

A Marshall Plan for Arab economies

- To revive Arab economies such as Egypt and Tunisia hit hardest by revolution and unrest, G8 leaders pledged in May at least \$20bn in financial aid through multilateral organizations and individual countries.
- Egypt's external account has been affected by a decline in manufacturing, tourism revenues, FDI inflows and remittances as well as by non-resident sales of Egyptian securities.
- International financing and investment will be needed to help stabilize public finances and spur economic development.
- Qatar and Saudi Arabia have also promised Egypt \$12bn and \$4bn, respectively, in financing through loans, purchases of treasury bonds and capital investments.
- The key challenge for post-revolutionary Arab economies receiving conditional financial aid is to ensure inclusive economic growth and to reconcile popular demands with the requirements of international creditors.

In IBQ's latest GCC Brief: The prospect of a financial aid package to revive the North African economies hit hardest by revolution and unrest gained momentum recently after the G8 summit at Deauville, France in late May. In a throwback to the Marshall Plan of 1948 that saw war-ravaged Europe benefit from \$13bn (equivalent to \$290bn today) in reconstruction and development aid, international leaders pledged at least \$20bn in economic assistance to Egypt and Tunisia to help them stabilize their economies and successfully negotiate their transition to democracy. Aid will take the form of development loans, investments, debt forgiveness and financial guarantees that will be channeled through multilateral institutions such as the World Bank, the European Bank for Reconstruction and Development (EBRD) and the African Development Bank (ADB) as well as through bilateral agreements between the North African economies and individual donor countries.

Such financing will, however, also be contingent on the economies of Egypt and Tunisia, for example, demonstrating tangible progress in reforming governance, enhancing political participation, tackling corruption and developing the private sector. Much like in post-war Europe, the overall aim is the establishment of an optimum environment to ensure that jobs are being created and that the benefits of growth are widely distributed and shared.

The economic impact of the Arab uprising

The revolutions in Egypt and Tunisia caused significant dislocation to the economies of both countries. The IMF estimates the net effect of this is going to be slower real GDP growth for Egypt and Tunisia of about 1.0% in 2011, following rates of 5% and 3.7% in pre-crisis times. The impact has been most severe on manufacturing, tourism and foreign investment, on which both countries depend heavily. Industrial production in Tunisia fell by 13% in January while tourism, which accounts for 7% of GDP, declined by 40% in the first two months of 2011. In Egypt, the number of tourist arrivals, which averaged 1.38 million per month in the last quarter of 2010 and 1.14 million in January 2011, dropped by 81% in one month to register just 211,000 in February. The IMF estimates the economic impact this year of a drying up of tourism revenues in both countries to subtract about 1% of GDP. Similarly, net foreign direct investment in Egypt, which had averaged \$9bn a year during the last 5 years and which accounts for 3% of GDP, is projected to reach \$2.5bn in 2011, a drop of almost 60% from the previous year, according to the Institute of International Finance (IIF).

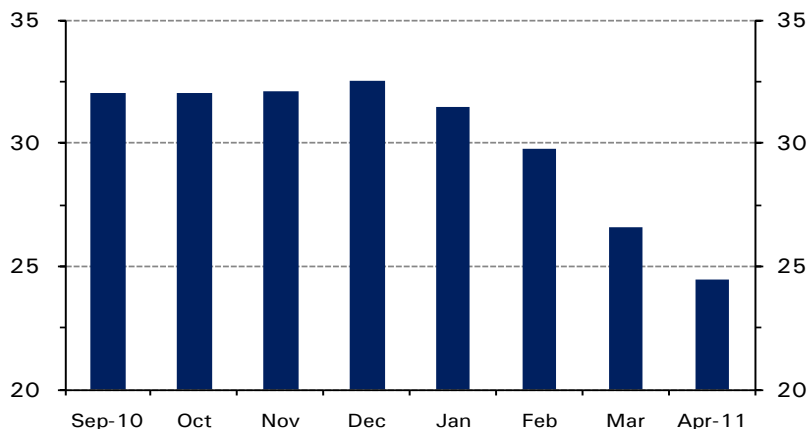
Remittances have also been affected by the turmoil in North Africa. The return of more than 100,000 workers from the civil war in Libya, for instance, is likely to lead to a significant drop in transfers received by Egypt from its nationals employed overseas in 2011. These inflows had reached \$6.3bn in the second half of 2010.

