MIDDLE EAST ECONOMICS FOCUS
1st Sep. 2015

CAPITAL ECONOMICS

Five reasons why we're upbeat on the outlook for Morocco

- **After a difficult few years, the outlook for Morocco is finally brightening. We think the country could be one of the best performing economies in the emerging world over the coming years.**
- **First, Morocco has enormous scope for "catch-up" growth**. GDP per capita stood at $3,300 last year, equivalent to just 6% of the level in the US and far below those in most other major EMs. This suggests that Morocco should be able to enjoy robust growth rates simply by getting the basics right in terms of economic policy and adopting technologies available elsewhere.
- **Second, macroeconomic stability is improving**. A combination of tighter fiscal policy, low global commodity prices and booming exports have led to a sharp reduction in the country's twin budget and current account deficits.
- **Third, the government has undertaken a series of reforms to improve the previously dire business environment**. Indeed, Morocco has enjoyed one of the largest improvements in the World Bank's *Doing Business* survey over the past five years.
- **Fourth, the drag from Morocco's agricultural sector should ease**. A bumper harvest means output is set to rise sharply this year. And further out, the government's *Plan Maroc Vert* has been commended by a number of international institutions for helping to modernise the agricultural sector and encourage farmers to shift towards crops that are better suited to Morocco's warm, dry climate.
- **Finally, and perhaps most importantly, we expect Morocco to build on its enormous potential as a manufacturing hub**. Morocco has started to establish itself within Western European manufacturing supply chains (particularly in the automobile sector). With more firms announcing their intention to set up plants there, coupled with plans to expand Tangier port, we expect this to continue.
- **Of course, the outlook for Morocco is not without risks**. High levels of corruption and the poor quality of education are major obstacles. Political problems in the rest of North Africa could spill over into the country. And Morocco would be hit if a fresh escalation of the euro-zone debt crisis led to weaker growth and investment flows. **But as things stand, we think the Moroccan economy could reasonably grow by around 5-6% annually for the next five to ten years.**

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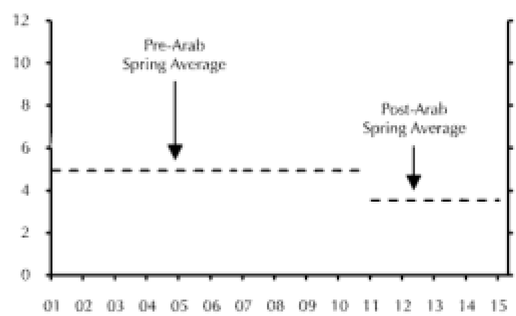
Five reasons why we're upbeat on the outlook for Morocco

Morocco's economy has struggled over the past few years. But the outlook is brightening and, as we explain in this *Focus*, we think it could be one of the fastest growing economies in the emerging world over the coming years.

A difficult few years

The past few years haven't been kind to Morocco. Although the country managed to avoid the political upheaval that afflicted Egypt and Tunisia, the economy still weakened. GDP growth has averaged around 3.5% since 2011, substantially below the average of 5.0% seen in the preceding decade. (See Chart 1.)

Chart 1: GDP (% y/y)



Sources – CEIC, Capital Economics

Alongside weaker growth, the unemployment rate has crept up. And, worryingly, this has been driven by a sharp rise in the youth unemployment rate (a factor often cited as a trigger for the Arab Spring revolutions elsewhere in the region). (See Chart 2.)

Chart 2: Unemployment Rate (%, 4Q avg.)

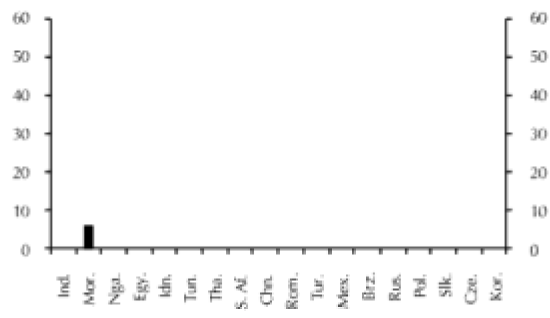
Sources – CEIC, Capital Economics

But in spite of this gloomy recent history, we think the outlook for Morocco's economy is bright. There are five key reasons that underpin our view.

1. Scope for "catch-up" growth

The first is that Morocco has enormous scope for "catch-up" growth. GDP per capita stood at $3,300 last year, which is equivalent to just 6% of the corresponding figure for the US and below the level in moth other EMs. (See Chart 3.)

