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ECONOMIC TRANSITION IN THE MIDDLE EAST AND NORTH AFRICA

DRAFT REPORT

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* Until this document has been approved by the Economics and Security Committee, it represents only the views of the Rapporteur.

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I. INTRODUCTION

1. The Middle East and North Africa (MENA) is a politically and economically heterogeneous region that is nonetheless frequently characterized as a collection of relatively similar states. The reason why this flawed view has taken hold might be explained by the common if hardly identical religious, cultural and ethnic profiles of the region's nations, elements of a common historical narrative, and a range of common political, security, diplomatic, and economic challenges. This report will deal largely with these economic challenges, but it will begin from the assumption that the region is indeed heterogeneous, despite a range of shared challenges. Indeed the MENA countries of the region vary in size, natural and energy endowments, income levels, human capital and skills, social and political structures and institutions (Nabli).

2. The end of the Cold War has dramatically altered Middle East and North Africa's strategic landscape as well as that of NATO. The salience of terrorist threats after the September 11 attacks coupled with political and military instability in the Middle East are now recognized as threats to international stability, and this has inevitably shifted NATO's attention to the region. Yet hammering out a common strategy to contend with the broad array of challenges to security and stability in the region has proven exceedingly difficult. The trans-Atlantic fall-out over Iraq illustrated the difficulties involved in developing out a common Western approach to the region.

3. There are nonetheless numerous areas of obvious common trans-Atlantic interests with regard to the Middle East and North Africa. The economic development of the region certainly ranks among the most important of these. More rapid growth in the region would confer benefits well beyond the borders of these countries--to the region's neighbours and trade partners to begin with, but also to the broader international community. Economic liberalization and the expansion of human liberties are mutually reinforcing, if hardly identical phenomena. Advances on one front frequently trigger progress on the other, and improvement in both arenas is now widely understood as fundamental to building a more stable regional and international order.

4. The problem throughout the MENA region has not only been the cautious and partial manner in which reforms have been undertaken, but also the widespread failure to open the political process to broader participation, a practice that would deepen the public's sense of ownership in reform. The lack of openness, engagement and institutional development is perhaps the central explanation for why the region has failed to keep pace with a number of other developing regions. Over the course of the 1990's the average growth rate in the MENA region was only 1.3% as opposed to 2% for all developing countries. (Abed and Davoodi)

5. The Atlantic Community can certainly support reform provided the approach taken is responsive to the region's unique needs, sensitivities, and concerns--many of which are rooted in centuries of foreign intervention in the region. It can do so by according MENA greater market access, providing training and foreign assistance and sharing knowledge about transition experiences which have had such a profound effect in expanding the zone of peace and security in Europe itself. Many MENA countries urgently need to embark on economic and political transition, and the process of change could well provide the foundation for a new partnership with the West.

II. UNITY AND DIVERSITY OF THE REGION

6. According to Clement M. Henry and Robert Springborg, the MENA region can be divided very loosely into several types of political regimes :

- Authoritarian Praetorian Republics (Algeria, Egypt, Libya, Syria, Sudan, Tunisia, and Yemen);
- Monarchies (Bahrain, Jordan, Kuwait, Morocco, Oman, Qatar, Saudi Arabia and the United Arab Emirates). Several of these are beginning to experiment with democratic forms. Jordan and Morocco, in particular, have made important strides in this direction. Others, like Saudi Arabia, are anything but democratic at the moment although local elections were held in the region for the first time this spring, although they fell short of international standards for free and fair elections.
- Democracies in this part of the world are a fragile flower indeed. Palestine has, however, recently undertaken an important fair and open national election to chose the successor to Yasar Arafat—an opportunity to select a national leader that few in the region have enjoyed. Lebanon is sometimes characterized as a democracy as well, but it has also been occupied by Syria and does not yet enjoy full political autonomy. (This report is not dealing with Turkey and Israel, which are more vital democracies.)
- Theocracy: Iran is ultimately administered by a group of senior clerics, although it does have a relatively highly developed civil society, probably the most vibrant one in the region apart from Israel. Thus, the potential for a home-grown democratisation process seems to be greater than in other states despite the problematic/special character of the present regime.
- Post-Conflict State: A fifth category must also be added for Iraq, which had long been a praetorian republic, and is now a post-conflict state still in the midst of grave crisis. Iraq confronts a range of problems directly arising from the horrific legacy of Saddam Hussein's utter misrule; the recent war and ongoing insurgency and the still uncertain political situation. (Van Gennip) That said, Iraq like Palestine, has recently undertaken a consequential if still flawed national election—an event that could mark an important step toward the restoration of stability in that troubled country.

7. While it is difficult to generalize, there are nonetheless signs that each of these categories of government has also produced different economic structures. As suggested above, those states that never confronted a fundamental challenge to their own traditional and modern market legacies have proven the most adept at adjusting to economic globalisation. The monarchies of Jordan and Morocco, which to varying extents have embraced democratic forms, have achieved a higher level of development than those praetorian republics that projected coercive state powers into the economic life of their countries. It is interesting to note that the countries of the region that first signed on to structural economic reforms with the support of the World Bank were Israel, Jordan, Morocco, Tunisia and Turkey. These were also the first states to forge partnership agreements with the EU. Lebanon has followed closely on the heels of these countries, although a long civil war delayed its embrace of reform.

8. In general terms, therefore, several of the monarchies have been more receptive to the notion of economic reform than the Praetorian Republics, some of which all but destroyed their own market legacies and entrepreneurial classes in order to consolidate their leadership's hold power. Saddam Hussein's Iraq was particularly notorious in this regard. Hussein destroyed Iraq's entrepreneurial class and replaced it with a patronage-oriented and highly corrupted crony system. International sanctions further consolidated their grip on the national economy. This legacy has made the reconstruction task there all the more difficult. (Van Gennip)

9. Differences are even evident in the banking systems, which also reflect colonial legacies. Here three models have emerged: the Anglo Saxon model of capital market allocation driven by individual investors preferences (Lebanon and the Gulf States, where even Islamic banks have adopted elements of the Anglo-Saxon tradition); the French model of state influenced capital allocation with a key role played by state-owned banks (Israel and several of the Praetorian Republics) and a German model of highly concentrated and integrated commercial and financial sectors in which universal banks play a dominant role, and which like the French models, represented a financial response to extant capital shortages (Morocco and Turkey).

