

Working Paper

INTERNATIONAL MONETARY FUND

IMF Working Paper

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WP/97/125

INTERNATIONAL MONETARY FUND

Middle Eastern Department

Globalization and Growth Prospects in Arab Countries

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September 1997

Abstract

Globalization—the intensification of international trade and finance linkages underpinned by economic liberalization and technological change—presents both challenges and opportunities to Arab countries. After reviewing this region's disappointing performance in integration and growth, this paper analyzes the empirical relationship between the two and concludes that integration is necessary if high growth rates are to be attained and the region is not to become marginalized. It then identifies the main obstacles to the integration of Arab countries into the world economy and reviews recent progress in overcoming them. On this basis, the paper derives some policy prescriptions.

JEL Classification Numbers: F15, F21, F43, O40

Keywords: Globalization, growth, Arab countries.

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¹This paper was presented at the conference “Sustainable Growth in the Arab States” in Sana’a in June 1997. We are grateful to Mohamed A. El-Erian, Susan Fennell, Thomas Helbling, Przemyslaw Gajdeczka, Richard Jolly, and conference participants for helpful comments. The assistance received from Peter Kunzel and Marie-Geneviève Labeyrie is very much appreciated.

Globalization and Growth Prospects in Arab Countries

	Page
Summary	<u>4</u>
I. Introduction	<u>5</u>
II. Background: Globalization and Growth	<u>5</u>
III. Integration and growth Performance of the Arab Countries	<u>10</u>
A. Recent integration performance of Arab countries	<u>10</u>
B. Growth and integration performance	<u>17</u>
IV. Empirical Analysis: the Link Between Integration and Growth in Arab Countries	<u>24</u>
A. What does empirical evidence suggest about the link between integration and growth?	<u>24</u>
B. Evidence for the Arab countries	<u>26</u>
V. Obstacles to Integration in Arab Countries	<u>29</u>
A. Macroeconomic imbalances	<u>29</u>
B. Structural impediments	<u>30</u>
C. Institutional shortcomings	<u>36</u>
D. Socio-political obstacles	<u>38</u>
VI. Concluding Remarks	<u>41</u>
 Boxes	
1. Forces Driving Globalization	<u>7</u>
2. Privatization in Arab Countries	<u>35</u>
3. Arab Countries are Lagging Behind in Telecommunications	<u>37</u>
 Charts	
1. Selected Trade Indicators, 1980-95	<u>12</u>
2. Trade and Competitiveness Indicators, 1980-95	<u>14</u>
3. Investments, 1980-95	<u>19</u>
4. Growth, 1970-95	<u>20</u>
5. Selected Indicators, 1980-95	<u>23</u>
6. Central Government Wage Expenditure, 1980-90	<u>34</u>

Tables

1.	Summary of Customs Tariff and Other Duties and Charges on Imports and Quantitative Restrictions on Imports	<u>15</u>
2.	Real per Capita GDP Growth Averages	<u>17</u>
3.	Convergence: a Long Road Ahead	<u>21</u>
4.	Pooled Regressions for Arab Countries	<u>28</u>
5.	Credit Ratings	<u>32</u>
6.	Government Size Indicators, 1980-90	<u>34</u>
7.	Infrastructure in Arab Countries	<u>39</u>
8.	Liberalization of International Financial Relations	<u>40</u>

Appendix

I.	Regression Methodology	<u>44</u>
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References	<u>45</u>
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SUMMARY

This paper examines the challenges and opportunities that globalization—the widening and intensification of international linkages in trade and finance underpinned by economic liberalization and technological change—presents to Arab countries, especially if high and sustainable growth rates are to be achieved. These countries are not well integrated in the world economy and, on present trends, they risk becoming even more marginalized. Moreover, their recent growth performance has been disappointing, and the gap relative to industrial countries is widening. Achieving faster sustained growth is essential for Arab countries because their populations and labor forces are growing faster than in any other region; unemployment is high; social needs are pressing; and traditional sources of growth, which are highly volatile, are slowing.

This paper finds empirical evidence that the poor integration performance of Arab countries has indeed hindered their growth. It reviews the main obstacles to their integration into the world economy and recent progress in overcoming those obstacles and then derives some policy prescriptions. The ability of Arab countries to garner the potential gains from globalization will depend primarily on the quality of their domestic policies—a quality critical to the speed of both integration and growth—given the mutually reinforcing relationship between the two.

The structural and economic characteristics of the Arab countries will require growth to be outward oriented. They will need to implement policy measures designed to maintain a stable macroeconomic environment, attract foreign capital, increase non-oil exports, and create favorable conditions for private sector development and for absorbing technological progress while upgrading human resources. They should also minimize the short-term transition costs of global integration by establishing well-targeted social safety nets and measures to enhance human capital, which would increase support for trade liberalization and other reforms.

I. INTRODUCTION

Our times are characterized by extraordinarily rapid change; in particular, the dramatic internationalization or globalization of economic activity over the last couple of decades, and the profound political and social consequences that flow from this. A powerful confluence of forces drives globalization. Some of them reflect government policies, but fundamentally these are forces with a life of their own—forces unleashed by technological change, especially in the fields of transport and communications. The benefits of globalization are yet to be globally enjoyed, however: living standards are rising steadily in many, but not all, countries. While global economic integration is helping to increase prosperity in many transition or developing countries, the challenge remains to prevent the marginalization of those lagging behind.²

This paper examines the opportunities and challenges that globalization presents to Arab countries, especially if high and sustainable growth rates are to be achieved. Arab countries are not well integrated in the world economy, and on present trends they risk becoming even more marginalized. Moreover, the growth performance of Arab countries has been disappointing, and the gap relative to industrialized countries is widening. Achieving faster sustained growth is essential for Arab countries for a number of reasons: their populations and labor forces are growing faster than in any other region, unemployment is high, social needs are pressing, and traditional sources of growth—highly volatile—are slowing down. The paper finds empirical evidence that their poor integration performance has indeed hindered growth. Due to their structural and economic characteristics, Arab countries' growth will need to be outward oriented. Thus, they will need to implement policy measures that promote integration: policies geared to attracting foreign capital and increasing non-oil exports, while absorbing technological progress and upgrading human capital.

The paper is organized as follows: section II reviews the economic impact of global economic integration and regional growth patterns over recent years. Section III reviews the integration performance of Arab countries and the need to speed up such integration into the world economy if growth prospects are not to be jeopardized. This provides the framework for Section's IV analysis of the empirical relationship between integration and growth in Arab countries. Section V examines the main obstacles that have hindered so far the integration of Arab countries in the international economy, derives some policy prescriptions for removing them, and reviews recent progress of Arab countries in this regard. The paper's concluding remarks are contained in Section VI.

II. BACKGROUND: GLOBALIZATION AND GROWTH

The world is becoming smaller and more interconnected. The pace of global economic integration—the widening and intensifying of international linkages in trade, finance and communications—has accelerated in the past decade, underpinned by the liberalization of

²R. Ruggiero (1996).

economic policies and by technological discoveries that facilitate transport and communication networks. Production and trade have become intertwined: production processes are spread across the globe and most products entering the market are either traded or heavily reliant on traded components. While world production has increased six-fold in the last four decades, trade flows have multiplied fifteen-fold; more jobs are in some way related to trade.

This trend has been accompanied by a dramatic shift in the amount and nature of capital flows to developing countries, with private flows becoming more important relative to official financing. A striking increase in foreign direct investment (FDI) has occurred, and FDI and portfolio investment now constitute the bulk of private flows (see Box 1). FDI has joined international trade as the primary motor of globalization. It facilitates the international division of labor; it is the most effective mechanism for the diffusion of productive know-how and capital and the creation of wealth; and it can release much of the untapped production potential of today's development and transition economies, while opening up new markets for high value added products and services that generate high-income jobs.

Over the next ten years, the pace of international economic integration is likely to increase further for a number of reasons: world trade is projected to grow at rates exceeding 6 percent per annum, in the wake of the Uruguay Round and other global or regional multilateral trade liberalization initiatives; transport and communications costs will continue to decline; economic reforms are liberalizing capital flows and encouraging privatization; and the international economic environment is expected to be more stable (with relatively low real interest rates and inflation), helping outward-oriented countries.

In view of the growing impact of global economic integration, it is useful to highlight some of its more important features. First, globalization cannot be halted and cannot be ignored. The powerful forces that drive globalization—linked to technological advances in transport and communications—have a life of their own and are largely independent of governments. Hence, participating in globalization may not be optional, given the irreversible changes in the external environment. In the age of information technology, it might prove very difficult for a country to isolate itself from the world marketplace.

Second, globalization implies that some of the old distinctions between international and domestic policies are becoming increasingly irrelevant. With greater reliance on private capital, countries must strive to retain the confidence of international financial markets and attract FDI: sound domestic policies are all the more important. Conversely, good policies do pay, as seen in the aftermath of the Mexico crisis, when private capital continued to flow to developing countries with appropriate policies. Meanwhile, there is less margin for governments to conduct policies that ignore external constraints. A typical example is taxation: Tanzi (1995) notes that countries will face limitations when setting tax structures and levels as they become less able to maintain tax differentials on relatively mobile factors of production. Moreover, as argued by Heller (1997), a more open capital regime that holds the