The fall in tourism receipts, foreign investment and remittance flows, when coupled with a decline in export manufacturing revenue and sales of Egyptian equities and fixed income securities by non-resident investors, has put significant pressure on the country's balance of payments (BOP). By April 2011, the country's official foreign exchange reserves had declined by more than 20% to reach \$24.5bn as the Central Bank of Egypt has been forced to draw down its holdings to provide liquidity for the system and to protect the currency (Chart 1).

The Marshall Plan of 1948

- The Marshall Plan was named after US Secretary of State George Marshall but was officially known as the European Recovery Program (ERP).
- \$13bn in financial aid was sent by the US from 1948-1952 to reconstruct Europe's economies and prevent the spread of communism after World War 2.
- Urgent financing was needed to rebuild infrastructure, restore European manufacturing and international trade, and replenish depleted foreign exchange reserves. Technical assistance was also provided.
- A significant proportion of the aid was used to purchase US goods.

Chart 1: Egypt's Foreign Exchange Reserves (\$ billion)



Sources: Central Bank of Egypt

Samir Radwan, the Egyptian Finance Minister, estimates that, as a result, the country will have a BOP gap of \$10-12bn for the fiscal year 2011/12, and would thus benefit greatly from international financing.

Similarly, some MENA governments' fiscal positions, already hamstrung by deterioration in economic output and tax revenues, have been placed under greater strain by the raft of public spending and subsidy measures that were promised by the old regime. The previous Egyptian government had committed to a 15% increase in state salaries as well as to a maximum of \$1.2bn in food subsidies. Tunisia, in turn, is expected to honor its public commitment for increased welfare spending and extended subsidies.

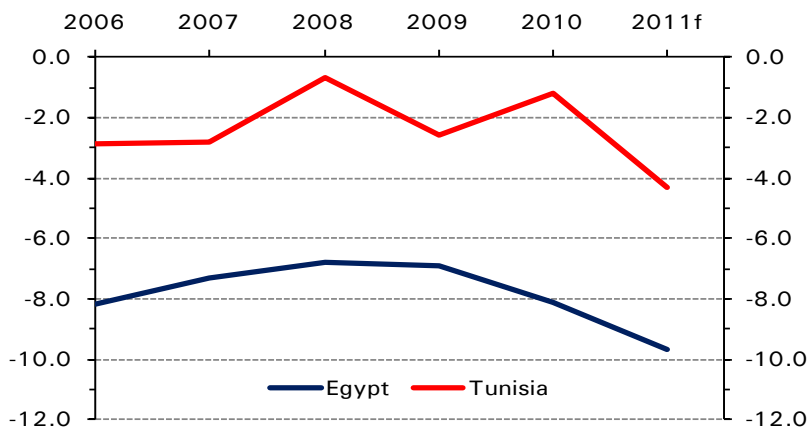
The expectation of widening fiscal deficits, which, according to the IMF, are estimated to reach almost 10% of GDP for Egypt and 4.7% of GDP for Tunisia in 2011 (Chart 2), and balance of payments deficits has made the need to secure funding from the international community that much more pressing. This is especially marked given the premiums being demanded today by investors on Egyptian and Tunisian debt.

The 'Deauville Partnership' and international aid

The international community has pledged at least \$20bn in the form of loans, credit guarantees, investments and debt relief for Arab economies. The actual amount is likely to be significantly higher, however—possibly in the region of \$50-100bn over the next 4-5 yrs—on the assumption of more countries emerging to seek financial assistance over the next few years.

