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SURVEY OF ECONOMIC AND SOCIAL DEVELOPMENTS IN THE ESCWA REGION 2004

SUMMARY

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EXECUTIVE SUMMARY

The year 2003 was a year of war in the ESCWA region. Unlike the fragile regional economies, wars in the ESCWA region exhibit a scale effect. Wars do not end the cycle of violence; rather they extend it on a larger scale. Given two ongoing conflicts in the Occupied Palestinian Territories and Iraq, Western Asia stands faced with yet another potentially sweltering cycle of hostility. Oil prices rose in 2003, along with oil revenues and economic growth in oil exporting countries. But that is reminiscent of what occurred in the last Gulf War and the war before. The positive developmental impact of the short-lived bout of oil price rise was short-lived. The International Country Risk Guide has listed the ESCWA region as one with the greatest number of internal and external conflicts. And the firmest observation that can be made about the regional economic cycle is that it is principally driven by war or by tensions attendant on the prospect of war and oil revenues. Short time gains or windfall oil revenues are continuously sapped by persistent tensions. Financial accounts add up to a dictum: 'what oil gives, real or perceived during the short-run, risks more than take away in the medium to long runs'. At least in the official records, the region spends more than twice the global rate on defence, while small and fragmented markets distort capital formation and allow for consistent resource leakages out of the region's economies. For economic growth to take root and filter into development, oil revenues should, time and again, more than offset the security premium. In view of the dependence of economic growth on highly volatile oil prices, the distortions that oil rents introduce into the process of capital formation, and ultimately the insuperable bond of politics to the economics of oil make plain that a turn around in development strategy is long overdue. The transmigration of all round development into peace represents the modality upon which economic policy should be based. In this year's Survey, ESCWA adopts this line of reasoning: *heightened risks discourage investment, lower growth and raise unemployment*. The region now faces the highest global rate of new entrants into the labour market, the highest unemployment rate and, when calculated over the past two decades, the lowest global rate of per capita GDP growth. It is no longer valid to introduce further market reform without articulating a common position on overdue institutional reform between regional and extra-regional policy makers with the aim of reversing adverse trends.

As of the early 1980s, the ESCWA region's real per capita GDP has grown by a yearly average of approximately negative two percentage points. Over this period as well, economic decline occurred irrespective of the steady rise in oil revenues. Over the past two decades, the investment rate fell steadily by some two percentage points on average, a trend only disturbed by short spells of unexpected hikes in oil prices. Unlike other developing regions, ESCWA is a high saving region. Between 1971 and 2001, the oil economies alone accrued, in constant prices, an estimated 850 billion dollars in excess saving over investment. Yet, less and less of the saving went into investment. The region as a whole experienced a significant resource and consumption leakage. Apart from the regular symptom of capital flight, only in 2002, 27 billion US dollars were remitted by foreign workers out of the oil economies. Resource divestiture, consumption biases, and small markets reduced the saving that could potentially be channelled into regional investment. Oil rents were directed into raising consumption either directly, or through shifting resources currently earmarked for investment in plant and equipment. The latter is made easier when unlimited supplies of comparatively low wage expatriate labour hold steady state growth at a very low capital to labour ratio and, consequently, slow down the need to invest in technology-embodied capital formation. Oil rents did not de-industrialize the region because the region was already at a very low level of industrial development before oil. The untimely trade liberalization in small developing markets, and the weakening of regional demand components by resource divestiture and rigid institutional frameworks that have inhibited closer regional integration, are serious impediments to any dynamic rise in productivity and, hence, development.

The relatively high oil revenues this year held down inflation rates even when most of the regional currencies were pegged to the weakening US dollar while nearly all the import basket of the region was produced in non-dollar zones. Prospects are for oil prices to recede and for the weaker dollar to stay put. It is unlikely that regional Governments, which are already constrained on the foreign exchange and fiscal

side, can ward off the potentially negative impact of high tensions, low dollar and low oil prices. Based on the secular trends, epitomized by low investment rates, poor growth and rising unemployment, successful hedging against risks and low oil prices did not transpire in the region's economic history. Unless old policies change, economies become insulated against the vicissitudes of the oil market, and job creating economic growth kicks in, the chances are such that the secular trends will likely persist.

Even if we exclude the ongoing human toll in Iraq and the Occupied Territories or the mounting abject poverty in rural Egypt and Yemen, on the economic side our biggest economy, Saudi Arabia, records a less than average performance. A 168 billion dollar domestic debt and a real per capita GDP that fell by more than 42 per cent in constant US$ between 1980 and 2000 which raised the percentage of people living in poverty. This year's Survey postulates that the region's most defining deficit is in need of stability that promotes investment, a repatriation of saving for investment and a process that fosters public accountability in public investment. Regional investment in physical plant and equipment, with territorial and extra territorial guarantees for regional capital and labour, represent the predicate around which technology, knowledge and other factors of production begin to demonstrate their scale component. When capital accumulation and labour demand go up, deeply encoded cultural values become more susceptible to change and, consequently, it becomes much easier to act on the issues of deficits in freedom and gender equality.

In line with its mandate for regional integration, ESCWA continues to stress the importance of stability to the region. It recommends that diversified and oil economies should coordinate macroeconomic policies for the purpose of lessening the region's sensitivity to oil fluctuations and for stabilizing regional output. In a context where politics meddles directly with economics, it is the strength of institutions and the power relations behind prices, and not prices per se, that make resource allocation work for regional development. The so-called Dutch-disease[1] is Dutch and it has only the semblance of existing in the oil cluster of ESCWA because oil rents pushed wages up for regional nationals. However, when more than ten million expatriate workers, earning comparatively low salaries, permeate the economic landscape, it is the dependence on extra-regional markets and low wage employment that stalls capital accumulation and productivity growth, rather than high national wages. The ESCWA region has to redress the regional demand component by regaining control of policy instruments it has long lost to instability causing high burdens of military expenditure, capital flight and a bias for private over public in the welfare function.

[1] In development literature, the 'Dutch Disease' refers to the impact of incomes generated by the hydrocarbons sector's growth on rising wages (and costs of production) in other sectors. In the Netherlands, such a phenomenon of rising wages due to the development of the natural gas sector was known to have reduced the competitiveness of manufacturing output and exports. Similar phenomena have affected the competitiveness of several developing countries with similar economic structures.

