ECONOMIC AND SOCIAL COMMISSION FOR WESTERN ASIA (ESCWA)

SURVEY OF ECONOMIC AND SOCIAL DEVELOPMENTS IN THE ESCWA REGION 2007-2008

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This edition of the Survey is dedicated to Professor Issam El Zaim, who passed away in 2007. Professor El Zaim was long associated with the Survey and provided valuable contributions and advice on a range of issues, most notably on pro-poor policies, which have proved decisive in steering the course of research.

The Survey was prepared by a core team led by Ali Kadri, composed of Yasuhisa Yamamoto, Shaun Ferguson, Fouad Ghorra, Maya Ramadan, Linda Mattar and Arpy Atamian. The Survey benefited from the comments and suggestions of participants of roundtable discussions, and in particular Mr. Alfredo Saad Filho, Mr. Ben Fine, Mr. Costas Lapavitsas, Mr. Erik S. Reinert, Mr. Fadle Naquib, Mr. George Corm, Mr. Gilbert Achcar, Mr. Gilbert Ritschard, Ms. Hind Khalifa, Husnia Al Kadri, Mr. John F. Weeks, Mr. Kamil Mahdi, Mr. Mahmoud Abdel Fadhil, Ms. Martha Mundy, Mr. Massoud Karchenas, Mr. Mohamed Dowidar, Mr. Raymond Bush, Mr. Raymond Hinnebusch, Mr. Reyad Nader Ali, Ms. Valentine Moghadam and Mr. William Tabb.

Preface

Boosted by rising oil prices, the ESCWA region continues to record high rates of economic growth for the sixth consecutive year. It also continues to record the highest rate of unemployment globally and an even higher rate of capital export. In a region that is vastly under-capitalized, the retention of capital and labour is vital for the development process. It is for this reason that the current issue of the *Survey of Economic and Social Developments in the ESCWA Region* builds on the two previous issues in addressing these pervasive topics in line with rights-based, pro-poor and employment-intensive economic strategies.

Certain distinguishing features differentiate the current oil boom from that of the 1970s. In comparison with the previous oil boom, there has been a significant rise in conspicuous consumption and rising inequality. Existing social problems were further compounded when the recent vagaries of the market, encapsulated in rising inflation and higher food prices, had a significant impact on the poorer social strata of the region. In one country at least, there were deaths related to food riots. Raising wages to a level that would keep pace with inflationary pressures would require intensive private-public coordination and the right to form and join trade unions. A recent report[*] by the International Trade Union Confederation, however, indicates that ”workers in this region still have fewer trade union rights than anywhere else in the world”. Had developments in trade unionism been autonomous and regionally coordinated, nominal wages could have kept pace with rising prices and the calamitous impact of inflation on the purchasing power of the poor would consequently have been allayed. In comparison with the previous oil boom, the quality of investment has veered more closely towards low capital output ratio activity. The regional economy has come to resemble what is commonly known as a FIRE economy (Finance, Insurance and Real Estate), with the real estate component taking the largest share. A considerable rise in capital flows has been associated with the recent oil price spike and, unlike the previous boom, a significant proportion of these flows has been private. To a lesser extent, the lingering phenomenon of capital flight has come to represent a significant share of gross domestic product (GDP). Capital flight, on its own, is symptomatic of a deep macroeconomic malaise, or a condition in which long-term risks and uncertainties blight the investment climate. Some argue that the sparsely populated oil-rich States lack absorptive capacity and that resource flight is thus justified. But only three years after the decline in oil prices in the first oil boom, per capita income fell drastically and certain States resorted to short-term borrowing from private banks at high interest rates to redress their fiscal deficits. Recently, moreover, speculative elements have accounted for a significant proportion of the oil price. If speculative pressures subside, a fall could occur again, yet this time at a higher rate. That is why the argument that resource flight is justified on the basis of lack of absorptive capacity founders on the grounds that in terms of industrial criteria, all ESCWA member countries remain in the developing or least developed category. Indeed, there is ample room for investment in industrial and increasing returns economic activity, even in the small oil-rich States. The argument that risks and uncertainties constrain investment can also be countered by appropriate insurance against economic losses due to non-economic causes. As has been repeatedly contended in previous issues of this Survey, a regional industrial project represents in itself a safety net for investors over the long term. A major change in the economic environment is therefore needed to help the region to revamp its mono-product mode of integration with the global economy and move from the existing consumption-led path of growth to a more sustainable, investment-led path. It is a formidable task, but change remains a compromise between the real and the ideal.

Notwithstanding propinquity and cultural resemblance, in economic terms, countries in the ESCWA region are heterogeneous and include oil-exporting, diversified, conflict-affected and least developed economies. Optimal policies to achieve distributive and employment-generating goals will differ between these countries. This year’s Survey examines these policy differences and the scope for maximizing regional integration in the process of delivering socially desirable goals based on regional rights-based development strategies. These strategies, which have been

[*] Annual Survey of Violations of Trade Union Rights (2007).

outlined in previous issues of this Survey, are significant for three reasons. First, they are intrinsically worthwhile, because rights-based strategies maximize the welfare impact of growth and contribute to the distribution of power, as well as wealth. In other words, they are compatible with, and conducive to, the expansion of democracy. Second, countries in the ESCWA region have significant potential to achieve rapid advances in social welfare, given their available resources (particularly in terms of raw materials, labour and savings). Third, in most countries in the region, current policies have led to suboptimal outcomes across a broad spectrum of measures of welfare. These include high levels of unemployment and the leakage of savings from the region, despite the availability of investment opportunities and the need for rapid employment generation.

Policies currently in place are based on the premise that both labour markets and capital flows should be liberalized to the maximum extent possible and that an adequate regulatory framework can ensure compatibility between these liberalized markets and flows and desirable social goals (GDP growth, macroeconomic stability and employment generation). The Survey finds that the extent to which these outcomes have been achieved remains below potential. It also notes that rent-based economies can pursue full employment strategies through distributive measures in the short term and capacity-building in employment-generating activity in the long term. It also considers appropriate regulations and a more conducive institutional framework that can accelerate the achievement of internationally mandated developmental objectives in the ESCWA region, in particular the Millennium Development Goals (MDGs).

Full employment and social policies should be fully integrated into national economic policymaking and should play a central role in the selection of development strategy for the countries in the region. The desirable outcomes associated with a rights-based development strategy for the ESCWA region can be achieved in most countries through a combination of rapid, sustainable and employment-intensive growth and the distribution of income and assets, especially if these are supported by greater regional integration. The implementation of these proposed policies will require close co-ordination between private and public sector activities and the regulation of the intersectoral and intertemporal allocation of resources by the State, through activist and growth-promoting industrial and financial policies. These concerns are not fashionable. However, as Keynes reminds us:

> If, indeed, public opinion were an unalterable thing, it would be a waste of time to discuss public affairs. And though it may be the chief business of newsmen and politicians to ascertain its momentary features, a writer ought to be concerned, rather, with what public opinion should be.[**]

This year's Survey has five chapters. The first reviews recent socio-economic developments and the second examines the state of capital flows, with particular emphasis on capital flight. The third reviews employment issues in the ESCWA region, while the fourth provides a synopsis of integrated social policies, which will be fully detailed in the forthcoming social policy report. The fifth details the nature and scope for rights-based economic strategies in the ESCWA countries, focusing on employment generation programmes for the region.

The Survey was completed while there was conflict in Lebanon, Palestine, Yemen and Iraq. The impact of conflict on development in the region as whole cannot be overestimated. The recent estimates of the human toll in Iraq are particularly shocking. A new security compact for the region is a necessary condition for the success of any development strategy. Security should be understood in three senses. First, national security, including the protection of the rights of the peoples in the region to self-determination. Second, democratic security, through the promotion of citizen rights and the institution of democratic accountability in member countries. Third, economic security, including the right to decent employment and macroeconomic stability, which should be promoted through regional regulation and economic integration. When human security represents the basic building block of this compact, these security measures will facilitate the transition to the new rights-based economic development strategy being proposed for the ESCWA region.

[**] Keynes (1922), p. 182.

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ABBREVIATIONS AND EXPLANATORY NOTES

AHDR	Arab Human Development Report
AMF	Arab Monetary Fund
b/d	Barrels per day
BIS	Bank for International Settlements
CIS	Commonwealth of Independent States
DPD	Domestic public debt
ENDP	Emirates Nationals Development Programme
ERL	Employers of last resort
EU	European Union
EU-15	The 15 Member States of the European Union as at 30 April 2004
FDI	Foreign direct investment
FTA	Free trade agreement
GCC	Gulf Cooperation Council
GDP	Gross domestic product
HDI	Human Development Index
IFI	International Financial Institution
ILO	International Labour Organization
IMF	International Monetary Fund
IMR	Infant mortality rate
IPO	Initial public offering
ITCC	Independent technology creating capacity
ITLC	Independent technology learning capacity
LDCs	Least developed countries
LNG	Liquefied natural gas
m/b/d	Million barrels per day
M&A	Mergers and acquisitions
MDEs	More diversified economies
MDGs	Millennium Development Goals
MENA	Middle East and North Africa
NEER	Nominal effective exchange rate
NGO	Non-governmental organization
OAPEC	Organization of Arab Petroleum Exporting Countries
ODA	Official development assistance
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
PPP	Purchasing power parity
PWPs	Public works programmes
QIZ	Qualified industrial zone
R&D	Research and development
REER	Real effective exchange rate
SAP	Structural adjustment programme
SOE	State-owned enterprise
UDHR	Universal Declaration of Human Rights
U5MR	Under-five mortality rate
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNDRD	United Nations Declaration on the Right to Development
WTI	West Texas Intermediate
WTO	World Trade Organization

References to dollars ($) are to United States dollars, unless otherwise stated.

I. RECENT ECONOMIC TRENDS AND DEVELOPMENTS IN THE ESCWA REGION

A. THE GLOBAL CONTEXT

1. *World economic developments in 2007*

The expansion of the world economy eased in 2007 and towards the end of that year the prospects for 2008 became significantly less certain. In terms of real gross domestic product (GDP), the world economy grew 3.7 per cent in 2007 (table 1), which is moderately lower than the increase registered in 2006. By the summer of 2007, the credit crunch in the financial markets in the United States of America and Western Europe had become apparent. Over a short period of time, this has resulted in radical changes to the risk assessments and economic behaviour of world economic actors. The complications and controversies in risk valuations embodied in securitized financial products made appropriate adjustments to the balance-sheets of affected financial institutions difficult. In developed countries, the systemic risk of financial covenants and regulations attached to complicated securitized products has created a higher degree of uncertainty in the financial sector. Despite a series of interventions by central banks in developed countries, notably the Federal Reserve System of the United States, in aggressively easing monetary policy by lowering interest rates and providing significant amounts of additional liquidity, the credit turmoil continued in developed countries. Given this weakening in the financial sector, economic actors in developed economies, particularly on the production side, have become more risk-averse.

TABLE 1. GROWTH AND INFLATION, 2005-2008

	Real GDP growth rate				Consumer inflation rate			
	2005	2006	2007	2008[a/]	2005	2006	2007	2008[a/]
ESCWA region	6.9	5.9	5.4	5.7	4.9	7.5	7.9	9.8
World	3.4	3.9	3.7	3.4	..	..	..	..
Developed economies	2.4	2.8	2.5	2.2	2.1	2.2	1.9	1.7
United States	3.1	2.9	2.2	2.0	3.4	3.2	2.7	1.8
European Union (EU-15)	1.6	2.8	2.7	2.3	2.0	2.0	2.0	2.0
Japan	1.9	2.2	2.0	1.7	(0.3)	0.2	0.0	0.7
Economies in transition	6.6	7.5	8.0	7.1	11.6	9.0	9.1	8.5
Developing economies	6.5	7.0	7.0	6.5	5.1	5.0	5.6	5.4
Africa	5.2	5.7	5.8	6.2	5.8	6.0	6.2	5.4
East and South Asia	7.5	8.1	8.1	7.5	4.2	4.3	5.5	4.9
Western Asia[b/]	6.5	4.6	5.7	5.2	4.5	6.0	5.1	5.8
Latin America and the Caribbean	4.7	5.7	5.3	4.7	6.6	5.7	5.6	6.3

Sources: Figures for the ESCWA region are ESCWA staff calculations (see table 5 for details). Other figures are from the United Nations Department of Economic and Social Affairs *World Economic Situation and Prospects 2008*.

Notes: Parentheses ( ) indicate negative numbers.
Two dots (..) indicate that data are not available.

a/ The figures in those columns are forecasts.

b/ This regional classification of Western Asia includes two neighbouring countries of the ESCWA region, namely, Israel and Turkey, and does not include Egypt.

As of early 2008, the current credit crunch has been limited to developed countries, particularly the United States, and has not yet become a worldwide phenomenon. Developing countries in general, including ESCWA member countries, have not faced severe shortages in monetary liquidity. Indeed, in 2007, global liquidity continued to grow, due to the monetary easing of the United States and rapidly accumulating foreign reserves in developing countries. The international flow of funds continued to be directed to support the global imbalance which is represented by the substantial current account deficit of the United States. Demand for US treasury bonds and bills remained strong as investors became more risk-sensitive. Moreover, the simple structure of financial obligations of developing countries, such as straight bonds and equities, attracted more investors as the perceived risk on more complicated mortgage-backed financial products surged. In contrast to the credit crunch in major developed economies, the shift in attitudes to the risk of financial products was in favour of developing countries, which maintained a high domestic demand growth in parallel with a rapid credit expansion in most of the developing countries. The developed economies registered 2.5 per cent of real GDP growth in 2007, while developing economies grew by 7.0 per cent in the same period (table 1).

Meanwhile, inflationary pressure grew rapidly during 2007 as commodity prices surged across the board, including crude oil, precious metal and food crops. Developing countries faced rapid and severe inflation, more as a result of international than domestic factors. The consumer inflation rate is on average significantly higher in developing economies than in developed economies. In 2007, the consumer inflation rate was 1.9 per cent on average in the developed economies; yet reached 5.6 per cent in the developing economies over the same period (table 1).

Given the challenges for countries in meeting the Millennium Development Goals (MDGs), the current trend of economic growth is of extreme concern to policymakers around the world. To date, the pattern has not been in favour of the poorer segments of global society. Despite the consistently positive growth in GDP since 2002, the employment situation has not improved at a similar rate (table 2). As the current cycle has been caused by rapid growth in monetary liquidity and a surge in commodity prices, the slump in employment creation and the continuing adverse employment conditions imply a skewed income distribution, benefiting non-labour income. In other words, the current pattern of economic growth has not been benefiting labour. This situation has most severely affected the poor segment of society, given its greater reliance on labour income than non-labour income. Moreover, the purchasing power of the poor has been eroded by rapid inflation, particularly in developing economies.

TABLE 2. WORLD UNEMPLOYMENT RATES, 2006-2007

	Change in unemployment rate 2002-2007 (*percentage*)	Unemployment rate (*percentage*) 2006	Unemployment rate (*percentage*) 2007	Annual labour force growth rate 1997-2007 (*percentage*)
World	(0.5)	6.0	6.0	1.7
Developed economies and European Union	(0.9)	6.3	6.4	0.7
Central and Eastern Europe (non-EU) and Commonwealth of Independent States	(1.3)	8.5	8.5	0.6
East Asia	(0.4)	3.4	3.3	1.0
South-East Asia and the Pacific	0.1	6.2	6.2	2.5
South Asia	0.1	5.1	5.1	2.4
Latin America and the Caribbean	(0.4)	8.5	8.5	2.4
Middle East	(1.1)	11.8	11.8	4.9
North Africa	(2.9)	11.0	10.9	3.3
Sub-Saharan Africa	(0.8)	8.2	8.2	3.0

Source: International Labour Office, *Global Employment Trends*, table 3: Labour market indicators, world and regions, January 2008.

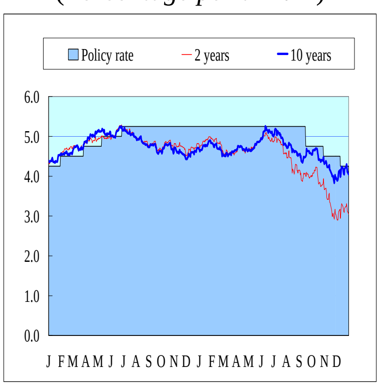
Note: Parentheses ( ) indicate negative numbers.

The economy of the United States has been slowing down and is estimated to have grown just 2.2 per cent in 2007. The Federal Reserve Board reversed its monetary stance in the wake of the credit crunch and has lowered the benchmark policy interest rate, the federal fund target rate, since September 2007 (figure I-A). The federal fund target rate has subsequently been cut aggressively in parallel with other measures to supply sufficient monetary liquidity to the financial sector. This policy change indicates the shift in the priorities of the monetary authority of the United States from an anti-inflation position to an anti-recession stance. However, this policy shift will take several quarters to be sufficiently effective to lift domestic demand, and the effect of the monetary easing to date has been absorbed into the financial sector for balance sheet adjustments. The fiscal stance has also been changed to sustain the domestic demand level, but this fiscal stimulus has yet to improve the business and consumer confidence associated with the uncertainty in the financial and housing sectors. Faced with weakening domestic demand, the economy of the United States has become more dependent on external demand to sustain growth levels. The price-competitiveness of exports has been strengthened as a result of the weakness of the US dollar against other major currencies. Current account deficits have therefore marginally narrowed from US$ 811 billion in 2006 to US$ 738 billion in 2007. In terms of the investment-savings gap, net savings continued to be negative in both private and Government sectors in 2007. In the Government sector, this gap increased, while in the private sector, a moderate decrease was registered, reflecting the active fiscal stance taken by the United States. The widening yields between 2-year and 10-year Treasury Bonds (figure I-A) point towards future inflation. This gap could also indicate that the cost of borrowing has not been lowered sufficiently to stimulate domestic demand. The risk of higher inflation and lower growth is high for the United States when monetary policy is directed to support the financial sector in the credit crunch. Weak domestic demand may correct the external imbalance, but a significant improvement in the current account position is not expected, as the active fiscal stance will result in a wider investment-savings gap in the Government sector. Although exports from the United States are expected to increase in 2008, the economy will still depend on active capital inflows from overseas to fill the external imbalances. However, as the rapid increase in commodity prices and the worldwide rise in price levels continue, capital inflows to the United States are unlikely to maintain the levels seen in previous years. The general prospects of the economy are, therefore, weak. The United States economy is expected to grow at 2.0 per cent in 2008, with the possibility that this forecast may be significantly adjusted downwards.

Figure I. Interest rates of major world currencies, 2006-2007

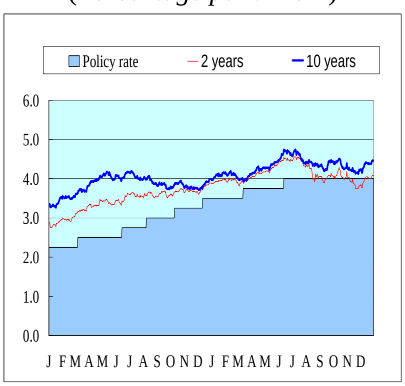
I-A. US dollars

(*Percentage per annum*)



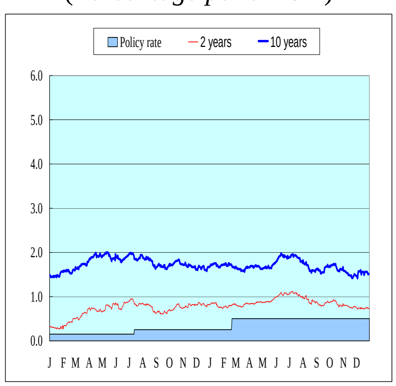
I-B. Euro

(*Percentage per annum*)



I-C. Japanese yen

(*Percentage per annum*)



Sources: For US dollars: Board of Governors of the Federal Reserve System, http://www.federalreserve.gov; for euro: Deutsche Bundesbank, http://www.bundesbank.de; for Japanese yen: Bank of Japan, http://www.boj.or.jp.

Figure II. Foreign exchange rates of major world currencies, 2006-2007

II-A. US dollar/euro **II-B. Japanese yen/US dollar** **II-C. Chinese yuan/US dollar**

Source: Board of Governors of the Federal Reserve System, http://www.federalreserve.gov.

The resilient economic performance of European Union countries continued in 2007, as demonstrated by the strong economic rebound of France and Germany. The real GDP growth of the western part of the European Union is estimated to be 2.7 per cent in 2007, slightly lower than the 2.8 per cent of the previous year. The current upward economic cycle is characterized by robust growth in domestic demand, both in physical investment and private consumption. Moreover, despite the appreciation of the euro (figure II-A), the steady growth in external demand contributed to sustaining economic performance. Even this region, however, could not escape the credit crunch stemming from the United States, as major European banks were also involved in mortgage-based financial products. The housing market, particularly in the United Kingdom, has shown signs of cooling down. Moreover, rising price levels, mainly of commodities, have weakened the expectation of future economic activities. Both the European Central Bank and the Bank of England have been cautious in the face of rising inflationary pressures and maintained a tightening stance on their monetary policies during the first half of 2007. The European Central Bank raised its rate in March and June (figure I-B), while the Bank of England raised its policy rate in January, June and July. However, as the credit crunch appeared to increase the systemic risk of the financial markets, both monetary authorities changed their priorities towards the end of the year. The European Central Bank suspended its anticipated interest rate increases and the Bank of England lowered its policy rate in December. The monetary authorities in the European Union region are expected to face continuing policy dilemmas in the need to alleviate inflationary pressures and sustain domestic demand. However, as consumer and business confidence indicated that the current upward economic cycle peaked in the middle of 2007, the monetary stance is expected to lean toward easing, to support the growth of domestic demand. The economies of the EU-15 are, on average, projected to grow by 2.3 per cent in 2008.

The recovery of the Japanese economy slowed in 2007, with a real GDP growth rate of 2.0 per cent. Weak levels of physical investment and housing construction were observed, while private consumption showed signs of recovery. Export growth continued to take advantage of the weaker Japanese yen (figure II-B) until the first half of 2007. Although the price competitiveness of Japanese exports was receding in parallel with the appreciation of the yen towards the end of the year, external demand remained a pivotal factor in sustaining the growth of the Japanese economy. Despite the fact that the current credit crunch has not affected the Japanese economy to the extent of other developed economies, it is not expected to be clear of deflationary pressures, due to its fragile domestic demand structure. The Bank of Japan raised its policy rate in February 2007 (figure I-C), but nominal interest rates remained extremely low compared with other major economies. The prospect for 2008 is dependent on the economic performance of its major export destinations. While weak demand is expected from the United States, a steady growth in demand from other destinations, such as China, is anticipated. The Japanese economy is expected to grow at 1.7 per cent in 2008.

The rapid growth of domestic demand, a sign of overheating, continued in the economies in transition, which include south-eastern European economies and the Commonwealth of Independent States (CIS). Capital inflows to the region, represented by active foreign direct investment, continued, and the high price of commodities accelerated the growth of resource-exporting economies in the region. This region registered 8.0 per cent real GDP growth in 2007, while the consumer inflation rate registered 9.1 per cent in the same period. With the exception of the Russian Federation, significant levels of current account deficits have commonly been observed in the economies of this region. Despite efforts by the monetary authorities to neutralize the effect of foreign capital inflows and the high level of monetary liquidity, the over-stretching demand expansion has shown its weaker side in the wake of the current credit crunch. It is expected that the economies in transition will start to slow down in 2008, with a growth rate of 7.1 per cent anticipated in 2008.

African economies registered a GDP growth rate of 5.8 per cent in 2007. High commodity prices continued to buoy export earnings for commodity-exporting countries, in particular those exporting crude oil and precious metals. Despite the credit crunch in the developed economies, foreign capital has continued to flow into the region. The growth of domestic demand has been sustained without foreign exchange ceilings in most countries. Improving the investment environment has attracted FDI into the region, with an increase in intraregional investment. While a steady economic diversification has been observed, constraints on economic growth have remained in the supply capacity in both private and public arenas. An active fiscal policy, supported by a significant increase in official development aid, has been urged to resolve the supply bottleneck and achieve the MDGs. Despite these challenges, the region is forecast to grow at 6.2 per cent in 2008.

The robust economic growth in East and South Asia continued with average real GDP growth at 8.1 per cent in 2007. A pattern of intraregional complementary relations has been continuously observed, while strong domestic demand growth in the Chinese and East Asian economies pulled export growth of the South East Asian economies. On the other hand, appreciation of national currencies against the US dollar, including the Chinese yuan (figure II-C) has negatively affected the price competitiveness of exports to the United States. However, expanding regional demand and increasing intraregional trade have levelled up the economic performance of most economies in the region. Moreover, the rapid growth of the South Asian economies, represented by that of India, has also contributed to the robust growth in the region. Increasing purchasing power contributed both to the rapid development of the services sector and to industrial development in the region. As most of the economies in the region are net importers of fuel, food and other commodities, inflationary pressure accelerated in 2007, although rates of consumer inflation have varied between economies. While inflation has been accelerating in China and India, it has remained within a range that can be controlled through a careful demand management. However, in certain economies, such as that of Viet Nam, signs of hyperinflation have started to emerge. As has been the case in other developing economies, the region was not affected by the credit crunch in the developed economies, but uncertainty regarding future levels of world liquidity has increasingly placed some economies with a weak external balance in a vulnerable position. Moreover, the current pattern of growth has been drawing rural labour to the urban sector and this unbalanced pattern of growth, acting to the detriment of rural development, has led to weak growth in the agricultural sector in the region. East and South Asia is projected to grow at 8.1 per cent in 2008.

The economies of Latin America and the Caribbean continued to improve their external balance and investment environment in 2007. High commodity prices led to growth in exports of crude oil and agricultural goods. Real GDP in the region grew at 5.3 per cent in 2007, compared to 5.7 per cent the previous year. Despite the credit crunch in the developed economies, the inflows of capital continued through active FDI. The economies in this region, in particular Argentina, Brazil, Chile, Mexico and Peru, have regained economic resilience through a strong domestic demand base. As in other developing economies, inflationary pressures have been mounting in this region, both from rising commodity prices and rapid expansion of domestic demand. These pressures have translated into actual consumer inflation to a greater extent in economies with lower domestic supply capacity. The ongoing uncertainties of the credit crunch in the developed economies have increased the vulnerability of economies that face high inflation and a weak external balance. However, the general economic sentiment in the region remains strong and the region is expected to grow at 4.7 per cent in 2008.

2. *Implications for the ESCWA region*

Set against this global context, the ESCWA region[1] showed its resilience in economic expansion, with the sole exception of Palestine, where regional conflicts and hostilities had a devastating economic effect. Given growing oil revenues, accumulating foreign assets and the associated robust expectations of regional business and consumers, particularly in the countries of the Gulf Cooperation Council (GCC), the financial sector in the region has been able to provide ample monetary liquidity. This resulted in a robust growth in domestic demand, particularly in terms of conspicuous consumption, in ESCWA member countries in 2007, with the exception of Palestine.

Despite the credit crunch in the developed economies, external factors favourable to the ESCWA region remained intact in 2007. Commodity and energy prices, including oil and oil-related products, remained high and the growth of global monetary liquidity accelerated in 2007. Figure III-A shows the movement in the averaged crude oil price[2] and the growth in global monetary liquidity in terms of the total of the US monetary base and foreign exchange reserves held by central banks around the world. The shift in the stance of monetary authorities in the developed economies has accelerated the level of global liquidity growth. Moreover, the relative lack of sovereign risk in developing economies, compared with existing systemic risk of financial sectors in developed economies, brought additional inflows of capital into the developing economies in the second half of 2007. The direct income effect on oil-exporting countries in the ESCWA region, combined with ample monetary liquidity, continued to support the expansion of domestic demand across the region, including that of non oil-exporting countries.

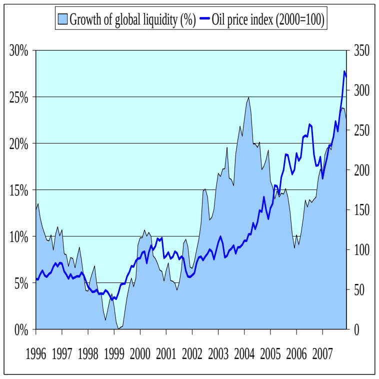
Figure III-B shows annual incremental change in stock market capitalization, current account surplus and gross oil export revenue in the ESCWA region in total. Stock market capitalization in 2007 recovered to the 2005 level and the incremental change was at the same level as oil export revenue. Considering the downward adjustment in 2006 following the extreme increase in stock market capitalization in 2005, this may imply that the growth in stock market capitalization has been in line with oil export revenues. However, figure III-B indicates that ample oil revenue alone does not explain the current economic boom in oil-exporting ESCWA member countries. The rapid growth in stock market capitalization alone has been equivalent to the gross crude oil export revenue. Considering the significant increase in total current account surplus and active investment abroad, the extent of economic activities has exceeded crude oil revenues. The expansion in domestic demand, which, being based on conspicuous consumption, has played a crucial part in the current economic boom in the ESCWA region and the regional economy has clearly been leveraged upon crude oil revenues.

[1] The ESCWA region comprises two subregions: GCC countries and non-GCC countries. GCC countries are members of the Gulf Cooperation Council (GCC): Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates. Non-GCC member countries in the ESCWA region are henceforth defined as more diversified economies (MDEs) and include Egypt, Iraq, Jordan, Lebanon, Palestine, the Syrian Arab Republic and Yemen.

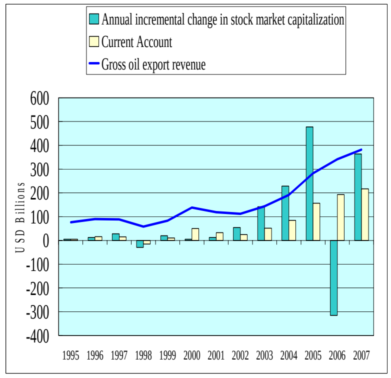
[2] The average of representative brands of crude oil. See *International Financial Statistics*, IMF.

Figure III. Implications for the ESCWA region

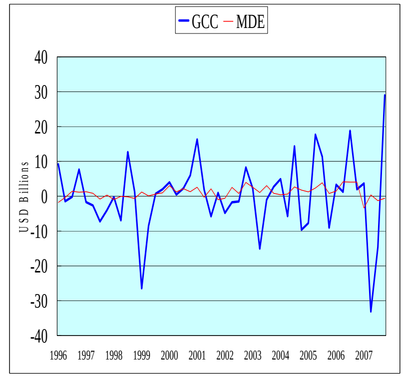
III-A. Global liquidity growth and crude oil prices 1996-2007



III-B. Oil export revenue, stock market capitalization growth and the current account surplus



III-C. Bank deposit flows



Sources: III-A. International Monetary Fund, *International Financial Statistics.*

III-B. Stock market capitalization: Arab Monetary Fund; gross oil export revenue and total current account calculations: ESCWA.

III-C. Bank for International Settlements.

Figure III-C shows the change in the net deposit levels (deposit minus lending) of the reporting banks for the Bank for International Settlements (BIS). Those reporting banks are major world banks with international lending and deposit portfolios. A large fluctuation in bank deposit flows in and out of the GCC countries is seen, while in the more diversified economies (MDEs) a general low-level inflow to the net deposit was observed until 2006. Although bank deposits represent a fraction of international capital flows, this trend implies active financial transactions in GCC countries. While GCC countries have been active investors in overseas assets, they have also been an investment destination for foreign investors. The MDEs, meanwhile, have become more dependent on foreign borrowing, while remaining an investment destination for foreign investors.

Among external factors, the principal foreseeable risk facing the ESCWA region is the rapidly rising price of non-oil commodities. ESCWA member countries are net importers of food, precious metals and other materials. The high requirement of imported goods for domestic economies has created a structure that is sensitive to import-led inflation. Moreover, as the economy of the region is significantly leveraged, the management of monetary liquidity will continue to play an important role. Despite the fact that the region has so far been immune to the current credit crunch, the situation is likely to change if the price of crude oil drops sufficiently to change the present overly strong sentiment. The regional economy has already developed more than the size of its crude oil revenues, but it still depends on them as a source of monetary liquidity and credit expansion. In this sense, oil sector development is crucial to predict the prospects of the economies of the ESCWA region.

B. OIL SECTOR DEVELOPMENT

1. *World demand and supply*

The world demand for crude oil continued to grow in 2007, albeit at a more moderate rate than in 2006. According to statistics from the Organization of the Petroleum Exporting Countries (OPEC),[3] total world demand for 2007 averaged 85.8 million barrels per day (m/b/d), increased from 84.6 m/b/d in 2006. In 2006, global demand for crude oil was led by

[3] OPEC Monthly Oil Market Report, March 2008.

developing countries, notably China. The energy requirements necessary to sustain high economic growth led to an increase in demand for crude oil in developing countries. Although demand from North America showed a modest recovery, demand for crude oil in developed countries has been on a declining trend since 2005 and the projected rebound in demand from developed countries was successively revised downwards in the course of 2007. The continuing high prices of fuel products have led a further shift in developed countries towards energy-saving technologies and such other energy sources as natural gas and ethanol. World demand for crude oil is thus expected to be led by developing countries in 2008.

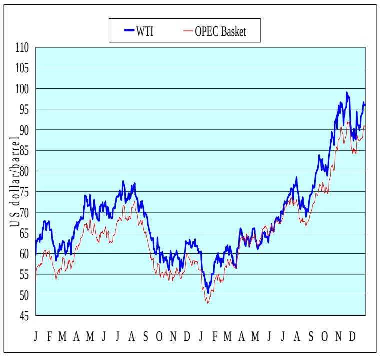
Total world crude oil supply increased to 84.8 m/b/d in 2007, up from 84.4 m/b/d the previous year. This increase can be attributed to the production of non-OPEC oil producers, as the reduced OPEC production quota target has resulted in a continuing decline in crude oil production by OPEC member countries. After a further cut in the production quota target to 25.8 m/b/d in February, OPEC raised the target to 27.25 m/b/d from November 2007. However, this target level is still lower than that of 2005-2006. Total OPEC crude oil production in 2007 is estimated at 31.0 m/b/d, a moderate decline from 31.4 m/b/d the previous year.

The crude oil price surged throughout 2007 (figure IV-A). The yearly average Western Texas Intermediate (WTI) spot price was US$ 72.34 per barrel in 2007, compared with US$ 66.05 the previous year. The crude oil price in the OPEC Reference Basket averaged US$ 69.08 per barrel in 2007, compared with US$ 61.08 the previous year. It marked its yearly low at US$ 47.92 per barrel on 17 January and reached its yearly high at US$ 90.84 on 28 December.[4] Many observers saw the tight supply conditions as the fundamental reason for the high prices of crude oil. On the demand side, there has been rapidly growing energy demand from developing countries, particularly China and India. Alternative energy sources have been elaborated, but are not expected to replace crude oil in the near future. On the supply side, the risk of disruption from geopolitical factors in Africa and the Middle East persisted. Moreover, the slow development of supply capacity, in both exploration and refining stages, continues to cast uncertainty over the long-term supply capacity of crude oil and fuel products. However, many observers have interpreted this surge in the price of crude oil as a result of financial speculation, rather than a fair assessment of the supply-demand conditions. In fact, supply capacity, particularly at the refinery stage, has become the supply bottleneck of fuel products. As a result of investment over the last two decades, worldwide refining capacity has not been increased to meet increasing demand. However, if this interpretation were to explain the surge in crude oil prices, the price of the representative fuel product, gasoline, should be following a similar trend to that of crude oil. Yet figure IV-B shows that the price of crude oil, represented by the WTI spot price, continued to surge in 2007, while the price of gasoline declined from its peak in May until September. This break in the parallel between the prices of gasoline and crude oil is one indication that the price surge of crude oil, particularly after May 2007, does not reflect actual supply-demand conditions, due to the lack of refining capacity. Moreover, given ample global monetary liquidity (figure III-A) and the rising risk of securitization-based financial assets, crude oil futures, together with other commodity futures, have become an attractive class of financial assets. Data from the United States Commodity Futures Trading Commission (non-commercial participants in US futures markets, mainly comprising investment funds and banks) show that non-commercials remained “long” in their net position on crude oil futures and options markets (figure IV-C) throughout 2007. Moreover, with the exception of a significant dip in late August, the “long” position level has been surging.

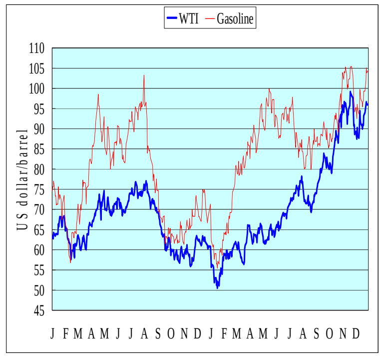
[4] The OPEC Reference Basket price marked a historic high at over US$ 100 per barrel in the first half of 2008.

Figure IV. Oil sector development

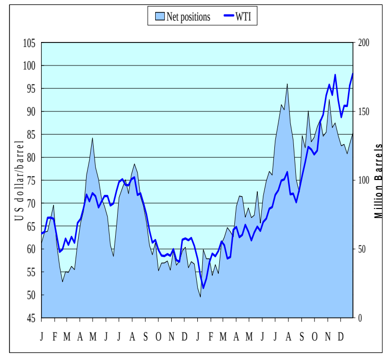
IV-A. Oil prices: WTI and OPEC Basket



IV-B. WTI crude price and gasoline price



IV-C. Non-commercials net long position and WTI



Sources: IV-A. US Energy Information Administration and OPEC.

IV-B. ESCWA staff calculation based on US Energy Information Administration data.

IV-C. US Energy Information Administration and US Commodity Futures Trading Commission.

Financial speculation through crude oil futures has played a significant part in the price surge of crude oil in 2007. However, tight supply-demand conditions also exist. Predicting crude oil prices is difficult at present, as the 'justifiable' price range varies, depending on the view taken of global oil sector development. In March 2007, the OPEC Reference Basket price was projected at an average of US$ 75 per barrel in 2008. That projection was based on the following factors: (a) a solid expectation of high crude oil prices, given robust demand growth from developing countries; (b) continuing growth in global monetary liquidity and financial speculation in crude oil futures; (c) significant effect from the crude oil futures and options market, which will continue to be sensitive to geopolitical developments in the Middle East and Africa; and (d) a risk that the credit crunch may spread to crude oil futures, potentially leading to a corresponding plunge in prices.

2. *Oil sector development in the ESCWA region*

Total crude oil production in ESCWA member countries is estimated to have declined again in 2007, following a slight decrease in the previous year (table 3). Total production is estimated at 18.7 m/b/d in 2007, a 3.0 per cent decline from 2006 levels. Among OPEC member countries in the region (Iraq, Kuwait, Qatar, Saudi Arabia and the United Arab Emirates) and non-OPEC oil-exporting countries (Bahrain, Egypt, Oman, the Syrian Arab Republic and Yemen), only in Iraq and Egypt is crude oil production estimated to have expanded in 2007. With its flexible supply capacity, crude oil production in Saudi Arabia in 2006 was 8.6 m/b/d, a decline of 5.1 per cent on the previous year. Other OPEC member countries in the region registered more moderate decreases in annual crude oil production in 2007, with the exception of Iraq, where crude oil production increased by 8.1 per cent. The annual production figures are 2.46 m/b/d for Kuwait, 0.8 m/b/d for Qatar and 2.5 m/b/d for the United Arab Emirates. Non-OPEC member oil-exporting countries in the ESCWA region have seen a continuous decline in crude oil production, with the exception of Egypt, where output levels have been increasing. Yemen experienced a significant decline in crude oil production in 2007, continuing a trend that was caused by low-level investment in exploration and production activities in the 1990s. Although new investment projects in exploration and production are underway, the additional production capacity thus created will not be effective until 2010. In 2008, production of crude oil in the ESCWA region is expected to be reduced by 2.3 per cent. This projection takes into account two factors: firstly, the reluctance of OPEC to raise production quotas and the commitment of its member countries to those quotas; and secondly, the fact that non-OPEC member countries, with the exception of

Egypt and Iraq, are projected to maintain a long-term trend of declining production.

Given their active investment in the sector, increasing levels of crude oil production are expected in Egypt and Iraq, and despite the ongoing security concerns, Iraq is expected to restore a stable crude oil supply at pre-war levels.

TABLE 3. OIL PRODUCTION IN THE ESCWA REGION, 2003-2008
(*Thousands of barrels per day*)

							Percentage change	
Country	2003	2004	2005	2006	2007[a/]	2008[b/]	2006/7	2007/8
Bahrain	240	209	187	185	180	160	(2.7)	(11.1)
Kuwait	2 108	2 289	2 573	2 520	2 465	2 300	(2.2)	(6.7)
Oman	819	780	774	738	710	700	(3.7)	(1.5)
Qatar	676	755	766	821	807	700	(1.7)	(13.3)
Saudi Arabia	8 410	8 897	9 353	9 112	8 651	8 500	(5.1)	(1.7)
United Arab Emirates	2 248	2 344	2 378	2 540	2 504	2 350	(1.4)	(6.2)
Total, GCC countries	14 501	15 273	16 031	15 916	15 317	14 710	(3.8)	(4.0)
Egypt	750	709	579	639	650	750	1.7	10.8
Iraq	1 378	2 107	1 853	1 932	2 089	2 200	8.1	5.3
Syrian Arab Republic	621	457	435	408	380	360	(6.8)	(5.3)
Yemen	478	450	453	396	308	300	(22.3)	(2.6)
Total, MDEs	3 226	3 724	3 321	3 375	3 427	3 610	1.5	5.3
Total, ESCWA region	17 727	18 997	19 352	19 291	18 744	18 320	(3.0)	(2.3)

Sources: OPEC for OPEC member country data (Iraq, Kuwait, Qatar, Saudi Arabia and the United Arab Emirates); Organization of Arab Petroleum Exporting Countries (OAPEC) for Egypt; national sources for other countries.

