for the Network of Funds

Objectives

The *objectives of this partnership* are to coordinate policies and assistance in line with agreed national and regional development priorities for the countries of the region. To achieve this objective, the NOF will conduct information sharing on current and upcoming activities, policy dialogue and collaboration as well as to identify joint technical and financial initiatives where appropriate. The NOF seeks to enhance rather than duplicate other coordination mechanisms and fora by creating a venue for multilateral coordination in the region, as well as encouraging regional initiatives, cross sectoral approaches, proactive engagement with the private sector and others. Participants will participate in these projects according to the specific mandates of each institutions and line of their business.

Membership

The Network of Funds is open to all financial institutions active in the region.

Modalities

An existing regional institution will serve as the anchor to provide support to the meetings and working groups under this initiative.

The NOF will meet twice a year at a High Level Representatives level concurrent with the World Bank and IMF Annual/Spring Meetings. It will decide on and review progress on joint initiatives as well as identify important issues facing the region as input for the Ministerial meeting. Each institution nominates a representative to serve on the deputy level working group.

The deputy level working group will prepare the agenda and input for the High Level Representatives meeting, share information on current and upcoming activities and propose new activities.

Partnership for Financial Excellence
Financial Regulators' Initiative
Update, May 2006

In September 2003, finance ministers gathered in Dubai to create the Partnership for Financial Excellence (PFE), a joint initiative to promote financial sector development. Central to the PFE is the Middle East & North Africa Financial Regulators' Initiative, a technical partnership between U.S. and Arab Banking Supervisory authorities. Through this initiative regulators from the US and across the region have collaborated on training programs for staff from Central Banks and supervisory authorities to enhance technical capacities in banking supervision, anti-money laundering, and other regulatory topics.

Thirteen countries from the region actively participate in the MENA financial regulators training program: Algeria; Bahrain; Egypt; Jordan; Kuwait; Lebanon; Morocco; Oman; Qatar; Saudi Arabia; Tunisia; United Arab Emirates; and Yemen. Other participants include the Arab Monetary Fund, the Arab Academy of Banking and Financial Sciences and the Union of Arab Banks, plus from the US the Federal Reserve, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and Treasury Department.

The MENA Financial Regulators' Initiative is guided by a Consultative Group in which all participating countries are represented. The Consultative Group has meet three times - most recently in December 2005 in Egypt - to evaluate recent training events, discuss training priorities going forward and set the course calendar for the coming year. The initiative has been funded by the Middle East Partnership Initiative of the U.S. Department of State.

To date, the Financial Regulators Initiative has conducted seven training sessions in the region. The topics included:

- Risk-Focused Supervision and Risk Assessment (hosted by Egypt)
- Bank Resolution (Jordan)
- Bank Analysis and Examination School (UAE)
- Examination Management School (Tunisia)
- Problem Bank Supervision (Egypt)
- Evaluating Bank Management (Kuwait)
- Risk-Focused Supervision and Risk Assessment Seminar (Oman)

Case Study: Seminar or Risk-Focused Supervision & Risk Assessment

The first regional supervisory training event under the MENA Financial Regulators' Training Initiative was held in Cairo, Egypt, during December 12-16, 2004. The Egyptian Banking Institute and the Central Bank of Egypt were the host institutions, and the training was provided by the US Federal Reserve. Forty-seven participants from eleven countries in the region attended the event

This hands-on training event combined lectures with case-studies and group work, and covered issues related to the risk-focused supervision examination process, examination documentation, credit risk assessment, including credit risk examination techniques modeling. It also provided an overview operational risk assessment and operational risk examination techniques and modeling. Market and liquidity risk assessment and related examination techniques were also covered. The program concluded with an aggregate risk assessment lecture and case-study.

The US Federal Reserve team was led by staff from the Division of Banking Supervision & Regulation. Lecturers and facilitators included a Federal Reserve Vice President, a Supervisory Financial Analyst, and an Examining Officer, plus a special lecture on issues related to risk, compliance, and controls assessments in the area of anti-money laundering and financial crimes by the President of the newly created MENA Financial Action Task Force.

In February, 2006, the Central Bank of Oman hosted a second seminar on risk-focused supervision and risk assessment for 43 participants from 9 countries.. This intensive, case-study driven course was based on risk management concepts, including risk-focused supervision, credit and operational risk as well as liquidity and market risk assessment. Student expectation met or exceeded in all cases per course evaluations, as 99 percent agreed or strongly agreed that the course contents met the stated objectives, while the course materials were found to be clear and the instructors knowledgeable and well prepared. The instructors included four Federal Reserve staff and one guest lecturer from the Special Investigation Commission of Lebanon.

Concrete Activities in 2006

In 2006 the Partnership for Financial Excellence Financial Regulators Initiative will offer the following training opportunities:

- Evaluating Bank Management (hosted by Egypt, May 21-25)
- High-Level Conference on Financial Sector Challenges (Lebanon, June 19-21)
- Risk-Focused Supervision and Risk Assessment Seminar (UAE, September 3-7)
- Fundamentals of Interest Rate Risk Management (Lebanon, September 11-15)
- Problem Bank Supervision (Tunisia, October 30-November 3)
- Bank Analysis and Examination School (Egypt, November 5-9)

Background Paper No. 6

G8/Arab Business Council Investment Task Force

Executive Summary

Foreign direct investment and increased levels of private domestic investment are critical to the economic growth and prosperity of the Middle East region. Recognizing the poor performance of the MENA region in attracting investment, both from abroad and domestically, the Arab Business Council, in cooperation with the G8, are forming an Investment Task Force.

The mission of the G8/ABC Investment Task Force (ITF) is to provide a forum for discussion and analysis of the existing barriers to investment in the Arab World and to provide a platform by which CEOs and senior business leaders from the G8 and the Arab World can convene to discuss these impediments to investment. The ITF will provide an opportunity for all parties to discuss future investment opportunities, areas of collaboration, and best practices for the region.

ITF Mission

The mission of the G8/ABC Investment Task Force is to provide a forum for discussion and analysis of existing barriers to investment in the Arab World and provide concrete policy initiatives that can attract investment in the short and long term. This will take place through a mechanism that provides a forum for CEOs and senior business leaders from the G8, India, China, and the Arab World to convene to present case studies and examples of barriers experienced and then to propose solutions and discuss opportunities for future investment.

The ITF will provide an opportunity for all parties to discuss sectorial investment opportunities, areas of collaboration and best practices for the region. The ITF output will be provided to the ABC, OECD-MENA initiative and interested governments and international organizations. The ITF will include CEOs and leaders from all aspects of the private sector, including small and medium-sized businesses.

ITF Mechanism

The mechanism by which the ITF will function will be private sector driven. The secretariat of the ITF will support Executive Workshops that will occur two times per year. These Workshops will include CEOs and senior representatives from their company. The outcomes will be fed up to the ministerial level through official representation of the ITF at meetings of the Arab Business Council, the OECD-MENA Investment programme, and meetings of Finance Ministers of the G8-Forum for the Future. The ITF will also maintain the option to convene its own ministerial level meetings if required.