I. WORLD ECONOMY AND INTRODUCTION

It is now evident that the global economy was on a recovery course in 2003. The European economy is bottoming out, Japan regained momentum after a decade of slow growth and a sturdy economic performance characterizes the US economy. Developing Asian economies also continued to exhibit signs of solid economic performance. Strong commodity prices over 2003 buttressed the economies of sub-Saharan Africa, Latin America and the Caribbean, and the transition economies. However, persistent high unemployment rates, increasing external indebtedness, particularly in the US, and increasing social vulnerability mixed with heightened political risks may put the present upturn on a shaky ground.

In this context, three conduits link the region to developments in the world economy: oil, liquidity and political tensions. In 2003, a combination of high oil prices and excess liquidity resulted in a positive impact on growth. Low interest rates and a post 9/11 aversion to investment abroad reduced the outflow of capital by residents to the major financial centres. The prospects for heightened instability arising from concerns over continued violence in Iraq and the Occupied Territories in conjunction with calls for political reform perceived as externally motivated by many in the Arab world put added pressure on the regional economy. Increased spending on security and defence concerns, along with the dispiriting factors that instability poses to long-term investment, continue to establish the old conditions that inhibit the normalness needed for the regional economies to develop. It is this insuperable bond of the economy to the volatile oil price and the continual ravages of the political cycle that sever linkages between economic performance and social development. Consequently, with the onset of the poor growth period beginning in the early 1980s, progress in many social areas, including the quality of education, gender equality and developments in civil society, either stood still or declined. Women in the region may have become more literate over the years but still, where progress counts most, they rank lowest in terms of political representation. Regress in the social domain, specifically the recorded dilution in the stock of human capital, cyclically re-contributed to poor growth and rising unemployment.

The social impact of this unbalanced mode of integrating into the global economy further widens the gap, economic, social and cultural, between social entities or groups linked to external markets through oil and those that have become marginalised. Already the region displays the highest inequality in income distribution. Social groups marginalized from development and the distribution of wealth, will increasingly distinguish themselves culturally from those that develop Western values and may invoke their indigenous culture in the quest for equality. Governments, in turn, appear to resist the mounting pressure by placating public opinion through reasserting patriarchal mores or habits and delaying political reform. It is therefore difficult in this context to introduce the required social reforms when the political agenda remains stagnant. In this globalizing world, the region's most discrete task of all remains in differentiating between which values are acceptable and which are not from an increasingly polarized world. ESCWA's position is to develop social policies aimed at protecting the differentiated rights of the marginalized and to instil a culture of democracy in which social differences are mediated by peaceful means.

A. CONDITIONS IN THE ESCWA REGION

For the ESCWA region, 2003 was a good year in terms of overall economic growth on the back of high oil output and prices, notwithstanding the negative consequences of the war in Iraq. Irrefutably, the escalating regional instability and political tensions in the ESCWA region represent significant risks and lead to reduction in regional investments and misallocation of resources to security and defence rather than financing development. GDP in the ESCWA region (excluding Iraq and the West Bank and Gaza Strip) grew by 5 per cent compared to a meagre 1.25 per cent achieved in 2002. Due to a relatively high population growth rate in 2003 at 2.4 per cent for the region, overall GDP per capita increased by 2.5 per cent, a significant improvement over the contraction of 1.2 per cent in 2002. However, economic performance was very distinct for the two subgroups within ESCWA: the GCC cluster enjoyed an upturn in GDP real growth, whereas the More Diversified Economies (MDEs) cluster witnessed a small decrease in its growth rate in 2003. For 2004, the overall GDP for the ESCWA

region (excluding Iraq and the West Bank and Gaza Strip) is expected to decline to 3.2 per cent with expectedly falling oil production and prices over the year.

1. *Growth in GCC countries*

Overall real growth in the GCC countries increased from 0.4 per cent in 2002 to 5.8 per cent in 2003 causing a reverse in per capita growth from a negative 2.5 per cent in 2002 to a positive 2.8 per cent in 2003. All GCC economies improved as a result of increased oil production and revenues. Moreover, non-oil sectors performed well in 2003 boosted by the restored confidence and better economic prospects following the short war in Iraq. Other factors that contributed to the exceptional growth during 2003 are strong public expenditures, high domestic liquidity and low interest rates, which enhanced domestic consumption and investment. Moreover, the rise in the stock markets together with the solid upturn in real estate prices in GCC countries during 2003 echoed capital repatriation from abroad and was translated in higher domestic demand. Qatar is estimated to have achieved the highest GDP per capita growth rate among GCC countries at 5.44 per cent, while Oman recorded a negative -0.80 per cent. For 2004, overall economic growth in GCC countries is expected to decline to 3 per cent due to a forecasted cut in oil production and declining oil prices. In order to lessen their dependency on oil, sustain economic growth and generate employment opportunities for their growing national labour force, the public policies of GCC States should be directed towards encouraging investments and private sector participation, and developing dynamic and competitive non-oil sectors.

2. *Growth in the More Diversified Economies*

Political instability remains the most influential factor in determining growth for the MDE group. The war in Iraq and subsequent instability, in addition to the enduring Palestinian conflict, have pronounced short-term and long-term negative effects on most diversified economies. The combined GDP growth of this subgroup remained almost constant, from 3.15 per cent in 2002 to 3.14 per cent in 2003, with their overall GDP per capita growth stagnating at a low 0.8 per cent in 2003. The most negatively affected countries were Jordan and the Syrian Arab Republic, particularly in their manufacturing and trade sectors, recording a negative per capita growth in 2003. The Jordanian economy remains highly vulnerable to regional factors and its losses from the war in Iraq were mainly alleviated through foreign aid. In the Syrian Arab Republic, the economy suffered from the repercussions of the war and from slow reform measures and mounting population and external pressures during 2003. Egypt's currency devaluation boosted exports, tourism and services, partially offsetting the negative impacts of rising inflation and weak domestic confidence. Lebanon's economic performance slightly improved over 2002 reflecting a growth in tourism and exports, while domestic demand remained stagnant. Yemen's increasingly oil dependent economy picked up slightly in 2003 due to an increase in the value-added of agriculture and services with continuous stagnation in oil production. The outlook for economic growth in 2004 for this group is moderately better with real GDP growth rising to 3.5 per cent on the condition of more regional stability and the resumption of economic linkages with Iraq, which would increase intra-regional trade and support development of industrial and financial sectors, along with attracting international and regional investments to these countries.