Note: Parentheses ( ) indicate negative numbers.

a/ For OPEC member countries: OPEC Monthly Market Report, February 2008; for Oman: Ministry of National Economy; for other countries: ESCWA estimates, based on official and other sources as at February 2008.

b/ ESCWA forecasts as at February 2008.

Total gross oil export revenues in the ESCWA region are estimated at US$ 431.1 billion, an increase of 12.9 per cent on 2006 (table 4). The decline in production was more than compensated by the rise in oil prices and, as a result, oil revenues in the region grew considerably. In the GCC countries, oil revenue growth varied between 10.9 and 12.9 per cent, due to the concerted adjustment in crude oil production. The growth in oil export revenue of the MDEs also varied, due to changing production levels, and Yemen registered a negative growth in oil export revenue, due to significant decreases in production. Projections for 2008 have been based on the expected OPEC Reference Basket price of US$ 75 per barrel (yearly average). All oil-exporting ESCWA member countries, with the exception of Egypt and Iraq, are expected to experience a decline in their gross oil export revenues in the coming year, which are expected to amount to US$ 364.7 billion in 2008.

The income effect from increasing oil revenues benefited oil-exporting ESCWA member countries significantly in 2007, with the exception of Yemen, where gross oil export revenues returned negative growth. The main beneficiaries of the income effect were Governments, as the development of the oil sector resulted in another year of considerable fiscal contribution from oil revenues. The fiscal surplus of the GCC countries continued to grow and improvements to the fiscal balance were achieved in other oil-exporting ESCWA member countries.

However, the effect of the current oil boom has been seen as a core thrust in expanding leverage in the economies in the region. This became clear in 2007, in parallel with a rapid expansion of the money supply, private credit and domestic demand in the GCC countries. The leverage in an economy may be seen as a positive sign, as it indicates that the economy has diversified in such areas as finance, services, construction and commerce. Appropriate leverage contributes to stabilizing domestic demand growth by creating a buffer between fluctuating oil sector development and the domestic economy. Nevertheless, the extent of leverage may be a problem, as it could potentially lead to a financial bubble. However, it is difficult to evaluate the current situation and to assess whether there is a financial bubble in the ESCWA region. The continuing boom in construction and real estate, particularly in the GCC countries, does not constitute an indication of a financial bubble, as it may be a sign of economic transformation directed by economic diversification strategies. For policymakers in the region, it is crucial to bear in mind that the economy of the region is leveraged by strong prospects in oil revenues, rapid growth of domestic demand, ample monetary liquidity, relatively easy credit and the economic diversification and liberalization strategies pursued by Governments. Among those factors that support the leveraged economy, several, including monetary liquidity and credit, are based on expectation rather than actual economic activity, and business and consumer expectation thus plays a crucial role in the current relationship between oil and economic performance.

TABLE 4. GROSS OIL EXPORT REVENUES IN THE ESCWA REGION, 2003-2008
(*Billions of US dollars*)

							Percentage change	
Oil exporting countries	2003	2004	2005	2006	2007[a/]	2008[b/]	2006/7	2007/8
Bahrain	4.9	5.6	7.8	9.2	10.8	9.5	17.1	(12.2)
Kuwait	19.8	27.7	44.1	55.7	61.7	57.2	10.9	(7.4)
Oman	7.9	9.2	13.4	14.5	15.1	14.9	4.3	(1.6)
Qatar[c/]	6.7	8.5	12.8	16.0	18.0	15.4	12.9	(14.6)
Saudi Arabia	82.0	110.4	161.1	187.7	211.1	207.1	12.5	(1.9)
United Arab Emirates	22.1	29.6	43.5	58.1	65.1	60.7	12.1	(6.8)
Total, GCC countries	143.5	191.1	282.7	341.1	381.9	364.7	12.0	(4.5)
Egypt	3.5	4.7	7.5	10.5	11.1	12.9	5.0	16.9
Iraq	8.3	17.5	23.2	29.7	39.8	42.1	34.0	5.8
Syrian Arab Republic	4.4	3.7	4.1	4.2	4.5	4.2	7.1	(5.8)
Yemen	3.5	4.3	6.0	6.7	4.9	4.8	(27.3)	(2.8)
Total, MDEs	16.2	25.5	33.3	40.6	49.2	51.1	21.1	3.9
Total, ESCWA region	159.7	216.5	316.0	381.7	431.1	415.8	12.9	(3.5)

Source: Balance of payments data from national sources.

Note: Parentheses ( ) indicate negative numbers.

a/ ESCWA estimates, based on official and other sources as at February 2008.

b/ ESCWA forecasts as at February 2008.

c/ Qatar has experienced substantial increases in non-crude oil exports, principally liquefied natural gas (LNG), which are not accounted for in these figures.

Taking advantage of the low exploration costs of crude oil, oil sector development in the region has expanded to include “downstream” areas. However, expansion into the refining sector has been relatively slow, although a number of large-scale projects are being planned. The difficulty in the downstream areas of the oil sector, such as refining, is that in the current boom conditions, profit margins are much smaller than those in exploration or production. The unsettled price structure of crude oil and refined fuel products also poses an obstacle for expansion into downstream areas. However, the petrochemical industry in the region, particularly in Saudi Arabia, has marked out a significant global presence as a major competitor against low-cost producers, such as China. As the region has a competitive edge over the rest of the world, thanks to its natural endowments, the development of its petrochemical industry is expected to continue. The current trend of high crude oil prices has pushed more oil-importing countries to diversify their energy policy, and such diversification has also been visible in the oil-exporting countries of the ESCWA region, particularly in natural gas. In a significant development, Qatar has become the world's largest exporter of liquefied natural gas (LNG). Natural gas production in Egypt led to a further growth in its exports to Jordan and in 2008 it also started exporting gas by pipeline to the Syrian Arab Republic and Lebanon. LNG exports from Oman continued to increase and Yemen is expected to start exporting LNG by 2010.

C. Output and demand

Real GDP growth for 2007, averaged across ESCWA member countries, is estimated to be 5.4 per cent, compared with 5.9 per cent in 2006 and 5.6 per cent forecast for 2008 (table 5). A steady expansion of domestic demand, led by affluent consumption, continued throughout the region, with the sole exception of Palestine. High oil prices, associated oil revenue forecasts and strong wealth effects buoyed business and consumer confidence, which have not yet been dented in the current oil boom cycle. Meanwhile, supply constraints have become apparent, particularly of basic commodities such as food staples, since the region depends heavily on food imports.

The subregion of the GCC countries is estimated to have had an average 5.2 per cent growth in GDP in 2007, having registered 6.1 per cent growth in 2006. Despite the continuing dependence of the subregion on the oil sector, the non-oil sector appears to have established a solid foundation in construction, finance and business services. Moreover, the contribution of industrial development to output has increased in significance in such sectors as aluminium, steel and petrochemical. Domestic demand expansion has accelerated to such an extent that it has become a major source of home-grown inflation in the real estate and equity markets. While development of the non-oil sector in the GCC countries has boosted less inflationary economic growth in the current oil boom, the high price of crude oil and an increasing growth in regional monetary liquidity are expected to bring about accelerated growth in the subregional economy, forecast to average to 5.6 per cent in 2008.

Strong, investment-led growth in Bahrain resulted in real GDP growth estimated at 6.3 per cent in 2007 and forecast at 6.5 per cent for 2008. Supply capacity in the non-oil sector has seen steady growth in aluminium and petrochemicals. Investment is projected to increase its share in domestic demand consistently through projects on infrastructure, construction, and the service sector, including tourism. However, if the credit crunch were to intensify, this would not be the case. The economy of Kuwait decelerated slightly to 6.0 per cent in 2007, having been on a stable growth path following an extraordinary expansion in the three years to 2005. Following the trend set by Bahrain and Qatar, domestic demand has steadily been replacing external demand to drive economic growth in Kuwait. This pattern of demand composition indicates the existence of wider linkage channels, in which leverage from oil revenues lifts domestic demand. The development of the financial, construction and business services sectors can be seen as such linkage channels. Investment is consistently increasing, which provides the economy of Kuwait with resilience and its real GDP growth rate is projected at 6.2 per cent in 2008.

Oman experienced a deceleration in its GDP growth rate from 7.2 per cent in 2006 to 5.5 per cent in 2007. The decline in crude oil production, combined with modest growth in the LNG sector, has made its economy more dependent on domestic demand, and this has been represented by growth in the service and tourism sectors. Although a healthy external trade balance ensures a stable expansion of domestic demand, the economy has become increasingly sensitive to such external factors as rising import price levels. As a result, real GDP growth in Oman is projected to decline to 5.0 per cent in 2008, down from 5.5 per cent in 2007 and 7.2 per cent in 2006. Qatar has experienced strong, investment-led growth in the energy-related sector, infrastructure, construction and business services and the strong external demand for the country's expanding capacity in LNG and crude oil exports is expected to continue. The steep expansion in domestic demand has resulted in extraordinarily high nominal growth in GDP, comprising high real GDP growth and high inflation. Real GDP growth in Qatar is estimated at 8.2 per cent in 2007 and forecast at 9.7 per cent in 2008.

TABLE 5. GROWTH AND INFLATION IN THE ESCWA REGION

	Real GDP growth[a/] (*Annual percentage change*)					Consumer inflation rate[a/] (*Annual percentage change*)				
Country/Area	2004	2005	2006	2007[b/]	2008[c/]	2004	2005	2006	2007[b/]	2008[c/]
Bahrain	5.6	7.9	6.5	6.3	6.5	2.3	2.6	2.1	3.3	5.2
Kuwait	10.8	11.7	6.6	6.0	6.2	1.3	4.1	3.0	5.3	6.5
Oman	5.4	6.0	7.2	5.5	5.0	1.1	1.9	3.4	5.9	7.0
Qatar	20.8	6.1	7.0	8.2	9.7	6.8	8.8	11.8	13.7	12.5
Saudi Arabia	5.3	6.1	4.3	3.5	4.1	0.3	0.7	2.2	4.1	6.0
United Arab Emirates	9.7	8.2	9.3	7.4	7.5	5.0	6.2	9.3	11.0	10.5
Total, GCC countries	7.7	7.3	6.1	5.2	5.6	1.8	2.7	4.3	6.3	7.4
Egypt	4.6	6.9	7.1	7.3	6.7	11.0	4.7	7.3	9.6	10.2
Iraq	23.0	10.0	5.9	6.1	7.0	27.0	37.0	53.2	30.8	11.0
Jordan	8.6	7.1	6.3	6.0	5.5	3.4	3.5	6.3	5.4	6.7
Lebanon	5.0	1.0	0.1	2.0	3.0	4.0	4.7	8.2	7.0	7.5
Palestine	2.0	6.0	-8.8	-2.2	1.0	3.0	3.5	3.8	2.5	5.2
Syrian Arab Republic	6.7	4.5	5.1	4.5	4.0	4.6	7.4	10.0	5.5	6.5
Yemen	3.9	4.6	4.2	4.5	3.2	12.5	11.8	20.8	10.6	12.5
Total, MDEs	6.3	6.2	5.6	6.0	5.8	11.1	9.1	13.6	11.1	9.5
Total, ESCWA region	7.2	6.9	5.9	5.4	5.7	5.0	4.9	7.5	7.9	9.8
Conflict-affected economies[d/]	11.4	5.2	1.7	3.5	4.7	15.4	20.7	30.2	18.4	7.3

Source: ESCWA staff calculations, based on rescaled real GDP figures at constant 2000 prices.

a/ Data for country groups are weighted averages, where weights for each year are based on GDP at 2000 constant prices.
b/ ESCWA estimates, February 2008. It should be noted that these forecasts are influenced by highly volatile oil prices.
c/ ESCWA projections, February 2008.
d/ The average of Iraq, Lebanon and Palestine.

The economy of Saudi Arabia is estimated to have grown 3.5 per cent in 2007 and is forecast to grow 4.1 per cent in 2008. Diversification into the non-oil sector continued, illustrated by the creation of the King Abdullah Economic City, and this diversification resulted in the consistent growth of investment spending in the demand composition. The need to replenish past investments and make active investment in infrastructure adds to the resilience of the economy. Consumer and business confidence remained high in 2007 in parallel with the stock market recovery, although there were signs of stabilization as a result of rapid inflation. Real GDP growth in the United Arab Emirates is estimated at 7.4 per cent for 2007. Although crude oil production and related revenue remained crucial to the supply structure, the rapid expansion into the non-oil sector has accelerated in the petrochemical, aluminium, steel, finance, construction, business services and transport sectors. Although reliance on external demand is considerable, the importance of domestic demand is underscored by its significant contribution. However, due to rising import requirements for ongoing economic diversification, the country is structurally vulnerable to import-led inflation and despite the continuing rapid expansion in domestic demand in nominal terms, real GDP growth for the United Arab Emirates is thus forecast at 7.5 per cent for 2008.

Average GDP growth in the MDE subregion is estimated at 6.0 per cent in 2007, compared with 5.6 per cent the previous year (table 5). The MDEs have distanced themselves from potential foreign exchange constraints, which could have restricted the growth of domestic demand. Free from such constraints, domestic demand exhibited continuous expansion in most MDE countries in 2007. Consumer expectation was relatively stable and, with the exception of Palestine, business confidence was resilient, centred around the construction, business services and tourism sectors. Consistent expansion was observed in the manufacturing sector, although it is not yet sufficient to create a significant export-led development path. Despite the rise in the international price of agricultural goods, the lack of past investment in this sector meant that the MDE subregion received little benefit. The untapped supply potential of agricultural goods in the subregion is not expected to be realized in the near future and the area is therefore prone to the risks of import-led inflation. It is also subject to another type of vulnerability – the potentially contagious effects of the global credit crunch – although an abrupt change in external economic conditions is unlikely to occur in 2008, at least not to the extent of severely affecting the macroeconomic balance of the countries in this subregion. Taking these factors into consideration, the average real GDP growth rate for the MDEs is forecast at 5.8 per cent in 2008.

Real GDP growth in Egypt for 2007 is estimated at 7.3 per cent (table 5). The role of investment spending has increased in significance as a component of domestic demand in Egypt in parallel with expanding affluent consumption. The growth in the energy sector and the apparel and textile sector have contributed to the export-oriented supply capacity. The construction sector was also strong in 2007 and industrial development in the manufacturing sector was also significant as greater FDI was directed towards it. Towards the end of 2007, rapid inflation had started to soften consumer confidence, but the expansion of domestic demand is expected to continue, due to investment spending. Egypt is forecast to grow 6.7 per cent in 2008. Domestic demand expansion was also stable in Jordan, where real GDP growth is estimated at 6.0 per cent for 2007. Consistent industrial development in pharmaceuticals and chemical fertilizers continued, and the apparel and textile sector in the qualified industrial zones (QIZs) showed resilience, despite increasing competition from Egyptian QIZs. Despite a stable level of investment spending in domestic demand, the share of affluent private consumption is estimated to have been increasing in recent years. As a result, the Jordanian economy is sensitive to consumer confidence, which has been negatively affected by the rapid price increases in basic commodities. Economic vulnerability rests on the risk of the weakening external balance, although an abrupt emergence of foreign exchange constraint is unlikely, as support from the ample monetary liquidity in the region is expected. Real GDP growth in Jordan is forecast at 5.5 per cent for 2008.

Despite political instability, real GDP growth in Lebanon for 2007 is estimated at 2.0 per cent. Consumption spending remained weak, but construction activity and reconstruction work on the infrastructure that was destroyed by the war in the summer of 2006 were active. Finance was also strong. However, such demand-led economic growth remains vulnerable to the risk of external imbalance where the economy has been sustained by foreign investment and the remittances of Lebanese nationals abroad. Moreover, the economy remains sensitive to import-led inflation. Although the global credit crunch poses a risk, the Lebanese economy is forecast to grow 3.0 per cent in 2008, led by continuing investment in construction and relatively weak consumption spending. The Syrian Arab Republic is expected to register 4.5 per cent growth in 2007. Oil revenues remain an essential contributor to its economic growth, but domestic demand, in terms of both investment and consumption spending, has become crucial to lifting the economy. Industrial development in the Syrian Arab Republic progressed during the year with its entry into car assembly production. Moreover, the country is able to enhance its food security through self-sufficiency in the production of wheat and flour. Consistent growth in supply capacity is expected through stable investment growth, but increased prices have led to weaker consumer confidence. The economy of the Syrian Arab Republic is forecast to grow 4.0 per cent in 2008. Real GDP growth in Yemen is estimated at 4.5 per cent for 2007. Despite decreased crude oil revenues, the economy of Yemen was sustained by the expansion of domestic demand, in particular of consumption spending. Foreign exchange constraint was not binding during the year and domestic demand continued to grow, surpassing the 2006 rate. Despite efforts to diversify the economy out of crude oil exports into LNG, agriculture, fisheries and tourism, the country has yet to see the results of such diversification efforts. LNG production is expected to start in 2009. In 2008, however, the economy in Yemen is expected to slow down further to just 3.2 per cent in real GDP growth.

Conflict-affected Iraq and Palestine both remained in a fragile economic state throughout 2007. GDP growth in Iraq, estimated at 6.1 per cent in 2007, was heavily dependent on oil exports. The lack of infrastructure continued to hamper reconstruction and the development of the non-oil production sector. While a recovery in domestic demand was seen as the security situation gradually improved in Baghdad, the situation remained unstable and volatile. Despite ongoing security concerns, further gradual progress in the non-oil production and services sector is expected. Furthermore, as the supply capacity of crude oil stabilizes, the anticipated increase in oil export revenue will provide consistent growth in terms of real GDP. However, domestic demand is expected to remain weak, implying that improvements in the standard of living are not as likely as the GDP figures may suggest. The GDP growth rate in Iraq is forecast at 7.0 per cent in 2008. The Israeli blockade of Palestine, particularly the Gaza Strip, continuing security instability and ongoing hostilities all continue to place serious constraints on economic activities in the Territory. Moreover, the suspension of international development aid from major donor countries subdued already fractured domestic demand. As estimated in February 2008, Palestine is expected to register a second consecutive year of negative economic growth in 2007, at -2.2 per cent, following -8.8 per cent in 2006. The forecast for 2008 is 1.0 per cent real GDP growth, as a certain recovery is expected through a consolidation of domestic demand in the West Bank and a resumption of international aid that should lift the Gaza Strip out of its current humanitarian crisis. However, as no improvement in the Israeli stance on the economic blockade is expected, the economic prospects for Palestine are expected to remain extremely weak.

D. COST AND PRICES

The cost of living and the cost of production both rose significantly in the ESCWA region in 2007. The rising level of costs reflects the international trend of high commodity prices, including those of food items and raw materials, and the regional trend of high commercial and housing rents. To a certain extent, the increased costs are attributable to these external factors, although for each ESCWA member country, the deviation from them reflects such domestic factors as supply capacity, market structure, labour cost, transaction cost, monetary policies and the foreign exchange rate regime. In the GCC countries in particular, a shortage of skilled workers in the private sector and a rise in public sector wages through legislation resulted in rising wage levels, while the rapidly rising price of basic goods caused a significant decrease in real wage levels, an area in which further Government intervention had been called for. However, there have been indications that these Government-initiated wage rises may have caused a spiral of cost-push inflation. A similar rise in wages has not been observed in the MDEs.

The increase in general price levels accelerated to a critical state in 2007 and the trend is expected to continue in 2008. The average consumer inflation rate for the ESCWA region stood at 7.9 per cent in 2007, an increase from 7.5 per cent in 2006 (table 5), ranging from a low of 2.5 per cent in Palestine to a high of 30.8 per cent in Iraq. The acceleration of consumer prices was more apparent in the GCC countries, where the consumer inflation rate was 6.3 per cent in 2007, an increase from 4.3 per cent in 2006. The cost of living rose steeply in 2007, even in Bahrain, Kuwait, Oman and Saudi Arabia, where a low inflation price regime had been in force until 2006. Rapid consumer inflation continued in the MDEs, where the average consumer inflation rate has been higher than that of the GCC countries. A downward correction for a number of MDE countries stabilized the consumer inflation rate at 11.1 per cent in 2007, down from 13.6 per cent in 2006. Moreover, the hyper-inflation previously seen in Iraq ended in late 2007.

The international rise in wheat prices caused an increase in the cost of bread, a staple food in the region, and ESCWA member countries attempted to maintain bread prices through subsidies. Additional Government interventions were increasingly required to maintain the provision of basic goods at affordable prices. The agricultural production potential of the region, located primarily in the MDEs, could not be fully utilized due to a lack of investment in the rural agricultural sector. Saudi Arabia and the Syrian Arab Republic have been achieving self-sufficiency in wheat and flour, but Saudi Arabia has decided to phase out its domestic production of wheat due to the extremely high cost of agricultural water. As regards rising housing rents, GCC countries have been dealing with the issue mainly through rent law reforms. However, since rents have been rising in parallel with the price of residential and commercial properties, which in turn reflects the tight demand and supply of properties and the rising cost of construction materials, rent law reforms have faced difficulties in stabilizing rents.

ESCWA member countries, with the exception of Egypt, Iraq, Kuwait, Palestine and Yemen, maintained a foreign exchange regime that pegged their national currencies to the US dollar. The depreciation of the US dollar against other major international currencies caused a price appreciation of imported goods from Europe and Asia. Moreover, the US dollar-pegged exchange rate regime constrained the monetary policy in these countries, which were forced to follow that of the United States. As a result, effective monetary measures to alleviate domestic inflationary pressures have been difficult to implement in those ESCWA member countries with a US dollar-pegged foreign exchange regime. The issue of foreign exchange rate regimes has consequently become controversial, but no agreement has been reached at a regional level. The GCC summit in December 2007 confirmed no imminent change in the US dollar-peg for GCC countries, with the exception of Kuwait, which has been pegging its currency to a trade-weighted basket of currencies since June 2007. The advocates for withdrawing from the US dollar-peg claim that doing so will bring the inflation rate down through lower import prices and a flexible monetary policy. However, such effectiveness has also been questioned, as countries with other foreign exchange rate regimes, notably Egypt and Kuwait, were unable to bring their inflation rate down in the same period.

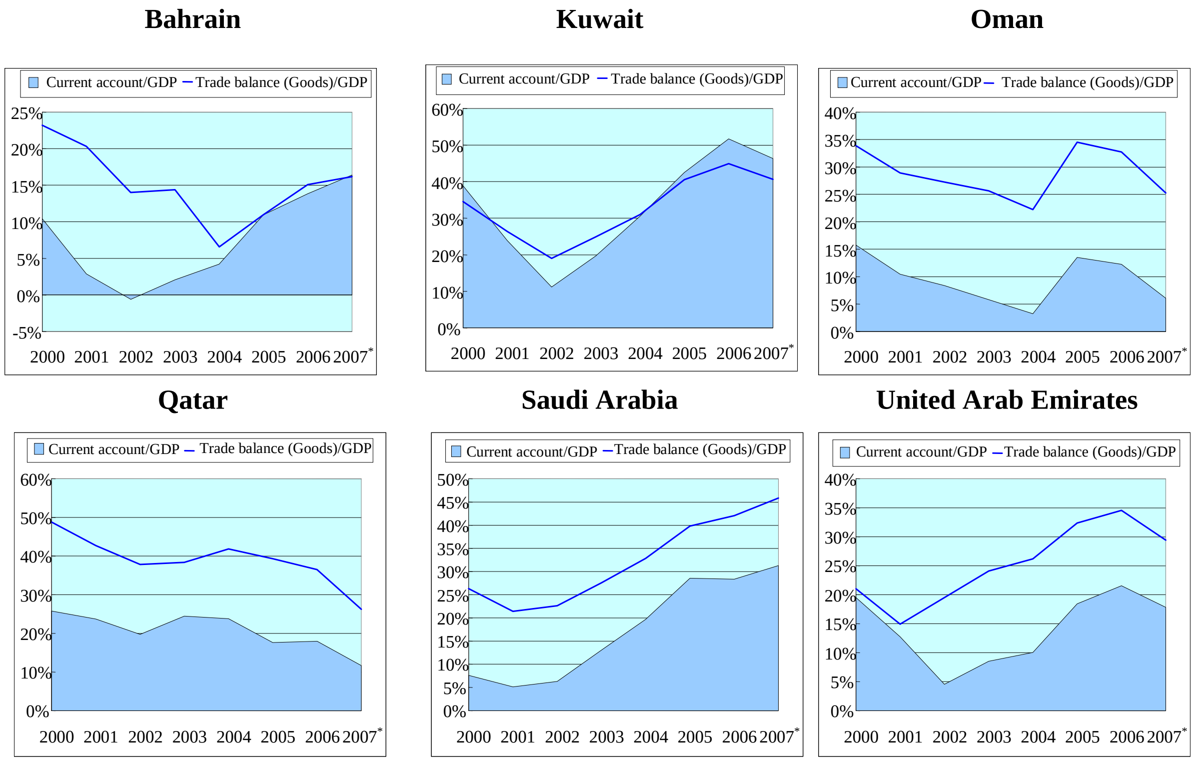
E. External sector

1. *External balance*

External sector performance in the ESCWA region remained strong in 2007. The total current account surplus of the GCC countries was estimated at US$ 217 billion, an increase from US$ 193 billion the previous year. The total current account surplus of the MDEs was estimated at US$ 12.6 billion, an increase from US$ 6.8 billion the previous year. The current account balance of ESCWA member countries stabilized in the positive zone, with the exception of Jordan, Lebanon and Palestine, while trade activities in the region continued to expand and the investment income from foreign assets increased. With the exception of Palestine, no signs of external fragility have been observed, even in those countries with current account deficits. However, the potential risk of external vulnerability is becoming more apparent as current account deficits are forecast to increase in terms of GDP in Egypt, Jordan, Lebanon, Palestine and Yemen in 2008.

In GCC countries, the trade balance surplus of goods in terms of nominal GDP has remained high (figure V) due to the rapid growth in the value of energy-related exports. In 2007, the percentage ratio was estimated at 16.2 per cent for Bahrain, 40.6 per cent for Kuwait, 25.3 per cent for Oman, 26.2 per cent for Qatar, 45.9 per cent for Saudi Arabia and 29.4 per cent for the United Arab Emirates. However, Kuwait, Oman, Qatar and the United Arab Emirates are expected to mark a lower percentage ratio in 2007 than in 2006. These lower figures are due to the increase in import value and the rapid rise in the share of domestic demand in the GDP of those countries. Meanwhile, Bahrain and Saudi Arabia are expected to mark an increase in the trade balance surplus of goods in terms of nominal GDP in 2007, as export growth surpassed the speed of domestic demand expansion.

Figure V. Trade balance and current account, 2000-2007, GCC countries

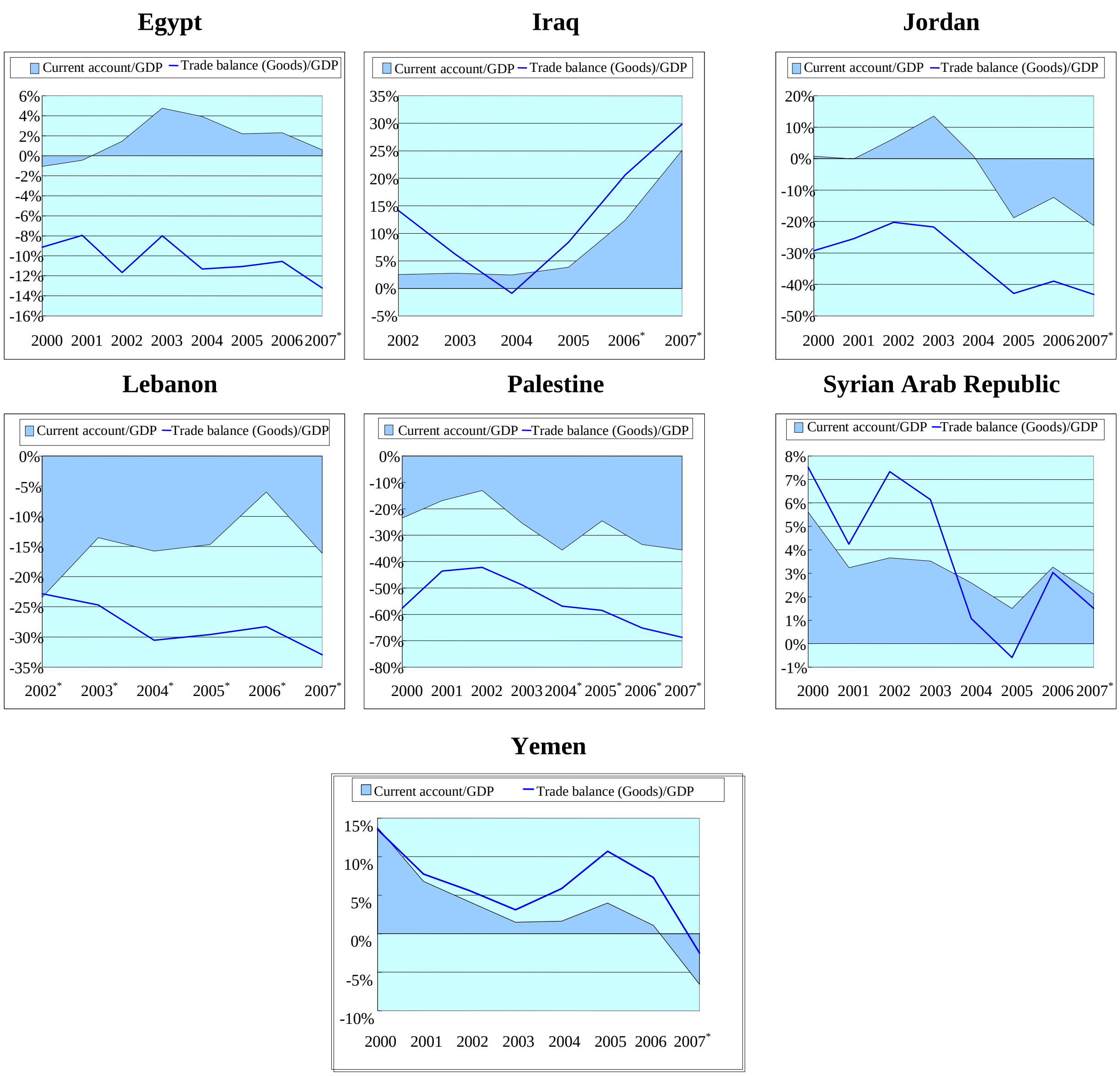


Source: ESCWA staff calculation, based on national sources.
* Estimated figures.

Despite consistent growth in the finance, tourism and transportation sectors in the GCC countries, net trade in services is expected to remain negative, with the exception of Bahrain. There has also been a continuing increase in the outflow of current transfers that include remittances of foreign workers in the subregion. However, an increase in income from overseas investment by the subregion contributed to narrowing the gap between the trade balance surplus of goods and the current account surplus, most notably in Kuwait. In 2007, current account surpluses in terms of nominal GDP were estimated at 16.4 per cent for Bahrain, 46.3 per cent for Kuwait, 6.1 per cent for Oman, 11.6 per cent for Qatar, 31.3 per cent for Saudi Arabia and 17.8 per cent for the United Arab Emirates. Although the absolute level of the current account surplus marked a historic high in 2007 as a total, the ratio in terms of nominal GDP has shown varying states of external balance among the GCC countries. The percentage ratio of current account surplus to GDP shows a declining trend, particularly in Oman and Qatar, while Bahrain and Saudi Arabia show a clearly increasing trend. This indicates that domestic demand expansion has already been faster than export growth in Oman and Qatar, while domestic demand in Bahrain and Saudi Arabia still has considerable room for further expansion. Kuwait and the United Arab Emirates show signs of stabilization, as domestic demand expansion has started to surpass the speed of export growth.

In the MDE subregion, the trade balance of goods for 2007 is estimated to be in surplus in Iraq and the Syrian Arab Republic, but negative in Egypt, Jordan, Lebanon, Palestine and Yemen (figure VI). Stable levels of crude oil export revenue contributed to the trade balance surpluses of Iraq and the Syrian Arab Republic. Despite an increase in manufacturing exports in Egypt and Jordan, particularly in the apparel and textile sector, the rapid increase in the value of imported goods resulted in widening trade balance deficits. This increase in the value of imported goods is attributable to increasing volumes and prices of food crops and commodity materials, due to the import requirements of sustaining continued expansion of domestic demand. Lebanon and Palestine are expected to mark a significant level of trade balance deficit, due to the stagnation of exports and price increases in food crops, consumer goods and fuel products. The trade balance surplus in Yemen is expected to move into the negative, due to a decrease in crude oil export revenues and an increase in the value of imported goods related to the rise in prices of food crops and commodity materials. In 2006, the trade balance of goods in terms of nominal GDP is estimated to be in deficit for Egypt at 13.2 per cent, Jordan at 43.2 per cent, Lebanon at 32.9 per cent, Palestine at 68.7 per cent and Yemen at 2.5 per cent; and in surplus for Iraq at 29.8 per cent and the Syrian Arab Republic at 1.5 per cent.

Figure VI. Trade balance and current account, 2000-2007: more diversified economies



Source: ESCWA staff calculation, based on national sources.

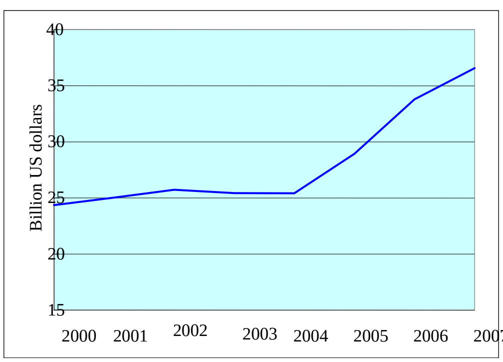
* Estimated figures.

Following recent trends, in 2007 the MDE countries experienced a surplus in current income transfer inflow that includes workers' remittances. Due to this inflow of funds, current account deficits have been significantly smaller than trade balance deficits. Moreover, the tourism sector was robust in Egypt, Jordan, the Syrian Arab Republic and Yemen. The transport sector was particularly strong in Egypt, due to the income from the Suez Canal, which increased to US$ 4.6 billion in 2007 from US$ 3.8 billion the previous year. However, in 2007 this positive margin was not sufficient to support the external balance in terms of current account, due to the increase in the value of imported goods. The price of imported goods has risen significantly for such items as food crops, consumer goods and fuel products. Moreover, the expansion of domestic demand, driven by recent economic growth, led to an increase in the volume of imports with a luxury goods component. The weakening external balance of the MDEs was, however, supported by an increase in investment inflow to all these countries. Furthermore, no significant signs of foreign exchange constraint were observed in 2007, implying that funds were available to import the goods and services necessary to sustain domestic demand; this applied equally to the countries which ran into current account deficit. For 2007, the current account balance in terms of nominal GDP is estimated to be in surplus for Egypt at 0.6 per cent, Iraq at 25.1 per cent and the Syrian Arab Republic at 2.1 per cent; and in deficit for Jordan at 21.2 per cent, Lebanon at 16.1 per cent, Palestine at 35.6 per cent and Yemen at 6.6 per cent.

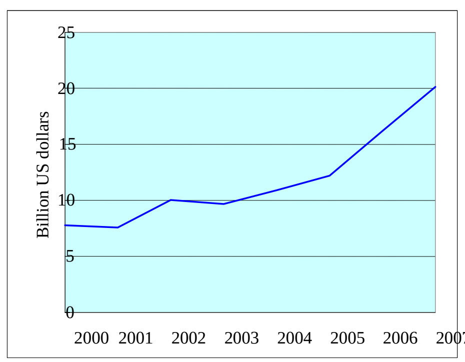
The outflow of workers' remittances from GCC countries is estimated at US$ 36 billion in 2007 (figure VII). Since 2004, the outflow to the home countries of expatriate workers in South and Southeast Asia and the subregion of the MDEs has accelerated. The total inflow of workers' remittances into the MDEs is estimated at US$ 20 billion in 2007, of which most originated from North America, Europe and the GCC countries. The inflow of workers' remittances remained crucial for maintaining the external balances of Jordan, Lebanon, Palestine and Yemen in particular. Moreover, as the current pattern of economic growth has failed to create significant employment opportunities in the MDEs, workers' remittances continued to be crucial for sustaining domestic demand in these countries. Inflows of workers' remittances in 2007 are estimated at 18 per cent of GDP in Jordan, 29 per cent in Lebanon and 20 per cent in Palestine.

Figure VII. Flows of workers' remittances, 2000-2007

Total estimated outflow from GCC countries



Total estimated inflow into MDEs



Source: ESCWA staff estimates, based on national sources.

2. *Exchange rates*

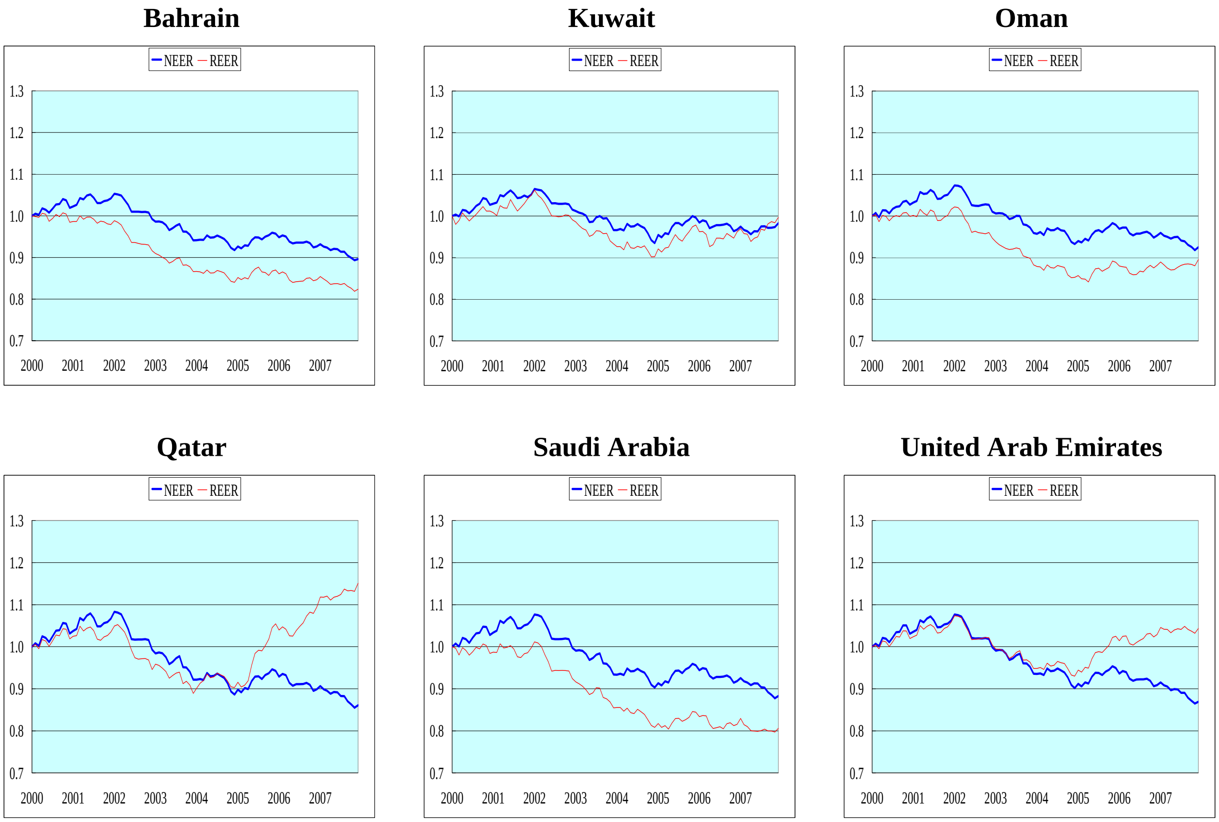
The exchange rates of ESCWA member countries remained stable throughout 2007, though continuous appreciation pressures were placed on their national currencies. The Kuwaiti dinar appreciated by 5 per cent, the Egyptian pound by 4 per cent and the Iraqi dinar by 9 per cent against the US dollar. Kuwait abandoned the US-dollar peg of its national currency in May 2007 and reintroduced an exchange rate regime that pegged its national currency to a basket of currencies of its major trading partners. Other GCC countries, and Jordan and Lebanon, retained a US dollar-pegged foreign exchange rate regime. The Syrian Arab Republic and Yemen have not officially pegged their national currencies to the US dollar, but the exchange rate of both countries was effectively fixed against the US currency during 2007. The depreciation of the US dollar against other major currencies (figure II) caused a parallel devaluation of the currencies pegged to it in the region. The resulting increase in import prices from Europe and Asia raised questions about the effectiveness of the US dollar peg foreign exchange rate regime. However, the GCC Summit in December 2007 failed to propose any change to the current regime and confirmed the schedule for the GCC Currency Union to be established by 2010.

Figure VIII shows the estimated nominal and real effective exchange rates of the GCC countries. The nominal effective exchange rate (NEER) is an index of foreign exchange rates of a national currency against the currencies of its major trading partners, weighted by trading values. The real effective exchange rate (REER) is a modified index of the NEER based on consumer inflation rates.[5] Following a trend starting in 2006, the moves of the NEER in 2007 indicate a depreciation in parallel to the move of the US dollar against the euro, with the exception of Kuwait, where the NEER shows a slight appreciation. In 2007, the REER depreciated in Bahrain, while it appreciated in Kuwait and Qatar. It remained unchanged in Oman, Saudi Arabia and the United Arab Emirates. The implications of this are: (a) the inflation rate of Kuwait was faster than that of its trading partners, despite the reform of its foreign exchange rate regime; (b) the inflation rates of Bahrain, Oman, Saudi Arabia and the United Arab Emirates were in line with those of their major trading partners and the effect of the currency depreciation on inflation was possibly neutral; and (c) the inflation rate of Qatar was faster than that of its trading partners and the effect of the currency depreciation on inflation was possibly significant. Furthermore, the moves of the REER since 2000 indicate that the price level remained relatively low in Bahrain, Kuwait, Oman and Saudi Arabia, while it hovered around the 2000 level in Qatar and the United Arab Emirates.