Dubbed the 'Deauville Partnership', the international community's commitment to support the transitioning economies of North Africa represents belated recognition that political and economic transformation in developing countries requires concerted engagement and sustained support. To that end, funds will be made available through the African Development Bank (ADB), the European Investment Bank (EIB), and the European Bank for Reconstruction and Development (EBRD) as well as through individual countries (see Table 1).

Chart 2: General Government Fiscal Balance (% GDP)



Source: National authorities and IMF projections

The ADB is the first international institution to offer financing for the North African economies, having extended \$500m in loans to the Tunisian government since its January revolution. In conjunction with additional financing from the World Bank, the European Union and the French Development Agency, a combined package of \$1.4bn has already been allocated to the country. Similarly, the EIB expects to sign a \$550m loan facility with Tunisia in July and, through the European Union's Facility for Euro-Mediterranean Investment and Partnership (FEMIP),

has indicated that up to \$8.7bn can be provided in financing once approval has been granted by the EU's budgetary authorities. The EBRD, a notable contributor to the post-Communist reconstruction of Central and Eastern European economies in the 1990s, has indicated that shareholder approval has been sought to make available up to \$3.6bn a year for development financing in Egypt and Tunisia.

In terms of bilateral economic assistance, Qatar has emerged as the country most publically committed to the rejuvenation of the Egyptian economy. Qatar has promised the largest single financial package pledged so far: up to \$12bn in financing and investment. The Qatari government is prepared to purchase \$2bn worth of Egyptian treasury bonds and contribute \$10bn to the domestic economy through a broad range of investments and joint ventures in industrial projects such as the two new ports being constructed at Alexandria and Port Said. The potential for job creation in Egypt is immense: the Port Said project alone will lead to the creation of 1 million jobs. Furthermore, Qatar is also planning to employ Egyptian workers and companies in its own domestic development projects. And, taking inspiration from the role of the EBRD, Qatar has also proposed the establishment of a Middle East Development Bank in cooperation with other GCC countries. The aim is to provide financing outside the IMF to help promote economic diversity and tackle the Arab world's burgeoning unemployed youth population.

Forthcoming but conditional assistance

As the G8 leaders have indicated, however, continued access to funding beyond current emergency stabilization will be subject to the respective economies demonstrating tangible progress in political and economic reforms. Robert Zoellick, Group President of the World Bank, for example, has already stated that the Bank's financial aid package of \$6bn over the next two years—\$4.5bn for Egypt and \$1.5bn for Tunisia—will be linked to governance and openness reforms as well as to initiatives to strengthen the economy and provide more inclusive growth.

From the public commitments made so far, the impression gained is of a concerted effort by the international community to engage with recipient countries to an extent beyond established practice. Previous international efforts to promote economic development in North Africa through multilateral financing institutions were frequently cited as underwhelming. For example, in recent years criticism has been directed at the European Union's Euro-Mediterranean Policy framework (EMP) for focusing exclusively on immigration and security issues and not linking financial aid to democratic institution-building. At the same time, the organization failed to address the economic needs of the North African economies for greater access to European markets for their products.

Table 1: Potential financial aid to Arab economies

Creditor	Amount (\$ bn)	Description
World Bank	4.5	Coverage for Egypt's budget and reserve shortfalls, economic reforms and investment projects
World Bank	1.5	Coverage for Tunisia's budget and For investment projects.
IMF	35.0	Financing over for MENA (5 yrs)
EBRD	3.6	Financing for Egypt and Tunisia (max yearly amount)
EIB	0.5	Loans to Tunisia