3. *Growth in disaster zones: Palestine and Iraq*

In 2003, tension and political instability continued to shatter economic growth and development in the conflict zones in the ESCWA region, namely, Palestine and Iraq. The Occupied Palestinian Territories showed signs of marginal recovery from a very low base during 2003 attributable to a relative loosening of Israeli closures and restrictions as well as a transfer of tax revenues to the Palestinian Authority. Conflict had tremendous negative consequences, including the sharp reduction in the economy's domestic supply capacity and the deprivation of the Palestinian population. The outlook remains gloomy for 2004 with continuous deterioration in living conditions as a result of Israel's occupation and aggressive pursuit of economic isolation through the wall-building programme. In Iraq, the war, occupation and subsequent difficult political and security situation restrained an upturn in economic activity in 2003 despite lifting UN-sanctions and terminating the oil-for-food programme. The sharp reduction in oil production and difficulties in several State Owned Enterprises (SOEs) contributed to a contraction in GDP. Over

the past two decades, wars and sanctions resulted in unthinkable human suffering and severe degradation of Iraq's economy. According to the joint UN/World Bank report, entitled *Iraq Needs Assessment*, an estimated $36 billion are needed over the next four years to rebuild Iraq, apart from the $20 billion estimated by the CPA for other sectors not covered by the report such as security and oil. Revival of economic growth in 2004 is mainly dependent on restoring adequate security and public services, the availability of foreign aid for reconstruction and the cancellation of a significant amount of foreign debt. However, Iraq's rebuilding if properly implemented represents a potential for spurring growth and integration in the ESCWA region.

TABLE. REAL GDP AND GROWTH RATES IN THE ESCWA REGION AT CONSTANT 1995 PRICES, 2001-2004
(*Millions of US dollars and percentages*)

Country/area	2003[a/]	2004[b/]	Percentage change 2001	2002	2003[a/]	2004[b/]
Bahrain	8 368.6	8 787.0	4.64	5.10	5.30	5.00
Kuwait	30 945.60	31 874.0	0.64	-0.38	6.00	3.00
Oman	18 243.1	18 899.9	7.51	1.70	2.50	3.60
Qatar	15 079.1	15 983.90	6.30	4.36	7.00	6.00
Saudi Arabia	173 112.1	177 093.6	1.31	-0.65	6.36	2.30
United Arab Emirates	64 558.6	67 141.0	3.46	1.79	5.00	4.00
GCC States	310 307.2	319 779.4	2.34	0.40	5.81	3.05
Egypt	93 999.8	97 477.8	3.20	3.10	3.50	3.70
Jordan	8 851.5	9 294.0	4.20	5.00	3.20	5.00
Lebanon	13 147.3	13 476.0	1.40	2.00	3.00	2.50
Syrian Arab Republic	17 303.5	17 770.7	3.37	3.23	1.00	2.70
Yemen	6 241.6	6 460.1	4.70	3.60	3.90	3.50
More diversified economies	139 543.7	144 478.6	3.17	3.15	3.14	3.54
ESCWA region[c/]	449 850.8	464 257.9	2.60	1.25	4.96	3.20

Source: ESCWA, based on national and international sources.

a/ ESCWA estimates.

b/ ESCWA projections.

c/ Excluding Palestine and Iraq owing to the unavailability of the reliable data.

B. OIL PRICES AND PRODUCTION IN 2003

While the drive towards diversifying and liberalizing the regional economy is gaining momentum, the ESCWA region continues to be dependent mainly on oil production and revenues with its share of total world oil supply at an estimated 23 per cent. In 2003, OPEC basket price reached $28.10, the highest nominal average since 1984, although in real terms the purchasing power of the barrel diminished due to continuous weakening of the American dollar against the Euro. Nevertheless, a sizable increase in oil output by 6.3 per cent over 2002 allowed most of ESCWA oil producing countries to reap the benefits of high prices with total oil exports revenues for the region estimated at $161 billion in 2003, up by 22 per cent from 2002. Iraq and the Syrian Arab Republic were the only exceptions with their oil exports plunging due to the war and ensuing political and security conditions. Iraqi oil exports, which constitute the basis of Iraq's economic recovery, are still susceptible to political and security developments there.

Oil developments mirrored positively on public finances and the monetary conditions in the majority of GCC countries, which recorded large current account and budget surpluses, and a build up in foreign reserves. Fiscal prudence through conservative oil price budget assumptions for 2003 contributed to these large fiscal surpluses. Tax systems remain almost entirely indirect and based on flat rates that lump low incomes with high incomes. To lessen the impact of oil price fluctuations and correct fiscal imbalances, oil-dependent ESCWA States should adjust their fiscal policies by making more progressive their tax systems and broadening their tax base.

1. *Inflation*

Inflation rates remained relatively moderate in 2003 despite the depreciation of the American dollar against the Euro and the increase in the prices of imports from the Euro Zone, with the national currencies firmly pegged to the dollar in the GCC States. In Egypt, the currency devaluation in 2003 did not increase much the CPI index because of subsidies on essential items, however the Wholesale Price Index rose significantly. Consumer price inflation increased modestly in 2003 for most countries except Yemen and Iraq, ranging from -0.6 per cent in Oman to 4.4 per cent in the Occupied Palestinian Territories. In Yemen, inflation soared to a double-digit rate because of the expansion in monetary aggregates, the depreciation of the exchange rate and the increase in prices of food items. In Iraq, liberalized prices and rising demand expectations after the war led to price hikes in real estate as well as several consumer commodities causing a soaring inflation rate estimated at 33 per cent.

2. *Investment and savings in the regional economy*

Countries of the ESCWA region achieved a high rate of economic growth during the 1970s. Had that growth continued, real per capita income would have reached in the mid 1980s double its level in 1971 and by now the region's average would have been above the second tier's East Asian NICs. However, the rate of growth in real per capita income became negative in the 1980s, and less than half of one per cent during the 1990s. These occurrences followed closely the decline in the investment ratio from a high 29 per cent in 1978 to a low 16 per cent in 2002.[2] The decline in investment expenditures and its consequent impact on capital formation represent the principal cause behind the meagre economic performance. The low contribution of technology and the dilution in human capital stock represent also inevitable consequences to the fall in the investment ratio.