Figure IX shows the estimated nominal and real effective exchange rates of the MDEs. The NEER of Egypt has been stable since 2004, despite the recent appreciation of the currency against the US dollar. Its REER shows an appreciation trend, due to rapid domestic inflation, but the level stabilized towards the end of 2007 as a result of the higher inflation rates experienced by its trading partners. Due to a series of revaluations of the Iraqi dinar, the NEER of Iraq shows a clear appreciation in 2007, while the appreciation of its REER slowed down, indicating that hyper inflation had finally ended. Jordan experienced depreciation in both its NEER and REER in 2007, as the inflation rate remained relatively low while the country retained its US dollar peg. Both Lebanon and Yemen experienced depreciation in terms of NEER in 2007, while the REER showed appreciation. In both countries, the inflation rate rose, while the value of their national currencies depreciated against that of their major trading partners. In the Syrian Arab Republic, the NEER stabilized, but the REER indicates that domestic inflation was faster than that of its major trading partners. Compared with 2000 levels, the price level remained relatively low in Egypt, Jordan, Lebanon and the Syrian Arab Republic against that of their trading partners, despite the emergence of rapid inflation.

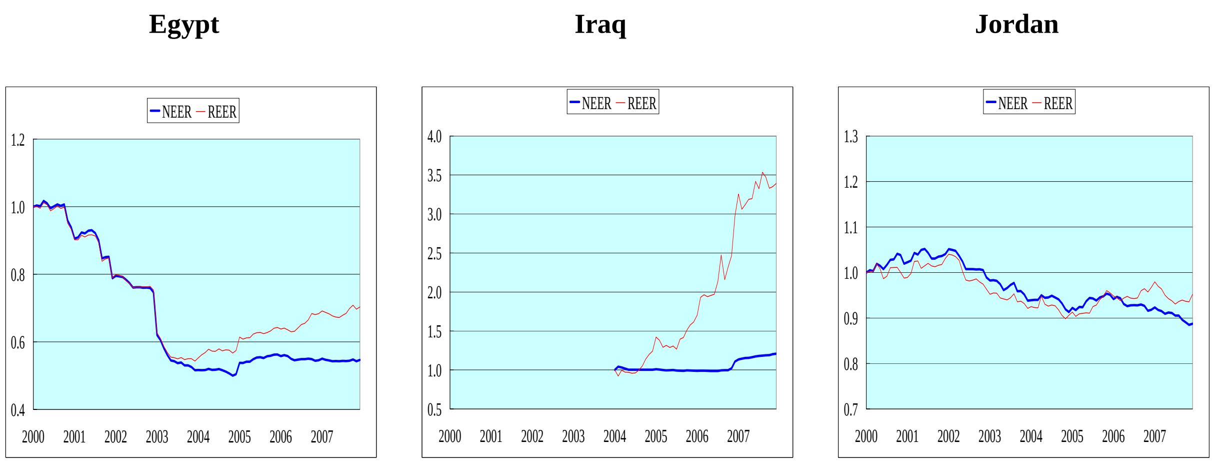
[5] The NEER falls when the value of a national currency depreciates against the weighted sum value of the currencies of its major trading partners. The REER falls when the exchange rate-adjusted inflation of trading partners grows faster than domestic inflation. The difference between the NEER and REER shows the extent to which the nominal devaluation of a national currency (NEER) has affected the country's inflation in comparison with that of its major trading partners (REER). The NEER and REER show the same path when the exchange rate does not affect inflation rates, and diverge when the exchange rate correlates price levels.

Figure VIII. Nominal and effective real exchange rates, 2006-2007: GCC countries

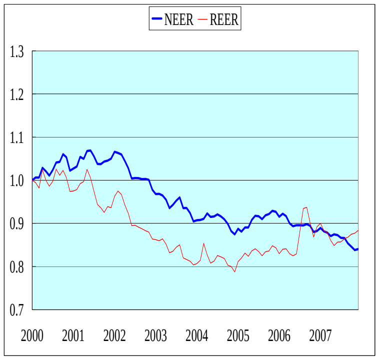


Source: ESCWA staff estimates.

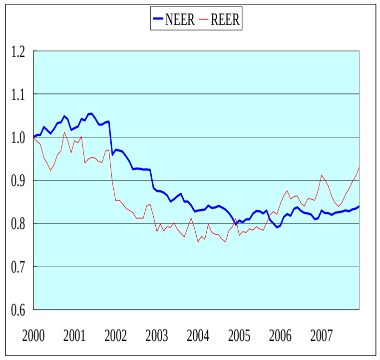
Figure IX. Nominal and effective real exchange rates, 2006-2007: more diversified economies



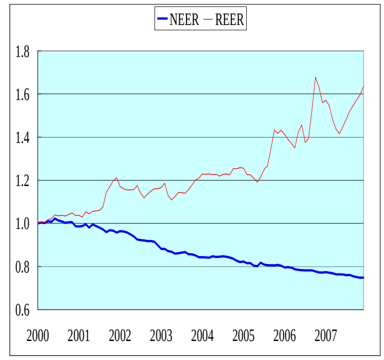
Lebanon



Syrian Arab Republic



Yemen



Source: ESCWA staff estimates.

Note: The REER and NEER of Iraq are only weighted against the US dollar; only the inflation data of Iraq and the United States have been used to estimate the REER.

The patterns of development in nominal and real effective exchange rates indicate that the direct correlation between depreciation of national currency and domestic inflation, relative to the inflation of major trading partners, remained weak in the ESCWA region, with the exception of Qatar, the United Arab Emirates and Yemen. A counter example is Kuwait, where the inflation rate accelerated, despite the reform to its foreign exchange rate regime in 2007. This casts doubt on the effectiveness of reforms to the foreign exchange rate regime and on a revaluation in those ESCWA member countries which have adopted the US dollar-pegged foreign exchange rate regime. Inflation in the region can been seen as the reflection of an international trend and other factors pertaining to domestic economic structures and policies.

F. Social dynamics

Social dynamics in the ESCWA region are following a trend of growing divergence between social classes in terms of income levels and attainment of financial and social resources, in spite of the efforts of ESCWA member countries to foster balanced economic and social development. The rapid rise in the price of housing has created an environment in which the dynamic of real income growth has changed fundamentally, in that those who own property are able to fend off the negative effects of rent increases, while the rise in housing rents places a heavier burden in terms of expenditure on the poor. This social cleavage can be seen not only in income and property ownership, but also along lines of nationality, as the ESCWA region is at the crossroads of international migration. Refugees from conflict-affected Iraq, job seekers from poorer MDEs and temporary labour from the economies of South and South-East Asia migrating to the GCC countries continue to shoulder the real burden of price increases and low real wage growth.

The pattern of maldistribution of income in the ESCWA region continued to be a matter of concern, as the combination of a chronically high unemployment rate and slow per capita income growth persisted. The per capita real GDP growth of ESCWA member countries (table 6) has been on a declining trend since 2004. It averaged 3.2 per cent in 2007, down from 3.6 per cent in 2006. Although it is estimated to rise moderately to 3.4 per cent in 2008, the level of growth in each country is relatively low at less than 5 per cent, with the exception of Iraq and Qatar, although per capita GDP in Iraq remains significantly below 2002 levels. Meanwhile, no signs of significant improvement in employment creation have been observed in the region (table 6). The current situation implies inequality against the younger cohorts of the population, indicating persistent difficulty for new entrants into the labour market. The rise in the proportion of the population that is of working age could present a demographic window of opportunity for economic and social development if employment generation commensurate with GDP growth were possible. However, given the dominance of rents and the ineffectiveness of the productivity-driven real economy, the growth in the numbers of the unemployed continues to present a social problem.

TABLE 6. PER CAPITA GDP GROWTH AND UNEMPLOYMENT RATES, ESCWA COUNTRIES

Country	Per capita GDP growth rate (*Annual percentage change*)					Unemployment rate (*Percentage*)			
	2004	2005	2006	2007	2008	2004	2005	2006	2007
Bahrain	3.3	5.7	4.5	4.4	4.6	..	..	..	..
Kuwait	7.2	8.3	3.6	3.3	3.7	..	..	..	..
Oman	4.5	4.8	5.5	3.5	2.8	..	..	..	..
Qatar	14.9	1.8	3.7	5.7	7.7	..	..	..	..
Saudi Arabia	2.7	3.6	1.9	1.2	1.8	5.8	6.1	6.3	5.6
United Arab Emirates	5.0	4.0	5.6	4.2	4.6	..	..	..	..
Total, GCC countries	4.8	4.5	3.5	2.7	3.2	..	..	..	..
Egypt	2.7	5.0	5.2	5.4	4.8	10.3	10.3	9.5	9.1
Iraq	20.4	7.9	4.0	4.3	5.2	..	..	..	..
Jordan	5.3	3.8	2.9	2.5	2.1	12.5	14.8	14.0	13.1
Lebanon	3.7	(0.2)	(1.0)	0.9	1.9	..	..	..	..
Palestine	(1.5)	2.4	(11.8)	(5.3)	(2.1)	26.8	23.5	23.6	21.5
Syrian Arab Republic	3.8	1.7	2.3	1.8	1.4	12.3	8.0	8.3	..
Yemen	0.8	1.5	1.1	1.4	0.2	16.2	..	..	..
Total, MDEs	4.0	3.9	3.4	3.8	3.6	..	..	..	..
Total, ESCWA region	4.8	4.5	3.6	3.2	3.4	..	..	..	..
Conflict-affected economies[a/]	9.0	3.1	-0.2	1.6	2.8	..	..	..	..

Source: Per capita GDP growth rates have been calculated by ESCWA staff, based on estimated GDP figures re-scaled to the base year 2000 and total population estimates from the United Nations Department of Economic and Social Affairs *World Population Prospects: The 2006 Revision*. Unemployment rates are taken from national sources where available.

Note: Parentheses ( ) indicate negative numbers.

a/ Iraq, Lebanon and Palestine.

The issue of unemployment and underemployment remains the major socio-economic hurdle for the region. The lack of employment opportunities in many ESCWA member countries appears paradoxical, as the ESCWA region as a whole continues to host a high level of immigration of temporary labour, primarily from South Asia, South East Asia and Africa. However, upon closer examination, it is clear that the power of commercial capital (as opposed to national industrial capital), with its stronger ties to external financial markets, tends to benefit from hiring temporary low-paid Asian labour, rather than capitalizing on and locking in labour and other resources within the region. Despite achievements in education in ESCWA member countries, particularly with the rapid growth seen in the enrolment of women in higher education, a lack of employment opportunities persists for youth in the region, both men and women, implying a disjuncture between physical and human capital accumulation. The ESCWA region, particularly the GCC subregion, has accumulated significant levels of financial capital in the current oil boom, but has failed to utilize its human capital. It has a talented young population seeking decent employment, yet has been unable to realize this potential, continuing to depend on floating labour, moving in and out of the region with the attendant seepage in resources from the economic cycle of overseas remittances.

However, reform measures have been initiated, as Government intervention has been recognized as the key to social change directed towards balanced and pro-poor economic growth. The status of foreign workers is being strategically clarified in GCC countries and GCC Governments have shown a clear shift in policy to acknowledge the rights of foreign workers. Bahrain, Kuwait and the United Arab Emirates implemented an amnesty in 2007 for illegal foreign residents, which allowed them either to legalize their status or to return to their home countries without facing prosecution. There were discussions on the abolition of the sponsorship system for foreign workers in GCC countries, to be replaced by a contract-based system. Meanwhile, human resource development and vocational training of nationals continued in the GCC countries with the objective of achieving higher representation of nationals in the workforce, particularly in the private sector. Greater participation of women in labour markets is being encouraged and legislative reforms to labour and related laws have been drafted. With appropriate institutional and legal support, it is hoped that the shortage of skilled labour in the GCC countries, combined with the high enrolment of women in higher education in the ESCWA region as a whole, will bring about a major advancement of women in the labour markets in the near future.

Box 1. Integrating a social aspect into economic policy: generational equity

Generational aspects of policy discussions are often limited to specific issues, such as pension systems. The "pay-as-you-go" type of public pension system is a direct transfer of funds from younger generations to post-retirement generations. However, generational transfers take place through a variety of channels, some compulsory and others voluntary. A significant channel of generational transfer to younger generations are bequests, which may determine a considerable part of personal financial endowment. Within extended families, there is often a traditional mutual help system, such as the *Takaful* in Islamic families, through which generational transfers also take place. The composition of taxes and public expenditure also determines generational transfers, albeit indirectly. As an example, public education can be seen as a transfer to younger generations, as the majority of its beneficiaries are children and young people. If public education is supported by income tax, this transfer stream is clear. If it is supported by value added tax, the transfer stream is less clear, as consumption by children is also taxed. The life-cycle cost and benefit of an individual can be defined by various types of generational transfer, in terms of one's fundamental endowments as a human being, rewards for one's labour services and generational transfers. Labour income and income from other sources may be spent on consumption or invested in savings, both of which may have a generational transfer element.

The importance of generational consideration is twofold. Firstly, inequality between those who receive significant generational in-transfer from their family and those who do not often starts at the beginning of life. Entitlement to private generational in-transfer is exclusive and decisive to social class, in accordance with the transferable endowment. Secondly, the stagnation of the labour income share of the economy, as illustrated by the current high levels of unemployment in the ESCWA region, implies an expanding income inequality, which works against those who were not endowed with private generational in-transfer at the start of life.

Generational consideration can contribute to poverty reduction by integrating a social aspect into economic policy. Generational accounting has been established in several countries[*] and the concept can be expanded to other social aspects, such as gender, to estimate lifetime tax burdens and benefits. Generational transfers through public policy can resolve both intra-generational and inter-generational inequality. Considering demographic pressures and the rapid increase of the younger generation as a proportion of the population of the ESCWA region, generational consideration can provide a basis for the creation of effective policy tools.

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[*] Auerbach, Kotlikoff and Leibfritz (1999).

The security situation in conflict-affected countries has contributed to prolonging the humanitarian crisis and hampering balanced socio-economic development. Humanitarian crises and the associated displacement of human capital precludes healthy socio-economic development in the ESCWA region. According to the United Nations Office for the Coordination of Humanitarian Affairs,[6] poverty in the Gaza Strip has reached unprecedented levels. It estimates that approximately eight out of ten households are currently living below the poverty line of US$ 594 per household per month. Moreover, it suggests that 66.7 per cent of Gazan households are living in deep poverty (defined as less than US$ 474 per month). Consequently, more Gazans than ever before are almost entirely dependent on food aid and direct assistance: 80 per cent of Gazan families currently receive humanitarian aid. Many Iraqi refugees had to return to the country, due to the imposition of visa requirements by Jordan and the Syrian Arab Republic, yet with little progress in economic reconstruction in Iraq, the number of refugees and those displaced internally remains high. In September 2007, the United Nations High Commissioner for Refugees

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[6] OCHA (2007).

estimated that 1.2-1.4 million Iraqi refugees had sought asylum in the Syrian Arab Republic, 500,000-750,000 in Jordan, 200,000 in the GCC countries, up to 70,000 in Egypt and 20,000-40,000 in Lebanon.[7] ESCWA member countries, particularly Jordan and the Syrian Arab Republic, have supported Iraqi refugees through basic public provision, which has required additional fiscal expenditure on the part of both countries.

Social conditions in the ESCWA region are forecast to remain stagnant in 2008, especially in the area of employment creation, and if the ripple effect of the global credit crunch and declining oil prices were to set in at the same time, the situation could deteriorate. Worse still, the ongoing conflicts in Iraq and Palestine have displaced a sizeable population and prevented them from engaging in productive economic activity. The situation has been further complicated by the fact that national social policies have to date failed to achieve a decent standard of living for all, let alone assure the pivotal issue of human security. Integrated social policies enshrined as universal values in the core functions of the State represent an optimal setting for a social contract, but require effective cooperation at a regional level.

G. Policy developments

The social aspect of economic policies has increasingly been recognized by policymakers in the ESCWA region. With the decision to lift fuel subsidies, the Government of Jordan strengthened its social safety net by providing income support to the poorest households through the National Aid Fund. The adoption by Bahrain of an integrated social policy led to the country taking gender into consideration when setting the budget for the forthcoming year. Current account conditions duly considered, with the exception of Lebanon and Palestine, ESCWA member countries must adopt an active fiscal expenditure policy for the fiscal year 2007, emphasizing the socio-economic developmental needs of each country, including health, education and infrastructure.

Inflation rates in ESCWA member countries remained high in 2007. Home-grown inflation stemmed from the rise in housing prices and the corresponding increase in rents throughout the year. The combined effect of domestic and international price surges in commodities led the reanimation of the subsidies policy debate, in particular regarding the effectiveness of direct cash transfers and subsidies in stabilizing the price of basic commodities and averting social unrest. Most member countries were in a solid external position, making it less distorting to intervene with subsidies than in the past. The cost of skilled and unskilled labour has also been on a generally increasing trend, but not to the point of being on a par with inflationary pressures. Meanwhile, pressing developmental needs required policymakers to be continuously engaged in active fiscal policies amid rising excess demand, constituted mainly of conspicuous consumption, and mostly imported inflationary pressures. Subsidies on fuel, wheat and other basic products have not represented a significant fiscal burden in Egypt, Jordan, Lebanon or Yemen; yet reforms leading to a lifting of the subsidy system are being considered. In contrast, policy in the GCC countries was to increase subsidies to keep the price of basic goods under control. Fiscal policy management in the region remained prudent. The GCC countries experienced substantial fiscal surpluses, while well-planned, tight budgeting kept fiscal deficits manageable in the MDEs. The diversification of fiscal revenues has also been sought as the GCC countries and the Syrian Arab Republic planned the introduction of value added tax. Meanwhile, the suspension of international development aid flows to Palestine has further weakened the institutional base of its fiscal policy and while the national budget of Iraq saw rapid growth, the security situation prevented effective implementation of budgeted projects.

For most ESCWA member countries, monetary policy was ineffective in absorbing excess liquidity and containing domestic excess demand for equity (real estate) and luxury items, while broad sections of the population were having to deal with the higher prices of basic necessities. Under the pegged or well-targeted stable exchange rate regime against the US dollar, central banks in the ESCWA region experienced difficulties in controlling monetary liquidity. Monetary authorities in the region were obliged to follow the aggressive monetary easing of the United States from September 2007. A number of

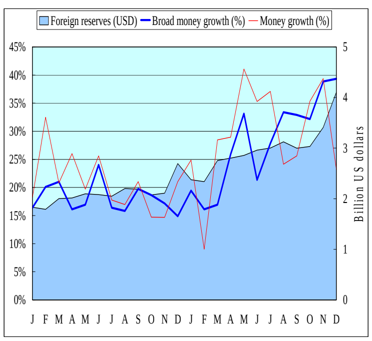
[7] UNHCR (2007).

policy options were actively sought by the monetary authorities in order to counter the monetary easing; these included open market operations, increases in reserve requirements, and asymmetric setting of interest rates for lending and borrowing. However, the effect was limited and demonstrated that selective demand control in the region is extremely difficult to achieve.

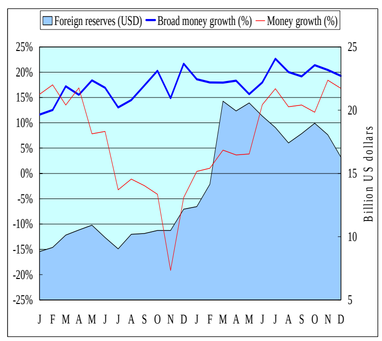
Despite that, monetary indicators showed signs of monetary tightening towards the end of 2006 in the GCC countries, a trend which was reversed in 2007 (figure X). The growth in the money supply in terms of narrow money increased significantly with the accumulation of foreign reserves, indicating that the monetary authorities in the subregion were facing difficulties in taking effective sterilization measures against the inflow of foreign funds and the increasing demand for national currencies. Meanwhile, the growth in the money supply in terms of broad money, remained at a high level, indicating a continuing rapid credit expansion in the GCC countries for higher income groups, as opposed to pro-poor credit. The growth of broad money has been stable at a high level, compared with that of narrow money, which again indicates the difficulties faced by monetary authorities in the subregion in controlling monetary liquidity and the associated expansion of credit.

Figure X. Monetary indicators, 2006-2007: GCC countries

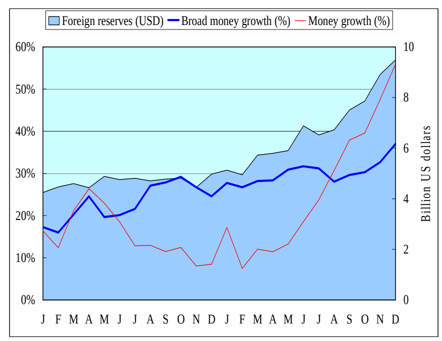
Bahrain



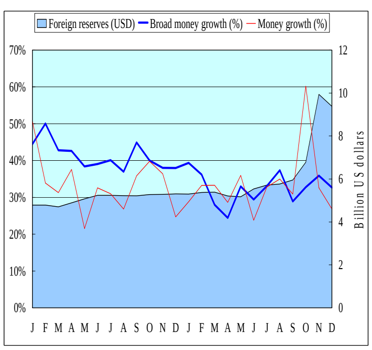
Kuwait



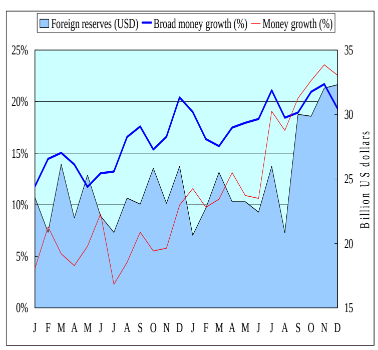
Oman



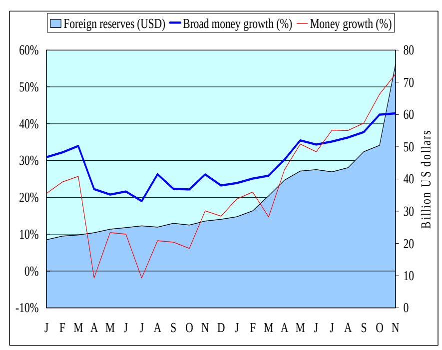
Qatar



Saudi Arabia



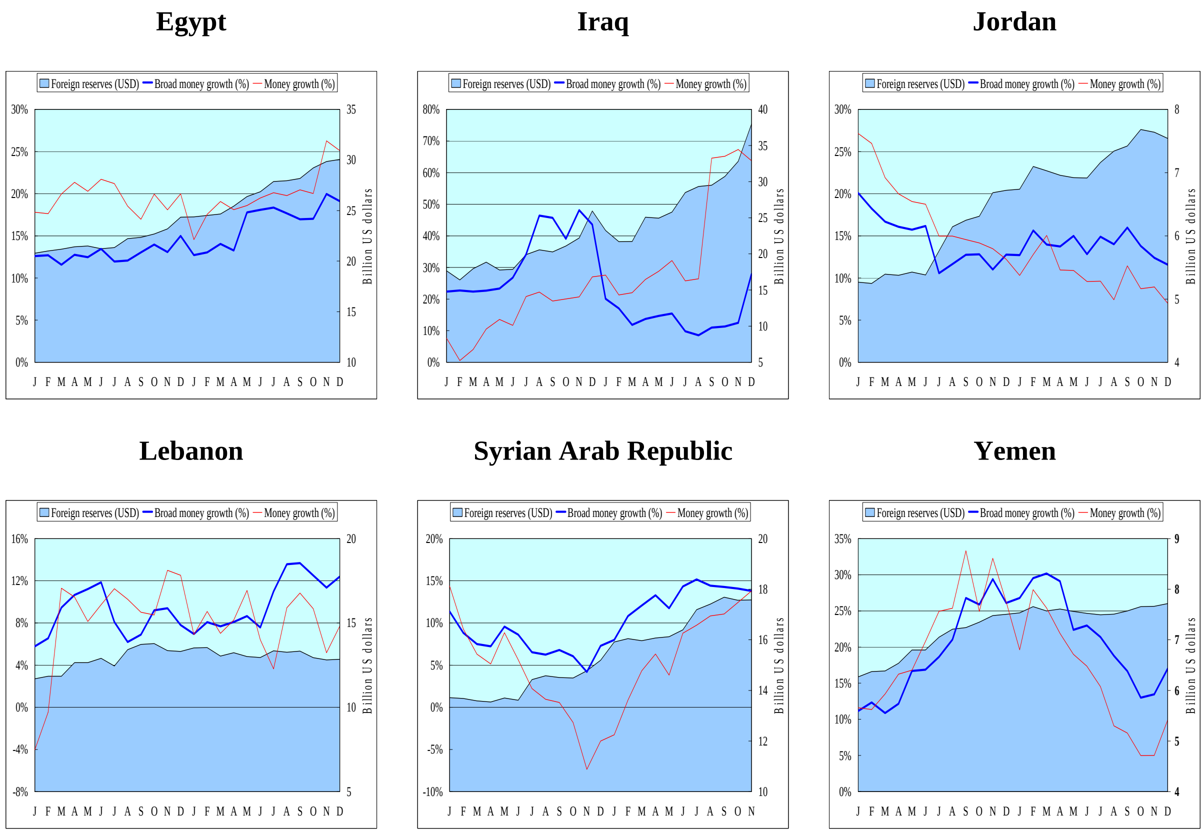
United Arab Emirates



Sources: ESCWA staff calculations, based on national sources.

Figure XI shows the monetary indicators for the MDEs. Foreign reserves have accumulated to a sound level, even though the countries in this subregion have been facing deteriorating current account balances (figure VI). This is an indication that imports of goods and services were solidly financed by the inflow of funds from overseas. In the face of surging inflows of funds, however, monetary authorities in the MDEs have adopted varying stances. A monetary tightening trend was noted in Jordan and Yemen in 2007, where year-on-year growth rates of both narrow money and broad money declined in the course of the year. The monetary stance adopted in Jordan is remarkable for its consistency in policy over a two-year period, which indicates that the country has been successful in sterilizing the effect of capital inflow through monetary measures. As its broad money growth is shrinking in line with narrow money, the tight monetary policy adopted by Yemen has also affected the slow credit expansion in the country. Egypt maintained a relatively stable, though expansionary, monetary stance throughout the year, while Lebanon showed moderate growth in both narrow and broad money. Despite active monetary measures, money demand in Iraq remained subdued. The Syrian Arab Republic adopted an expansionary monetary stance, with a pattern similar to that of the GCC countries.

Figure XI. Monetary indicators, 2006-2007: more diversified economies



Sources: ESCWA staff calculations, based on national sources.

H. Prospects

The ESCWA region is projected to grow at 5.6 per cent in real GDP in 2008 and the average inflation rate is expected to rise to 9.5 per cent. These projections are based on the forecast high price level of international commodities, domestic demand expansion and supply capacity constraints. The economies in the region are expected to remain resilient, despite accelerating inflation. However, it is anticipated that ongoing inflation, based on the rise in the cost of food and housing, will place increased pressure on the poor segments of society. The Governments of ESCWA member countries are therefore expected to take further action to maintain the provision of basic goods at affordable prices.

Current economic conditions may allow the decoupling of the ESCWA region from the global credit turmoil in the course of 2008, unless the oil price were to suffer a sudden, significant plunge. Although the probability of such a contingency is fairly small during this period, it should be noted that the consequences of such an event could be severe, particularly in the MDEs. The economy of the region is still heavily dependent on oil revenues at its core, together with associated business expectations and expansive monetary liquidity. The industrial sector has grown in the region and that non-oil sector in the GCC countries has extended its share of output, but these developments would not yet be sufficient to drive the economies of the region in the case of a sudden, significant plunge in oil prices.

Discussions on the foreign exchange rate regime, in conjunction with the establishment of the GCC Currency Union in 2010, will be intensified. However, despite pressure from the market, the US dollar-peg regime is unlikely to be changed, unless there is strong political intervention regionally or internationally. It should be noted that de-pegging or revaluation of national currencies against the US dollar may have only a moderate effect in alleviating inflation. As the case of Kuwait shows, a reform of the exchange rate regime alone may not be sufficient to lower domestic price levels. A selective demand management, though extremely challenging, is required through flexible monetary and fiscal policies that aim to enhance national supply capacity. In order to increase supply capacity, a country must build up its human capital, as well as its financial capital, through the participation of all social classes in order to capitalize upon the economic and social advantages that the region possesses.

The challenge for policymakers in the ESCWA region is to seek an effective aggregate demand management through selective fiscal and monetary policies that treat development as a long-term pay-off process. The options may appear limited at present, due to institutional settings and constraints. However, the development of policy infrastructure must be continued so that sterilization policy can work to control monetary liquidity and credit expansion at an appropriate level, boosting pro-poor credit in particular, as opposed to credit that fosters speculation on local equity markets. An appropriate and consensual foreign exchange rate regime in the regional context represents a challenging agenda, in the sense that competitive devaluation could represent a negative sum game when export market shares are relatively stable. However, the ongoing discussion regarding the GCC Monetary Union, the establishment of which is planned for 2010, ushers in a new era of hope, especially if it is extended to include the MDEs. The developmental aspirations in socio-economic fields in the ESCWA region require member countries to adopt active fiscal policies and, given that inflation is mainly imported, it should not represent an obstacle to such expansion. Integrating additional social aspects into fiscal policy will partially alleviate the supply constraint through the participation of a potentially productive national labour force, including educated women. Moreover, further progress in economic diversification will develop a level of domestic demand that will sustain short-term economic growth, which in turn is a necessary condition for long-term economic and social development in the ESCWA region.

II. CAPITAL FLOWS IN ESCWA COUNTRIES

As expected, the huge rise in oil revenue in recent years has resulted in a sharp increase in total capital flows. By 2006, excess savings over investment in the region topped 0.5 trillion dollars and is fast approaching the trillion dollar mark. This situation is markedly different from the stagnant situation in the 1980s and 1990s, and similar to the major boom of the 1970s, although not without qualification. While in the late 1970s, a much higher share of oil revenues was retained for investment in the social and physical infrastructure, with the current greater involvement of the private sector in the development process, a lower rate of oil revenues is retained within national borders. In the first oil boom, the absolute value of investment in the Gulf economies increased nearly four times between 1974 and 1977. In the current oil boom, the value of investment has remained steady and, more importantly, has been of poor quality, exhibiting many of the characteristics of a FIRE economy. Furthermore, between 2003 and 2006, oil prices more than doubled, from US$ 28 per barrel to US$ 61,[8] whilst in the case of Saudi Arabia, for example, portfolio investment assets nearly quadrupled over the same period.[9] Moreover, the rate of capital flight from the region has quickened once more, reflecting the uncertainty associated with geopolitical risks and institutional fragility, and hampering the prospects of badly-needed long-term investment in scale economies. In view of the openness of capital account regimes and the stark volatility of oil prices and capital flows, the region must be prepared for a higher rate of reverse flows. The best preventive action is joint action and collaboration between member countries with the clear aim of retaining financial resources in the region.

The ESCWA region is noticeably different from most other developing areas, in the sense that the region harbours tremendous wealth and does not require external financing to bolster the development process. However, it continues to export capital and labour at the expense of long-term development and, given the huge regional disparities, the positive spillover of the neighbourhood effect remains limited. The argument that resource flight is justified on the basis of lack of absorptive capacity founders on the grounds that all ESCWA member countries, in terms of industrial criteria, remain slotted in the "developing" or "least developed" categories, and there is thus ample room for investment in industrial and increasing returns economic activity over the long term. The argument that risk and uncertainty holds back investment can also be countered by appropriate insurance against non-economic causes of economic losses. More importantly, in view of the considerable scope for investment, the export of resources runs counter to Article 1 of the substantive provisions of the International Covenant on Economic, Social and Cultural Rights, which holds that:

> All peoples may, for their own ends, freely dispose of their natural wealth and resources without prejudice to any obligations arising out of international economic co-operation, based upon the principle of mutual benefit, and international law.

A major change in the economic environment is therefore needed to help the region to move from the current consumption-led path of growth to a more sustainable investment-led path. This would include changes in fiscal, monetary and exchange rate policies that promote the inclusion of the poor in economic activities related to investment, employment and export. This change in policy is in line with the right to development policies delineated in previous issues of the Survey. Such a change would bring about a process that would help to break dependence on volatile oil revenues in two ways. First, rapidly rising productivity and income should allow more savings to be retained in the GCC, and MDE savings to be raised faster than output, thereby increasing total financial resources, which can be used to finance a sustained flow of investment. Second, sustained growth under a set of regional guarantees on unforeseen non-economic causes of business losses would attract both domestic and foreign capital, thereby reducing dependency on public investment in the long term. In the short term, however, a feasible way to end oil

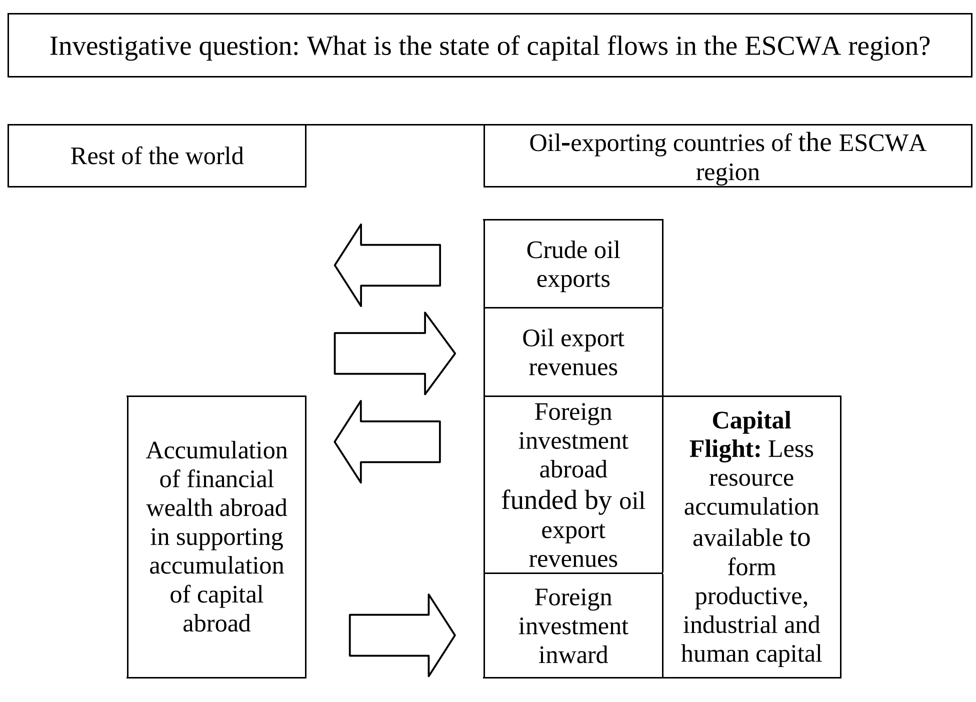
[8] OPEC Reference Basket prices.

[9] IMF (2008).

dependence is to launch a major regional industrialization programme, boosted by public investment, and to sustain rapid growth for a sufficiently long period to allow the retention of savings and external private flows gradually to replace official involvement. The experience of the East Asian countries that successfully broke out of the vicious cycle of poverty and inadequate domestic resources during the 1960s and 1970s suggests that if GDP growth could be raised to some 6 per cent per annum and sustained at that rate for a period of 10-12 years through a large injection of public resources, accompanied by appropriate industrialization policies, the need for official financing would gradually diminish as alternative sources came forward. But if the minimum quantum of public resources needed to initiate and sustain such industrialization processes is not provided, oil dependence is likely to continue unabated.

This chapter examines the rising tide of capital flows and attempts to chart the policy landscape for appropriate links between capital flows, sustained productivity growth and economic growth, which are employment-creating. It includes an empirical composition of capital flows, but the analysis was carried out in the face of a paucity of data. It also constitutes a fact-finding and data-processing exercise with the following two subordinate aims. The first is to ascertain the magnitude of aggregate resource flows pertaining to ESCWA countries as a result of the oil boom and the attendant international capital flows. The second is to estimate the extent of capital flight from the region in order to shed more light on the need to counter long-term uncertainties that restrict quality investment. The development implications of these trends are also discussed, with a view to taxing capital flows and gains in a way that assists expanding fiscal policy, including investment in social infrastructure, which is in line with pro-poor policies and the right to development.

Figure XII. Capital flight from the ESCWA region



Box 2. Resource leakage and underutilization of resources

Outflows of resources from the region reflect the underpinnings of a vicious cycle of low capacity build-up and rising leakage in the cycle of capital. Low overall levels of demand and underutilization of resources can be viewed as the result of a power discourse associated with the international financial community and issues of global and regional security that undervalue the developmental impact of resource transfer.

Responding to underutilization requires benchmarking for social development and linking oil-generated surpluses to capacity growth, greater utilization of resources, and ultimately productivity growth through region-wide industrialization, trade and diversification. State industrialization policies should aim to raise demand of high-productivity sectors and sponsor comprehensive service sector strategies that are linked to leading sectors and augment their profitability.

Reserves can be dedicated within the region in support of fiscal expenditure that spearheads long-term investment priorities. Limiting the risk of short-term flows can be aided by imposing presumptive taxes on capital gains and flows, financial withdrawal provisions, ownership requirements, and subsidies and protections for investments in strategic sectors.

A. RECENT HISTORY

The rapid growth of international capital flows since 2003 has significantly affected ESCWA countries and influenced their economic performance. This recent wave of capital flows to and from the region is related to the oil boom that began in 2002-2003. The effect of capital flows has been different for oil-exporting countries (primarily the Gulf countries) compared with the MDEs in the region. During the period 1990-2002, aggregate resource flows declined for diversified ESCWA economies, while remaining volatile for oil exporters. Moreover, since the commencement of the oil boom, aggregate resource flows have turned negative for oil exporters. The composition of flows, meanwhile, is characterized by reduced official and increased private rates of flows. As resource flows became increasingly private, ESCWA countries kept their long-term debt under control (repaying sizeable amounts), while receiving smaller volumes of official grants and attracting very limited portfolio equity flows. The new environment of primarily private flows has not led to increased investment levels for ESCWA countries.

FDI, on the contrary, has presented a more complex picture. Certain diversified economies have attracted sizeable flows of FDI since 2000, mostly through mergers and acquisitions, though not enough to raise the level of aggregate investment significantly (see table 7). On the other hand, oil-exporting countries have recorded far stronger inflows and outflows of FDI since the oil boom started. Inward FDI flows have been heavily directed towards the construction sector, though plans have also been announced for investment in other sectors. The effect of these flows on investment and the economic performance of the oil exporters remains to be seen. Finally, there is anecdotal evidence that significant FDI has also taken place from the oil exporters to the MDEs in the ESCWA region, but quantifying and assessing the importance of this phenomenon is difficult, given the lack of data.

Since the late 1990s, capital flight, the most telling symptom of deep macroeconomic malaise, has occurred from all ESCWA countries, but primarily from the oil exporters. Capital flight from the MDEs – especially from Egypt, the Syrian Arab Republic and Lebanon – became significant after 2000. For oil exporters, capital flight of a different order of magnitude has taken place in recent years. Towards the end of the 1990s, strong capital flight had already been noted from the United Arab Emirates and Kuwait. However, once the oil boom had commenced, capital flight became particularly pronounced. A substantial part of the rents from the recent oil boom has leaked abroad and been invested in non-transparent instruments. The development implications of these resource outflows are not quantifiable, yet they clearly represent a drain of resources from a region characterized by low investment rates.

Data availability and quality are major problems in estimating capital flows to the ESCWA region. However, total FDI inflows into the region were estimated at US$ 24 billion by the United Nations Conference on Trade and Development (UNCTAD) in 2006.[10] According to the same source, the flows were most heavily concentrated in the United Arab Emirates and Saudi Arabia. Privatizations and M&A were key causes of FDI, though investment in oil and gas was also a significant contributor. The United

[10] UNCTAD (2006b), p. 59.

Arab Emirates has engaged in privatizing utilities (water and energy), while Jordan, Bahrain, the Syrian Arab Republic, Oman and other countries have put in place frameworks for extensive privatization of manufacturing, utilities and telecommunications. Governments in the region are implementing liberalization policies with the aim of attracting further flows of FDI. The United Arab Emirates already has some 15 free trade areas in operation. Furthermore, legislation and regulations applying to FDI have also been increasingly relaxed: Qatar has established the Qatar Financial Centre, allowing full ownership and repatriation of profits; the United Arab Emirates has opened the Dubai International Financial Exchange, allowing for full foreign ownership, and also plans to improve data collection and reporting on FDI by creating a database; and Saudi Arabia has commitments to facilitate FDI in insurance, banking and telecommunications. Bilateral free trade agreements have been signed or planned between several countries in the region, as well with the European Union, India and elsewhere.

TABLE 7. NET FOREIGN DIRECT INVESTMENT, ESCWA COUNTRIES
(*US$ million*)*

Country	1990	1995	2000	2001	2002	2003	2004
Egypt	734	595	1 235	510	647	237	2 157
Jordan	38	13	815	138	75	436	651
Lebanon	6	35	964	1 451	1 336	2 860	1 899
Oman	125	29	83	5	109	489	200
Syrian Arab Republic	71	100	270	110	115	180	275
Yemen	(130.9)	(217.7)	6.4	135.5	101.7	5.5	143.6
Bahrain	(183)	431	364	80	217	517	865
Kuwait	6	7	16	(112)	4	(67)	24
Qatar	5	94	252	296	624	625	1 199
Saudi Arabia	1 861	(1 875)	(1 881)	20	(614)	(587)	(334)
United Arab Emirates	(116)	400	(515)	1 184	1 307	4 256	8 359

Source: UNCTAD *World Investment Report*. Bahrain: no difference; Kuwait UNCTAD 1990-1994: no difference; Qatar: only UNCTAD available; United Arab Emirates: no difference; Saudi Arabia: ESCWA calculation, much lower than UNCTAD from 2000.