Timeline

Pre-Launch

ITF Formation of Project Proposal and budget: Completed May 2005.

Meeting at BMENA Ministerial Washington, D.C. April 2005 on ITF: Completed April 2005.

Phase I-II: 2 Year Plan

Phase I:

Purpose: Formation of ITF and Launch
Duration: 6 months
Dates: September 2006 – February 2007

Phase I will be the initial formation stage. During the initial six month phase the following will occur:

1. ITF formation meeting to take place in WEF Jordan summit in May 2005
   G8 and Arab CEOs and senior business leaders will participate with ABC members to review the ITF proposal, mission, structure and timeline.
2. ITF Secretariat
   Secretariat to be formed.
3. First Executive Workshop

Phase II:

Purpose: Implementation of ITF mission
Duration: 1.5 year
Dates: March 2007 – August 2008

Phase II will be the implementation stage. During the 18 month period, the following will be achieved:

- Establishment of full Secretariat
- Biannual Executive Workshops, focused on specific issues identified in Phase I (March 2007, September 2007, March 2008)
- Involvement in Ministerial-level meetings as above, including presentation of results of Executive Workshops and supporting research
- Production of two Annual Reports (July 2007, July 2008) including conclusions of research, specific recommendations developed and endorsed by Executive Workshops
- Production of at least two research papers to support Executive Workshops

INTERNATIONAL MONETARY FUND

MIDDLE EAST AND CENTRAL ASIA DEPARTMENT

"MENA CAPITAL MARKETS AND GLOBAL IMBALANCES"

Background Paper for the G-8/BMENA Meeting
Sharm-El-Sheikh, Egypt, May 21, 2006

egypt.doc May 10, 2006 (3:43 PM)

I. Introduction

Global current account imbalances in the world economy have been increasing since 1996 and the recent surge in oil prices has brought oil producers into the picture. The Middle East and North African (MENA) region, being home to the largest oil producers in the world, has naturally become a factor in the global imbalances debate.[1] Despite considerable differences across countries, the region as a whole has greatly benefited from high oil prices, with robust growth and a large current account surplus.

MENA oil producers are therefore in a strong position to use the additional oil revenues to support the private sector in creating jobs. The expansion in domestic demand should also contribute to the reduction of global imbalances. However, monetary authorities are finding it increasingly difficult to control the liquidity generated by sizeable oil revenues and capital inflows. While consumer price inflation has increased only slightly so far, signs of substantial overheating have appeared in asset markets. The surge in liquidity has helped to accelerate the development of regional financial markets, showing the potential for deepening regional integration.

This paper examines the issues highlighted above, and addresses the following questions:

- How is the oil price shock affecting the MENA region and what is its impact on global imbalances?

---

[1] MENA oil exporters include: Algeria, Bahrain, Iran, Kuwait, Libya, Oman, Qatar, Saudi Arabia, Sudan, Syria, United Arab Emirates, and Yemen. Iraq is not included because of the lack of data.

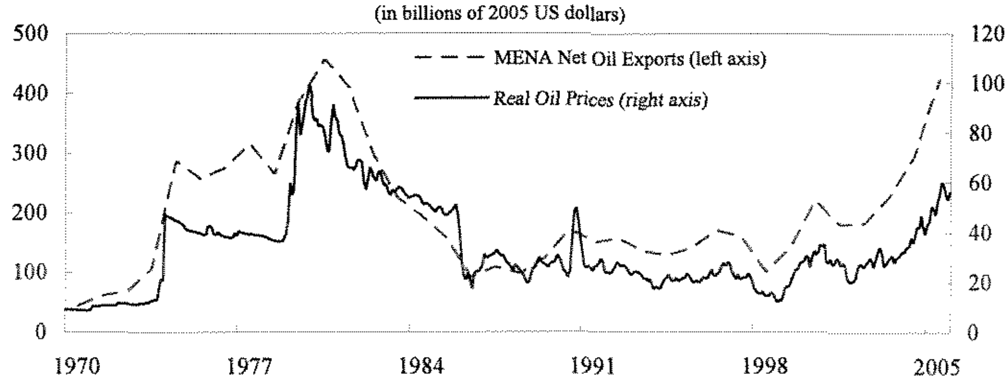
- How is the MENA region using the additional oil revenues?
- What is the impact on MENA capital markets?
- What are the best policies to maximize the payoff from high oil prices and contribute to the orderly reduction of global imbalances?

II. The Oil Price Shock, The MENA Region, and Global Imbalances

A. The Impact of the Oil Price Shock on the MENA region

Oil prices started rising in 1999 and experienced a sharp acceleration in 2003. Driven largely by growing demand in advanced and emerging economies, oil prices doubled in the period 2002-05. The oil price run continued in 2006, mainly out of concerns about future supply disruptions. Although the oil price in real terms has remained well below the peak reached in the late 1970s, the current boom in net oil exports of the MENA region comes close to the one experienced in that period (Figure 1).

Figure 1. Real Oil Price and MENA Net Oil Exports, 1970-2005
(in billions of 2005 US dollars)



Source: IMF, World Economic Outlook.

Global imbalances were apparent well before oil prices started to rise, with the U.S. current account deficit widening since 1996. But the oil price shock contributed to a significant worsening. Between 2002 and 2005 the additional oil export receipts amounted to almost $440 billion (more than 33 percent of GDP) for all fuel exporters, of which $230 billion (about 39 percent of GDP) accrued to MENA oil exporters alone. This was matched by an increase in the oil import bill of almost 4 percent of GDP for China, and over 1 percent of GDP for the United States, other advanced economies, and other developing countries (Table 1).

Table 1. Change in Net Oil Exports, 2002-05

	Billions of Constant 2005 US dollars	In percent of World GDP	In percent of own GDP
Fuel exporters	437	1.2	33.2
Of which: MENA	230	0.7	39.1
United States	-124	-0.4	-1.1
Other advanced Economies	-198	-0.6	-1.3
China	-53	-0.2	-3.8
Other developing countries	-53	-0.2	-1.2

Source: IMF, World Economic Outlook.

1/ Fuel exporters include MENA oil exporters (see Table 2), Brunei Darussalam, Republic of Congo, Equatorial Guinea, Gabon, Kazakhstan, Nigeria, Norway, Russia, Trinidad and Tobago, Turkmenistan, and Venezuela. Criteria for inclusion are that, over the past five years, the average share of fuel exports exceeds 40 percent and the average value of fuel exports exceeds $500 million. The sample excludes large oil producers for which oil is not a key export earner, such as Canada, Ecuador, Mexico, and the United Kingdom.

As a result, the MENA region saw GDP growth accelerate from 3.6 percent in the period 1998-2002 to 5.8 percent in the period 2003-05, largely outpacing global growth. The benefits from high oil prices, however, were not evenly spread across the region. While the regional current account surplus rose from 4.2 percent of GDP in 2002 to 15.8 percent of

GDP in 2005, reflecting an improvement by 16 percentage points of GDP for the group of oil exporters, oil importers saw their small surpluses vanish as their balances worsened by more than 3 percent of GDP. The negative impact was particularly significant for Djibouti, Jordan, and Mauritania. Among oil producers, the external position of Sudan, Syria, and Yemen also worsened (Table 2).

