Kuwait Programme on Development, Governance and Globalisation in the Gulf States public lecture

Saving the Arab Spring: economic development in the Middle East

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Saving the Arab Spring: Economic Development in the Middle East

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Outline – I

A new era, old economics

- The Arab world is entering a new era - with both hope and fear
- But the problems are old: if the Arab revolts were fuelled by the demand for freedom, bread and social justice these concerns are as distant as ever
- Unemployment has nearly doubled in Tunisia and Egypt; tourism revenues are declining and fiscal challenges remain at large
- What some Arab countries have achieved in the political arena can be lost on the economic front.
- A new era cannot be shaped *without* a new economics of the region

Outline – II
A crisis not just of the state, but also the private sector

- And: a new economic order cannot be envisaged without:
  - developing a strong private sector
  - cultivating regional synergies

- The Arab spring was not just a crisis about the state – its ability to reform, redistribute and represent ordinary citizens' interests

- It was also a crisis about the private sector – or, more appropriately, its weakness!

- Arab countries need to create at least 100 million jobs in coming years.
- Without a strong private sector, this is an impossible task to achieve.

Outline III
Private sector development is not just a technocratic issue

- Q: how to develop a strong private sector?
- Traditional World Bank recipes (e.g., investment climate reforms) are hopelessly inadequate – their narrow, technocratic and apolitical lens fails to address the root cause of the problem.

- *Two central contentions of the paper*:

1. Creating a robust private sector is a *political* problem – an independent private sector is often viewed as a threat, since economic power can translate into political power.

2. And, it is a *regional* challenge – since fragmented markets prevent Arab firms from realizing the benefits of producing for a bigger market and locating next to each other.

Outline – IV
The regional dimension to prosperity has long been ignored

- Finally: a new economic era – and a strong private sector – is unthinkable without regional synergies.

- When it comes to flow of goods, people and capital, the Arab world is one of the most fragmented regions of the world.

- Past attempts at reform have partly failed because they ignored the regional dimension of prosperity.

- Needed: a new infrastructure of regional cooperation

- *The single most important collective action problem since the fall of the Ottoman Empire*

Middle East as a differentiated tapestry

- Differs in: policy, resources, size, ideological orientation…
- …but five common denominators across commonly recognized conceptual boundaries:
- (1) concentration of economic and political power
- (2) coercive security apparatus
- (3) profound demographic shifts
- (4) centralized state with a strong public sector
- (5) primacy of external revenues (oil, aid, remittances)

An evolving demography

- One of the highest rates of population growth - the largest youth cohort in the region's history
- Growing in numbers, but also in educational attainment
- Demography and the generational struggle for inclusion
- High and persistent youth unemployment
- Why is demography not resulting in growth dividends?
- The region suffers from a precarious employment strategy: public sector remains the main avenue for job creation

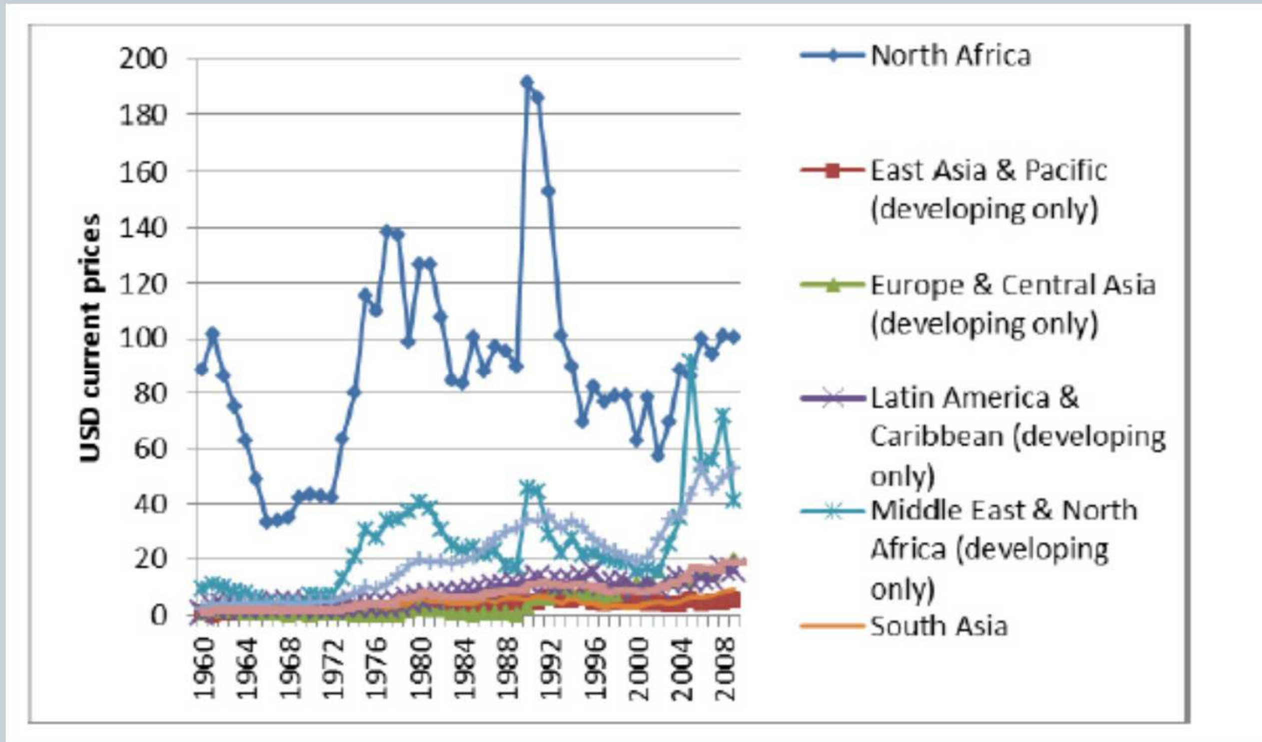
…but a rigid economic structure

- State is the *provider of first and last resort* – whether it is food, jobs, shelter or other public services
- This state-centred development paradigm rests on the *uninterrupted flow of external windfalls*
- High dependence on exports of oil and hydrocarbons