ESCWA is an excess saving zone. It is said that in a normal world 'a high level of saving and investment is one of the keys to a prosperous economy'. By normal, ESCWA simply means the right to development under peaceful conditions and without the scourge of intermittent wars. Because the region has reached a point in the trade-off between elevated risk and the savings-investment nexus where normal operations of a market economy have ceased to function correctly, there remerged, in a new form, a whole set of functional or causal relationships that distinguish the high tension ESCWA case from others. At the political economy level, rigid institutional frameworks with an extreme bias towards capital inhibit closer regional integration and/or the enhancement of regional welfare. Patriarchal modes of conducting state and business affairs were not altered with the move to a market economy after independence. In the mode of integration of the national states to the global economy, the set of rigid hierarchical social relations continued to work well for local elites and international business. Given this specificity, the region's issues have to be addressed on their own merit rather than on the grounds of concepts borrowed from more developed formations, providing more legal guarantees and liberalising markets will be of limited worth in small and risky markets. However, a major reordering of national priorities, according to which resources allocated to increasing physical investment in plant and equipment and improving meritocratic mobility and conditions of the social infrastructure in a 'defused tensions' context represent more pertinent and effective prerogatives.

When addressing issues of development, it is often said that the most pressing problem is too little savings. The result is too little investment in the productive capital that is indispensable for economic growth. The ESCWA region, because of its excess saving, should enjoy one of the highest investment rates and, by consequence, a high growth rate. But it does not for the simple reason that, in the rentier context, nearly 850 billion constant US$ in current account surpluses over the past 30 years did not translate into investment.[3] As elsewhere, when tested empirically, investment interacts with variation in output. However, interest rates, exchange rates and real wages display little significance in the determination of investment. In the ESCWA region, however, the causality is clear: a lower investment rate and a change in its composition away from plant and equipment reduced the economic growth rate. A set of market friendly reforms was introduced during the 1980s and 1990s. However, reforming the investment

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[2] According to World Bank – World Development Indicators data.

[3] Ibid.

climate in favour of private investment when the risks are high meant that the latter could not fill the void left by its public counterpart. In an unsafe business atmosphere, public investment through various linkages and contracts represented a security blanket for private investment.

Investment is not low because the financial intermediaries between saving and investments are absent, or because the judicial framework guaranteeing investment is missing; it is low because a combination of small markets and regional risks reduce the urge for investment. It is therefore the institutions, in their constituted existence and their rentier mindset, which engender fragmentation and risk simultaneously, that have to be reformed. The overarching objective has to deal with how the region can halt significant resource and/or consumption leakages, hence raising prospects for investment and economic growth.

C. UNEMPLOYMENT IN THE ESCWA REGION

Labour demand follows economic growth. Low economic growth and sluggish employment creation combined with high population and labour force growth (2.5 and 4.5 per cent, respectively) raised the overall ESCWA unemployment rate to 16 per cent. Worse yet, because of a high concentration of youth in the population, the youth unemployment rate (15-24 years old) stands at approximately 30 per cent. If anything, acquiring statistics on unemployment is difficult in the region. In official estimates, however, these statistics are the highest in the world. And, if one were to consider the despondency rate, the actual average unemployment rate for the region may be higher still, even if Iraq and Palestine were excluded.

Regional averages mask significant variation in unemployment rates in different ESCWA economies (notably between oil-producers and non-oil producers). National unemployment rates in the GCC economies are about half the average of non-GCC economies because initially, during the oil boom, the public sector absorbed many nationals in permanent employment positions. Job creation through the expansion of Government employment was sometimes worthwhile and may have enhanced welfare in the ESCWA region by acting as a semi-automatic stabilizer, but such a stabilizer also draws upon potential investment funds by diverting resources into public consumption. Because of poor growth and mounting fiscal constraints, the present rate of expansion in public employment does not suffice to curb the high rate of new entrants into the labour market. The situation is such that now in Saudi Arabia unemployment rates amongst educated nationals are on the rise.

The unemployment rates of the more educated are high partly because of significant increases in schooling and partly because the quality and type of education do not match labour market needs. Though in the 1950s the ESCWA region had the lowest educational attainment in the world (average years of schooling less than one year), by 2000 the regional average had increased to more than 5 years. This average is comparable to the average years of schooling in South East Asia and greater than in South Asia (4.5 years) and sub-Saharan Africa (3.5 years). This rise and the fact that most unemployed are young, lead to significant unemployment among the graduates of intermediate education (mainly in the non-GCC economies) and higher education (mainly in the GCC economies). Some part of educated unemployment can be attributed to queuing ('luxury' or 'waiting') phenomena for prospective employment in the Government sector, and this is more prevalent in the GCC economies. However, there are two issues to raise here. First, the quality of education began to recede with the onset of the low growth period beginning in the early 1980s. This, in turn led to a dilution of education over the number of educated and, consequently, a steady dilution in the human capital stock that was exacerbated by a significant 'brain drain'. These matters contributed unconstructively to economic growth. Secondly, the educated remain under-remunerated and the brain drain syndrome lingers adding to an already weak contribution of knowledge and management to the economy as a whole.

Women's share in the regional labour force is generally below that in other developing regions, but has been increasing more rapidly although starting from a very low base. This increase and the low rates of employment creation in the region are partly responsible for the high rates of female unemployment. Because of measurement problems in estimating rural employment or the urban informal sector especially in the diversified regional economies, it is difficult to pin a number on the rates of women labour force participation. Still, there must be a

differentiation between work and gainful employment. The work of women in the informal sectors and in unpaid house work represents a seminal effort in the reproduction of a healthy work force and the maintenance of a parallel social welfare net in the presence of weak official systems. These contributions played a relevant role in mitigating the impact of abject poverty during two decades of economic decline.

The decline in labour productivity was closely followed by a decline in real wages since they last peaked in the early 1980s. Regional labour regulations vary but are not among the most restrictive in the world (for example, they are on par with East Asia and the Pacific region and lower than in Latin America and the Caribbean, East Europe and Central Asia). The immense divide in income distribution, already the highest in the world,[4] and the significant divide in wages between national and non-nationals represent a dampening effect on regional demand and a thwarting impact on capital accumulation. Of particular importance is the issue of foreign worker stability in the Gulf region where the incapacity to localize the workforce induces low productivity on the one hand, and a high leakage of worker remittances abroad, on the other. Re-distributing tax policies and effective social and political protection to all workers through accord between the State, industry and labour organisations represent essential but pending reform measures.