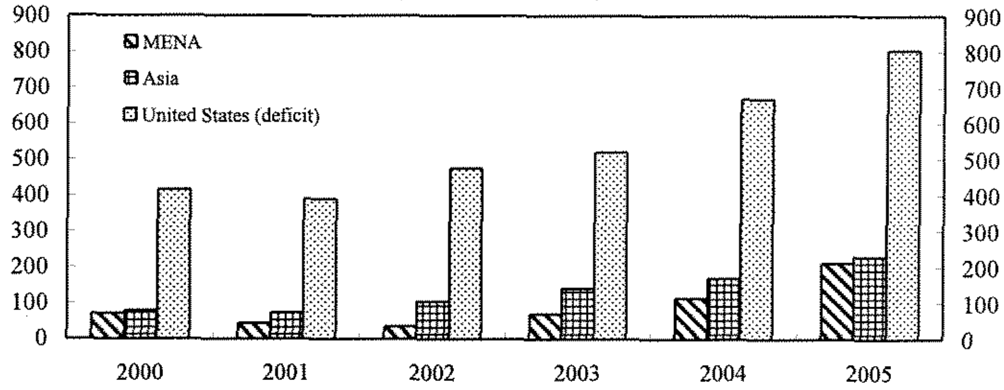
Table 2. MENA: Current Account Balance, 2002-05
(in percent of GDP)

	2002	2003	2004	2005
MENA	4.2	7.4	10.2	15.8
Oil exporters	5.6	9.7	14.0	21.6
Algeria	7.6	13.0	13.1	21.3
Bahrain	-0.4	2.3	4.0	5.8
Iran	3.1	0.6	2.5	7.5
Kuwait	11.2	20.4	31.1	43.3
Libya	2.9	21.5	24.2	40.2
Oman	6.6	4.0	1.7	7.0
Qatar	16.5	25.9	37.9	45.6
Saudi Arabia	6.3	13.1	20.5	28.3
Sudan	-9.8	-7.7	-6.3	-10.7
Syria	4.6	3.2	-2.0	-5.5
UAE	5.0	8.7	11.8	22.0
Yemen	5.4	-0.1	1.9	2.6
Oil importers	0.8	1.4	-0.1	-1.8
Djibouti	4.5	5.5	-0.8	-4.2
Egypt	0.7	2.4	4.3	2.8
Jordan	5.6	11.6	-0.2	-17.8
Lebanon	-15.4	-15.2	-18.2	-12.7
Mauritania	-3.7	-18.3	-36.8	-35.5
Morocco	4.1	3.6	2.2	0.9
Pakistan	3.7	3.4	0.2	-2.4
Tunisia	-3.5	-2.9	-2.0	-1.3

Source: IMF, World Economic Outlook.

The combined current account surplus for the MENA region, which was small compared with the magnitude of global imbalances in 2002, has grown rapidly. In 2005, it amounted to about $210 billion, which is equivalent to more than 26 percent of the U.S. deficit, up from some 7 percent in 2002, and almost as large as Asia's surplus (Figure 2).

Figure 2. MENA: Current Account Positions of Selected Regions, 2000-05
(in billions of US dollars)



Source: IMF, World Economic Outlook.

The impact of the oil price shock on global imbalances has been exacerbated by the shift that occurred in fuel exporters' spending patterns. Fuel exporters today spend much more on goods imported from China and other developing countries and much less on goods imported from the United States and other advanced economies (Table 3). Hence, as the shock redistributes income toward fuel exporters, in the first round the relative demand for U.S. goods declines, aggravating the U.S. current account deficit.[2]

[2] This effect might be partly offset by higher demand for U.S. services, if oil exporters, as anecdotal evidence suggests, are large consumers of U.S. financial and other services.

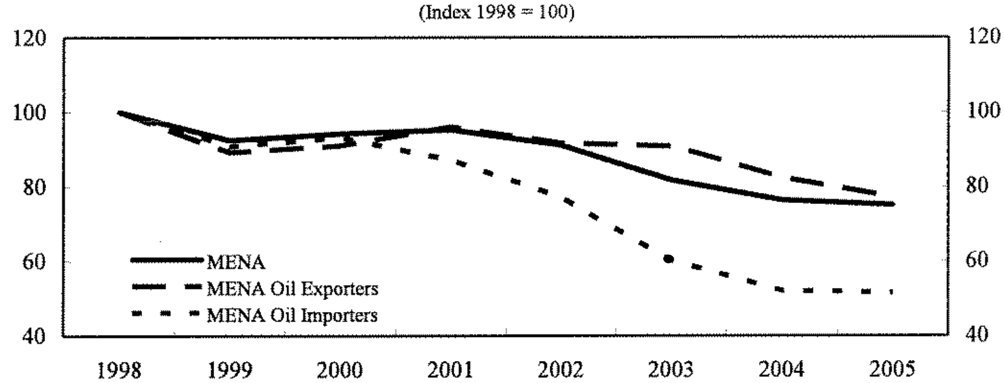
Table 3. MENA: Composition of Merchandise Imports
(Percent of imports of given importing region sourced from given exporting region)

	Exporting Region					
	Fuel Exporters 1/	United States	Other advanced economies 2/	China	Other developing countries 3/	Total
Importing Region—2004						
Fuel Exporters 1/	—	8.4	59.0	7.6	25.0	100
United States	8.3	—	54.0	13.8	23.9	100
Other advanced economies 2/	19.5	25.8	—	21.3	33.4	100
China	9.2	8.6	65.3	—	17.0	100
Other developing countries 3/	13.3	19.5	59.3	8.0	—	100
Importing Region—Change Between 1981 and 2004 4/						
Fuel Exporters 1/	—	-5.7	-9.0	6.6	8.0	...
United States	-11.4	—	-4.9	13.0	3.2	...
Other advanced economies 2/	-19.6	-8.7	—	18.1	10.1	...
China	8.5	2.6	-14.7	—	3.6	...
Other developing countries 3/	-9.2	-4.8	7.8	6.3	—	...

Source: IMF World Economic Outlook, Spring 2006.
1/ For the definition of fuel exporters, see Table 1.
2/ This group included all the countries in the World Economic Outlook group of advanced economies, except for the United States.
3/ This group includes all other countries.
4/ Percentage point difference in the share of imports between 1981 and 2004 (i.e., a positive number indicates an increase since 1981).
The year 1981 is the earliest date available with data coverage comparable to 2004.

A second reason for the large impact of the oil price shock on global imbalances is that movements in exchange rates have not contributed to the adjustment. For the MENA region as a whole, the nominal effective exchange rate has depreciated significantly since oil prices started rising, partly reflecting the negative shock facing oil importers. But interestingly, the nominal effective exchange rate of oil exporters also depreciated on average by more than 20 percent since 1998 (Figure 3), while theory would suggest that the large oil revenues would lead to an appreciation.