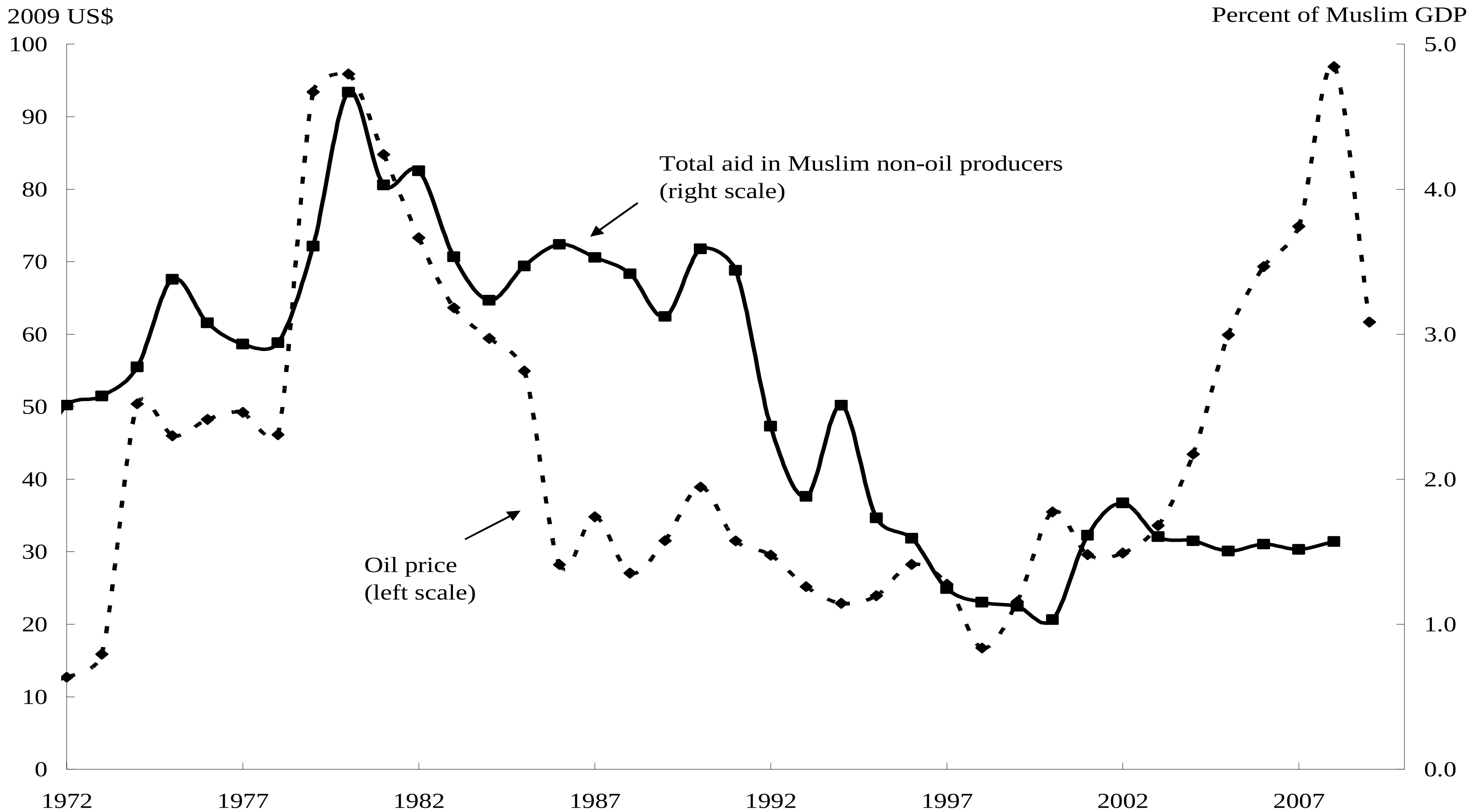
  (share in merchandise exports is nearly 80%)
- Dependence on natural resources is high even in otherwise resource scarce countries (Syria, Yemen, etc.)
- Others are more dependent on windfalls from aid and remittances.

- These rents are the *original sin of development* => turn economies away from production to patronage

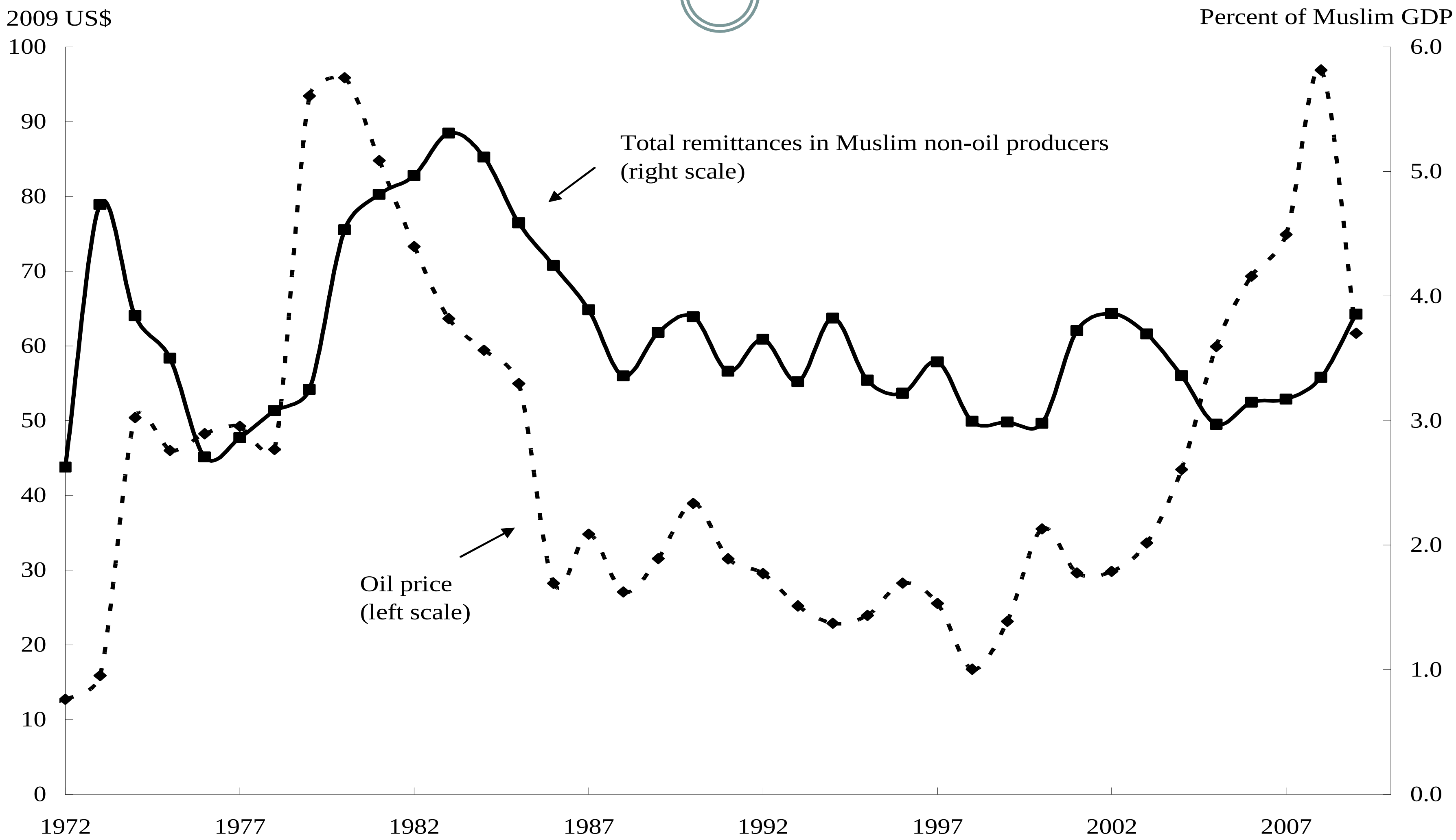
MENA is the biggest recipient of net aid per capita



Aid and oil prices



Remittances and oil prices



The rising cost of social bargain

- Social order rests on *repression* and *redistribution*
- The cost of both of these is rising in the face of:
- - changing demography
- - technology
- - rising food prices
- - corruption

A crisis about the private sector

- Prevailing development model is unsustainable in the long term.

