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With special thanks to Mary Saba

EDITORIAL

MOVING TOGETHER ON THE PORTFOLIO

In the past few months, the Lebanese press has actively reported on "un-disbursed" loans made by the Bank and other donors to Lebanon and the possible cancellation of such loans. We, in the Bank, applaud the role of the press in shedding light on developmental issues in Lebanon and the status of the portfolio. But, we are also keen to ensure that the measures taken by the Bank and the Government are well understood and not misinterpreted. Thus, we saw it fit to tackle this issue of portfolio performance and measures to correct it upfront in our editorial of the Update.

The Bank does not shy away from risk taking to realize development objectives. The Bank in Lebanon, as in other parts of the world, does not shy away from funding risky projects as long as the development outcomes justify taking such risks. Such projects are not limited to "brick and mortar" projects, but involve new and innovative ways of decision making; building new capacity for regulation and public sector management; trying new approaches for reaching the most vulnerable groups and involving them in setting their own preferences and priorities; and challenging old bureaucracies with new systems which ensure transparency and higher efficiency.

Implementation problems do occur, and have several sources. Given the challenging agenda, it is not uncommon for projects to run into implementation problems. Sources of problems vary. First, in designing projects, we sometimes run the risk of "over-shooting," and ending up with over-designed projects which are too ambitious or far exceed existing capacities. Second, we sometimes find that exogenous factors affect project performance such as natural disasters, conflict, change of government, macro-economic difficulties, etc. These often disrupt project performance in ways that are hard to predict or prepare for. Third, we sometimes find that the "development objectives" for which the project was initially designed are no longer a priority, either because they have been addressed through other means, or because other pressing priorities have come to the surface. Finally, some projects face problems from within: competency of the implementing team, delays in decision making, etc. Some of these problems are within the Bank's control, others are within the Government's control, and yet others are beyond both the control of the Bank or the Government.

Corrective measures are there to ensure that development objectives are realized and scarce resources not wasted. A lot can happen between the time a Bank project is designed, and the time it goes into full implementation. The Bank introduced the ability to correct project design or implementation aspects so as to provide the flexibility to ensure that the development objectives of the loan are achieved. These include: minor adjustments to implementation procedures; project restructuring (changes in components and amounts); or outright cancellation. This is not, as sometimes perceived in the press, a "punishment" to the country. It is rather, part and parcel of proactive portfolio management aimed at ensuring that the scarce project funds are put to good use, and that the portfolio of projects is relevant to the development agenda of the country and fully "owned" by its implementing agencies.

Corrective measures can be costly, but not as costly as leaving problems unattended. Starting projects and restructuring them midway involves high transaction costs, both to the Bank and to the Government. It underlines the importance of ensuring quality, realism, and full readiness at the outset of the process. ***A common misperception, however, is that cancellation of un-disbursed funds denies the country future access to such fund. Not so.*** The Bank allows for a "lending envelop" for any country. The cancellation of funds or the closing of a project that is not fully disbursed simply increases the room for new lending within this envelop and allows the Bank to focus more of its own resources on addressing current needs rather than trying to salvage old operations.

The task ahead for both the Bank and the Government of Lebanon is to continue to ensure the relevance and effectiveness of the portfolio in meeting the priority needs of the people of Lebanon. This partnership is indeed underway, and is being reflected in improved disbursement, shorter ratification of loans by Parliament, willingness to restructure/close projects, and jointly thinking of new priorities within the next period of the Country Assistance Strategy.

This Update covers a number of areas directly relevant to policy debate in Lebanon. The economic quarterly update takes stock of recent developments and points to the risks of giving up on an aggressive reform strategy to reverse the debt dynamics. The article on privatization takes on the issue of "preconditions" to successful privatization. Another article provides the gist of the four reports produced by the Bank for the MENA region (trade and investment, governance, labor markets, and gender). This Update also contains the regular sections on the portfolio, recent and upcoming events, and recent Bank publications.

PRIVATIZATION: FROM PANACEA TO PRECONDITIONS

This essay summarizes the theoretical debates and empirical evidence from around the world, and draws useful lessons. The evidence, coming mostly from the Eastern block and, specifically, the telecom sector, sheds a more nuanced light on this particular policy and identifies preconditions for its success.

Privatization has been touted as a solution to two main problems: (i) revitalizing the private sector by improving the management of assets previously owned by public enterprises, encouraging investments and technological catch up, and closing up incestuous relations between the State and public firms which prevent fair competition; and (ii) helping out the distressed finances of heavily indebted governments.

The common assumption is that the value of the enterprise (measured by the satisfaction of its consumers) in private hands is higher than in public hands, and that the productivity of public money (measured by the satisfaction of citizens with the delivery of public services) is higher than that of private money. Of course, there is no strong theoretical reason to uphold these assumptions all the time, and all possible configurations can apply. Empirically, though, the economic literature generally finds private firms superior to public firms in terms of micro-economic performance. Of 52 empirical studies reviewed by Shirley and Walsh (2000), 32 found that the performance of private firms are significantly superior to public firms, while 15 found no or ambiguous relationships between ownership and performance. As for the difference between the social productivity of money and the private one, this depends very much on the quality of the public expenditures.

PRIVATIZATION AND REVITALIZING THE PRIVATE SECTOR

Probably the largest experiments on privatization aimed at strengthening the private sector and the telecom sector have occurred in countries of East Europe and the Former Soviet Union (FSU). Privatization has been key in the transition from plan to market in the FSU. It was a way of imposing discipline and promoting restructuring of the ailing state-owned industrial sector; and a way of creating a demand for stronger property rights and institutions of corporate governance. Different countries have tried a wide range of privatization techniques ranging from free share distribution to the population to negotiated deals.

Who is the best new owner?

The empirical literature on the privatization effect on restructuring in Eastern Europe and the FSU is now endowed with at least 30 studies. A review of these studies shows the following main conclusions:

- Privatization to concentrated owners not linked to the preexisting management or employees has been the most beneficial to the restructuring of privatized enterprises.
- Privatization to diffused owners and to enterprise workers and/or mangers has not been beneficial.

One reasonable hypothesis for the ineffectiveness of diffused or insider ownership is the lack of mechanisms in these countries to protect minority shareholders and to establish clear corporate governance rules. This allows some of the new owners to “cannibalize” the assets of the privatized enterprises (asset stripping) for their own interest (see the Box on Kazakhstan on the following page). Another reasonable hypothesis is the reduced ability of diffused ownership to bring capital or knowledge to the firm.

Within the concentrated owner category, the studies show that:

- Enterprises controlled by strategic investors have performed better than those controlled by financial institutions (investment funds) or holding companies.
- Enterprises sold through transparent and competitive bids have generally attracted better owners, outperforming enterprises sold directly to politically connected parties, frequently at highly subsidized prices.

How fast to privatize? Which legal and institutional environment do you need?

The right speed of privatization also depends on whom public assets are sold to. Selling to diffused owners through distribution or share auctions can be done quite quickly. On the other hand, preparing a company for a successful bid to strategic investors requires more time.

The two approaches require, in fact, different legal and institutional infrastructures:

- If countries choose privatization to concentrated owners, it is necessary to give the agency which will be in charge of carrying out the privatization strong autonomy from political powers.
- If countries choose the diffused privatization, strengthening external supervision and control of internal management and protection of minority shareholders is key. When court enforcement of contracts is weak, strict market regulation for financial intermediaries should be strengthened to give more authority to investment funds and brokers to monitor compliance by all participants in the financial markets.

But in both cases, a clear lesson from the first decade of transition economies is the need to strengthen corporate governance, despite opposition form oligarchs and insiders.

Ex-post, in transition economies, the question has arisen of whether it might not have been preferable in some countries to keep assets in State hands, waiting to identify and then sell the enterprise to reliable strategic investors. The experience of Eastern Europe and the FSU shows that a positive answer would have to rely on two conditions. First, the privatization agency needs the autonomy to carry out its functions with transparency and without political interference. Second, there has to be enough institutional capacity to prevent asset stripping by state managers in the interim. In many countries these conditions were not met, entailing that the permanence in State hands brought "spontaneous" privatization by the current managers while enterprises were still owned by the State.

Liberalize, regulate, privatize: which one first?

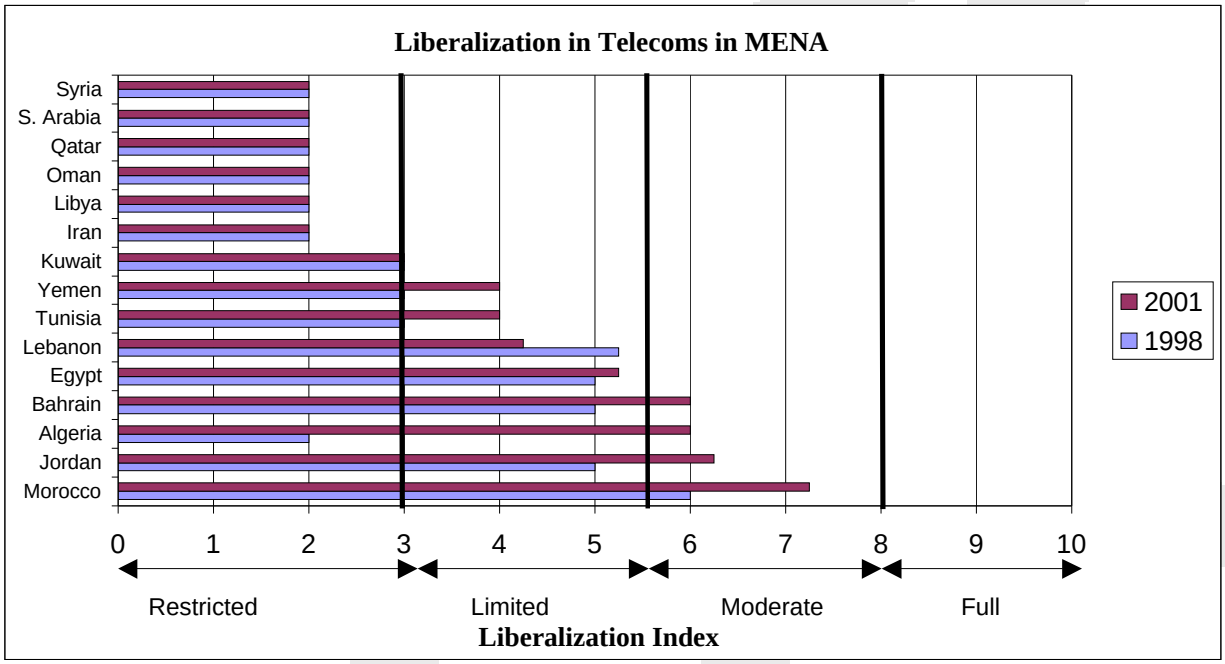
The trade-off between privatization and liberalization stems from the fact that privatizing a firm that operates in a monopolistic environment will bring higher proceeds to the government, as the expected stream of profits will be higher for the new private owners, and therefore the price they are ready to pay. On the other hand, the social value of the firm might not increase after privatization, as it retains its monopoly power, to the detriment of consumers. Still, the decision to privatize might be justified if the use by the government of privatization proceeds generates sufficient satisfaction among citizens to offset the limited impact of the privatization on the social value of the enterprises newly acquired by the private sector.