Figure 3. MENA: Nominal Effective Exchange Rate, 1998-2005
(Index 1998 = 100)



Source: IMF, Information Notices System.

B. The Use of Additional Oil Revenues

The use that fuel exporters make of the additional revenues has important consequences for how global imbalances will unwind. The reflow to the rest of the world of the oil revenues accrued can take place through two different channels. One is the current account. The surplus can be spent to finance domestic consumption and investment, which will raise imports and eventually reduce the current account surplus. The other channel is the capital account. In this case, oil revenues are saved and used to buy foreign assets, boosting capital outflows.

The impact of these two channels on global imbalances is quite different. The current account channel contributes directly to narrow imbalances by decreasing the oil exporters' surplus. Moreover, as long as the additional imports come from oil-importing countries, the current account channel helps reduce the pressure on the oil importers' current accounts. Conversely, the capital account channel does not contribute to the reduction of imbalances, but it may help achieve a more gradual adjustment. Capital outflows from oil exporters ease liquidity conditions in oil-importing countries, contributing to keep lower interest rates and stronger demand in those countries. Investment of additional oil revenues in U.S. dollar assets help support the U.S. dollar exchange rate. These effects combine to delay the adjustment, allowing economic activity to remain stronger in oil-importing countries.

The current account channel

High oil prices have increased the resources available to fuel exporters enormously. After years of low oil prices and limited social expenditures in many oil-exporting countries, one might expect to see spending adjust rapidly to higher prices, especially in countries with large populations and extensive development needs. The use of these resources, however, depends largely on how long the oil price shock is expected to last. If high oil prices are expected to decrease, the additional oil revenues will be considered only temporary and oil exporters will be inclined to save them.

What can be said about the persistence of the current shock? The historical experience does not provide a good guide for the future because conditions are different from those prevailing in other episodes. About one-half of the 1973-74 shock proved long-lasting, but the 1979-81 shock was reversed faster. Nonetheless, despite the enormous uncertainty attached to any long-term projections of oil prices, both market expectations and medium-term market fundamentals suggest that a considerable proportion of the current shock will be permanent.[3]

---

[3] See Chapter IV of IMF *World Economic Outlook*, April 2005.

From this perspective, the implications of the oil price shock for MENA oil exporters are even larger. In fact, while making up for only a little more than 35 percent of world oil production, MENA oil exporters are endowed with almost 67 percent of the world petroleum reserves. The value of these reserves rose by more than $37 trillion between 1999 and 2005 (Table 4). Assuming that only one third of the shock will prove temporary in nature, in line with the estimates contained in the April 2005 *World Economic Outlook*, permanent income for MENA oil exporters would have increased by about $750 billion, more than three times the increase in net oil exports experienced in the period 2002-05.[4]

Table 4. MENA Oil Exporters: Petroleum Reserves

			Change in Value of Reserves, 1999-2005		
	Percent of World Reserves	Value of Reserves in percent of 2005 GDP	Percent of 2005 GDP	Percent of 2005 World GDP	Percent of World Crude Oil Production
Algeria	1.0	635	522	1.3	2.4
Bahrain	—	53	36	—	0.1
Iran	11.1	3,679	3,199	14.8	5.1
Iraq	9.7	—	—	12.1	2.5
Kuwait	8.3	8,178	6,708	10.5	3.0
Libya	3.3	5,847	5,034	4.3	2.0
Oman	0.5	1,033	849	0.6	1.0
Qatar	1.3	2,244	2,143	1.9	1.2
Saudi Arabia	22.1	4,722	3,856	27.6	13.2
Sudan	0.5	1,290	1,280	0.8	0.4
Syria	0.3	661	572	0.4	0.7
UAE	8.2	4,129	3,368	10.3	3.3
Yemen	0.2	1,010	995	0.4	0.5
Total	66.5	3,801	3,175	85.0	35.4

Sources: BP, *Statistical Review of World Energy 2005*; Energy Information Administration; and IMF staff calculations.

1/ Estimates of reserves refer to end-2004 and production to 2004, except for Bahrain, for which 2003 production is reported.

2/ Total value of stock of reserves calculated using average petroleum spot price for December 2005.

[4] Based on the assumption of a U.S. long-term interest rate of 3 percent, in line with the average of the last 30 years.

Faced with a massive increase of oil resources, MENA oil exporters have been remarkably prudent in their spending. On average, about two-thirds of the increase in oil export revenues received since 2002 was saved (measured as the ratio of the change in the current account balance to the increase in oil export receipts). Governments, to which most of oil revenues accrue, have been careful in their spending plans, adopting conservative assumptions about the path of oil prices in their budgets.[5] On average, governments saved about three-quarters of the increase in oil revenue accruing to the budget since 2002 (measured as the ratio of the change in the fiscal balance to the increase in government oil revenues). As for the private sector, while investment spending increased strongly, consumption remained generally restrained. Most of the oil revenue increase was reflected in improved trade and current account balances.[6]

There were, however, significant differences across countries. Those with larger populations or larger expenditure needs, such as Iran and Algeria, showed a somewhat higher propensity to import and, correspondingly, a more limited improvement in the current account, than most of the Gulf Cooperation Council (GCC) countries.[7] Despite the increase in oil receipts, Sudan and Yemen saw their current account balance decline owing to the increase in imports

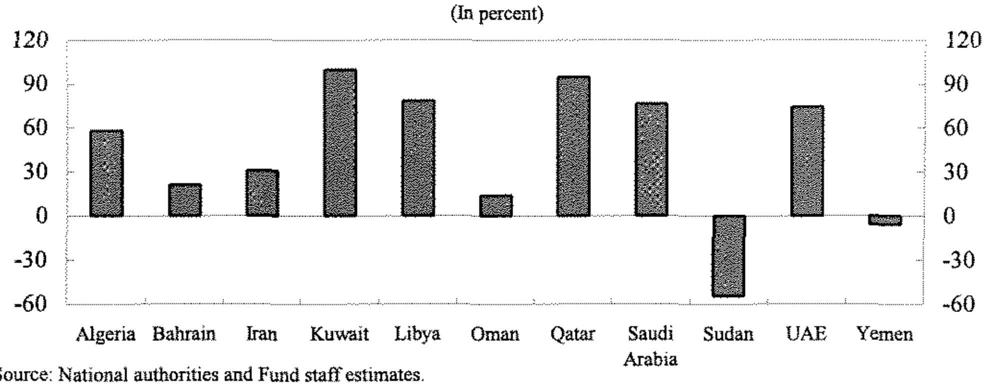
[5] For example, the oil price assumed in the 2006 budgets of MENA oil exporters averages only $30 per barrel.

[6] See also Box 1 of *IMF Regional Economic Outlook: Middle East and Central Asia*, May 2006.

[7] The GCC countries include Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and U.A.E.

connected with large investment projects. In Syria, oil receipts actually shrank due to dwindling production (Figure 3).