Box 1: Forces Driving Globalization

- **Upsurge of trade and changing trade linkages.** During 1985-95, supported by the proliferation of multilateral and regional trade initiatives, the ratio of world trade to GDP rose three times faster than in the preceding ten years and twice as fast as in the 1960s. Developing countries increased their share of world trade from 23 percent in 1985 to 29 percent in 1995; they also deepened and diversified trade linkages: inter-developing countries trade increased from 31 percent of total developing country trade in 1985 to 37 percent in 1995. Between 1985 and 1995, the share of manufactured products in developing countries' exports increased from 47 percent to 83 percent. A significant share of world trade is intrafirm and stimulated by FDI, as firms seek to reduce costs and tap domestic markets: in 1992, world sales of multinationals amounted to US\$5.3 trillion, compared with worldwide exports of US\$4.6 trillion (US\$1.3 trillion and US\$1 trillion respectively for developing countries). But wide disparities persist: except for Asia and Latin America, integration has been slowing down. In fact, the share of Africa and the oil-producing countries in world trade has fallen dramatically since the mid-1980s.
- **Integration of world capital markets.** Developing countries are becoming increasingly integrated into the global financial system, following the liberalization of financial markets of recipient and source countries. Many developing countries have removed restrictions on payments for current account transactions (99 have accepted the IMF's Article VIII obligations), and lifted controls on cross-border financial flows, especially controls on foreign inflows. By end-1995, 35 developing countries had liberalized their capital account. The share of developing countries' trade under current account convertibility has increased from 30 percent in 1985 to 70 percent in 1996. The good growth performance of some developing countries has contributed to make emerging markets more attractive to investors from advanced economies wishing to diversify their portfolios.
- **Increased importance of private flows and FDI.** The magnitude of private flows now overwhelms official financing. Capital inflows doubled in relation to developing country GDP between 1983 and 1996, with private capital flows rising from an annual 0.5-1 percent of developing countries GDP in 1983-89 to 2 percent of GDP per annum in 1994-96. Net private capital flows to developing countries (excluding Asian NIES) averaged about 150 billion a year over 1993-96 and almost hit \$200 billion in 1996—nearly a sixfold increase from the average annual inflow over 1983-89. Unlike in the 1970s and early 1980s, when most capital flows consisted of bank lending, the largest flows in recent years have been equity and portfolio investment. FDI posted the largest rise: over 1985-94, FDI doubled as a share of world GDP, and rose to a record US\$90 billion in 1995, while the share channeled towards developing countries rose to more than a third. Contributing to the rapid growth of FDI to developing countries in recent years has been the adoption of strong outward-oriented policies, including substantial improvements in their investment codes, embodying a shift from sovereign discretion to a free flow of FDI. FDI, however, has flowed massively towards only a few developing countries experiencing fast economic growth: during 1990-96, Asian countries received twice as much in percent of their GDP than African countries. Two thirds of all FDI during the last decade went to just eight developing countries, and half received almost none.
- **Advances in telecommunications and transport.** The main factor behind globalization has been the increased ease and falling cost of communications—including transportation. The cost of phone calls has fallen by a factor of sixty since 1930; air-passenger miles per capita have increased 15 times in 20 years; and the advent of faxes and a global computer network has brought about what has been dubbed the “end of geography”.
- **Changes in the movements of labor.** As the world becomes more interconnected, flows of people across national borders have increased—though they remain small—contributing to ease labor bottlenecks and transfer managerial know-how. The largest flows are between developing countries, but flows from developing to industrial countries have accelerated over the past two decades. In the future one can expect pressures for increased migration from developing countries, whereas developed countries will lower their demand for immigrant labor.

Sources: WEO (1997), World Bank (1995) and Riordan et al. (1995).

prospect of large and volatile capital flows will generally call for a more conservative fiscal stance and constrain the sustainable fiscal structure.

Third, globalization is not always painless. Continuing international economic integration and trade liberalization can have in the short run social and economic costs due to the displacement of workers as protected sectors open up to competition. There is a transition period before other sectors expand, even if in the long run efficiency gains stimulate economic activity and create jobs, more than compensating for the losses. But in the short term there may be winners and losers in most cases. Globalization exposes the social fissures between those with the education, skills and mobility to flourish in an unfettered world market—the apparent “winners”—and those without.³ Rodrik (1997) argues that the world economy faces a serious challenge in ensuring that international economic integration does not contribute to domestic social disintegration. In social terms, governments face the task of managing the transition and dealing with the distributional consequences of change.

Finally, the benefits of globalization have yet to reach all. The current external environment offers greater opportunities for integration, but countries need to take them. Increased participation in the world economy yields important benefits: it improves resource allocation, towards areas of comparative advantage, enhances efficiency by increasing competition among firms, and induces learning and technology. As a result, a nation’s wealth is increased. In a more open and integrated world economy, there are many reasons to expect greater income convergence, with poor countries enjoying faster per capita income growth than rich countries. With open trade and liberal financial markets, poorer countries should be able to benefit from technology spillovers—for instance via imported capital goods—and, in view of the very wide technology gaps that exist, the potential for technological catch-up is great. Furthermore, capital to labor ratios are lower in developing countries: returns to capital should hence be higher and attract inflows, leading to increased productivity and growth. It is surprising, therefore, that there is little evidence of income convergence in recent decades.

The most recent WEO (1997) focuses on the reasons for this striking outcome. The extent to which countries have benefited so far from integration is extremely uneven. While living standards in most countries have gone up in the last thirty years—excluding the NIEs, developing countries as a group more than doubled their real per capita income between 1965 and 1995—many countries are not realizing their potential. Asia was the only major developing region that managed to raise its per capital income towards those of industrial countries. The average per capita income level of African countries fell in relative terms from 14 percent of the developed countries’ level in 1965 to 7 percent in 1995.

³This argument is quite different from the old protectionist fallacy that trade liberalization entails a “race to the bottom”, with countries pitted against each other, seeking gains in ill-defined “competitiveness”. As Krugman (1996) says, trade liberalization is not a zero-sum game and growth in real incomes depends ultimately on the rate of domestic productivity growth. But opening up can and does contribute to increase domestic productivity growth.

In fact, countries are becoming polarized into high and low income clusters. Over the past thirty years the vast majority of non-oil developing countries—84 out of 108—have either stayed in the lowest income quintile or fallen into that quintile from a relatively higher position. There are now fewer middle-income developing countries, and upward mobility of countries into higher income categories has become less frequent over time, particularly since the early 1980s. But, argues the WEO, although most developing countries are not converging towards the income levels of advanced economies, there are cases where growth conditions and policies are favorable, and where progress towards convergence has been achieved in a relatively short time.

What are the sources of growth of these countries, and what policies could accelerate convergence? Most studies on rapidly-growing countries that use the conventional growth-accounting framework (based on a production function, i.e. simple Cobb-Douglas) describe the contribution to growth of capital, labor and total factor productivity, and generally emphasize the role played by capital accumulation.⁴ Policies aimed at raising the rate of investment and savings are thus seen as playing a crucial role in raising growth.⁵ But in order to achieve long-term growth, the quality of the physical capital accumulated, as well as the existing human capital, may be even more important than the amount itself. Recent studies, attempting to identify determinants of factor productivity or technological progress, present evidence on the influence on growth of education, the absence of distortions affecting investment decisions, openness, macroeconomic stability, and freedom from political and civil unrest.⁶ In particular, the fastest growing regions also show the largest advances in integration with the world economy, as measured by the size of capital inflows and export growth.⁷ No policy by itself can ensure fast growth and, for high growth rates to be secured, a comprehensive reform package with at least moderate success on several fronts is needed.⁸ The rate of convergence depends on all these factors, and on the gap between the initial and potential income levels. The larger the gap, the faster the rate of growth.

Growth and increased integration are thus mutually reinforcing. There is a lesson for countries lagging behind in integration and growth—mostly Arab countries and sub-Saharan

⁴Young (1994).

⁵Levine and Renelt (1992) find that only the share of investment in GDP turns out to have a positive and robust correlation with growth.

⁶Barro and Sala-i-Martin (1995).

⁷World Bank (1996).

⁸The WEO (1997) concludes that a successful growth strategy should include, at a minimum, trade openness, macroeconomic stability and limited government intervention. Easterly and Levine (1995) add political stability and the spillover effect of neighboring countries' economic performance to this list.

Africa.⁹ If current policies are maintained, not only will the large differences in per capita income with respect to developed countries or faster-growing developing countries persist, but the gap will continue to widen.

Moreover, several factors—of special relevance to Arab countries—may aggravate the plight of the countries that fail to integrate over the coming years. First, the share of primary commodities other than food in world trade is expected to decline, as commodity prices are projected to flatten or decline in real terms—heightening the pressure for adjustment on oil exporters. Food prices, on the other hand, may increase following the Uruguay Round, negatively affecting net food importers. Second, the competition in labor-intensive manufactures from low-income countries like China, India and Bangladesh is bound to intensify; in some cases, products from the transition economies will displace exports from other countries in their traditional markets, notably in the EU.¹⁰ Third, new migration patterns will limit the growth of worker remittances of some developing countries. Finally, there are growing constraints on official foreign aid flows. In 1994, official development assistance accounted for a third of net resource flows to low and middle-income countries (excluding transition economies) and two thirds of those channeled to low-income countries. Yet aid flows have been falling in recent years, a trend that is likely to continue against the backdrop of fiscal consolidation in industrial countries, the end of the Cold War, and mounting skepticism about the effectiveness of government assistance. If countries are less able to rely on official flows, they will need to take measures to attract private foreign financing instead.

III. INTEGRATION AND GROWTH PERFORMANCE OF THE ARAB COUNTRIES

With a positive association between an outward-oriented trade strategy and rapid growth and employment, integration acquires greater importance.¹¹ Arab countries are lagging behind in economic linkages with the rest of the world—be it in terms of trade flows or their ability to attract capital inflows—and in terms of growth. After reviewing the poor integration performance of the Arab countries in recent years, this section argues that in order to foster growth, given the characteristics of their economies, efforts to increase integration are needed.

A. Recent integration performance of Arab countries

- **Trade of goods and services**

Arab countries as a whole appear relatively open *prima facie*—with total trade-to-GDP ratio of 70 percent, higher than most industrial and developing countries, and surpassed

⁹Riordan et al. (1995), World Bank (1996), and WEO (1997).

¹⁰Chabrier et al. (1996).

¹¹See, for example, Sachs and Warner (1995).

only by Asia.¹² A cursory examination of this indicator would show that Arab countries have actually a good ranking relative to other developing countries (Chart 1).¹³ Although this level appears high by international standards, it is significantly influenced by the particular factor endowments of the region (rich in oil and a shortage of water), which result in sizable oil exports and basic food imports and thus in a comparatively high traded goods ratio. The picture is quite different, however, with regard to intraindustry trade.¹⁴ Indeed, Arab economies remain relatively closed owing to remaining substantial tariff and non-tariff barriers and restrictions of trade in services (See Table 1). Trade ratios are high, owing to the particular factor endowments of Arab countries, but in the absence of restrictions, they would be considerably higher.

Developments in openness also reveal an unfavorable trend. The trade to GDP ratio averaged 84 percent in 1976-80, declined to 60 in 1986-90, and rebounded to 70 percent in 1991-95. While such ratios are influenced by the variation in the terms of trade, even abstracting from such variations, Arab countries' real trade to GDP ratio declined considerably during 1975-84 and has risen at a very slow rate since then, slower than all other regions, except sub-Saharan Africa.¹⁵ Furthermore, since 1982 the region has lost ground vis-à-vis the rest of the developing world in terms of its share of total exports (Chart 2).

Looking at another indicator of openness/global integration, per capita exports of oil-exporting countries declined precipitously after 1982, and they have recovered only marginally since then, remaining well below the rate of growth for developing countries as a group. On the other hand, per capita exports of Arab non-oil countries have been above the average for developing countries since the mid-1980s (Chart 2). Aggregate figures conceal significant diversity in the extent of openness of individual Arab countries: the more open countries are the major oil exporters (GCC) and those that are highly dependent on food imports (Djibouti, Egypt and Mauritania). Trade is less of a policy option in those circumstances. Remaining trade is quite small. As expected, those countries that have pursued more inward policies in the past (Libya, Sudan, Yemen) have much low trade/GDP ratios than others in the region.