Empirically, the question of sequencing has been researched more accurately in the telecom sector. Wallenstein (2002), using a sample covering 200 countries from 1985 to 1999, finds granting monopoly rights does increase the price fetched in telecom privatization. However, in a sample of about 20 countries which privatized their telecom companies he also found that investment was substantially lower in countries that gave exclusivity periods to private investors (in particular for international calls) than in countries that encouraged competition. A similar result applies to internet penetration, which is larger in countries with greater market openness in telecoms. The empirical studies also found that investors were also willing to pay substantially more for telecom firms in countries where regulatory reforms took place before privatization, and that establishing a credible regulatory authority before privatizing is correlated with improved telecommunication investment and telephone penetration.

Why did privatization fail in Kazakhstan?

Economic restructuring in the late 1990s in Kazakhstan is the story of a failure. All sectors except oil and gas experienced declining output and productivity. Empirical studies on a sample of 6,600 firms from 1996 to 1999 show that while newly-established enterprises performed better than state-owned firms, privatized enterprises performed as badly, and often worse than state-owned enterprises. Perversely, distressed privatized enterprises received more financing from the government budget than either state-owned enterprises or newly-established firms. These results match the anecdotal evidence that privatization in Kazakhstan fell prey to powerful business groups organized around top central and regional government officials.

Source: Why did privatization fail in Kazakhstan? S. Djankov, T. Nenova, Working Paper (2000)



Source: Rossoto et al. (2003)

PRIVATIZATION AND FISCAL ADJUSTMENT

The second main motivation for privatization is using the proceeds of sale of assets to help adjust government finances. The rationale is that under difficult fiscal conditions, the State may not have sufficient resources to provide basic social services to its citizens. In particular, in highly indebted countries, debt service tends to absorb a large part of revenues and crowds out primary expenditures, thus countries become more vulnerable to financial crises. Under these conditions, it is generally considered that, if well used, the proceeds from privatization can improve the welfare of the nation by allowing to crowd-in primary expenditures and by reducing the risk of fiscal collapse.

The main issue, however, is that privatization proceeds are not a permanent source of income and cannot be a definitive solution to fiscal problems. This has become explicit in the now accepted way of accounting for privatization receipts in the budget. The 1986 Government Finance Statistics (GFS) Manual of the IMF treated privatization as revenue, but IMF practice has changed over time, and the revised GFS standard treats privatization as an asset operation, not revenue counting towards reduction of the fiscal deficit. The European Commission also considers in its various treaties and pacts privatization proceeds as financing and not as revenue. Such proceeds cannot be incorporated in the calculation of deficit to GDP ratios, but can conversely be used in the calculation of gross public debt to GDP ratios.

This approach to treating privatization proceeds has a number of important consequences:

- Since privatization proceeds are not revenue, they cannot be spent to increase expenditures without increasing the deficit. They should, therefore, be used in priority to retire debt (except the possibility of very specific one-off expenditure items).
- When privatization proceeds are used to retire debt, their direct social impact is non-existent. The actual impact is an indirect one that works through a reduction in interest payments (which gives the government greater flexibility to increase primary expenditures or reduce taxes) and through a reduction of the risk of financial crises.
- When privatization proceeds are used to retire debt in a situation that is structurally unsustainable from a financial point of view, the reduction in interest payments will be short-lived, and a perverse debt dynamics will resume as soon as privatization proceeds run out. The potential positive effect of privatization proceeds will, therefore, be wasted if they are not used in the context of an overall fiscal consolidation agenda.

The experience of fiscally-led privatizations in the 1990s sheds some light on how countries have dealt with the issues mentioned above. An empirical study by the IMF, using data for 18 different countries, reports that, on average, privatization proceeds were in the majority of cases used to reduce debt, and were not used to finance larger deficits. But in at least two countries, Argentina and Turkey, this was less the case, and both endured serious financial crisis. As Gary S. Becker, the 1992 Nobel Laureate for economics remarked about Argentina in an article in Business week: " … [Argentina's policy] did not eliminate the tendency for the provincial and central governments to spend much more than they collected in taxes. Spending by these governments grew to more than 30% of gross domestic product. These budget deficits were hidden during the first half of the 1990s by revenues from the sale of government companies." A study by the Economic Research Forum for Arab Countries, Iran and Turkey (ERF) on the fiscal situation in the MENA region and Turkey's situation in the years preceding the crisis concluded that "when privatization revenues and interest payments on public debt not recorded in conventional measures are factored in, total Public Sector Borrowing Requirement (PSBR) for 1998 increases from 8.7 to 10.5 percent of GNP. When net expenditures on quasi-fiscal activities of state-owned banks are factored in, PSBR rises even further, to 15 percent. After the corrections, the 1998 operational deficit increases from near zero to about four percent of GNP." Using privatization to hide an otherwise unstable fiscal situation is therefore a strategy that needs to be avoided.

CONCLUSION

Speaking about the right preconditions for privatization will certainly be taken by some as an argument for indefinitely postponing privatization plans. Overall experience with privatization has shown that the economic benefits of a well-prepared privatization policy are important, so moving on privatization, in a open and transparent way, is likely to bring good economic pay-out. However, when the aim of privatization is to retire debt, two cautionary notes have to be made. First, an exclusive pre-occupation with privatization proceeds hides the fact that higher proceeds can sometimes be obtained at the expense of competitiveness and future private capital investments in the sector. This can be extremely detrimental in the Lebanese context where competition and capital investments are needed in both the power and telecom sectors. Second, using privatization proceeds to retire debt represents the best use of such proceeds (as opposed to increasing expenditure). However, unless this is carried out in the context of a comprehensive fiscal consolidation agenda, the positive effects will be short-lived and the perverse debt dynamics will resume once the privatization proceeds run out. This article has focused on the preconditions necessary to realize the economic benefits of privatization. A follow up article in the next edition of this review will address the issues of the social and environmental impact of privatization.

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BANK GROUP OPERATIONS

IBRD Ongoing Projects

The current World Bank portfolio in Lebanon consists of 13 Projects for a total commitment amount of US$534.75, of which US$184.70 million has been disbursed through October 31, 2003.

Irrigation Rehabilitation and Modernization Project (IRMP). (US$57.23 million). The Project is designed to help increase agricultural production, agriculture-based income and employment in previously neglected rural areas, and achieve improved sustainable management of water resources.

Revenue Enhancement and Fiscal Management Technical Assistance Project (REFMTAP). (US$25.25 million). The Project seeks to support Government efforts to enhance revenue and strengthen fiscal management.

Health Sector Rehabilitation Project (HSRP). (US$35.7 million). The objective of this Project is to improve Lebanon's health conditions through better allocation and use of resources in both the public and private sectors.

Solid Waste / Environmental Management Project (SWEMP). (US$25.0 million). This Project is designed to help improve the methods of solid waste collection and disposal; improve cost recovery and modernize municipal management and finance systems; and strengthen the management capacities of sector institutions.

National Roads Project (NRP). (US$42.0 million). The objective of this Project is to improve the capacity of the road administration to undertake the rehabilitation of the primary road network.

Agriculture Infrastructure Development Project (AIDP). (US$24.0 million). The Project's objectives are: (a) increasing farmers' incomes and conserving the environment through land terracing and development and storage of runoff water; (b) improving access to rural areas; and (c) upgrading institutional capabilities.

Vocational and Technical Education Project (VTEP). (US$29.0 million). The Project's objective is to improve the performance of the VTE System by making it more demand-driven and responsive to market needs.

General Education Project (GEP). (US$56.6 million). This Project is designed to support the Government's efforts to enhance the capacity of the Ministry of National Education to function as an effective manager of the education sector and to restore the credibility of the Public Education System.

First Municipal Infrastructure Project (MIP-I). (US$80.0 million). This Project aims at addressing urgent municipal works while setting the stage for the gradual assumption of responsibility for municipal services at the local level.

Community Development Project (CDP). (US$20.0 million). This Project is designed to raise living standards in targeted poorer communities, and to raise economic activity levels in such communities by investing in grass-roots social and small infrastructure activities, and in employment creation.

Commitments and Disbursements as of October 31, 2003

Project Name	Approval Year	Loan Amount	Amount Disbursed
		US$ Million	
Irrigation Rehabilitation and Modernization	1994	57.23	50.84
Revenue Enhancement and Fiscal Management Technical Assistance	1994	25.25	19.12
Health Sector Rehabilitation	1994	35.70	26.75
Solid Waste/Environmental Management	1995	25.00	8.54
National Roads	1996	42.00	26.55
Agriculture Infrastructure Development	1996	24.00	15.78
Vocational and Technical Education	1998	29.00	4.64
General Education	2000	56.57	2.24
Municipal Infrastructure – I	2000	80.00	28.41
Community Development	2001	20.00	0.74
Ba'albeck Water and Wastewater	2002	43.50	0.44
Urban Transport Development	2002	65.00	0.65
Cultural Heritage and Urban Development	2003	31.50	0.00
TOTAL		**534.75**	**184.70**

Ba'albeck Water and Wastewater Project. (US$43.5 million). The major development objectives of the Project include: improving the access of satisfactory water supply and wastewater services to the region's residents; introducing appropriate sector reforms– particularly the development and strengthening of the capacity of the existing Ba'albeck Hermel Water and Irrigation Authority and, once it is established, the Bekaa Regional Water Authority; and involving the private sector in the operation and maintenance of water and wastewater facilities by preparing for a Management Contractor (MC) through a lease or concession contract that would secure the long-term financial needs for sector investments. The Board of Directors approved the Project in June 2002.