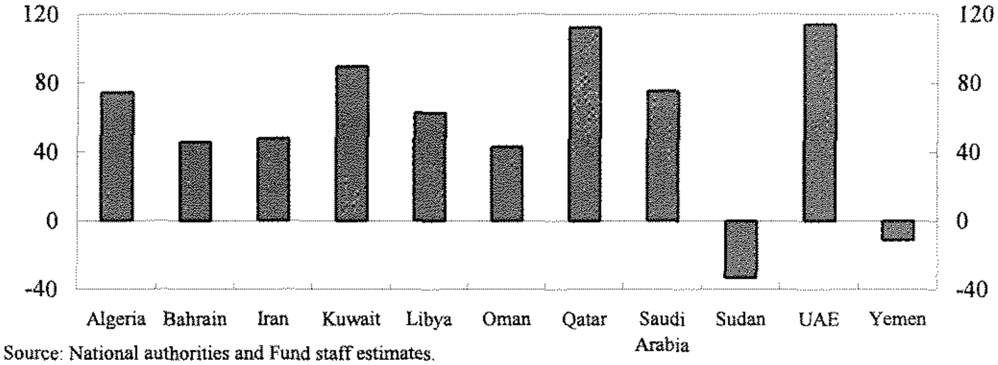
Figure 3. MENA: Change in Current Account to Change in Oil Export Receipts, 2002-05 1/
(In percent)



Source: National authorities and Fund staff estimates.
1/ Syria is not included as its oil export receipts declined.

The increase in oil revenues have been at least partly saved by governments, generating large improvements in the overall balance (Figure 4). The fiscal position for the MENA region improved dramatically, moving from a deficit of 2.4 percent of GDP in 2002 to a surplus of 5.2 percent of GDP in 2005. The increase in the non-oil deficit for oil exporters has been contained, rising from 19 percent of GDP on average in the period 1998-2002 to 20 percent of GDP in the period 2003-05. A substantial share of the additional oil revenue has been used to acquire financial assets (both at home and abroad) or reduce public debt, particularly in Kuwait, Iran, and Saudi Arabia. As a result, the ratio of total government debt to GDP for the MENA region fell from 63.3 percent of GDP in 2002 to 49.3 percent of GDP in 2005.

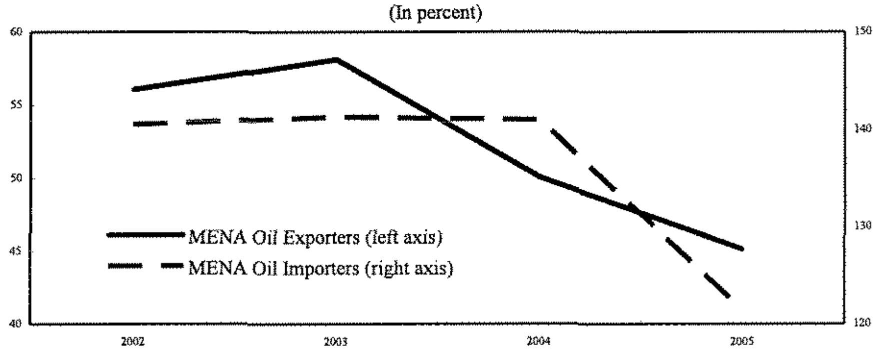
Figure 4. MENA: Change in Fiscal Balance to Change in Oil Revenue, 2002-05 1/
(In percent)



Source: National authorities and Fund staff estimates.
1/ The value for Syria (not included) is -237.7.

The cautious reaction of MENA oil exporters can be explained by several factors. First, history suggests that it takes time for spending to fully adjust to higher oil wealth. In past episodes, spending continued to grow well after oil prices had peaked. Moreover, unlike in previous episodes, the oil price increase has been gradual, and the realization of the size of the shock accordingly slower. Second, past episodes show that it might be unwise to base spending plans on long-lasting high oil prices. In the 1970s and 1980s, many oil exporters increased their expenditure substantially only to face painful retrenchments when oil prices slumped . Third, many oil exporters have improved the management of their oil wealth by setting up oil stabilization funds and fiscal guidelines to protect the budget from oil price volatility and to reduce the procyclicality of fiscal policy. Fourth, having enjoyed the benefits of sound public finances over several years, the authorities of many countries have become more conservative in conducting their fiscal policies.

Figure 5. MENA: Ratio of Domestic Gasoline Prices to US Prices, 2000-05
(In percent)



Source: National authorities and IMF staff estimates.

Nevertheless, government spending has increased significantly. Furthermore, sizeable resources have been devoted to cushion the impact of higher oil prices on consumers. In fact, the average pass-through of higher oil prices to domestic gasoline prices between 2002 and 2005 was about 45 percent for the MENA region, and only 24 percent for oil exporters. As a result, the ratio of domestic gasoline prices to U.S. prices — used here as a yardstick as US prices at the pump adjust promptly to international oil prices — has declined since 2002, particularly for oil exporters (Figure 5).[8]

The capital account channel

Given the large amount of additional oil revenues that are being saved, it is important to see how the surplus funds are being used and how global financial conditions are being affected. After the previous shocks, the current account surpluses of oil exporters were almost entirely

---

[8] See also Box 2 in *IMF Regional Economic Outlook: Middle East and Central Asia*, May 2006.

used to accumulate international reserves and bank deposits (mostly in European and U.S. banks).

Gross international reserves increased substantially in recent years. The level of gross official reserves in the MENA region more than doubled to more than $425 billion between 2002 and 2005, equivalent to about 15 months of import cover. Of these, $361 billion belong to MENA oil exporters. However, the accumulation of reserves in MENA oil exporters accounted for less than 50 percent of the cumulated current account surplus of these countries in the period 2002-05. Outflows to foreign banks appear quite limited. The increase in bank deposits in BIS-reporting banks amounts to only about 20 percent of the investable funds generated by the oil price increase for all fuel exporters.[9]

There is strong evidence that portfolio investment flows have increased substantially. Data limitations, however, do not allow a careful analysis of the allocation of these flows. The purchases of U.S. securities registered with the U.S. Treasury International Capital Reporting System explain about 10 percent of the cumulative current account surplus of oil exporters as a whole.[10] A large part of portfolio flows from oil exporters to the U.S. may not be detected as it transits through London, Geneva, Honk Kong or offshore financial centers to avoid the

[9] This information refers to all oil exporters. See McGuire, P. and N. Tarashev, "The International Banking Market", *BIS Quarterly Review*, December 2005.

[10] McCown, T.A., Plantier, L.C., and J. Weeks "Petrodollars and Global Imbalances", *U.S. Treasury Occasional Paper*, No. 1, February 2006.

reporting requirements of the post-9/11 Patriot Act. These inflows may have contributed to reduce long-term interest rates in the U.S. by as much as $\frac{1}{3}$ of a percentage point.[11]

U.S. assets are likely to remain an important component of MENA oil exporters' saving allocation. Oil sales are still priced, invoiced, and settled in dollars. GCC countries are pegged to the dollar and a large part of central bank reserves in the area remains invested in dollars. Nonetheless, it is likely that a significant amount of funds, while still denominated in US dollars, have been directed to other countries, and to large hedge funds outside the U.S. Part has been used to repay debt. According to IMF staff estimates, about 10 percent of 2005 hydrocarbon revenues have been used by fuel exporters to prepay their external debt obligations. More importantly, much of the surplus may have remained in the region, which now offers more appealing investment opportunities than in the past. Considerable anecdotal evidence points at an increased preference of local investors for regional markets, which in turns has contributed to the tremendous boom in regional equity and property markets.