	8.7	Loans to MENA economies
ADB	0.5	Loans to Tunisia
	7.0	Loans for MENA economies
EU	0.13	Loans to Tunisia
GCC	10.0	Fund for Bahrain & Oman (10 yrs)
France	0.26	Loans to Tunisia
Qatar	10.0	Development projects
	2.0	Purchases of Egyptian t-bonds
KSA	2.5	Grants & concessionary loans
	1.0	Deposits with central bank of Egypt
	0.5	Purchases of Egyptian t-bonds
UK	0.17	Loans for Egypt and Tunisia (4 yrs)
US	1.0	Debt relief for Egypt
	1.0	Job creation in Egypt
Total	100	Potential funding for MENA over the next 4 yrs

**European Bank for Reconstruction & Development (EBRD); European Investment Bank (EIB); African Development Bank (ADB); European Union (EU)*

As a result, in an effort to capitalize on the aspirations of the Arab people and prevent rollback to instability in North Africa, organizations such as the European Union, the World Bank and the IMF have begun to prioritize the tracking and attainment of a broad range of human and economic development achievements beyond traditional measurements. No longer would gains in domestic productivity be the yardstick against which to measure the success of financial assistance—or for that matter, economic and political stability. Financial aid will be accompanied by the following objectives: supporting civil society; increasing female participation; enhancing social accountability; strengthening corporate governance; promoting education and innovation; expanding the private sector; accelerating employment creation; stimulating international trade and investment, as well as facilitating greater integration with the global economy.

Key challenges for transitioning economies

The IMF has estimated that the MENA region will need \$160bn in financial aid over the next four years to alleviate both short-term and longer-term, systemic problems. Beyond the immediate necessity of shoring up the balance of payments and public finances in Arab economies affected most by the unrest, the IMF has indicated that MENA economies will need to undergo a ‘fundamental transformation’ of their economic models in order to ensure that the socio-economic and political grievances that gave rise to revolution and turmoil do not go unresolved.

The solution is for economic growth to be inclusive, with as many segments of society benefiting as possible. This is one of the charges most frequently leveled at previous government policies. Control of important corporations and key growth industries as well as access to the economic gains generated from them have often been the preserve of the few.

A tradition of bloated governments accompanied by underdeveloped private sectors, structurally inefficient labor markets, burdensome regulatory restrictions and sub-optimal educational systems are among the areas identified as requiring special attention. In the MENA region, expanding labor forces are being fueled by a burgeoning youth-heavy demographic that is, at present, comprising 25% of the population. This is placing considerable pressure on governments to create sufficient jobs to tackle existing double-digit unemployment rates and absorb future entrants to the workforce. The World Bank has estimated that 40 million additional jobs are needed over the coming decade in order to prevent the 'demographic dividend' from turning into a socio-economic and politically destabilizing demographic deficit.

Furthermore, in the short term, given the fact that domestic initiatives in post-revolutionary Egypt and Tunisia will be driven by popular mandate, a key challenge will be reconciling demands for statist policies: enlarged public sectors, increased subsidies and government expenditure, with the realities of fiscal deficits and free-market economics. Despite the recent downward revision to the Egyptian budget deficit for the fiscal year 2011/12, from 10.9% to 8.6% of GDP, on the back of a reduction in government spending and projected increases in tax and gas export revenues, the government faces a challenging fiscal predicament. At \$22bn, food and fuel subsidies alone account for more than a quarter of the \$83bn in forecasted spending in 2011/12. Along with public sector salary raises and the provision of low cost housing, these represent commitments that the transitional government intends to honor in the current circumstances.

The key for Arab economies faced with the need to turn to international markets and foreign creditors for short term help will be to ensure that debt repayments and the obligations and conditions that are invariably attached to them do not become fiscally burdensome and politically sensitive. Indeed, the recent announcement by the Egyptian finance minister that the country does not need to tap IMF and World Bank loans was largely a response to those public concerns.

While the opportunity cost of not requesting international aid may prove too great—given the necessity of macroeconomic stabilization—governments will, nonetheless, need to keep debt levels in check and avoid over-optimistic growth assumptions. □