Urban Transport Development Project (UTDP). (US$65.0 million). The Project's objectives are to provide the city of Beirut and the Greater Beirut Area with the basic institutional framework that is currently lacking, and to support critical investments needed to maximize the efficiency of existing urban transport infrastructure. The Board of Directors approved the Project in June 2002.

Cultural Heritage and Urban Development Project (CHUD). (US$31.5 million). The Project will finance site conservation, enhancement investments, and associated urban infrastructure improvements in selected sites, and provide technical assistance to strengthen the capacity of the Directorate General of Antiquities, Ministry of Tourism, and targeted municipalities in cultural heritage preservation and tourism development. A signing for implementation of the Project was held in July 2003.

IFC Projects in Lebanon

Uniceramic. The Project supports the modernization of the company's existing production line and the expansion of the plant's capacity of glazed ceramic floor tiles.

Bank of Beirut and the Arab Countries (BBAC) Credit Line. The Project offers innovative residential mortgages to middle income customers.

Banque Saradar SAL. The Project involves an equity investment in common shares of the company.

Byblos Bank Syndicated Credit. The Project aims at providing long-term project finance to small- and medium-sized enterprises in Lebanon for infrastructure project finance, and to increase its housing loan portfolio.

Société Générale Libano-Européenne de Banque. IFC extended a Line of Credit to Société Générale Libano-Européene de Banque to be utilized in support of its housing finance program.

Fransabank. IFC extended a credit line to Fransabank to support its housing finance program.

Agricultural Development Company (ADC). The Project is designed to rehabilitate and expand the existing facilities of ADC, which is involved in the poultry business, into an integrated broiler meat production facility.

Lebanon Leasing Company (LLC). The Project involves the establishment of Lebanon's first leasing company, providing lease finance to local small- and medium-size enterprises. It also includes two credit lines from IFC to fund LLC's leasing activities.

Middle East Capital Group (MECG) The Project consists of the establishment of the first regional investment bank in the Middle East, and is headquartered in Beirut.

Banque Libano-Française. The Project offers innovative residential mortgages to middle income customers.

Bank of Beirut Lebanon Credit Line. The Project consists of credit lines to four Lebanese private sector commercial banks for on-lending to local small- and medium-sized enterprises in the private sector and to middle income families to finance either the purchase of their first residence or the expansion of their existing home.

Idarat, SAL. The Project funds the company's investment program in hotels and restaurants and is designed to help revive the tourism industry, which is a key sector in Lebanon.

Idarat SHV (Société Hôtelière "de Vinci" SAL). The Project supports the Company's investment in a Greenfield 5-plus stars "boutique" all suites hotel in an up-scale residential district of Beirut.

ECONOMIC DEVELOPMENTS IN THE THIRD QUARTER OF 2003

A year has passed now since the Government of Lebanon (GOL) convened the Paris II donors' meeting. In Paris, the GOL presented a set of policy intentions aimed at reversing the debt dynamics and fostering growth under three major pillars. The first pillar was fiscal, and reflected a major effort to bring the primary surplus to 8-9 percent of GDP by 2007 (from an estimated 1 percent in 2002). Current and capital expenditures (excluding social expenditures) were to be reduced across the board and tax revenue significantly raised. The second pillar was financial, and consisted of restructuring the public debt towards longer maturities and lower interest rates. The third pillar of the program considered the privatization of major state-owned companies, and/or the securitization of their future revenue, whose proceeds would be entirely used to reduce the stock of the debt. Under the assumption of a full and timely implementation of the plan, GDP growth was supposed to resume (to reach a steady 4 percent annual growth rate by 2007 onwards) as a result of declining interest rates. Net debt was expected to decline sharply, from approximately US$30 billion in 2002 to US$21 billion in 2007.

But financial, fiscal and privatization developments since Paris II have fallen short of initial expectations. Although Paris II cash flows definitely helped to stabilize the financial situation, increase foreign reserves and lower borrowing costs for the Government (see Table 1), they were not supported by enough progress on the fiscal and privatization fronts to start reversing the debt dynamics. Donors' and banks' contributions were lower than initially anticipated. Sustained progress in raising tax revenue was offset by a slippage in Treasury expenditures and higher-than-expected debt service. Consequently, the deficit (Budget plus Treasury) to expenditures ratio culminated at 37 percent after nine months, against 27 percent targeted for the whole year 2003. On the privatization front, divergences among the authorities on which strategy to adopt, blocked any tangible steps forward, with no proceeds in sight in the foreseeable future. Meanwhile, the "real" economic activity remains subdued. While the Third Quarter (Q3) 2003 showed some slight signs of improvement, there is no evidence at present to support the view that economic activity could resume on a sustainable basis in the face of current macro-economic imbalances.

As a result, the net public debt continues to escalate, and peaked at US$30.6 billion by end-September 2003. By way of comparison, in November 2002 the GOL was foreseeing a net debt at US$26.3 billion by end-2003 without any external support from Donors.

But more importantly, the recent ratification by the Cabinet of a "status quo" budget for 2004 signifies that the authorities have given up, at least for the time being, to pursue their strategy presented at Paris II. Consequently, the debt will continue to grow exponentially next year – the result of ongoing deficits, and the burden of adjustment will increase accordingly. While the current level of foreign reserves at the Central Bank (Banque du Liban, BDL) limits the risk of a financial crisis in the short run, it can by no means be considered as a sufficient solution to address the overriding economic policy issue in Lebanon, the sustainability of the public debt.

Table 1. Paris II Developments September 2002-September 2003

	Jan-Sep 02	Jan-Sep 03
Net Public Debt (LBP billion)	44,346	46,118
Public Deficit (LBP billion)	2,859	2,908
Primary Balance (LBP billion)	300	495
Gross Foreign Reserves (US$ million)	3,557	10,194
Net Capital Inflows (US$ million)	-236	3,275
Dollarization Rate	72.2%	66.7%
Interest Rate on 24-month TBs/ Certificates of Deposits	14.1%	8.5%
Average Lending Rate to Private Sector (lending in US$)	9.8%	8.6%

Source: World Bank Staff calculations based on MOF and BDL.

In all cases, this sudden halt in the reform process calls for a deep and open reflection on what would constitute the right reform package in the face of current political and economic conditions in Lebanon today. Two dimensions warrant particular attention. The first one relates to the design of an "optimal" macro-economic package and concerns primarily fiscal and monetary policies, as well as debt management and the privatization program. The second is more political in nature, and relates to how the cost of adjustment would be shared among the population – with a particular view on its most vulnerable segments. A (non) option, which would consist in eventually letting the country confront financial turbulence bears enormous risks, not only for its devastating consequences on the social fabric, but also for its likely negative impact on institutions and the quality of public governance which commonly magnifies the severity of crises and undermines the potential for future recovery.

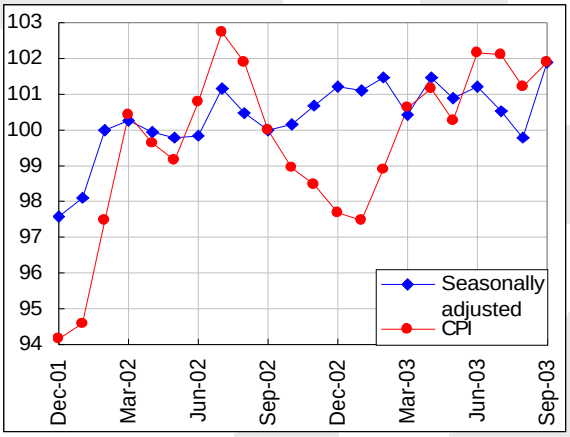
Using the most recent data available, the following briefly summarizes economic developments during the period July-September 2003: Real Sector Indicators; Balance of Payments; Public Finance and Public Debt; and the Financial Sector.

Real Sector Indicators

The absence of national accounts regrettably prevents a rigorous monitoring of the economic activity in Lebanon. Unlike the financial and public sectors which are well covered statistically (see sections below), observers have no choice but to rely on indirect information to appraise the evolution of Lebanon's GDP and its various components, not to mention the absence of any regular information on labor markets' developments and households' living conditions.

Continued low consumers price inflation. The monthly Consumer Price Index (CPI) computed by the Consultation & Research Institute (CRI) gives some indication of the tension between demand and supply. Over Q3-2003, price levels were, on average, 0.5 percent higher than that of the Second Quarter. The fact that the Third Quarter is generally characterized by higher than average price levels (due in particular to tourism inflows), probably means that the gap between demand and supply did not significantly narrow over the summer of 2003. As a matter of fact, consumer prices declined by 0.4 percent between Q2 and Q3-2003 when the index was adjusted to control for seasonal effects. On a year-to-year basis (Q3-2003 against Q3-2002), consumer prices rose 0.2 percent. For the first nine months of 2003, consumer prices were 1 percent higher than that of the first nine months of 2002.

Figure 1. Consumer Price Index (Index 100: September 2002)



Source: World Bank staff calculations based on CRI

Likely stagnation in the prices of domestic goods in 2003, slight rebound over the Third Quarter of 2003. The CPI is a combination of domestic and imported goods' prices. As far as imports are concerned, a rough calculation shows that approximately half of imports originate from the Euro Zone (Source: Directorate General of Customs). This share has remained fairly constant over the last year, in spite of large fluctuations between the LBP and the Euro. For the first nine months of 2003, the Euro appreciated 20 percent over the LBP (compared to the same months in 2002), mechanically exerting an upward pressure on the price of imported European goods. In 1997, the last year for which national accounts were disposed (Source: Ministry of Economy and Trade), imports constituted approximately 28 percent of total domestic absorption (intermediate consumption, public and private final consumption of goods and services, investment expenditures), excluding housing. The fact that European imports still continue today to represent 13 to 14 percent of total absorption, implies that the price of the remaining 86-87 percent (other imports and domestic goods) declined approximately 2 percent over the first nine months of 2003. Unless offset by a strong decrease in the price of imports from other regions (mainly from the United States of America, the Arab countries and Russia), such estimates suggest, at best, a stagnation of domestic prices, and accordingly, of the remuneration of domestic factors. Over Q3-2003 though, the Euro depreciated by 1 percent (compared to Q2-2003), while prices rose 0.5 percent, suggesting a slight rebound in the price of domestic goods.