10. Throughout the region, there is also a deeply entrenched traditional and informal banking sector known as Hawala. While these institutions have achieved a certain notoriety for the role a few have played in money laundering and terrorist finance operations, they are, in large measure, a legitimate low-cost market response to the basic financial needs of the people of the region and the fact that the large banks essentially cater only to wealthy and/or politically connected clients. (NATO PA Secretariat Report on NATO Terrorist Finance Conference, Rome, Italy 2004)

III. A REGION FALLING BEHIND

11. MENA confronts grave economic, social and political challenges. Many of the region's countries have failed to take advantage of development opportunities that other developing regions are successfully exploiting. MENA countries have slipped below the level of human development that one would have anticipated for the region given its adjusted per-capita income. The gap between it and regions like Latin American and South East Asia is now widening inexorably.

12. Indeed, recent World Bank studies suggest that the region has not been performing anywhere near its potential, particularly since 1985. With only a few exceptions, this holds true for oil exporting as well as non-oil exporting countries. This slippage is all the more alarming because MENA is failing to build a foundation for future economic and social development. One World Bank study estimates that because of explosive demographic expansion, 47 million new jobs will have to be created in 16 MENA countries between 2002 and 2012 simply to keep unemployment at its current (official and likely understated) level of 15%. 6.5 million additional jobs would bring that rate to below 10%, and well over double the number of existing jobs would have to be created over the next decade to absorb unemployed and new entrants into the labor force. (Nabli) To achieve this would, in turn, require growth rates that are at least 2% higher than today's. Such a pace of job growth was not even achieved by East Asia during the height of its most brisk employment growth. (Keller and Nabli)

13. The state sector has typically assumed the burden of job creation in the MENA region. But today's fiscal realities suggest that there is little room for state engineered job creation. At the same time, the possibilities for labour migration are growing more restricted. As a result, the region's unemployment rate is highest today among young first-time job seekers. These young people on average have three more years of education than did first time job seekers twenty years ago. The problem is undoubtedly generating enormous frustration in the region, and it has political as well as economic consequences. (Cassidy)

14. Arab women have the lowest labour market participation in the world, although they are increasingly demanding the opportunity to work. These demands are rising as the opportunities to meet them are diminishing. Throughout MENA, unemployment for women is 30% higher than for men. The problem is most acute in Bahrain, Syria, Egypt and Saudi Arabia where women's unemployment ranges between 2 and 3 times higher than the region's average. (Nabli)

15. The MENA region is only attracting 1% of the world's foreign direct investment (FDI) flowing to developing countries. This points to the grave difficulties the region will confront in generating new jobs unless important structural changes are made. (OECD Briefing to the NATO PA Economics and Security Committee, Feb. 2005) Potential investors are discouraged by a business climate characterized by high transaction and service costs, heavy public administrative interference and delays, imposing trade barriers, high freight costs, long customs clearance times, and regional insecurity. Yemen, Saudi Arabia, Lebanon and Egypt have erected some of most daunting entry barriers for business in the world according to a recent World Bank survey of 110 countries. (Irqbal) Foreign investors are also discouraged by large, often unaccountable and coercive state structures that tend to squelch economic initiative and pervasive suspicions and widespread reservations in the region about the phenomena of globalisation, which has been a crucial element of economic take-off in other developing regions.

16. The MENA region's huge oil endowment--60% of global oil reserves, 25% of gas reserves and a 44% share in global oil trade, very low oil and gas production costs (Tempest) has ironically lowered incentives to broaden the foundation for economic development. Oil wealth provided a facile means to meet immediate consumption requirements, but it has tended to discourage measures that might yield more sustainable and broadly based forms of development. Oil earnings certainly provided the initial impetus for rapid economic and social development throughout the region both for oil-producing economies as well as for the resource-poor neighbours that benefited from labour remittances, transit fees and aid flows from their oil rich partners. All used oil revenues to underwrite important social programmes that helped redistribute this wealth.

17. Another development challenge relates to climate. The MENA region's lack of water and its growing demand for it are increasingly seen as a source of regional tension as well as a barrier to development. Water scarcity is linked to other environmental problems including deforestation, desertification, the preservation of seacoasts, and the relative scarcity of arable land. MENA governments' capacity to monitor environmental trends and set appropriate policies, moreover, is very low. (Esty, Levy and Winston)

18. History too has imposed development-related burdens on the MENA region. For some two hundred years, much of the region has been an object of great power politics and rivalries. This has left a powerful mark both on its collective psychology and on its political and state structures. The colonial or semi-colonial experience in much of the region was protracted. The nationalist elites that succeeded colonial administrations adopted import substitution, statist models of development that helped concentrate economic authority in the hands of state authorities or elites linked to the ruling class. Yet even this failed to curtail the role of outsiders, who saw in some elite groups, proxies through which they might compete for commercial and strategic influence. This dynamic only compounded the problems of building coherent national political and economic systems. Throughout much of the region, globalisation and liberal economic reform came to be seen as a new expression of old colonial forms. In this way, the economic logic of liberalization has frequently fallen victim to a myriad of deeply rooted apprehensions about the outside world.

19. This particular narrative, however, has not held uniformly across the region. Several states initially embraced elements of the standard prescriptions of the "Washington-based Bretton Woods Institutions" and accepted a more liberal approach to internal economic development that would better structure their economies to operate in a global setting. (Page) Importantly, in these countries a commercial middle class had consolidated powerful social and political positions at critical moments in their respective histories and subsequently pursued development strategies at least partly premised on integration in world markets. In other settings, the reform agenda advanced by small liberal groups ultimately generated a powerful political backlash and, at best, were only adopted in a very partial manner or simply rejected as inappropriate.