The ratio of manufactured exports to total exports provides a good indicator of how a country is able to compete in foreign markets, and to what extent it has been able to keep up

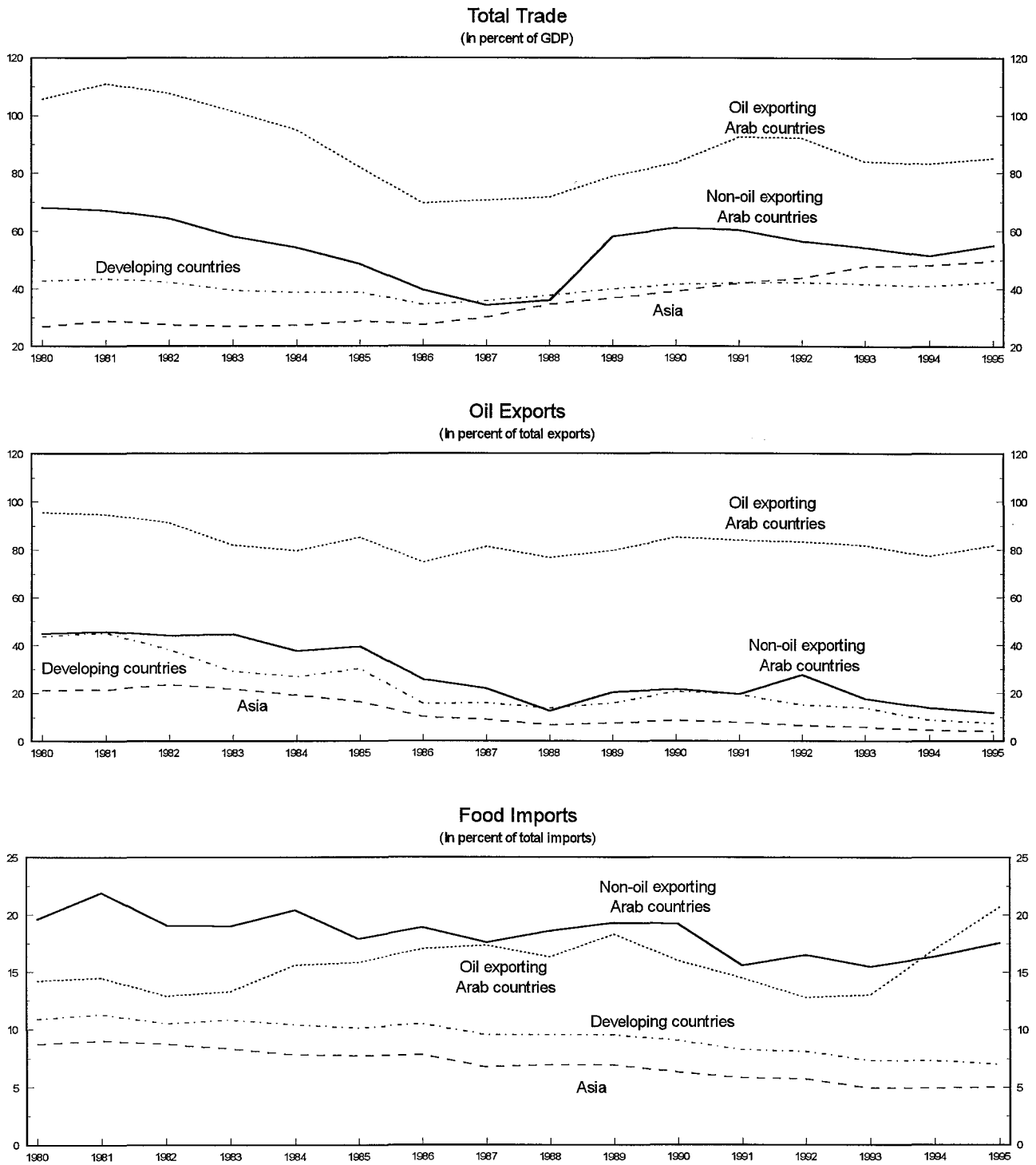
¹²For the analysis in this paper, Arab countries include Algeria, Bahrain, Kuwait, Syria, Oman, Qatar, Saudi Arabia and UAE (oil countries), and Djibouti, Egypt, Jordan, Lebanon, Mauritania, Morocco, Somalia, Sudan, Tunisia and Yemen (non-oil countries).

¹³This indicator is affected by the size of GDP measured in US dollars. Following a decline in GDP, for instance due to a devaluation, this index would indicate, perhaps misleadingly, that the country had become more integrated with the world economy.

¹⁴Havrylyshyn and Kunzel (1997).

¹⁵Alonso-Gamo, Fennell and Sakr (1996).

Chart 1
Arab Countries: Selected Trade Indicators, 1980-95



Sources: World Economic Outlook, and Trade Analysis Reporting System (TARS).

with technological progress and has diversified its production. Chart 2 shows that Arab non-oil countries, while still below the average for developing countries, have managed to raise the share of manufacturing exports, whereas oil-exporting countries have not managed to do so. It is clear that countries that lacked oil resources and were forced to adjust earlier are now ahead in terms of outward orientation

Arab countries remain highly exposed in other ways. Excessive reliance on volatile oil export receipts increases vulnerability to terms of trade shifts and external shocks: oil exporting Arab countries have the biggest variation in terms of trade of all countries. However, it is striking that non-oil Arab countries are also more subject to terms of trade changes, more so than either Asian countries or developing countries as a group (Chart 2).

- **Capital flows**

While several developing countries experienced in the early 1990s a large increase in private capital flows, Arab countries have been largely bypassed by the process of globalization and integration of international capital markets. Indeed, the region has not benefitted so far from the surge in private capital being channeled to emerging markets, and the bulk of inflows are still in the form of short-term capital.¹⁶ Until recently, the linkages of Arab countries to international capital markets were limited at the aggregate level and unevenly distributed within the region.¹⁷

The trends and composition of capital flows have varied over time. In the 1970s and early 1980s, the Arab region experienced net capital inflows of about US\$8 billion per year on average, owing to the large current account surpluses of oil-producing countries and the corresponding investments abroad, mostly by the private sector.¹⁸ Private capital outflows of US\$17 billion a year—largely invested outside the region—more than offset the external borrowing of US\$10 billion a year. Intra regional differences were quite striking: non-oil economies were borrowing from official creditors to the tune of US\$6 billion per annum on average in the period 1975-89. The trend was reversed in the early 1990s, when the region as a whole experienced net inflows of capital of about US\$25 billion per year—reflecting mainly an increase in net private short-term inflows (US\$23 billion per annum) that compensated for a decline in net new external lending by official creditors. Recent inflows to the region also coincided with low oil prices and stepped-up external borrowing connected to the Gulf crisis.

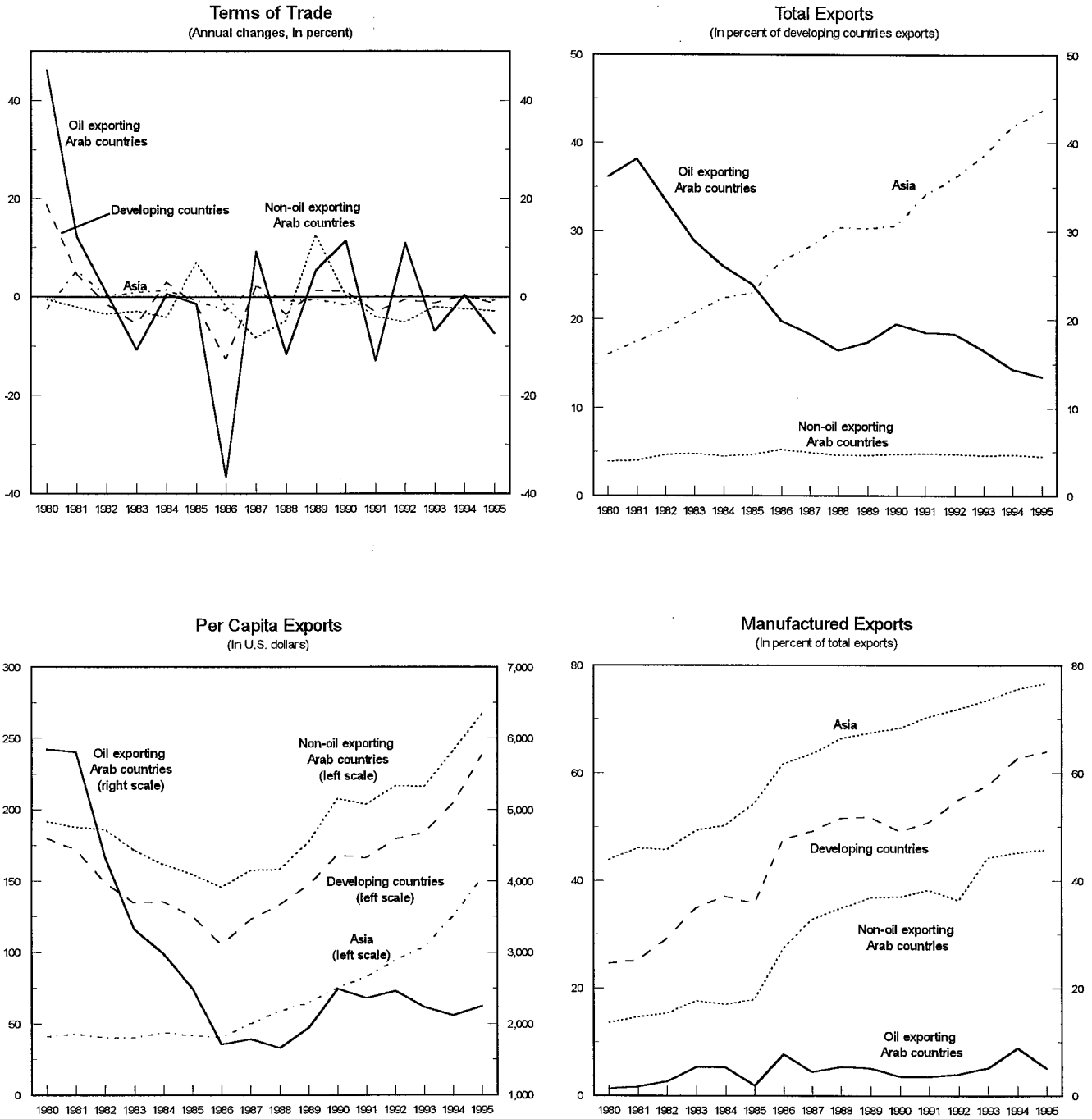
¹⁶El-Erian and Kumar (1995).

¹⁷For a detailed analysis of the issue, see El-Erian and Sheybani (1996).

¹⁸For a discussion of capital market developments in oil producing countries, see Abisourrou (1994) and Azzam (1995).

Chart 2

Arab Countries: Trade and Competitiveness Indicators, 1980-95



Sources: World Economic Outlook, and Trade Analysis Reporting System (TARS).