Strong imports growth over the Third Quarter of 2003. According to the same national accounts, imports represented 55 percent of the total absorption of goods (excluding services) in Lebanon in 1997. As such, a change in imports largely contributes to a change in the absorption of goods. Besides, one can assume that almost all imports are consumed by private agents, given the structure of public demand, mainly composed of services.[1] During the first nine months of 2003, imports grew in value by 6.6 percent, but most likely less in volume given the appreciation of the Euro vis-à-vis the LBP. Most of the increase actually took place over Q3-2003, during which imports grew 17 percent in value compared with Q2-2003. This suggests a significant increase in private demand over the summer of 2003. The extent to which this increase also reflects an increase in the demand for domestic goods and services is unknown, but the previous indication that price stagnated in Q3-2003 could suggest a lower growth in the demand for domestic goods than that for imports.

[1] In 2002, the Government's purchases of material, supplies, and equipment represented less than 5 percent of current and capital expenditures, excluding debt service (Source: Ministry of Finance).

Likely stagnation of investment in 2003, slight rebound over the Third Quarter of 2003. Imports of equipment, which constitute an indication for investment (in 1997, the acquisition of equipment represented 36 percent of total investment expenditures), followed a somewhat different path, with an 8 percent decline in the value of imports of machinery and electrical instruments (a proxy for imported equipment) over the first nine months of 2003 compared to the same period in 2002. Q3-2003 also marked a rebound, with these imports 11 percent higher than that of Q3-2002. The evolution of the other component of investment expenditures – construction services, tends to confirm the view that investment grew less rapidly than consumption over the first nine months of 2003. Investment expenditures of construction services might at best be approximated by the volume of cement deliveries (expressed in tons).[2] The latter grew by 1 percent over the first nine months of 2003 compared to the same period in 2002. Q3-2003 also witnessed a small rebound, with a 3 percent growth compared to Q3-2002. This supposed stagnation of investments is consistent with the observation that the demand for domestic goods remains weak and that the cost of investment (measured with lending rates) stays high in the face of limited remunerative opportunities and substantial country risk.

The evolution of cleared checks and the consumption of electricity complete this rough picture of private absorption. The value of cleared checks (mirroring the evolution of transactions) grew 5 percent over the first nine months of 2003, compared to the same period in 2002. But, unlike the previous indicators of demand, Q3-2003 marked a slight decline compared to the first half of 2003, with a value of cleared checks only 4 percent higher in Q3-2003 compared to Q3-2002. The consumption of electricity (measured in Kwh.) grew 4 percent in 2003 (first nine months) compared to 2002. The fact that this was, nevertheless, lower in Q3-2003 than that of 2002 (-4 percent) might reflect the Government's efforts to enforce the collection of electricity fees and/or the difficulties faced by the public electricity company to supply electricity 24 hours a day during the summer of 2003.

Demand for domestic goods sustained by public consumption and exports. The last two components of GDP, public expenditures and exports, are somewhat easier to track. The first one (Budget plus Treasury expenditures, excluding debt service) grew 9 percent over the first nine months of 2003. The Third Quarter marked a significant decline compared to the first six months of 2003, with public consumption 1 percent lower than during Q3-2002. Export receipts, on the other hand, continued to grow rapidly during Q3-2003. Over the first nine months, export receipts were 37 percent higher than that of 2002. Q3-2003 marked a small deceleration, with exports 30 percent higher than that of Q3-2002.

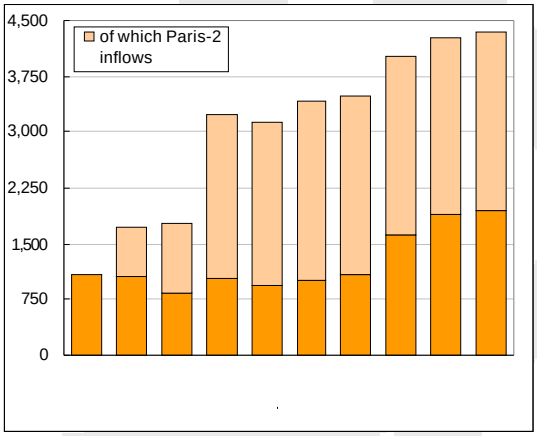
All in all, the impression left from these indirect indicators is that of a slight acceleration of economic activity over the summer of 2003, maybe building on a renewed confidence following Paris II and seemingly relaxed regional tensions. Demand for domestic goods continued to be pulled by public consumption and exports growth, while investment expenditures remained weak. Private consumption seems also to be on the rise, but the extent to which it is directed towards domestic goods and services (rather than imported goods) remains unclear. But the fact that price inflation remains subdued suggests that the output gap, - i.e., the difference between productive capacities and actual demand for domestic products - is not significantly narrowing.

Balance of Payments

Steady growth of capital inflows in 2003. As already mentioned in previous issues of this Update, Lebanon critically depends on continuous foreign capital inflows to finance its trade and public deficits. Over the first nine months of 2003, the Balance of Payments (measured by the variation of foreign currency reserves at the Central Bank and in commercial banks) registered a net cumulated surplus of US$3,275 million. During the same time, the trade deficit (imports of merchandise minus export of merchandise) amounted to US$4,019 million. Therefore, cumulated gross foreign capital inflows culminated to US$7,294 million over the first nine months of 2003. This represents a strong improvement compared with the same period a year ago (on the eve of Paris II), during which Lebanon experienced an inflow of US$3,750 million, insufficient to finance a trade deficit of US$3,986 million.

[2] The evolution of construction permits, sometimes considered as a proxy for investment, is probably more a reflection of investment plans rather than actual investments. Besides (and this is also valid for cement deliveries), permits do not distinguish between residential and professional buildings.

Figure 2. Cumulated Net Capital Inflows (US$ million)

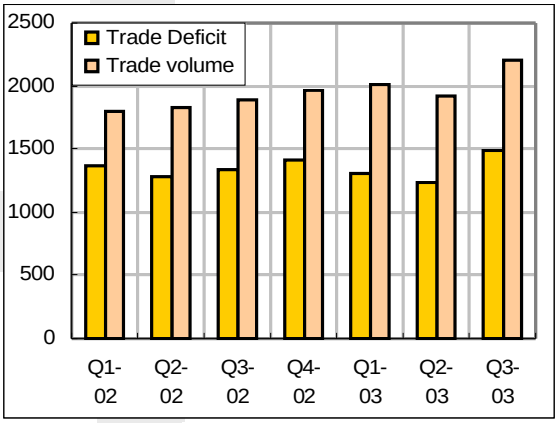


Source: World Bank s taff calculations based on BDL.

Foreign capital attracted by government papers. While the composition of these flows remains unfortunately unknown (transfers, foreign direct investments, portfolio investments, etc.), there is little doubt that a significant part was private. Since January 2003, the Treasury received US$2,040 million worth of Paris II contributions, the rest, US$5,254, almost entirely originated from private sources.[3] Gross private capital inflows culminated to US$2,344 million during Q3-2003, against US$1,278 million and US$1,632 million respectively in Q2 and Q1 of 2003. Two elements can probably explain this surge over the summer: the inflow of tourism (495,000 passengers landed at Beirut International Airport during the Summer of 2003, against 306,000 during the Spring); and the financial incentive procured by the possibility from April 2003 onwards to acquire Certificate of Deposits (CDs) yearly remunerated at 12.3 percent (for 3-year maturities) when purchased with foreign currencies. As a matter of fact, there is little doubt that the surge of capital inflows since Paris II was mainly triggered by greater financial stability in Lebanon. While current transfers and foreign direct investments had no particular reason to increase sharply, it is likely that most of capital inflows were attracted by high and relatively secured (convertible) remuneration offered on Government and Central Bank papers (see the Financial Sector Section below).

Growing trade transactions. The evolution of trade transactions also warrants particular attention. As already mentioned in previous paragraphs, merchandise exports grew 37 percent and imports 7 percent over the first nine months of 2003, with a deceleration for exports and an acceleration for imports during Q3-2003. As a result, the trade deficit after nine months, US$4,019 million, is similar to that of 2002, US$3,986 million. But the value of goods exchanged (imports plus exports of merchandise) rose by 11 percent between the two periods. Several reasons are candidate to explain this trend. First, Lebanon has been pursuing in 2003 its trade liberalization policy, with an average effective import tax of 16.3 percent in 2003 (first nine months) against 17.5 percent in 2002 (Source: Directorate Gene ral of Customs). Second, the de facto depreciation of the LBP vis-à-vis the Euro might have encouraged additional exports to the Euro zone. Third, the depreciation of the LBP and other external shocks might have increased the value of some relatively pri ce-inelastic imported goods, like oil for instance.

Figure 3. Quarterly Trade Deficits and Trade Volumes (US$ million)



Source: World Bank staff calculations based on Directorate General of Customs.

Trade growth concentrated on two items. Based on information available for the first nine months of 2002 and 2003, the rise in exports of pearls and precious stones (+US$161 million) contributed for 57 percent to the total rise in exports of merchandise (+US$283 million). Prepared foodstuffs (+US$37 millio n), machinery and mechanical appliances (+US$33 million) and base metals and articles of base metal, (+US$29 million) are the other main product categories on the rise. As far as imports are concerned, mineral products (+US$135 million) contributed for mo re than 43 percent of the total rise in imports (+US$315 million). Base metals and articles of base metals (+US$58 million) and chemical products (+US$56 million) are the two other main categories on the rise. During the same time, exports of paper and paperboard (-US$18 million) and imports of machinery and mechanical appliances (-US$54 million) were less traded in 2003 than in 2002. As far as origin and destination of trade is concerned, the

[3] Regular public transfers (official development assistance) amounted to US$220 million in 2002 and could amount to US$114 million in 2003. Net project lo ans financed by foreign agencies were negative in 2002, -US$48 million, the result of higher amortization than disbursements, and could be negative as well in 2003, -US$63 million (Source: International Monetary Fund).

same pattern seems to emerge: Europe absorbed most of the increase in Lebanese exports (Switzerland in particular); and Arab Countries and Russia were the principal origin of the new Lebanese imports.

Public Finance and Public Debt

The fiscal situation improved during Q3-2003 compared to the two previous Quarters, but insufficiently to meet the deficit targeted in the Budget Law, LBP2,524 billion (Budget plus Treasury) by the end of the year. After only nine months in 2003, the public deficit, at LBP2,908 billion, already exceeds the targeted deficit for the full year, with still three months to pass. Various elements concur to explain the evolution of public finances since January 2003. In brief, while revenue has met - and sometimes even exceeded - expectations, the GOL has been unable to contain expenditures.