Note: Parentheses ( ) indicate negative numbers (outflows).

* Due to data constraints, most of the tables presented in this chapter only extend to 2004.

Of particular interest with regard to FDI are intraregional flows.[11] It appears that there have been strong flows from the Gulf countries, which have benefited from high oil prices, to the MDEs. According to UNCTAD estimates,[12] Kuwait, Saudi Arabia and the United Arab Emirates account for 88 per cent of outward intraregional flows, while Lebanon, Saudi Arabia, the Syrian Arab Republic and the United Arab Emirates have been the major recipients, accounting for more than 90 per cent of the total. Inevitably, there has been a corresponding increase in intraregional cross-border M&A.

Finally, outward FDI from the ESCWA region also increased very rapidly during 2004-2005. The main institutions engaged in these flows were the state-owned investment firms of the oil exporters, principally Kuwait, Saudi Arabia and the United Arab Emirates. Outward FDI flows have been estimated at US$ 7 billion in 2004 and US$ 16 billion in 2005. In a new development for the oil exporters, who engaged mostly in portfolio investment during the previous oil boom, investment has been directed to oil-related manufacturing and services.[13] Nonetheless, outward FDI remains a small part of the total capital outflows of the oil exporters, the bulk being bank accounts and portfolio holdings. Private equity firms and institutional investors from the oil exporters have played a key role in the recent growth of outward FDI. Finally, Kuwait and Saudi Arabia have a “look East” policy in place which amounts to FDI in the service sectors of certain Asian and African economies (India, Pakistan and the Sudan), as well as closer links with oil companies from China and India.

[11] Reliable data are difficult to obtain, as balance of payments statistics in the region are generally poor.

[12] UNCTAD, op. cit., pp. 62-3.

[13] Ibid, p. 63.

Box 3. Global context and its impact on the ESCWA region

The recent capital flows in the ESCWA region must be set in an appropriate global context. International private capital flows were heavily influenced by the 1997-1998 financial crises in Asia and Russia, and the crises in Turkey and Argentina in 2000-2001. The sum total of capital flows declined from some US$ 4,000 billion in 2000 to just over US$ 2,000 billion in 2002, though there have been important differences in the behaviour of flow components. In particular, flows to developing countries collapsed. Recovery from these successive crises began in 2003 and accelerated dramatically in 2004 and 2005. In 2005, global flows were estimated at a record level of US$ 6,000 billion,[a/] and a substantial share of the aggregate was directed to developing countries. For 2005, the World Bank estimated that a record sum of US$ 491 billion of private international capital flows went to developing countries.[b/]

Equally important, however, have been financial changes within developing countries during the same period. Reserves have risen to unprecedented levels across the developing world, but above all, China holds more than US$ 1,000 billion in reserves. Since these reserves are held primarily in US-dollars, developing countries have in reality been net exporters of capital during this period, despite the substantial rise in capital inflows. Thus, in net terms, capital has been flowing from poor to rich countries.[c/] This net export of capital has been made possible by substantial current account surpluses for several developing countries, above all, China and the oil producers. The counterpart to these surpluses has been the sustained current account deficit of the United States, which has given rise to deeply-embedded imbalances in the world economy. In short, developing countries, including the poorest, have been financing the current account deficit of the United States since the early 2000s.

The rise of FDI to the developing world has been driven by a new wave of mergers and acquisitions (M&A) and privatizations, though the sums involved have not yet reached the magnitude of 1999-2001 in terms of number and value of deals.[d/] It should be stressed that in theoretical and empirical terms, the impact of FDI on development is far from clear. Generally speaking, FDI is expected to provide fresh capital that might lift liquidity constraints in developing countries. Technology and human skills are also likely to be transferred, further improving the scope for productivity increases. In the literature on FDI, these benefits are often related to the advantages enjoyed by multinational firms, compared with local firms. Thus, multinational corporations are perceived to be technologically superior, improving the mobility of workers in local markets,[e/] improving vertical linkage in the economy,[f/] and facilitating the flow of knowledge to the local economy.[g/] However, the empirical evidence regarding technology spillovers is far from conclusive. It appears that imitation, learning and direct transfer of technology from multinational to domestic firms is neither regular nor widespread. In broader terms, it has not been shown conclusively that FDI has a positive impact on growth rates. Ram and Zhang (2002) found qualified evidence of a positive impact and Li and Liu (2005) reported even stronger positive findings, while Dutt (1997), Carkovic and Levine (2005) and Busse and Croizard (2006) found no robust link between FDI and income growth. In the ESCWA region, FDI is of the resource-seeking type, particularly for oil exploration, and does not translate into dynamic growth processes.

In telecommunications, banking and real estate, such inflows have also been related to the stock market boom in 2004-2005, which in the ESCWA region resulted in a series of sharp corrections as early as 2006.[h/] More pertinently, and concerning the area of positive externalities resulting from FDI in the region, ESCWA examined FDI and growth through absorptive capacity (defined as the technology gap, the level of workforce education, financial development and institutional quality) and found that it is unlikely that the average Arab country stands to gain from FDI unless it invests in the knowledge economy. As a consequence, costly financial incentives to attract greater FDI might be wasteful, if not welfare-reducing, in Arab countries. Although it is difficult to assess the exact contribution of FDI to growth, in the case of Egypt, for instance, the recent food riots are a telling example of a precarious growth experience. Although Egypt has been a positive recipient of FDI for more than two decades and significant inward FDI has taken place since 2003, after 25 years of 5 to 6 per cent average real GDP growth, a 15 per cent rise in the price of bread led to mass riots and exposed the fragility of the development process. Upon closer analysis, it was found that income inequality, measured over the same period, was rising. The net result is that an inequitable and narrowly based path of growth was experienced, from which the gains of the poor were minimal.

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a/ Goswami, Ree and Kota (2007).

b/ World Bank (2006b).

c/ Prasad, Rajan and Subramanian (2007).

d/ UNCTAD (2006b), p. 14.

e/ Fosfuri, Motta and Ronde (2001), pp. 205-222.

f/ Markusen and Venables (1999), pp. 335-356.

g/ Blomström (1986), pp. 97-110.

h/ The impact of merger and acquisition-oriented FDI is not immediately comparable to that of greenfield FDI. The former comprises portfolio acquisitions, while the latter represents a direct transfer of capital and technology, leading to employment increases in the recipient country.

FDI flows have integrated ESCWA oil exporters much more closely with the world economy during the last three or four years. One particular indication of this trend is outward FDI from the United Arab Emirates in 2005-2007, which included the acquisition of British port operator P&O in 2005, Pearl Energy Limited of Singapore in 2006, Marfin Financial Group of Greece in 2006 (31.5 per cent), and the Brae oil and natural gas assets of Talisman Energy of Canada in the North Sea in 2007.[14] Much inward FDI, as previously mentioned, has been directed to the construction and financial sectors. It remains to be seen whether such inward FDI will have lasting effects in the Gulf and, even more, whether it will have a significant impact on other ESCWA countries.

Developing country (emerging market) bond issuing increased substantially during 2004-2005 in both gross and net terms, following its recovery from the shocks of 1998-2001. Despite becoming more widespread, issuing of bonds by developing countries has remained heavily concentrated. The fastest growth in issuing was by countries from Eastern Europe and Central Asia, led by Poland and Russia. Latin American countries were second and East Asian countries third, led by China. About half the bonds were issued by sovereign borrowers, while private borrowing represented approximately one third of the total in 2005. Bond issuing by ESCWA countries also increased strongly in 2004-2005, but from a very low base and remaining a small fraction of the number issued by the three leading areas.

The oil boom that started in 2000 has raised significant development issues for ESCWA countries, with obvious similarities to the earlier oil boom of 1974-1984, but also with major differences. Two of these differences are that global capital flows are considerably freer and more extensive than in the earlier period, and that the financial systems of ESCWA countries are now far more sophisticated in dealing with the increased flows of funds. Since the early 1990s, ESCWA countries have been taking steps towards greater integration with the world market, in particular by lifting regulations on trade and finance. Nonetheless, significant regulatory constraints remain on the capital accounts of ESCWA countries, as well as constraints on the ability of foreign capital to operate in domestic financial sectors and in the economy more generally. These constraints are stronger for the Gulf oil exporters than for the more diversified ESCWA economies. Finally, since the early 1990s and partly at the behest of multilateral organizations, ESCWA member countries have been engaged in reducing fiscal deficits, mostly through the lifting of subsidies for goods and services and through reductions in public investment. The intermediate result, as judged by average regional real per capita income between 1990 and 2000, which is about half a percentage point, shows that such measures were devastating, both in terms of efficiency and welfare gains. If it were not for the high oil prices, starting in 2003, poor growth trends would have continued, implying that contractionary macro policies are incompatible with the delivery of optimal outcomes. When restrictive fiscal and monetary policies are practised within a short-term horizon, as opposed to the expanding fiscal policies supported by adequate monetary coverage over the long term that are required for development, economic growth remains unsteady and subject to terms of trade shocks emanating from the vagaries of oil price movement. Moreover, the openness of capital accounts allows more resource leakage at the expense of what is needed for long-term development, which is a strong industrial investment component, crowded-in with incentives from rising pubic investment.

B. THE SIGNIFICANCE OF CAPITAL FLIGHT FROM ESCWA COUNTRIES

Capital flight has long been perceived as a key weakness of the ESCWA countries and is indicative of their poor investment climate. For this reason, repatriating and retaining domestic capital has often been perceived as a lever of development for Arab countries. For obvious reasons, the heaviest capital flight in recent years has occurred in the oil exporters, though our estimates show that MDEs are also prone to capital flight. Capital flight from ESCWA countries appears to have become more severe as a result of the recent oil boom and the surge of global capital flows since the early 2000s. It is not possible to tell what kind of assets have been acquired through these flows, since capital flight

[14] EFG-Hermes (2007a), p. 20.

is by nature opaque, but it can be assumed that they principally comprise the purchase of developed country debt instruments and bank deposits. It is also likely that the larger part of these flows is in US dollars. If allowance is also made for increased reserves, the ESCWA region emerges as a substantial net supplier of resources to the developed world, heavily invested in short-term debt Government instruments and bank deposits.

In view of the problems of unemployment and poverty faced by ESCWA countries, and bearing in mind the persistent weakness of investment, capital outflows and, in particular, capital flight represent both a missed opportunity and a significant economic problem. It is true that, from the perspective of the Gulf countries, the surpluses generated on current account are too large to be directly and immediately reinvested in the domestic economy in the short term. In the long term however, the prospects of building physical and social infrastructure show vast potential. It would also be desirable for significant parts of the surpluses to be redirected towards productive investment in other ESCWA economies. This type of investment, however, was sparse during the last oil boom and, although it has picked up recently, continues below potential. Slightly rising inter-Arab FDI flows have been seen in recent years in finance and real estate, although the size of these flows is difficult to ascertain. On the other hand, our estimates of capital flight and the figures for reserves indicate that most of the available surplus resources have been directed towards debt and other financial instruments abroad.

Box 4. The impact of conflict on development

Capital flight is driven principally by an environment of political uncertainty. In the ESCWA region, conflicts or the prospect of enlarged conflicts continue to impede development. Indeed, member countries that are off-track on the path to achieving the MDGs are likely to be situated in conflict, near-conflict or post-conflict zones. These underachieving countries depend for their economic growth on the export earnings of a primary product and the limitations imposed on their course of development are twofold. First, the determining undercurrent in the development of these countries lies in the immediate damages of war or the drag that political tensions impose on economic, social or institutional development post-war. Second, although economic growth, rapid industrialization and technological advancement are important policy measures in themselves for these countries to adopt, unless there is a more equitable distribution process, allowing people to exercise their rights and achieve valuable human tasks, the development debacle will linger on. Abject poverty in these countries is the result of highly unequal distribution in national incomes and lost opportunities in investment resulting from capital flight, resource leakage and the ineffectiveness of regional cooperation policies.

When it comes to these underachieving ESCWA countries, macroeconomic questions have to be put differently. It is all too simple for small, risky and fragmented markets to garner the prospect to continuously stifle human and financial resources, and what remains of assets are usually channelled into ephemeral, non-productive activity, namely patronage and political capital-building. In an area so rich in resources, a turnaround could be readily achieved if a more integrative and tension-diffused environment were to be created in which the interests of the rich hinge on the betterment of the poor. A rejuvenated, actively involved public sector and the issues of poor investment that result in rising unemployment should be central to Government policy. In order to render the MDGs comprehensively sustainable, a better employment environment must be provided on the basis of social accountability, as well as considerations of economic efficiency. In the long run, a healthy social environment more than pays for the short-term economic shortfall.

On an individual level, owners of capital decide where to invest on the basis of rates of return and the general investment environment. Exchange rate risk and political risk are also major considerations, and industrial policy and incentives to attract capital may also play a role. ESCWA countries have generally adopted strategies of liberalization and increasing openness to the world market in recent years, most clearly in the more diversified economies. Liberalization of the economic environment in Egypt and the Syrian Arab Republic, for example, preceded significant capital flight in 2000-2004. Yet, as the oil boom took hold, greater FDI flows from the Gulf countries have been directed to Egypt and other diversified ESCWA economies since 2004. Nonetheless, large volumes of resources have also been kept in reserves that pay very low rates of return and carry considerable exchange rate risks. On the other hand, rising oil revenues, together with some liberalization of the economic environment in the Gulf, have led to significant transformation of the Gulf economies, especially that of the United Arab Emirates. The clearest indication of this change has been strong flows of inward and outward FDI, some of it to other Arab countries, with much of it concentrated in the construction sector as a result of bubble building in real estate. The longer-term implications of these trends for ESCWA countries remain to be seen, but there is a missed opportunity resulting from the channelling of resources away from increasing returns activity and infrastructure development. Economic diversification, which is required for broad-based economic and steady employment growth, has not been prevalent in the region so far.

The problematic investment performance of ESCWA countries has complex links with saving patterns. In this respect there are clear differences between diversified and oil-producing economies. The former show low or very low levels of gross domestic saving, though there is some variation between them, since the Syrian Arab Republic, for instance, has significantly higher savings than the other countries in this group. In general, however, the financial systems of the diversified economies have been unsuccessful at mobilizing available surpluses among businesses and across the economy more generally. Making matters worse, liberalization of the financial systems of diversified ESCWA economies in recent years appears to have created banks (the main financial institutions in ESCWA countries) that are reluctant to lend to private enterprises. Financial institutions exhibit a preference for lending to Governments, to individuals for consumption purposes and on mortgage.[15] Investment weakness has persisted and in this context, in the absence of deep financial intermediation, which is an indispensable condition of broad-based industrialization, the issue of whether capital flows from abroad can successfully buttress investment acquires additional significance.

Among oil exporters, savings have increased dramatically since 2002, mostly due to rising oil prices (see figure XIII). Consequently, the problem of stagnant investment in these countries is quite different from that in diversified countries. It is possible, for example, that domestic investment has simply not responded quickly to rising domestic surpluses, and the effects of the oil boom may become apparent in the near future. More pertinently, however, the excess of savings over investment during recent years indicates that these countries are channelling surpluses abroad, much as happened in the previous oil boom, although now on a larger scale. The magnitude, direction and composition of these capital flows are again matters of considerable importance. The same question, therefore, arises as during the previous oil boom: are the huge oil surpluses (rents) accruing to certain ESCWA countries supportive of broad-based development or even steady economic growth? Judging by economic growth rate, the answer is clearly no. Indeed, the real GDP growth rate fluctuates highly as a result of oil price variation and, when measured over the last 25 or 35 years, the annual per capita average growth rate is nearly zero or negative. It is important to note that during this oil boom, net outward flows have been accompanied by substantial inward flows related to the recent expansion of global FDI and other capital flows, although these are minor when compared with the value of outflows. Moreover, the oil exporters now have sizeable and relatively sophisticated financial systems, most notably banks.[16] These financial systems are playing a significant role in managing capital flows to and from ESCWA oil exporters. However, it is to be noted that a lower rate of investment has been made in the physical and social infrastructure in comparison with the previous oil boom.

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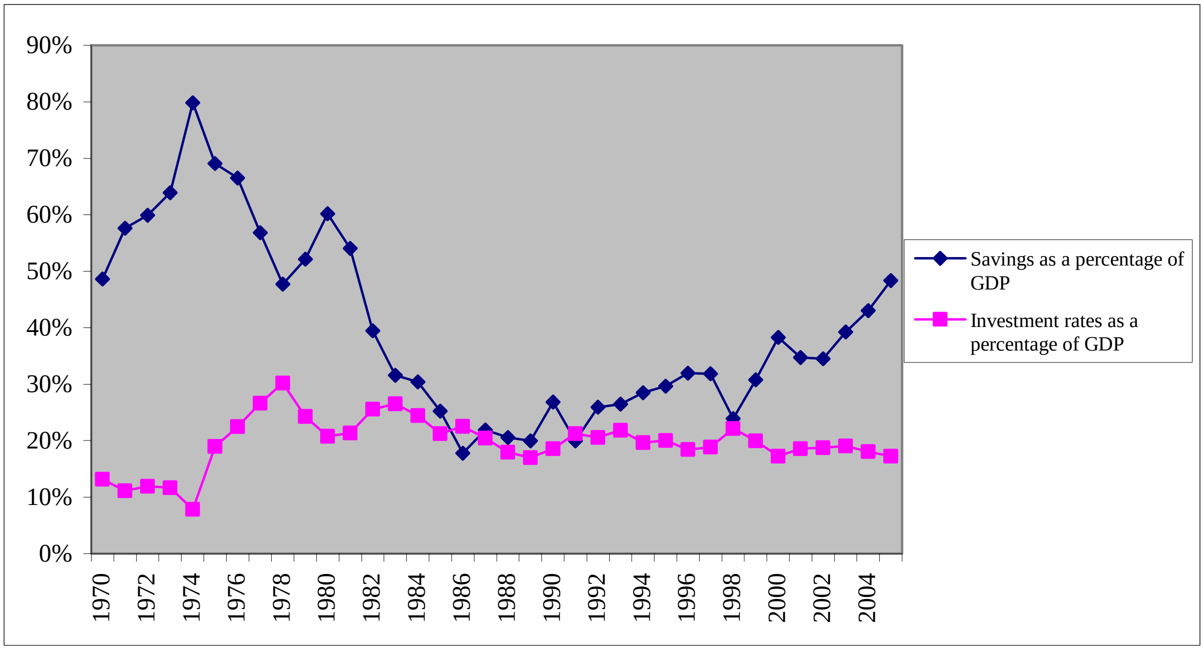
[15] World Bank (2006a).

[16] IMF (2006f), EFG-Hermes (2005) and EFG-Hermes (2007b).

Figure XIII. Savings and investment rates



Source: ESCWA calculations based on World Bank, *World Development Indicators*, (various years).

C. Residual estimation of capital flight

Capital flight has been a matter of some concern to developing countries since the early 1980s, as unrecorded export of short-term capital from developing countries is assumed to hinder domestic investment and growth prospects. The putative effects of the loss of resources potentially available for investment would be all the more serious if the exporting country also carried significant external debt. More broadly, capital flight may be an indicator of the investment climate of a country. Since it involves mostly short-term capital, it is also a gauge of the outlook on productive long-term investment by those who control money capital. Pronounced capital flight, other things being equal, indicates the preference of money capital owners for short-term investment abroad, principally in financial instruments.

It is apparent that capital flight is likely to be influenced by political uncertainty and major political events. In measuring capital flight from the ESCWA region, therefore, we need to take into account at least two major events of recent years, namely the first (1990-1991) and the second (2003) Gulf wars. Furthermore, the outflow of capital is also likely to respond to the internal political situation in a number of countries in the region. The investment choices made by the oil exporters in the Gulf region, for instance, reflect the internal political and social equilibrium in relation to regional stability. The investment outlook of the holders of money capital in the Gulf countries is certainly influenced by the mix of political uncertainty, small indigenous populations, large migrant labour forces and significant expatriate communities from Western Europe. The oil exporters, consequently, have long been characterized by a rentier outlook. In contrast, for the more diversified ESCWA economies, such as Egypt and the Syrian Arab Republic, capital flight probably reflects perceptions of internal stability in the face of political uncertainty, rapidly growing populations, persistent poverty and mediocre economic performance. Finally, capital flight across the region is primarily influenced by political instability across the Middle East.

The first step in any analysis of capital flight is to gauge its extent, something that is far from easy for ESCWA countries. A major difficulty is identifying an appropriate concept of capital flight for our purposes. As a starting point, it is necessary to differentiate between normal and abnormal flows. The former relates to portfolio choices of agents and institutions in developing countries that are part and parcel of international economic transactions for any country integrated into the world economy, including FDI, trade credit and bank activities abroad. The latter concept purports to capture unusual, irregular and possibly illegal flows that spring from such domestic concerns as potential loss of wealth due to Government action or the possibility of speculating on a fall in the exchange rate.[17,18] The latter is presumably the type of capital flight that is most likely to generate problematic economic outcomes. However, in practice it is extremely difficult to distinguish between the two empirically. Most studies in the literature, therefore, have opted for a broad concept of capital flight that captures all outflows of capital on the grounds that they could create economic problems, especially with regard to financing the balance of trade and making debt payments.

A better sense of what is being measured can be gained from the standard IMF Balance of Payments framework.[19,20] In that context, a broad measure of capital outflow is given by bank acquisitions of foreign assets, plus other short-term private capital outflows, plus other bond purchases, plus errors and omissions. By construction, this is identical to the negative of the sum of the current account balance, plus net equity flows, plus additions to reserves, plus other long-term capital of the resident official sector. Since they are identical, both sums provide a measurement of capital flowing out of a country, but the former measures it directly, while the latter measures it indirectly. Moreover, the former relies entirely on balance of payments data, which may be unreliable or not available. The latter, however, can be obtained by utilizing data available from other sources. The latter sum has therefore become the most widely used, or “residual”, method in the literature. A key aspect of the method is the use of World Bank data in order to capture net increases in external debt.

[17] Deppler and Williamson (1987), pp. 39-58.

[18] Kindleberger (1987).

[19] Claessens and Naude (1993).

[20] Schneider (2003).

The residual method compares the sources of capital inflows (that is, net increases in external debt plus net inflows of FDI) to the uses of capital inflows (that is, the current account deficit and additions to reserves). When using standard IMF data on the balance of payments, sources and uses should be equal. When using World Bank data on external debt, however, there may be differences between sources and uses. Thus, if sources exceed uses, the difference (or residual) is perceived as capital flight.[21] It follows that the residual method categorizes all unrecorded private capital outflows as capital flight. The residual method was originally used by the World Bank (1985) and Erbe (1985). It has been applied, with modifications, very widely in the literature; for instance, Morgan Guarantee (1986), Boyce and Ndikumana (2001), Schneider (2003), Mohamed and Finof (2004) and Salisu (2005). The standard residual method is also adopted for the measurements that appear below.

D. ESTIMATES OF CAPITAL FLIGHT FROM ESCWA COUNTRIES

The estimates shown in table 8 indicate significant capital flight across the ESCWA countries, in particular from the oil exporters. For the diversified economies, capital flight is shown to have been negative for most of the 1990s. However, following the introduction of liberalization and the partial lifting of controls on finance, capital flight became positive after 2000, with the exception of 2003. The inward flows in 2003 are almost entirely accounted for by exceptional inflows into Lebanon during that year. For Egypt, the Syrian Arab Republic and Jordan, and even for Lebanon except for 2003, capital flight was prevalent during the period 2000-2004. However, as the effects of the oil boom began to emerge, the figures, at least for Egypt, for 2005-2006 are likely to be very different. FDI from Gulf countries has increased substantially, thus reversing capital flight. Unfortunately, the lack of data availability makes it impossible to calculate capital flight across the ESCWA region after 2004. Even so, the significance of the results obtained has to be assessed with caution.

[21] Hermes, Lensink and Murinde (2002).

Capital flight, however, has been of a different order of magnitude for the oil exporters. The sums are large, as is to be expected from countries that have generated substantial current account surpluses in recent years. During the first half of the 1990s, the oil exporters saw reverse (negative) capital flight, especially in 1991 with the financing of the first Gulf war. Towards the end of the 1990s, capital flight turned positive and was sizeable, led by the United Arab Emirates and Kuwait. The flows became particularly pronounced after 2000 and reached a peak after 2003 as the oil boom commenced. It is reasonable to assume that capital flight was equally strong in 2005 and 2006, given the further increase in oil prices, but calculation is not possible for those years. The main source of capital flight since 2000 appears to be Saudi Arabia, though strong outflows were also registered by Kuwait and the United Arab Emirates. It is worth stressing once again that Saudi figures are highly problematic. Given that Saudi reserves are kept and reported by a number of different institutions, it could be that the figures used here are an underestimate, thus overestimating the extent of capital flight. Nonetheless, there seems little doubt as to the existence of capital flight. In summary, table 8 shows that a substantial part of the rents accrued by the Gulf oil exporters during the recent oil boom has been invested abroad in often opaque ways.

The relative magnitude of capital flight can further be seen in table 8. For diversified ESCWA economies, capital flight since 2000 has been of the order of 1.5-3.5 per cent of GDP. This represents a substantial loss of resources for countries that continue to suffer from investment shortfalls. However, this is dwarfed by capital flight from the oil exporters, which ranges from 6 per cent to 17 per cent of GDP (more than double that of the diversified economies). In Kuwait alone, capital flight reached nearly 30 per cent of GDP in 2004. The conclusion is again apparent: since 2000, Gulf oil exporters have channelled large volumes of resources abroad, while investment in the broader ESCWA region has remained weak and unemployment high.

TABLE 8. CAPITAL FLIGHT, ESCWA COUNTRIES
(*US$ million*)

Country	1991	1995	2000	2001	2002	2003	2004*
Egypt	(1 015)	(751)	(381)	810	1 452	3 034	3 749
Jordan	744	(419)	(525)	579	245	595	390
Lebanon	(3 073)	(878)	1 741	1 674	271	(4 602)	2 118
Oman	(762)	(868)	3 290	1 330	(599)	187	538
Syrian Arab Republic	3 179	1 065	19	307	1 120	1 013	(148)
Yemen	(700)	(365)	(1 275)	(104)	19	(432)	(167)
Subtotal, MDEs	(1 627)	(2 216)	2 868	4 596	2 508	(205)	6 480
Bahrain	1 733	2 552	3 017	2 200	2 132	..	..
Kuwait	(26 808)	5 073	12 518	5 352	4 815	10 789	16 629
Qatar	(4 758)	(1 933)	2 598	5 632	7 041	..	..
Saudi Arabia	(26 810)	(6 581)	10 131	10 434	7 763	25 146	46 893
United Arab Emirates	2 856	(834)	5 433	3 608	(1 591)	2 574	12 362
Subtotal, GCC countries	(53 787)	(1 723)	33 696	27 227	20 160	38 510	75 884

Source: Calculated from several sources discussed in the text.

Notes: Parentheses ( ) indicate negative numbers (inflows).
Two dots (..) indicate that data are not available.

* Estimated figures.

TABLE 9. CAPITAL FLIGHT AS A PERCENTAGE OF GDP, ESCWA COUNTRIES

Country	1991	1995	2000	2001	2002	2003	2004
Egypt	(2.2)	(1.2)	(0.4)	0.8	1.7	3.7	4.8
Jordan	17.1	(6.2)	(6.2)	6.5	2.6	5.8	3.4
Lebanon	69.0	(7.9)	10.4	9.8	1.5	(23.1)	9.7
Oman	(6.7)	(6.3)	16.6	6.7	(2.9)	0.9	2.2
Syrian Arab Republic	22.5	6.4	0.1	1.5	4.9	4.5	(0.6)
Yemen	(5.6)	(2.9)	(13.3)	(1.1)	0.2	(3.6)	(1.2)
Subtotal	(1.8)	(1.8)	1.7	2.7	1.5	(0.1)	3.7
Bahrain	37.6	43.6	37.9	27.8	25.2	..	..
Kuwait	(247.6)	18.7	33.2	15.3	12.6	23.4	29.8
Qatar	(69.1)	(23.7)	14.6	31.7	35.7	..	..
Saudi Arabia	(20.4)	(4.6)	5.4	5.7	4.1	11.7	18.7
United Arab Emirates	8.5	(1.9)	7.7	5.3	(2.1)	2.9	11.8
Subtotal	(28.7)	(0.8)	10.5	8.7	6.1	10.1	16.8

Source: Calculated from several sources discussed in the text.

Notes: Parentheses ( ) indicate negative numbers.
Two dots (..) indicate that data are not available.

The factors that make for capital flight can be traced through the tables below. Thus, the oil boom has led to the emergence of large current account surpluses for the oil exporters, primarily Kuwait, Saudi Arabia and the United Arab Emirates, as shown in table 10. Indeed, most ESCWA countries have reported current account surpluses since 2000, including Egypt. The exception is Lebanon, where the current account has been continually in deficit since 1990. It should be noted, however, that high oil prices since 2002-2003 have inflated the oil bills of some of the diversified economies, including Jordan and Lebanon, leading to difficulties with the current accounts. The high price of oil has also exacerbated poverty among some of the diversified economies, including Egypt, Jordan and Yemen, particularly as Governments have been trying to eliminate subsidies on oil products used by the poor.

TABLE 10. CURRENT ACCOUNT BALANCE, ESCWA COUNTRIES, CURRENT PRICES
(*US$ million*)

Country	1990	1995	2000	2001	2002	2003	2004
Egypt	(2 593)	387	(1 163)	(33)	614	1 943	3 418
Jordan	(654)	(257)	59	(5)	538	1 179	(18)
Lebanon	(1 098)	(1 071)	(2 852)	(3 278)	(2 855)	(3 020)	(3 953)
Oman	1 099	(818)	3 089	1 854	1 333	863	433
Syrian Arab Republic	1 748	207	1 024	1 199	1 639	1 071	(3)
Yemen	(293)	125	1 265	507	535	(8)	255
Bahrain	70	237	846	239	-35	219	442
Kuwait	3 720	5 016	14 671	8 328	4 250	9 414	17 323
Qatar	(742)	(2 224)	3 205	4 152	3 824	5 754	7 552
Saudi Arabia	(4 153)	(5 325)	14 336	9 366	11 889	28 085	51 993
United Arab Emirates	7 942	2 178	12 218	6 590	3 045	7 148	10 645

Source: IMF, World Economic Outlook Database, September 2006.

Note: Parentheses ( ) indicate negative numbers.

The surpluses on current account have been also benefited from FDI inflows, representing a significant new phenomenon for ESCWA countries, which generally missed out on these during the previous global boom of 1996-1997. FDI increased rapidly in Egypt after 2003 as financial liberalization and privatization encouraged mergers and acquisitions. During

2005-2006, FDI in Egypt accelerated as funds came from the Gulf countries. FDI was also strong in Lebanon, as reconstruction proceeded apace until the recent political unrest. It seems likely that a significant proportion of the FDI to diversified economies (Egypt, Jordan and the Syrian Arab Republic), including the industrial sector (cement and oil refineries), originated in the Gulf countries, although it is difficult to measure the extent of these flows and much of the evidence is anecdotal.

The main beneficiaries of FDI inflows have undoubtedly been the Gulf oil exporters themselves, especially Bahrain, Qatar and the United Arab Emirates, although Kuwait less so. These countries are also the main sources of FDI from the ESCWA region to the developed world. FDI flows in both directions represent a significant feature of the current boom and capture the increasing integration of the Gulf oil exporters with the world economy in sectors other than oil extraction. It is likely that Saudi Arabia is a significant receiver of FDI, as noted by UNCTAD.

The United Arab Emirates and, to a much lesser extent, Qatar and Bahrain are currently receiving substantial flows of investment funds from abroad. Reports from securities companies indicate that this investment is primarily directed at the construction business and the financial sector. A number of plans are being prepared for investment in infrastructure and the oil industry in the near future. These include construction of residential units on Al Reem island in Abu Dhabi, developing the waterfront in Dubai, developing the Ras Al Khor area, building an aluminium smelter at Taweelah, expanding the airport at Abu Dhabi and building a new metro system in Dubai.[22] It remains to be seen how many of these industrial and infrastructure plans will materialize. For the moment, the investment boom in the United Arab Emirates, partly fuelled by FDI, has resulted mainly in the construction of serried ranks of new residential buildings and luxury hotels, creating entire new cities along the Gulf coastline. It is clear that the United Arab Emirates, especially Dubai, hopes to become an international tourist attraction as well as a commercial and residential centre for West and South Asia. While it is still early days for judging the success of this strategy, there is little doubt that the booming construction sector has provided fresh scope for the activities of the financial sector in the Gulf countries.

The counterpart to inflows of FDI and surpluses on current account (minus debt repayments) has been substantial reserve accumulation by ESCWA countries. Table 11 shows the general trend toward strong reserve formation, similar to other developing countries and regions in recent years. Indeed, reserve formation is particularly striking in the more diversified ESCWA economies, especially Egypt, Lebanon, the Syrian Arab Republic and, above all, Yemen. While developing countries have customarily kept reserves worth three months of imports, these ESCWA member countries currently hold more than a year's worth. As a large part of these reserves is kept in the form of US Government instruments, there are significant costs for these countries in terms of low rates of return on US debt compared with domestic debt. Moreover, ESCWA member countries, and especially Saudi Arabia, which has accumulated the largest reserves, are taking a substantial exchange risk in terms of potential further decline in the US dollar.

To summarize, the analysis in this section has shown that the recent surge of global capital flows, together with the oil boom of the last five years, has led to current account surpluses for the oil exporters, increasing levels of FDI for certain ESCWA member countries, reductions in debt and increasing levels of reserves. Taken together, these flows indicate that there is not only considerable capital flight from ESCWA oil exporters, but also from a number of the diversified economies. For a fuller appreciation of the significance of these estimates it is useful to consider net errors and omissions from the balance of payments, which is the main component of the "hot money" method. A key weakness of this method for ESCWA is that Saudi Arabia reports zero net errors and omissions, thus casting considerable doubt on all its balance of payments statistics. The methods of reporting balance of payment data, moreover, continue to change for ESCWA countries, particularly for Egypt. Data from net errors and omissions, therefore, should be treated with caution. Thus,

[22] EFG-Hermes (2007a), p. 19.

for the Gulf oil exporters, who are the largest source of capital flight, net errors and omissions are not available (as is the case for Qatar and the United Arab Emirates), zero (as is the case for Saudi Arabia), or indicate capital inflows (as in Kuwait). For the diversified economies, on the other hand, net errors and omissions are highly variable and without clear patterns.

TABLE 11. CHANGE IN RESERVES, ESCWA COUNTRIES, CURRENT PRICES
(*US$ million*)

Country	1991	1995	2000	2001	2002	2003	2004
Egypt	2 565	2 709	(1 405)	(187)	478	528	735
Jordan	(34)	283	671	(267)	942	1 249	81
Lebanon	326	681	(1 978)	(911)	2 841	5 963	(594)
Oman	857	186	(392)	(14)	728	420	..
Syrian Arab Republic	460	10	563	686	759	338	375
Yemen	255	364	1 428	758	756	580	679
Bahrain	275	111	193	120	52	64	165
Kuwait	1 378	69	2 219	2 820	(521)	(1 442)	718
Qatar	9	(122)	(147)	155	255	1 379	462
Saudi Arabia	(139)	1 260	2 516	(1 980)	3 319	2 352	4 766
United Arab Emirates	756	815	2 841	625	1 099	(268)	3 442

Sources: IMF data in the World Bank *World Development Indicators 2006* for all countries except the Syrian Arab Republic: *Joint Arab Economic Report* (1996, 2001, 2003 and 2006 and IMF *Statistical Appendix 2005*).

Notes: Parentheses ( ) indicate negative numbers.
Two dots (..) indicate that data are not available.

TABLE 12. NET ERRORS AND OMISSIONS AS A PERCENTAGE OF GDP, ESCWA COUNTRIES

Country	1990	1995	2000	2001	2002	2003	2004
Egypt	0.7	0.5	0.6	(1.2)	2.2	1.9	(0.1)
Jordan	1.8	(5.0)	3.4	0.4	(1.7)	2.6	4.1
Lebanon	..	..	..	..	(6.5)	(16.0)	(7.2)
Oman	(4.1)	2.8	(2.5)	(2.8)	(4.1)	(2.4)	(2.7)
Syrian Arab Republic	0.9	0.2	(0.9)	0.1	(0.7)	1.7	4.1
Yemen	(6.3)	1.5	3.1	(1.2)	0.4	1.3	0.4
Bahrain	(19.6)	25.7	(8.2)	2.7	14.4	(7.2)	0.8
Kuwait	(28.4)	(18.9)	(2.2)	(7.8)	(4.9)	(1.3)	(2.0)
Qatar	..	..	..	..	..	..	..
Saudi Arabia	0.0	0.0	0.0	0.0	0.0	0.0	0.0
United Arab Emirates		..	..	..	..	..	..

Source: IMF, *International Financial Statistics*, February 2007.

Notes: Parentheses ( ) indicate negative numbers.
Two dots (..) indicate that data are not available.

E. AGGREGATE RESOURCE FLOW ESTIMATES

Aggregate resource flows (which include flows of long-term debt, FDI, portfolio flows and official grants) and aggregate transfers (which subtract interest on long-term debt and profit remittances on FDI from aggregate resource flows) and the broader gross resource flows (which add remittances and grants for technical cooperation to aggregate resource flows) are key measures of resource transfer. Additionally, in accounting for short-term debt, which is important for the oil exporters, total debt service (which includes debt service payments on long- and short-term debt; both interest and amortization) is also measured.

Constructing data series appropriate for the estimation of aggregate resource flows in ESCWA countries – both the diversified economies and the oil exporters – is far from straightforward. Data for the diversified economies is available from the World Bank, but data for the oil exporters had to be assembled primarily from individual balance of payment statistics reported to the IMF. There are significant disparities in reporting practice, including the categories used by each country, which complicated the task and frequently necessitates judgment. The figures discussed in this section must therefore be treated with caution: they are highly useful for capturing trends, but less useful for indicating the precise magnitude of flows. Moreover, while the flows for the diversified economies can be split into official and private, this is not possible for the oil exporters. Nonetheless, it is a fair assumption that similar patterns hold in this respect for both diversified economies and oil exporters.

The main results for the diversified ESCWA economies are summarized in tables 13 and 14 below. Table 13 shows that aggregate resource flows to the diversified economies declined substantially throughout the 1990s, falling from US$ 6.4 billion in 1990 to US$ 4.5 billion in 1999. The most severe decline occurred in Egypt, while in Lebanon, the end of the civil war brought a rapid and substantial recovery of capital inflows. The reason for the decline in aggregate resource flows to the diversified economies of the ESCWA region in the 1990s is not hard to find. Official resource flows fell from US$ 5.7 billion in 1990 to US$ 1.3 billion in 1999. The fall was dramatic in Egypt: from US$ 4.5 billion in 1990 to US$ 0.3 billion in 1999. Overall, official flows fell from 89.1 per cent in 1990 to 28.3 per cent of the total in 1999. As official flows declined, private flows failed to make good the shortfall. These figures show clearly that the diversified ESCWA economies failed to attract significant volumes of the rapidly growing global private capital flows of the 1990s. The reasons for this are likely to include low growth rates (relative to East and South-East Asia) and a more heavily regulated environment in the ESCWA countries. Failure to attract private capital flows entrenched the investment weakness of the 1990s, although by and large, the ESCWA countries were spared the worst of the crises of the late 1990s as foreign capital flows were reversed, especially in Asia.

Recovery of aggregate resource flows to diversified economies commenced in 2000, as oil prices started to rise. The trend has been generally upward, with the exception of a precipitous decline in 2003, clearly due to the second Gulf war. Thus, aggregate resource flows rose from US$ 4.5 billion in 1999 to US$ 5.9 billion in 2004. It is notable that this recovery has largely been due to increasing inflows of private capital. Official flows continued to decline, falling from US$ 1.3 billion in 1999 to US$ 1 billion in 2004, with the exception of a sharp rise in 2003, again due to the second Gulf war. Official flows in 2004 stood at only 17.1 per cent of the total, compared with 28.3 per cent in 1999. These figures show the growing importance of private capital in the international transactions of the diversified ESCWA economies and indicate their profound transformation since the early 1990s. Increasing openness and the rising price of oil have encouraged far stronger inflows of private capital into the diversified ESCWA economies. Nonetheless, domestic investment has remained low. In short, the benefits of opening up to global capital flows have not yet become evident.

TABLE 13. AGGREGATE RESOURCE FLOWS, SELECTED ESCWA COUNTRIES, SELECTED YEARS
(*US$ million*)

Country	1990	1995	2000	2001	2002	2003	2004
Egypt	5 182.9	1 352.7	1 955.3	2 007.6	333.9	-578.6	1 571.4
Jordan	1 159.0	512.5	952.9	565.5	426.3	804.9	786.4
Lebanon	203.2	882.8	1 869.7	2 939.5	4 939.1	1 078.0	3 006.3
Oman	(212.3)	115.1	154.1	(212.6)	(1 148.9)	(174.9)	9.5
Syrian Arab Republic	(259.5)	341.9	226.3	74.2	78.2	78.3	208.1
Yemen	332.6	(72.7)	223.4	273.8	282.9	98.5	359.9
Total	6 405.9	3 132.3	5 381.8	5 647.9	4 911.7	1 306.2	5 941.6

Source: World Bank, *Global Development Finance*, April 2006.

Note: Parentheses ( ) indicate negative numbers.