Chart 3: GDP per Capita (% of US, 2014)



Sources – IMF, Capital Economics

The key point here is that relatively poor countries can, in theory, grow much faster than richer ones simply by getting the basics right in terms of economic policy, replicating technologies and production techniques readily available in the developed world, and shifting workers from low productivity sectors (such as agriculture) to high productivity sectors (such as manufacturing). In other words, EMs can "catch up" with developed countries.

As evidence for this, Chart 4 (over the page) plots GDP per capita for a range of EMs as a share of the US's in 1999 on the horizontal axis, and subsequent average growth in real GDP per capita (from 2000 to 2014) on the vertical axis. As the Chart shows, low-income EM economies have historically experienced faster growth in real GDP per capita. And those with the lowest incomes tended to grow even faster than the rest.

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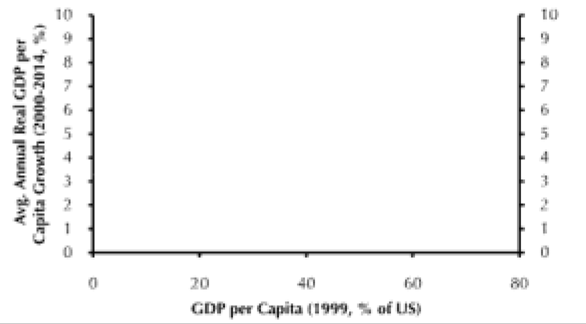
Chart 4: GDP per Capita & Real GDP per Capita Growth

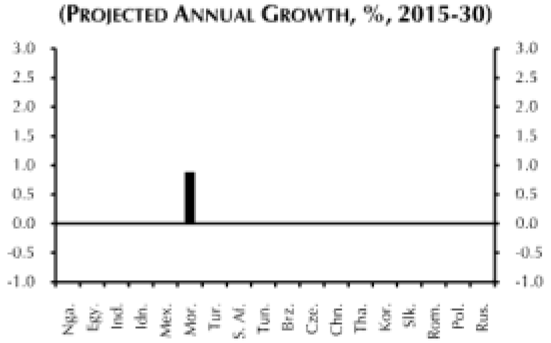


Sources – IMF, Capital Economics

Over the past 15 years, Moroccan real GDP per capita grew by an average of 2-3% a year. This is respectable, but history suggests that it could do much better. As Chart 4 shows, at Morocco's current level of income (6% of US GDP), the best performing EMs managed to record real GDP per capita growth of 5% a year.

Morocco also has a rapidly-growing population. Based on projections by the UN, the country's working-age population is on course to expand by around 0.8% per annum over the next fifteen years. (See Chart 5.)

Chart 5: Working-Age Population (Projected Annual Growth, %, 2015-30)



Source – United Nations

Putting together possible rises in output per worker and in the labour force, Morocco's economy appears to have the potential to achieve annual GDP growth of as much as 5-6% a year.

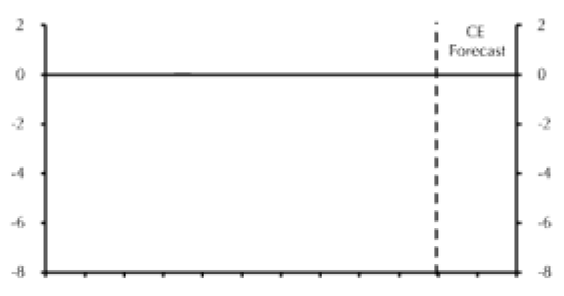
Of course, even if Morocco has a fast potential growth rate it doesn't necessarily mean the economy will grow this quickly. Indeed, it failed to do so by a significant margin over the past four years. However, as we explain in the rest of this *Focus*, we think there have been promising developments in Morocco which make the economy more likely to achieve its potential over the coming years.

2. Improving macroeconomic stability

This brings us to our second reason to expect strong growth, which is that the country's macroeconomic vulnerabilities have diminished.

Notably, the government has made significant progress in reducing energy subsidies, most of which have now been eliminated. According to the IMF, overall subsidy spending is likely to fall to less than 2.0% of GDP by 2017, from 6.6% in 2012. This should help to rein in the budget deficit – we expect it fall to under 4.0% of GDP by next year, from a peak of 7.4% in 2012. (See Chart 6.) As the fiscal deficit narrows, Morocco's public debt ratio – which rose from 47% of GDP in 2008 to 65% last year – is likely to stabilise.