20. Even among the region's opposition movements, the liberal economic impulse has remained quite weak. Islamic movements, for example, tend to demonstrate greater concern with social matters than with technical economic ones as such, and rarely do they embrace the opportunities to participate more fully in the global economy. Restrictions on political debate in some societies have impaired dialogue between economic reformers and their Islamic critics--something that might have made it possible for the two to achieve a kind of synthesis. Certainly there is no reason that the positions of the two groups need to be mutually exclusive, as Turkey's current government has so ably demonstrated. (Henry and Springboard, p.20)

21. During the post-colonial phase of development, trade policy was heavily protectionist. MENA governments tended to employ an import substitution model of development that accorded selected domestic firms a privileged and protected position in local markets. The problem was that this model was highly inefficient. It led to gross resource misallocation, spawned highly concentrated, vertically integrated companies and nourished huge and parasitic bureaucracies. It also prevented these societies from accruing the natural benefits that integration in the global economy confers including: comparative advantage specialization, external markets for locally produced goods, efficiency generating competition and lower prices for consumers and producers alike.

22. At the same time, legitimacy problems for certain regimes in MENA fed the habit of patronage spending as a means essentially to purchase loyalty among the well-connected and the potentially hostile--an approach that made governance all the more opaque, while further entrenching powerful groups opposed to economic reform. Governments throughout the region have historically played the role of employer of last resort--a practice that now imposes serious fiscal burdens throughout the region, gravely hampers economic flexibility, and has opened a widening gap between state–incurred social and employment obligations and the capacity to deliver these services. Of these, state job creation has also driven wage costs up at a faster rate than productivity gains—a labour policy that has effectively prevented the region from exploiting a potential comparative advantage in labour costs that would certainly enhance its international competitiveness.

23. Unfortunately regional and internal insecurity have also been part of the economic picture. War and terrorism have fuelled abnormally high levels of defence spending which stands at 20% of GDP as opposed to a developing country average of 12%. This has diverted scarce budgetary resources from targeted projects that would provide a more stable foundation for sustainable and broadly based economic development. Concerns about the region's stability have added an enormous risk premium to the cost of doing business there, although arms sellers have flourished. This is yet another illustration of the importance of creating a peaceful environment to sustain development in the region.

24. Macro-economic policies in the MENA region have also posed problems. Loose spending policies pursued throughout the 1980’s were premised on high oil prices that the cartelisation of oil production wrought after 1973. But that cartel power eroded substantially over the course of the 1990s with the rise of non-OPEC production--a development that helped precipitate significant oil price falls. The region's states, however, lacked sufficient fiscal flexibility to adjust to oil price fluctuations. Top-heavy states scrambled to survive financially but did so by cannibalising resources that might otherwise have been invested in projects conducive to long-term investment. Fiscal rectitude as well as real investment were the casualties.

25. Of course, oil prices today are once again quite high. Ineluctably rising Chinese energy demand suggests that over the long term, the central point around which oil prices fluctuate will rise substantially. (OECD Briefing) But given the high population growth rates in the MENA region,

even higher oil prices will not be sufficient to cushion the region's governments from the need to generate new sources of investment and finance.

26. Not surprisingly demands for a broad-based structural and political reform are on the rise throughout the region. The 2002 UN Arab Human Development Report, authored by eminent group of Arab experts, for example, pointed to a range of problems that are pushing the region ever lower in the rank of nations in human development terms. The report's call for action was startling in its clarity and in its warning of what failure to reform might portend.

27. That report laid out a range of human development indexes in which the MENA region is clearly falling behind. The problems are particularly worrisome, not the least because the global economy is increasingly premised on the cultivation of knowledge workers and information infrastructure. In this emerging economy lower wages and high skilled societies will obviously fare better in attracting investment than low wage low skill societies, other things being equal. Only the former will build a foundation for longer-term job creation based on productivity improvement. Investment is thus the best way to drive productivity and wages upward. The bad news for MENA is that over the last fifteen years prevailing development, social and commercial policies have combined to increasingly wed low skills to relatively higher wage costs, a deadly combination that has help dissuade both domestic and international investors from operating in local markets. The MENA region is currently ill-placed to derive commercial benefit from its human capital. It suffers from relatively low literacy rates, poor-test scores, inadequate schools and universities, a dearth of opportunities for those emerging from the university, underdeveloped telecommunication infrastructure and a lack of access to computers. The fact that women are prevented from exploiting opportunities in the school and the work place effectively slashes the region's potential work force and talent base. (Arab Human Development Report 2002, 2004) When heavily interventionist states, corruption, military tension and authoritarian political practice are thrown into the mix, the situation begins to look dire and indeed unsustainable.

28. Education systems throughout MENA are lagging behind other developing regions. Illiteracy Is high, particularly among women, some children still do not have access to basic education, the number of students enrolled in higher education is declining as is public spending on education, which, despite the large increase in the number of young people, is actually less than in 1985. Access to the Internet is very low, and there are only 18 computers per 10000 people in the Arab region, compared to a global average of 78.3. A mere 4.4 translated books per million people were published in the first five years of the 1980s or less than one book per million people per year. The rate in Hungary and Spain for the same period was respectively 519 and 920. (Arab Human Development Report 2003)

29. Research and development spending is very low throughout the MENA region. Scientific research centres in the Arab world suffer from inadequate funding, poor institutional structures and a political environment that restricts scientific dialogue. Poor working conditions perpetuate the problem. It is particularly difficult to attract new generations of research workers when the sector is capital-starved and politically neglected. This weakness has, in turn, harmed the region's capacity to adapt and integrate foreign developed technology and develop it own. It is not surprising, therefore, that many of the region's top scientists have emigrated. Indeed, some 25,000 of the 300,000 first degree graduates from Arab universities emigrated in 1995/1996 while more than 15,000 Arab doctors left the region between 1998 and 2000. (Arab Development Report 2003.) Only by training sufficient cadres of knowledge workers and providing them the opportunity to conduct their work will help the region's societies stem the brain drain and tap into technology in ways that might trigger their own development.

