

The Arab Economies in a Changing World

Marcus Noland and Howard Pack • April 2007 • ISBN 978-0-88132-393-1 • \$24.95

The economic performance of the Arab countries of the Middle East has been middling over the past four decades. It has been worse than East Asia, better than sub-Saharan Africa, and about the same as Latin America and South Asia. While the region has suffered no major economic crisis, it now faces a major challenge: the demographic imperative to create jobs for the large cohort of young people reaching working age and to raise living standards.

The stakes are high. Rapid labor force growth in many Arab countries has contributed to despair among young people about their job prospects and consequent worries about political stability. The region's reputation as a risky business environment, and deep uncertainty about the future of many of the region's political regimes, significantly inhibits successful globalization. The central role of oil in the economic and political life of a number of these countries creates additional opportunities—and potential pitfalls.

To productively absorb the growing labor force, aggregate growth must accelerate, and this growth will have to be labor-intensive. However, the growing competitiveness of low-income rivals, such as India and China, and the existing economic, political, and social practices and beliefs in the Arab economies may inhibit or preclude the growth necessary for these economies to succeed or indeed for their governments to maintain political viability.

The authors conclude that Islam, the dominant religion in the region, is not the problem, at least not in a simple sense that the adherence to the faith encourages behavior antithetical to economic development. But it is relevant: Islam is the spiritual prism through which many in the region interpret existence, many adherents increasingly regard Islam as under threat, and for a variety of reasons political opposition to the region's ubiquitous authoritarian regimes has an increasingly Islamist bent.

The study suggests that macroeconomic instability is not the main culprit either. While macroeconomic policy management may not be perfect, and the presence of oil and other natural resources may present “Dutch disease” challenges for some countries, macroeconomic management is sufficiently good that alterations in macroeconomic policies are not likely to deliver large improvements.

However, the portrait derived from measures of microeconomic policies and institutional characteristics is less positive. As a group, the Arab countries have weak links to the global economy (outside of the special cases of oil, other natural resources, and tourism); low levels of foreign direct investment; lack of technology

transfer, dissemination, and application; lack of innovation; lack of industrial competence as measured by exports of manufactures; high levels of government investment and ownership; and high costs of doing business. Also, there is considerable intraregional variation, particularly with respect to progress on institutional reform. Islam or Arab culture may have many effects on local institutions and practices, but they cannot explain why it takes 15 times as long to enforce a contract in Egypt as it does in Tunisia. Strengthening linkages with the rest of the world, and addressing the microeconomic and institutional weaknesses, will be a prolonged and uncertain slog, requiring both supportive policies and sufficient local productive capacity organized by local entrepreneurs or foreign investors.

The authors stress the complementary roles of education and technology. Social returns to education in the Arab countries may not be particularly high in the absence of complementary technology and an enabling business environment. Given the post-9/11 diplomatic environment and restrictions on cross-border movement, the most feasible strategy would be to educate the domestic labor force and encourage foreign firms to establish production locally. The challenge is not only how to marry local capacities to imported technology but also how to make globalization acceptable to a skeptical public and how to overcome entrenched special interests in an environment where policymakers are risk averse.

The authors also consider how commitments through the World Trade Organization or bilateral agreements might help lock in reforms, reduce policy uncertainty, and leverage domestic support for greater openness. Both modalities have potentially constructive roles to play yet require complementary reforms in policies, institutions, and practices to encourage a positive local response enabling the Arab countries to capitalize fully on the opportunities created.

If the region's employment challenge can be addressed, the Arab world could reap a demographic dividend as the new generation enters its most productive working years—a phenomenon that contributed to the outstanding performance of East Asia over the past four decades or so. If the region were to both grow and increase political and social liberalism, it could experience a virtuous circle of enhanced cross-border economic integration, economic efficiency, rising incomes, self confidence, and satisfaction. The region's young demographic could then turn from a potential liability to a bonus.

There is no guarantee that this positive vision will become a reality. An alternative outcome is a vicious circle in which impoverishment, discontent, militancy, and repression feed upon one another, deterring reform and impeding growth. The fact that neither scenario can be dismissed underscores the extraordinary salience of this study for today's global geopolitical as well as economic development debate.

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