Chart 6: Budget Balance (% of GDP)



Sources – CEIC, Capital Economics

Admittedly, the falls in global food and energy prices over the past year mean that the subsidy bill would have fallen in any case. But the key point is that, by reducing subsidies, the fiscal position won't worsen again if commodity prices spike up in the future.

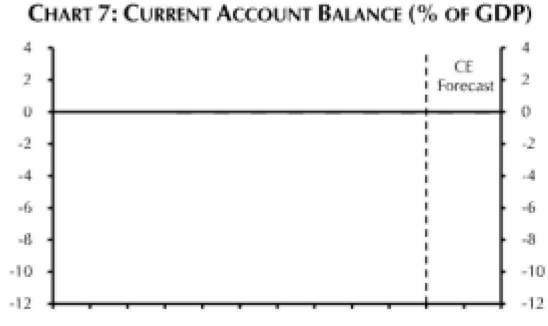
On top of this, a new budget law, currently making its way through parliament, should help to strengthen fiscal discipline over the medium-term. A key pillar of this will be the establishment of a "golden rule" which will only permit net new borrowing by the government in order to finance capital spending. There will also be a limit on the amount of spending that can be allocated for public sector wages.

Of course, "golden rules" can, and have been, disregarded elsewhere (the UK's being a case in point). But these policies do at least show that the authorities recognise the importance of fiscal discipline (something which is sorely lacking elsewhere in the region). And the improving health of the public finances should alleviate concerns about rising debt as well as providing the government with scope for a policy response to counter any economic downturn.

Alongside a narrowing budget deficit, Morocco's current account position is also on the mend. As a large net oil importer, Morocco is a key beneficiary from lower oil prices, and we estimate that the country's energy import bill could fall by as much as 5% of GDP this year. (See "How the fall in oil prices will benefit North Africa", 13th January.)

The combination of a lower import bill and rising exports (more on this later) are helping to reduce Morocco's trade deficit and, therefore, its current account deficit. (See Chart 7.) This means Morocco is becoming less dependent on foreign capital inflows. As a result, the economy's vulnerability to strains in the balance of payments, which could cause a sharp drop in the currency and/or fall in domestic demand, are in decline.

Chart 7: Current Account Balance (% of GDP)



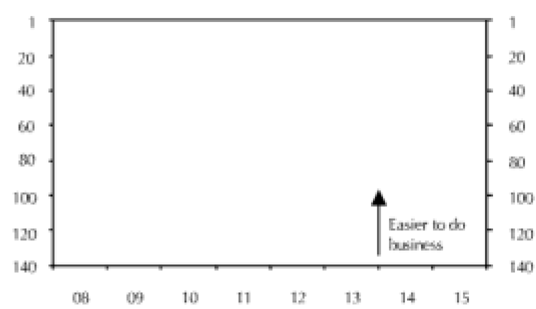
Sources – Thomson Datastream, Capital Economics

3. Business environment improving

The third reason why we're upbeat on the outlook for Morocco is that the government has made great efforts to improve the previously dire business environment. Recent reforms include measures to simplify construction permits and property law, reduce the number of administrative documents required for exportation, and eliminate minimum capital requirements for limited liability companies.

As a result of these reforms, Morocco has jumped from a lowly rank of 130 out of 183 in the World Bank's *Doing Business* report in 2010 to a rank of 71 out of 189 in the latest survey. (See Chart 8.) That is the second largest improvement in ranking over this period (after Rwanda).

Chart 8: Morocco Ease of Doing Business Rank



Source – World Bank

Of course, Morocco's business environment is far from perfect. But in spite of these pitfalls, the overall progress made so far is impressive and should help to encourage a rise in investment.

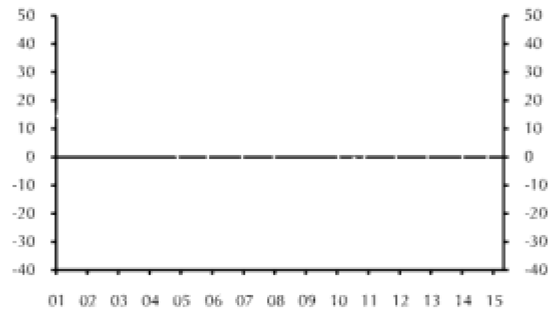
4. Modernisation of the agricultural sector

The fourth reason to expect growth to strengthen is that Morocco's agricultural sector (which accounts for around 20% of GDP) should perform well, both over the short-term and longer-term.