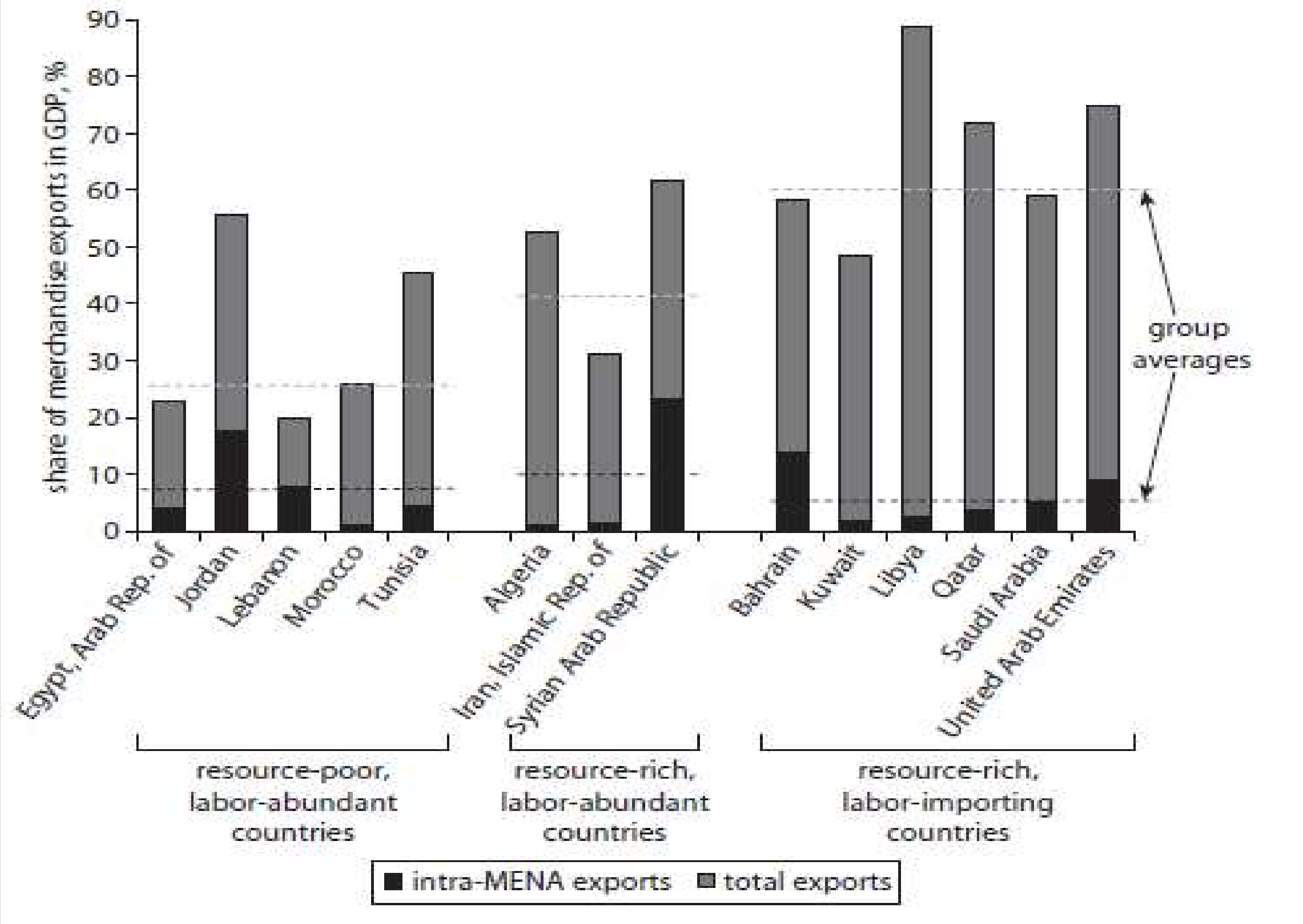
- State-business relationship is personalized, rather than insitutionalized
- Businessmen and rulers connected through overlapping networks

- Limited export presence and low productivity
- Two facts that point to a *dangerous dearth of manufacturing*