III. The Impact on MENA Capital Markets.

The general improvement in the regional economic situation and large privatization programs have attracted sizeable capital inflows. Foreign direct investment has increased considerably toward oil exporters (GCC countries), but also emerging markets (Jordan, Morocco) and low income countries (Mauritania, Djibouti). Together with the considerable amount of funds that remained in the region, capital inflows have contributed to create conditions of ample

[11] See Box 2.3 in *IMF World Economic Outlook*, April 2006.

liquidity that the monetary authorities have found increasingly difficult to control. Broad money growth in the region has accelerated significantly from 15.3 percent on average in the period 1998-2002 to 18.3 percent in the period 2003-05. Credit to the private sector has expanded rapidly throughout the region.

As a result, consumer price inflation has been edging up from 5.2 percent in the period 1998-2002 to 6.4 percent in the period 2003-05. In oil-exporting countries, where inflation has been fairly stable, energy subsidies may have played an important part in containing inflation by cushioning the impact of higher oil prices. Easy liquidity conditions, however, have affected regional capital markets, which have shown clear signs of overheating.

A. The Boom in Equity Markets

Middle East equity markets experienced an unprecedented boom in 2003-05. Market turnover increased dramatically and stock prices soared in all countries, with the highest increases taking place in Egypt (931 percent), Saudi Arabia (564 percent), and U.A.E. (450 percent) (Table 5). In early 2006, regional market capitalization stood at nearly US$1.3 trillion, having exceeded that of central and eastern Europe ($1.1 trillion) or Latin America ($1.1 trillion). Growth was particularly strong in 2005, when the region was home to eight of the top ten performing bourses in the world, and prices in Egypt, Dubai, Lebanon, and Saudi Arabia more than doubled. This strong performance contrasts with generally modest gains in industrial countries, and substantially exceeds the average of emerging markets as measured by Morgan Stanley's index (MSCI), which grew only by 30 percent.

Table 5. MENA: Stock Market Indicators, 2002-05

Country	Index	Market Capitalization (in percent of GDP) End 2002	End 2005	End 2002 to End 2005 Growth (%)	End 2005 to Date 1/ Growth (%)
Bahrain	Bahrain Stock Exchange	90	134.7	106.0	-4.1
Egypt	Hermes Index	...	84.9	930.6	1.8
Iran	Tehran Stock Exchange	12.6	20.5	103.4	-7.3
Jordan	Amman Stock Exchange General Index	...	326.6	381.8	-14.1
Kuwait	Kuwait Securities Market	91	190	380.9	-10.2
Lebanon	Blom Stock Index	...	351.7	188.9	21.8
Morocco	Casablanca Stock Exchange	...	51.0	75.3	43.8
Oman	Muscat Stock Index	25.6	41.9	154.1	3.8
Pakistan	Karachi Stock Exchange 100 Index	...	31.5	253.8	22.3
Qatar	Doha Stock Market	151.2	230.1	375.6	-17.3
Saudi Arabia	Tadawul All Shares Index	39.7	209.9	563.7	-17.3
Tunisia	Tunis Stock Exchange Index	...	8.9	45.9	15.9
U.A.E.	Natl Bank of Abu Dhabi (Composite)	399	173	450.4	-25.4

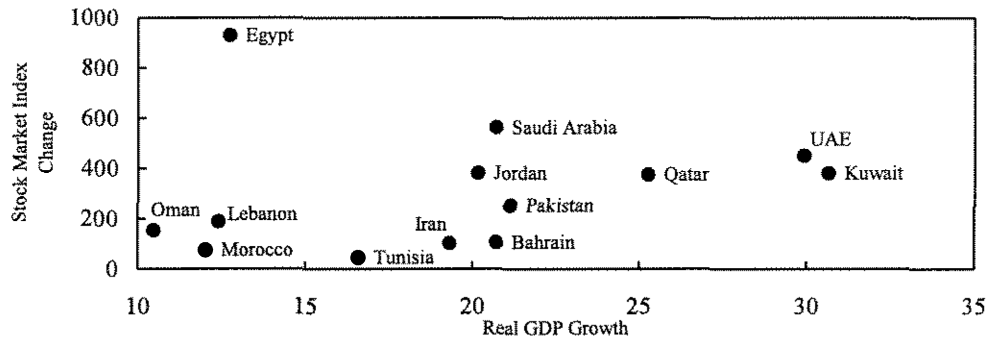
Source: Country authorities, Bloomberg, and Fund staff estimates.
1/ March 31, 2006.

Several factors account for the extraordinary growth of MENA stock markets. The improvement in regional economic conditions following the increase in oil prices has certainly been the driving force. In fact, equity market prices have increased broadly in line with real economic developments, GDP growth in particular (Figure 6). Moreover, low returns on global financial markets have made equity very attractive to regional investors, now faced with a dramatic surge in corporate profitability, particularly in hydrocarbon-related companies.[12] Finally, large privatization programs, usually implemented via IPOs at very favorable conditions, increased the demand for shares from the public, contributing to

[12] In Saudi Arabia, the performance of one giant Saudi petrochemicals company, SABIC, explains about half of the increase in the stock market index since January 2003. By contrast, price increases were more subdued in Oman and Bahrain, where the economy is more diversified and hydrocarbon-related companies account for a smaller share of the market.

the vast oversubscription of most IPOs and the rapid price adjustment experienced subsequently.[13]

Figure 6. MENA Stock Market Indexes and Cumulative GDP Growth, 2002-05



Source: Bloomberg and IMF International Financial Statistics.

Warning signs, however, point at excessive valuations in some markets.[14] With the exceptions of Bahrain and Oman, the 2005 surge in stock prices in the Middle East largely exceeded that experienced during the 2000 "dotcom" bubble in the United States and the 1990 Nikkei episode in Japan, and is only partially explained by the jump in oil prices. Price-to-earnings ratios indicate high valuations in some regional markets, but they remain well below those reached in mature markets during boom periods.[15] Stock market volatility has

---

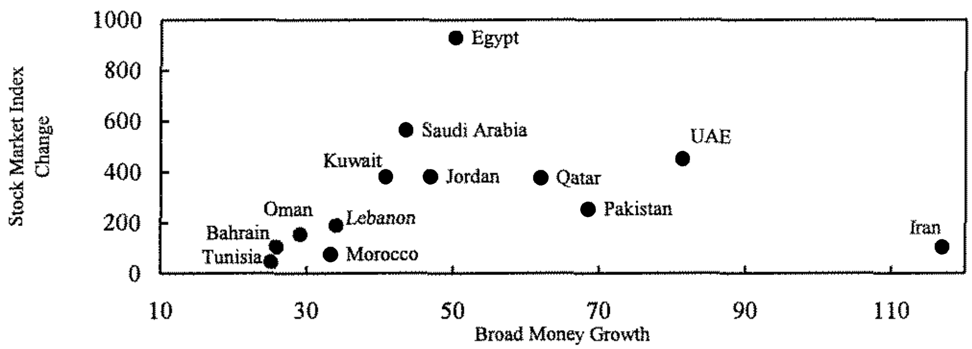
[13] The increase in the share prices of Industries Qatar and Qatar Gas Transport following their IPOs explains almost two thirds of the gains in the Qatari stock price index in the period 2003-05.