Table 1. Arab Countries—Summary of Customs Tariff and Other Duties and Charges on Imports and Quantitative Restrictions on Imports

	Customs Tariffs (Imports)			Other Duties and Charges (Imports)	Quantitative Restrictions	Other Observations
	Min.	Max. ¹	No. of Bands			
Maghreb countries						
Algeria	3	50	6	0 % - 6 %	None	Application to WTO pending; EU Association Agreement being negotiated
Morocco	0	45	19	15 % (fiscal levy) + para-fiscal 0.25 %	Yes (agricultural products + specified industrial inputs)	WTO member; EU Association Agreement signed
Tunisia	0	73	numerous	2 % import customer fee + countervailing import duty	Yes (8 % of domestic production)	WTO member; EU Association Agreement signed
GCC Countries						
Bahrain	4 ²	20	5	None	Yes (specified items + procurement rules) ³	WTO member; discussion through GCC with EU to establish free-trade area.
Kuwait	4 ²	--	5	None	Yes (specified items + procurement rules) ³	Same as above
Oman	5 ²	--	6	None	Yes (refined petroleum products) ³	Same as above
Qatar	4 ²	--	3	None	Yes (very few; imports from specified countries) ³	Same as above
Saudi Arabia	0	20	3	None	Yes (very few; imports from specified countries) ³	WTO membership under discussion; discussions through GCC with EU to establish free-trade area
UAE	4	4	--	None	Yes (same as above) ³	Became member of GATT in 1994; final act of the Uruguay Round not yet finalized
Mashrek countries						
Egypt	5	70	--	2 % and 5 % import surcharges	Yes (import bans on poultry, textiles, and garments)	WTO member; EU Association Agreement being negotiated

Table 1 (concluded). Arab Countries—Summary of Customs Tariff and Other Duties and Charges on Imports and Quantitative Restrictions on Imports

	Customs Tariffs (Imports)			Other Duties and Charges (Imports)	Quantitative Restrictions	Other Observations
	Min.	Max. ¹	No. of Bands			
Jordan	0	40	6	0.1 % import license fee + 10 % exchange permit fee for imports	Yes (import bans on 5 commodities)	WTO accession under discussion; EU Association Agreement reached.
Lebanon	0	50	12	None	Yes (on specified commodities, bans on imports from certain origin)	Potential candidate for EU Association Agreement
Syria	0	200	n.a.	2 % import license fee + other specific import fees + 6-35 % import surcharge	Yes (numerous and complex)	Potential candidate for EU Association Agreement
Libya	0	100	n.a.	Numerous excise taxes on a number of commodities	Yes (specified imports by origin + annual commodity budget)	
Mauritania	0	30	33	0 or 5% customs duties + 3 % statistical duties + 9 % for veterinary imports	None	WTO member
Yemen	5	30	4	0.4 - 2 % service fees	Yes (ban for noneconomic reasons; few agricultural products and used vehicles)	

¹Excluding alcoholic beverages, tobacco products, certain types of automobile and vehicles or other luxury items, depending on country.

²Non-GCC countries.

³Specified import prohibitions for reasons of religion, health, and national security.

The increase in short-term flows masks to a certain extent the troubling fact that, to date, Arab countries have only attracted a modest amount of FDI. The region as a whole attracted less than one percent of equity capital flowing to developing countries from industrial country investors—disproportionately low for the size of the regional economy (Chart 3). The impact of this shortfall goes well beyond the forgone external financing contribution that might have supported higher investment and growth. FDI not only contributes significantly to upgrading the capital stock and to gains in investment efficiency, it also encourages the transfer of technology and managerial techniques. Since the mid-1980s, FDI has hovered well below the level of countries in Asia and Latin America (Chart 3), and has concentrated largely in the energy sector. However, since the early 1990s, there have been some encouraging signs of change: FDI (mainly to Egypt, Lebanon, Morocco and Tunisia) has doubled to about US\$2 billion a year, and has begun to be channeled to other sectors.¹⁹

B. Growth and integration performance

The economic performance of Arab countries during recent years has been characterized by a marked deterioration in the rate of real economic growth; in fact, since 1970, real GDP levels have even declined over some periods (Table 2). In terms of growth, Arab oil countries have performed even worse than sub-Saharan Africa, while changes in real per capita GDP show that Arab countries' growth rates are particularly volatile (Chart 4).

Table 2. Real per Capita GDP Growth Averages

	1971-75	1976-80	1981-85	1986-90	1991-95
Developing countries	3.75	2.49	1.55	2.83	4.03
Arab countries	2.56	1.22	-0.26	-2.01	0.75
Arab oil	1.57	-0.72	-3.39	-1.76	0.11
Arab non-oil	3.36	2.78	2.24	-2.21	1.25
Sub-Saharan Africa	0.71	0.33	-0.44	-0.18	-0.75
Asia	3.95	3.70	4.88	5.46	6.74
Western Hemisphere	3.90	3.12	-0.96	0.17	1.08

Source:IMF

Sluggish per capita income growth reflects the vulnerability of the sources of income of Arab countries, and the continuing high rate of population growth of this region—of about 2.7 percent per annum—entailing a yearly expansion of the labor force of 3.3 percent.²⁰ By the

¹⁹Bisat, El-Erian, El-Gamal and Mongelli (1996)

²⁰This compares with rates of labor force expansion of 2.5 percent in sub-Saharan Africa and (continued...)

year 2010, on present trends, the region will count 120 million more inhabitants, from 253 million in 1995, implying the need to create 47 million new jobs. With the assumed rate of fertility and increased education, the rate of growth of the labor force will be even higher, as female labor force participation is bound to increase.²¹ Creating the needed employment opportunities will not be easy, considering that, in 1995, the Arab region already had one of the highest rates of unemployment in the world, at more than 15 percent.

Compared to other regions, Arab countries have performed poorly in terms of growth so far: in 1995 the median per capita GDP in the region (excluding the main oil producers), measured in PPP terms, was well below 20 percent of the level of the GDP per capita in the industrialized countries (Table 3). But, more importantly, on present trends the gap between their income levels and those of developed countries would continue to widen. In the period 1970-95 the newly industrialized Asian economies had almost reached the GDP per capita level of the industrialized countries, even if it had been more than 60 percent lower in 1970. During the same period, the gap between Arab and industrialized countries hardly narrowed, and even widened for some countries. A dramatic change in growth performance is warranted if the needed catch-up process is to resume.

A simple accounting exercise, analogous to that of the WEO, would help to visualize the task ahead (Table 3). Assuming the growth performance of the last 15 years were to be sustained in the future, in the best cases (Tunisia and Syria) it would take at least 15 years for the gap in GDP per capita between the Arab and industrial countries to be reduced to 50 percent, while for some countries (Djibouti or Somalia) this objective would never be reached. In a second scenario, assuming that Arab countries were to see their **nominal per capita** GDP growth reach 10 percent a year (for most countries of the region with high population growth, assuming low inflation, this would represent real GDP growth rates of around 9.5 percent) the number of years needed to reach 50 percent of the per capita GDP of industrial countries would range between 10 to 40 (except for Lebanon). Finally, a third scenario calculates the growth rates needed for the sample of Arab countries under consideration to attain in 20 years 50 percent of the per capita GDP of industrial countries: they range from about 7 percent (Algeria, Jordan, Syria, Tunisia) to about 14-15 percent (Mauritania, Sudan, Djibouti).

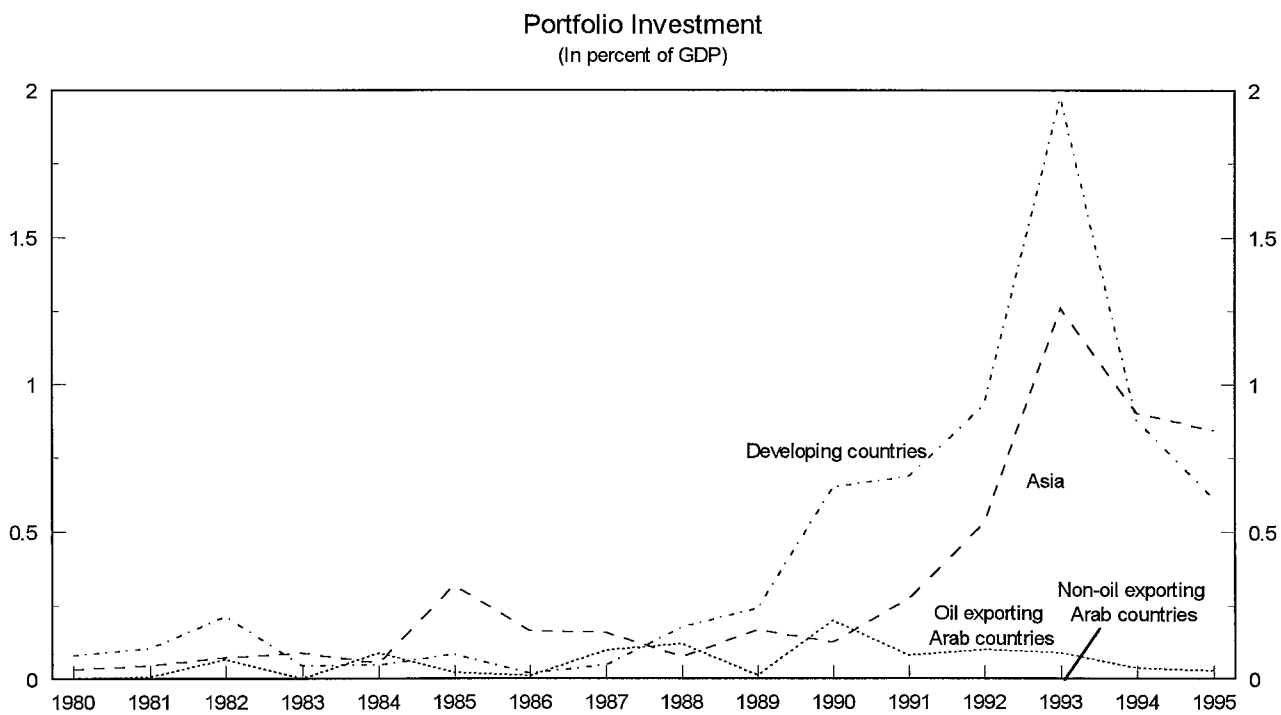
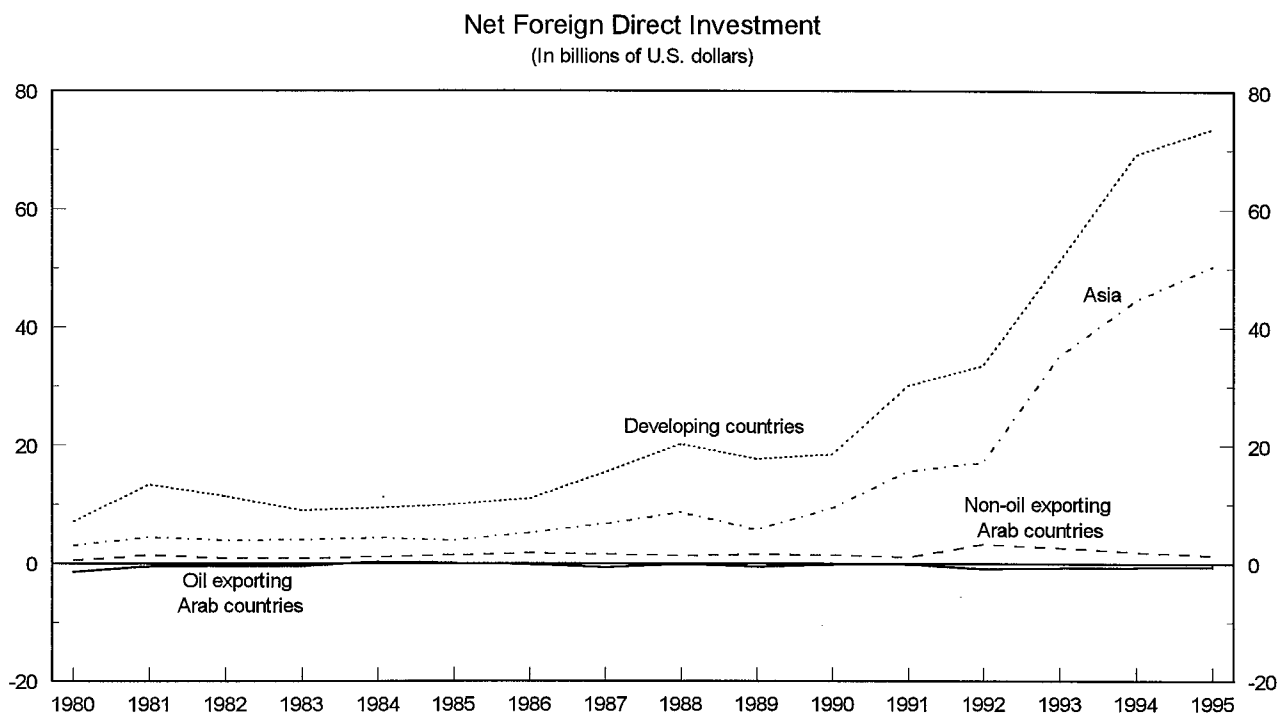
Thus, in order to ensure per capita income growth, the creation of adequate employment opportunities, and the provision of needed social services, Arab countries would have to achieve annual real GDP growth rates well in excess of 5 percent in the next