Agricultural output contracted by 1.7% y/y (in real terms) last year on the back of poor weather conditions. And, overall, the sector has fared poorly since 2010. (See Chart 9 over the page.)

Nonetheless, good rainfall this year is likely to result in a bumper harvest, boosting growth. The first signs of this were seen in national accounts data for the first quarter of this year, which showed that agricultural output rose by 12% y/y.

CHART 9: AGRICULTURAL OUTPUT (% Y/Y)



Sources – CEIC, Capital Economics

And we think things should improve in the sector over the medium-term. The government is aiming to modernise the agricultural sector as part of its *Plan Maroc Vert* (Green Morocco Plan), launched in 2010 in conjunction with the World Bank.

For small-scale farms, the authorities are trying to encourage the formation of cooperatives, providing finance for equipment, as well as shifting farmers away from growing rain-dependent, low-yielding crops, such as wheat, towards those that are better suited to Morocco's dry climate, such as cherries and olives. Meanwhile, larger agricultural projects benefit from subsidies for upgrading equipment. As a result, agricultural output should both increase and become less volatile. **This, in turn, should help to support Morocco's exports and GDP growth.**

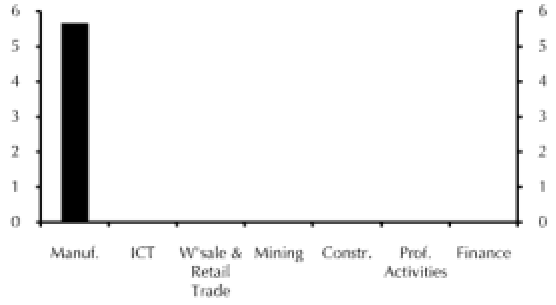
5. Emerging as a manufacturing hub

The final reason for optimism on Morocco is that the country is capitalising on its potential as a manufacturing hub.

Historically, a key ingredient of sustained economic growth in emerging markets has been the development of a manufacturing sector. This is because manufacturing is relatively more open than other sectors to advancements in technology and has more scope to adapt production processes.

The upshot is that the manufacturing sector tends to experience greater productivity gains than the rest of the economy. (See Chart 10.)

CHART 10: EMERGING MARKET LABOUR PRODUCTIVITY BY SECTOR (% Y/Y) (2005 – 2013)



Sources – OECD, Capital Economics

We've argued before that Morocco has many of the ingredients to become a successful manufacturing hub. It has low wages, a young and growing workforce, and a geographical position near rich European markets. (For more, see our *Focus*, "North Africa: A potential manufacturing hub?", 15th April 2014.)

In a bid to build on the country's potential as a manufacturing hub, the Moroccan authorities have put in place a number of incentives to lure manufacturers to its shores. A free zone near the port of Tangier (TFZ), opened in 2007, is the flagship project of the country's industrial policy. Goods entering and leaving the free zone are not subject to exchange rate controls, the taxation system is more generous, and administration has been streamlined.

Meanwhile, the government is investing in the TFZ's infrastructure. Two new terminals are under construction at Tangier port will increase capacity from around 3mn teu (twenty-foot equivalent units) to 8.5mn teu by 2017. **If fully utilised, this would place Tangier among the twenty largest ports in the world and the fourth largest outside Asia.** (See Chart 11 over the page.)

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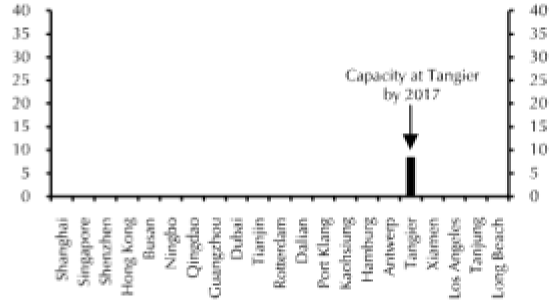
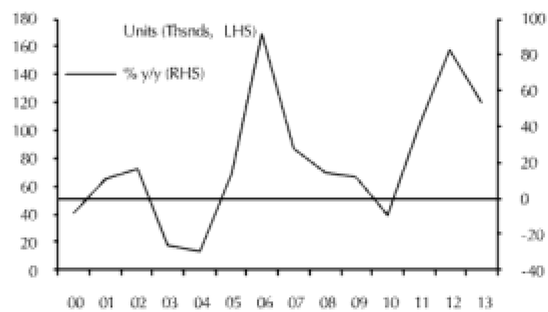
CHART 11: CONTAINER TRAFFIC BY PORT (TEU MN, 20 LARGEST IN THE WORLD)