30. Despite these real problems, some improvements have also been registered. In a recent study of 12 MENA countries, the segment of the population over 25 years of age with no schooling declined from 80% in 1970 to 46% in 2000. Average years of schooling increased in that same

period from 1.3 years to 4.5 years (Abed and Davoodi). These gains reflected the strong social component of state spending in the MENA region. The challenge today lies in finding gainful employment for school leavers who are finding it increasingly difficult to put their skills to work.

31. There are a number of factors shaping MENA's rather unique economic profile. Perhaps the most salient of these is that many of the region's countries have depended on oil exports or transfers from oil exporting countries to underwrite consumption and development. But there are important structural differences as a result of varying energy endowments in the regions. Countries like Egypt, Jordan, Lebanon, Morocco and Tunisia are resource poor and labour abundant. Others are resource rich with abundant labour including Algeria, Iran, Syria and Yemen while the Gulf countries are rich in oil and have long imported labour. All, however, have fallen behind other developing countries in human development terms. (Iqbal) Un Human Development reports 2002, 2003)

32. Secondly, central planning, nationalization, consumption subsidies and import substitution policies were pillars of the region's national development strategies. In some respects, these approaches assured a minimum level of development and helped broadly raise consumption in this impoverished region, particularly after the enormous oil prices hikes of the 1970s when OPEC had essentially cornered the international oil market. Oil exports generated funding for infrastructure, public health, and education spending; since the 1960s illiteracy has fallen markedly while health care and longevity registered sharp improvements.

33. Yet, once oil prices began to slump, the vulnerabilities of the region's economies became more evident. Income flowing to the public sector declined, and investment in infrastructure and social spending fell along with it. This has led to a 60% fall in the physical capital stock per worker since the late 1970s, attendant productivity decreases, mounting macroeconomic imbalances, an ever poorer investment climate, rising unemployment and very low growth.

34. This extended downturn led Morocco, Tunisia, and Jordan to undertake a range of critical reforms: the introduction of value added taxes (VAT), reduced subsidies, improved public management, tighter monetary policies and more liberalized trade regimes. Morocco and Tunisia joined the GATT and engaged in exchange rate liberalization, fiscal modernization, trade and financial reform as well as privatisation. The three also signed agreements with the EU in the 1990s that provided access to new markets and new EU support regimes. These countries have subsequently enjoyed higher factor productivity gains and relatively stronger per-capita growth than many oil-producing countries. (Abed and Davoodi)

35. Yet, the reform impulse in other countries proved weaker and faded over time. Egypt, for example, reversed its reform programs through excessive administrative controls. Lebanon also embarked on reform, but these too were watered down, in part, because of the difficult legacy of a catastrophic civil war and continued occupation. Algeria, Syria, and Yemen were more partial in their reform efforts. Algeria suffered from serious macroeconomic imbalances after the oil price collapse and as a result had adopted spending discipline to contain the deficit. But it was slow to adopt structural reforms, and it subsequently abandoned several trade liberalization measures it had earlier embraced. Likewise, Syrian reforms were not sustained while Yemen has simply failed to diversify its economy, although it has managed to adopt a more open trading system.

36. The Gulf countries of Saudi Arabia, the United Arab Emirates, Bahrain, Kuwait, Qatar, and Oman have long enjoyed relatively open trade and capital movement policies, but all were afflicted by the downturn in oil prices. This inspired the smaller Gulf countries to pursue a degree of economic diversification. Oman, for example, embarked on a policy of privatisation and introduced more open foreign capital investment laws. Saudi Arabia, however, has been much slower in its reform process, and the state there continues to play a dominant role in an economy, which is highly dependent on oil revenues. State finances in the Kingdom are opaque, while the distribution

of oil wealth is highly uneven and biased toward consumption rather than investment. A high concentration of wealth restricts domestic demand, limits the potential for setting up local production, and reduces the potential for setting-up small and medium-sized enterprises. Statist policies have destroyed local Bazar structures and the commercial class that used to exist in Arab states. These are some of the most serious impediments to self-reliant development in the region.

IV. THE CURSE OF THE OIL ENDOWMENT

37. Over thirty years, per capita income in oil producing countries declined at a rate of 1.3% per year, while non-oil producing countries in the region grew by an average of 2% per year. These non-oil producers thus managed to keep pace with the rest of the developing world over at least until the 1990s when their per capita growth also slowed. Yet many of the oil exporters fell behind. Although energy prices are now higher and could stay high for some time to come given changing demand conditions, there are still important reasons why economic diversification is needed. First of all, several oil producing countries including Egypt, Yemen and Algeria will soon confront oil production declines. Several other countries are approaching peak production points in the life cycles of their oil supplies and will simply have ever less to export over time. Few states in the region have taken measures to encourage domestic energy conservation and so are consuming ever-higher amounts of their own oil. Commodity dependant economies are also subject to radical swings in income over time. This can have adverse effects on employment while complicating development planning. Meanwhile, other key sources of income to the region including aid and labour remittances are unlikely to make up for declining long-term foreign exchange earnings generated by oil exports

38. Large oil exports and oil-related capital investments have also sparked real currency appreciation in a number of MENA countries. This has led to a bias against the manufacturing sector. The high cost of local currencies have priced many other domestically produced goods out of international markets and dissuaded potential market entrants from investing in non-oil businesses. One recent study suggests that high currency prices reduced the ratio of manufactured exports to GDP in the region by 18% a year between 1985 and 1999. (Iqbal)

39. Economic reliance on oil also seems to have diminished incentives to engage seriously in broader pro-development reform. Oil revenues have long provided a convenient if nevertheless volatile means of sustaining consumption in exporting countries. Reliance on one commodity, however, has left some of the region’s important economies susceptible to highly volatile shifts in their terms of trade, while government spending patterns tend to exacerbate the effects of commodity price swings. Kuwait, Oman and Iran have established Oil Stabilization Funds in which portions of oil earnings are saved abroad in order to weaken the impact of oil price changes on the non-oil domestic economy. Other countries in the region, however, have found themselves caught up in "sink or swim" earnings fluctuations that provide a poor foundation for nurturing long-term sustainable growth in which benefits can be more generally shared.