TABLE 14. OFFICIAL RESOURCE FLOWS, SELECTED ESCWA COUNRIES, SELECTED YEARS
(*US$ million*)

Country	1990	1995	2000	2001	2002	2003	2004
Egypt	4 514.6	1 066.1	336.6	(56.1)	(98.8)	(217.3)	520.1
Jordan	906.7	700.5	324.0	660.1	449.0	917.9	302.1
Lebanon	190.5	164.5	184.9	187.2	140.2	687.4	134.0
Oman	45.4	83.9	59.3	311.6	(49.6)	(5.9)	(92.4)
Syrian Arab Republic	(250.8)	247.3	(39.7)	(34.4)	(35.4)	(77.7)	(62.7)
Yemen	302.6	147.1	217.7	125.5	168.9	187.5	216.3
Total	5 708.9	2 409.4	1 082.9	1 193.8	574.5	1 491.9	1 017.5
Official/Aggregate	89.1%	76.9%	20.1%	21.1%	11.7%	114.2%	17.1%

Source: World Bank, *Global Development Finance*, April 2006.

Note: Parentheses ( ) indicate negative numbers.

The picture is much more complex for oil exporters, or rather for Bahrain, Kuwait, Saudi Arabia and the United Arab Emirates, the countries for which it has been possible to collect data. It is clear from table 15 that aggregate resource flows have been far more variable, swinging from positive to negative, and reflecting the impact of changes in oil prices, as well as changes in the large stocks of assets held abroad. These variations have been driven largely by changes in the flows to and from Saudi Arabia. Given the difficulty in obtaining reliable data on Saudi Arabia, caution is required in interpreting the data. Thus, there is no clear pattern in the aggregate resource flows for the oil exporters in the 1990s, although Bahrain registered inflows throughout that period, reflecting its role as a regional commercial centre. In the other countries, flows swung from positive to negative, depending on geopolitical events (such as capital returning from abroad to finance the first Gulf war) and portfolio decisions. Even so, it is apparent that ESCWA oil exporters did not play a prominent role in the upsurge of global capital flows in the 1990s.

As oil prices began to rise after 2000, aggregate resource flows turned strongly negative, with outflows rising from US$ 21.5 billion in 2000 to US$ 33.6 billion in 2004 (see table 15). It is certain that outflows were even stronger in 2005 and 2006. The main sources of the negative flows were Saudi Arabia and the United Arab Emirates. Bearing in mind the caveat about Saudi figures, the table supports the perception prevalent among observers of the Gulf oil exporters that oil rents have resulted in net flows of capital out of the region.

TABLE 15. AGGREGATE RESOURCE FLOWS, ESCWA COUNTRIES
(*US$ million*)

Country	1990	1995	2000	2001	2002	2003	2004
Egypt	5 182.9	1 352.7	1 955.3	2 007.6	333.9	(578.6)	1 571.4
Jordan	1 159.0	512.5	952.9	565.5	426.3	804.9	786.4
Lebanon	203.2	882.8	1 869.7	2 939.5	4 939.1	1 078.0	3 006.3
Oman	(212.3)	115.1	154.1	(212.6)	(1 148.9)	(174.9)	9.5
Syrian Arab Republic	(259.5)	341.9	226.3	74.2	78.2	78.3	208.1
Yemen	332.6	(72.7)	223.4	273.8	282.9	98.5	359.9
Subtotal, MDEs	6 405.9	3 132.3	5 381.8	5 647.9	4 911.7	1 306.2	5 941.6
Bahrain	(259)	148	653	(87)	407	1 324	1 313
Kuwait	537	747	(49)	(320)	113	623	466
Qatar	..	..	..	..	..	..	..
Saudi Arabia	..	1 254	(12 411)	(7 706)	3 180	(19 325)	(26 989)
United Arab Emirates	..	..	(9 700)	(4 100)	(7 300)	(7 800)	(8 400)
Subtotal, oil exporters	278	2 149	(21 507)	(12 213)	(3 600)	(25 177)	(33 609)
ESCWA total	6 684.2	5 281.1	(16 125.6)	(6 565.1)	1 311.6	(23 871.3)	(27 667.8)

Sources: World Bank, *Global Development Finance*, April 2006; IMF Balance of Payments Annual Report, 2007.

Notes: Parentheses ( ) indicate negative numbers (outflows).
Two dots (..) indicate that data are not available.

F. COMPONENTS OF AGGREGATE RESOURCE FLOW

Further insight may be obtained through closer examination of long-term debt and portfolio equity flows, both of which are components of aggregate resource flows. Data on long-term debt for ESCWA countries is not always available and composing an appropriate series is fraught with difficulty. The estimates are summarized in table 16.

For the MDEs, long-term external debt from 1994 to 2000 remained stable at around US$ 60 billion and then rose to US$ 71 billion by 2004. However, practically all this increase was accounted for by Lebanon, the external long-term of which rose from US$ 0.8 billion in 1994 to US$ 18.2 billion in 2004. The rise in Lebanese debt is clearly related to the reconstruction of the country after the civil war. In contrast, the other diversified economies of the region either reduced long-term external debt or maintained it at stable levels. This is particularly apparent in Egypt, which has successfully managed to contain its long-term debt following a period of debt forgiveness in the early 1990s associated with the first Gulf war. In short, the long-term debt of the diversified ESCWA economies has followed the same pattern as the debt of other developing countries: long-term debt has either been repaid or remained stable.

Long-term debt of the oil exporters has followed the same pattern as that of other developing countries. Stagnant or falling debt levels throughout the region since 2000 have been a source of negative aggregate resource flows during this period. For the oil exporters, long-term debt has traditionally been a less important part of external flows. They accumulated significant long-term debt towards the end of the 1990s, rising from US$ 18 billion in 1996 to US$ 40 billion in 2000. However, once oil prices began to rise, they started to reduce their exposure, lowering long-term debt to US$ 33 billion in 2002. It is probable that levels have reduced even further since then. This volume of long-term debt is unlikely to pose problems for the economies of the oil exporters in the near future.

Total debt (long-term plus short-term) for the region presents a somewhat different picture. In 1998, total debt rose sharply to US$ 169.2 billion, primarily as a result of a rise in long-term debt for the oil exporters. Since then it has gently declined, falling to US$ 145.1 billion in 2004. While this pattern is broadly similar to that of long-term debt, the relative weight of short-term debt has varied significantly between diversified and oil exporting economies. Table 17 shows that short-term debt has declined as a proportion of total debt for both groups. For the diversified economies it fell from 24.9 per cent of the total in 1990 to around 16 per cent at the end of the 1990s and remained around that level until 2004. For the oil exporters, on the other hand, short-term debt has always been a far more important part of their total debt, primarily as a result of the need to finance the trade in oil. Nonetheless, short-term debt remains a declining proportion of the total debt of oil exporters and fell from 71.9 per cent of the total in 1990 to around 45 per cent in the late 1990s and remained at that level until 2004. Considering the accumulation of reserves by both diversified economies and oil exporters – discussed in the next section – short-term debt is unlikely to be a source of significant economic problems for ESCWA countries in the near future, with the possible exception of Oman and the Syrian Arab Republic.

Relatively stable, even declining, levels of long-term debt thus confirm that aggregate resource flows to ESCWA countries have been shifting away from official and towards private flows, the latter of which comprise FDI and portfolio equity flows. FDI is the principal component of private flows, while portfolio equity flows, despite the growth of capital markets in a number of ESCWA countries, reflect the increasing depth and sophistication of financial systems in the region, and have remained a minor part of aggregate resource flows to the diversified economies.

Stock market activity in ESCWA countries is primarily the result of mergers and acquisitions, which are the outcome of the privatization policies adopted in the mid-1990s. In monetary value, the sums involved are small and unlikely to influence aggregate resource flows decisively. In the diversified ESCWA economies, stock markets are unlikely to act as sources of necessary investment funds and thus levers of development, although the situation is different for the oil exporters, whose stock markets have boomed since oil prices began to rise. The boom has also affected the stock markets of the diversified economies since 2004 and large-scale declines occurred in 2006. While the scarcity of data precludes in-depth analytical comparisons, it is clear that stock markets, given their negligible volume in relation to overall output, are unlikely to provide a major source of investment funds in the ESCWA countries.

TABLE 16. LONG-TERM DEBT, ESCWA COUNTRIES
(*Current, US$ million*)

Country	1990	1995	2000	2001	2002	2003	2004
Egypt	28 438.7	31 023.2	25 082.8	25 960.5	26 533.4	27 581.4	27 352.7
Jordan	7 201.8	6 624.2	6 182.8	6 632.3	7 071.7	7 172.6	7 233.6
Lebanon	357.6	1 600.5	7 315.4	9 788.4	14 530.1	15 474.2	18 205.9
Oman	2 400.2	5 235.1	5 265.8	4 755.3	3 520.2	2 719.3	2 565.3
Syrian Arab Republic	15 107.5	16 853.3	15 929.8	15 809.2	15 848.7	15 847.6	15 742.4
Yemen	5 160.4	5 527.9	4 059.2	4 276.8	4 497.4	4 744.5	4 799.3
Subtotal, MDEs	53 506	61 336	59 777	62 946	67 504	68 795	71 100
Bahrain	1 269.3	2 462.8	1 205.3	936.6	1 151.7	..	..
Kuwait	522.5	6 172.0	2 563.6	3 153.1	5 490.4	..	..
Qatar	311.3	4 811.1	8 482.6	7 463.9	7 595.1	..	..
Saudi Arabia	2 473.6	5 786.9	21 512.0	16 583.8	12 826.2	..	..
United Arab Emirates	1 902.5	3 170.0	6 116.1	6 845.3	6 063.2	..	..
Subtotal, oil exporters	6 479	22 403	39 880	34 983	33 127	..	..
ESCWA total	59 985	83 739	99 656	97 928	100 631	..	..

Sources: MDEs: World Bank, *Global Development Finance* April 2006; oil exporters: OECD, *External Debt Series*.

Note: Two dots (..) indicate that data are not available.

TABLE 17. SHORT-TERM DEBT (AS A PERCENTAGE OF TOTAL EXTERNAL DEBT),
ESCWA COUNTRIES
(*Current, US$ million*)

Country	1990	1995	2000	2001	2002	2003	2004
Egypt	13.5	7.1	14.1	11.5	11.6	12.1	9.7
Jordan	12.4	10.2	9.7	6.2	6.8	8.9	7.4
Lebanon	79.9	46.0	25.8	21.4	14.9	16.8	17.9
Oman	12.3	9.4	19.8	21.0	25.2	31.4	33.7
Syrian Arab Republic	12.5	21.3	26.4	25.9	26.2	26.5	26.8
Yemen	18.8	11.1	13.8	8.6	6.5	4.3	5.7
Average, MDEs	24.9	17.5	18.2	15.8	15.2	16.7	16.9
Bahrain	20.7	15.3	25.0	40.0	28.1	..	..
Kuwait	93.7	38.2	71.1	69.1	57.9	..	..
Qatar	77.3	26.2	19.0	21.8	18.8	..	..
Saudi Arabia	84.0	66.7	44.7	53.1	57.9	..	..
United Arab Emirates	83.6	70.7	59.1	61.6	64.3	..	..
Average, oil exporters	71.9	43.4	43.8	49.1	45	..	..

Sources: MDEs: World Bank, *Global Development Finance*, April 2006; oil exporters: OECD, *External Debt Series*.

Note: Two dots (..) indicate that data are not available.

To recapitulate, between 1990 and 2000, aggregate resource flows declined for the diversified ESCWA economies, whilst remaining volatile for the oil exporters. After the start of the oil boom, aggregate resource flows turned heavily negative for the oil exporters and the composition of flows moved decisively away from official and towards private flows. ESCWA countries have thus kept their long-term debt under control and received smaller volumes of official grants, while portfolio equity flows have remained a relatively insignificant proportion of aggregate resource flows.

G. GROSS RESOURCE FLOW AND NET TRANSFERS

Aggregate resource flows, as has been noted above, do not take into account two flow components that have important implications for ESCWA countries: remittances and technical cooperation grants.

Remittances have always formed a significant part of international resource flows for ESCWA countries, since the diversified economies supply migrant workers abroad and the oil exporters receive migrants. Table 18 shows that workers' remittances continued to be a major source of external funds for the diversified economies, although their volume has been variable. Thus, incoming remittances rose from US$ 8.5 billion in 1990 to US$ 10.2 billion in 1993, but then declined, remaining between US$ 7 billion and US$ 8 billion until 2000. However, remittances began to rise significantly again after that, reaching US$ 10.5 billion in 2004. It should be stressed that the volume of remittances remained greater than the aggregate resource flow throughout this period, underlining the fact that such flows constitute the most important source of international funds for the diversified ESCWA economies.

There is significant variation between the diversified economies with regard to remittances. Their importance has declined for Egypt, falling from a high point of US$ 6.1 billion in 1992 to US$ 3.3 billion in 2004, although the sums involved remain significantly larger than the aggregate resource flow for the country. Remittances continue to be a dominant source of funds for Yemen, though the high point of US$ 1.5 billion in 1990 has not been surpassed since. In Lebanon, on the other hand, where the volume of remittances has always been sizeable, their significance has increased in recent years and a new high point of US$ 2.7 billion was reached in 2004. The most notable changes in remittances have taken place in Jordan and the Syrian Arab Republic, which have become major labour exporters in recent years. Table 19 shows that the destination of emigration from these two countries is overwhelmingly to other Arab countries, most notably the Gulf oil exporters. The spread of destinations is more balanced for Lebanon and Egypt, where more than half the incoming remittances originate in non-Arab countries. In sum, the links between ESCWA countries that are created by worker emigration (and thus the channels through which the effects of oil booms are transmitted) have changed significantly during the last 15 years.

TABLE 18. WORKERS' REMITTANCES AND EMPLOYEE COMPENSATION
(*US$ million*)

Country	1990	1995	2000	2001	2002	2003	2004
Egypt	4 284	3 226	2 852	2 911	2 893	2 961	3 341
Jordan	499	1 441	1 845	2 011	2 135	2 201	2 287
Lebanon	1 818	1 225	1 582	2 307	2 500	2 700	2 700
Oman	39	39	39	39	39	39	40
Syrian Arab Republic	385	339	180	170	135	889	855
Yemen	1 498	1 080	1 288	1 295	1 294	1 270	1 283
Subtotal, MDEs	8 523	7 350	7 786	8 733	8 996	10 060	10 506
Bahrain	(332)	(500)	(1 013)	(1 287)	(872)	(1 082)	(1 120)
Kuwait	(769.6)	(1 354)	(1 734)	(1 785)	(1 926)	(2 144)	(2 403)
Qatar	(1 132)	(1 071)	(1 354)	(1 506)	(1 483)	(1 594)	(2 176)
Saudi Arabia	(11 221)	(16 594)	(15 390)	(15 120)	(15 854)	(14 783)	(13 555)
United Arab Emirates	(2 424)	(3 242)	(3 676)	(3 910)	(4 139)	(4 389)	(4 648)
Subtotal, oil exporters	(15 879)	(22 760)	(23 167)	(23 608)	(24 273)	(23 992)	(23 902)
ESCWA total	(7 356)	(15 410)	(15 381)	(14 875)	(15 277)	(13 932)	(13 396)

Sources: World Bank, *Global Development Finance*, April 2006; Gulf countries: IMF, *Balance of Payments Annual Report*, 2007; United Arab Emirates and Qatar: AMF, 2006.

Note: Parentheses ( ) indicate negative numbers (outflows).

TABLE 19. DISTRIBUTION OF REMITTANCES BY REGION OF ORIGIN, 2004
(*Percentage*)

	Arab countries	European Union	North America	Others
Jordan	85	5	7	3
Syrian Arab Republic	65	5	10	20
Lebanon	45	10	25	20
Egypt	45	11	32	12

Source: AMF, *Joint Arab Economic Report 2006*, table 10/3.

The oil exporters, by contrast, are recipient countries for workers from the Arab world, as well as from South and South-East Asia and elsewhere. Their economies rely on skilled and unskilled labour from abroad, and this is reflected in substantial outflows of remittances. Remittances from the oil exporters rose from US$ 15.8 billion in 1990 to US$ 24 billion in 1994, then declined to US$ 21.4 billion in 1999, although recent estimates suggest they have risen to US$ 24 billion. However, while the increase is evident for Kuwait, Qatar and the United Arab Emirates, remittances from Saudi Arabia have been falling.

Grants for technical cooperation (including military contracts) complete the picture of international flows. Table 20 refers to the diversified economies and shows that the inflows of such grants have been volatile since 1990 and have not shown a clear trend. While grants have been falling since they last peaked in 2002, the total sums represented by technical cooperation grants since 1990 have been substantially higher than aggregate resource flows during the same period. This is clearly a result of the continuing geopolitical instability in the region, punctuated by wars and leading to high military expenditure.

Adding remittances and technical cooperation grants to aggregate resource flows matches estimates for gross resource flows. The broad direction of gross resource flows (table 21) does not differ from that of aggregate resource flows. Thus, diversified economies are still recipients of flows from abroad, although the sums involved are substantially larger. This brings into sharper focus the importance of remittances in particular to the domestic economies. For the oil producers, inclusion of remittances renders the flow of resources strongly negative throughout the period. The oil producers are vast sources of funds for other ESCWA countries, as well as for countries in South and South-East Asia.

TABLE 20. TECHNICAL COOPERATION GRANTS, SELECTED ESCWA COUNTRIES
(*US$ million*)

Country	1990	1995	2000	2001	2002	2003	2004
Egypt	8 116	7 439	4 724	7 330	7 831	5 574	2 015
Jordan	676	1 597	1 204	1 332	1 561	1 147	1 092
Lebanon	389	943	554	630	781	1 015	1 106
Oman	130	173	154	105	53	55	88
Syrian Arab Republic	311	825	421	454	509	942	707
Yemen	1 063	648	509	568	567	540	525
Total	10 684	11 625	7 565	10 418	11 302	9 272	5 533

Source: World Bank, *Global Development Finance*, April 2006.

Finally, by subtracting interest payments on long-term debt and profit remittances on FDI from aggregate resource flows, we obtain aggregate net transfers, which are a better estimate of the external finance actually available to ESCWA countries. The availability of data means that this is only possible for the diversified economies. Tables 22 and 23 confirm the declining importance of official sources of external funds once interest payments are taken into account. This is shown even more clearly in table 24. The table also shows, however, that private sources of funds are not nearly as significant when profit remittances are included. This applies particularly to Oman and Yemen, both of which have strongly negative net transfers. Openness to international capital flows and FDI have not simply failed to raise investment levels in diversified ESCWA economies, but have also resulted in net transfers abroad from some of the poorest countries in the region.

TABLE 21. GROSS RESOURCE FLOWS, ESCWA COUNTRIES
(*US$ million*)

Country	1990	1995	2000	2001	2002	2003	2004
Egypt	17 582.9	12 018.0	9 530.8	12 248.5	11 057.8	7 956.7	6 927.2
Jordan	2 333.7	3 550.8	4 002.2	3 908.8	4 122.5	4 152.4	4 165.6
Lebanon	2 410.1	3 051.0	4 006.1	5 876.4	8 220.4	4 792.5	6 812.2
Oman	(43.8)	326.8	346.7	(69.1)	(1 057.4)	(80.9)	137.2
Syrian Arab Republic	436.6	1 505.5	827.3	697.9	721.9	1 909.5	1 770.5
Yemen	2 893.4	1 655.4	2 020.0	2 136.9	2 144.1	1 908.0	2 167.6
Subtotal, MDEs	25 612.9	22 107.5	20 733.2	24 799.3	25 209.4	20 638.2	21 980.3
Bahrain	(591)	(352)	(360)	(1 374)	(465)	241	193
Kuwait	(232)	(606)	(1 783)	(2 105)	(1 813)	(1 520)	(1 937)
Qatar	(1 132)	(1 071)	(1 354)	(1 506)	(1 483)	(1 594)	(2 176)
Saudi Arabia	(11 221)	(15 340)	(27 801)	(22 825)	(12 673)	(34 108)	(40 544)
United Arab Emirates	(2 424)	(3 242)	(13 376)	(8 010)	(11 439)	(12 189)	(13 048)
Sub-total, oil exporters	(15 601)	(20 612)	(44 674)	(35 820)	(27 873)	(49 170)	(57 511)
ESCWA total	10 012.1	1 495.9	(23 941.3)	(11 021.2)	(2 663.3)	(28 531.7)	(35 530.9)

Sources: World Bank, *Global Development Finance*, April 2006; IMF, *Balance of Payments Annual Report*, 2007.

Note: Parentheses ( ) indicate negative numbers (outflows).

TABLE 22. OFFICIAL NET TRANSFERS, SELECTED ESCWA COUNTRIES
(*US$ million*)

Country	1990	1995	2000	2001	2002	2003	2004
Jordan	784	585	166	489	311	791	169
Egypt	3795	(55)	(236)	(631)	(666)	(765)	(20)
Lebanon	181	146	140	159	101	626	55
Oman	31	55	27	266	(102)	(61)	(145)
Syrian Arab Republic	(283)	189	(141)	(98)	(84)	(132)	(111)
Yemen	279	122	173	77	122	137	155
Total	4 788	1 041	128	264	(317)	596	102

Source: World Bank, *Global Development Finance*, April 2006.

Note: Parentheses ( ) indicate negative numbers (outflows).

TABLE 23. PRIVATE NET TRANSFERS, SELECTED ESCWA COUNTRIES
(*US$ million*)

Country	1990	1995	2000	2001	2002	2003	2004
Jordan	65	(282)	547	(144)	(59)	(146)	471
Egypt	367	(72)	1 480	1 922	182	(498)	915
Lebanon	11	684	1 268	2 134	3 875	(825)	1 707
Oman	(811)	(796)	(1 001)	(1 764)	(2 498)	(1 884)	(1 417)
Syrian Arab Republic	(18)	93	266	108	113	156	271
Yemen	(259)	(654)	(850)	(652)	(726)	(1 034)	(1 146)
Total	(644)	(1 027)	1 710	1 604	888	(4 230)	800

Source: World Bank, *Global Development Finance*, April 2006.

Note: Parentheses ( ) indicate negative numbers.

TABLE 24. AGGREGATE NET TRANSFERS, TOTAL AND COMPONENT PROPORTIONS
(*US$ million*)

Year	1990	1995	2000	2001	2002	2003	2004
Total	4 144	14	1 839	1 867	571	(3 634)	903
Official/total	115.5%	7 285.4%	7.0%	14.1%	(55.6%)	(16.4%)	11.4%
Official/private	(7.4)	(1.0)	0.1	0.2	(0.4)	(0.1)	0.1

Source: World Bank, *Global Development Finance*, April 2006.

Note: Parentheses ( ) indicate negative numbers.

H. CONCLUSION AND POLICY ALTERNATIVES

Total net capital inflows as a proportion of GDP have followed a somewhat predictable path, rising or declining in tandem with the movement in oil prices. However, over the last three decades, the region has always had more savings than investment and channelled those resources abroad when capital was needed at home for development. Financial flows are now more volatile and the region is subject to frequent terms of trade shocks. Accordingly, it should come as no surprise that growth will continue to be erratic, and slow to permit an increase in both living standards and nationally-retained domestic savings. It should be remembered that despite the current bout of growth, the long-term average real per capita growth rate, which is the principal quantitative measure of development, was around zero per cent for the period 1971-2005. Growth continues to have relatively little effect on jobs and does not proportionately lower the rate of unemployment, which is higher in the ESCWA region than in any other region in the world. Retransitioning the economy of the region from the current slow, unpredictable path of growth to a higher, rights-based and more sustainable path that could substantially reduce unemployment levels and eradicate poverty requires a huge injection of financial resources capable of making a "big push" on both demand and supply. Investment and coordination between physical and human capital is also necessary for the big push to deliver. Further recommendations include a multi-tiered approach that accommodates intraregional redeployment of official sources of finance, policies that recognize the need for market-based incentives, a greater role for the State, and institution building to serve production-based strategies.

While some progress can be seen in the efforts of certain ESCWA countries to mobilize domestic resources through institutional or policy reforms, resources are still seriously lacking in many priority areas, including health and education, poverty reduction, rural development and intraregional infrastructure. The private sector has the ability to play a crucial role through public-private partnership in developing countries and with capital and technology flow from developed countries. But for this to take place, private sector activities must be channelled into productive investment, as opposed to speculation on poorly-regulated capital markets for quick returns. In this respect, if the Governments of the ESCWA region wish to seek methods to protect their markets from erratic short-term capital flows, the literature is replete with case studies and examples of why and how to proceed.[23] One area in which policy options could be considered is tax. Taxes that could curb erratic flows include the following:[24]

(a) A tax on foreign assets, which would have the advantage of increasing the opportunity costs of holding foreign assets, encouraging investors to shift to domestic assets;

(b) A minimal tax levied on capital outflows, earmarked for financing a development fund to combat poverty;

(c) A sliding scale capital gains tax, in which short-term capital gains would be taxed at a higher rate.

These measures could be considered with a view to reducing potentially harmful currency speculation, minimizing exchange rate volatility and protecting ESCWA countries from financial contagion. A fund for the development of poor areas could benefit from the revenue generated by this pro-poor tax structure. To these ends, regional financial architecture must be improved, recognizing the importance of the interaction between domestic actions and international policy cooperation. Monetary, fiscal and financial market reforms in the ESCWA region need to secure further monetary stability, however, with the emphasis on employment creation rather than targeting inflation. Stronger and deeper fiscal discipline is needed, not as a short-term stabilization tool, but for long-term development. Longer-term returns from investment in the physical and social infrastructure are associated with healthy and sustainable economic growth and development.

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[23] See, *inter alia*, Eatwell and Taylor (2002), Godley (1999), Grabel (1996), Kindleberger (2000), Ocampo and Taylor (1998), Taylor (1988, 1990, 1991b, 1993 and 2004) and Taylor and O'Connell (1985).

[24] Capital flows are deemed erratic when they shift from positive to negative and vice versa in a short time, often from one year to the next. For examples, see table 15.

Box 5. Inflation and development issues

Inflation should not to be seen as a deterrent to accelerating the development agenda. Inflation in the region is predominantly import-driven. A weak dollar, non-dollar denominated imported goods and rising basic commodity prices globally translate into vulnerability to imported inflation in the highly "open" ESCWA region. Shifting away from the dollar peg and targeting strategic domestic sectors could offset dependency on imports in the long term.

Where generated domestically, inflation should not hinder strategic expenditure. Unbalanced growth is a normal state of development and is by its very nature inflationary; rising prices can be a healthy signal of the need for greater supply. Governments can attenuate inflation and promote private sector initiatives in certain sectors in order to smoothe out transitional adjustment and avoid spiralling prices. Inflation does not signal a need to reduce fiscal expenditure, particularly in countries characterized by chronic underutilization. Higher overall levels of demand are required, with discretionary targeting by active and responsive public investment to crowd-in private investment and attract resources back into the region, thus reducing capital flight. Sustained growth of the productive base must continue in order to serve the welfare of growing populations.

With broad-based development, ESCWA countries can strengthen the role of sectors that generate income through higher value added activities in technologically advanced or innovative sectors, while other sectors can absorb greater numbers from the pool of the unemployed, usually in services. Although many ESCWA economies are pursuing diversification strategies, they fall short of providing increasing productivity; productivity growth for the region is estimated at less than 1 per cent per year, and it is noteworthy that even in some of the fastest-growing countries of the GCC, productivity growth has been negative.

Structural change, therefore, is paramount for sustainable growth and will require action by central Governments to enable innovative industries to flourish in the private economies of the region. For countries with fiscal difficulties, however, and due to market convention, targeted expansionary fiscal policies may not be on the cards. In such cases, growth opportunities can be pursued by the public sector without massive expenditure by encouraging the implementation of bilateral trade agreements that aim for regional integration, industrial upgrading and dynamically growing sectors.

The limited industrial capacity and negligible industrial integration in the ESCWA region suggests that few countries will be able to increase productivity by relying on the private sector to undertake investment without being underscored by national development programmes. Government allocation of credit programmes, loan and export guarantees, and other forms of protection can help higher productivity sectors grow in order to face global competition. If successful, a long-term strategy of this nature would deter capital flight through the provision of growth-generated investment opportunities.

When used as a supporting mechanism for an expansionary fiscal and social policy, financial policy and regulation are able to contribute to rights-based development and pro-equity growth. In its current context, financial policy has an inbuilt anti-poor bias, in that it allows the wealthy to convert national capital into foreign currency and send it abroad, thereby weakening the pool of resources available for investment at home. The financial markets of the ESCWA region are underdeveloped insofar as financial intermediation is concerned, but the freedom to move capital in and out of a country has assumed greater significance recently. Only three years after the end of the first oil boom, reserves began to dwindle and certain GCC Governments resorted to high interest rate borrowing from private banks in order to offset their deficits. With greater capital account openness now, it may take less than three years to erode the gains of the current oil boom. In this regard, the following four policy recommendations should be considered, with a view to reinventing financial policy as an anti-poverty tool.

(a) First, fiscal discipline and short-term soundness of public finances should be relaxed through fiscal reforms in order to broaden and deepen the tax base by introducing presumptive taxes on both capital flows and capital gains and, subsequently, targeting groups in need. In parallel, effective debt management policies geared towards controlling overall indebtedness should be adopted in order to enable long-term development and growth, which would pay for short-term deficits, in particular foreign debt and the servicing thereof;

(b) Second, accompanying the increase in public revenue resulting from the tax on capital flows and capital gains, radical administrative reforms should be implemented to decentralize and restructure the public sector, increasing its efficiency and effectiveness in carrying out public services;

(c) Third, further growth and diversification of regional capital markets are needed for retained income to play an effective role in financing for development and industrialization on an equal footing with the banking sectors of the region. Domestic financial and capital markets could be deepened by providing support for the growth of institutional investors (insurance companies, pension funds and investment funds) and improving the financial regulatory environment. Banks are not fully involved in industrial financing at present for fear of risk and the State could therefore step in to fill the void by partially underwriting a process of industrial finance;

(d) Finally, policies and strategies could be geared towards improving access to finance for private industrial enterprises through the domestic banking system in the short term and, in the longer term, through strengthened capital markets and insurance against non-economic causes of economic losses.

Given the above emphasis on industrial development, it may be relevant to note that any industrial project requires infant industry protection in the early stages. Most ESCWA member countries are members of the World Trade Organization (WTO). However, 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 when domestic industries are competitive. Reforms must include a focus on making industrial policy more effective, through FDI and multilateral/bilateral trade agreements, adopting a market-seeking and efficiency-seeking stance, as opposed to remaining resource-seeking. The provision of basic physical and institutional infrastructure to host FDI continues to be an essential building block of this process (emphasis should be placed on the positive externalities of the market, as opposed to resource-seeking FDI). In order to preserve equity in the provision of services to the public and minimize potential adverse social consequences of market-determined prices, careful consideration must be given to providing regulatory frameworks for private participation in infrastructure projects when these are planned in such traditional public sector areas as health, electricity and water. Regulating the cost of services to the poor must always be a priority in the delivery of such services.

Perceived or real long-term risks and the potential for low returns on investment have lowered the investment rates necessary for growth and job creation in the ESCWA region. The continuation of the current trend of poor job creation – an essential link in the fight against poverty – despite high growth, may prove difficult to reverse when its impending social consequences begin to take effect. In the short term, therefore, transforming ESCWA into a "regional bloc" requires an industrialization policy that promotes physical investment in plant and equipment. In the long term, emphasis can be placed on the complementarity of physical and human capital and on the contribution of knowledge to the economy.

It may be true for all countries that a comprehensive regional capitalization strategy can provide a mechanism that defuses potential security threats, both regionally and globally, but nowhere is it more of a priority than in the Middle East, where for almost two decades the region has suffered continued tensions, volatile rates of per capita GDP growth and a high unemployment rate. In addition to the promotion of regional dialogue for promoting investment, the ESCWA region also needs coordination aimed at enlarging the policy options of its member countries, and supporting statistical system developments at the regional level to nurture an evidence-based culture for policy setting and monitoring.

III. RIGHTS-BASED EMPLOYMENT CREATION IN THE ESCWA REGION

The present bout of economic growth, supported by high oil prices, has not significantly affected unemployment levels in the ESCWA region, particularly youth unemployment. These levels continue to remain crucially high – even against most standards of measure – and rank among the highest of all regions of the world. A variety of reasons have been offered to explain the persistent problem of unemployment in the ESCWA region. Existing literature on the problem ranges from descriptive reviews of striking differentials between population and economic growth rates to slightly more complicated causal accounts of the alleged mismatch between labour supply and demand due to insufficiencies in education and training. Underpinning both approaches is the view that Government inefficiency has contributed to a wide range of macroeconomic dislocations in ESCWA member countries. One view maintains that this has happened because of excessive protectionism, misallocation of resources and the introduction of restrictions to the workings of the market, as if markets alone could be relied upon to resolve spontaneously the large disequilibria in the ESCWA labour markets. However, when compared to other developing regions, labour markets in the ESCWA region are not as rigid as they may appear. More importantly, with more than half the regional GDP originating from oil or geopolitical rents, employment generation has not been able to offset the rising supply of labour, in large part because of the absence of labour-intensive or knowledge economies and dynamic productivity growth. Unemployment is in large part due to insurmountable initial conditions related to an overdependence on primary activities, such as natural resource extraction, but which is veiled by cyclical upswings generated by one particular sector. The rentier-supported system in this context produces few jobs and those left outside the system, on average half the labour force in the informal sector, subsist at poverty wage levels. Had it not been for the job creation and buttressing of real wages arising from rent redistribution, the non-oil economy and declining productivity would have allowed unemployment rates to rise further and wages to sink even lower. Countervailing public sector employment expansion represents a rent distribution measure aimed at stabilizing the social structure and redressing an anaemic labour share, especially in the absence of universal unemployment insurance coverage and adequate welfare policies.

This chapter examines unemployment in the ESCWA region and argues that in the absence of commensurate job creation in the productive sectors and a dynamic rise in productivity stemming from the internalization of knowledge, the policies that are currently in place are insufficient to deal with the persistence of unemployment. Fortified rent redistribution measures represent the optimal tool to offset the lingering unemployment rate until such time as a more viable regional industrial policy is in place to support the non-oil economy and start producing decent jobs.

A. Overview

The population growth rate in the ESCWA region has been among the highest in the world in the post-World War II era, reaching 2.9 per cent per annum in the period between 1950 and 2000. During this period, the population of ESCWA countries quadrupled to 200 million and is expected to reach 240 million around 2015.[25] Population levels in ESCWA are not expected to stabilize for at least another five decades.[26] The population growth rate in the region declined to 2.5 per cent per annum between 2000 and 2005 but is still high, as nearly 5 million people are added to the region’s population each year. These population pressures can create significant short-term problems for social welfare provision. For example, in Yemen, GDP growth rates between 1995 and 2003 averaged a healthy 5 per cent per annum; however, income growth was only 1.5 per cent per annum because of the high population growth rate in Yemen.[27]

[25] ESCWA (2007b), p. 3.

[26] See Gardner (2003), p. 1 and Karshenas (1994), p. 1.

[27] Ibid. (p. 2) and UNDP (2005), p. 99.

Box 6. Rights-based development

Development is about unleashing human potentialities and broadening the choices of people. It is a fair and balanced outcome, combining the right to sustenance, shelter, health and education, the right to vote and freedom of expression. It is freedom from hunger and want, from oppression and all that stands in the way of people participating fully and unhampered in shaping their future.[a/]

More concretely, rights-based development is regarded as a process of economic growth, with expanding output and employment, institutional transformation and technological progress of a country that steadily improves the well-being of all people. When that well-being is regarded as the fulfilment of human rights and fundamental freedoms that enhance the capability of people to realize their full potential, the process of development that leads to the improvement of that well-being can be claimed as a human right. The realization of the right to development needs to be seen as the fulfilment of a set of claims by people, principally on their State, but also on society at large, including the international community, to a process that enables them to realize the rights and freedoms set forth in the International Bill of Human Rights.[b/]

The intrinsic value of the right to development is now widely recognized and accepted by the international community. In essence, "[t]he right to development is an inalienable human right by virtue of which every human person and all peoples are entitled to participate in, contribute to, and enjoy economic, social, cultural and political development, in which all human rights and fundamental freedoms can be fully realized".[c/]

The right to development includes:

(a) Full sovereignty over natural resources, including self-determination and popular participation in development;

(b) The right to work and equality of opportunity;

(c) The creation of favourable conditions for the enjoyment of other civil, political, economic, social and cultural rights;

(d) Peace and security are essential elements for the realization of the right to development.

The individual is identified as the beneficiary of the right to development, as well as all other human rights. The right to development can be invoked both by individuals and by peoples. It imposes obligations both on individual States, namely to ensure equal and adequate access to essential resources, as well as on the international community, namely to promote fair development policies and effective international cooperation. And, where the State recognizes the right to development and international covenants on economic, social and cultural rights, economic policies – both public and private – should bridge the wealth divide, and promote the right to decent work and the right to all-round development.

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a/ Sen (1999).
b/ United Nations Office of the High Commissioner for Human Rights (2004).
c/ Available at: http://www.unhchr.ch/development.

A closely-related issue concerns the large migratory flows within the region, particularly between rural-urban migration in the MDEs, where the share of urban population has increased from 30 per cent in 1950 to 50 per cent in 1980 and to 75 per cent in 2005 (this ratio is much higher in the GCC, while Egypt, the Syrian Arab Republic and Yemen continue to have a significant rural population).[28] There has also been substantial international migration in the ESCWA region, especially from the MDEs, including Egypt, Jordan, Lebanon, the Syrian Arab Republic and Yemen, to the sparsely-populated oil economies in the GCC. In addition to these migratory flows, the participation of women in the workforce has been increasingly rapid in most countries, especially since the 1990s. This is partly because of the demographic transition, changing attitudes and rising aspirations and, partly, in order to counteract the tendency towards falling real household incomes in the region.[29] In contrast, the participation rate of men has been declining, in part because of the lack of attractive job opportunities.[30]

These demographic trends have created significant and persistent pressures on labour markets in the ESCWA region.[31] In the 1980s and 1990s, these pressures were compounded by the impact of a depressed oil market and the ravages

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[28] See ESCWA (2007b), p. 3 and World Bank (2004), pp. 102-4.

[29] See, for example, UNDP, op. cit., p. 99.

[30] Gardner, op. cit., p. 4.

[31] For an overview, see World Bank (2007), pp. 28-35.

of conventional structural adjustment policies in the region. When compared with 1990, the most recent data on gross fixed capital formation as a ratio to GDP shows declines in Egypt, Jordan, Saudi Arabia and the Syrian Arab Republic, leading to a squeeze on productive sector expansion, especially in industry, and depreciated and outdated capital stocks (see table 25). The Government Debt-GDP ratio declined in Egypt and Lebanon (see table 26), and public sector employment also declined, especially in Egypt. Between 1980 and 2002, the ESCWA region experienced negative productivity growth and declining per capita income growth, which limited the scope for real wage rises.[32] In addition to this, the scope for labour exports from the MDEs declined because of the recession in the GCC and the growing difficulties faced by aspiring migrants to the Organisation for Economic Co-operation and Development (OECD) countries.[33]

For these reasons, and above all because of the preponderance of rents, low labour shares, lack of emphasis on productive investment and weak regional integration, employment growth in the region has been too slow to absorb the growth of the workforce, resulting in a significant increase in the rate of unemployment and underemployment, especially among the youth. While it is difficult to offer reliable statistics, widely accepted estimates put the overall ESCWA unemployment rate in 2008 at 13 per cent, while youth unemployment stands at between 25 and 30 per cent. These figures are approximately twice as high as the international average. In conflict areas such as Iraq and Palestine, unemployment rates in 2004 were 27 and 29 per cent respectively.[34] Worse still, in 2005 youth unemployment rates in Jordan and Egypt were 3.6 and 5.9 times higher than adult unemployment rates, respectively. A conspicuous case is Qatar, where the youth unemployment rate in 2005 was 22 times the adult unemployment rate.[35] Furthermore, female employment averaged a mere 25 per cent of total employment in agriculture, 17.9 per cent in manufacturing and 26.7 per cent in services. The corresponding world averages for female employment are 39.9 per cent in agriculture, 31.2 per cent in industry and 45 per cent in services.[36]

In addition to this, real wages in the ESCWA region have been flat for the best part of the past two decades.[37] The problem can be explained simply: If the economically active population grows by 5-6 per cent per annum and productivity growth is only 1-2 per cent annually, the economy needs to grow by 6-8 per cent per annum merely in order to stabilize the labour market. This is much higher than the regional growth rates achieved in the recent past. Even higher growth rates would be needed to absorb the unemployed after a significant period of economic underperformance.[38] Concretely, 35 million jobs need to be created in the ESCWA region in the next ten years, and up to 100 million in the next 20 years, simply to maintain current conditions in the labour market.[39]

The oil boom that began at the end of 2002 has contributed to the acceleration of the GDP growth rate in the ESCWA region. These growth rates have also been converging across the region, but significant differences persist. For example, annual average GDP growth rates in the GCC stood at 7.1 per cent during this period, while in the MDEs growth rates reached a more modest 4.2 per cent per annum.[40] The differential impact of the oil shock in the MDEs is largely due to the diverse implications of oil prices in these economies; it is marginally positive in the small oil-exporting countries, but negative in the oil-importing countries. The differential impact is also due to varying regional patterns of, among others, labour migration, regional tourism, overseas development aid and financial and real estate markets. In general, most countries have benefited from the delayed pass-through of higher oil prices (as in the case of Jordan) and higher rents (as seen in increased revenues from the Suez Canal in Egypt).[41]

[32] ESCWA (2007b), p. 11.

[33] Tzannatos (2002), p. 123.

[34] See ESCWA (2007a), pp. 2-5, ESCWA (2007b), p. 7 and Abrahart, Kaur and Tzannatos (2002), p. 26.

[35] UNDP and League of Arab States (2008), p. 22.

[36] Ibid.

[37] ESCWA (2007b), p. 10.

[38] See Karshenas, op. cit., p. 20.