Sources – CEIC, Capital Economics

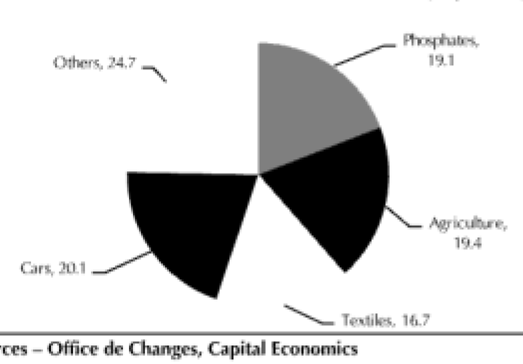
There are signs that the government's efforts to promote manufacturing are starting to bear fruit, particularly in the automobile sector. Vehicle production more than doubled between 2011 and 2013. (See Chart 12.) And automobiles have overtaken traditional goods, such as textiles, phosphates and agriculture, to become Morocco's largest single exported good. (See Chart 13.)

CHART 12: VEHICLE PRODUCTION



Source – Organisation Internationale des Constructeurs d'Automobiles

CHART 13: SHARE OF TOTAL GOODS EXPORTS (%, 2014)



Sources – Office de Changes, Capital Economics

The momentum in the auto sector seems to be building. Until recently, Morocco only had capacity to build around 60,000 cars per year. But large investments by the French car manufacturer Renault, under its Dacia brand, will raise this to 400,000 over the coming years. And Renault has hinted that rising wage costs in Romania could prompt it to shift more production to Morocco.

Meanwhile, PSA Peugeot Citroen recently announced plans to build a factory with an initial capacity of 90,000 vehicles, which is expected to rise to 200,000 further down the line. Several other large car manufacturers are rumoured to be considering Morocco as a destination for future investment. **These investments could bring Morocco's automobile sector into the same league as fairly major emerging markets, such as Poland and South Africa.**

All in all, investment into Morocco's manufacturing sector would help to boost exports and GDP growth, while narrowing the country's current account deficit. And there could also be spillover effects on the rest of the economy. Most notably, supply chains could build up in the rest of Morocco to provide intermediate parts and services. What's more, the introduction of better management techniques, the equipping of workers with new skills, and improvements to infrastructure could all trickle down and raise productivity in other sectors.

Conclusion

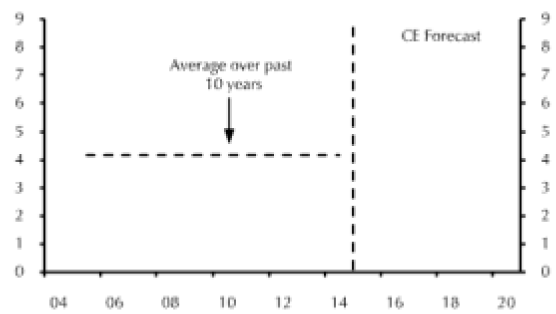
Of course, the outlook for Morocco is not all rosy. The country relies heavily on the euro-zone as a destination for exports, and as a source of investment and tourism. Hence, a severe re-escalation of the euro-zone debt crisis or, indeed, a period of much weaker growth there, could weigh on the Moroccan economy. Moreover, there is a risk that political problems in the rest of North Africa spillover into Morocco.

What's more, additional reforms will be needed further down the line to improve the business environment and sustain rapid growth rates.

Particular areas of concern include: the labour market, which suffers from high levels of restrictions (such as high costs for firing workers); generally low levels of education, which lead to skills mismatches in the labour market; and corruption.

That all being said, the progress made by Morocco over the past few years is impressive and we think the ingredients are in place for a period of strong growth of 5-6% annually over the next five to ten years. (See Chart 14.) **This would make Morocco one of the few emerging markets where growth over the next ten years is likely to be stronger than it was over the previous decade.**

CHART 14: MOROCCO GDP GROWTH (%)



Source – Thomson Datastream, Capital Economics