V. TRADE

40. Another key problem for the region is its very weak integration in the international economy, its falling share of world export markets, and low level of intra-regional trade. The MENA region is among the most heavily protected in the developing world. The problem is that global competition is growing fiercer. New entrants in the global economy like Central Europe and the burgeoning

commercial power of Asia and Latin America all are well ahead of the MENA region. Without dramatic reform, it will be hard pressed to compete even in those sectors like textiles where it has managed to carve out a niche for itself.

41. Most development economists now recognize that poverty reducing economic growth cannot be achieved without some degree of openness to the global economy. Trade is now widely seen as a critical counterpart to reform, investment, and aid in fostering sustainable development. The international economy not only offers export markets for locally manufactured goods, it also generates capital for investment, competition to ensure that firms are structured on competitive foundations and a means to contain prices. In the MENA region where import substitution was a critical feature of the old development model, the level of protectionism remains quite high. This has driven costs upwards and penalized the region's exporters. Protectionism has thus made diversification away from the oil sector all the more difficult. Not surprisingly it is the oil-poor countries like Tunisia, Morocco, Lebanon and Jordan that have achieved a reasonable degree of diversification, while oil rich countries have fared far worse on this front.

42. That said, the region boasts few exports beyond oil and gas, and its economies are among the most highly protected in the world. Beyond energy, it tends to export low value finished goods while importing most of the parts for its very inefficient, vertically integrated manufacturing base. (Iqbal). High tariff walls, overvalued currencies, high regional transport and service costs, poor, opaque and often corrupt border controls, and an array of administrative non-tariff barriers all hinder trade. At the regional level, there is a very little commercial integration among the MENA countries. The level of intra-regional exports among Arab countries has hovered between 8-9% over the last two decades as compared to 22% in ASEAN and 25% for MECUSOR. (Nabli).

43. Although the similar manufacturing profiles of the region economies suggest that the gains from more open interregional trade would not likely be of overriding consequence initially, service trade liberation would have a far more immediate positive impact. Services in much of the MENA region are very high priced and of low quality, and this has long penalized other sectors. Opening up services to regional competition, would benefit manufacturers by lowering in-put costs. Of course, intra-regional service integration should only be a first step to commercial integration and the region’s full participation in a liberal multilateral trading system. Indeed, the latter should remain the ultimate goal. (Hoekman and Messerlin)

44. There are some signs of improvement on this front. The Tunisian government has progressively reduced import quotas in textiles, automobiles, and agriculture goods while Morocco has eliminated most of its quotas. Algeria has moved somewhat more hesitantly on this front, while Jordan has made progress in reducing quantitative restrictions significantly as has Egypt. Syria and Lebanon, however, have kept trade barriers high.

45. The Euro Mediterranean Partnership (EMP) has deepened trade cooperation between the EU and 12 non-EU Mediterranean countries. But the partnership extends beyond mutual trade matters; it also includes a human rights clause (article 2), and strongly endorses sub-regional cooperation. Morocco, Tunisia, Jordan and Egypt formed the “Agadir Group’ created in May 2001 to establish a sub-regional free trade area as a first step in building a greater EU-Mediterranean free trade zone. The EU is also providing funding under the MEDA program, the EU’s primary vehicle for extending technical and financial assistance to the region. The EU spent some 5 billion € between 1995-99 and has allocated some 5.4 billion for the current programming period from 2000-2006. The goal is to create a free trade area by 2010 of 600 to 800 million people engaging some 40 countries. But if one looks at export trends just from North Africa, it emerges that despite preferential access to EU markets, the market shares of these countries have declined since 1980. This is due both to competition from other developing countries and also to the many restrictions the EU attaches to states receiving preferential access. For example, agriculture exports face a range of non-tariff barriers when entering the EU market. (Ghoneim, von Hagen and Wolf)

VI. FOREIGN INVESTMENT, THE BUSINESS CLIMATE AND GOVERNANCE

46. The level of foreign direct investment in the MENA region is extraordinarily low and this too is undermining the region’s capacity to export. Poorly structured equity markets, the relatively low level of private business activity, inadequate worker training, political uncertainty, regional insecurity, red tape and corruption continue to scare off potential investors. Recent World Bank and IMF studies suggest serious problems in public-private sector relations (Iran, Tunisia, Mauritania and Pakistan) woeful statistical data collection (Algeria, Tunisia, the United Arab Emirates, Morocco and Oman), and low levels of fiscal and financial transparency particularly related to money laundering and terrorist financing (nearly all the countries of the region) are all discouraging trade creating investment flows. (Abed and Davoodi) International and domestic pressures, however, are likely to result in change on all of these fronts.

47. Investment capital is very scarce in the MENA region so firms have few opportunities to enhance the technical or physical capacity of their operations. Even worse, many of the region’s firms are compelled to navigate through a daunting web of red tape that imposes enormous costs on their operations. Poorly developed, opaque and sometimes corrupt judicial systems adds further burdens by undermining the rule of law, transparency and predictability that markets need in order to thrive. One World Bank analyst suggests that it costs significantly more to set up a business in the MENA region than in East Asia and Central Europe due largely to heavy handed bureaucracy and other barriers to market entry. (Iqbal)