[39] See ESCWA (2007a), pp. 2-3, ESCWA (2007c), p. 9 and World Bank (2004), p. 1.

[40] ESCWA (2007b), pp. 5-7.

[41] IMF (2006i), p. 71.

TABLE 25. GROSS FIXED CAPITAL FORMATION (AS A PERCENTAGE OF GDP)

	1990	1995	2000	2001	2002	2003	2004	2005
Bahrain	18.9	17.3	13.5	13.3	17.3	19.7	21.6	..
Egypt	26.9	19.2	18.9	17.7	17.8	16.3	16.4	17.9
Jordan	26.0	29.6	21.1	19.4	18.9	20.5	24.2	23.7
Kuwait	18.0	13.6	10.7	14.3	17.1	16.5	17.8	19.7
Lebanon	17.8	36.5	20.8	20.5	19.4	19.6	21.7	20.7
Oman	12.3	15.0	11.9	12.6	12.8	16.3	17.8	..
Qatar	..	30.0	19.5	23.4	29.0	30.2	30.1	33.6
Saudi Arabia	19.0	19.4	17.5	18.4	18.1	18.4	16.7	15.0
Syrian Arab Republic	16.5	27.2	17.3	20.3	20.3	23.3	21.2	..
United Arab Emirates	19.5	28.4	22.1	23.6	23.1	22.6	21.2	22.8
Yemen	11.9	20.6	18.6	20.9	20.5	23.1	..	..

Source: *World Development Indicators*, November 2007.

Note: Two dots (..) indicate that data are not available.

TABLE 26. CENTRAL GOVERNMENT DEBT (AS A PERCENTAGE OF GDP)

	2000	2005
Bahrain	29.3	29.9
Egypt	82	112.5
Jordan	93.7	84.7
Kuwait	40	13.1
Lebanon	144.8	174.6
Oman	19.1	10.8
Qatar	59.9	30.5
Saudi Arabia	96.7	39.6
Syrian Arab Republic	62.9	60.2

Source: *World Development Indicators*, November 2007.

Despite the overall economic recovery, the unemployment rate in the ESCWA region declined by only two percentage points in 2003-2005.[42] This is partly due to the high capital intensity in the oil industry. The weak internal multiplier of this industry has dampened the already limited employment-generating impact of the current boom, which is especially affecting women and the young in the GCC and the relatively oil-rich MDEs, such as the Syrian Arab Republic and Yemen.[43]

B. LABOUR MARKETS IN THE ESCWA REGION

Labour markets have distinct features in the countries of the ESCWA region. This section focuses on the GCC because their labour markets are relatively unconventional; moreover, the dynamics of GCC growth largely determine labour market outcomes across the region.

The GCC countries were relatively poor and sparsely populated until the latter half of the twentieth century. At that time, their extreme dependence on oil rents had already created some of the most dichotomous economies in the world. A highly productive oil sector generated little direct employment because of its high capital-output ratio (for example, only 4 per cent of the workforce in Qatar is employed in the energy sector),[44] while large numbers of low productivity and poorly-paid jobs existed at the margins of the oil economy, in both the formal and the informal sectors.

Since the early 1970s, growing prosperity in the GCC has led to a significant increase in welfare standards and a very rapid rate of

[42] ESCWA (2007a), pp. 2-3.

[43] ESCWA (2007b), p. 17.

[44] UNDP and League of Arab States, op. cit., p. 42.

population growth in these countries. The GCC has experienced a huge expansion in labour demand, which has attracted millions of relatively unskilled workers from less wealthy and more densely populated countries in the ESCWA region and elsewhere, as well as large numbers of relatively skilled Western expatriates.[45] Currently, more than ten million foreign workers live in the GCC and are mostly employed in poorly-paid construction and service sector jobs.[46] This is twice the number of migrant workers in 1985,[47] and more than 80 per cent of workers are non-nationals, especially in some of the smaller GCC States such as Kuwait, Qatar and the United Arab Emirates.[48]

The combined pressures of rapid population growth, the social and cultural transformations taking place in recent decades (especially those leading to the rising participation of women in the labour force), and the mounting inflow of overseas workers leveraged by the power of national commercial capital have made it difficult for the GCC economies to fully absorb these new entrants into their labour markets. Labour market stability has been even more elusive because of the volatility of oil rents, which affect the capacity of the GCC economies to create jobs for national workers and to permanently accommodate foreign workers in the oil industry and in those sectors that are heavily dependent on it.

As a rule, rent-based growth is not employment-intensive.[49] Worse still, when oil prices decline, the demand for labour across the economy tends to contract sharply, initially because of the fall in Government spending and, at a further remove, because of the multiplier effect of this externally-induced contraction of national income. At the same time, the number of secondary school and university graduates has been rising in the GCC. This has led to the emergence of open unemployment among qualified GCC nationals, especially women and youth, as well as to extensive disguised unemployment, particularly in the public sector. The number of new entrants into the labour market not finding ‘decent’ work is today nearly twice what it was a quarter of a century ago, while a large number of foreign workers continue to be employed in these oil-rich economies.[50]

Labour market tensions in the GCC are significant. This is not only because of the importance of wages for household income and social welfare in the ESCWA region. These tensions also affect social integration which, in the GCC, has often depended on the transfer of oil rents to the non-oil sectors of the economy through State patronage and public sector employment. These transfers have taken the form of low productivity (civilian and military) employment in the public sector, large-scale investment in construction and real estate, and the selective provision and maintenance of infrastructure in the economy. However, these investments have often been insufficient, uncoordinated and biased towards the provision of services for the few rather than necessities for the many. They have also been limited by the rent leakages to the rest of the world, especially through imports of luxury goods, military hardware and exceptionally high levels of overseas investment, particularly in the United States.[51] Consequently, the welfare impact of oil rents has lagged well behind potential.

These insufficiencies created significant difficulties for GCC Governments between the late 1980s and the early 2000s, when oil prices were low. Various Governments have stated that they were concerned by this situation and wished to provide employment for all GCC nationals. However, during that period Government budgets did not allow the creation of public jobs on demand because of fiscal constraints. Another related issue is that most unemployed nationals in the GCC are young secondary school graduates

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45 “In the GCC States ... expatriate workers represent the majority of the total labour force, ranging from some 33 per cent in Bahrain to almost 90 per cent in the United Arab Emirates. Expatriate workers hold a variety of jobs, ranging from those that are relatively low-paid and require minimal skills and education, to professions that require the most technically advanced knowledge and experience.” ESCWA (2002), p. 5.

46 ESCWA (2007c), p. 16.

47 Tzannatos, op. cit., p. 125-8.

48 World Bank (2004), p. 59.

49 ESCWA (2007a), p. 3.

50 See ibid., p. 3 and Girgis (2002), pp. 95-7.

51 See ESCWA (2007b), p. 11.

whose qualifications are not in demand. Worse still, many private sector employers prefer to hire foreign workers because they can be dismissed more easily. Some employers also believe, rightly or wrongly, that national workers are more expensive, less productive, enjoy a personal safety net, that they would resign if employment conditions were not exactly 'right', and that they always aspire to move into the public sector, which offers better pay and conditions. This view is shared by the World Bank:

> The structure of unemployment … suggests that a significant part of unemployment results from high job expectations by workers with some formal education, as well as from a low valuation of these credentials by the private sector, because education systems have concentrated on making public sector jobs accessible rather than building skills … Educated new entrants continue to queue for Government jobs, despite falling civil service wages, because of such non-wage benefits as allowances and job security.[52]

Finally, labour markets in the GCC are highly imperfect and information on supply and demand is often unavailable to prospective employers and employees.[53] Some of these difficulties have been disguised by the steep rise in oil prices since 2002. However, the underlying problems remain. They not only limit labour productivity in the GCC, but also reduce employment-creating capacity in these countries. These limitations have a profoundly adverse impact on the economic development of the ESCWA region.

The MDEs have more conventional labour markets. Like other developing countries, these countries have a considerable excess supply of workers, who are currently unemployed, underemployed, employed in the informal sector, discouraged or who work but receive no wage. Large pools of rural sector workers, especially in Egypt and the Syrian Arab Republic, have been gravitating to urban areas to seek employment. The unemployment backlog and the number of the working poor have expanded significantly since the mid-1980s because of the slowdown in economic growth across the region, the lack of economic diversification and the retrenchment of the public sector in the wake of structural adjustment reforms. The unemployment crisis is especially severe in Yemen, where the official unemployment rate was 8.4 per cent in 1999. However, a broader definition raises the unemployment rate to an estimated 11.5 per cent and youth unemployment to 18.7 per cent. If current trends were maintained, 188,000 new jobs would need to be created every year, but Yemen only has the capacity to create 117,000. Consequently, unemployment would have reached 17 per cent of the labour force in 2006, even though around a quarter of the Yemeni labour force (one million workers) currently works abroad. In Yemen, private sector growth is not vibrant enough to generate sufficient new jobs, and most private sector employment consists of either self-employment, poorly paid or largely unpaid work.[54] In addition to this, the GCC shift against Yemeni migrant labour has contributed to the simmering unemployment crisis in the country.

Emigration has often functioned as a safety valve in the MDEs. It contributes to the adjustment of the labour market and to household welfare, especially among the poor. Many poor households in the MDEs are kept afloat financially thanks to transfers from relatives and friends working abroad. Worker remittances also make an important contribution to the balance of payments of these countries, especially Jordan, Lebanon, the Syrian Arab Republic and Yemen (see tables 7, 8 and 9).[55] Emigration to the GCC, where incomes can be five times higher than in their home countries, has been facilitated by the common language shared across the region. However, the scope for labour migration has been limited by the volatility of the oil rents in the GCC and by increasingly stringent labour policies in OECD countries, especially in the European Union after its recent enlargement.[56] These

[52] World Bank (2004), p. 6 and p. 89.

[53] Girgis, op. cit., pp. 96-100.

[54] See UNDP, op. cit., p. 100.

[55] Ibid.

[56] Tzannatos, op. cit., pp. 125-8.

prospects were further reduced by the policy shift in the GCC, leading to the large-scale expulsion of migrant nationals of Yemen and Jordan from Saudi Arabia and Palestinians from Kuwait, and, since the mid-1980s, the shift to imported labour from South and South-East Asian countries.[57] The impact of these shifts has been compounded by the 'Saudisation' policy implemented in Saudi Arabia (and similar policies elsewhere in the GCC), which significantly increased the cost of hiring non-nationals in order to create more opportunities for the growing number of Saudis entering the labour force.[58] The situation faced by the MDEs deteriorated further following the loss of industrial dynamism between the mid-1980s and the end of the 1990s.

Rapid regional population growth and the availability of foreign workers have removed the most significant supply constraints on GCC labour markets. Although the inflow of migrant workers can increase the flexibility of GCC labour markets, it is insufficient to resolve unemployment problems in the labour-exporting MDEs. This is partly because the number of unemployed and underemployed workers in the MDEs is too large and partly because an increasing share of the migrant workers in the GCC come from outside the ESCWA region.[59]

In addition to this, there is a considerable mismatch between the skills available in the GCC and MDEs and labour market demands. In contrast with conventional claims, this is only partly the result of inadequate schooling. It is also due to the leakages created by emigration and the withdrawal of large numbers of graduates from the workforce every year as they are not tempted by lacklustre jobs in the public sector and the excess supply of qualified workers in sectors in low demand. In contrast, there is a significant excess demand for workers skilled in science and technology. These mismatches and the high rate of withdrawal from the labour market make it particularly difficult to resolve the employment problems faced by ESCWA member countries. In broad terms, more and better job opportunities must be provided in the MDEs in order to reduce poverty and improve the distribution of income and assets. In the GCC, productive employment needs not only to expand, but also to diversify towards socially useful sectors and to shift more aggressively away from expatriates from OECD countries and towards ESCWA nationals at the top end of the labour market.

C. CONVENTIONAL VIEWS AND POLICY PROPOSALS

Conventional analysis[60] holds that the structural features of the labour market in the ESCWA region were shaped by the macroeconomic policies that have been implemented since the 1940s and, most evidently, since the oil boom in the 1970s. During most of this period, there was excessive reliance on the public sector to distribute resources, provide economic and social infrastructure (for example, health, education and transportation facilities), induce and maintain domestic economic dynamism, and absorb the impact of fluctuations in oil prices. The latter has been done, especially, through the deployment of the public sector as – effectively – the employer of last resort, particularly in the GCC. There, and, to a lesser extent, in other countries in the region (for example, Egypt and the Syrian Arab Republic), public sector employment represents a substitute form of social protection. Although this strategy may be justifiable during relatively stable periods or during brief downturns, and although it delivered some of the highest growth rates in the world between 1965 and 1980, this "social contract"[61] is highly dysfunctional over the long term, in periods of sharp volatility, or when the price of oil declines significantly.

In the long term, excessive State intervention leads to resource misallocation, a rising incremental capital-output ratio, the proliferation of rent-seeking activities and persistent economic underperformance. These distortions tend to reduce the capacity of the economy to create productive employment and numb the economy's response to labour market

[57] See Girgis, op. cit., p. 97 and World Bank (2005a), p. 38.

[58] ESCWA (2007b), p. 7.

[59] Girgis, op. cit., p. 95.

[60] See, for example, Abrahart, Kaur and Tzannatos, op. cit., Gardner (2003) and Tzannatos, op. cit.

[61] World Bank (2004), p. 2.

pressures. These rigidities cannot be compensated by the protection to domestic activities afforded by tariffs and other trade restrictions. Eventually, the State itself becomes unable to absorb the growing pool of the unemployed, with predictable consequences in the form of underemployment, informal employment and the marginalization of a growing section of the population. Furthermore, the faltering dynamism of the economy prevents the generation of new economic activities which could offer alternative sources of employment and wealth creation.[62]

These insights are supported by several labour market surveys, indicating that rising unemployment has hit first-time job-seekers especially hard. Perversely, those with secondary education have been affected most harshly. This is partly due to education policies in several ESCWA countries and, partly, because countries have been unable to create new jobs sufficiently rapidly to absorb new entrants into the labour market. This may also reflect the willingness and ability of educated youths to wait for jobs in the formal and public sectors to open up, rather than to accept the first available offer of employment, as well as the inability of the education system to provide pupils with the skills they need to obtain good jobs in the private sector.[63]

From a conventional perspective, under these macroeconomic circumstances and demand constraints, and with insufficiently high GDP growth rates to induce the creation of enough new jobs, additional employment can be generated through lower wages and more flexible employment conditions (including non-wage costs to employers, for example social security and pension contributions).

However, this adjustment strategy would tend to provide incentives to labour-intensive and low-productivity industries, potentially creating more employment, but not necessarily higher output. Moreover, technical progress in a demand-constrained economy could be employment-destroying if it allows fewer workers to produce the same level of output. In contrast, if the key constraints are on the supply side, a less painful policy would be to aim for technical improvements that lower costs and make the expansion of production (and employment) more profitable, leading to higher investment and tax contributions, thereby avoiding the need to cut wages.

There is mixed evidence about the nature of the key constraints to growth in the ESCWA region, and about the nature and implications of the labour market rigidities currently prevailing in the region. In particular, there is insufficient evidence that local labour markets are flexible enough for firms to adjust to competitive innovation and promote employment. Real industrial sector wages are generally flexible and labour market regulations are no more significant than in other developing areas (although in some ESCWA countries they can impose significant costs on formal sector firms). While it is difficult to estimate the overall macroeconomic and employment impact of these rigidities, there is no question that they create allocative distortions and generate significant efficiency costs.

In order to overcome these problems and generate enough jobs to address the employment crisis in the ESCWA region, conventional analysis recommends the introduction of ambitious policy reforms. These include opening the local private sector to stronger international competition, while strengthening the institutions that support markets, encouraging investment and stimulating productivity growth. The positive impact of this competitive shock on employment can ostensibly be maximized through targeted labour market reforms including, for example, more flexible labour market regulations to enable firms to respond more promptly – and with greater certainty – to market signals. In order to support and sustain this process, the role of the public sector needs to be modified. Sound physical and institutional infrastructure in this strain of analysis is sufficient for the functioning of markets, rather than being simply the purveyor of jobs primarily for the better-off.[64]

[62] See, for example, World Bank (2007).

[63] See Gardner, op. cit., p. 4.

[64] Ibid., p. 11.

D. SHORTCOMINGS OF THE CONVENTIONAL PERSPECTIVE

The previous section has shown that the process of structural adjustment (*infitah*) in the ESCWA region has been hampered by labour market and real wage rigidities, and that the availability of public sector employment has shielded privileged segments of the workforce from market pressures. While it is claimed that these distortions have reduced investment and productivity growth, and led to insufficient employment creation in the region, these claims are not strongly supported by the evidence. Furthermore, the role played by regional security issues in shaping priorities in resource allocation is often sidelined in the conventional view.

Labour markets in the ESCWA region are structurally flexible on three levels. First, even in those countries where the labour market is apparently tight, the supply of workers remains elastic because it is always possible to import additional workers from the rural or informal sectors, from the pool of discouraged workers or from overseas (where they can be returned in bad times). This has been the case both in the GCC and in the MDEs, with the obvious difference that the MDEs export labour, while the GCC imports a large number of foreign workers.

Second, ESCWA economies have shown a high degree of real wage flexibility in recent years. A large part of the adjustment burden in these countries has been carried by formal sector workers, who have been penalized through real wage cuts, falling employment rates and the reduction of the share of wages in value added.[65] For example, real hourly manufacturing wages in the oil-exporting economies fell by almost half between 1986 and 1992, and only began slowly to recover until the end of the decade.[66]

Third, the public sector has often spearheaded the process of wage compression and flexibilization of the workforce in the ESCWA countries. Across the region, public sector real wages have been highly flexible and their movement has increased the flexibility of private sector wages.[67] However, public sector employment also helped to protect incomes, employment and social welfare during the protracted economic decline between the mid-1980s and the late 1990s. In this sense, public sector employment has often fulfilled – if only imperfectly – the twin roles of automatic stabilizer and provider of unemployment insurance or, alternatively, as the employer of last resort in the region (see box 8).[68] In sum, the so-called "rigidities" of the labour markets in the ESCWA region, where they actually existed, have had an important *stabilizing* and *employment-creating* effect during the adjustment period.[69]

However, in spite of their flexibility, labour markets in the ESCWA region remain deeply segmented between the private and public sectors, the formal and informal sectors, male and female employment, and rural and urban employment. For example:

> [I]n Egypt there are various types of sectors with different labour regulations: public sector, public enterprise sector, share holding companies, investment sector. Various labour relations in countries with free zones create another layer of labour market segmentation. In some cases, workers combine jobs in different sectors, with one mostly in the public sector, making the issue of labour flexibility and market segmentation complex.[70]

The complexity of the labour markets in the ESCWA region is hardly surprising. It suggests that rapid labour market liberalization (or, more precisely, the shift to neoliberal modalities of regulation of the labour market) in this region could be costly, severely destabilizing and could compromise social welfare. At the same time, there is no guarantee that neoliberal reforms would raise the level, quality or productivity of employment. For example, although the removal of social safety nets could provide incentives for

65 El-Mikawy and Posusney (2002), p. 82.

66 See World Bank (2004), p. 115.

67 The case of Yemen is examined in UNDP, op. cit.

68 ESCWA (2007b), p. 2.

69 See ibid., p. 15 and Karshenas, op. cit., p. 51.

70 El-Mikawy and Posusney, op. cit., pp. 82-4.

matching educational qualifications and labour market demands in the medium term, there is no reason to expect that this would be sufficient to reduce the backlog of unemployment and underemployment in the region. Even if it were to do so, the adjustment process could easily be detrimental to social welfare. For example, in the light of the declining rate of investment that has occurred in the region over the past several years, a significant rise in productivity growth could be obtained in the short-term through labour-shedding. However, even if this were profitable for a limited number of firms, it would be disastrous for most households. Counter-intuitively, low productivity growth in the ESCWA region can be a blessing in disguise because it protects employment and household income.[71] In other words, unfettered market processes cannot rapidly or cheaply tackle the structural problems associated with insufficient employment generation in the ESCWA region, nor address the mismatch between available skills and labour market demands. In fact, if productivity advances are not outpaced by increased demand, it is possible that further labour market liberalization would worsen the social fractures that already exist in the region.

Conventional policy reforms are also flawed at a deeper level. First, they ostensibly aim to create situations, at least in the economic sphere, that provide a (never clearly defined) level playing field and sound fundamentals for the operation of markets. This is both problematic and vague, and therefore endlessly open to interpretation; it is also insufficient to support sustained rights-based economic growth. Second, the mainstream agenda carries the (generally implicit) corollary that ESCWA member countries must shift their social base towards a narrower coalition, in which the emerging class of entrepreneurs need to take a more prominent place than they have up to now.[72] This is a tall order and is based on an interpretation of the political economy of the ESCWA region that is neither internally consistent nor, ultimately, conducive to socially desirable outcomes. Third, the mainstream approach is analytically inconsistent because it focuses excessively on short-term stabilization while, at the same time, undercutting the basis for long-term growth, especially as it undermines the long-term payoff that would accrue from integrated social policies.[73]

The inability of conventional liberalization programmes to bring about economic stability and rapid growth has become increasingly evident during the past 25 years, both in the ESCWA region and elsewhere. In the light of the resources that are currently available in the region and those that could be generated through faster growth, the slow improvement in the welfare of the poor is a severe indictment of mainstream economics and the international community. The market is incapable of responding to the key problems of development, such as the challenges of how to create sustainable competitive advantage; how to support business growth in strategically important areas; how to assist employment creation and productivity growth; and how to monitor resource use in order to achieve rights-based development objectives, while simultaneously securing balance of payments stability and environmental sustainability.

Simply positing a non-existent dichotomy between States and markets as an analytical principle is both insufficient and misguided. It suggests that the most profound problems of economic development can be resolved simply through the withdrawal of the State and the subordination of the economy to so-called global forces. It ignores the fact that private sector decisions can be costly and destabilizing, and that quality public sector intervention is essential to stabilize the economy and steer it in a socially desirable direction. It also vastly overestimates the capacity of ESCWA member countries to respond constructively, and at short notice, to adverse shocks.

E. THE SEARCH FOR ALTERNATIVES

Employment generation is the most important link between growth and poverty alleviation in the ESCWA region, and its persistent weakness is symptomatic of a deep macroeconomic malaise. The weak real economy in the ESCWA region contributes to shaping

[71] ESCWA (2007b), p. 15.

[72] Hinnebusch (2001), p. 116.

[73] See Fine and Stoneman (1996) and McKinley (2001).

rents, in large part because employment tends to expand proportionally to the rent redistribution towards labour. These employment problems are potentially destabilizing, both socially and politically, and for this reason alone, they should be addressed constructively and collectively by ESCWA Governments. The existing high levels of unemployment and underemployment in the ESCWA region are a waste of human potential and the missed opportunities to increase social welfare. The recent oil boom offers a unique opportunity to make a decisive break with these economic shortcomings. This could be done before the reserve number of those unemployed becomes too large and so ingrained in the economic, social and political structures of the region that the problem becomes too difficult to resolve; any measures that may be taken should also seek to preserve political stability.

The previous sections have shown that the trajectories of unemployment and underemployment in the ESCWA region are closely related to the implementation of development strategies and neoliberal adjustment policies. In the long term, these strategies have consolidated highly unequal social structures, while short-term adjustment policies have been driven primarily by foreign exchange scarcity (in the case of the MDEs) and by concerns about rampant economic inefficiency, however defined. As construed in the conventional discourse, unemployment in the ESCWA region combines both structural and cyclical features and covers structural mismatches between labour supply and demand in key markets (which are especially evident in the GCC and arise as a result of sluggish growth in diversification allowing for the capitalization of labour) and unemployment due to demand deficiencies or short-term macroeconomic fluctuations.[74]

This is insufficient. The most important structural factor explaining the reproduction of unemployment, poverty and vulnerability in the ESCWA region is due to the manner in which it is integrated into the world economy, especially its heavy reliance on rents and unrequited transfers (for example, oil and geopolitical rents, the Suez Canal in Egypt, and aid and workers' remittances in most MDEs)[75] and the region's massive import dependency. At the macroeconomic level, this mode of integration generates significant vulnerability in the oil-rich economies to shifts in the price of oil and to symptoms of Dutch Disease (only the symptoms and not the paraphernalia of outcomes, as explained in the previous Survey),[76] and to resource leakages through the export of savings, high defence expenditure and capital flight. For example, between 1971 and 2001, the oil economies alone accrued, at constant (2000) prices, about US$ 850 billion in excess savings over investment.

In contrast, vulnerability in the MDEs is primarily due to the structural imbalances associated with import dependency and low value-added production, insufficient export diversification, the unreliability of labour remittances and the heavy burden of defence spending. The absence of a diverse economic base and the ensuing forms of inequality are justified by powerful ideological processes. These include values handed down from former regimes which, on the basis of religious faith, have not promoted equality in economic, social or political domains.[77] In addition to this, the export of large numbers of workers from the MDEs to the GCC has contributed to the consolidation of a structural divide in the regional labour markets that has helped to reproduce poverty in the ESCWA region. While the wage divide between nationals and non-nationals in the GCC has consolidated structural poverty in these economies and limited the scope for economic diversification and the development of the domestic market, the export of workers and the ensuing remittances (as well as aid) have contributed to the economic, social and political stabilization of inequitable policy regimes in the MDEs.

This combination of forces has created powerful trends which contribute to the reproduction of unemployment, poverty and inequality. These include institutional processes that intensify social and cultural differences in order to secure the exclusionary appropriation of oil, transport, agricultural and other rents. In the

74 See Girgis, op. cit., p. 96.

75 See ESCWA (2006).

76 See, however, ESCWA (2007d).

77 See Tuma (2000), p. 5.

past, this appropriation has tended to favour the military and technocrats, but wealthy entrepreneurs have frequently been the principal beneficiaries since the *infitah*. These poverty and inequality-generating institutions and processes include the structure of labour markets, the tax system, property rights, inheritance laws, shortcomings in public health and education systems, and the administrative machinery of the State. The continuing importance of these structural features shows that, in spite of the good intentions harboured by many political regimes vis-à-vis the welfare of the poor, most ESCWA economies tend to be structurally biased against this social group. By the same token, most ESCWA Governments tend to avoid the task of addressing the social, economic and political structures that create inequality and transforming them into *rights-based equality-generating structures*. These are examined in detail below.

F. PRINCIPLES OF RIGHTS-BASED DEVELOPMENT

Economic growth is a necessary but insufficient condition for poverty reduction, because the poor need expanded opportunities for decent work in order to capture a larger share of the benefits of growth. This section brings together both aspects of the debate in order to formulate employment-friendly strategies for the development of the ESCWA region.

Rights-based economic strategies are based on three principles.[78] First, mass poverty is the most important problem facing ESCWA countries and its elimination should, ideally, be a central policy priority of their Governments.[79] Conventional analysis suggests that poverty is created by social exclusion, defined as segregation from free market processes through the imposition of arbitrary limitations to voluntary exchange and is measured by the inability to reach arbitrary expenditure levels, for example US$ 1 or US$ 2 a day. This viewpoint posits markets unproblematically as creators of wealth and market integration as the main force for economic growth and poverty reduction. The conventional view is insufficient and potentially misleading because it decontextualizes poverty and obscures its origins and mechanisms of reproduction over time and across countries and regions. In minimally complex market economies, exclusion from local or international markets is normally not the cause but, rather, a *consequence* of poverty. In these economies, poverty tends to be created by the manner in which specific social groups are integrated into the dominant mode of social and economic reproduction.[80] It is their modalities of economic and social integration that impose upon the poor highly exploitative labour regimes, including badly paid wage labour, precarious commodity production, insecure self-employment and, potentially, degrading forms of labour, such as child labour. In turn, these labour regimes are associated with low productivity, low incomes and precarious living standards.

A rights-based development approach can not only offer a richer understanding of poverty, but can also generate useful policy guidelines to address the reproduction of poverty in the ESCWA region. For example, it suggests that poverty cannot be reduced to the inability to reach an arbitrary level of income. Rather, insufficient income is one of the *implications* of the structural inequalities that have come to characterize the economic systems of ESCWA member countries. This approach also suggests that markets can create poverty as well as wealth; however, at all times markets will maintain their central role as vehicles for the exercise of economic and political power. Markets are never neutral and need constant nurturing, regulation and supervision by democratic States. At a further remove, it should be recognized that poverty is not transient in the ESCWA region, but deeply rooted in the economic and social structure of the countries in this region. The elimination of poverty requires structural social and economic reforms in order to eradicate the inequalities responsible for the reproduction of poverty amid pockets of wealth. These include legally condoned inequalities of access to, and control over, labour, economic resources and political power.

[78] See ESCWA (2006).

[79] This aim is not only important in itself; it is also mandated by the United Nations through the Universal Declaration of Human Rights, the Declaration on the Right to Development and the Millennium Development Goals. See ESCWA (2007c), pp. 12-15.

[80] See Bracking (2004) and Bush (2004).

It follows that the solution to deeply ingrained problems of poverty and inequality is primarily political, rather than economic. Within these limitations, rights-based macroeconomic policy can make an essential contribution to the complex and, inevitably, contentious process of redressing structural inequalities and eliminating the symptoms of poverty in the ESCWA region. The urgency of these problems, their ramifications and the difficulty involved in addressing them, while trying to preserve political and economic stability, suggests that, unless Governments give absolute priority to the elimination of poverty, this goal will almost always fall by the wayside, in spite of the high human (and economic) costs of poverty.

The second principle is that rights-based growth must benefit the poor more than the rich; growth is rights-based when it reduces relative as well as absolute poverty.[81] In a rights-based framework, economic policies are not selected in order to maximize growth; reciprocally, equity is not an instrument for the achievement of rapid growth. Although high growth can facilitate the achievement of rights-based outcomes, the type of growth is at least as important as the rate of economic growth.[82] Rights-based policies can eliminate poverty and material deprivation faster than any other combination of policies; they can also uphold the intrinsic value of economic equity and its potential contribution to democracy and human rights.[83] In this approach, GDP growth, inflation control, high investment, low public debt and other conventional parameters of economic "success" should not be the most important objectives of Government policy. Instead, they should be seen as *instruments* for the elimination of mass poverty and the achievement of secure, sustainable, equitable and empowering human development.

Third, improvements in distribution and social welfare are best pursued directly. These improvements should not be merely marginal or conditional on trickle-down processes and must be unambiguous across a broad spectrum of welfare and distribution measures. Changes in the initial distribution of income and wealth in the ESCWA region (for example, through universal basic education and training, the introduction of pensions and other entitlements funded by progressive taxation) can promote several rights-based objectives simultaneously across all countries in the region. However, these distributional shifts can be achieved only through the intervention of public policy, because "empirical evidence ... consistently indicates that size distributions of income are quite stable, in the absence of radical changes in institutions and political power".[84] In addition to these *ex ante* distributive shifts, the process of income generation also needs to be transformed across the ESCWA region in order to ensure that the poor benefit the most. Possible changes include the deployment of industrial policy instruments to support strategic economic activities, aggressive employment generation programmes, and incentives for wage increases for low-skilled workers.[85] These outcomes are fully compatible with international instruments, such as the Universal Declaration of Human Rights. Article 23 of this declaration states that:

(a) Everyone has the right to work, to free choice of employment, to just and favourable conditions of work and to protection against unemployment;

(b) Everyone, without any discrimination, has the right to equal pay for equal work;

(c) Everyone who works has the right to just and favourable remuneration ensuring for himself and his family an existence worthy of human dignity, and supplemented, if necessary, by other means of social protection;

(d) Everyone has the right to form and to join trade unions for the protection of his interests.

[81] See McKinley (2003) and Weeks (2003).

[82] An expanding economy will always contribute to alleviating poverty, except in a small number of perverse cases. This is hardly sufficient, as it misses the point on how to maximize the impact of growth on poverty over the long term. See Dagdeviren et al. (2002), p. 391.

[83] See Doraid (2002), ESCWA (2006) and Sengupta (2004).

[84] Rao (2002), p. 7.

[85] See Amsden (1997, 2001), Chang and Grabel (2004), McKinley (2003), Osmani (2001) and Pasha (2002).

Macroeconomic policy instruments can make an important contribution to the elimination of mass poverty and the achievement of internationally mandated rights-based development outcomes. Ideally, the central policy objective of Governments in the ESCWA region should be to seek a sustainable and rapid growth rate that maximizes poverty reduction, i.e. a pattern of sustainable growth for which the rate of poverty reduction is high. Increasing the poverty-reducing impact of growth is as important as raising the growth rate because recent trends in poverty, social indicators and employment imply that the MDGs and other development goals cannot be achieved by growth alone, even if the rate of growth is much higher than in the recent past. The two ingredients for achieving these goals – faster growth and redistribution – require a broader role for the public sector, with emphasis on public investment.

Macroeconomic stability is an important constraint on the achievement of rights-based outcomes, including rapid growth, redistribution and the structural transformation of the economy. Stability includes, at a minimum, intertemporal fiscal and balance of payments equilibrium, real exchange rate stability, and the minimization of inflation and macroeconomic volatility. As was indicated above, these are not in themselves objectives, but such stabilizing policies can help to address obstacles to the achievement of rights-based goals. Interference in macroeconomic stability may come directly from inflation that can redistribute income towards the rich, capital flight that can trigger exchange rate instability, and balance of payments crises that can limit essential imports, or indirectly from expectations of instability that can erode support for the policies of the Government.

In order to minimize the scope for these destabilizing outcomes, the macroeconomic limits of Government policy should not be defined precisely in advance. While the rights-based goals should be described in detail and achieved within a given time frame, the optimal policy stance with respect to macroeconomic stability is country-specific. Stability must be pursued because of its instrumental value, but listing a set of arbitrary restrictions on Government action (such as maximum fiscal deficits, inflation rates or exchange rate levels) alongside rights-based targets devalues the latter, introduces artificial constraints to Government programmes and undermines policy implementation, because it signals that the Government is only conditionally committed to rights-based policies. Macroeconomic imbalances need to be addressed on a case by case basis in order to minimize the economic and political costs of achieving distributive goals. This does not imply that stability is unimportant, but recognizes that it has costs. On the one hand, the preservation of stability should not become an objective in itself, much less an excuse to undermine the rights-based programmes of the countries concerned. On the other hand, the distribution of the costs of stabilization should support, rather than undermine, the achievement of rights-based outcomes.

A large share of the national income of the countries in the ESCWA region derives directly or indirectly from oil rents, especially in the GCC, while for the MDEs rents are a determinant in their business cycle. Historically, oil rents have been highly concentrated and have fostered conspicuous consumption, speculative investment and political corruption.[86] They have also contributed to significant leakages from the region as a large part of these resources are transferred to OECD markets through imports and capital outflows. Given these distortions and limitations, the creation of decent employment for all and the elimination of the worst forms of poverty in the ESCWA region will require significant changes in existing economic and social structures in the region. Reforms are needed to address existing inequalities, support economic diversification, expand domestic markets and ensure a smooth transition to employment-intensive growth.

Any changes in the development strategy in the ESCWA region will first, however, need to be preceded by a recognition of the international

[86] "[M]uch of [ESCWA] income is derived from oil rents that buttress affluent consumption and that do not get re-ploughed back in the productive side of national economies for fear of risks, lack of national absorptive capacity or both. It also points to deep-seated reasons associated with the nature of the accumulation process that disrupt the intermediation between economic expansion and social development." ESCWA (2007c), p. 15.

covenants related to the right to development[87] and their implementation through rights-based development compacts tailored to each country in the region.

Second, a rights-based approach to development requires a coordinated industrial policy strategy that focuses on the redistribution of income and assets in a way that promotes effective demand by economic diversification and the internalization of key value chains through forward and backward linkages in order to increase regional self-sufficiency, generate employment and diversify exports. This strategy should include the provision of basic infrastructure and services (for example, housing, clean water, sanitation, electricity and transport) by local firms and the expansion of manufacturing capacity, high value-added agricultural production and tourism infrastructure in the region.

Third, this rights-based development strategy can be conducive to faster economic growth if wage goods are produced locally. Wage earners spend most of their income, but investors inject demand into the economy based on their confidence and outlook. If the economy is underperforming, investor response is likely to remain tepid. Increasing demand and profitability, and the likelihood of investment, therefore, are often linked with rising demand for consumption goods resulting from a more robust wage share in the economy, but only if regional production is broad-based.[88] Rapid growth has a direct impact on absolute poverty levels through the creation of new income-generating activities and boosts the demand for foodstuffs and raw materials produced by the poor. Growth also increases the availability of goods, services and employment opportunities and expands markets, sales revenue and consumption. Poverty reduction can also be affected indirectly by economic growth by encouraging financial development and generating savings to support investment and the expansion of consumer credit. If growth is appropriately targeted it can also improve the relative position of the poor. For example, it can raise real wages through the creation of labour scarcity, fund redistributive social programmes and finance the provision of public goods, thereby potentially reducing "basic" and "market-generated" poverty.[89]

Faster growth in the region will require a significant scaling up of both public and private investment. Finance will be required from a wide variety of sources, including oil revenues, increased taxation of non-oil incomes and lower international reserves. Debt relief and much higher official development assistance (ODA) flows will be needed in the case of Yemen – one of only two least developed countries (LDCs) in the ESCWA region.[90] It will also require a significant upgrade in the education systems in the region and employment regimes. The shift towards a rights-based development strategy should expand significantly the number and share of high-productivity jobs in the ESCWA region (see box 7).

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[87] "The rise in unemployment [in the ESCWA region] stands in utter contrast to the right to work as per the [Universal] Declaration of Human Rights and the goals of poverty reduction as per the proclamation of the Millennium Summit." ESCWA (2007a), p. 4.

[88] See Taylor (2004), pp. 124-172 on wage-led versus profit-led growth.

[89] Basic poverty is due to low income and productivity levels in a country and tends to decline as the economy grows ("a rising tide lifts all boats"). Market-generated poverty is due to a lack of (or loss of access to) productive assets.

[90] See UNDP, op. cit.

Box 7. Critical dimensions of the unemployment problem in the ESCWA region

The majority of the unemployed in the ESCWA region are first-time job-seekers, and mostly youth. In the 1950s, 1960s and 1970s most of those seeking work lived in rural areas, but also included uneducated and unskilled workers living in urban areas. Another important dimension is the duration of unemployment that job-seekers experience. By the end of the 1990s, the average duration of unemployment was 36 months in Egypt and 35 months in Jordan. These unemployment queues are lengthening and the pool of the unemployed is getting deeper.

Duality of labour markets and earning in ESCWA countries

Wage and income inequality in the ESCWA region has risen substantially since the mid-1980s. Available data show that the widening "earnings gap" does not merely reflect differences in productivity (or investment in human capital), but is more closely associated with better access to highly paid jobs and positions through family connections and institutional factors (for example, endowment of "symbolic capital" à la Bourdieu), which make the labour market highly segmented.

On the other hand, low-paid workers face a greater risk of losing their jobs compared with those in the primary labour market. High job turnover and more irregular earnings are leading to a large section of the workforce in the ESCWA region falling into the secondary labour market, with low, irregular income and weak social protection. This may explain why the recent debate on employment within the ESCWA region has focused on work insecurity as much as income inequality.

In many ESCWA countries the transition in the 1990s to a new growth path, based on economic liberalization and a greater integration into world markets added new challenges for the labour market as a result of rising levels of job destruction and job creation. This led to increased insecurity and the informalization of a substantial portion of the workforce in the ESCWA region. As a result, unprotected and low-skilled workers in non-tradable activities are increasingly taking up casual jobs with low and unstable incomes. These new socio-economic dichotomies need to be addressed urgently, as they affect the macroeconomic stability of the region.

Future labour-demanding development strategy

Inadequate job growth in the recently liberalized ESCWA economies has created new employment challenges for policymakers. However, any future rights-based development strategy in the ESCWA region would first and foremost need to establish a more equitable distribution of rents in view of the high rate of income inequality, and incorporate a renewed emphasis on public investment. One of the conclusions of the 2004 Survey was that public investment has a clear "crowding-in" effect, particularly when concentrated in sectors providing broad positive externalities, which make private investment more profitable in the longer run. The policy recommendation supports a strategy based on a two-pronged approach, which should be based on:

- An optimal mix of public investment and private investment;
- The existence of high-tech industries side by side with small and medium-sized enterprises with high labour intensity;
- The introduction of policy measures to promote small and medium-sized enterprises in order to enable them to play a greater role in new job creation through a labour-demanding strategy. Such a strategy could eventually lead to high growth and high levels of job-creation in the medium term.

G. EMPLOYMENT AND POVERTY

A rights-based development strategy should ideally be based on rapid and sustained economic growth.[91] At the most basic level, this is because the redistribution of existing income, although potentially effective in reducing poverty, is intrinsically limited and can generate severe political tensions. The capacity to work is the only significant resource of poor people. Even when a development strategy improves the access of the poor to productive assets, such as land or machinery, the process of poverty reduction generally depends more heavily on the enhancement of the opportunities available to the poor to be employed in more intensive, productive and remunerative activities.

In general terms, the poor commonly suffer from underemployment and low returns to labour (in other words, insufficient quantity and quality of employment). Underemployment can be either open (involving those who cannot earn enough to rise above the poverty line because they do not

[91] This section draws heavily on Osmani (2002) and Khan (2002).

have a full-time job), or disguised (those who work on a full-time basis but with low intensity and in an institutional framework facilitating both work-sharing and income-sharing). In turn, low returns to labour can be due to three analytically distinct causes. First, competition with potential entrants with very low reservation wages (due to surplus labour in the economy); second, low productivity (due to poor skills or technologies, or inadequate complementary factors); or, third, adverse terms of trade (due to low product prices or high input costs, including high credit costs).

