Introduction: The Middle East and North Africa region is recovering from the financial crisis along with the global economy. Growth in 2010 is expected to be 4.4 percent region-wide, driven by domestic absorption as well as a positive contribution from external demand. The recovery from the crisis differs by country depending on initial conditions and the intensity of the impact via the three principal channels through which the global financial crisis affected MENA economies - the financial sector, the price of oil, and the balance of payments, reflecting the impact on trade, remittances and FDI flows.

The GCC Countries: The GCC countries are leading the regional recovery as oil prices have rebounded and the GCC financial sector is stabilizing. Growth in the GCC countries is projected at 4.4 percent in 2010—a remarkable comeback, given close to zero growth in 2009. These countries were hardest hit by the crisis because of a negative terms-of-trade shock associated with the drop in oil prices and a financial shock which destabilized overextended domestic banks and led to the bursting of a real estate bubble. Accumulated reserves and other assets enabled governments to respond quickly with monetary and fiscal stimuli, preventing a deeper deceleration in growth, and supporting the growth rebound. The recovery in the GCC countries is expected to have a positive impact on other MENA countries, mainly through increased flows of remittances and FDI.

The Dubai financial crisis is still unfolding, but the Dubai World debt restructuring offer has contributed to greater clarity about UAE’s prospects. The restructuring package is partially funded through loans from Abu Dhabi to Dubai and its adverse impact on UAE banks is cushioned by the likelihood of increased support to these banks from Abu Dhabi and federal entities. These short-term measures are helping to contain the negative impact of these events on UAE growth.

Ongoing large fiscal spending by Abu Dhabi is also expected to help the recovery and support the “service center approach” to integration and economic development. The question remains whether growth of the private sector will pickup when the public sector starts spending less, and the effects of the stimulus packages in UAE and Saudi Arabia wear off.

The Developing Oil Exporters: Growth of developing oil exporters is expected to accelerate to 4.2 percent in 2010 from 2.2 percent in 2009. Developing oil exporters felt the impact of the crisis, and now the recovery, largely through the oil price channel, due to the limited integration of their banking sectors into global financial markets and
the importance of oil in their export baskets. The sustainability of their recovery therefore hinges on the evolution in the global demand for oil and oil prices. Iran and Iraq are especially vulnerable to oil price volatility. At present, further upward pressure on oil prices is not expected due to ample spare capacity and little or no growth in oil demand in the G3. Temporary spikes, however, cannot be ruled out in response to unanticipated shocks over the course of 2010–11. Recognizing their vulnerabilities, most countries in this group have launched stimulus packages, but the extent to which they have been able to respond has varied depending on their fiscal space, accumulated reserves, and access to external financing.

**The Oil Importers:** The oil importers felt the impact of the crisis through the secondary effects of the crisis on trade, remittances, and FDI flows, so their recovery will depend crucially on the recovery in key markets, especially the EU and the GCC countries. The feeble recovery expected in the euro zone will drag down growth in the near term, particularly the growth of those with strong links to EU markets. Growth of oil importers is expected to decelerate to 4.5 percent in 2010 from the moderate, yet respectable pace of 4.8 percent in 2009, when key non-oil sectors, such as services, remained relatively resilient. Trade is recovering, with export revenue of oil importers expected to grow by 7.7 percent in 2010, after contracting by 13 percent in 2009. Remittance flows are expected to grow by 1.3 percent in 2010, albeit this pace is much slower than the one observed during the pre-crisis years.

The crisis has not led to reform reversals, and reforms have broadly remained on track, while in some cases countries have steamed ahead with reforms started prior to the crisis. Examples of the latter include the financial sector reform in Egypt and trade liberalization and economic integration in Tunisia. Fiscal policy is expected to continue to be expansionary, as countries use various measures to stimulate demand, and in some cases the private sector. Expansionary fiscal policy will have an adverse effect on fiscal balances. For some oil importers, including Lebanon, Jordan and Egypt, the fiscal space is limited and the fiscal situation may become a long-term growth issue, hence the need for these countries to trim fiscal deficits in the coming years.

**MENA’s Employment Challenge:** High unemployment has been a problem in MENA for years, and the crisis has dimmed prospects for improvements in the near term. While the impact of the crisis on official unemployment rates has been negligible in most MENA countries, participation rates, which were already low compared to other countries prior to the crisis, have declined as discouraged workers dropped out of the labor force and decided not to seek work in the official labor market. In addition, aggregate labor statistics hide the negative impact on some sectors. Workers in the manufacturing sectors have been especially vulnerable during this crisis, although job losses in these sectors were offset to some extent by the job creation in the non-tradable goods and services industries.

**World Bank Group Response:** The World Bank Group responded actively to the economic downturn in the MENA region. In Iraq, where the fall in oil prices severely affected public finances, the World Bank provided financial support through a development policy loan, working closely with the IMF. In oil importing countries, such as Egypt, Jordan, Morocco and Tunisia, the World Bank has provided technical support through diagnostics work as well as financial support through several development policy operations focusing on financial sector, public sector reforms and trade integration. These operations also aim to build crisis resilience for the future. In the GCC countries, the short-term response of the World Bank Group was to step up economic and financial monitoring.

IFC’s Global Trade Finance Program has helped businesses, especially small ones, access trade finance, while its Global Trade Liquidity Program has helped infuse liquidity into the trade finance market. IFC has also helped banks across the MENA region by sharing views and solutions on how to successfully navigate the crisis, structure robust risk management systems, and train key bank staff on risk management.

**Longer Terms Challenges in MENA:** Ample oil and gas resources, a youthful and growing workforce, and a growing momentum to look for ways to diversify their economies imply that the growth potential of the region is high. Looking beyond the next couple of years, however, MENA countries continue to face formidable longer term challenges. Standards of living in the region have stagnated as income growth has not been sufficient given MENA’s high population growth. High unemployment rates, particularly youth unemployment, low labor force participation,
especially for females, and informality have translated into one of the world’s lowest formal employment rates. Private investment rates have not increased commensurately with greater market and private sector orientation in most countries in the region. Among key long term growth challenges are access to finance, which is very low in MENA, competitiveness, and the non-competitive business environment facing enterprises in MENA.

Ensuring access to finance without compromising financial stability will be a major challenge in MENA, although issues related to weak regulatory systems, corporate governance and overdependence on the banking system also loom large. The slowdown of credit growth as a result of the crisis has added urgency to the access agenda because the credit tightening expected in the post-crisis period affects disproportionately the underserved segments, typically high risk households and firms. Addressing the stability agenda will be equally challenging. The preconditions for effective market discipline are weaker in MENA than in developed countries due to weaker institutions and less sophisticated market players.

In addition, the generous support programs in response to the crisis may have further weakened financial institutions. The severity of the financial crisis and the uncertainty about how the financial system will evolve has sparked interest in regional and domestic financial markets. Pursuing financial integration in MENA might be a good strategy given the mix of countries, which include both capital exporters (the GCC countries) and capital importers (oil importing countries), as this would facilitate trade integration.

Key problems of the business environment in MENA include policy and regulatory uncertainty and discretion in implementing reforms which prevent a level playing field for all firms and encourage the pursuit of privileged access. These problems, coupled with barriers to entry and exit, have created an environment of stagnation. Addressing these issues will require applying rules and regulations consistently and without discrimination among firms and introducing reforms that promote business dynamism, private investment, and innovation.