Revenue on track. On the revenue side, tax revenue as of end-September 2003 are in line with the budget law, with an 11 percent increase compared to the first nine months of 2002. Thanks in particular to the Value Added Tax (VAT), whose collection exceeded initial plans (+46 percent so far, against 11 percent budgeted for the full year) and somewhat compensated for more disappointing results on other taxes (-1 percent on income tax, +1 percent on taxes on international trade, +2 percent on property tax). VAT collection is benefiting from one additional month in 2003 compared to 2002, and its threshold was lowered. The fact that the collection on other taxes did not improve as rapidly reflects the stagnation of the economic activity in 2002 (for direct taxes) and 2003 (for indirect taxes). Non tax revenue will probably also exceed initial targets, thanks in part to the unexpected transfer of the operational surplus of telecom companies that were supposed to be privatized.

Slippage in debt service and Treasury expenditures. Public expenditures, on the other hand, were not contained as much as initially budgeted. While non debt budget expenditures growth was so far below targets (+8 percent for the first nine months against 19 percent planned), debt service (which grew by 8 percent in 2003, while planned to decrease 13 percent in the budget) was underestimated in 2003 for various reasons: first, because donors' actual contributions were lower than anticipated; second, because banks' contributions (mainly in cash) did not enable the GOL to restructure its debt towards lower rates as much as it expected; and third, because the lack of privatization proceeds did not permit the government to reduce its stock of debt. Finally, Treasury expenditures far exceeded initial plans (a 48 percent decrease targeted for 2003, against an actual 12 percent increase over the first nine months of 2003), as transfers to EDL[4] and expenditures on previous years' appropriations continued to be substantial. LBP280 billion was also paid to the two mobile phone companies in settlement of the temporary acquisition of their assets.

Table 2. First Nine Months Public Finances (LBP billion)

	2002	2003	2003 Budget Law*
Revenue	**3,989**	**4,902**	**6,875**
Tax Revenue	2,989	3,306	4,726
Of Which VAT	654	953	1,100
Non-Tax Revenue	999	1,253	1,749
Of Which Transfer from the Telecom Surplus	548	786	-
Treasury Receipts	346	343	400
Expenditures	**5,943**	**7,810**	**9,400**
Non-Debt Expenditures	2,784	3,009	4,600
Debt Service	3,160	3,402	4,000
LBP-Denominated Debt	2,302	2,203	-
Foreign Currency – Denominated Debt	858	1,199	-
Treasury Expenditures	1,251	1,399	800
Deficit	**2,859**	**2,908**	**2,525**

*** Over twelve months. Source: Ministry of Finance.**

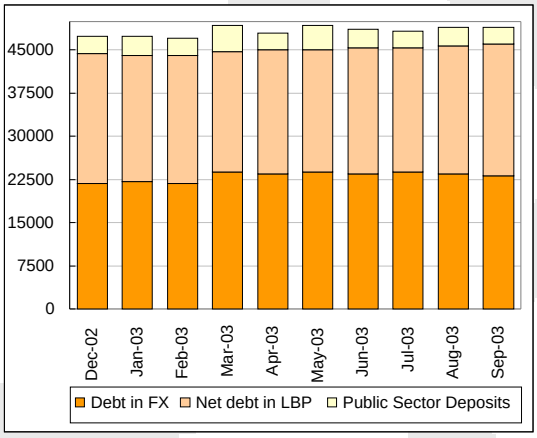
Public Debt grows. Due to ongoing deficits, net public debt grew by LBP1,772 billion over the first nine months of 2003. Yet, the reason why it increased significantly less rapidly than the deficit, LBP2,908 billion, remains to be clarified[5]. Net Public Debt stood at US$30.6 billion by end-September 2003, up from US$29.4 billion by end-December 2002. The Net Public Debt in LBP amounted for 49.4 percent of the total net debt by end-September 2003, down from 50.4 percent in December 2002, with contributions in foreign currencies from Donors, commercial banks and swaps to Eurobonds from the Central Bank exceeding

[4] Formally though, advances to EDL on behalf of the company's debt service should not be accounted for in the public deficit.

[5] For instance, in 2003 US$400 million worth of maturing Treasury Bills detained by the National Social Security Fund (NSSF) - a liability of the GOL to the NSSF – were seemingly transferred to the public deposits – hence becoming an asset of the GOL and reducing by the same amount the Net Public Debt. As another example, the subscription over the Third Quarter 2003 by the BDL of LBP3,648 billion worth of T-bills at 4 percent (while Certificate of Deposits were remunerated at much higher rates) also rendered more difficult the readability of public debt's evolution.

acquisitions of LBP-denominated Treasury Bills (TBs) from commercial banks and the BDL.

Figure 4. Net Public Debt (LBP billion)



Source: Ministry of Finance

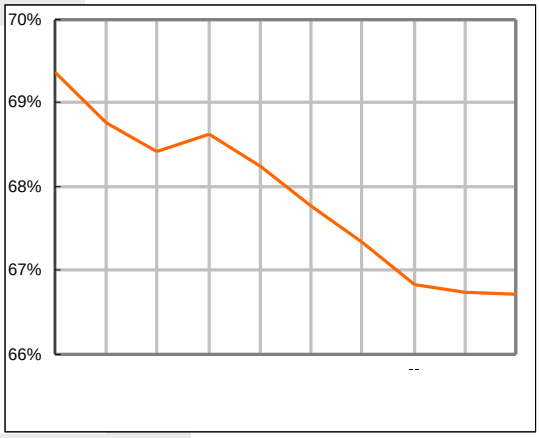
The debt in foreign currency increased by 26 percent from September 2002 and by 6 percent from the beginning of the year. Out of the US$3.1 billion increase in foreign currency-denominated debt, US$2.4 billion were from Paris-II Donors' contributions. The debt stock in foreign currency reached US$15.5 billion in September 2003, and amounts now for 47.5 percent of the total gross debt. The increase in foreign exchange reserves allowed the Government to repay US$500 million and US$450 million worth of maturing Eurobonds and their interests in April and September 2003. The gross debt in LBP increased by 2 percent since December to US$17 billion. The structure of the LBP-denominated debt changed with the Central Bank holding 21 percent of the total in September 2003, the banks 26 percent, and non-banks the remaining. In December, ratios were respectively 2 percent, 68 percent and 30 percent (see the Financial Sector section below).

Financial Sector

Money Supply (M3) grew steadily by 8.9 percent in 2003, notably as a result of sustained capital inflows, though, most of the increase in deposits was sterilized at the Central Bank via the emission of CDs. This policy also enabled the Central Bank to replenish its stock of foreign currency reserves, hence maintaining confidence in the parity in the face of high public deficit.

Stabilization of the dollarization rate over the Third Quarter 2003. Paris II cash flows, compounded with the financial engineering initiated by the Central Bank entailed a large increase in banks' deposits. In an environment marked by high and growing gross foreign currency reserves at the Central Bank, the new deposits were mainly converted into Lebanese Pounds in order to benefit from the higher remuneration on LBP-denominated deposits. The dollarization rate of deposits dropped from 72.2 percent in September 2002 to 69.4 percent in December 2002, 67.4 percent in June 2003 and 66.7 percent in September 2003. The relative stabilization of the dollarisation rate over Q3-2003 might be attributed to the fact that the incentive structure (given by the interest rates and risks structure) remained largely unchanged over the Summer of 2003, encouraging investors to maintain their positions.

Figure 5. Dollarization Rate



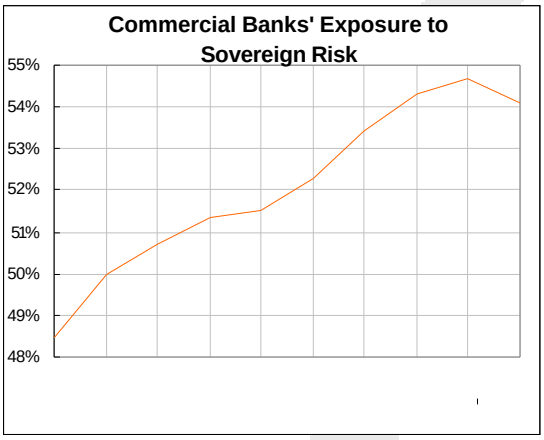
Source: World Bank staff calculations based on BDL.

Strong increase of deposits over the Third Quarter 2003. The increase in all categories of commercial banks' deposits witnessed in 2003 was particularly pronounced during the Third Quarter. Over the first nine months of 2003, deposits rose by US$4.6 billion, out of which US$2.0 billion during Q3-2003. By comparison, deposits rose by US$0.7 billion in the first nine months of 2002. In relative terms, deposits increased by 10.7 percent over the first nine months of 2003, against 1.7 percent for the same period in 2002. Out of the US$4.6 billion increase, approximately one-third can be attributed to the mechanical growth of deposits stemming from their remuneration. The remainder, US$2.9 billion, result from additional capital inflows and the credit multiplier.

Additional banks' deposits sterilized at the BDL. The increase in deposits in 2003 did not have any impact on credits to the private sector. The total amount of outstanding loans (in LBP and US$) remained at US$15 billion between December 2002 and September 2003. Meanwhile, the increase in deposits, together with banks' contributions at 0 percent, translated into a substantial US$8.2 billion rise in commercial banks' deposits at the BDL. Thus, the US$2.9 billion worth of new deposits in LBP were subscribed in CDs and, hence, completely sterilized. Another US$3.6 billion came from the 0 percent contribution of the banking sector,

and the major part of the remaining US$1.6 billion were new compulsory reserves linked to the increase in commercial banks' deposits. As a result, commercial banks' exposure to the sovereign risk (GOL plus BDL) continued to increase over Q3-2003, from 49 percent of banks' assets in December 2002, to 54.0 percent in June 2003, and 54.5 percent in September 2003. The slight reversal witnessed in September 2003 was due to the reimbursement of US$450 million maturing Eurobonds by the GOL.