Addressing these distinct causes of poverty can help the poor to obtain access to jobs with higher incomes. This can be achieved through supply or demand-side economic measures. On the supply side, there are long-term forces affecting the growth of the labour force, and there are both long and short-term factors affecting the supply of labour of a given labour force. On the demand side, too, there are both long-term and short-term forces. The short-term forces are related to the business cycle, as explained by conventional Keynesian theory. In the long term, the potential income of the poor is determined by the growth rate of the economy, the elasticity of employment with respect to output growth and the quality of employment. Quality of employment refers not only to the returns to labour, but also to a host of attributes of work that are subsumed under the notion of labour standards and the 'decent work' criteria set by the International Labour Organization (ILO), including, for example, protection against unfair dismissal, health and safety standards at work, the length of the working day, the right of workers to organize and engage in collective bargaining with employers, and the scope for the workers to participate in decision-making processes.

The extent to which employment increases with each additional percentage point of growth depends on the sectoral composition of growth (the extent to which it is concentrated in labour-intensive sectors), the choice of technique (the extent to which technology is labour-intensive) and the terms of trade (the extent to which internal and external terms of trade favour labour-intensive sectors). One of the main reasons why economic growth has not led to a significant reduction in poverty in many ESCWA countries in recent years is that growth has not promoted labour intensity in either the composition of output or in the choice of technique within sectors – a prime example being the oil industry.

In sum, growth leads to an expansion in employment, a tendency for unemployment to fall and a rising return to labour. On another level, employment can grow in a stagnant economy only if the returns to labour are reduced, or if the rate of underemployment rises. Neither scenario is good for the poor. Only sustained growth of the real economy, boosted by a redistribution of rents redressing the unusually small labour share in the ESCWA region, can enable the poor to enjoy rising incomes through more – and better – jobs and more productive employment.

H. LABOUR MARKET REFORMS AND RIGHTS-BASED GROWTH

Experience shows that conventionally optimistic expectations about labour market reforms and the efficacy of market incentives for the creation of employment are often untenable. The fact that the unemployment rate in the ESCWA region has stabilized at double-digit levels for many years and responded weakly to the recent rise in oil prices – even though this has supported an improvement in the economic fundamentals – suggests that there are elements of current policies in the region that are fundamentally flawed.[92] In fact, even when they seek to induce growth in selected sectors, these conventional strategies systematically fail to address the structural inequalities creating poverty, even while the economy is expanding.

The labour market reforms underpinning the new proposed rights-based development strategy in the region do not focus on liberalization or flexibilization per se, because they are inefficient, costly and socially divisive. Labour market reforms should instead aim primarily at the right to work in decent jobs, as defined in the following ILO guidelines:

> Decent work sums up the aspirations of people in their working lives – their aspirations for opportunity and income; rights, voice and recognition; family stability and

[92] ESCWA (2007c), p. 1.

> personal development; and fairness and gender equality … Decent work is captured in four strategic objectives: fundamental principles and rights at work and international labour standards; employment and income opportunities; social protection and social security; and social dialogue and tripartism. These objectives hold for all workers, women and men, in both formal and informal economies; in wage employment or working on their own account; in the fields, factories and offices; in their home or in the community … Decent work is central to efforts to reduce poverty, and is a means for achieving equitable, inclusive and sustainable development.[93]

Achieving this goal requires State-led efforts to alleviate poverty through the creation of low-wage and low-productivity public sector employment, for example through employment in employers of last resort (ELR) programmes. The only way to sustain a rights-based development strategy over the long term is to offer employment opportunities to the poor and, particularly, poor youth, thereby contributing to the realization of the right to development in the ESCWA region.

This policy is not simply aimed at generating employment within the region. It will also reduce the leakage of wages and consumption and help to support the development of the manufacturing and services industries in the region. This shift in the structure of regional labour markets should draw on regulation, but also on incentives for firms to hire young workers, offer early retirement schemes, promote gender equality and provide equal opportunities.[94] In addition to this, loan facilities and institutional support should be available to new entrepreneurs, especially simplified procedures to register new businesses.[95] In this context, the employment of non-ESCWA workers should be regulated, and workers from non-ESCWA member countries can thus be guaranteed decent jobs, where those jobs are productive, necessary and cannot be taken up by workers from within the region.

I. Employment programmes in the ESCWA region

Despite the seriousness of the unemployment problem in the GCC, these countries appear to have sufficient time and resources to accomplish the transition to a rights-based development strategy aimed at reducing unemployment and raising labour force participation among nationals, and ultimately erasing the dual labour markets that exist in these countries. The key is to raise the skills and productivity of nationals so that they can compete on equal terms with highly skilled foreign workers, despite the high reservation wage of national workers.[96] The situation is different in the MDEs, as they face more severe levels of unemployment, underemployment and unproductive employment, and have scarcer resources to address these problems than the countries of the GCC.

Higher levels of employment and higher wages are essential to improve the welfare of all. However, wage growth cannot exceed productivity growth by a large margin and over long periods because of its potential implications for profitability, investment and (in the case of public sector employees) the fiscal balance. There is no ready-made solution to this dilemma, and short-term and sector-specific solutions will have to be negotiated periodically on a case by case basis. In certain sectors, unit costs fall when sales increase, permitting relatively generous pay increases; in other sectors, unit costs are constant or even increasing, while others are funded by general taxation. No solution will be optimal for all sectors of the economy. In general, however, there should be maximum leeway for improvement in wages and equity through sustained productivity growth and centralized tripartite negotiations between workers, employers and the Government in order to strike a balance between wage increases, productivity growth and economic stability. Instruments

[93] More information on the concept of decent work is available at: http://www.ilo.org/global/About_the_ILO/Mainpillars/WhatisDecentWork/lang--en/index.htm.

[94] See Abrahart, Kaur and Tzannatos, op. cit., p. 26.

[95] See, for example, ESCWA (2007a), p. 3.

[96] Girgis, op. cit., p. 102.

available to support the achievement of rights-based outcomes include targeted credit, export and employment incentives, import policies, public sector intervention and negotiation of regulations.

In general, if average wages are raised gradually as the region's share of imports is reduced, it will benefit not only low-paid workers, but also the most productive firms, especially in capital-intensive sectors, as these firms capture profits associated with a greater extent of the market, thereby raising productivity. Less efficient competitors will, however, face losses. Export incentives, targeted credit and selective import protection will support the adjustment of labour-intensive sectors to the new policy regime, while offering an alternative avenue for profitability and growth. Finally, those workers made redundant because inefficient firms went into bankruptcy, or because of the declining availability of low-paid jobs, should be retrained with public funds in order to find more productive and better-paying employment elsewhere. These medium-term policies will help to raise productivity, increase labour market flexibility and reduce structural unemployment, while creating incentives for exports and long-term productivity growth in the economy.

The employment of workers from outside the region can be regulated across the region; external workers can be guaranteed decent jobs, particularly jobs that are productive, necessary and cannot be fulfilled within the region. The regulation of regional labour markets can usefully draw on the experience of European Union countries, which secures the right of regional workers to seek employment anywhere in the region, while restricting the inflow of other workers to areas of particular need. This policy is not simply aimed at generating employment within the ESCWA region, it will also reduce the leakage of wages and consumption and help to support the development of the manufacturing and service industries in the region. This shift in the structure of regional labour markets should draw on regulation, but also provide incentives to firms hiring young workers, as well as to firms that offer early retirement schemes and promote gender equality and equal opportunities.[97] In addition to this, loan facilities and institutional support should be available to new entrepreneurs, especially simplified procedures for the registration of new businesses.[98]

Public work programmes (PWPs) can provide low-paid temporary jobs to relatively disadvantaged groups of workers, especially unemployed, underemployed, unskilled or semi-skilled workers. These programmes can target, in particular, older workers, women, the young or the long-term unemployed in distressed regions, and provide a temporary safety net programme. Depending on the deployment of these workers, PWPs can also provide poor communities with basic amenities or infrastructure. Public work programmes are relatively easy to manage because the workers tend to self-select: given the nature and location of employment and pay scales, workers with alternative sources of income do not normally seek employment in PWPs. These programmes can also provide opportunities for flexible employment (task-based payment or piecework, for example), which are compatible with flexible work schedules.

Despite the potential advantages presented by PWPs, especially in times of distress, these programmes are limited for several reasons. First, there is no inherent incentive to deploy workers productively, or to raise the productivity of labour over time.[99] Second, empirical assessments show that PWP participants are less likely to obtain an unsubsidized job and tend to earn less than individuals in control groups. These programmes are also unlikely to improve the employment prospects or the wages of young workers. In general, the most successful PWPs have been implemented under favourable macroeconomic conditions.

The same is also true with regard to active labour market programmes. Their impact and cost-effectiveness depends not only on the way they have been designed, but also on the overall macroeconomic framework in which they are implemented. For example, training for the long-term unemployed tends to be beneficial only when the economy is improving (with small-scale,

[97] See Abrahart, Kaur and Tzannatos, op. cit., p. 26.

[98] See, for example, ESCWA (2007a), p. 3.

[99] See Tzannatos, op. cit., pp. 146-8.

tightly targeted on-the-job training programmes offering the best returns to labour). Training programmes for young workers generally have little positive impact on their employment prospects or post-training earnings. In other words, training cannot make up for the failures of the education system. Only a small fraction of the unemployed choose to participate in micro-enterprise development programmes; such programmes are in any case often associated with high deadweight and displacement effects. The failure rate of these businesses is quite high. As in the case of training for the long-term unemployed, assistance targeted at particular groups (such as women and older persons) seems to have a greater likelihood of success. Finally, wage-subsidy programmes are unlikely to have a positive impact. They have substantial deadweight and substitution effects, and the wage and employment outcomes of participants are also generally negative when compared to a control group. Finally, job-search assistance is usually cost-effective if it is well-designed and implemented.[100]

J. CONCLUSION

This chapter has shown that a rights-based development strategy requires close coordination between private and public sector activities and State-sponsored regulation of intersectoral and intertemporal resource allocation (including international capital flows), through growth-promoting industrial and financial policies. These policies and the strategic shift that they are designed to support are essential for the achievement of the stringent employment-generating targets that are currently required in the ESCWA countries. The challenges posed by ingrained unemployment, poverty and concentration of power in the region cannot be addressed effectively by the range of conventional policies currently being deployed across the region. They require a paradigm shift towards rights-based development strategies and the creation of decent employment for the majority of the population in the ESCWA region.

Regional security represents a major prediction for development, as it will lead to economic policies with a development impact. It is all too well known that conflict or the prospect of conflict has a detrimental effect on and mitigates against the adoption of a desirable course of development. A new security compact in the region therefore represents an intrinsic broad-based economic development strategy. In this context, the concept of human security encompasses national security, including the protection of the right of the peoples in the region to self-determination, especially in Palestine; democratic security, through the promotion of civic rights in the ESCWA countries and the institution of democratic accountability in the region; and economic security, including the right to decent employment and macroeconomic stability, which should be promoted through regional regulation and economic integration. When combined, these security measures will facilitate the transition towards a new rights-based economic development strategy being proposed for the ESCWA region.

The rights promoted under the new economic strategy should be seen as forming a comprehensive package and the implementation and consolidation of this ‘bundle of rights’ is the main goal of the proposed rights-based strategy. After several decades of disappointing developmental outcomes and limited achievement in terms of democratization and welfare improvements, it is time to review the experience and lessons and consider an alternative development strategy for the region.

[100] See Abrahart, Kaur and Tzannatos, op. cit., pp. 36-39.

Box 8. Employers of last resort

In view of the fact that rents constitute about half the income of the region and the shares of the productive economy and labour are relatively small and incapable of generating productivity growth and job expansion commensurate with the growth of the labour force, redistribution measures can help mediate the impasse of unemployment until such time as industrial job growth is proportionate to the growth of the labour force. Government action can therefore help to stabilize capitalist economies through a wide variety of channels, including fiscal and monetary policy initiatives, employment creation programmes and negotiations with social partners (especially employers and trade unions). A more radical scenario envisaged by Hyman Minsky[a/] in situations similar to those faced in the ESCWA region proposes that Governments should become employers of last resort (ELR). In this case, the Government would set a wage rate to motivate those willing to work and obtain a State-sponsored job. In many respects, public sector underemployment in the ESCWA region shares many of the characteristics of this approach.

Minsky[b/] offered this policy suggestion in order "to substitute resource-creating public spending for the multitude of transfer payments and entitlements that now make up a major part of non-military spending" in the advanced economies. This would be achieved through "the creation of an infinitely elastic demand for labour that does not depend upon long- and short-run profit expectations of business". Keynesian analysis states that this demand must be created by Government fiat.

While the premises underpinning ELR programmes are simple enough, the details are crucial if similar measures are to be tailored to this region. In particular, if the wage level in such Government programmes is too low, they could fail to eliminate unemployment and poverty. Alternatively, if it is too high they could become too costly and could drain workers away from the private sector, potentially leading to resource misallocation. The guaranteed wage could also trigger demand inflation or wage inflation (in contrast, Minsky expected the guaranteed wage to anchor nominal wage expectations in the private sector, helping to stabilize inflationary expectations). Furthermore, the pursuit of full employment can trigger balance of trade pressures, especially in small open economies, because of the impact of the additional consumption on imports. This outcome is more likely if the real exchange rate appreciates due to rising domestic prices. In sum, expansionary programmes, and particularly ELR, will generally trigger inflation and current account deficits, but the existence of unemployment would justify their use. At a further remove, ELR-type policies could run against certain political limitations, as ELR programmes would strengthen the bargaining power of organized workers. Once the threat of unemployment is essentially removed, workplace discipline and labour productivity could decline, although the extent to which this would actually happen would depend on the institutional context.

ELR does not need to have an inflationary impact if the guaranteed wage is fixed close to the current minimum wage. In this case, even if there is a one-off increase in prices as part of the adjustment process to the new policy environment, runaway inflation need not follow. This conclusion is questionable, especially in the case of small economies. New public sector employees will demand goods and services produced by the private sector, as well as imported goods, and businesses may increase prices to compensate for their higher wage costs or to profit from the increase in demand. This will raise the bargaining power of workers, which may in turn lead to further price increases in the economy and, depending on the nature and intensity of foreign competition, the extent to which the exchange rate is devalued and the response of the financial markets, especially if the economy is known not to be stable.

A successful ELR programme needs to be crafted carefully and include not only the level of guaranteed wages and recognition of the need to adjust the exchange rate in order to preserve the balance of payments equilibrium, but also the planned deployment of the new Government workers into productive employment and/or socially useful training programmes. This deployment of workers must consider the efficiency of resource allocation in the economy, and should aim to raise labour productivity in the short term; otherwise talents may be wasted and the economy will, over time, have to pay a very high price for the elimination of unemployment. As a rule of thumb, labour productivity should rise faster than unit wage costs in order to preserve macroeconomic stability, create resources for distribution and dampen inflationary pressures. If employment and productivity rise simultaneously, it is also possible – though by no means guaranteed – that the monopoly sector would gradually lower its unit profit expectations because of the improvement in market conditions.

Achievement of these positive outcomes will be supported by a suitable credit policy, including Government initiatives and the provision of incentives for compliant behaviour by private financial institutions. The ensuing flow of resources to selected activities will expand capacity and productivity and will help to check inflationary pressures resulting from expansionary Government policies.

Finally, it is necessary to examine the implications of currency devaluation on real wages. Devaluation tends to generate inflation and reduce the purchasing power of workers. The resulting regressive distributive shift will reduce the value of the multiplier and, unless net exports rise sufficiently (which depends on the Marshall-Lerner condition), domestic employment levels could even fall. These adverse outcomes could at least be partially avoided through a compensatory reduction of taxes on wages, which could preserve real wages and the multiplier effect, despite a devaluation of the currency of the country or countries involved. Alternatively, direct or indirect subsidies could be granted to domestic producers, but these would be limited by WTO rules.

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a/ Minsky (1986), p. 300.

b/ Ibid., p. 151.

IV. SYNOPSIS OF INTEGRATED SOCIAL POLICIES

A. ACHIEVEMENTS IN THE ESCWA REGION

Over the past five decades, countries in the ESCWA region have experienced unprecedented human development. National social statistics point to remarkable progress across the region in health, education, nutrition and living standards. However, the overall (average) indicators of progress mask wide disparities both between and within countries.

In the 15 years between 1990 and 2005, the infant mortality rate (IMR) declined in all countries of the ESCWA region, but large variations persist between individual countries. In 2005, the IMR ranged from a high of 77.2 infant deaths per 1,000 live births in Yemen to a low of 7.7 infant deaths per 1,000 live births in the United Arab Emirates.[101] Similarly, under-five mortality rates (U5MR) have also fallen in all countries of the region during the same 15-year period. In 2005, the United Arab Emirates and Kuwait had the lowest U5MRs for both males and females, with 10.3 and 9.4 for the United Arab Emirates and 10.4 and 9.4 for Kuwait. At the other end of the spectrum, Yemen had the highest U5MR for both males and females at 92.9 and 91.7 respectively.[102] Another health indicator, life expectancy at birth, also showed improvement during the same period in all ESCWA member countries with the exception of Iraq, where life expectancy dropped significantly between 1990 and 2006 due to the ongoing conflict, falling from 63 to 54.9 years for men and from 62 to 61.6 years for women.[103]

Access to improved sanitation and drinking water exceeded 90 per cent in eight of the 13 ESCWA member countries in 2005. However, more than half the population in Egypt, Palestine and Yemen does not have access to improved sanitation. In Iraq, 20 per cent of the total population and 40 per cent of the rural population does not have access to improved drinking water, while half the population of Yemen does not have access to safe drinking water.[104]

ESCWA countries have similarly made important overall progress in education and the eradication of illiteracy. Bahrain, Qatar, Kuwait and the United Arab Emirates are very close to achieving universal primary education, with net enrolment ratios reaching or exceeding 97 per cent. The gender gap in primary education has been bridged in most ESCWA countries as more than one third of the countries achieved parity in primary education enrolment in 2005.[105] Indicators show a similar trend in secondary education. Adult literacy rates also increased during the same period, but with major intraregional and gender disparities. In 2005, 90 per cent or more of the population aged 15 and over was literate in Bahrain, Jordan, Lebanon, Palestine, Qatar and the United Arab Emirates. However, more than a quarter of adults in Egypt and almost half in Yemen could not read or write. Adult illiteracy among women is correspondingly highest in Egypt and Yemen, where no more than 60 and 34.6 per cent of women respectively are able to read and write.[106]

B. THE HUMAN DEVELOPMENT BACKLOG

Despite the gains made in human development and the impressive economic growth and great wealth of many parts of the region, considerable backlog of human deprivation persists. Past editions of the Arab Human Development Report (AHDR) have articulated the development challenges facing the region and their implications for the future.[107] The first AHDR traced obstacles to human development to deficits in three main areas: “the freedom deficit”, “the women’s empowerment deficit” and “the human capability/knowledge deficit”. The AHDR

[101] ESCWA (2007e), p. 8.

[102] Ibid., p. 10.

[103] Ibid., p. 12.

[104] Ibid., p. 7.

[105] Ibid., p. 19.

[106] Ibid., p. 22.

[107] UNDP and Arab Fund for Economic and Social Development (2002, 2003 and 2005).

highlighted the following persisting problem areas:[108]

(a) High illiteracy rates;

(b) Deterioration of education;

(c) Slowdown of scientific research and technological development;

(d) Poor productive bases and competitive capacity;

(e) Rampant poverty;

(f) Rising unemployment rates.

In many parts of the region, there is a growing sense of unease over the direction of economic development that has been charted in recent years. Increased economic insecurity linked to rising inequality and the retrenchment of social services has led to a vicious cycle of poverty, economic insecurity and political instability. This has created a situation in which the poorest and most vulnerable communities are those least able to withstand shocks caused by financial crises, natural disasters and civil conflicts. The recent rise in the cost of basic food staples has caused widespread discontent. In Egypt, bread prices have risen by more than half and about 10 people have died in clashes in bread queues in the past few months.[109] The food riots in Egypt and elsewhere have exposed the fragile nature of the economic livelihoods of the poor and vulnerable.

The vulnerability of large segments of the population comes against the backdrop of continuing adherence to the principle of economic growth as the engine driving social security and prosperity. Governments in the region genuinely expected integration in the global economy would lead to increased economic growth, better standards of living, reduced social tensions and overall political and economic stability. The reality in many countries of the ESCWA region points to a different outcome and economic growth alone has not translated into clear and systematic social benefits. Poverty and unemployment continue to burden many countries in the region, basic social services (for example, health and education) are unevenly distributed and inadequate to meet demand, and the disparities in social and health indicators continue to widen.[110] Even in countries enjoying economic prosperity and high standards of living, there are legitimate concerns about simmering social and economic tensions that could spill over, allowing for extremist ideologies to take hold.[111] A 2005 ESCWA report on Arab progress in meeting the MDGs[112] noted that:

> It is unlikely that the Arab region as a whole will succeed in eradicating poverty and hunger, particularly in the LDCs. Despite modest progress since 1990, in 2002 almost 20 per cent of children of primary school age were not enrolled, and some 44 million adult women aged over 15 years could not read or write. While gender equality in enrolment across all levels of education has generally improved, gains in education have not translated into economic and political empowerment for the women of the region, whose economic and political participation rates are among the lowest in the world.

C. CHANGING THE "GROWTH-FIRST" MINDSET

Theories backing "growth-first" approaches have often argued that only a dynamic, sustained and profitable economy can eventually prompt an equitable social and political order. However, experience around the world to date has failed to prove that a "growth-first" approach can deliver socially stable societies and achieve equitable, gender-sensitive and environmentally friendly developmental dividends. Countries in the ESCWA region are among many globally that have sought to rely on economic growth as the main engine of change, and from which social

[108] UNDP and Arab Fund for Economic and Social Development (2002), p. v.

[109] BBC News online: http://news.bbc.co.uk/2/hi/middle_east/7477441.stm.

[110] See ESCWA (2003).

[111] ESCWA (2008).

[112] ESCWA (2005), p. 2.

benefits were expected to flow. The challenges of globalization and the conditions of structural adjustment policies only serve to reinforce this mindset. The focus on a "growth-first" approach has meant that social policy and programme responses have often focused on devising accompanying social packages in the form of, among others, safety nets and targeted social services to be delivered by sector-specific ministries. Egypt, for example, has experienced the dislocation of traditional economies and when trying to apply structural adjustment policies continues to face a worrisome rise in the numbers of unemployed and people living in poverty.[113] In Jordan, a recent Household Income and Expenditure Survey showed that between 2002 and 2004, the wealthiest segments of the population saw a significant rise in their share of income compared with no change in the income of the poor, which is leading to growing disenchantment with the current course of economic development and concern about the widening economic gap between rich and poor in the country.[114]

The oil-rich countries of the Gulf, however, have applied variations of a "growth-first" economic approach, but have achieved mixed results. The United Arab Emirates has used its vast oil resources to build its economy and Dubai is now an important hub for business enterprise and free trade. Its trajectory of successful economic growth has brought prosperity to its people, but the dividends of this growth have not benefited everyone equally. The United Arab Emirates relies heavily on low-paid foreign migrant labourers (such as construction workers and domestic help), who exist on the fringes of society and who may not have adequate social protection and care.

The ESCWA region is not the only region in the world to have adopted a "growth-first" approach. Many countries in Asia, Latin America and elsewhere have also implemented such policies, only to discover later that economic expansion and stability were not enough to reach the threshold that would allow the establishment of conditions of equal citizenship for different social groups. A growing body of evidence-based research and information from countries around the world (including Finland and several Asian and European countries) suggests the need instead to examine a "growth with equity" approach.[115]

D. The role of social policy

The absence of a clear social policy is a key factor in obstructing equitable and sustainable economic development. Most social policies have to date focused on alleviating poverty through social safety nets and programmes rather than addressing the structural causes that lead to impoverishment and exclusion. These short-term interventions are designed to tackle the symptoms of poverty but do not necessarily improve the opportunities for the poor to achieve full social, economic, political and cultural integration.

Social development literature defines social policy as the totality of interventions designed to effect changes in social welfare, social relations and social institutions in order to expand choices and opportunities for people in the development process. It simultaneously addresses all aspects of social production, reproduction, protection and redistribution, as well as issues of equity, inclusion and rights.[116] Social policy integrates and links the economic and social dimensions of development into a coherent whole.

According to an ESCWA report,[117] social policy is:

> [A] consistent, engaging and ethical approach that systematically and institutionally checks social equity and equal opportunity implications … be [they] economic, fiscal, environmental, gender-based, or otherwise – and seeks to curb and control its possible adverse effect on particular groups or constituencies

[113] ESCWA (2008).

[114] Al-Darawi (2007).

[115] Wiman, R. et al. (2007).

[116] See United Nations Research Institute for Social Development (UNRISD) project on financing social policy, available at: http://www.unrisd.org/unrisd/website/projects.nsf/(httpProjectsForProgrammeArea-en)/5D06F96FA42129E0C12571D30037DC63?OpenDocument.

[117] ESCWA (2008).

> from the outset. It engages with economic growth imperatives in a manner designed to help individuals and communities shape and manage their lives through equity-based and redistributive public policymaking.

Social policy enhances economic growth by addressing those social structures and conditions that may prevent people from enjoying their basic right to full inclusion as equal citizens in society. Social policies address the needs of the poor and vulnerable and ensure that people have access to social services that promote their health and well-being and, by extension, their ability to work and contribute to society, and obtain equal access to opportunities and participation in society and the economy. Social policy also ensures that the necessary regulations and institutional mechanisms are in place to remove any barriers to inclusion and participation. Social policy is therefore consistent with an approach that frames human development as a process of expanding choices for people and one in which development efforts are people-centred.

Social policy is also consistent with a commitment to human rights, as defined in the Universal Declaration of Human Rights. The right to development is a cornerstone of social policy, as human development and human equity are in themselves inalienable human rights, as all peoples of the world are equally entitled to participate in, contribute to and enjoy the fruits of economic, social, cultural and political development. Social policy emphasizes the language of equity and human rights with a "minimum decent living wage" rather than raising incomes first and then achieving minimum wages.

V. CONCLUSION: A RIGHTS-BASED MACROECONOMIC POLICY FOR THE ESCWA REGION

The oil boom offers an opportunity for ESCWA countries to shift their economic policies away from a conventional agenda and orientate them towards a new rights-based compact. Such a compact would offer these countries the opportunity to direct the resources made available through the oil price boom towards a sustainable alternative economic growth model that is simultaneously broad-based, democratic, employment-intensive and distributionally progressive. This concluding chapter examines five macroeconomic aspects of rights-based development strategies, namely: investment and growth; fiscal policy and public investment issues; monetary and financial policy; balance of payments policy; and regional integration. These are preceded by a review of rights-based policy issues in the context of a resource-fuelled boom.

The policy suggestions offered below seek to consolidate internal and external balance in the ESCWA countries (including low inflation, domestic debt sustainability, exchange rate stability, balance of payments equilibrium and the reversal of dollarization), and protect the region against adverse external shocks. They also aim to transfer policy levers to domestic authorities, increase the degree of intersectoral policy coordination and link macroeconomic stability with the achievement of rights-based development goals, in order to deliver economic prosperity and higher living standards for the majority of the population in the ESCWA region. The achievement of these goals will require additional policy space for countries to select their own priorities and identify the most suitable tools in each individual case. There is no question that this will be a long and costly process. However, if successful, it could build the conditions for the attainment of stable and rights-based development goals within the ESCWA region.

A. RIGHTS-BASED POLICIES AND THE OIL BOOM

The current oil boom presents a valuable opportunity for ESCWA countries to address three key constraints to growth, namely the availability of foreign exchange, the availability of domestic savings and the sustainability of Government budgets. Surpluses can make a greater contribution to efforts to address these constraints in the GCC than in the MDEs. However, if the oil boom alleviates balance of payments constraints in the latter group of economies through an improvement in the oil bill (in the form of higher exports or lower imports), or if it leads to higher transfers due to labour migration to the more prosperous economies in the GCC, the effects will be similar in both groups of economies, even if their magnitude differs, and the policies examined below will be relevant to both the GCC and MDE countries.

On a general level, the foreign exchange windfall is tantamount to an unrequited (and potentially long-lasting) transfer of foreign resources, and as it is closely associated with, among others, foreign capital inflows, its macroeconomic impact should be similar to other forms of capital inflow in the form of FDI, portfolio inflows and overseas development aid. At the balance of payments level, windfalls can be absorbed through a combination of accumulation of reserves, imports or capital outflows. If these foreign resource transfers lead to higher import demand, a real appreciation of the exchange rate is inevitable (although its modality depends on the exchange rate regime of the country). This only becomes problematic if it hinders export growth or diversification, or leads to an excessive concentration of economic activity in or around the booming resource sector, which could further increase macroeconomic vulnerability. The key to preventing these adverse outcomes is to offset the impact of any real appreciation of the exchange rate on international competitiveness through productivity-enhancing public policies and the careful management of the internalization of resources.[118]

The transfer of foreign resources alleviates balance of payments and fiscal constraints simultaneously, which in turn can assist the expansion of domestic productive capacity and support improvements in domestic welfare. However, if it is poorly managed, the windfall can generate inflation and destabilize exchange rate movements. The outcomes will depend to a large

[118] Chowdhury and McKinley (2006), p. 4 and p. 23.

extent on the policy mix implemented by Governments in the region. The impact of public policies is especially significant because as the oil windfall comes largely through public channels, such as the taxation of State-owned oil monopolies, Governments can have a decisive influence on its macroeconomic implications.

Broadly speaking, higher investment, employment and capacity utilization, sustained productivity growth and export diversification will all require additional finance, which in turn will absorb a large part of the impact of the resource boom. If industrial policy is judicious, it can also address the bottlenecks that would ordinarily trigger inflation and shift relative prices towards non-tradable goods and services, triggering real exchange rate appreciation. Coordinated fiscal, monetary and exchange rate policies set in a regional context make it possible for countries to spend from savings in order to finance larger public programmes and to absorb the windfall through higher imports of real resources.[119]

B. Investment and growth

Rapid growth is a necessary but insufficient condition for the success of a rights-based development strategy.[120] This limitation creates a paradox, as growth, which normally contributes to the alleviation of poverty, can also create poverty because it is often associated with the dispossession of a significant number of peasants and rural labourers as a result of rural development projects, technological changes that deskill urban workers and eliminate jobs, and environmental changes that undermine livelihoods and the productive capabilities of the poor.[121] Without State support, many workers may be unable to find alternative productive assets or jobs with equivalent pay, or to retrain in order to seek better opportunities elsewhere. The self-employed may also find that their economic prospects are depressed as a result of insufficient access to credit and markets.

The complex relationship between growth and poverty implies that rights-based development strategies need to be pro-growth; in other words, they should be more expansionary than is permissible under conventional wisdom and should be geared towards rapid capital accumulation, supported by the mobilization of domestic resources and the efficient utilization of external funds.[122] However, as indicated above, high growth rates in themselves are insufficient. In order to maximize its distributive and poverty-alleviating impact, growth should be concentrated in two complementary areas. First, sectors that directly benefit the poor, especially in generating income and decent jobs for the poor and in the production of goods and services consumed primarily by them. Second, growth should promote investment. It is well known that investment is the driving force behind growth and, therefore, high investment is a precondition for sustained growth and large-scale employment generation. A low investment rate complicates the task of reallocating resources towards rights-based sectors. The manipulation of interest rates is unlikely to resolve this problem as there is no evidence that marginal shifts in interest rates can trigger the required infra-marginal response.[123]

Incentives could be made available for labour-intensive sectors producing non-tradable goods, such as small-scale diversified agriculture based on sound water conservation principles, fishing, the construction industry, repair workshops and other service industries.[124] These industries have significant employment-generating potential, as they train new entrants to the labour markets, in addition to producing food and inputs for the manufacturing sector. Public works programmes will almost certainly need to be expanded in most countries. They not only create decent jobs and directly promote social welfare, but also relieve supply constraints through, among others, the construction of housing, rural roads, irrigation and water conservation projects, maintenance of agricultural

[119] Ibid, p. 1.

[120] See Saad-Filho (2007).

[121] See Dagdeviren et al., op. cit.

[122] McKinley (2004), p. 1.

[123] See Rao, op. cit.

[124] These examples are merely indicative. The impact of growth on poverty depends on the initial distribution of income and, in particular, its distribution near the poverty line and the occupational composition, skills and other features of the workforce.

terraces, storage facilities, and electricity, water and sewerage projects.

In most ESCWA countries, especially the MDEs, it is important to support the development of agriculture and develop links with other sectors for three main reasons: economic importance, the fact that large numbers of poor people live in rural areas (especially in Egypt, the Syrian Arab Republic and Yemen), and the potentially severe dislocation to agricultural production and rural labour following trade liberalization. ESCWA countries can draw upon the strategies deployed in China, Indonesia and Viet Nam between the 1970s and the 1990s as they attempt to raise agricultural productivity, boost the links between agriculture, the manufacturing industry and other new and dynamic sectors of the economy, and increase the output of exportable goods. In order to do this, it may be necessary to reform the land tenure systems in some countries and invest heavily in better technology and physical and social infrastructure, such as better seeds and fertilizers, improved crop selection, irrigation, storage and transportation facilities.[125] These programmes can be funded through a combination of taxation (at any level of Government) and targeted credit by State-owned and private financial institutions. The sectoral priorities identified above will contribute to a rights-based growth process in which the poor will benefit more than the rich and will lead to a consistent decline in poverty and inequality levels in the ESCWA region. The ensuing economic dynamism will translate into both infrastructure provision for sustained growth and significant welfare improvements for the poor majority.

In order to kick-start the virtuous cycle of growth and investment in strategically selected areas, ESCWA countries need to identify those sectors with the greatest potential for medium-term demand and productivity increases. These sectors are not easy to identify, but should include areas where production is already taking place and where regional trade could offset import dependencies from outside the region; these two areas provide the first obvious place to look for new channels that can lead to rapid and sustained growth, the reduction of poverty and inequality, and the alleviation of balance of payments constraints. Expansion of these areas could be fostered through targeted industrial policies, public investment and focused incentives for the expansion of capacity and output. These policies should also address the economic inefficiencies that currently plague the ESCWA region. Without a significant improvement in the productive efficiency of existing economic assets in the region, an excessive burden would have to be placed on labour in order to increase the competitiveness of domestic industry, which would ultimately detract from a rights-based development strategy.[126]

Public investment can lead the way in breaking through existing supply bottlenecks in the ESCWA region. Rights-based development strategies require the public sector to induce, regulate and sustain the growth process, target resources in priority sectors and preserve macroeconomic stability. Empirical studies offer no firm evidence to support the conventional view that public investment both crowds out and is less efficient than private investment. On the contrary, a significant body of research indicates that public investment can crowd in private investment in upstream and downstream sectors, including those sectors that supply inputs and consumables, cleaning, maintenance and security services, trading, finance, and workforce training.[127] Public investment can also support private investment and output growth if it leads to an expansion of the physical infrastructure (roads, ports and airports, water, sewerage and irrigation systems, electricity generating capacity and transmission lines, for example), boosts labour productivity (through public education and training programmes, public transport or public health provision) and fosters private savings. Historical evidence also shows that public investment has played an essential role in fostering growth and reducing poverty,[128] and that when it falters, aggregate profits decline, since it reduces the incentives (and the resources available) for private domestic and foreign direct investment.[129]

[125] See Karshenas (2001).

[126] Karshenas (1994), p. 53.

[127] These claims are increasingly being accepted by the orthodoxy; see, for example, World Bank (2005b).

[128] See, for example, Weeks, op. cit., and Vandemoortele (2004).

[129] See McKinley (2004), after Kalecki (1972).

In the GCC and the middle-income MDEs, these investment priorities could be funded primarily from domestic sources, as foreign savings and investment tend to be volatile, difficult to target and are often inimical to rights-based development objectives; for example, foreign investors in the GCC and middle-income MDEs have concentrated their investments in the production of luxury goods and services rather than basic consumer goods and manufacturing inputs. Savings levels in the ESCWA region are such that domestic investments are possible, in contrast with many other poor regions in the world. However, despite the pressing need for domestic investment, regional savings continue to far outstrip investment – a phenomenon that is largely explained by capital exports by the GCC countries to developed country markets (see tables 10 and 11). This outflow of savings is reinforced by regional uncertainty and political instability and it is unrealistic to expect the private sector in these countries to lead the growth process; this can only be undertaken under the overall direction of the State. Only the State can channel the required resources and generate the momentum needed to accelerate growth, but this should be conducted within an internationally agreed framework for improvements in regional security.

Additional investment will help to raise productivity in the region, which will in turn create conditions for firms to grow and improve pay and conditions. However, the institutions required for rapid, stable, employment-intensive and pro-poor growth are not always spontaneously created by the market. They include those economic shifts which lead to higher exports, the internalization of value chains, salaries commensurate with productivity growth and adequate health and safety standards in the workplace. In the absence of such conditions, economies are likely to stagnate over long periods, with severe economic implications and significant social costs. State regulation and incentives are essential to achieve these outcomes. Regulation and incentives should make it difficult for firms to increase profitability by cutting wages, arbitrarily extending the working day, or bypassing health and safety rules. Productivity growth and better working conditions can also be promoted by raising the minimum wage and reducing wage dispersion; facilitating trade union activity; offering tax and other incentives for firms investing in priority sectors; introducing new technologies; and paying high wages. These policies can be partly funded by progressive income tax and social security contributions.[130]

Raising the necessary resources domestically will require a concerted effort, as available savings in the MDEs tends to be insufficient to support ambitious rights-based development programmes and, as mentioned earlier, the GCC tend to export a significant volume of savings despite the existing need for additional investment in the region. Tax revenues will need to rise in most ESCWA countries in order to help to fund these programmes. This will demand a more progressive tax system, the taxation of unearned incomes and financial transactions, and the taxation of windfalls and the benefits of growth. These additional resources, if adequately targeted, and especially in the context of the current resource boom, will make it possible to set up or expand long-term public-private savings initiatives (such as development banks) in order to fund investment in a range of public and strategic goods. These outcomes would best be achieved under a broad policy umbrella, including a new security compact in the region. Some of these initiatives can be easily associated with employment-intensive public works programmes, especially in the poorer regions. In contrast, in low-income MDEs the savings potentially available domestically may not be sufficient to reach the MDGs and other related rights-based objectives, even with an optimal combination of policies. In this case, rapid rights-based growth may demand additional foreign aid, other unrequited transfers (such as additional workers' remittances) and large-scale debt forgiveness.

In addition to these policy measures, it is also essential to improve the accountability of public and private investment in the ESCWA region, especially in the case of investments drawing on oil or other rents. As the resources being deployed are evidently collective, the citizens of the countries concerned have a legitimate democratic claim to influence their allocation. This applies not only to investment undertaken by States or State-owned enterprises,

[130] See Onaran and Stockhammer (2002) and Taylor (1988).

but also by private capital drawing on privileged access to social property or natural resource rents. Finally, it will be difficult to implement these rights-based investment policies in the absence of political stability in the region. Improved political conditions would promote regional investment and growth, and release significant resources that are currently tied up in defence and security spending. Political stability would also help the countries concerned to progressively move away from rentier activity and move towards productive activity, which is essential to support the achievement of rights-based outcomes in the ESCWA region.

C. FISCAL POLICY

The current policy combination in several ESCWA countries, including fixed exchange rate regimes, underdeveloped tax systems that rely heavily on indirect taxation, the increasing pressure of external debt and relatively free capital mobility, greatly reduces the potential impact of fiscal policy for rights-based growth.[131]

The recent acceleration of growth in the region has been accompanied by a significant improvement in the fiscal balance of most GCC countries (see table 2), as well as several other oil-exporting countries in the ESCWA region. It has been estimated that the revenue of the Middle East and North Africa (MENA) countries more than doubled between 2002 and 2005, rising from US$ 202 billion to US$ 433 billion.[132] Governments in oil-exporting countries have also saved about two thirds of their extra oil revenues.[133] Several countries in the ESCWA region, especially Kuwait, Oman and Saudi Arabia, have been able to make fiscal improvements, including large repayments of the domestic public debt (DPD).[134]

These achievements have brought few direct benefits to the majority of those living in poverty. However, they illustrate the potential of fiscal policy to mobilize and transfer resources within the region. Fiscal policy can do more than repay DPD, it can also play a key role in transferring rents and by increasing gains from trade and productivity improvements in the non-export economy and in strategic economic sectors. This includes the development of linkages between existing productive sectors, as well as support for the emergence of new economic sectors that may contribute to the development of new competitive advantages and offset the trend towards an excessive dependence on traditional exports. As a general principle, fiscal policy should support the macroeconomic objectives of the Governments concerned, including macroeconomic stability; balance of payments sustainability; low inflation; control over the DPD; sustainable taxation levels; and rapid growth and improvements in welfare standards. Fiscal policy also needs to support any investment programmes that may be required by a rights-based development strategy for the region.

In order to finance these public investment programmes, ESCWA countries can ease their excessively restrictive and entrenched fiscal policies; this is particularly the case in the GCC. Despite claims to the contrary, this approach need not be inflationary, as there is no obvious relationship between fiscal deficits and inflation.[135] Public investment programmes can be deficit-financed and have no significant adverse macroeconomic implications if the economy is operating below capacity (as is the case in most ESCWA countries, especially the MDEs). This applies particularly if the balance of payments constraint is not binding (which is more likely to be the case in an export boom); if the import coefficient is high (in which case the windfall tends to leak out; and if the fiscal deficit can be financed in a sustainable manner (for example, if the additional public sector debt can be paid off by the oil windfall and/or by the tax revenues generated by future growth). In these cases, public sector deficits should have limited inflationary impact.[136] However, if the Government or Governments concerned need to monetize their deficit on a regular basis, perhaps because financial markets in poor MDEs are insufficiently developed, the expansion of demand must be regulated because of its potential

[131] See ESCWA (2007b), p. 19.

[132] World Bank (2006d), p. 26.

[133] IMF (2005a), pp. 6 and 25.

[134] See ibid., p. 29 and World Bank (2006d), p. 27.

[135] See Fischer, Sahay and Végh (2002), pp. 876-7.