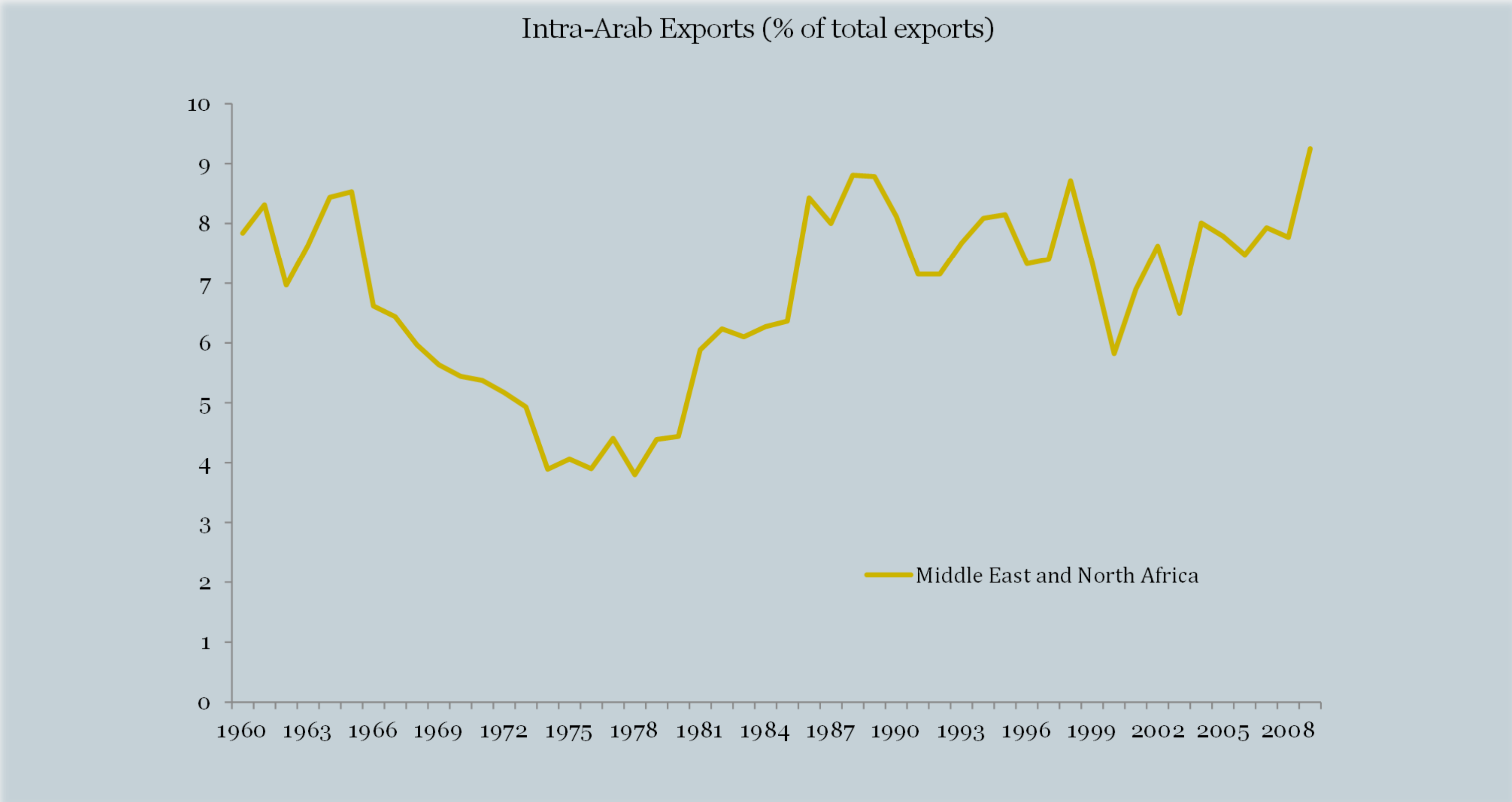
- MENA holds less than one percent of world market share in non-fuel exports - compared to 10% in EA and 4% in LA

- In 2003 the combined manufactures exports from the MENA region were less than those from one country – Philippines!

Borders matter:
The small share of intra-regional exports



…and the share of intra-Arab trade has stagnated



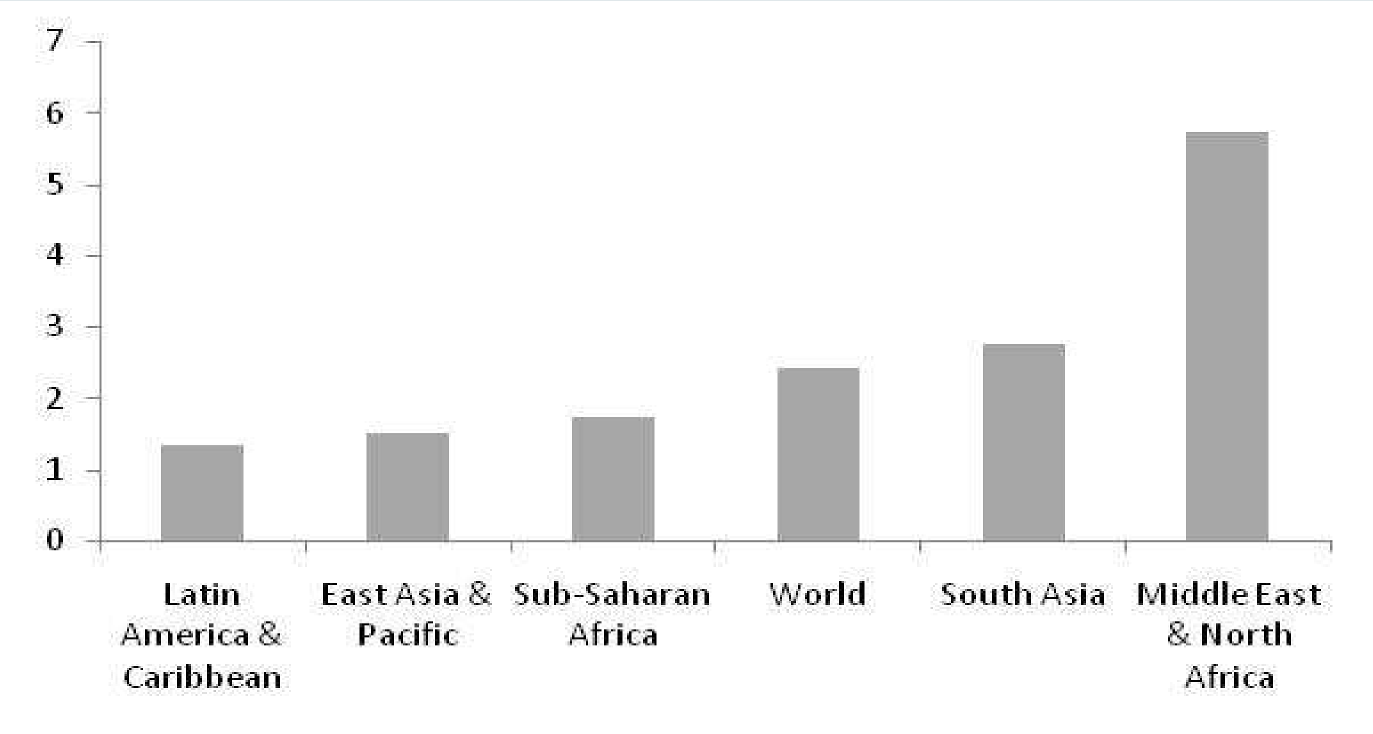
Limited intra-regional trade

- Insignificant pan-Arab trade; lower than most other regions
- Falls short of its potential, given the economic size, geographical distance and country characteristics (forces of gravity)
- Two other features:
- Trade is clustered: 58% of the intra-Arab exports of GCC go to other GCC countries; similar ratios for the Arab Maghreb
- Trade is segmented: trade integration is particularly poor between North African countries and rest of the Arab world