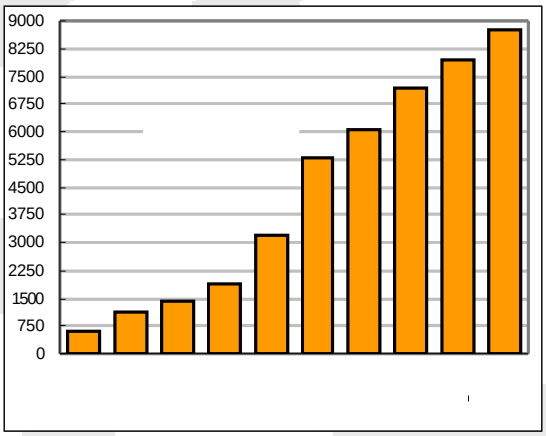
Figure 6. Commercial Bank's Exposure to Sovereign Risk



Source: World Bank staff calculations based on BDL.

Continued increase in Certificate of Deposits over the Third Quarter 2003. The CDs portfolio reached US$5.8 billion at the end of September 2003, up from US$4.0 billion in June 2003 and US$0.4 billion by end-December 2002. The issuance of CDs fulfilled two major tasks during the last months. First, they allowed the BDL to sterilize huge amounts of Lebanese Pounds, thus limiting the possibility of a sudden reversal (a conversion of LBP to US$), which would immediately exert a downward pressure on foreign currency reserves. Second, they allowed the banks to maintain an important spread between rates offered on LBP-denominated financial instruments and those offered on US$-denominated ones, hence, reinforcing conversion to the Lebanese Pound. It is believed that the issuance of CDs played a major role to attract foreign capital and increase foreign reserves. A BDL circular even allowed the commercial banks to invest fiduciary deposits (off-balance sheets' items, not included in the definition of money supply) in CDs at the demand of the depositors. Besides, special arrangements between BDL and commercial banks resulted in a de facto increase in yields offered on CDs when purchased with foreign currencies. In June 2003, the weighted average rate on CDs reached 11.6 percent (against 7.9 percent in March, Source: Association of Banks in Lebanon, ABL), and then declined by end-September 2003, the result of the conversion into CDs of the last two banks' installments at 0 percent.

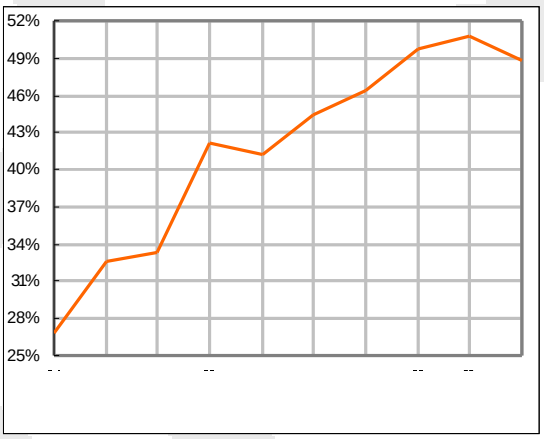
Figure 7. CDs Portfolio (LBP billion)



Source: World Bank staff calculations based on BDL.

Increased gross foreign currency reserves. Currency conversions, Paris II inflows, and commercial banks' contribution at 0 percent in foreign currencies enabled the BDL to increase its gross foreign currency reserves from US$5.1 billion at the end of December 2002 to US$10.2 billion at the end of September 2003. The stock of gross reserves slightly decreased in September 2003 with the reimbursement of maturing eurobonds, which were placed abroad in non-residents banks (+US$560 million between August and September 2003). Still, the coverage rate of total Money Supply in LBP by gross foreign currency reserves culminated at 49 percent by end-September 2003, up from 46 percent in June 2003.

Figure 8. Foreign Reserves Coverage of Money Supply in LBP

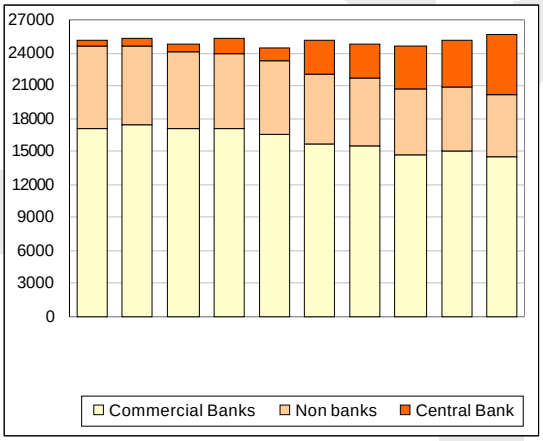


Source: World Bank staff calculations based on BDL.

Treasury Bills (TBs) transferred to the BDL. The structure of the TBs portfolio continued to change during Q3-2003. The portfolio held by the Banks

decreased by LBP2,718 billion between December 2002 and September 2003. This new liquidity in LBP was mainly invested in CDs. The non-banking system portfolio also decreased by LBP1,585 billion, a large amount of which was formerly detained by the National Social Security Fund. Conversely, the holding of TBs by the Central Bank substantially increased during the same period, reaching LBP4,815 billion, an amount slightly lower than that of September 2002.

Figure 9. Holders of LBP Treasury Bills



Source: World Bank staff calculation s based on BDL.

Interest Rates on a slight decline. Interest Rates on both private deposits and loans in the banking sector declined. The spread between private loans and deposits in LBP declined substantially, while the spread between loans and deposits in US$ decreased more slightly. Depositors' rates kept a substantial difference with international rates in order to stimulate capital inflows. Moreover, the spread between the Lebanese Pound deposits and the foreign currencies deposits remains high, which keeps the level of incentives of converting deposits into Lebanese Pound high. The average spread has indeed reached 4.5 percent between the LBP and the local US$ rate, and 6.8 percent between the LBP and the three months LIBOR. The spread between local US$ rate and LIBOR reached 2.32 percent in September 2003.

Table 3. Commercial Banks' Interest Rates for the Private Sector

Average Interest Rates	December 2002		September 2003	
Currency	*LBP*	*US$*	*LBP*	*US$*
Loans to the Private Sector	16.10	9.62	12.04	8.63
Private Sector Deposits	9.83	4.00	7.93	3.48
Spread	6.27	5.62	4.11	5.15

Source: World Bank staff calculations based on BDL.

FUNDAMENTAL TRANSITIONS FOR THE REGION'S GREATEST CHALLENGE

The Middle East and North Africa Region of the World Bank produced four major regional reports on the occasion of the World Bank-International Monetary Fund Annual Meetings in Dubai in September 2003. These reports - on trade and investment, governance, gender, and employment - are intended to enrich the debate on the major development challenges of the region in the beginning of the 21st century.[1] The following note attempts to provide a general overview without going into the details of the four reports.

Between eighty and one hundred million new jobs to be created by 2020. Economic growth to be lifted from a sluggish 3.4 percent over the late 1990s to at least 6-7 percent a year. Governance to move from traditional autocracies to more inclusive governments, accountable to the people. Women to be more equitably included in economic activity and to harness the significant potential economic benefits from an increasingly educated and healthy female population. Public sectors to open the door to more private initiatives. Economies dependent on oil and workers' remittances to diversify into manufacturing and services. Closed trading regimes to integrate with new trading partners in the region and the world. Impossible? No. Imperative? Yes. For these are precisely the changes needed to improve living standards throughout the Middle East and North Africa (MENA) over the next two decades. The political imperatives for such change and the stability of the old order are two opposing forces. The balance is shifting toward the need for reform as joblessness and slow growth make the old order increasingly costly and unsustainable.

MENA's prosperity depends heavily on establishing regional security and stability. Regional and civil conflicts, wars, and embargoes have all reduced the development performance of the region, diverting resources to military and security expenditures, degrading the investment climate and diminishing the attractiveness of the region through neighborhood effects, and sustaining economic and political structures that are not conducive to good governance and development. Resolving these conflicts and restoring security and stability are important. But even more important are the domestic policy and institutional reform agendas, the focus of this work. The regional conflict and security concerns may partly explain the slow pace or absence of reforms, but they also make the reforms even more necessary and urgent.

Employment Problems in a Changing Environment

Over the next two decades the region faces an unprecedented challenge. With the labor forces of the region totaling some 104 million workers in 2000 and expected to reach 146 million by 2010 and 185 million by 2020, some 80 million new jobs will be needed in the first two decades of the 21st century just to absorb new labor force entrants.

These new entrants are increasingly educated, young, and female. Labor force growth rates averaged more than 3 percent a year between 1970 and 2000. The labor force growth rate is forecast at 3.5 percent a year between 2000 and 2010, and not until 2020 will pressure on labor markets fall to the more moderate rates last witnessed in the 1960s. The projected growth of the female labor force at about 5 percent per year during the same period is even more challenging. No other developing region has experienced this magnitude and persistence of labor market pressures. With unemployment above 15 percent, the more ambitious goal of absorbing unemployed workers in addition to the new entrants implies the need to create close to 100 million jobs by the end of the next decade, more than doubling the number of jobs in the region.

Past modes of employment creation are no longer sustainable. Many of the region's traditional systems for employment creation are fast coming to an end. The public sector represented a primary engine for job creation during the 1970s and 1980s and was still a major employer into the 1990s. Today, it accounts for a third of employment in the region, and as much as

[1] The interested reader is referred to the individual volumes listed at the end of this article.

80 percent in several Gulf Cooperation Council countries.

But the public sector can no longer be the employment outlet it has been in the past. Across MENA, evidence suggests that most branches of the public sector are overstaffed, by as much as a third or more in some countries, steadily eroding productivity. But efficiency losses aside, the strategy of providing refuge to vast numbers of unemployed and new labor force entrants is simply no longer sustainable with the marked change in fiscal circumstances throughout the region. Unless employment growth in the formal private sector accelerates, the rising numbers of new entrants will be pushed into the informal economy.

Oil and aid flows are declining. MENA's development has relied heavily on three financial sources: oil, aid inflows, and workers' remittances. These three sources provided an essential supply of public revenues and private earnings, supporting large-scale public employment and sustaining a state-led development strategy based on central planning and economic and social policies for income redistribution and equity.

But all three sources are under great pressure. Oil prices are projected to decline steadily over the next decade to levels that prevailed in the 1970s. Known oil resources will be depleted in about four decades in some countries (such as Algeria and Iran), and much sooner in others (such as Egypt and Yemen). Aid flows are expected to similarly decline, except in temporary periods of strategic importance and conflict resolution. Finally, labor remittances are not projected to increase significantly, a result of deteriorating prospects for labor migration.