[14] See also Box 3 in *IMF Regional Economic Outlook: Middle East and Central Asia*, May 2006.

[15] In Lebanon, Qatar, Saudi Arabia and U.A.E. share prices have risen to 40 times earnings on average, but otherwise regional P/E ratios are below 25. By comparison, average P/E ratio for S&P 500 companies had risen to 60 times earnings by the end of 2001.

also increased, just as it did for the U.S. and the Japanese equity markets towards the end of those boom periods, although there is large variability across countries. The increase in daily trading volumes also suggests greater investor activity. Bank credit to the private sector has been expanding rapidly across the region, often moving in tandem with equity prices, and margin lending increased strongly (Figure 7). The available evidence indicates that strong increases in property prices may have accompanied the surge in equity prices.[16]

Figure 7. MENA Stock Market Indexes and Cumulative Money Growth, 2002-05



Source: *Bloomberg and IMF International Financial Statistics.*

B. The Recent Correction

Market sentiment began to change in late 2005. Increasing concern about the sustainability of current valuations started spreading through investors in the U.A.E. and Qatar, where stock price increases had been especially large. Selling pressures became more apparent in November, extending to Egypt and Jordan, while other regional markets benefited from the

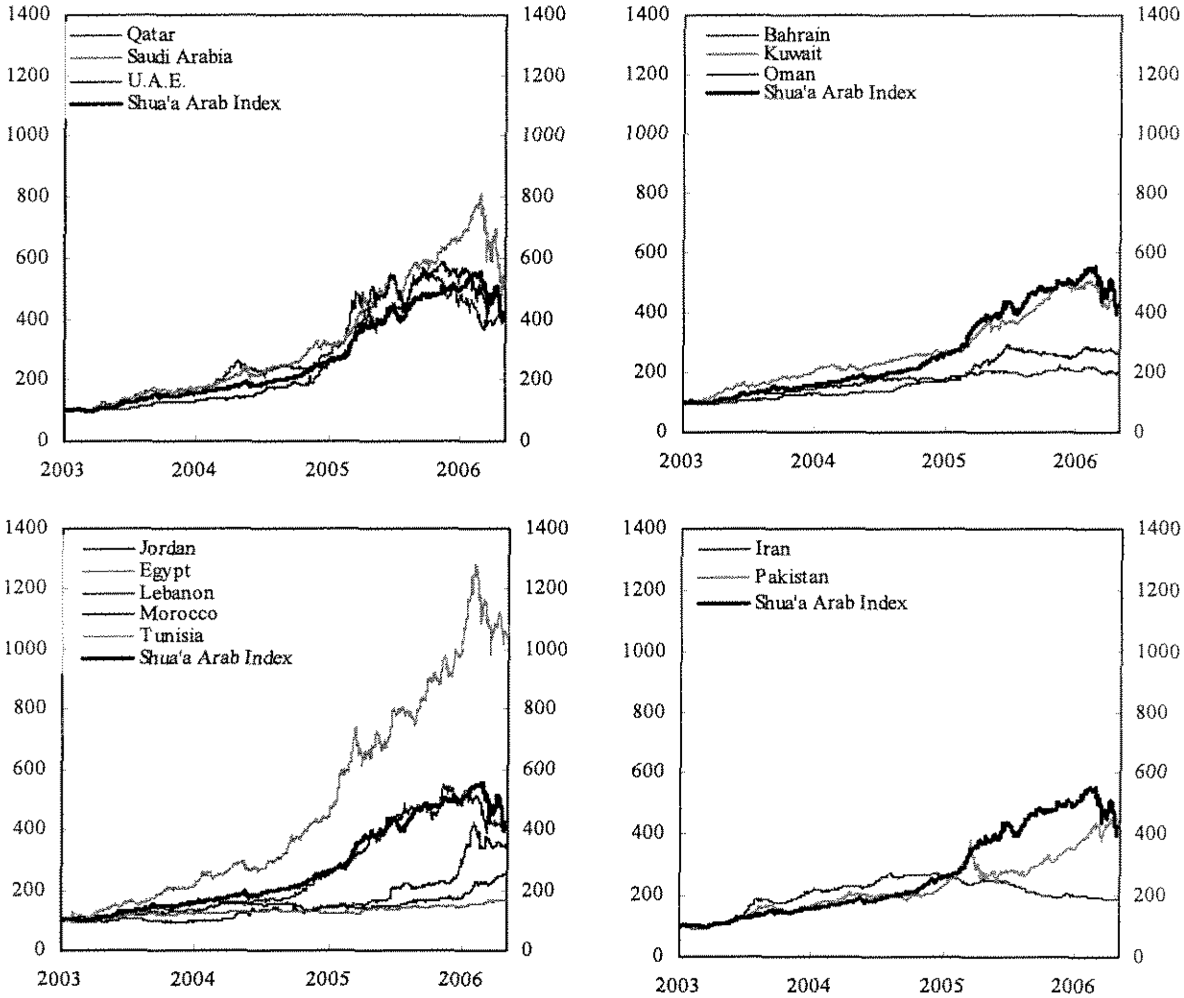
[16] Although there is no direct evidence on property prices, the stock market valuation of real estate and construction companies, as measured by an index compiled by Shuu'a Capital for Arab countries, shows a fivefold increase in the period 2003-05.

rebalancing of investor portfolios (Oman and Bahrain) or the strong performance of individual shares (SABIC in Saudi Arabia).

The correction became precipitous in 2006. After most markets rallied in January, pessimism became generalized. The launch of new IPOs in Jordan and the U.A.E. may have contributed to drain liquidity from the market, with market commentators reporting cases of buyers taking profits by selling off other holdings in the region to participate in the "guaranteed" value appreciation of IPOs. As margin calls increased rapidly, investors withdrew from other regional markets to cover losses at home, leading to panic selling on "Black Tuesday", March 14 (Figure 8).

In most countries, the authorities refrained from providing direct market support. The policy response focused on measures to support market liquidity and open up the markets to new investors. The Saudi authorities lifted the exclusion of foreign residents — previously restricted to dealing only in mutual investment funds — and lowered the minimum face value of traded stocks in an effort to make smaller shares attractive to investors. Under pressure to reduce extreme market volatility in February, they narrowed the intraday trading band from 10 percent to 5 percent, reversing the move when the market stabilized in early April. The U.A.E. authorities raised the ceiling on bank lending against equity holdings from 70 percent to 80 percent of the market value and reduced to two weeks the time limit for companies to refund IPO subscriptions. In Jordan, the authorities revoked the prohibition for listed companies to buy back their shares.