Before labour market reforms, the region needs high rates of growth and a social plan favouring women and youth employment. The region has an abundance of resources that, if put into employment generating investment, will take little time before a reduction in the unemployment rate occurs despite the underlying high population growth rate. Over the next decade the ESCWA region will need to create an estimated 35 million new jobs to lighten the unemployment load. This would require a more or less immediate and permanent increase in the growth rates of the economy in the range of 6-8 per cent per annum. These rates could be achieved through resource retention and re-ploughing of savings and by taking advantage of the fact that the growth of the economically active will in the future exceed that of the economically dependent population by a greater amount than in any other region.

[4] Texas Income Inequality Data Project.

D. TRADE, FOREIGN DIRECT INVESTMENT AND ECONOMIC INTEGRATION

Recent world economy recovery and strong demand for oil, gas and related products of the ESCWA region buoyed both international trade and FDI activities. Institutional and policy reforms in the areas of trade and FDI continued in 2003. The framework for such policy actions became increasingly bi- and/or multi-lateral. This trend was highlighted with Saudi Arabia's preparations for joining WTO and the ongoing GAFTA process. The end of economic sanctions against Iraq has brought the country back into more normal international economic relations. But there was little sign of reviving trade and investment activities around Iraq because of the uncertain security situation. Of special concern are the almost total liberalization of imports into Iraq and their impact on the fragile Iraqi industrial output and employment. Indeed, the laissez-faire economic agenda being imposed on Iraq without the proper institutional framework and public consent represents the most pressing item on the region's economic agenda. Moreover, the ongoing occupation of the Palestinian territories continued to restrain export and import activities at an extraordinarily low level for the third consecutive year.

Weak trade integration in the regional and global economy persists. Problems of market access persisted and no significant expansions in trade were witnessed linking the region's industry and agriculture to regional and global markets. Trade remains concentrated in a narrow group of commodities, despite sincere efforts at diversification away from oil. Thus, a gradual and selective approach to trade integration preceded by concrete measures to accede into the global economy as a regional block are recommended. It is perhaps too soon to stress trade liberalization without market access and capacity-building private investments going hand-in-hand.

1. *Overall trade performance*

The total gross value of merchandise exports of ESCWA member countries in 2003 was estimated at $228 billion, while the total gross value of merchandise imports was estimated at $143 billion. Of those exports, 88 per cent came from GCC member countries, which also

accounted for 72 per cent of all imports. Despite continuous development efforts in the diversification of exportable goods by most member countries, the percentage of crude oil, gas and related products went up in 2003. Although this is a usual observation in the boom year of oil production, reliance on energy exports was increasing not only in the major GCC oil exporting countries and Iraq, but also in Egypt, the Syrian Arab Republic and Yemen.

Gross total exports from the ESCWA region increased by 17.2 per cent compared to 2002. A steep annual increase of 21.2 per cent in value was estimated in GCC member countries for their increased energy exports. On the other hand, gross total exports from MDEs decreased by 4.7 per cent. The destruction and slow-recovery of Iraqi oil exports capacity, the less than expected speed of recovery in intra-regional trade around Iraq, and the ongoing occupation of Palestinian territories were contributing to the decrease in exports from this sub-region. Nevertheless, total exports from Egypt and Yemen increased substantially due to devaluation and their expanding energy sectors.

Gross total imports of the ESCWA region increased by 9.3 per cent compared to 2002. The expansion of domestic demand, due to the combined effect of high oil production and domestic credit expansion, pushed the 2003 value of total imports of GCC member countries up by 15.4 per cent. Total imports of the MDEs dropped by 3.8 per cent due to the decrease in imports of Egypt and Iraq. Devaluation of the Egyptian Pound in January 2003 led to a substantial decrease in total imports of Egypt all year round. Iraq's private sector import activities were yet to replace those imported by its reduced Government sector. Other countries of the MDEs experienced increases in their total value of imports. The positive income effects were spilled over the region from the GCC member countries through increased workers' remittances and other transfers. Moreover, the end of economic sanctions on Iraq increased demands for goods to be re-exported to that country under reconstruction.

Total net exports of the ESCWA region increased by 33.4 per cent in 2003. All GCC member countries were in positive territory, and they, with the exception of Oman, experienced substantial increases in net exports. Egypt, Jordan, Lebanon, and the Occupied Palestinian Territories were in chronic negative net exports position. Both Jordan and Lebanon were successful in expanding exports, though these countries failed to adjust their trade balances, which remained in large deficits. The rapid growth of garment exports from Qualifying Industrial Zones (QIZs) in Jordan also caused rapid growth in demands for materials to be processed in QIZs. Egypt reduced the magnitude of its negative net exports position due to the adjustment that followed devaluation, which was expected to improve the country's balance of payments.

2. *Trade flows*

The largest volume of exports from the ESCWA region in 2003 continued to be destined to Asian countries: in the first eight months of 2003 for which data were available, 49.6 per cent of such exports went eastwards, and 14.4 per cent of exports from the region went to the United States. The latter percentage inched up from 12.3 per cent in 2002 as the disruption of Venezuelan oil supplies resulted in increased demand for crude oil of the region. European Union member countries stayed as the largest export destination of the MDEs, and as the largest origin of ESCWA imports: 33.8 per cent of the region's imports came from the European Union in the first eight months of 2003; 29.1 per cent of the region's imports came from Asian countries; and 9.5 per cent of them came from the United States.

3. *Intra-regional trade*

For the first eight months of 2003, the share of intra-regional trade in terms of the region's total exports was 7.3 per cent. However, ESCWA's intra-regional trade structure was being changed in 2003 with developments in Iraq. The proportion was barely changed from 2002. Iraq was still the largest intra-regional trading partner with Jordan, but Jordan's intra-regional trade became more geographically diversified in 2003 with increased crude oil imports from Saudi Arabia and moderately increased exports to the Syrian Arab Republic. Iraq's intra-regional trade became more geographically diversified after the lifting of sanctions. As the reconstruction efforts in Iraq intensified, more diversified intra-regional trade flows were observed towards the end of 2003.