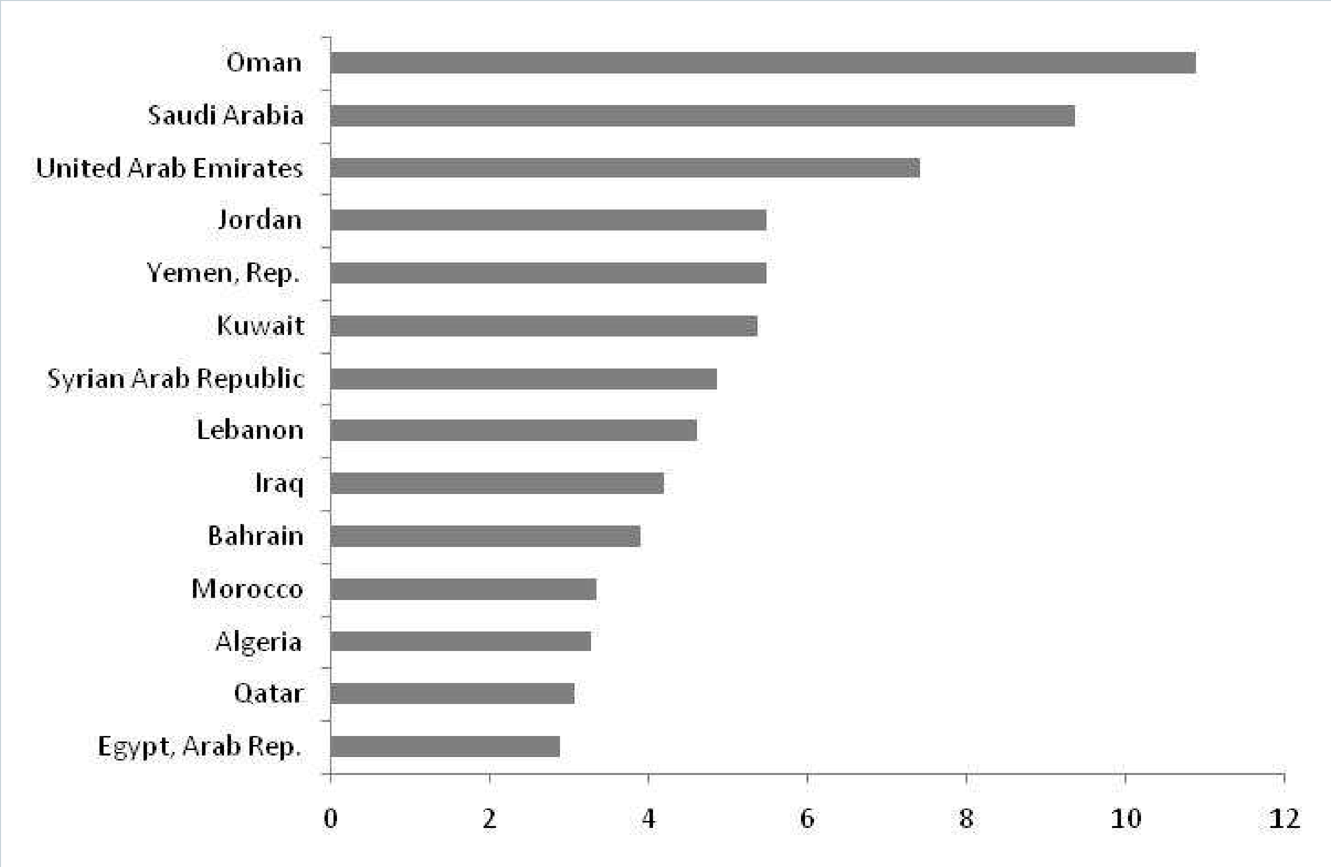
Size matters: the costs of fragmentation

- Fragmentation is costly in terms of:
- - loss of economies of scale
- - unequal distribution of wealth
- - high levels of monopoly power
- - higher returns to predation
- - adverse investment climate and coordination failures
- - under-provision of regional public goods

Defence Spending, % of GDP, 2000-09



Variation in Defence Spending



The Middle East defies the forces of gravity

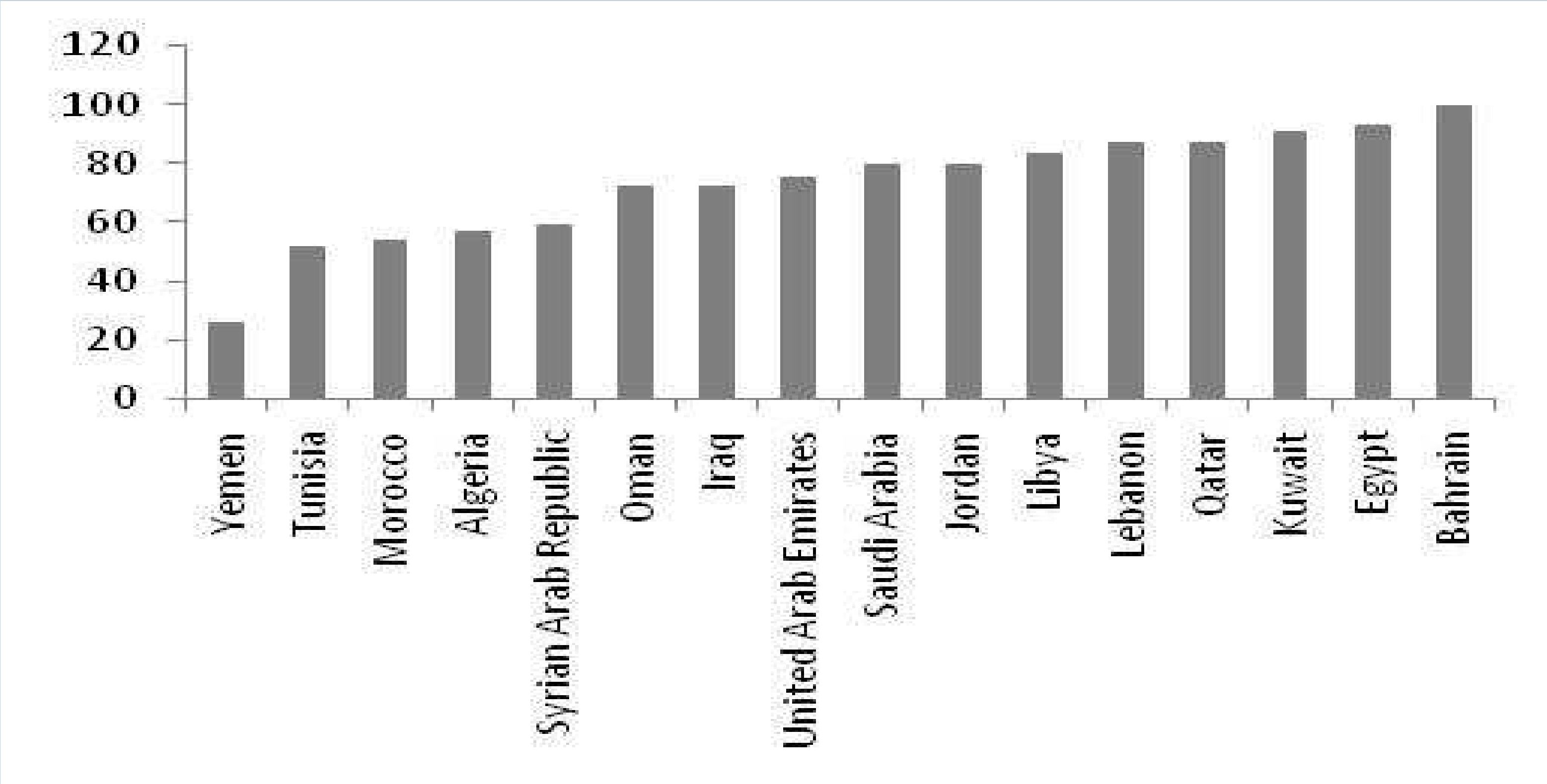
- *Puzzle 1*: coastal proximity without market access (both borders and sea are difficult to navigate)