Labor migration prospects have diminished. While regional migration provided an important employment outlet for workers in many of the non-oil-producing economies during the oil boom in the 1970s and 1980s, net outflows of MENA workers to other countries in the region decelerated rapidly in the 1990s. Migration to the Gulf countries has slowed. Lower oil prices, rapidly rising supplies of national labor, and competition from lower cost labor elsewhere in the world have together dampened the Gulf countries' demand for labor from the rest of the region.

Outside the region labor migration has become more complex. The demographics of MENA's young population structure and rising working-age cohorts and Europe's lower labor force growth and aging population provide an opportunity for mutually beneficial migration flows. But the barriers remain high, even to moderate and temporary migration.

In all, the region's traditional sources of wealth and job creation are fast disappearing. MENA's world has changed, and it must change with it.

Three Fundamental Realignments Are Needed

If the traditional engines of job creation will not meet the employment challenge in the 21st century, what will? The reports on trade and investment, governance, employment, and gender argue that to accelerate job creation and growth in the future, MENA must address a set of long-standing policy and institutional challenges to complete three fundamental and interrelated realignment in their economies:

§ ***From public sector-dominated to private sector dominated,*** by reducing the barriers to private activity while creating regulatory frameworks that make private and social interests mutually reinforcing. The private sector's contribution to value added is low compared to that in other regions, and it increased only marginally during the 1990s. The increase in the share of private investment in total investment was not enough to compensate for the decline in public investment. The scope for private sector expansion is very large in MENA, but it requires a conducive economic and social environment.

§ ***From closed to more open,*** by facilitating integration into global goods and services and factor markets while installing safeguards for financial stability and social protection. The region's potential for trade is large. Exports other than oil are a third of what they could be. Manufactured imports are half of what would be

expected, and foreign direct investment flows could be five to six times higher than they are.

§ ***From oil dominated and volatile to more stable and diversified,*** by making fundamental changes in institutions managing oil resources and their intermediation to economic agents. Diversification is a growing priority because per capita exports of hydrocarbons have been declining during the last two decades, a result of falling real prices, rising domestic demand, and rapid population growth. Diversification is especially urgent for countries such as Syria and Yemen, whose known oil reserves may soon be depleted. Better management of the volatility of hydrocarbon resources and planning for their decline and eventual depletion are important for insulating the real economy as well as ensuring the sustainability and efficiency of public expenditures.

Many countries in the region have already initiated reforms to achieve these transitions, but the reforms have generally been cautious and incomplete. Transitioning from the old to a new model of development, through these three realignments, represents a considerable challenge. At the same time, accomplishing the transitions provides the greatest hope for accelerating growth and delivering the jobs needed to respond to the growing labor force pressures. The success of these transitions hinges on progress in enhancing gender equality and education quality. Progress on bridging the gender gap in education and health has been impressive. But this has not translated into a commensurate increase in women's participation in the labor force. Women's low participation in the labor force carries large costs to families and society at large, and limits the flexibility of families to adapt to the changing economic conditions.

The transition to more market-driven and globally oriented economies requires continuing progress in widening and deepening the stock of human capital and, more critically, changes in the qualitative outputs of the region's education systems. Water resources and their management, which is a major challenge in the region is not addressed in this note, but is critical for most countries of the region.

Water, Growth, and Socioeconomic Development in MENA

Because MENA is in the driest part of the world, water is critical for growth, development, and poverty reduction in countries of the region. Average per capita water availability in the region is about 1,200 cubic meters a year -the world average is 7,000 cubic meters. By 2025, average regional water availability is projected to be just over 500 cubic meters/person/ year.

Current water use practices are unsustainable. The natural problem of water scarcity has been aggravated by inadequate use of economic instruments for managing demand, increases in household incomes, and such supply side factors as, inefficient public sector service delivery and significant expansion in irrigation.

Most MENA countries are extracting groundwater well beyond the renewal rate, mainly because energy subsidies make it cheaper for many users to do so. But because water supplies are not efficiently distributed, many other users, particularly in urban areas, are forced to rely on vended water, often at 10 -20 times official tariffs. Apart from efficiency concerns, therefore, there are serious equity problems with current water practices.

Significant amounts of water supplied for municipal use remain unaccounted for. Water used for irrigation is also wasted because incentives for farmers to adopt modern, water-conserving technologies are still inadequate. Untreated wastewater from municipal sources and agricultural runoff have been polluting shallow aquifers, rivers, streams, and lakes. The increased water contamination is affecting public health and thus generating significant opportunity costs as well. Studies of environmental degradation due to water pollution estimate the costs at about 1 percent of GDP.

Sustainable water management requires reforms on the demand (economic instruments) and supply (service delivery) sides. Water subsidies, which are both inefficient and inequitable, should be replaced by water pricing based on what users want and are willing to pay for.

Most public sector organizations (serving both irrigation and urban water supply needs) have been unable to serve their customers efficiently. The challenge is to develop alternative institutional arrangements in volving the public sector, the private sector, and communities, so that management of water resources is undertaken at the lowest appropriate level.

Foundations for the Transitions: Governance

The three realignments-key for managing the region's employment challenge-and associated progress on gender equality and education quality cannot be accomplished by policy change alone. Fundamental to each transition is improved governance, across the board. Each *transition* implies deep changes in the role of government and strong improvements in its effectiveness. The governance agenda is not a separate challenge, to be worked on at its own pace. It is a complementary and reinforcing agenda to reform efforts in private investment, trade, and economic diversification by changing governance mechanisms, thereby improving capacity and incentives within government while fostering a larger role for civil society in governance. While better governance cannot guarantee optimal economic policies, it is indispensable to guard against persistently poor policies and to ensure that the good policies needed to meet MENA's growth potential enjoy legitimacy and are implemented faithfully and with celerity.

The primary governance challenges derive from weaknesses in inclusiveness and public accountability. Inclusiveness reflects the notion that everyone who has a stake in governance processes and wants to participate in them can do so on an equal basis with all others. Accountability draws on the principle of proper representation-that those selected to act in the name of the people are answerable to the people for their failures and credited for their successes. Accountability depends on both transparency (knowledge and *information* about governance processes) and contestability (the ability to debate, question choice, and have competition among alternative representatives and policies).

Current governance systems show weakness in inclusiveness... Weakness in inclusiveness is reflected in rural dwellers having few public services, leaving in its wake some of the highest levels of illiteracy among middle-income countries. It is reflected in gender inequalities in voice and participation in society, and differing treatment under the law. It is reflected in nepotism, tribal affinity, patronage, or money, determining who gets public services and who does not-and who gets access to lucrative business opportunities and who does not. While every national constitution in the MENA region enshrines the value of equality for all, the inclusiveness gap between the MENA countries and their main competitors in the global economy is wide and persistent.

...And in public accountability. Weaknesses in accountability are reflected in failings in transparency in governance mechanisms and in contestability. While there are some glimmers of greater transparency, countries across the region exhibit a pattern of limited and reluctant transparency-reflected in the fact that MENA has the least empirical data on the quality of governance of all regions. No MENA country assures citizens the right to government information; some countries actively repress that right. Freedom of the press is carefully monitored and circumscribed in most countries and periodically assaulted in some by the harassment or arrest of journalists, dampening public debate.

As much as in transparency, there are weaknesses in contestability throughout the region. Contestability can come from within the government structure itself, such as from parliaments that can question national policies, or from the people being governed, such as from fair competitive processes for electing public officials, broader and more binding consultations with civil society, and a vibrant, independent, and responsible public debate on government behavior. While internal accountability mechanisms in executive branch administration are generally comparable to those in other countries with similar incomes, internal checks and balances across the branches of government are uniformly weak, the result of excessive concentration of power in the executive even in notionally pluralistic governments such as Algeria, Egypt, and Tunisia. External accountability, through contestability for public officials, has been rare in the region, leaving its governments the most centralized of all developing countries.

Countries Will Meet the Challenges of Reform in Different Ways

While the need to complete the three fundamental transitions and underlying governance improvements is common across the region, the priorities and sequencing of changes in policies and institutional improvements needed to achieve higher growth and complete the transitions will vary-depending on relative resource endowments of natural wealth and labor, and on past success in undertaking policy and institutional improvements, in particular the strength of governance. Political economy factors are also fundamental to external accountability, and national checks and balances and administrative measures for better internal accountability are indispensable.

The Impact on Income Growth and Employment Would Be Large

The impact of an integrated package of policy realignments that improves the business and investment climate for the private sector and fosters integration with the world economy is potentially very large. The trade report estimates, based on the experience of comparable countries, that output per worker could increase by some 2-3 percent a year. The governance report, using similar international evidence of good performing countries, suggests that improving the institutions for accountability and public administration could boost output growth per capita by 0.8 and 1.3 percent a year. Increasing the participation of women in the labor force to levels comparable to the highest performers in the region may add 0.4 percent or more to GDP growth.

While these effects are not additive and reflect changes in policies and institutions that are not exclusive, a conservative estimate of the sum of these projected effects, taking into account overlap in the channels through which the policy changes operate, would be output growth per worker of 2.5-3.5 percent a year, or roughly triple the 1 percent growth of today.

The suggested economic transformation and deep reforms would generate millions of new jobs and more productive jobs in traded sectors across manufacturing and services. For instance, bridging only half the gap between the current 6 percent share of nonoil merchandise exports in total exports and its potential of 20 percent, with associated increases in domestic and foreign private investment, would create more than 4 million new jobs over the next five years. That is equivalent to cutting the unemployment rate by 4 percentage points of the labor force. The broader reform agenda would bring even larger benefits.

MENA Development Reports:

- "Trade, Investment, and Development in the Middle East and North Africa: Engaging the World".
- "Better Governance for Development in the Middle East and North Africa: Enhancing Inclusiveness and Accountability".
- "Gender and Development in the Middle East and North Africa: Women in the Public Sphere".
- "Unlocking the Employment Potential in the Middle East and North Africa: Toward a New Social Contract".

The reports can be ordered on-line at:
http://publications.worldbank.org/ecommerce/

Overviews of the four reports are available in ***English, French and Arabic*** at:
www.worldbank.org/mna/

News, Recent and Upcoming Activities

World Bank Launches Arabic Website (www.albankaldawli.org)

The World Bank has launched an Arabic website that includes dozens of detailed web pages about the institution's work and new translations of Bank publications and issues briefs. The site is currently a mirror of the Bank's main homepage translated into Arabic. It also includes a regional site focusing on the Bank's work in the Middle East and North Africa (MENA). Over 100 web pages will be available in Arabic for the new site. These will highlight the World Bank's partnerships in the region, learning initiatives, publications and research reports in Arabic, as well as project stories. The site also features press releases and country, sector, and issue briefs on various topics. Summaries for key reports will be available in Arabic soon. This new Arabic site will be invaluable in promoting the World Bank's dialogue with the Middle East and North Africa at this critical period for the region. The World Bank's overarching objectives in the MENA region are to strengthen the momentum for building a climate for investment, job creation, and sustainable growth, and to empower poor people in the development process.