²⁰(...continued)

Latin America, and less than one percent in the industrialized OECD countries.

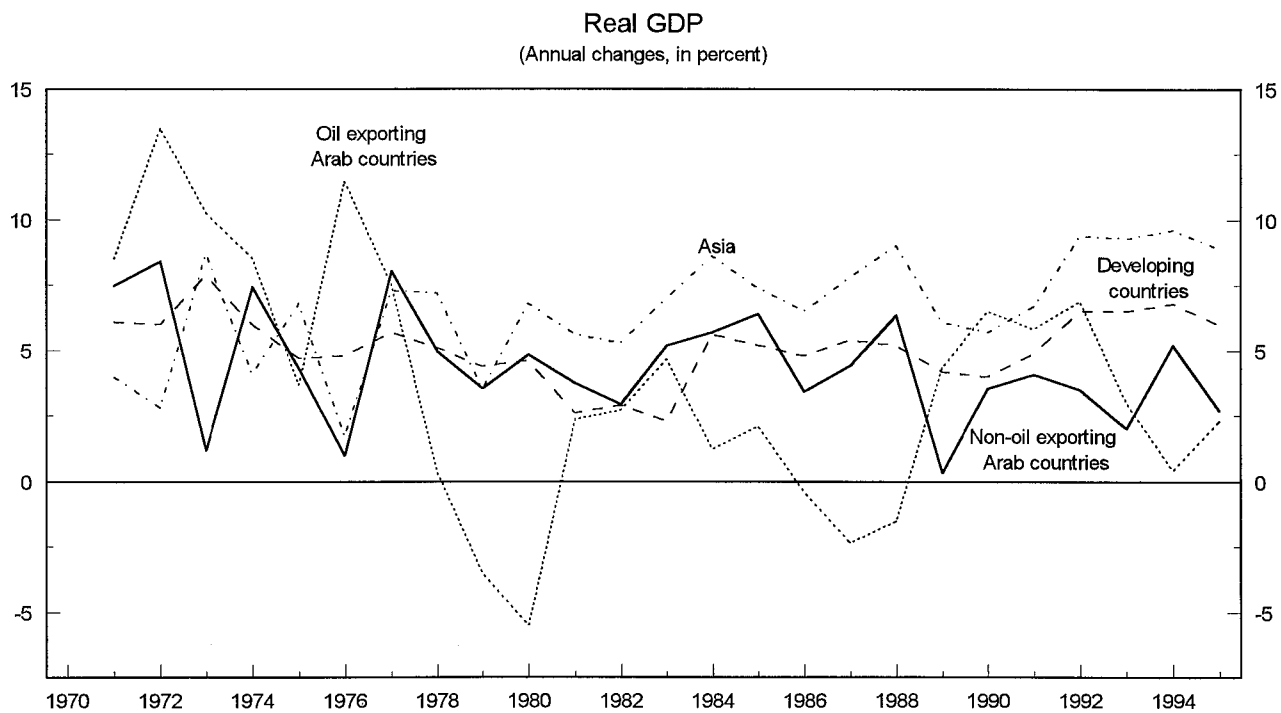
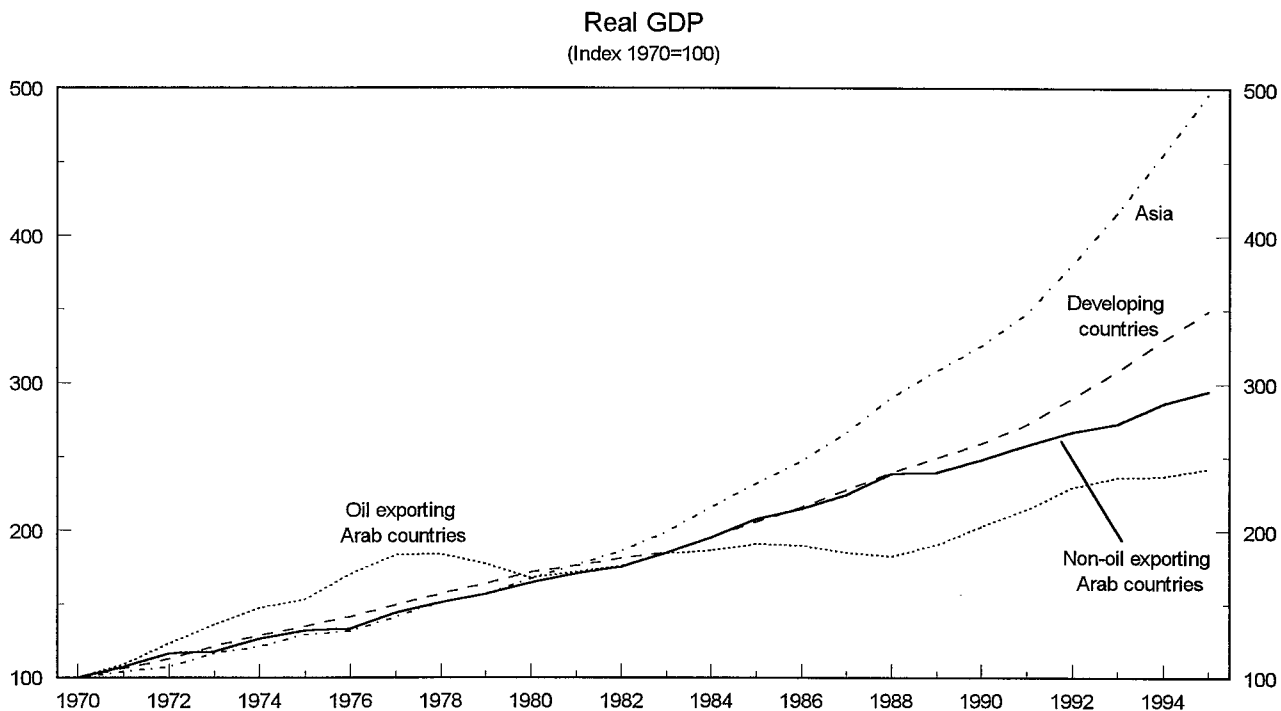
²¹Sirageldin (1996) underscores the magnitude and mounting nature of the problem. By the year 2030, total Arab population is forecast to climb to 514 million, and 75 percent of the population—around 332 million people—will be of working age (aged between 15 and 64), compared with 138 million in 1995.

Chart 3
Arab Countries: Investment, 1980-95



Sources: World Economic Outlook.

Chart 4
Arab Countries: Growth, 1970-95



Sources: World Economic Outlook.

Table 3. Convergence: a long road ahead

	GDP per capita in percent of industrialized countries	Per capita growth rate (in percent) 1/	GDP per capita in percent of industrialized countries	Number of years to reach 50 percent of industrialized countries GDP per capita		Growth needed to to reach 50 percent of industrialized countries
	1970	1970-95	1995	Scenario 1 2/	Scenario 2 3/	per capita GDP in 20 years 4/
Algeria	27.3	7.8	29.0	16	10	6.9
Djibouti	18.3	2.1	5.0	... 5/	43	16.7
Egypt	22.1	7.2	20.7	32	17	8.7
Jordan	27.4	7.2	25.2	25	13	7.7
Lebanon	132.5	-1.0	16.8	... 5/	20	9.9
Libya	148.8	2.4	44.1	...	2	4.7
Mauritania	15.6	5.0	8.5	270	33	13.6
Morocco	18.8	7.3	17.7	37	19	9.6
Somalia	13.3	3.1	4.7	... 5/	44	17.1
Sudan	14.3	4.9	7.7	329	35	14.3
Syrian Arab Rep.	26.3	8.0	29.7	15	10	6.8
Tunisia	22.3	8.5	28.0	15	11	7.1
Yemen, Rep. of	7.3	8.5	9.3	42	32	13.2
Hypothesis						
Percent of industrialized countries GDP				50	50	50.0
Average GDP per capita growth rate:						
In Arab countries				...	10	...
In industrialized countries				4.3	4.3	4.3
Number of years to catch up with industrialized countries						20.0
Memorandum items						
Industrialized countries	100.0	7.5	100.0			
Newly industrialized Asian ec	36.2	11.8	95.5			

Sources: IMF WEO databank; and staff estimates.

1/ Annual average.

2/ Scenario 1 is based on the last 25 years per capita growth rate for the Arab countries and the average growth rate of per capita GDP in the period 1990-2000 for the industrial economies. The 1995-2000 projections are taken from the World Economic Outlook.

3/ Scenario 2 is based on a uniform 10 percent average growth rate for the Arab countries and the average growth rate of per capita GDP in the period 1990-2000 for the industrial economies. The 1995-2000 projections are taken from the World Economic Outlook.

4/ Same assumptions than in footnote 3 for industrial countries' per capita growth rate.