48. This is made all the worse by woeful governmental accountability and transparency. According to one World Bank study the MENA generates very little reliable empirical data on the quality of governance. None of the region's governments recognize their citizens' rights to government information. In Egypt, the detailed government budget is neither fully published nor discussed outside of parliament. Iran's record, in this regard is far better. It fully publishes its budget and televises parliamentary debates. Press freedom is limited in many countries and has worsened because of post-September 11 crackdowns. The general scope for parliaments also varies, and the same can be said for local governing councils. Accounting mechanisms are weakened by the lack of checks and balances across governmental branches both in the monarchies and the more plural governments like Algeria, Egypt and Tunisia. In general, power is excessively concentrated, and this simply reduces the scope for checks and balances to work. It also makes it very difficult for governments to deliver public goods that increase competitiveness. These shortcomings have conspired to place MENA very low in global governance rankings; the region’s oil producers fare the worst of all. According to one model, had MENA matched the average quality of public administration of South East Asian countries, it growth rates would have been higher by 1% a year. (*Better Governance for Development in the Middle East and North Africa*, World Bank) Transparency International’s 2004 Corruption Perception Index places a number of MENA countries in the bottom half of its global rankings. (www.transparency.org)

49. As suggested above, state owned businesses have long enjoyed a privileged position in the national economies of the region. Large vertically integrated state monopolies and oligopolies, however, have constrained competition, jacked up prices and offered inferior services to consumers and private firms—conditions that have had adverse knock-on effects to other sectors. Although the pace of privatisation in the region has picked up in recent years, MENA countries have moved more slowly on this front than other developing regions. Over the course of the 1990s only $8.2 billion of state-owned assets were sold to the private sector as opposed to $65

billion for Eastern Europe and Central Asia and $44 billion for East Asia and the Pacific. (Abed and Davoodi) Some successes, however, have been registered particularly in Jordan, which has created a fairly robust regulatory framework for transparent privatisation. Egypt has floated state holdings on its bourse and allowed for some employee buyouts.

50. Not surprisingly there also problems in the region’s economic infrastructure although this varies by country. The Gulf countries, Lebanon, Jordan, Tunisia and Morocco enjoy relatively good and, in some cases, even excellent infrastructure. Several cities in the Gulf are perfectly modernized and enjoy cutting edge information networks. But they are very much the exception. Generally road systems throughout the region are reasonably well developed. Regional telecommunications networks, however, are less robust, in part, because of the lack of competition in the sector. For example, it can take four years to have a phone installed in Syria. The growing use of mobile telephones, however, is at least helping to circumnavigate that particular problem, although costs remain high. The electricity sector is also fairly underdeveloped. Electricity transmission loses in recent year years have approached 16% of output compared to 7% in East Asia, and this reflects a generally poor record in energy conservation. Many of the problems here can be traced to the existence of high cost, low service public monopolies that simply confront no competition and thus lack the impetus to do perform to a higher standard.

VII. POLITICAL REFORM

51. As mentioned above, the 2002 and 2003 United Nations Arab Human Development Reports also assessed the MENA region in terms of relative education levels, literacy, gender equality, life expectancy as well as the health, the vibrancy, transparency and democratic structure of public institutions. It linked these factors to development in broad terms. In many of these areas, MENA has done very poorly indeed. The report directly linked the problem of governance, politics, women’s rights, health care and education matters to development—subjects that are often considered taboo in the region. The authors made a powerful case for greater human rights protections, the empowerment of Arab women, and measures designed to help the region’s societies make better use of knowledge and information. The report systematically catalogued a broad array of shortcomings that undoubtedly have had much to do with the region’s relatively low level of development. But it also noted its successes, including the fact that life expectancy has increased by about 15 years, adult literacy has almost doubled and women's literacy has tripled. (Arab Human Development Report, 2002)

52. Economic reform is hardly a risk-free and apolitical process. Those regimes with a tenuous claim on legitimacy will invariably feel threatened by introducing policies that advance transparency, the free exchange of information, and the autonomous activity of entrepreneurs. Privatisation schemes, for example, are often viewed by insecure elites as an unacceptable ceding of a convenient lever of power. That these industries often represent an important source of additional income either for the political class or their clients makes sell-offs all the more difficult. Even the region’s more open governments have used clientalist techniques to cultivate their own legitimacy and thus share in the concerns of the political consequences of market reform.

53. Economic reform cannot unfold without some degree of political change. Markets require transparency, the rule of law, border stability, proper judicial oversight, and greater latitude for human freedom. All have been in short supply in the region. Indeed, MENA countries confront a genuine challenge in managing economic and political change simultaneously; movement on one front will invariably spill over into the other, often in unpredictable ways. Given the unique political and economic circumstances in each of the countries of the MENA region, reform will likely

advance in very different ways and at varying speeds. This is one reason why the future of the region today seems so uncertain.

54. Pressures from civil society for political change are undoubtedly on the rise, and MENA's governments are beginning to respond albeit in an uneven fashion. At this writing, Lebanon's population appears to have mobilized not only to push Syrian forces out of the country, but also to demand more accountable and transparent government. Saudi authorities like other governments in the Gulf increasingly seem to recognize now that some opening up of public life may be inevitable, although change in that society unfolds at a glacial pace. Egypt's authoritarian President Hosni Mubarak, under increasing pressure from Egyptian society and the United States--his country's principal source of foreign assistance-- recently announced that competing political parties will participate in September elections for the first time in three decades of emergency rule. (El-Rashidi) That announcement, however, was followed by the arrest of one of the leading opposition figures on charges that seemed to lack substance. Human Rights Watch has also protested the arrest of Ayman Nur, an elected member of parliament as well as a range of other important voices in Egyptian Civil Society. (http://HRW.org) This points to a pattern of rhetorical rather than real reform, and it is not unique to Egypt.

55. Although such gaps between reformist rhetoric and political reality have been the norm, there is a sense today even among elements of the region's ruling elite that harsh authoritarian practices are pushing their own societies into deeper crisis, providing fodder for extremist opposition groups, damaging relations with the West, and making their own hold on power ever more tenuous. Events since September 11 have further complicated the situation. The fight against terrorism has inspired some regimes to crackdown further on civil liberties and democratic movements. For its part, the West has certainly not been uniform in condemning the use of torture throughout the region. Censorship has, in some instances, increased. The struggle against terrorism has also effected the region's engagement with the outside world. The number of Arab students studying in America, for example, dropped by 30% between 1999 and 2002. This has occurred precisely when more rather than less contacts are needed to foster the region's openness to new ideas. (Arab Human Development Report 2003) To its credit, the US government is now working to bring more students from the region to study in the US.