Trade policies of ESCWA member countries were increasingly formulated within the

bi- and multi-lateral framework. Irrespective of GAFTA, the trend in intra-regional trade, notwithstanding the rise in undisclosed trade during the last years of the embargo on Iraq, was almost at a standstill in 2003. Though having some positive market opening aspects for the region's industrial exports, the proposal by the United States on the US-Middle East Free Trade Area is often perceived as no more than a 'stick and carrot' means of pursuing a political agenda on the bilateral level in the region. The US-Middle East Free Trade Area aims to create a network of bilateral free trade agreements (FTAs) between countries in the Middle East and the United States, liberalizing both inter- and intra-regional trade in process. Among ESCWA member countries as of 2003, only Jordan had completed the process of becoming an FTA partner with the United States. Overall, the mechanism of appropriation necessitates a strong hold on the public sphere by private interests. This, in turn, makes losses from intra-regional integration not even remotely compensable to the losers from intra-regional trade.

E. FOREIGN DIRECT INVESTMENT

1. *Trends in foreign direct investment*

Foreign direct investment flows into the region remain low and unstable. They stood at $1.6 billion (0.25 per cent of global inflows) in 2002, a fall of 7.61 per cent from the 2001 figure of $1.7 billion. The region's share of total FDI flows to developing countries peaked in 1998 at 2.96 per cent; the ratio, however, dropped to 0.84 per cent and 1 per cent in 2001 and 2002, respectively. Most ESCWA countries registered a below average grade on the Inward FDI Performance Index for the years 1999-2001, restating once more that overall FDI regional performance is still below average when compared to the rest of the world.

The total volume of inter-Arab FDI in 2002 stood at $2.9 billion, recording a 10 per cent increase over the previous year.[5] Saudi Arabia took the lead amongst host countries with Arab investments receiving $717 million in flows, an amount that represented 24.6 per cent of total inter-Arab investments during 2002. Lebanon came second with $650 million, followed by the United Arab Emirates ($218 million).

ESCWA has been attracting mainly resource seeking FDI to the petroleum sectors with very little market or efficiency seeking FDI channelled into the region. As it is well known, it is market and efficiency seeking FDI that contribute most in qualitative spillovers of skill and technology to a developing economy. The principal determinants of these highly desired FDI flows to the region, namely, high returns attendant on large markets with growing manufacturing sectors and low risk, were missing. Poor regional purchasing power into the region beyond the natural resources sector, a highly skewed income distribution and underdeveloped real and institutional infrastructures for fostering a stronger regional trade represent salient structural constraints creating FDI irresponsiveness.

2. *FDI policy developments*

In 2003, there were several new developments concerning policy and legal frameworks of FDI in the region. ESCWA States succeeded in introducing new rules, updating and amending currently existing ones with the aim of attracting FDI flows. Saudi Arabia introduced new capital market, insurance, and tax laws targeted at FDI promotion, and Kuwait introduced a new foreign investment law allowing 100 per cent foreign ownership. Oman also laid down flexible investment and tax regimes to allow for a free repatriation of capital and profits. These measures, in addition to various intra-regional and interregional trade and investment agreements, represent a continuation of a series of responses that began in the late 1980s with the purpose of ensuring greater FDI flows into the region. However, introducing FDI policies can only reap benefits to a developing economy when the economic fundamentals and structural conditions relating to market size and type or degree of integration into the global market fall in place. That is why, after so many policy reforms, the rate of responsiveness of FDI to policy initiatives remains torpid.

3. *Political uncertainty and conflict have affected FDI*

While political instability weighs heavily and systematically on all components of investment, including FDI, the war on Iraq in 2003 made for a particularly bad year whose effects are likely to be felt for some time to come. The region now stands for the first time faced with two ongoing conflicts in Iraq and the Occupied Palestinian Territories. Even at the present level

[5] The Inter-Arab Investment Guarantee Corporation. *Report on Investment Climate in Arab Countries, 2002.*

of economic and political regional integration, the potential of the spillover effect embodies threats that continue to make the investment climate in the region unfavourable to foreign investors. Hence, long-term regional security underwritten by the guarantee of a strong intra-regional integration arrangement, as part and parcel of an FDI promotional arrangement should constitute the strategic current around which all other policies fall in place. Without stability, actual or foreseen, fiscal and financial incentives to investors, liberalization of trade, and guarantees on ownership and return will only represent 'single deal' attempts that do not embed on the longevity required to encourage a consistent flow of FDI.

4. *Portfolio investment and the regulatory framework and assessment*

Portfolio flows, which in many Arab countries are traditionally negative, only started to turn in the late 1990s and, peculiarly enough, they are still far too low to be compared even with an already small FDI flow into the ESCWA region. And, on the whole, portfolio funds flow in the direction of a very limited number of Arab countries where, in most cases, they tend to earmark a change in property of an already existing capital stock resulting from a process of privatization. Both foreign equity and foreign held debt investment into the ESCWA member countries have remained below 1 per cent of GDP except for Lebanon, which has been receiving portfolio debt investment of nearly 8.12 per cent of GDP on average in the latter half of the 1990s. Market capitalization of the Arab capital markets stood at \$362 billion at end of 2003 compared to \$209 billion at end of 2002. Portfolio investments have been so low for several reasons. An unstable regional security situation accompanied by its high-risk premium, underdeveloped regional capital markets, and shallow level of financial services/instruments have led to this sustained outflow of portfolio funds. Stock markets are only just emerging and still highly volatile and with low capitalization.

F. DEVELOPMENT IN MONETARY AND FISCAL POLICY

In 2003, ESCWA's authorities continued to pursue prudent monetary policies with the aim of ensuring stability in the financial system. Encouraged also by the global trend of lower interest rates, many countries followed low interest rates policy easing access to credit (M_2 measurement). Monetary expansion increased slightly in the ESCWA countries (by 0.7 per cent). Inflationary pressures edged slightly upward but, on the whole, remained modest this year. In an area characterized by abundant capital resources, broader regional markets ensure the profundity required to lower risks and enable the increased effectiveness of monetary policy through the financing for development mechanism. Institutions that stand in the way of closer regional cooperation in the financial sphere wrongly assess their positions on the basis of an incomplete set of information and by welfare considerations that stem in part from interests that lie outside the bounds of the region. Regional coordination and macroeconomic management of financial concerns should, in the absence of mitigating extra regional interests and at least on account of lower territorial risks, make everyone better off.