Figure 8. MENA Stock Market Performance, 2003–06
(Index Jan 2003 = 100)



Source: Bloomberg, Teheran Stock Exchange and Shua'a capital.

At the end of March, many markets had registered significant losses relative to end-2005, ranging from more than 25 percent in U.A.E. to more than 17 percent in Qatar and Saudi Arabia, 14 percent in Jordan, and 10 percent in Kuwait. Losses in Iran and Bahrain were smaller. For markets in oil-importing countries (Lebanon, Morocco, Pakistan, Tunisia), which had not grown as rapidly, the correction was very mild or insignificant.

Despite the recent correction, equity prices remain significantly higher than two years ago in many regional markets. Although downside risks still dominate the outlook, the bulk of the correction may have already occurred, and a substantial portion of past valuation gains is likely to be retained as long as fundamentals remain strong and high oil prices and hydrocarbon output continue.

Overall, the impact of the market correction on the real economy and the financial sector should be limited. Wealth effects on consumer spending and the impact of a higher cost of capital on business investment will be contained by the persistence of favorable macroeconomic conditions. Although there are significant differences in the strength of the financial sector across the region, commercial banks — which have a central role in most countries — are generally well capitalized, have relatively good asset quality, and are very profitable. Banks' stock market exposures are in most cases subject to prudential limits and remain small.

IV. Conclusions and Policy Recommendations

With the world economy growing strongly, continued high oil prices, and favorable financial conditions, prospects for the MENA region are very good. While growth may ease in oil-exporting countries, the growth momentum is likely to accelerate in some oil-importing countries such as Lebanon and Morocco. The external position will continue to strengthen for most countries. Inflationary pressures will increase and tightening of macroeconomic policies will be required in some countries in response to rising fuel prices and strong capital inflows. Countries will have to be prepared for potential risks stemming from geopolitical uncertainties and a deteriorating security situation, weakening of international financial markets and rising interest rates, and further sharp corrections in regional equity and property markets.

For oil exporters, the key challenge is managing oil revenues so as to maximize the benefits of high oil prices. The realization that high oil prices are not a temporary phenomenon should gradually induce many countries to use more of their oil revenues on projects with high (private or social) rates of return. Depending on each country's particular circumstances, investing in infrastructure, social reform and education would boost the economies' growth potential and flexibility. To the extent that additional domestic spending results in higher imports, this will also contribute to narrow global imbalances. Oil price subsidies, however, should be scaled back substantially to limit excessive energy consumption. The fiscal saving could be partly used for targeted compensation mechanisms aimed at the poor.

With growing inflationary pressures, monetary policies will be challenged by large foreign exchange inflows, which fuel rapid money and credit growth. Increased exchange rate flexibility will allow the necessary adjustments to take place, with real appreciations in oil-exporting countries and emerging markets facing a lasting increase in capital inflows, and real depreciations in oil-importing countries. In any case, monetary policies will need to be tightened to contain inflationary pressures or to prevent higher inflation becoming entrenched.

The substantial increase in liquidity has been felt in regional capital markets, which experienced a remarkable boom between 2002 and 2005. Even after the recent reversal in many equity markets, the risks of further corrections remain. The authorities should carefully monitor these risks while implementing strong prudential measures and improved risk management practices to improve the resilience of financial systems to boom-bust cycles. The regulatory and supervisory frameworks in equity and other financial markets should be upgraded to international standards, where necessary. Transparency would be enhanced by strictly enforcing regulations and disclosure requirements, and taking prompt corrective actions against violators, thereby reducing insider trading. Restrictions on margin lending and higher risk-based capital could help improve risk management practices. Limiting banks' exposure to asset markets may be helpful in some circumstances. Direct intervention in the stock markets should be avoided, except for the use of standard market circuit breakers. The use of IPOs as a vehicle of privatization has had positive effects on the depth of some equity markets, but the policy of deliberate underpricing should be reconsidered in light of its impact on market stability.

Over the longer term, regional financial systems need to rise to the challenge of the efficient intermediation of vast oil revenues. This will require reducing public ownership and control of financial institutions, further opening the markets to foreign financial institutions and customers, strengthening institutional and regulatory frameworks, and integrating local markets into the global financial system. The issuance of domestic debt for sterilization purposes would enhance monetary policy effectiveness and deepen capital markets.

All in all, the MENA region has the ingredients to make the jump to a higher sustained growth path. Faster growth in the region is essential if the economies are to absorb the rapidly growing labor force. Clearly, higher growth and increased investment and consumption are necessary for domestic reasons. But they will also have the beneficial by-product of reducing global imbalances.

BMENA Finance Working Groups

Proposal: That G8-BMENA Finance Ministers endorse up to five sub-ministerial working groups, with a designated country lead, to address specific topics and advance concrete activities between Ministerials.

Rationale: The G8-BMENA Finance dialogue is well-established at the ministerial level. Misters have now indicated the need for a deeper dialogue among technical experts, to share expertise and generate ideas on growth, private sector development, and strengthening the financial sector. A series of working groups would meet this need. The working groups would have three main functions:

- ensure adequate, concrete follow-through on existing ministerial priorities;
- identify additional initiatives and generating proposals for ministerial consideration;
- interact with external experts to share ideas and expertise.

Officials in the region have also suggested it would be useful to share experiences with reform strategies and policy implementation, as well of international assistance programs, such as the initiatives under the G8-BMENA umbrella.

Proposed Working Group Topics (Proposed Chair)

- Tax Administration and Policy (Egypt)
- Foreign Exchange Management (Turkey)
- Banking System / Financial Sector Reform and Regulation (Bahrain, Lebanon)
- Microfinance (Jordan)
- Poverty Alleviation (Yemen)
- Productivity Enhancement (Morocco)
- Financial Services / Capital Market Development (Bahrain)
- Macroeconomic Stabilization (Pakistan)

Level of Participation: The working groups would be comprised of technical specialists in private sector development, investment, development, and microfinance who would benefit most from greater cooperation with colleagues in the region. Membership would be self-selecting, among interested countries.

Process: The working groups would function primarily though an e-mail based 'virtual network' of officials. E-mails could be supplemented with communications by phone, videoconference and meetings in person as needed. Each group would select a Chair to coordinate, facilitate communication, and prepare any materials for discussion by Ministers or senior officials.

Each group would report back to BMENA finance ministers before ministerial meetings, providing a review of the previous period's activities and proposed work plan going forward. The group would also provide an interim update for ministers at the finance officials' meetings in the margins of the Forum for the Future.

Work Plan: The Working Groups would focus on no more than two topics, defined by the members. In the first six months, each group would select its organizational Chair, set up its virtual network, and begin examining concrete activities to recommend to ministers. At the next BMENA Finance Ministerial the group would answer the following questions as relevant to its topics:

- Have the existing initiatives made sufficient progress in this area? What are the next steps?

- What have been the primary constraints - bureaucratic, financial, or cultural - that have constrained the initiatives? What can be done to remove those constraints?

- Are there important areas not being addressed by the current initiatives? What specific activities are needed and how can they be advanced?