56. International media play an important role in fostering critical public debate. Whereas some means of communication such as telephones and the internet are only available to a wealthy minority, satellite TV is widely available. People today learn the news – even about their own country – from the Qatar based Arab equivalent of CNN, Al Jazeera not from local media. Its reporting is free from intervention by national censors who cannot operate beyond national boundaries. The people of the region have begun to enjoy a comprehensive and increasingly uniform supply of information. This information often contradicts official government position and divergent trends in the region as well as the shortfalls of their own governments. Media will continue to play a key role in the reform process. Freedom of the media, thus needs to be further expanded.

57. Reform is thus needed on many fronts. But there are other factors that are likely to accelerate change over the coming years. Certainly the shock of the Iraq war has injected both enormous uncertainty and fluidity into the region. The suddenly improving dialogue between new and revitalized Palestinian leadership and the Sharon government could herald an important change in the region's strategic landscape. Progress on the Middle East peace process could significantly ease the siege mentality that pervades parts of the region. It would also undermine

one of the primary pretexts several of the region's governments hide behind to evade internal reform. Pressure and incentives from abroad are also part of the picture. But local ownership of the reform process is a key to success. Outside pressure risks being perceived as neo-colonialism and could thereafter backfire. Thus, the Sanaa Declaration of January 2004 committing members of the Arab League to human rights protection, democracy, the rule of law and market economic systems was an important first step. Following this local initiative in June 2004 the G8 launched a "Partnership for Progress and a Common Future" with the Broader MENA region aimed at supporting attempts at conflict resolution, democratic and economic reforms in the region. NATO complemented this at its Summit the same month with the Istanbul Co-operation Initiative designed to forge Partnership for Peace-type relationships with countries of the region and to forge enhanced practical collaboration beyond the Mediterranean Dialogue. Most recently, for example the United States has worked in close cooperation with France to pressure Syria to withdraw its forces from Lebanon after the killing of Prime Minister Hariri. This suggests that there is room for renewed trans-Atlantic cooperation in forging an approach to the region that will help create an international context to positive change. But this push should not simply focus on the region's problem states; several so-called friendly governments in the region have appalling human rights records and, not surprisingly, are pursuing policies that are hardly conducive to economic and political transition.

58. Indeed, the September 11 attacks helped American and European leaders to recognize that underdevelopment and the weakness of democracy in the MENA region represent a perilous problem that renders the old status quo untenable. The challenge lies in devising a new approach to a region that views both Europe and America with some suspicion.

VIII. REQUIREMENTS FOR THE FUTURE AND TENTATIVE CONCLUSIONS

59. For the MENA region to avoid a rapid rise in unemployment, it will have to achieve growth rates of nearly 6-7% a year for an extended period of time or double its current growth rate. Given the broad range of policy deficiencies governing the region's economies this is not an impossible goal if key reforms are made. There are great gains to be had simply by adopting of a range of policy changes including:

- Privatisation of a significant swathe of state industrial holdings;
- Rationalization of regulations;
- Support of economic diversification and reduced overall reliance on oil and gas exports;
- Labor market reform;
- Higher level of integration in the global trading and financial systems, significantly lower real tariff and quota rates, elimination or reduction of price distorting subsidies;
- A general opening up of national political systems to ensure broader participation of civil society in decision making, and the rise of a democratic culture that fits into the region's unique historical and cultural setting;
- Rationalization of state institutions and an improved legal and judicial climate;
- Fiscal and monetary reform.

60. Unemployment may be the greatest immediate and long-term challenge to the region. Failure to create new jobs poses serious political risks. The experience of other developing and transition countries suggests that labour output might increase by 2-3 percent a year simply through greater international integration. Improving institutional accountability and public administration could add from 0.8-1.3% in growth, while boosting women's participation in the labour market might add 0.7% to GDP growth per capita. In all policy changes like these could add an increase in output growth per labourer of 2.5-3.5% a year. This would generate millions of new

jobs in the MENA region in non-oil sectors and help attract long-term FDI to the region. These potential gains should provide an incentive to the region’s governments and to their foreign supporters to embark upon more robust transitions. Half measures are unlikely to work. The larger question is whether the politics of the region can sustain the introduction of such important reforms.

61. The MENA region stands to gain from what could be a permanent rise in oil and gas prices. Changing global demand conditions, driven by explosive growth in China and India, suggest that the region's oil exporters could well enjoy a new oil windfall. But this is not going to be sufficient to meet the region's economic requirements. More efficient and transparent means are needed to manage this wealth, save it and invest it is a way that will advance broader development goals. Oil endowments can be a curse in development terms if not properly managed.

62. Banking reform in the region will be vital to the overall reform process. The region’s financial institutions need to be more responsive to real economic opportunity and less responsive to demands for the political allocation of capital. State owned banks have customarily extended soft loans to politically connected state enterprises--a practice, which has only added to public liabilities while penalizing more entrepreneurial businesses. Investment banking capacity throughout the region is very weak. The banking sector needs to be far more stringently regulated and more transparent. It is also crying for greater competition. Currently there are restrictions on cross border mergers and prohibitions on foreign own banks; this is partly driven by a fear of colonialism by other means. The policy, however, has limited the capacity of this vital sector to modernize. (Wilson) Ultimately, some combination of privatisation and lowering financial protectionism, where it exists, would be helpful.

63. Indeed, achieving rapid growth in the region will only be possible through a significant expansion of the private sector. That sector cannot play a leading role, however, without developing the means to allocate capital to those firms that have the greatest potential to assume a competitive position in the international division of labour. The private sector in the MENA region is quite small compared to most developing countries. It is hamstrung by a lack of a capital, over regulation and high tariff and non-tariff barriers. Indeed, the entry costs for new firms is daunting; complying with regulations, high taxes, Byzantine and opaque legal systems and sometimes overt favouritism for national champions reduces competitiveness throughout the region and discourages foreign investment, which normally would be an important catalyst for development. Rent seeking is rampant as a result, and private firms have no choice but to hire a coterie of experts and political insiders capable of navigating a regulatory and legal minefield.