5/ This indicates that there is no convergence.

decades.²² These growth rates, albeit high, are not unrealizable—the Asian experience is a clear illustration in this respect—but to attain them Arab economies would have to undergo significant changes. Inaction would lead to a further erosion of the Arab countries' relative position vis-à-vis the rest of the world, and they are already lagging behind: in 1997, only the industrialized economies are expected to grow more slowly, and the corresponding per capita income growth rates would be the lowest of any region in the world.²³ In the absence of a swift and comprehensive reform effort, the Arab region could fail to attract the needed capital inflows—a fact that is even more worrying given that, for a number of reasons—outlined below—its financing requirements are the largest of any developing region.

First, due to the shortage of water, they have to import food. Looking at the amount of exports receipts absorbed by food imports, the comparison with other regions is staggering (Chart 5). For non-oil countries, more than 30 percent of export receipts is spent on food imports—down from around 50 percent at the beginning of the 1970s. This ratio was particularly large for the oil countries in 1986, when the international price of oil plummeted.

Second, more than half of Arab countries derive their GDP from natural resource-based sectors, particularly oil, gas, and mining, that are being exploited at unsustainable rates, and whose prices are unlikely to increase in real terms in the coming years, in part as they are constrained by the cost of alternative energy sources. While oil exports currently account for more than two thirds of total Arab countries' exports (and 85-95 percent of the exports of Algeria and some Gulf countries), the proven oil and gas reserves of Algeria, Oman, Egypt and Syria could be depleted in the next 20-40 years. Moreover, excessive reliance on volatile oil export receipts not only increases vulnerability to external shocks, but has led to a sharp fall in per capita income of oil producers over the past twenty years. From a record US\$297 billion in 1980, the revenues of the ten main Arab oil producers plummeted to around US\$92 billion in 1995—owing to the drop in oil prices and a weakening of the U.S. dollar—while their population surged, causing a decline in their per capita income from US\$1,700 in the mid-1970s to US\$500 in 1995.²⁴

A third reason why Arab countries need to generate foreign exchange is to service their external debt. Again, the problem is much less acute for oil countries, but only Western Hemisphere countries—traditionally plagued by high levels of debt—are in a worse situation than non-oil Arab countries (Chart 5).

The key to future growth in Arab countries therefore lies in adopting an outward-oriented strategy and supportive comprehensive reforms. Clearly, in order to spur growth and meet future import needs, particularly food, oil cannot be relied upon. The crucial challenge is thus to promote non-oil exports, and there is ample scope for such an expansion. With about

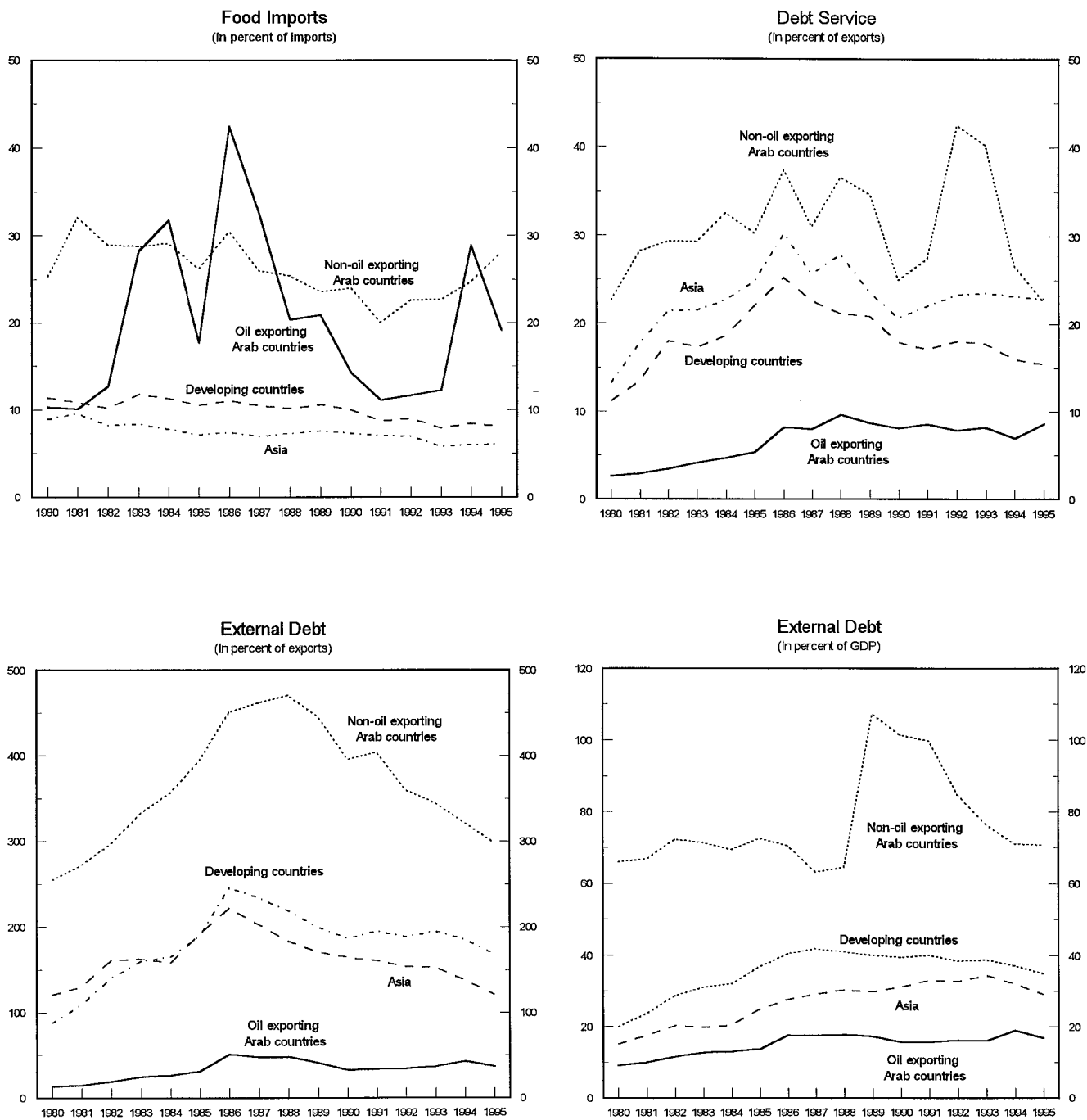
²²World Bank (1995).

²³WEO (1997)

²⁴Annual Report of the Organization of Arab Petroleum Exporting Countries (1996).

Chart 5

Arab Countries: Selected Indicators, 1980-95



Sources: World Economic Outlook, and Trade Analysis Reporting System (TARS).

250 million people, Arab countries' non-oil exports in 1995 (of the order of US\$45 billion) were about half the exports of Korea and one third those of Hong Kong; the openness of Arab economies lags behind competitors; and, as mentioned, manufacturing exports—one of the major sources of productivity gains—are growing more slowly than in other regions except for sub-Saharan Africa (Chart 2).

Are the Arab countries in a position to meet such a challenge? Riordan et. al. (1995) have analyzed how fast non-oil exports would have to grow for Arab countries to achieve a GDP growth rate of about 5 percent per annum, allowing a yearly growth in per capita income of about 2.5 percent. For some countries—Jordan, Morocco and Tunisia—which initiated structural reforms early on, the required growth in non-oil exports would be attainable in view of their most recent performance. Paradoxically, the lack of oil revenues, which forced these countries to adjust, has led to their being in a comparatively better position than countries that enjoyed such revenues and were able to forestall reforms. For a second group—the Mashreq and Gulf countries—the required export growth rates would be double their historic values, but they also appear attainable provided appropriate structural reforms were adopted. But many oil-producing countries would have to increase dramatically the growth rates of their non-oil exports for living standards to be maintained, let alone improved. This would require fundamental changes in economic policy, as well as the need to search for alternative sources of foreign exchange earnings.²⁵ Section IV below examines the link between integration and growth for Arab countries, while Section V focuses on the policies that would have to be implemented to encourage integration further.

IV. EMPIRICAL ANALYSIS: THE LINK BETWEEN INTEGRATION AND GROWTH IN ARAB COUNTRIES

Although economists have yet to identify with a reasonable degree of certainty the correct and comprehensive policy package that would steer countries towards high growth paths, there is little doubt that greater international integration must be a major component of any growth strategy.²⁶ In this section, first, we present an overview of the evidence in the literature about variables associated with integration that influence long-term growth. Second, we test the impact of various variables on growth for a representative group of countries of the region using pooled regressions.

A. What does empirical evidence suggest about the link between integration and growth?

Most recent empirical work attempting to shed some light on the determinants of the long-run rate of growth has been based on comparative cross-country analysis. These studies have been stimulated by the renewed interest on growth theory brought about by the

²⁵World Bank (1995).

²⁶The analysis of high growth performers is still fragile and even controversial (see Sarel (1995) on Asia).

endogenous growth approach initiated by Romer (1986). Following the seminal work of Robert Barro (1991), many variables have been included as growth determinants in econometric estimates, and evidence has been gathered to identify some important impediments to growth as well the beneficial effects of some key variables. We focus on the variables that are most closely associated with the integration of countries into the world economy.

While on theoretical grounds there is still some controversy about the relationship between the openness of an economy and its rate of growth, most of the empirical work performed so far has shown a positive impact of openness on growth. In particular, Levine and Renelt (1992) showed the unambiguous positive relation between growth and openness using a large group of countries in cross-country estimates. Edwards (1992) obtained a similar result and found some evidence as well of the negative impact of protectionist policies. Baldwin and Seghezza (1995) found that domestic protection depresses investment and thereby slows growth. Moreover, as mentioned, integration into the world economy goes well beyond trade. Accordingly, several authors have investigated whether there are positive effects stemming from financial integration or investment in R&D. Roubini and Sala-i-Martin (1991), Levine and King (1992) and Levine and Zervos (1996) followed that approach and were able to establish some evidence of the impact of financial structures or financial policies on growth. In these studies, the financial sector is seen as a sector that increases the microeconomic efficiency of the whole economy. As stated by Sala-i-Martin and Roubini: "it improves the link between savings and investment, it contributes to efficiently allocate the capital stock to its best use, and it also helps to collect and screen information".

Technological transfer in the form of knowledge or physical capital undoubtedly plays a crucial role in helping developing economies to adapt and compete in world markets. Indeed, empirical evidence has been found demonstrating the benefits for developing economies of technological integration, particularly in the way technological diffusion operates. Coe and others (1995) built a substantial data base on R&D expenditure that showed the potential spillover effect of R&D in industrialized economies on developing countries' growth through trading interaction. In the same direction, Borenzstein, De Gregorio and Lee (1995) utilizing data on FDI flows from industrial countries to developing countries found that FDI "is an important vehicle for the transfer of technology" and, thus, for fostering economic growth. In particular, their estimates suggest that FDI contributes more to growth than domestic investment.

The above studies attempted to identify common factors that are statistically significant across a large number of countries in limiting or promoting long-term growth. Few studies, however, have focussed on common specificities that could affect a group of countries or a region as a whole. De Gregorio (1992) tried to identify common characteristics that could explain the extremely poor growth performance of Latin America in the 30 years to the mid-80s. In particular, his estimates showed the disruptive effect of inflation and the positive impact of foreign direct investment on growth. Virtually no research has been carried out on other regions of the world that have been losing ground in terms of their share in world wealth. The lack of data certainly has proved a major constraint.