GCC countries went into fiscal surplus in 2003 due to high oil revenues, while the existing deficit widened for the MDEs. The budgets of MDEs continued to be restrained, with expenditure increasing at a lower rate than the rate of inflation, thus decreasing expenditure in real terms. Those countries also increased the mobilization of domestic resources, including the more efficient administration of tax collection and the introduction of new taxes and duties, despite the fall in non-tax revenue due to the war in Iraq. However, the management of public finance is once more left to the vicissitudes of oil prices constraining the long-term management of public finance and spending. The ESCWA region's tax system is almost exclusively based on indirect taxation. In an area that is characterized by the highest income inequality rate, direct and or progressive taxation will more than afford the regional economies with the space needed to make use of fiscal policy in countering the contraction in the cycle. Tax reform is long overdue for fiscal policy to be effective.

The banking sector in many ESCWA countries has been supporting net capital transfers out of the region. In 2003, profitability among ESCWA banks promises to be higher than in 2002. This is because most banks in ESCWA member countries have reported vigorous growth in assets and earnings that call for financing future expansion and improving domestic retail and government deposits in the wake of the war in Iraq. In conjunction with this, the decline in the international equity markets that pushed investors

to substitute overseas stock risks with regional excess money has also contributed to the more robust gains. The total credit extended by the banking sector in the ESCWA member countries amounted to $264.7 billion in 2003, making up 73.4 per cent of customer deposits, still a low percentage by international standards. Banks in this region continue to rely heavily on interest earnings in their total income. As interest rate spreads decreased in 2003, banks are encouraged to cross-sell more financial services, like mortgages, collective real-estate funds and property-related services. But what distinguishes our region is the small extent in which the banking sector and the corporate sectors operate, compared to more developed formations and even to developed economies. The share of credit for financing investment and development is relatively small. This can be attributed to the weakness of public monetary institutions and the stronger than usual rules of adverse selection enforced by private banking. In particular, it is the limitation of the public sector in providing guidance and coverage for an adequate link between financing and development that constitutes the principal reason for the low involvement of the banking sector in the more profuse financing of the economy. ESCWA countries need to rally monetary policy into position and it is high time for Governments and the banking sector to get involved in creating the proper regulatory framework before further liberalization.

This stronger presence of the banking sector combined with low interest rates on deposits, erratic international equity markets and repatriated capital from overseas following the events of 9/11 increased interest and capitalization in regional stock markets during 2002. In the GCC countries, the rise in the stock markets together with the solid upturn in real estate prices reflected capital repatriation and manifested itself in an increase in domestic demand and internal liquidity, despite increasing foreign workers' remittances. However, the ratio of market capitalization to the total ESCWA GDP was close to 67 per cent, which is considerably less than emerging markets. In 2003, stock market capitalizations in Saudi Arabia and Kuwait increased by 110 per cent and 95 per cent, respectively.

Falling interest rates in the ESCWA region in 2003 allowed member countries to reduce pressure on mostly domestic public debt. Saudi Arabia holds the largest amount of debt at $168 billion in the ESCWA region, followed by Iraq with an estimated external debt of $121 billion. The devaluation of the Egyptian pound in 2003 (by 26.7 per cent against the dollar) lowered the value of domestic public debt by 20 per cent, which decreased total public debt to $91.5 billion. While the total public debt to GDP ratio has fallen from 113 per cent in 2002 to 104.5 per cent in 2003 in the ESCWA region, it remains high compared to international norms. The total debt to GDP ratio in MDEs is three times that of the GCC countries. This signals a more pressing concern regarding better targeted expenditure and reforms in the tax structure not only to correct the fiscal imbalance, but also to make fiscal policy effective notwithstanding inflationary and debt pressures.

Important progress has been achieved in recent years towards balancing public finances but, alas, that remained without weighing socially relevant expenditure and or introducing progressive tax reform aimed at making less unequal the state of income distribution. Government spending and employment, in the absence of the regular automatic stabilizer, continued to play an essential counter-cyclical function. Yet here once more, regional instability channelled resources away from development as the region spent more than twice the global rate on defence. Precise fiscal rules that insulate Government consumption from windfalls and declines in oil revenue and that encourage private investment and or reform of the tax system in moving away from consumption and indirect (flat-rate) taxes to progressive income tax are not widespread. On the fiscal or monetary side, reform is held down by the strong rapport or converging interests of regional and extra-regional institutions. Policies recommending fiscal or monetary restrain do not account for the fact that deficits, debts, risks and small markets already tie up the economic instruments of intervention in a time of economic decline. In the status quo, the limitation on fiscal and monetary expansion appears to be a sort of force majeure. But a status quo should represent a starting point and not the benchmark for change. There exists the possibility of a more integrated regional market and a direct system of welfare enhancing taxation. Without these building blocks, more liberal reforms within the present institutional framework keep the partition of the economic pie as it is, mitigate a redistribution of income that may sanction the welfare of the broader public and,

more importantly, reduce the capacity of the State as an agent in regional development.

G. Social conditions in the ESCWA region

If it were for poverty to appear with conflict, then the region is now poorer. The social condition is certainly poorer in Iraq and in the Occupied Territories. Iraq is a country whose per capita GDP fell from an average of approximately $5 000 in the 1980s to some $1,000 in the 1990s. With more than 40 per cent of the labour force now unemployed, the extent to which poverty rose is huge. With about 28 per cent of the work force unemployed, conditions in the Occupied Palestinian Territories are bleak as well. But the real catastrophe that cannot be conveyed adequately with words lies in the human toll from the state of conflict in the Occupied Territories and, in particular, Iraq. The number of the disabled also rises in conflict. In the de-jure sense, many member States legislate in favour of disability rights, but on the de-facto level, things are quite different. Stigmas, neglect in funding and, ultimately, a lack of emphasis on a 'rights based culture' make the struggle for disability rights an uphill one. To many, humanity's biggest achievement was the outlawing of war by the Charter of the United Nations. Conversely, therefore, humanity's biggest failure is the persistence of war and occupation in places like Iraq and Palestine. To end the state of conflict in the Near East is to bring more stability to the globe and to redress outstanding suffering and agony.