64. The region's governments thus need to adopt comprehensive strategies to improve the business climate by easing government regulation, privatising state holdings particularly in the banking, telecommunications and service sectors, lowering tariff and non-tariff barriers to trade, upgrading judicial and legal transparency and the capacity of the state to implement law with consistency and transparency.

65. In many MENA countries, two thirds of the population is under thirty years old while Europe is ineluctably aging. This suggests a potential complementary structural demographic; yet the politics of immigration suggest that any large increase of migration to Europe from MENA is not likely to be politically acceptable. Still, both sides needs to look at how this demographic reality might be harnessed to better meet the future employment needs of both sides. Obviously improved trading and investment relations might be one vehicle for doing so. This should involve genuinely opening markets to the MENA region even in so-called sensitive products like agricultural produce. Western support for governance, financial, educational, and environmental capacity building also needs to be intensified. This assistance should be structured so as to encourage deeper regional and international cooperation.

66. Over the last decade Central and Eastern Europe have derived numerous lessons on both economic and political transition. The MENA region can learn a great deal from their experiences, even if there are important geographical, environmental and other differences. Of course, there is no single way to conduct a transition process; but there are nonetheless certain principals about what works and what does not. Initiatives to improve governance and transparency are needed and the West has a great deal of expertise in building internal and external accountability standards and control systems. Efforts to share these experiences with MENA governments, opposition groups and civil society in general should be deepened.

67. But none of this will work if political changes are not also introduced. These changes must include more democratically accountable political structures, more transparent legal and regulatory institutions, free and independent media, broader leeway for an increasingly articulated civil society, greater gender equality and improved education systems capable of endowing workers with skills appropriate for the global economy. Political repression has bred unaccountable and all pervasive state and para-state institutions that have all but strangled economic initiative. Repression has impeded broader social and economic development and left the region highly vulnerable to potential social and political explosion. Positive political change will be a critical complement to economic transition, and there is a growing push from civil society in the region for change. If the region's states do not move to accommodate these demands, the consequences could well be disastrous.

68. In this respect, aid to the region should focus on affecting this kind of transition rather than supporting the status quo. Too often Western policy in the MENA region has been rhetorically dedicated to human rights promotion but readily sacrificed those goals to pursue other interests: access to oil, short-term commercial opportunities and anti-terrorism among others. Pursuing these goals without balancing consideration for the need for regional political transition has helped entrench authoritarian governments and bred widespread cynicism in the region about Western motives. This is not to say that Western interests in anti-terrorism, arm sales and oil are illegitimate; they surely are not. But the pursuit of those goals should not hinder sustained and robust efforts to promote democratic structures, practices and dialogue in the region.

69. Western governments also need to distinguish between constitutionalism and democratic practice, on the one hand, and Western liberal democratic values or the content of politics, on the other. The former is about process and rights while the latter is concerned more with political culture. Although democratic legal orders foster conditions conducive to the emergence of democratic cultures, this is not likely to happen immediately and uniformly. The content of democracy in the MENA region should not be expected simply to mimic Western political mores. It very likely will not because of very different historical, cultural and religious contexts. Thus the West would be best to focus its regional policies on advancing democratic processes and forms, and give the region wide berth to work out the content of its own democratic existence. The West, however, can still lend support to the emergence of democratic culture by helping to provide an economic and an international legal and security framework conducive to democracy building while actively engaging in a so-called dialogue of civilizations. Resolving the Middle East conflict will provide fundamental boast to this process and it must remain a key Western priority. (Aliboni and Guazzone)

70. The US has recognised the need for regional reform. It has initiated the Broader Middle East and North Africa Initiative (BMENA) to engage the MENA and Europe in a dialogue on economic and political reform. It has also established a Middle East Partnership Initiative (MEPI) to support economic and employment growth by encouraging private sector expansion and entrepreneurship, fostering greater democratic dialogue in the political process, and improving governance and respect for the rule of law. MEPI, however, works at the margins of the political reform process by funding non-controversial educational exchanges and other initiatives acceptable to regional governments. Part of the problem is that it is operated out of the State Department and thus

bumps against those other American interests that American diplomacy is charged with advancing. In this sense, MEPI is a real contrast with the publicly funded but privately managed Asia Foundation, which is more free to advance an ambitious reform agenda. The US government might consider giving MEPI a similar status, as this would help it to differentiate its own interests and goals without having to play a balancing act that can be self-defeating. (Carothers)

71. The EU's recent European Neighbour policy allows the EU to differentiate among its Mediterranean partners to reward positive reform efforts more systematically that it has in the past. Those that move quickly toward reform will be accorded a closer relationship with the EU, gaining by extension, greater access to its markets and its lending facilities. The problem here is that some EU Mediterranean countries are somewhat leery of greater economic integration with a region that could directly compete in some areas like agriculture. There is thus a divide within the EU between those that advocate aid before trade and others that see trade as the most important means of improving the relationship with Mediterranean partners. It is also true that this relationship lacks the powerful incentives that the EU held out in its relationship with Central Europe during the transition process. The EU then was floating the possibility of accession to its Central Europe partners in the region. This provided a very powerful incentive for change. EU Accession, however, is not part of the picture for the Mediterranean dialogue countries, at least, not at this juncture. So the incentives are a bit more abstract and probably lack the attraction of those held out to the Central and Eastern European countries. If the EU is able to hold out the possibility of a genuine free trade area with the Middle East, one not riddled with caveats to protect certain sectors, the incentives for transition would accordingly be strengthened.

72. At the end of the day, however, it is the MENA countries that hold the greatest responsibility for managing transition and reform processes. Western governments should continue to advocate and support reform, but the burden of responsibility will fall on the people of the region and the governments that they must hold accountable.

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