B. Evidence for the Arab countries

As mentioned before, the real per capita growth of Arab countries has been almost as poor as for Latin America or sub-Saharan Africa. Using the methodology commonly found in the literature and available information, we performed various econometrics estimates in an attempt to shed some light on the growth performance of the region, focussing mainly on the interactions with the rest of the world.

In order to examine more in detail the long-term determinants of growth in the Arab region, we performed a series of pooled regressions following the above approach. Again, data limitations made it impossible to select a large number of countries and to cover an extended time period. Seven countries for which sufficient information was available were selected, and the 1970-90 time period was used.²⁷ In order to maximize the use of available information, the data were decomposed into four 5-year sub-periods. By calculating averages over a five year period, a large portion of the short-term fluctuation of the variables would be eliminated. The data was obtained from various sources, including the latest version of the Heston and Summers (1991) data base, the World Bank world tables and the WEO data base from the IMF (sources typically used in the studies mentioned earlier).

The estimates aim essentially at shedding light on the potential effect of some key economic variables that are thought to influence the growth process and more precisely the growth of total productivity. However, a number of caveats should be mentioned. First, the estimated relationships are not derived from a unique and well defined theoretical growth model. In particular, these estimates raise the usual problem of endogeneity: for instance, whether financial development stimulates growth or vice versa. Accordingly, it could be that the results obtained reflected spurious correlations and not economic relationships.

Second, data limitations constrained the ability to obtain direct information on many variables that could be considered to play a central role on growth in Arab countries. For instance, comprehensive information on trade restrictions (quantitative and tariffs), one of the characteristic features of Arab countries over the period under consideration—as described in the previous section—was impossible to obtain. However, using numerous data sources it was possible to identify proxies for each of what could be considered the main determinants of growth. In particular, several variables were used to explore the potential effect on growth of policies affecting the integration of Arab countries into the world economy and the external environment: the degree of openness measured by the ratio of exports and imports to GDP; the exchange rate black market premium;²⁸ the external debt/GDP ratio; the terms of trade; and the share of foreign direct investment in GDP.

The results are shown in Table 4. They are consistent with the cross-country results found in the literature with regard to the initial conditions. Accordingly, initial GDP for each

²⁷Algeria, Egypt, Jordan, Mauritania, Morocco, Syria and Tunisia.

²⁸From the Picks Currency Yearbook.

of the five sub-periods has, as expected, a negative sign verifying the convergence hypothesis. The variables related to the accumulation process are both significant. Indeed, the investment to GDP ratio (physical accumulation) appears to have, also as expected, a positive sign, but the small magnitude of the coefficient indicates a feeble contribution of investment to the growth process, suggesting a very high ICOR related to the inefficiency of capital.²⁹ The secondary school enrollment ratio at the beginning of each period, taken as a proxy of human capital accumulation, appears to positively influence growth. Variables related to the domestic macroeconomic environment were also tested but were found not significant. In particular, the rate of inflation and the size of government were tested without success. However, the latter variable tested in an ad hoc equation appeared to have a negative influence on investment (Table 4, column 3).

As regards external policies and the external environment, two variables were found to exert a strong influence on growth. First, the external debt to GDP ratio exerted a negative impact on growth, reflecting not only the severe financial constraints (debt overhang) that faced the Arab countries for most of the period under consideration, but also the low degree of “productivity” yielded by the debt accumulation process. The strong negative sign—a 10 percentage points decline in the debt ratio boosted growth by around 0.6 point—emphasizes the potential positive effect that debt restructuring operations could have in fostering growth.³⁰ At the same time, however, it underscores the need to attract more efficient investment under the form of foreign direct investment. The other variable tested successfully was the black market premium, which can be seen as a proxy for the distortions introduced by governments in the exchange system. Again, as expected, this variable negatively affects growth. In this regard, the progressive liberalization process underway in the region could play a crucial role in raising the growth potential of Arab countries.

Other variables related to the external environment were tested as well, but were found to be not significant. It is striking, for instance, that the terms of trade were found to be not significant, particularly taking into account the very limited diversification of exports that took place over the period and the strong dependence of Arab countries on a limited number of products (notably oil) that exhibited sharp price changes. But this result may be due to the fact that few oil producing countries of the region were included in the sample for this analysis. Foreign direct investment, identified in several studies as an important contributor to growth, was also found not significant. However, the fact that the Arab countries have been unable to attract so far substantial amounts of FDI is certainly a reasonable explanation for this result. The effect on growth of the degree of openness (trade/GDP ratio) while also not significant, was found to have a positive impact on investment (Table 4, column 3).

The results obtained in our econometric analysis highlight the need to remove exchange restrictions, to attract more productive and non debt-creating foreign investment,

²⁹ Barro and Sala-i-Martin (1995), performing cross-country regressions using the instrumental variables technique, found the investment ratio to be non-significant.

³⁰This is consistent with Dooley (1990).

Table 4. Pooled regressions for Arab countries 1/

Dependent variable:	GDP per capita (1) 2/	growth rate (2) 2/	Investment rate (3) 2/
Constant	0.693 (5.63)	0.768 (7.16)	--
Initial GDP 3/	-0.079 (5.22)	-0.088 (6.89)	--
Investment ratio (I/Y) (10 ⁻²)	0.165 (2.15)	0.159 (2.37)	--
School enrollment ratio (second degree)	0.033 (3.76)	0.036 (4.79)	--
Debt overhang (Debt/GDP ratio)	-0.066 (6.18)	-0.066 (7.41)	--
Black market premium	-0.020 (2.54)	-0.019 (2.99)	--
Terms of trade (percentage changes)		0.705 (1.69)	--
Foreign direct investment (percent of GDP)	--	-0.004 (0.11)	--
Government consumption (percent of GDP)	--	-0.018 (0.32)	-0.411 (2.63)
Openess (X+M/GDP)	--	--	0.180 (4.73)
	Adj. R ² =0.58	Adj. R ² =0.57	Adj. R ² =0.22

1/ Because of the lack of data, only 7 countries of the region were considered: Algeria, Egypt, Jordan, Mauritania, Morocco, Syria and Tunisia. Each country has four observations for each variable covering 5 years over the 1970-1990 period.

2/ In parenthesis below each coefficient are reported the absolute values of the t-student.

3/ This is the log of GDP at the beginning of each period.

and to proceed with a general liberalization of the economy. The reforms currently underway in Arab economies are a step in the right direction, and hence should open new growth opportunities. The next section discusses these and other obstacles to integration and growth in the region, and what Arab countries are doing to address them.

V. OBSTACLES TO INTEGRATION IN ARAB COUNTRIES

If Arab countries are to take advantage of the unparalleled opportunities offered by the current external environment, they should strive hard to remove obstacles to increased integration with world markets, and implement the appropriate policies for this to happen. The main identifiable obstacles that have hampered until recently the efforts of Arab countries to integrate into the global economy have been macroeconomic imbalances; structural impediments; a lack of institutions; and socio-political factors. For Arab countries to foster integration, in the quest for faster growth and higher standards of living, they need to focus on “getting right” a basic policy package.³¹ It is encouraging that progress on many fronts has already been registered in a number of Arab countries. Moreover, the countries that have started to implement sound domestic policies and to open up are now growing at the highest rates in the region.

A. Macroeconomic imbalances

In the face of serious macroeconomic imbalances it is often necessary to impose restrictions, and opening up becomes more difficult. In many Arab countries, a number of restrictive economic factors—excessive government intervention, distorted prices, and non-convertibility of the local currencies—have been maintained, discouraging private investment in the tradable sectors and hampering trade. Furthermore, large revenues deriving from oil and other natural resources have allowed many Arab countries to finance large external current account deficits and postpone needed reforms, including trade liberalization. Macroeconomic instability also undermines investment and growth.³² In particular, empirical studies for a large number of countries suggest that inflation has a negative impact on growth.³³ Large and persistent budget deficits also tend to slow down growth, by reducing available credit to the private sector and crowding out private investment.³⁴ By contrast, macroeconomic stability, by reducing uncertainty, allows investment and savings decisions consistent with underlying economic fundamentals, thereby promoting an efficient allocation of resources.

In recent years, financial instability in the region has been significantly reduced.³⁵ Inflation rates have fallen and foreign exchange losses have been either contained or reversed, largely mirroring the progress in reducing fiscal deficits. The countries with the fastest reduction in fiscal deficits have enjoyed higher growth, a prompter investment response, a faster decline in inflation, and lower current account deficits (Bisat et al, 1996). Chart 5 shows

³¹El-Erian and El-Gamal (1997).

³²Fischer (1993).

³³Sarel (1996), Bruno and Easterly (1995) and WEO October 1996.

³⁴See WEO May 1996 for a discussion on the consequences of fiscal imbalances.

³⁵El Erian et al. (1996), and World Bank (1995).

these results for five countries that have successfully started to undertake stabilization efforts.³⁶ Inflation has declined (with the exception of Algeria and Egypt in the early years, but the trend has been sharply reversed since 1995); fiscal deficits have been substantially reduced (Algeria started registering surpluses in 1996); real effective exchange rates have depreciated, following the move away from protectionist inward-oriented policies, and are probably much closer now to their equilibrium value; and current account deficits have been reduced, as the export sector has become more competitive.³⁷ Overall, these countries have registered favorable rates of growth, especially compared with the average for the region. However, they still need to reduce substantially the stock of their external debt (Chart 4). According to the results in Section IV, growth rates could have been higher in the absence of the dampening effect on growth of the debt overhang.

The macroeconomic challenge is far from over: inflation rates need to decline further; external positions are often still fragile; and fiscal balances remain vulnerable to oil price fluctuations, while the Association Agreement with the EU and other trade liberalization initiatives will entail a loss of fiscal revenue from tariff and trade taxes.³⁸ Further fiscal consolidation may therefore be needed, through fiscal reforms, by broadening the base of taxation on consumption and spending, and a by rationalization of expenditure.

B. Structural impediments

Appropriate macroeconomic policies alone may not suffice to integrate a country in the global markets: a broad range of structural reforms needs to be implemented to remove obstacles to integration. Trade liberalization, a well-established and clear regulatory framework, a transparent and non-distortionary taxation system, a stable and well-supervised and regulated domestic financial system, and adequate infrastructure, including transportation and communications, are all necessary to promote increased integration. In these areas Arab countries have indeed suffered from serious shortcomings, though in recent years structural reforms have picked up in the region.

● **High barriers to trade**

The need for trade liberalization is widely recognized, since greater openness strengthens the sustainability of a high growth path, creating a virtuous circle of higher and more efficient investment and growth.³⁹ However, until the successful implementation of more open trade policies in a number of countries in recent years, Arab countries undertook few

³⁶Algeria, Jordan, Egypt, Morocco and Tunisia.