[136] See Rao, op. cit.

implications for inflation and, especially, the balance of payments.

The expansionary fiscal policies required for the success of a rights-based development strategy in the ESCWA region will only be sustainable in the long term if tax systems are modernized and the tax base expanded significantly. It is simply impossible to finance rights-based strategies with tax rate levels that are much lower than 20 per cent of GDP, as is commonly the case in the ESCWA region. There is scope for raising tax revenues in most ESCWA countries and, simultaneously, to increase the political legitimacy of taxation and redistribute income. These reforms require the enforcement of existing tax laws and the reduction or elimination of opportunities for the well-off to benefit from deductions, exemptions and the exploitation of loopholes. It will also normally be necessary to increase existing tax rates, to tax wealth and large or second properties in rural and urban areas, and to tax interest income, capital gains, financial transactions and international capital flows.[137] Tax systems will also need to be coordinated across the ESCWA region in order to facilitate regional trade and investment, reduce the tax obstacles to cross-border activities within the region and eliminate the scope for tax competition. This includes the harmonization of taxes and tax rates, especially capital gains tax and income tax.[138] Experience shows that the most important constraints on the expansion of the tax base in ESCWA countries are political in nature and not due to poverty or the lack of managerial capacity to apply existing laws. However, domestic pressures for the preservation of inequitable privileges or threats of capital flight should not deter the State from mobilizing additional resources and striving to achieve rights-based development goals.

In the shorter term, fiscal policy is best seen as the primary tool for short-term economic stabilization, especially in the GCC. This includes smoothing the short-term impact of the windfall on public expenditure in a highly uncertain environment and promoting stabilizing and equalizing outcomes through health, education, welfare and employment policy. This also includes providing support for large-scale infrastructure projects that the private sector may be unable, or unwilling, to complete. In these countries, a rights-based fiscal policy should also target the non-oil primary balance of the Government over the medium term. This will highlight the distinction between the relatively volatile and relatively permanent components of public finances and help to minimize pro-cyclical spending swings. Smoothing these swings is especially important because they can be severely destabilizing for employment, investment and welfare.

In addition, initiatives seeking to expand fiscal space along with closer coordination of a region-wide investment strategy need to be accompanied by efforts to improve the business environment in the region in order to facilitate the achievement of rights-based outcomes through a dynamic and broad-based private sector. Significant improvements in the capacity of the private sector to support public sector initiatives could be made through the simplification of licences, fees and taxes, reduction of administrative regulations and procedures and increased accountability of the public sector.

D. MONETARY AND FINANCIAL POLICY

Monetary and financial policy can play an important role in short-run stabilization and rights-based development in the ESCWA region. In order to assess desirable monetary and financial policy developments in the region, it is essential to recognize the dysfunctional character of such policy in much of the region. Monetary policy in the ESCWA region has to date played only a marginal role in promoting sustained growth. Instead, Governments in most countries of the region have focused on inflation stabilization,[139] even though the literature shows that excessively contractionary monetary policy compromises growth and equity and that moderate inflation has no adverse implications for either growth or equity.[140] Financial systems in the region have operated in a similarly dysfunctional manner, as they have tended to lock resources into

[137] See McKinley (2003).

[138] See ESCWA (2007b), p. 20.

[139] See, for example, IMF (2006i), p. 71.

[140] See, for example, Pollin and Zhu (2005).

speculative circuits that do not usually benefit investment, production or social welfare.

Mainstream theory underpinning financial sector reforms in ESCWA countries suggests that bank loans for specific projects and collateral are based on rational decisions that are themselves based on expert assessments; however, such decisions ignore the environment in which investments are made. Investments, especially in large or infrastructure projects, can have a significant impact on the composition of growth and the direction of the development process. By the same token, economic growth can support investment projects that may not otherwise be viable. This does not imply that all projects can be equally profitable, but rather that investment coordination can improve loan performance and, simultaneously, contribute to the achievement of socially desirable goals.

In reality, despite these reforms, most national financial systems in the ESCWA region remain inefficient, shallow, short-sighted, speculative and subject to high costs. They are also highly concentrated and dominated by foreign banks. Financial institutions tend to concentrate their assets in liquid papers, consumer loans and financial speculation, and offer short-term loans backed up by readily available collateral when providing trading and working capital and personal credit for formal sector workers. Banks also finance the public deficit and participate actively in foreign exchange markets, but have tended not to fund economic diversification or offer long-term loans for the expansion of priority economic areas. These problems cannot be easily or simply resolved through efficiency gains within the financial sector. A financial system can be highly competitive (and, in the narrow sense, "efficient"), yet remain dysfunctional if it does not contribute to development objectives. For example, a more liberalized and internationalized financial system – being more "efficient" according to conventional criteria – could channel resources outside the region more easily and rapidly, given the small size of ESCWA markets and the prevailing insecurity in the region. In this sense, conventional efficiency criteria can be counter-productive and self-defeating within the scope of rights-based development in the region.

Liberalization is likely to exacerbate the dysfunctional nature of finance in the ESCWA region, rather than address existing weaknesses and shortcomings.[141] In particular, it will do nothing to reduce the speculative propensity of the financial system, or deepen it in a sustainable manner through the emergence of solid credit unions, pension funds and savings institutions. In the perverse climate currently dominating the financial sector in ESCWA countries, liberalization is likely to replicate the shortcomings of the speculative financial systems of the GCC across the region, as well as the pronounced fragmented nature of the Egyptian and Lebanese banking systems across other countries.[142]

Financial system liberalization tends to achieve three goals. First, it transfers part of the State capacity to coordinate economic activity and allocate resources intersectorally and intertemporally to the private sector. Second, it embeds private sector interests in the policymaking process, through the decisive role of commercial banks in the pricing of Government securities, the determination of interest rates and the financing of public sector expenditure. Third, it enhances the role of private financial institutions in the foreign exchange market and, therefore, in the relations of the country with the rest of the world. Financial sector control of the key sources of capital tends to increase the influence of this sector over State policies above and beyond its limited resources, and the ambiguous outcome of financial market activities from the point of view of the poor. In spite of its disproportionate (and growing) leverage over economic policies and outcomes in the ESCWA region, the financial sector remains structurally dependent on the State. This is not only because of the institutional and regulatory framework in which financial institutions operate, it is also because their main sources of revenue are heavily dependent upon the State, including the provision of public sector finance and providing capital to

[141] For a comprehensive analysis, see Creane et al. (2004), Molyneux and Iqbal (2005) and World Bank (2006d).

[142] "[I]n 2002 there were 71 banks in Lebanon, a country of some 3.6 million people with a GDP of US$ 13 billion; and 42 banks in Egypt, which had a population of approximately 61.4 million with a GDP of approximately US$ 90 billion." ESCWA (2004), p. 37.

State-owned enterprises, engaging in Government securities trading and currency trading backed up (either explicitly or implicitly) by the central bank and granting personal loans to State employees and contractors. In short, the financial system in ESCWA countries tends to drain public funds and social resources while systematically failing to channel them to priority and welfare-enhancing economic sectors.

These structural and policy shortcomings make it difficult for Governments in the ESCWA region to implement a rights-based economic development strategy. The cumulative shift to indirect monetary policy instruments will further increase the control of the financial system over social resources. In this sense, financial systems in the ESCWA region are only partially fulfilling their essential functions of making resources available for production and funding socially desirable investment projects.

A redirection of the financial sector into rights-based activities in the region will increase credit flows to priority sectors. This can be achieved more easily in the GCC, where Governments command substantial resources. In the MDEs, the redirection of resource flows will depend on the selective reduction of compulsory reserve requirements (possibly in excess of the value of the loans, up to a certain limit), tax incentives, adjustments in the calculation of risk-weighted capital to favour long-term investment in socially desirable sectors and a regional insurance scheme and/or loan protection to underwrite part of the costs that banks would have to bear in the event of loan defaults in priority sectors. The Government could also fund a specialist agency to trade priority loan packages through the sale of bonds, in order to help dilute credit risks that the banks may face. Experience in a number of poor and middle-income countries indicates that banks do not always find it profitable to lend to priority sectors, even if they are offered discounts on their compulsory reserve requirements. In addition to targeting priority areas, incentives should also be available for microcredit, especially in rural areas, because of its potential contribution to nutrition and other basic needs, and also in order to partly compensate for the chronic lack of access to credit in this sector. In this case, commercial banks could be offered tax and other incentives to make microcredit loans available; alternatively, they could be allowed to use part of their compulsory reserves in microcredit operations. These microfinance initiatives could provide assistance to poverty-alleviating projects in poor MDEs which cannot operate efficiently outside a broader framework of rights-based growth.

These policy priorities for the financial sector will need to be nested within a conducive monetary policy framework, leading to a more enabling growth environment. This will require lower interest rates and a more flexible approach to inflation which, while securing price stability, is not overly concerned with near-zero inflation at all times and regardless of its costs. This monetary policy framework will also aim to stabilize aggregate demand and increase the resilience of local economies against adverse shocks or the deterioration of economic fundamentals.

Stabilization becomes especially challenging during a resource boom. If the windfall is deposited in commercial banks, the inflow of foreign exchange does not increase base money, either immediately or automatically. However, the increase in reserves enhances the capacity of the commercial banks to create credit. As the banks sell foreign currency to expand credit in response to the increased import demand induced by the acceleration of economic activity, the domestic currency will tend to appreciate. The monetary impact of the windfall can be controlled by the central bank through monetary financial policy instruments. The measures available to central banks include raising the reserve requirements for commercial bank deposits, which reduces the ability of banks to create credit, and shifting Government deposits from commercial banks, where they count as part of the money supply, to the central bank, where they do not. This will reduce total bank deposits and, therefore, the scope for credit creation.

The central bank can also reduce interest rates, while at the same time introducing credit controls to avoid an upsurge in speculative activity in financial assets, consumer credit or real estate, overconsumption of imported goods and capital flight. This can be associated with the development of specialized low-cost programmes to support rights-based economic sectors. These policies will encourage the expansion of credit for socially desirable purposes, while also providing incentives for the expansion of bank reserves. The latter will increase the reserve-deposit and currency-deposit ratios and reduce the money multiplier. Since lower interest rates may stimulate domestic demand, the trade balance could deteriorate, but this can be financed with the foreign exchange reserves accumulated through the windfall.[143] In general terms, the regulated development of the financial sector in the context of rising international reserves can bring a number of benefits to the economy. It can support the expansion of domestic demand for money and financial assets, improve the efficiency and functionality of the financial system, and assist the growth of its capacity to fund long-term investment projects and finance domestic production. These outcomes can be readily linked to the priority sectors selected by the Government in its industrial policy.

Finally, it is also important to avoid using temporary windfalls as an excuse to reduce the tax burden on the domestic private sector. Temporary windfalls should be saved (either as foreign reserves or through the reduction of foreign debt) or, alternatively, invested in one-off, relatively short-term infrastructure projects that can relieve bottlenecks, support the balance of payments and expand productive capacity. These may include new roads, railways, bridges, ports, storage depots, power plants, oil refineries or other key infrastructure or industrial facilities. In contrast, consumption subsidies (including tax cuts or trade liberalization in countries where trade taxes contribute significantly to the fiscal budget) and other open-ended non-revenue-generating commitments cannot be adequately financed through windfalls. Attempts to do so are likely to trigger macroeconomic disequilibria that may become cumulative and have a destabilizing effect in the long run. In general, Governments should seek to assure themselves that any additional commitments could be financed, even if the resource boom were to be reversed.

E. BALANCE OF PAYMENTS POLICY

The currencies of poor countries are not international means of circulation, have no reserve value and do not serve as units of account for international transactions. This limitation restricts the ability of these countries to command resources in the world economy and imposes a balance of payments constraint. The balance of payments constraint is probably the most important barrier to sustainable growth in poor countries, particularly in the MDEs.[144] Rich countries also have a balance of payments constraint, but it is more flexible and supply bottlenecks can usually be bypassed through imports, at least in the short term.

The balance of payments constraint includes two types of restriction: on trade (the current account) and on capital flows (the capital and financial account). Trade gaps are created by conventional economic policies that regard import liberalization as enhancing productivity, through exposure of domestic production to foreign competitors. Such economic reforms are intended to shift resources towards the (presumably given) comparative advantages of the economy and provide incentives for capital inflows to attract foreign savings. This recipe has not been conducive to macroeconomic stability, nor has it worked to promote the welfare of the poor in the ESCWA region or elsewhere.

Rights-based foreign trade and financial policies in the ESCWA region should be linked to a broader industrial strategy fostering productivity growth and the development of domestic production capability in selected areas. The promotion and diversification of exports, especially in the MDEs, forms the first element of this approach. Export growth can make an important contribution to productivity growth because it exposes producers to the stringent test of competition in foreign markets.[145] Export growth is also essential for the generation of healthy trade surpluses and the accumulation of foreign currency reserves, which will in turn support the stabilization of the exchange rate. International reserves are especially important for the GCC, as they provide a buffer against any decline in the price of oil and can be used as a defence against real exchange rate appreciation. In contrast, the absence of sizeable currency reserves

[143] See Chowdhury and McKinley, op. cit., pp. 10, 13 and 24-7.

[144] See Karshenas, op. cit., p. 10.

[145] See Chang (1994).

obtained through trade surpluses would periodically compel the MDE countries to seek more volatile forms of international finance (especially short-term loans and portfolio capital inflows), or borrow from international financial institutions, whose conditionalities would limit their ability to pursue rights-based policies.

Export growth in the MDEs requires a competitive and stable real exchange rate and coordinated industrial policy initiatives to develop the competitive advantages of these countries in strategically important sectors.[146] Careful management of import restrictions is also necessary for long-term growth. Despite conventional myths to the contrary, "openness and trade integration, either separately or together, do *not* have a measurable impact on long-run growth".[147] Import liberalization must proceed cautiously and selectively because of its potentially adverse impact on the poor and on strategically significant sectors.

Rapid trade liberalization and surging imports should be avoided because they can be destabilizing, even in economies operating below capacity. Trade regulation is important because import liberalization can trigger severe social and economic dislocations, especially in strategic sectors such as agriculture, construction and new "growth" industries, but also because experience shows that relatively autonomous late development is only possible if it is supported by strategic trade policies.[148] Trade liberalization can have an especially severe impact on the poor for three reasons. First, the gains from trade can be concentrated in enclaves, or they can raise the returns for skills or assets that are beyond the reach of the poor, thereby increasing income and wealth inequality. Second, liberalization can increase predatory competition, which in turn reduces economic growth and the wages and employment opportunities of the poor. Third, subsidized exports from the rich countries (grain, sugar, cotton, fruit, meat and dairy products, for example) can undermine the viability of small-scale agriculture and the livelihoods of millions of the rural poor.

Rights-based development strategies also require the regulation of the capital and financial account of the balance of payments. Unbridled liberalization of the capital account can be destabilizing for four main reasons.[149] First, liberalization fosters the accumulation of foreign debt, especially by local banks, promotes speculative inflows that can finance consumption rather than investment, facilitates capital flight and increases the vulnerability of the country to balance of payments crises. Second, rights-based development strategies require monetary policy autonomy, which is severely curtailed by international financial liberalization. Third, rights-based development strategies require the State to direct investment and other resource flows to growth-promoting and poverty-reducing objectives, which may conflict with the short-term interests of the financial sector. Fourth, capital controls may be needed to curb tax evasion when tax rates required to fund rights-based development programmes are raised to higher levels than in other countries. Even if capital account liberalization raises growth rates in the short-term, this effect tends to vanish later. Several forms of capital control have been used in recent years in countries as diverse as Chile, Japan, Malaysia, the Republic of Korea and Sweden.[150]

> The use of controls did not interrupt economic growth; on the contrary, when controls were removed, as in Mexico in the early 1990s and in East Asian countries in the late 1990s, it resulted in financial crises and severe economic downturns. Whatever form they take, controls over the movement of funds across a country's borders are a necessary part of any general programme of economic change; in the absence of such controls, Governments cede the

[146] See Amsden (1997 and 2001) and Chang (2003).

[147] Weller and Hersh (2004), p. 492.

[148] See Chang (2002 and 2003) and Shafaeddin (2005).

[149] See Chang and Grabel, op. cit., Helleiner (1996) and Palma (1998).

[150] See, for example, Chang (2003), Chang and Grabel, op. cit., ch. 9, Eichengreen (2003), Epstein, Grabel and Jomo (2003), Grabel (2004), Helleiner, op. cit., Kaplan and Rodrik (2000) and MacEwan (2003).

regulation of their economies to international market forces, which often means the forces of large transnational corporations and other more powerful countries.[151]

Capital controls can include restrictions on foreign currency bank accounts and on currency transfers; taxes or administrative limits on outflows of direct and portfolio investment; restrictions on foreign payments for "technical assistance" between connected firms; non-interest-bearing "quarantines" on investment inflows; controls on foreign borrowing; and adequate exchange rate regimes determined by the priority of each type of investment. As a minimum, they should include the requirement that all foreign resource flows should be registered or (preferably) pass through the central bank so that the financial relations of the country with the rest of the world can be measured, allowing the central bank to regulate the external exposure of domestic banks and firms. This will help to ensure that they do not build up unsustainable financial positions for speculative reasons, which becomes especially easy to do during a resource boom. It will also help to reduce the scope for capital flight, for example through bank deposits, financial transactions, over-invoicing and other unauthorized means of capital transfers.[152] Managing these controls will place a burden on monetary authorities, but this task can be readily assumed by most central banks. The most significant obstacle to capital controls is not technical, but rather political.

Finally, it is important to delink the exchange rates of most ESCWA countries from the falling United States dollar. First, a shift to a managed floating of a local currency against a basket of international currencies will help to adjust the real exchange rate of the oil-rich countries, which is especially necessary during a resource boom. Second, it will improve the match between the trading patterns and financial relations of these countries and their respective exchange rate systems, which will help to deliver macroeconomic stability. Third, it will restore the scope for monetary policy in the region.[153] Fourth, it will make it easier for countries to defend their currencies and will enhance control of capital flows. Finally, it will ease the transition towards the devaluation of the currencies of the countries adversely affected by the oil boom. In the medium and long term, monetary and exchange rate policy coordination between ESCWA member countries is essential for the success of a regional pro-poor and rights-based economic strategy. This may in the future be extended to a regional system of fixed exchange rates, moving towards a single currency for the region (floating vis-à-vis other major currencies). Such a development would help the region to stabilize trade and promote investment in ESCWA member countries and, at a further remove, increase their monetary policy space.[154]

F. Regional integration

One of the distinguishing features of the region is the structural inequality between the GCC countries, where the resource surpluses are concentrated, and the MDEs, where social needs are most pressing. Implementation of the rights-based development strategy outlined in this and the two previous issues of the Survey would help to maximize social welfare in the ESCWA region as a whole. This will require a much greater degree of regional coordination of finance and investment and monetary, fiscal and exchange rate policy. Greater integration will help to protect the oil economies from the impact of oil price volatility, support economic diversification and protect the region from potentially adverse

[151] Ibid., p. 6.

[152] Chowdhury and McKinley, op. cit., p. 27.

[153] See ESCWA (2007b), p. 18.

[154] "After considering all other options (different fixed exchange rate arrangements, unilateral free exchange rate, integrating into one currency area and dollarization) it was found that monetary coordination among all the ESCWA countries aimed at adopting a unified exchange rate regime is most promising. The coordination could start by linking the various currencies in the region in a common bloc floating vis-à-vis the rest of the world. This will achieve double objectives. First, it will stabilize intra-regional trade by pre-empting relative shifts in the intra-regional exchange rate structure. Second, it will insulate the domestic economies from external developments, thereby permitting monetary policy to concentrate on the problem of unemployment. Monetary coordination could move gradually towards the ultimate goal of creating a common supernational currency." ESCWA (2007b), pp. 19-20.

developments in the world economy. For the MDEs, regional integration offers the prospect of secure access to larger (and wealthier) markets, improved infrastructure, better conditions for workers employed in other countries and greater security of access to oil when this becomes necessary. Regional integration can also permit greater access to overseas development aid and increased food and energy security for the poor countries. This integration strategy can also support the construction of more efficient bureaucracies in each State, which is an essential aspect of democratic governance. This, in itself, would be a gain for the region because it would assist the dilution of the power of the elites and support the assertion of popular sovereignty and Government accountability.

Regional coordination of production is essential in order to maximize the scope for success, especially in the manufacturing sector. This will require the development of supranational institutions with specialized advisory services to help increase business productivity through, amongst others, enhanced accountancy rules, business registration, tax policies, cross-country claims and labour regulations; influence the allocation of investment funds; and determine production priorities in the region. At a further remove, regional coordination of fiscal, tax, monetary and exchange rate policies will provide the level playing field needed for the success of integration efforts. In the absence of policy convergence within a negotiated framework, the gains from integration are likely to be limited.

This said, any development strategy will be limited by ongoing security concerns and political instability in the region. The international environment after 9/11 has illustrated the insecurities to which foreign investment by ESCWA (especially GCC) member countries are subjected. This can offer a catalyst for regional policy changes and incentives to invest in the region, which can be addressed in two ways. On the one hand, there needs to be a decisive international effort to introduce a new security compact in the region. This compact must address the key foreign relations problems in the region, in particular the occupation of Palestine, the occupation and destabilization of Iraq and continuing political instability in Lebanon. Regional powers – especially the GCC – can offer financial incentives aimed at stabilizing the region and fostering investment, such as a regional insurance scheme, for example. This already exists informally, as seen in the heavy Saudi investment in the stabilization of Lebanon, but it could be institutionalized through a multilateral body charged with the administration of a regional insurance scheme covering investments made by certain ESCWA member countries in other countries in the region.

In order to support the development of this new regional policy compact, preferential treatment for ESCWA capital (including repatriated capital and remittances from migrants) should be secured within the region, for example, through reforms in tax, procurement and company registration procedures, which should be exploited to the maximum extent compatible with WTO rules. These regulations need to form part of a regional industrial policy package aimed at raising regional investment and trade, internalizing supply chains and supporting employment generation and productivity growth. There is no question that this will be a long and costly process. However, if successful, it could build the conditions for stable and rights-based development in the ESCWA region.

Annex

DATA SOURCES AND METHODOLOGY

A. OVERALL APPROACH

Whenever the term "ESCWA countries" is used in this Survey, it refers to the member countries of ESCWA excluding Iraq and Palestine, which were omitted from these accounts because of the extreme political instability that they have experienced or insurmountable data problems. Computation of the various resource flows for the 11 remaining ESCWA countries are divided into two groups: the diversified economies (Egypt, Jordan, Lebanon, Oman, the Syrian Arab Republic and Yemen), and the oil-exporting economies (Bahrain, Kuwait, Qatar, Saudi Arabia and United Arab Emirates). Information on financial flows to ESCWA countries is available from national sources, UNCTAD and the following international financial institutions: the Arab Monetary Fund (AMF), the World Bank and the International Monetary Fund (IMF). As can be seen below, there are considerable disparities in data reporting among different countries in the ESCWA region.

All ESCWA countries report several data series and indicators to the AMF, which publishes fairly comprehensive statistical tables. However, these tables tend to be aggregated, no details are provided on methodology and variables are not defined. Coverage also tends to be limited; for example the AMF does not provide data on portfolio equity flows, which form part of the flows analysis that ESCWA needs to monitor. AMF data on total external debt are identical to those reported by individual countries to other international organizations, including the World Bank. Another limitation is that the bulk of the information in the AMF's *Joint Arab Economic Report* is not composed of full time series.

All ESCWA member countries report their data on FDI to UNCTAD, and they are then published in annual editions of the *World Investment Report*.[1]

[1] *World Investment Reports* are available at: http://www.unctad.org/Templates/Page.asp?intItemID=1485&lang=1.

Most ESCWA member countries also report data to the IMF, but coverage varies according to the database. Though most ESCWA member countries are now beginning to adopt international data dissemination and collection practices, some countries neither adequately monitor nor provide easily accessible data that complies with standard definitions. The problem is particularly severe in the Gulf oil-exporters. Thus, Qatar and the United Arab Emirates are not covered by the IMF's *Balance of Payments Yearbook*, although it does include data for Bahrain, Kuwait and Saudi Arabia. Coverage is different again in the IMF's *International Financial Statistics*. Net Errors & Omissions were reported by all ESCWA member countries with the exception of Lebanon (1990-2001) and, more significantly, by Saudi Arabia, which reported zero Errors & Omissions.

Finally, only six ESCWA member countries (Egypt, Jordan, Lebanon, Oman, the Syrian Arab Republic and Yemen) are covered by the World Bank's *Global Development Finance*, which is the main source of information on capital flows to developing countries. Gulf oil-exporters are notably absent from the list of countries covered by this publication. However, Bahrain, Saudi Arabia and, occasionally, Qatar are included in some World Bank tables on development indicators, such as GDP or reserves.

These data deficiencies present major problems in calculating capital flows. To confront these problems it was decided to build a core of data on financial flows from the World Bank's *Global Development Finance* and supplement it with IMF data for the Gulf countries. The main publication for this purpose was the *Balance of Payments Yearbook*, while databases such as the *World Economic Outlook* were used for GDP figures. Computations for resource flows required supplementing data with further details and analysis from other national and international studies, or from sources specific to the type of flows studied in each case.

The data used to estimate Aggregate Resource Flows in the table below originated in

Global Development Finance (April 2006) and *Balance of Payments* data from the World Bank and IMF respectively. Data for FDI estimation came almost exclusively from UNCTAD's *World Investment Report*. Data on Net Errors and Omissions and Reserves came from the IMF's *World Development Indicators* (2006), and data on Current Account Balances originated in the *World Economic Outlook* (September 2006). The core series on workers' remittances was extracted from the World Bank's *Global Development Finance* and *World Development Indicators*. For external debt data, three sources were used: the World Bank, OECD and a small number of individual country reports. The sourcing and construction of variables and time series deployed in this Survey are presented in more detail below.

ANNEX TABLE. COVERAGE OF ESCWA MEMBER COUNTRIES IN DATA SOURCES

OECD, UNCTAD, Arab institutions	IMF (*World Economic Outlook, Global Financial Stability*)	IMF (*Balance of Payments Yearbook*)	World Bank (*Global Development Indicators*)
Bahrain	Egypt	Bahrain	Egypt
Egypt	Jordan	Egypt	Jordan
Jordan	Kuwait	Jordan	Lebanon
Kuwait	Lebanon	Kuwait	Oman
Lebanon	Oman	Lebanon	Syrian Arab Republic
Oman	Qatar	Oman	Yemen
Qatar	Saudi Arabia	Saudi Arabia	
Saudi Arabia	Syrian Arab Republic	Yemen	
Syrian Arab Republic	Yemen		
United Arab Emirates			
Yemen			

Note: Coverage by publication/data sources does not imply even coverage across data series (for example, the Syrian Arab Republic reports Errors & Omissions but not reserves and the World Bank covers Bahrain, Kuwait and Saudi Arabia in only some series of the *Global Development Indicators*.

B. RESOURCE FLOWS DATA

For the six countries reporting data to the World Bank (Egypt, Jordan, Lebanon, Oman, the Syrian Arab Republic and Yemen), aggregate resource flows and aggregate transfers were calculated from the components series, using the standard World Bank definition. Thus, Aggregate Resource Flows (called Aggregate Net Resource Flows by the World Bank) are defined as the sum of net resource flows associated with long-term debt (excluding IMF credit) plus three non-debt-creating flows (net FDI, portfolio equity flows and official grants, excluding technical cooperation). Net FDI and portfolio equity flows are assumed to consist of private flows. Net flows of long-term debt are disbursements of long-term debt and IMF purchases minus principal repayments of long-term debt and IMF repurchases.

Aggregate Transfers (called Aggregate Net Transfers by the World Bank) are defined as Aggregate Resource Flows minus two outflows, namely interest payments on long-term debt and profit remittances on FDI. Aggregate Transfers are a more useful measure of the net external financing that a country is actually receiving at a given point in time.

However, both Aggregate Resource Flows and Aggregate Transfers have shortfalls. For example, Aggregate Resource Flows fails to include two non-debt-creating flows that are of particular significance in the context of the ESCWA region, namely workers' remittances and grants for technical cooperation (associated with military spending). Likewise, Aggregate Transfers, which are calculated on a long-term basis, fail to account for the implications of short-term external financing. In other words, Aggregate Transfers neither include the cost of arrears nor the servicing of short-term debt. Short-term debt is significant for the whole of the ESCWA region, particularly for the richer Gulf oil-exporters. A more useful concept in this connection is that of Total Debt Service paid (TDS), which covers all debt service payments, regardless of whether they cover short or long-term debt, amortization or interest payments.

For the remaining five Gulf oil-exporters (Bahrain, Kuwait, Qatar, Saudi Arabia and United Arab Emirates), Aggregate Resource Flows were estimated using the few series available in successive *Balance of Payment Yearbooks*. It was not, however, possible to calculate Aggregate Transfers, as OECD data on debt service was only available for the early 1990s and no series are available on profit remittances. Thus, the new flows prepared for all Gulf oil-exporter countries sought to match as closely as possible the flows used and defined by the World Bank. The method of calculation was as follows:

(a) For Bahrain, Aggregate Resource Flows were calculated by taking Net Direct Investment in Equity Capital and Reinvested Earnings and adding Net Portfolio Investment Liabilities and two components of Other Investments, namely Net Loans Liabilities and Net Trade Credit Liabilities;

(b) For Kuwait, Aggregate Resource Flows were calculated by taking Net Direct Investment in Equity Capital and adding Net Portfolio Investment Liabilities and Other Investments, namely Net Loans Liabilities and Net Trade Credit Liabilities;

(c) For Saudi Arabia, Aggregate Resource Flows were calculated by adding Net Direct Investment in the Reporting Economy, Net Portfolio Investment Assets, and the change in long-term debt as a proxy for long-term debt flows. No data were available for any of the series on loans, liabilities or Other Investments. It is not clear what the figure for Portfolio Investment Assets refers to, and although it is equal to Net Portfolio Investment, Portfolio Investment Liabilities are not reported;

(d) For the United Arab Emirates, only one source was available, namely the IMF's annual *Statistical Appendix reports* for 2003, 2004 and 2006; this data made it possible to compile a data series for Aggregate Resource Flows for 1997-2005. Aggregate Resource Flows were defined as the sum of Direct Investment Inward, Portfolio Securities and the net position of commercial banks and non-banks.

In sum, financial account data on the balance of payments for the Gulf oil-exporting countries is deficient. This presents considerable difficulties in obtaining reliable figures for calculation. Thus, most countries do not have FDI surveys and are unable to monitor the various components of FDI. Financial details are also scarce; for example, no detailed financial data is available for the United Arab Emirates, while for Qatar there is no data on Direct Investment, Portfolio Investment or Financial Derivatives. Moreover, Portfolio Investment and Financial Derivatives are a major source of data problems for balance of payments accounts across the world. For the former, there was a discrepancy of US$ 207 billion between liabilities and assets in 2004.[2] The data, therefore, should be treated with caution and are indicative of the direction of change, rather than the absolute size of flows. However, data accuracy is expected to improve in the future, as ESCWA countries have now subscribed to international Statistical Data Dissemination Standards (SDDS).

C. External debt data

The Survey uses two main sources for external debt stocks: the World Bank and the OECD, the latter having been formally referred to as the Joint BIS-IMF-OECD-World Bank database. The World Bank system is based on the Debtor Reporting System (DRS), or debtor country reporting system that excludes Iraq and the Gulf countries. The World Bank DRS system covers debt stocks and flows by type of flow and maturity. In recent years it has also started to provide information on the composition of these flows, namely whether the creditor and/or debtor entity is an official or private entity. The DRS system is the only international and cross-country source of information on debt profiles and debt structures, and covers disbursement, repayments, arrears, terms of commitments and currency compositions.

The OECD system was a creditor-based system covering all countries, but has unfortunately all but disappeared in recent years. The Joint BIS-IMF-OECD-World Bank database evolved from the OECD system, replacing it between 2000 and the end of 2006. The interim

[2] IMF (2005a), p. 6.

data series detailed indebtedness by type of creditor and then by maturity and type of finance (i.e. whether the debt was official and, if so, whether it was composed of loans, trade credits or other types of finance). The interim data series covered the period 1998-2002. However, the OECD stopped monitoring several sets of external debt statistics in December 2003. As a result, some data series that are crucial for the purposes of this Survey, especially those needed to calculate total external debt, namely non-bank trade credits, trade credits less than one year and official bilateral loans, were discontinued.

As of the end of February 2007, the Joint BIS-IMF-OECD-World Bank database was discontinued. It has now been replaced by the Joint External Debt Hub, which will combine external debt data and selected foreign assets from market, international creditor and national sources on a quarterly basis. As for the joint database, creditor/market data are complemented by series from the World Bank's Quarterly External Debt Database, which disseminates individual country data supplied according to the IMF's Special Data Dissemination Standard (SDDS). The main objective of this database is to generate efficiencies through the convergence of data flows into a common framework and to improve the transparency and timeliness of debt statistics to all users. Unfortunately, the new database only covers a small number of countries (approximately 60), most of which are advanced and/or industrial countries. Arab countries are only now beginning to participate in SDDS processes and only Tunisia and Egypt currently provide data to the Joint External Debt Hub.

The only recent and consistent snapshot of indebtedness in ESCWA member countries therefore dates back to December 2002, and is available from the Joint BIS-IMF-OECD-World Bank database. For the six diversified ESCWA economies, the source providing the longest and most internally consistent series, namely the World Bank's DRS system, was used. The data used in this Survey are available electronically or from the April 2006 edition of *Global Development Finance*, and cover the period up to 2004/2005. External debt statistics from OECD creditor sources also allowed for further time series, but only from 1990 to 2002. The data used for this purpose comprises Series 2 (1990-1997) from the original OECD External Debt Statistics and Series 3 (1998-2002) from the Joint database. It was also possible to extend the time series by two years (2003 and 2004) for Kuwait, Saudi Arabia and the United Arab Emirates by extracting data from individual IMF country reports and/or Public Information Notices. It should be noted that debt estimates are also circulated by research institutions, such as the *Economist Intelligence Unit*, but they were not used, as it was not clear what they represent, nor how they relate to established reporting systems.

Finally, it should be noted that as of 2005 the World Bank has ceased to classify countries according to the severity of levels of indebtedness. Countries are instead classified according to the lending categories used by the World Bank. The latest available classification of ESCWA member countries was for 2004 and showed that three ESCWA economies were seriously indebted, namely Jordan, Lebanon and the Syrian Arab Republic.

D. CAPITAL FLIGHT DATA AND METHODOLOGY

Capital flight was estimated using the "residual" or broad method. The content and implications of this technique are discussed in more detail below. Capital flight (KF) is defined as the difference between the sources and uses of funds flowing into and out of the economy. If there is no capital flight in the economy, sources and uses of these funds should be balanced, so increases in external debt and inflows of foreign investments must be equal to increases in reserves plus the deficit on the current account:

$$\Delta DEBT + FDI = \Delta RES + CAD \quad (1)$$

where ΔDEBT is change in External Debt, FDI is net Foreign Direct Investment inflows, ΔRES is change in foreign reserves, including gold, and CAD is the Deficit on the Current Account (CA). The right-hand side can obviously be rewritten as a change in reserves minus the current account surplus. As most countries report a current account surplus as a positive current account balance (CAB), it can be presented as:

$$\Delta DEBT + FDI = \Delta RES - CAB \quad (2)$$

If there are disparities between the left-hand and right-hand sides of (2), these must be as a result of unrecorded capital movements, namely capital flight. Thus:

$$KF = \Delta DEBT + FDI + CAB - \Delta RES \quad (3)$$

Data to estimate each of the components of this definition as they apply to ESCWA member countries were obtained as follows. Debt data presented serious difficulties and for the MDEs (Egypt, Jordan, Lebanon, Oman, the Syrian Arab Republic and Yemen), the series of change in total debt stock was therefore downloaded from *Global Development Finance* (April 2006). For the oil-exporters, on the other hand, a series for total external debt for the period 1990-2002 was compiled by using consecutive OECD databases. The series was then extended by adding data for 2003-2004 for Kuwait, Saudi Arabia and the United Arab Emirates from the IMF's country reports and/or Public Information notices.

FDI data was also compiled in two different ways. Although the World Bank covers foreign investment, it was decided to use the more rigorous and comprehensive database published by UNCTAD, usually as *World Investment Reports*. UNCTAD was also the only source for FDI in Qatar and the United Arab Emirates. For Bahrain, Kuwait and Saudi Arabia, data was obtained from various *Balance of Payments Yearbooks*. For Bahrain and Kuwait, it was possible to use the series for inflows of direct investment in equity capital and reinvested earnings. Figures obtained in this way were no different from UNCTAD data for Bahrain, and only differed for the years 1990-1994 for Kuwait. However, Saudi Arabia only reports "Net Direct Investment in Reporting Economy", and the data obtained in this way were very different from the net inflows of FDI reported to UNCTAD.

The time series for Current Account Balances (CAB) were downloaded directly from the IMF's World Economic Outlook database of September 2006. These balances are defined as exports less the imports of goods and services. Changes in Reserves were calculated as the reserves in the current year minus the reserves of the previous year. The time series for total reserves, including gold, were downloaded from the World Bank's Development Indicators database for 2006, except for those of the Syrian Arab Republic, for which data were compiled manually by adding the figures for gold reserves reported in the *IMF's Statistical Appendix 2006* to figures for foreign exchange reserves, excluding gold, reported in successive *Joint Arab Economic Reports* (1996, 2001, 2003 and 2006).

It should be noted that with respect to reserves, there are major differences between national and international practices for oil-exporting Gulf countries. For most of these, the international reserves reported in the IMF and World Bank general databases are only the liquid reserves held by the central bank or monetary authorities. The figures do not include the reserves held by the Government as a whole, or by other public entities. Hence, they are substantially lower than the total foreign assets of the country as a whole. To give an example, Saudi Arabia uses three series in its reports to the IMF: gross foreign assets, the sub-set of liquid foreign reserves held (or reported) by the Saudi Arabia Monetary Agency and the foreign reserves held by all Government institutions. For 2004, these stood at US$ 77.5 billion, US$ 22.7 billion and US$ 41.5 billion respectively. Qatar only reports the reserves of its central bank, and the Government neither publishes data on its reserve assets nor on its non-budgetary revenues.

Finally, data for GDP at current prices in United States dollars were downloaded from the IMF's *World Economic Outlook* database of September 2006.

E. RESIDUAL AND "HOT MONEY" METHODS OF COMPUTING RESOURCE FLOWS

A better sense of what is being measured can be gained by referring to the standard IMF Balance of Payments framework.[3] In that context, a broad measure of capital outflow is given by the bank acquisitions of foreign assets, plus other short-term private capital outflows, plus other bond purchases, plus errors and omissions. By construction, this is identical to the negative of the sum of the current account balance, plus net equity flows, plus additions to reserves, plus other long-term capital of the resident official sector. Since they are identical, both sums provide a measurement of capital flowing out of a country, but the former measures it directly, while the

[3] Claessens and Naude, op. cit. and Schneider, op. cit.

latter measures it indirectly. Moreover, the former relies entirely on balance of payments data, which may be unavailable or unreliable. The latter, however, can be obtained by utilizing data available from other sources and has therefore become the most widely used, or “residual”, method cited in the literature.

A key aspect of the method is using World Bank data in order to capture net increases in external debt. To be specific, the residual method compares the sources of capital inflows (net increases in external debt plus net inflows of FDI) to the uses of capital inflows (the current account deficit and additions to reserves). When using standard IMF data on the balance of payments, the sources and uses should be equal. When using World Bank data on external debt, however, there may be differences between sources and uses. Thus, if sources exceed uses, the difference (or residual) is perceived as capital flight.[4] It follows that the residual method categorizes all unrecorded private capital outflows as capital flight.

The residual method was originally used by the World Bank[5] and Erbe.[6] It has been applied, with modifications, very widely in the literature.[7] The standard residual method is also adopted in this Survey. Also used in the literature, however, is the “hot money” method, which directly measures capital flight. Thus,

$$KF = EO + SRKOut \qquad (4)$$

where KF is capital flight, EO are the errors and omissions reported on the balance of payments and SRKOut are short-term private capital outflows. Unrecorded and possibly illegal outflows that constitute capital flight should be captured by errors and omissions. Inclusion of the short-term flows, moreover, implies that long-term flows are “normal” and possibly aimed at investment. The hot money method (with modifications) has also been used extensively in the literature.[8] However, since data on short-term capital flows are not available for ESCWA member countries, this Survey focuses on errors and omissions and then discusses the additional insight that they offer in comparison with the residual method.

F. Other data

Other data used this Survey were obtained as follows:

(a) Net Errors & Omissions were downloaded from *International Financial Statistics* (February 2007);

(b) Gross domestic savings were calculated as GDP less final consumption expenditure (total consumption). Gross savings were calculated as gross national income less total consumption, plus net transfers. Both series were taken from *World Development Indicators* (September 2006);

(c) Multilateral Debt and Short-term Debt were taken from the World Bank’s *Global Development Finance*;

Workers’ Remittances were estimated as follows:

(a) For Egypt, Jordan, Lebanon, Oman, the Syrian Arab Republic and Yemen, data were downloaded from the April 2006 database of *Global Development Finance*;

(b) For Bahrain, Kuwait and Saudi Arabia, data were obtained from the IMF’s *Balance of Payments Annuals* (February 2006);

(c) For Qatar and the United Arab Emirates, data was taken from the AMF’s *Joint Arab Economic Report 2006*.

4 Hermes, Lensink and Murinde, op. cit.

5 World Bank (1985: 63-5).

6 Erbe (1985).

7 For example, Morgan Guarantee (1986), Boyce and Ndikumana (2001), Schneider, op. cit., Mohamed and Finof (2004) and Salisu (2005).

8 For example, Cuddington (1986) and Gibson and Tsakalotos (1993).

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