- *Puzzle 2:* Low agglomeration economies despite high levels of urbanization

- A striking contrast between Africa and Middle East
- Africa is structurally disadvantaged, fragmented by ethnicity and adverse geography

- Middle East is fragmented by *history* and *policy*

Agglomeration Index, %



Weak Merchants, Strong Rulers

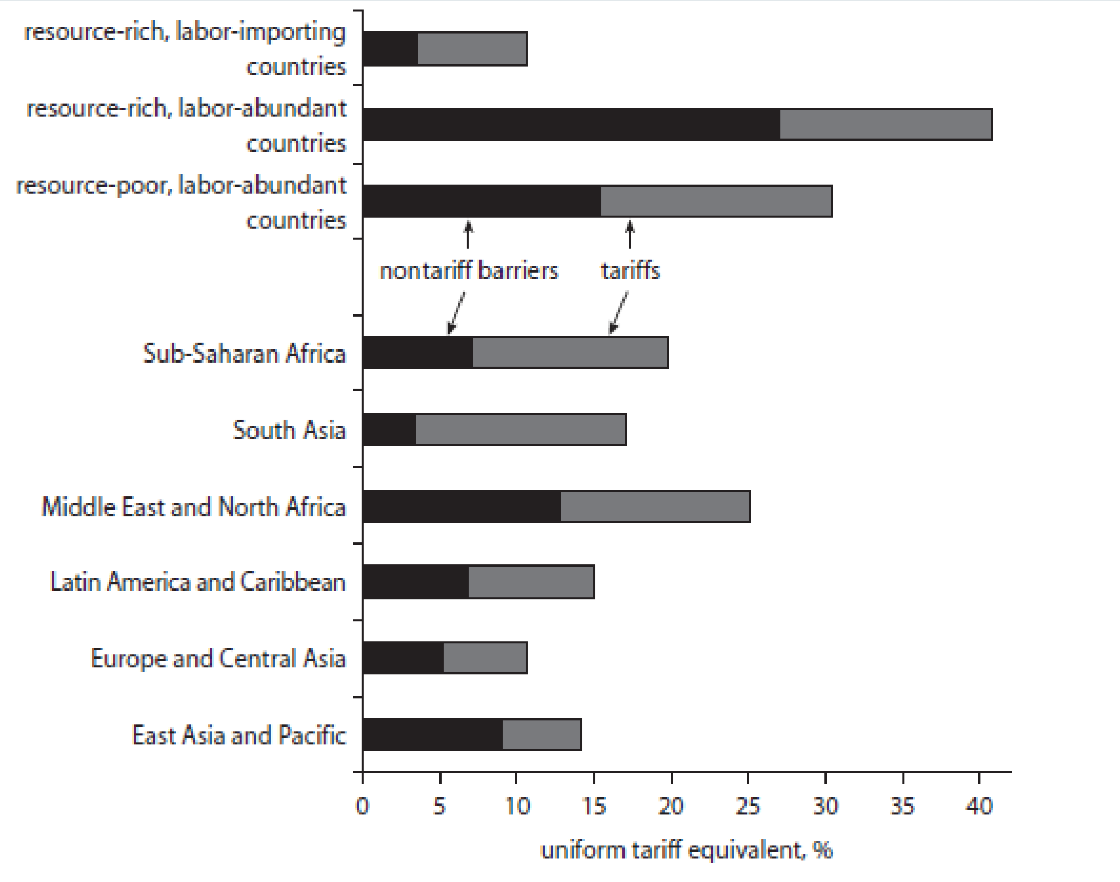
Merchants in the Ottoman Empire

- Historically, local merchants have been politically weak
- Merchants and craftsmen lacked autonomy to form associations
- Business was controlled largely by European merchants and their local protégés
- => politically expedient: foreign merchants were rarely seen as a threat; their economic power was unlikely to have translated into political power.
- The state actively prevented the emergence of any social group with the capacity to "initiate political action".

The nationalist moment strengthened the state at the expense of merchants

- Independence converted political boundaries into permanent economic boundaries => old trade routes became dysfunctional
- Exodus of European merchants => absence of a solid constituency for private sector development
- The nationalist moment strengthened the Arab state at the expense of business
- Although inspired by a socialist rhetoric, mass nationalizations were also politically expedient!
- Oil and conflict further locked in these divisions

MENA faces economic – not just political – repression



License raj of the Middle East

- The bureaucratic hand stifles entrepreneurship
- A maze of arbitrary restrictions, procedural requirements and controls
- Compared to EU, bilateral trade costs between Arab countries are twice as high
- Some of the most restrictive policies in the services sector
- Rules are not only cumbersome – but also inconsistently applied
- Trade restrictions => transaction costs => large cost differentials relative to global competitors

Trapped in trade logistics

- High cost of transport and logistics – ranked as the most important business constraint in 2008
- Trucking industry is fragmented and controlled by cartels
- Despite favourable coastal access, the region is only a transit point for major shipping routes
- Suffers from long and indirect sailing times: voyage from Jordan to New York requires 42 days; sailing times to Hamburg and Tokyo are 30 and 45 days
- Limits the potential to form a regional network of suppliers, and engage in *trade in tasks*