Parliamentary Network On The World Bank

In 2000, with a view to engaging Parliamentarians more deeply in development, and to inform them about the World Bank's role in poverty reduction and its knowledge resources, the World Bank encouraged the creation of the *Parliamentary Network on the World Bank* (PNoWB). This independent international network aims to encourage policy dialogue and the exchange of views between legislators and the World Bank. It is also a platform for parliamentary coordination and advocacy on international development and poverty eradication.

The PNoWB currently has over 200 members from over 60 countries, and a Steering Committee with the mandate to initiate, guide and oversee the activities of the network and organize meetings and consultations on a regular basis. The PNoWB's main activities, initiatives and projects include:

Annual Conference: The Network organizes an annual conference in partnership with a national parliament and the World Bank.

Steering Committee Meeting with World Bank Management: The Committee meets once a year with the President of the World Bank and senior management to relay the concerns and opinions of the Network on development policy issues.

Website: The Network has created a website to facilitate the exchange of information on international development issues among members and to serve as a clearinghouse for the latest parliamentary and World Bank news.

Field Visits: With support from the Government of Finland, the Network has initiated a program to organize field trips for parliamentarians from donor countries to visit World Bank projects in developing countries.

Handbook: Plans are underway to create a "Handbook on the World Bank for Parliamentarians" to serve as a comprehensive guide for parliamentarians on the functioning of the World Bank.

For more information and to access the website, please visit: *www.pnowb.org/*

The Information For Development Program

The Information for Development Program (*info*Dev) was started in September 1995 to address the obstacles facing developing countries in an information-driven world economy. It is a global grant program funded by 23 donors and managed by the World Bank. Through pilot projects and other activities, *info*Dev promotes innovation in the use of information and communications technologies (ICT) for economic and social development, with a special emphasis on poverty reduction. It operates as a "venture fund" for ideas and its main method of intervention is through grants to field test specific activities.

*info*Dev provides the mechanism for forming smart partnerships to mobilize intellectual and financial resources for economic and social development in the information age. To date, *info*Dev has created formal partnerships with eighteen governments and international organizations and four private corporations.

*info*Dev is cooperating with public and private donors, development organizations, international organizations, and developing countries. *info*Dev collaborates with institutions such as the International Telecommunication Union, UNDP, UNESCO, the European Union, OECD and many others in the promotion and development of ICT strategies and infrastructure.

Under the core program, *info*Dev provides grants to support demonstration projects in health, education, e-commerce, e-government, environmental protection, telecommunication sector reform, and Internet access by local communities. The *info*Dev Conference Scholarship Facility (iCSF) provides bloc grants to conference organizers sponsoring the participation of individuals from developing countries in major ICT conferences. With the International Institute for Communication and Development in the Netherlands, *info*Dev has developed a web-based environment for disseminating lessons and case study materials from information and communication technology projects: the ICT Stories Project.

The *info*Dev *Flagship Initiatives* are strategic projects complementing the core program; Country Gateways, e-readiness, e-government and regulatory colloquium are examples of the most current flagships. *Info*Dev is presently launching an Incubator Initiative dedicated, over an initial three-year period, to the establishment of a network of incubators to facilitate the emergence and development of small and medium size Information and Communication Technologies enterprises in developing countries.

For more information and to access the website, please visit: *www.infodev.org*

World Bank's Engagement with Civil Society

The growth of civil society has been one of the most recent significant trends in international development. Partnerships amongst governments, businesses and civil society organizations (CSOs) are increasingly seen as one of the most effective ways to reduce poverty and achieve sustainable development.

The purpose of the website is to provide CSOs with information and materials on the World Bank's evolving relationship with civil society throughout the world. CSOs will find information on ongoing policy consultations, funding sources, operational partnerships, and publications.

For more information and to access the website, please visit:
www.worldbank.org/civilsociety

Recent World Bank Publications

Trade, Investment, and Development in the Middle East and North Africa: Engaging with the World (ISBN: 0-8213-5574-0 SKU: 15574). *Engaging with the World* describes why expanding trade and investment is vital for this region. The greatest economic challenge is to create enough jobs for its rapidly growing labor force, which is increasingly young and educated, to ward off threats to social and political stability inherent in high unemployment rates. This effort requires higher, and more sustainable, economic growth than has been achieved in the past two decades. Expanding trade and private investment offers the best hope. The potential is enormous given the region's human resources, skills, location, history, and opportunities.

The book analyzes why the region has yet to tap fully into the rich stream of global commerce and investment--and the measures needed to do so, including improvements in the domestic investment climate and reforms in the policies of the region's trading partners. Its findings will appeal to policymakers in the region, the private sector and civil society, trade specialists, donors and partners, and anyone with an interest in the history and prospects of the Middle East and North Africa.

Better Governance for Development in the Middle East and North Africa: Enhancing Inclusiveness and Accountability (ISBN0-8213-5635-6). Good governance-in which public institutions function responsively, transparently, and accountably-is essential to reducing poverty and stimulating growth. As numerous studies have shown, weak governance translates into slower growth, less-than-effective public services, and missed opportunities for human development because of the limited participation of citizens in shaping their future.

This book seeks to enhance the dialogue on good governance in the Middle East and North Africa (MENA) region. To accomplish this goal, it marshals evidence showing that good governance matters, both regionally and globally, and draws on the universal values of inclusiveness and accountability to propose an analytical framework for discussing and measuring governance. While the MENA region's quality of administration is relatively strong, it lags behind in other key measures, notably public accountability. The region's legacy of limited public disclosure and transparency has, moreover, hampered the debate on governance.

Gender and Development in the Middle East and North Africa. Gender inequality—the differential access to opportunity and security for women and girls—has become an important and visible issue for the economies of the Middle East and North Africa.

Gender equality issues in MENA are usually approached from a social, anthropological, or political angle. But the costs of inequality are often borne at the economic level. This report seeks to advance the gender equality discussion in the region by framing the issues in terms of economic necessity. It analyzes the potential of women's greater economic contribution to the region's new development model, further discussed in three parallel reports on trade, employment, and governance. It identifies key economic and sociopolitical impediments to women's increased labor force participation and empowerment, and suggests a way forward in developing an agenda for change.

Unlocking the Employment Potential in the Middle East and North Africa: Toward A New Social Contract. As the region's increasingly educated and young populations complete their schooling, its already strained labor markets, with unemployment rates averaging 15 percent and a labor force growing at more than 3 percent annually, are facing a daunting test. In 2000, the labor force in the Middle East and North Africa totaled some 104 million workers, a figure expected to reach 146 million in 2010 and 185 million by 2020. Creating work for today's unemployed workers and future, first-time job-seekers will require nearly 100 million new jobs over the next two decades. This is much more than the number of jobs created in the region during the past 50 years.

The report says that to meet this employment challenge—not seen anywhere in the world in the past 50 years—the region's countries must reinvigorate the private sector, integrate into the global economy, and better manage oil resources. To fuel these economic reforms, a new "social contract" between the governments and their citizens is needed. This new social contract must couple political and economic reforms, linking reform to the principles of poverty reduction, income equality, and security that have

guided MENA's political economies for almost 50 years.

HIV/AIDS in the Middle East and North Africa: The Costs of Inaction (ISBN 0-8213-5578-3). Recent evidence suggests that the prevalence of HIV/AIDS is increasing in the Middle East, North Africa, and Eastern Mediterranean (MENA/EM) region, and that the total number of AIDS-related deaths has risen almost six-fold since the early 1990s. Although this figure is low compared with those for Africa, South Asia, and the Caribbean, low prevalence does not equal low risk. The situation can change rapidly, and even conservative estimates indicate that AIDS poses a real threat to the region's long-term growth.

This book reviews the current knowledge available on the prevalence of HIV/AIDS in the MENA/EM region with the goal of stimulating discussion among policy- and decision makers. In other regions, early investments in good surveillance and effective prevention programs have proved to be relative bargains, compared with the costs of a full-blown epidemic. As the authors argue, the time to act is now, while prevalence levels are still low. To that end, they make specific recommendations and offer best practices and case studies from around the world.

This volume is the product of the Joint United Nations Programme on HIV/AIDS (UNAIDS), the World Health Organization (Eastern Mediterranean Regional Office), and the World Bank. It will be of particular interest to those in the fields of public health, social policy, and economic development, as well as to students and scholars of the region.

Opening Up Telecommunications to Competition and MENA Integration in the World Economy (Working Paper Series No. 33). The paper investigates the potential impact of opening up telecommunications to competition in MENA on the sector's performance and on the participation of the region in the World economy.

Making Trade Work for Jobs – International Evidence and Lessons for MENA (Working Paper Series No. 32). Can trade expansion help MENA countries step up the pace of job creation? Despite the short-run costs of adjustment to trade liberalization, in a number of countries that successfully integrated into global markets, export-led growth has eventually brought large employment dividends. The paper examines the medium-term relationship between international trade and employment in manufacturing in developing countries.

Regulation by Contract: A New Way to Privatize Electricity Distribution? (ISBN 0-8213-5592-9). In many developing countries, both governments and investors have expressed disappointment with the performance of recently privatized electricity distribution companies. Some investors claim that the design of the new regulatory system is fundamentally flawed and recommend that independent regulatory commissions be replaced or supplemented by more explicit "regulation by contract" that would reduce the discretion of new commissions.

This paper examines whether regulation by contract or a combination of regulation by contract and regulatory independence would provide a better regulatory system for developing and transition economy countries that wish to privatize distribution systems. It pulls together a vast amount of country cases to identify key issues and approaches for addressing political tension and economic trade-offs.

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Data and Statistics

The World Bank offers multiple databases online, some free of charge, and some on an annual subscription basis. Almost all the data reported in the site mentioned below are derived, either directly or indirectly, from official statistical systems organized and financed by national governments. The World Bank, in collaboration with many other agencies, is actively involved in improving both the coverage of and effectiveness of these systems.

To access the on-line databases, please visit:
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