Unemployment data in the region is murky at best. In the 1980s, ESCWA surmised that the situation was such that for every person finding a job there were two new entrants into the labour force reaching working age. By the late 1990s, there were nearly four new entrants to every person finding a job within a similar search period. ESCWA's real wages have declined while labour supply continued to outgrow labour demand. Youth unemployment is estimated at about 30 per cent. How does such a bleak economic situation translate into the social sphere? The *2001 Unified Arab Economic Report* estimates that a little over half of the population in the Arab world lives below $2 a day. In the absence of adequate official social nets to protect the unemployed and the marginalized, informal social nets and informal sector activities bourgeon. Indeed, the cultural principle of *al-takaful* (Arabic for mutual support) has mitigated the dire effects of abject poverty and hunger. But that remains a non-rights based approach and, in any way, it does not meet the requirements for decent jobs or adequate living. Overcoming the demographic economic transition without substantive employment generating growth or at least sufficient funding for welfare to cushion the fall represents an impassable divide. While equity is a luxury, the region as a whole has the potential excess resources that could enable it to be less inequitable.

In the bigger picture, there are certain bright spots in respect to a marked increase in the life expectancy and educational attainment of women. While educational quality in general has added little to the human capital stock either because of a quality mismatch with the requirements of the economy or the brain drain, on average, more women now are literate and educated. In political representation, however, Arab women are the least represented globally. The gap raises concern over streamlining the social structure to accommodate the newly educated. More educated people become keenly aware of their rights and, when the mechanisms to politically achieve a certain goal, including gender equality, are absent, frustration builds to socially undesirable levels. ESCWA has always sought the sort of institutional change that would amount to a positive sum game to all: one where progress in legislations promoting equal rights and gender equality is carried out by peaceful means.

The more equivocal social question arises as to the constancy of social relations that characterize the ESCWA region. This lack of adaptability to new conditions that kept in place inherited patriarchal and rigidly hierarchical forms of management is particular. When market economies require flexibility of institutions, social structures reciprocated with some rigidity. With oil rents dependent on international market fluctuations, patriarchal institutions smooth their functioning by drawing on heavily skewed resource flows and wealth distribution. It is issues of redistribution of wealth and the transition cost that evoke relative inflexibility in the region. Setting social conditions on a changing path requires the understanding of many key players in the international community that a 'non-militarized commerce/investment' and a positive correlation between private and public interests need be the international future norm.

II. RECOMMENDATIONS

Political stability is the indispensable and a priori condition for development in the ESCWA region. Risks related to political tensions, whether real or perceived, have consistently lowered the investment rate and, consequently, the growth rate. Everything else comes after: human capital, technology and other more intensive factors of production trailed the decline in physical investment. If on account of high territorial risks, national private resources cannot be garnered to raise investment, growth, and create jobs, then until tensions recede, regional labour and capital should be granted privileges and extra-territorial rights and official sources should continue prop up infrastructure and physical investment in plant and equipment or to act as quasi-insurance of private business.

Economic policy in the region will also find its reprieve through effective institutional change, away from rentier activity and closer to productive activity. Liberalizing the investment environment and promoting private as opposed to public investment requires stability and market institutional safeguards that are already missing in the region. Investment policies have to be coordinated at a regional and international level for them to be effective. In the final analysis, decline in the investment rate and the concomitant fall in productivity in this region were closely followed by the decline in wages, living standards and overall welfare.

Regarding monetary, fiscal and financial market reform, monetary and fiscal authorities in the ESCWA region need to regain control of their policy instruments. First, fiscal expansion should be duly considered through fiscal reforms by making direct and progressive the tax base and targeting expenditures. Second, serious administrative reforms should be carried out to restructure the public sector, and increase its transparency and accountability in carrying out public services. Third, further growth, integration and diversification of regional capital markets are needed for these to play an effective role in financing for development. Domestic financial and capital markets should be deepened partly through support of the growth of institutional investors (insurance companies, pension funds and investment funds) and improvement and, first within the region, liberalization of the financial regulatory environment. And finally, policies and strategies should be geared toward improving the access to financing of private business enterprises through the domestic banking system in the short term, and in the longer term through strengthened capital markets.

In order to benefit from trade liberalization, it is essential to complement the liberalization process with institutional reform and appropriate industrial policy, as trade liberalization will be constructive only with competitive domestic industries. Reforms need include, first and foremost, a focus on regional integration, foreign direct investment and multilateral/bilateral trade agreements.

The very issue of high unemployment that the region faces today was long foreseen because of high population growth and slow economic growth. The then proposed recipes for reform displayed a universal characteristic: moving from the public to the private sector, from closed to open economies, and from oil to diversified economies. Many countries in the region have reformed since some gradually and some sluggishly, but for reformer and non reformer alike, the situation is not all that bright. Past policy prescriptions were too general and had not accounted for the specificity of this region. Under the prevailing circumstances it is inappropriate to compare such a complex region with more stable regions around the world and draw policy recommendation on that basis. The ESCWA region lives with the scenario of war, human and capital resources find refuge abroad, and member states trade more with the outside world than they do with one another. Tough economic medicine is inappropriate in a region where, in between wars, people live with the prospect of war. There need be trade liberalization, but within the region first. In a tense atmosphere, ESCWA has got to be selective about what to liberalize and only in reciprocation to what the big partners concede. There also need be a fostering of the environment for the growth and development of the private sector, but there need not be the view that the public/private relationship is an antagonistic one. When the risks to private returns are high and resources are plenty, a better-managed public sector can act as a quasi-insurer of private interests. There has to be a diversification away from oil, but when oil demand increases at two per cent yearly, it is difficult to show that oil producers have done well in other sectors unless the oil based and diversified economies link up more closely.

It is unlikely that any society can withstand the exigencies of the oncoming transition that ESCWA will face without a turnaround in policy coordinated regionally, and internationally. In the economic sphere, the promotion of a regional dialogue that retains natural, human and financial resources within the region and/or repatriates funds for the purpose of economic development represents an initial step in the right direction. There are only 12 years to go before the deadline of the Millennium Summit is reached. The international community cannot afford to be lax about poverty alleviation issues in a region that is so vital to global stability. The continuation of the status quo stands in utter contrast to the right to work as per the declaration of human rights and the goals of poverty reduction as per the proclamation of the Millennium Summit.