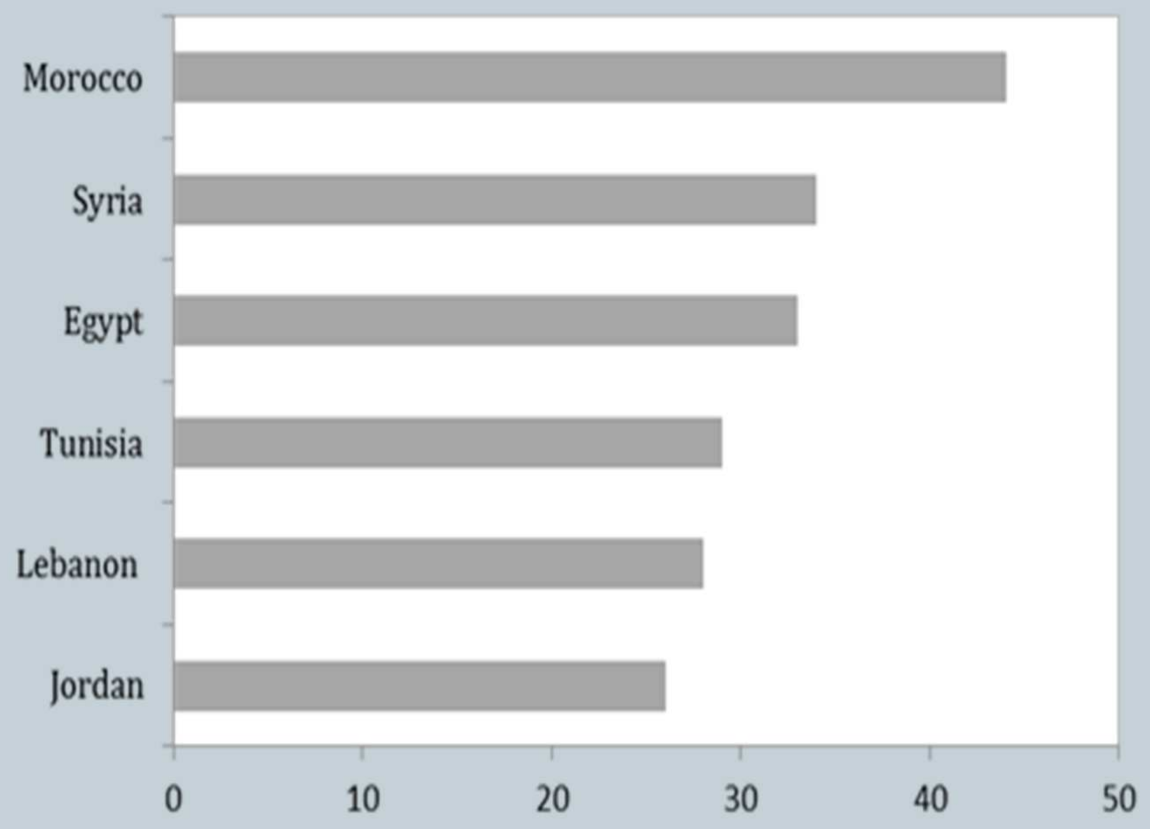
Trade barriers are not just procedural, but also political

- Rents/monopoly rights for insiders => serve a vital political function.
- Represent the economics of concessions and networks of privilege
- *Twin pillars of stability*: patronage and control

- Trade frictions *distort the level playing field and act as entry barriers*

- The average MENA firm is ten years older than its East Asian or Eastern European counterpart
- Number of registered businesses per 1,000 people is less than a third of that in Eastern Europe and Central Asia
- Only 8% of total lending in MENA is directed towards SMEs
- Egypt before Mubarak: politically connected firms absorbed more than 80% of corporate credit borrowing

Size of the informal sector, % of GDP



Caught in multiple traps:

- Small and thin markets => loss of economies of scale=> hampers investment =>reinforcing dependence on primary commodities
- Low complementarity of trade => limited intra-Arab trade => preserves the status quo
- Weak private sector => greater dependence on the state for job provision => absence of stakeholders for reform and growth of the private sector

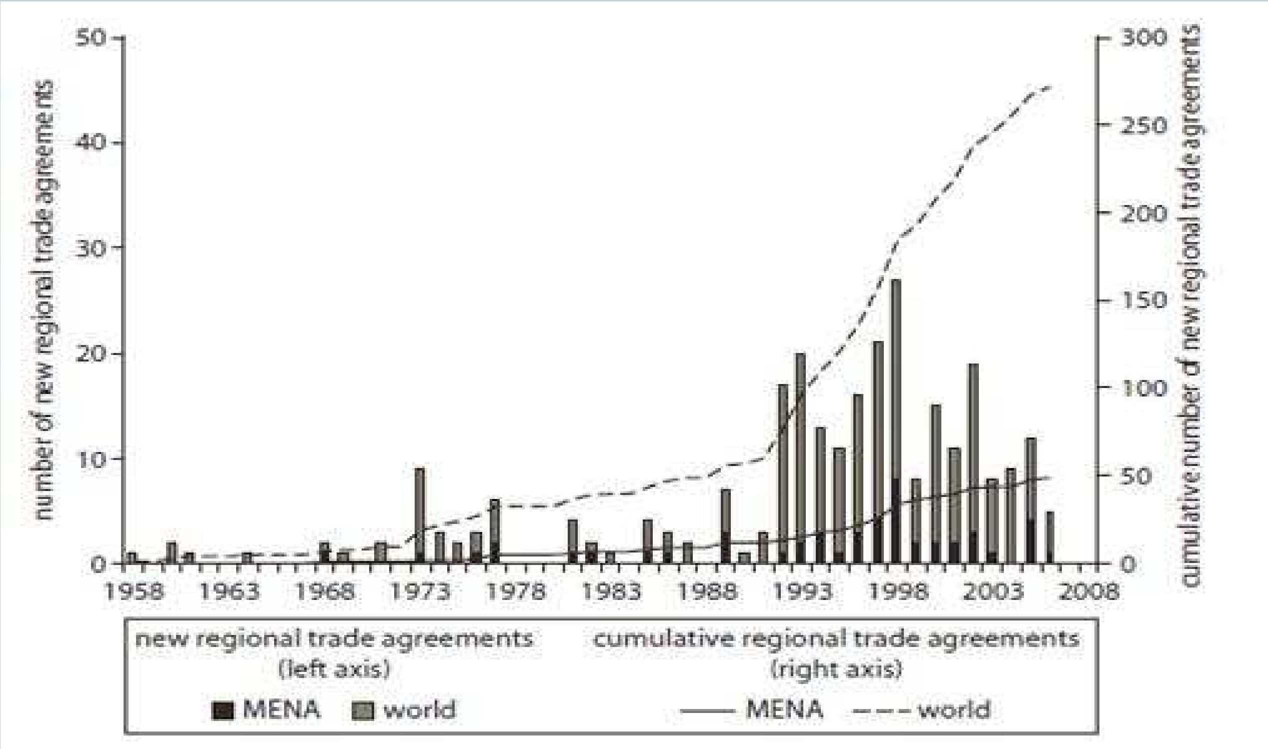
Trapped in an adverse political equilibrium

- This *politics of policy* has persisted in the era of neo-liberal reforms that have simply "reconfigured" political power
- The existing political equilibrium may not favour an autonomous and independent private sector
- The political economy of protectionism => no major stakeholders for dismantling trade barriers, but protectionism favours "small and cohesive" groups at home.
- Trade can displace incumbent advantage - financial linkages have been politically more palatable
- Oil engenders autonomy from integration.

Can regional trade integration be a strategic political concession?

- Fragmentation is consistent with the incentives of local elites and international stakeholders
- Most MENA countries are integrating vertically with global commerce and finance, but horizontal integration remains minimal (=> figure)
- EU agreements with the Mediterranean; bilateral agreements between US, Bahrain, Jordan, Lebanon, Morocco, Egypt
- Limited external agency – No silk road initiative for MENA!
- Region is united when it comes to security policies, can it act collectively to save the future of its teeming millions?

A honeycomb structure of trade integration



A questionable sequence

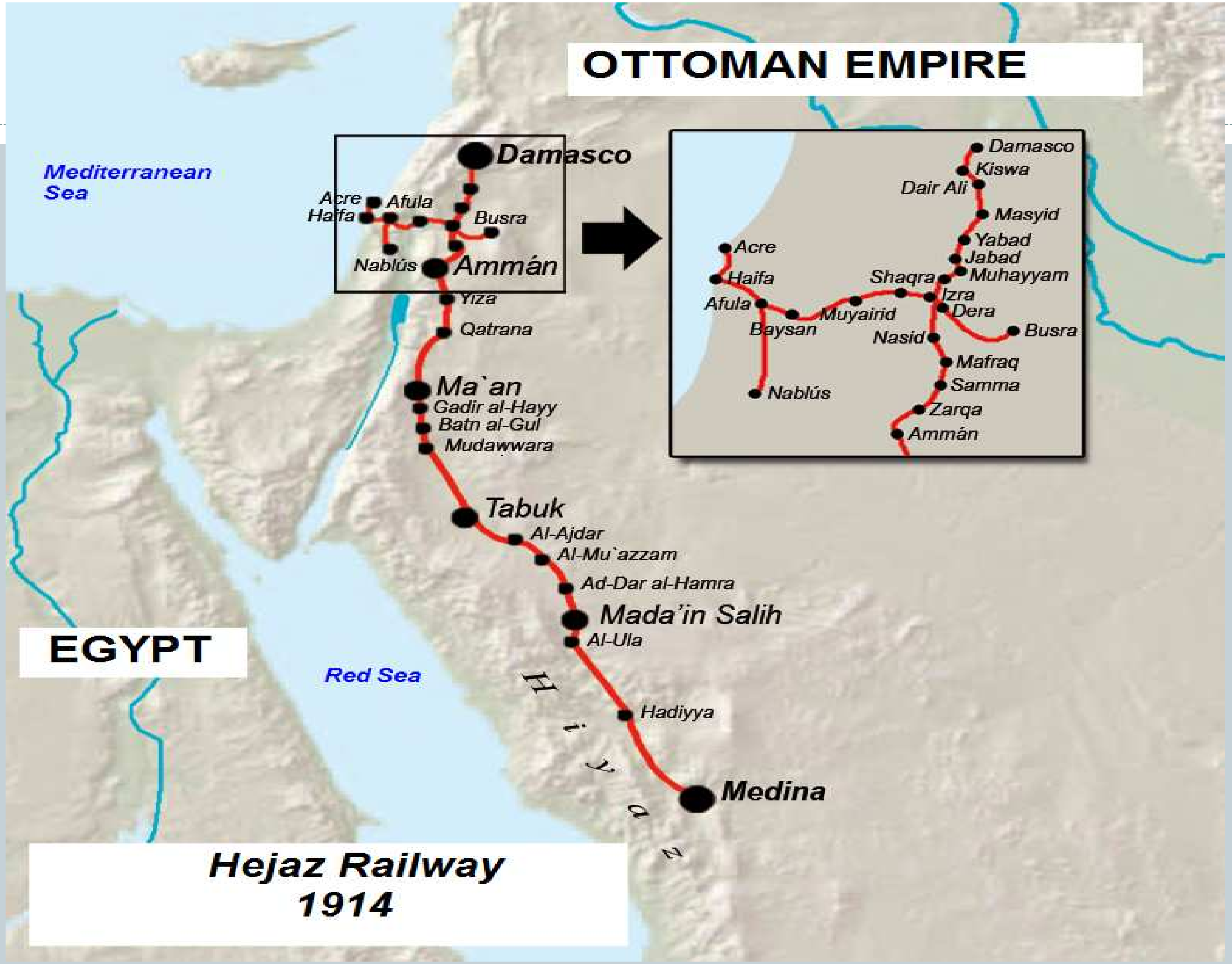
- “Rather than set as their first economic policy priority the goal of regional integration, MENA countries should focus on domestic policy reforms and the associated process of greater integration into the world economy” (El-Erian and Fischer, 1996).

- “It seems advisable for MENA policy makers to focus first on how to maintain and strengthen their countries’ competitiveness in the global market and only then ask what contribution regional integration can make toward achieving this end” (Shui and Walkenhorst, 2010).

Why is this sequencing misplaced?

- Globalization is no more politically expedient than regional trade
- Primacy of scale economies and contested markets
- Regional trade => wider and more powerful scale economies: accrue more widely to industries
- *Example*: regional public goods (transport, infrastructure)

- Regional trade => deeper trade liberalization (NTBs, coordination and harmonization of policies, better investment climate, etc.)
- Critical for diversification: fragmented markets => loss of economies of scale that are more important for manufactures
- Thick economic borders => disadvantage in intra-industry trade
- …which is especially suitable given the region's educated populations, urbanization and favourable access to coasts


OTTOMAN EMPIRE
Mediterranean Sea
Damasco
Acre
Afula
Haifa
Busra
Nablús
Ammán
Yiza
Qatrana
Ma`an
Gadir al-Hayy
Batn al-Gul
Mudawwara
Tabuk
Al-Ajdar
Al-Mu`azzam
Ad-Dar al-Hamra
Mada'in Salih
Al-Ula
Hadiyya
Medina
H i y a z
EGYPT
Red Sea
Damasco
Kiswa
Dair Ali
Masyid
Yabad
Jabad
Muhayyam
Acre
Haifa
Shaqra
Izra
Afula
Muyairid
Dera
Baysan
Nasid
Busra
Mafraq
Samma
Nablús
Zarqa
Ammán
Hejaz Railway
1914

Regional complementarities in infrastructure

- *Increasing returns characteristics of regional infrastructure*
- Entail big investments and constrained by limited demand
- Linkages and complementarities in providing regional public goods

Consider Jordan

- - Red-Dead Canal project for the supply of de-salinated water
- - Oil pipelines from western Iraq to Zarqa and Aqaba
- - Gas pipeline from Qatar to Jordan through Saudi Arabia, and gas de-liquefaction plant at Aqaba

Intra-Arab linkages

- Electricity grid interconnection for the GCC
- Maritime shipping/ports – in Tunisia, Libya, Algeria and Syria
- Railroad networks across the region

An open access order

- Fragmentation is partly a consequence of centralization

- Centralized systems undermine dense horizontal relationships
- Deviance from established norms and creative destruction are discouraged

- Reform has been a centralizing instrument
- *Key question*: Will reforms once again be a centripetal or a centrifugal force? This is the true crucible of the Arab Spring.

- Private sector development is at once the most *despised* as well as the most *desirable* aspect of reform.
- The struggle for a new Middle East will be won or lost in the private sector.

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