³⁷The average for Jordan in 1990-95 is adversely affected by the exceptional developments in 1990-91; indeed, the current account deficit in 1996 was much lower, at 3 percent of GDP.

³⁸Alonso-Gamo, Fennell and Sakr (1996).

³⁹Sachs and Warner (1995).

trade liberalization efforts. Their trade systems have been characterized by high rates of protection, lack of transparency, and distortions, with the economies remaining relatively closed. While the average custom rates in the GCC are relatively low—as low as 5 percent in Bahrain and UAE—the trade regimes of the non-GCC Arab countries tend to be much more restrictive, with an average customs tariff as high as 30 percent in Egypt, Jordan, Libya, Syria and Yemen. The weighted average tariff rates in the Southern Mediterranean Rim countries are more than double the international average, and most of the region's non-oil economies have in place significant tariff and nontariff trade barriers (see Table 1).

The broadly restrictive stance of the region reflects in part the legacy of the inward-oriented policies pursued in the 1960s and 70s, when many Arab countries adopted development strategies aimed at import substitution and self-sufficiency goals that usually involved the imposition of extensive barriers to trade.⁴⁰ Excessive protectionism and distorted incentives led to production structures inconsistent in some cases with the comparative advantages of the individual countries. This resulted in turn in limited complementarity in the production and trade structures among the countries in the region, and hence little intraregional trade.⁴¹ Moreover, Arab countries have been slow to join multilateral liberalization initiatives. Only nine Arab countries have become members of the WTO with very high bindings.⁴² In the context of the WTO negotiations to liberalize maritime transport services suspended in June 1996, Morocco was the only Arab country that had tabled an offer.

Recent years have witnessed a trend for greater trade liberalization in non-GCC countries (Egypt, Jordan, Morocco and Tunisia), both in the context of the WTO and through the conclusion of bilateral Association Agreements with the EU. For many countries in the region, these agreements will help to broaden the opportunities for trade, by securing market access, anchoring reform and regulatory changes, enhancing credibility in countries' commitment to trade liberalization, and encouraging investment.⁴³ Furthermore, the financial assistance available from the EU to offset the costs of trade liberalization (including, for example, the loss of trade-related revenues) will be important in easing the resistance of domestic interest groups. These agreements can not only serve as a catalyst for reform, they also offer the potential to serve as a stepping stone towards more multilateral trade liberalization.⁴⁴ It will be important, however, to ensure that regional trade initiatives are compatible with further global trade liberalization.

⁴⁰Sachs (1996) and El-Naggar (1992).

⁴¹El-Erian and Fischer (1995).

⁴²Bahrain, Djibouti, Egypt, Kuwait, Mauritania, Morocco, Qatar, Tunisia, and the UAE are members. Algeria, Jordan, Saudi Arabia, Sudan, and Oman are negotiating accession.

⁴³Hoekman (1995) and Alonso-Gamo, Fennell and Sakr (1996).

⁴⁴Nsouli, Bisat and Kanaan (1995), Havrylyshyn (1996).

● **Underdeveloped financial markets**

In Arab countries, the existence of restricted and inefficient financial markets resulted in a low level of domestic savings, and fostered an inefficient allocation of resources, imposing an explicit/implicit tax on investment capital and lowering the rates of return. Market capitalization has remained low, especially compared with some other emerging markets. For example, Jordan had the highest rate of market capitalization as a percent of GDP in 1995, equal to 70.9, Egypt had 13.4, Morocco had 17.8, and Tunisia had 22.1.⁴⁵ In the same year, the rate for Thailand was 84.7, and for Chile 108.3. Restrictions on the establishment of foreign banks have limited competition and hindered the transfer of know-how and technology: for instance, while in Jordan there are basically no restrictions on private or foreign ownership of banks, in Egypt no more than 49 percent of a domestic bank can be held by foreigners; in Lebanon a foreign bank can open only one branch; and in Morocco offshore branches are allowed but can deal only with non-residents.

Few countries have stock markets (Morocco, Tunisia, Egypt, Jordan, Oman, Kuwait, and Bahrain). The stock market was reopened in Lebanon in early 1996, but activity remains modest. Even fewer countries have received credit ratings from international agencies, discouraging portfolio investments (Table 5). It is however encouraging that in 1997, the number of countries rated by Standard & Poor's grew to five, from zero in 1994—and three received investment grades. Several Arab countries (Kuwait, Oman, Qatar, Saudi Arabia, Tunisia and UAE) also received Moody's investment grade ratings.

Table 5. Credit Ratings, as of February 1997

	Moody's	Standard & Poor's
Bahrain	Ba1	--
Egypt	Ba2	BBB-
Jordan	B1	BB-
Kuwait	Baa1	--
Lebanon	Ba1	BB-
Oman	Baa2	BBB-
Qatar	Baa2	BBB
Saudi Arabia	Baa3	--
Tunisia	Baa3	--
UAE	Baa1	--

Source: MEED, February 14, 1997.

The Moody's ratings refer to long-term foreign currency bonds and notes (from D, C, Ca, and Caa: default rate; B and Ba: noninvestment grade; and Baa, A, Aa, and Aaa: investment grade.) Intermediate rankings range from 1 (highest) to 3 (lowest). S&P's ratings refer to long-term foreign currency credit (from C to CCC+: default rate; B- to BB+: noninvestment grade; and BBB- to AAA: investment grade.

⁴⁵Source: IFC Emerging Markets Database.

Over recent years, a number of Arab countries have embarked on sweeping reforms of their financial and banking sectors, in order to promote savings and both domestic and foreign investment, ensuring a more efficient allocation of available funds. Several countries are also taking steps to broaden and deepen their capital markets (for example, Jordan is now reforming the Amman Financial Market in an effort to create an efficient capital market; see also Bisat, 1996). Capital flows to Arab countries are already undergoing a healthy change.⁴⁶ Foreign direct investment has doubled to about US\$2 billion a year. Access to international markets has improved: Tunisia has been successful in issuing bonds in both the European and Japanese bond markets; Jordan issued a US\$50 million bond for its Telecommunications Company and is now considering issuing a US\$100 million Eurobond for its Phosphate Company; Egypt made a successful GDR placement in October 1996 and has been included in the IFC emerging market index; Lebanon has been able to place both sovereign issues and GDRs (related to its large reconstruction program); the divestiture program of the Kuwait Investment Authority has triggered the interest of foreign capital as well as the repatriation of some domestic capital. Equity mutual funds directed to the region, both of the country and regional varieties, have also experienced dramatic increases. In this context, timely dissemination of economic and financial information to domestic and international markets can play an important role in improving the magnitude and nature of capital flows.

- **A large and dominant public sector**

Large public sectors in Arab countries have tended to crowd out private initiative, and resulted in a lack of investment opportunities for foreign and domestic capital.⁴⁷ While investment ratios do help explain growth (Section IV), the excessive presence of the government in investment activities creates distortions, lowers competition, and typically hampers efficiency. Also, as the results in Section IV confirm, the presence of the government as measured by government consumption has a significant negative effect on growth. In this respect, Arab countries have tended to have the largest government sector among developing countries, although the government size has been declining over the years (Table 6). Within government consumption, wages and salaries in percent of GDP were as much as nine percentage points above the developing countries' average in the period 1980-90, and higher than even in the poorest sub-Saharan African countries, which calls for needed civil service reforms (See Table 6 and Chart 6).

Most significantly, privatization has made little headway until recently (Box 2). This is particularly important, since in many developing countries, privatization has attracted large capital inflows-both in terms of FDI (including initially through "anchor investors") and through domestic stock markets. Only recently is privatization taking hold in some Arab countries, both in the oil and non-oil economies, and is being accompanied by steps aimed at regulatory reform, including the opening up of certain sectors previously reserved for the

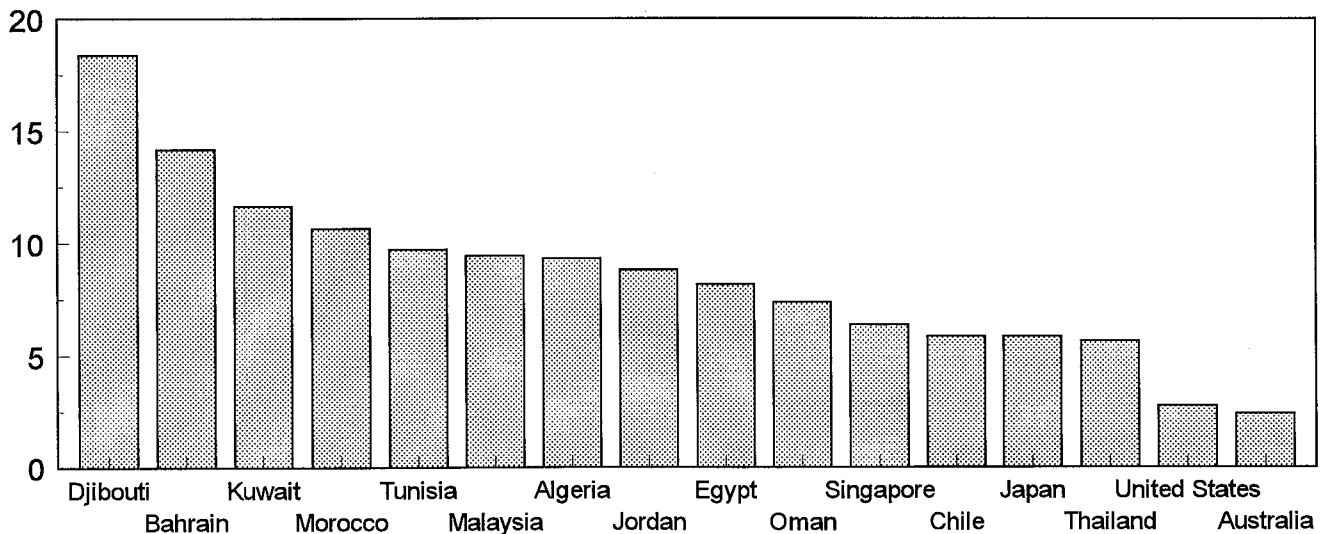
⁴⁶El-Erian and Sheybani (op. cit.)

⁴⁷Bisat et al. (1996).

Table 6
Government Size Indicators, 1980-90

	1980	1985	1990	Average 1980-90
Central Government Wages as Percent of GDP, Weighted Averages				
Industrial countries	4.7	4.2	4.4	4.5
Developing countries	5.1	5.1	5.1	5.2
Western Hemisphere	4.3	4.0	3.5	4.0
Sub-Saharan Africa	7.0	6.7	8.3	7.1
Middle East and North Africa	10.9	9.8	8.4	9.8
Far East and Central Asia	3.0	3.2	3.1	3.1
Central Government Expenditure as Percent of GDP, Weighted Averages				
Industrial countries	28.8	28.5	27.6	28.2
Developing countries	24.4	25.6	24.5	25.5
Western Hemisphere	20.4	24.5	26.1	24.8
Sub-Saharan Africa	26.3	24.7	27.9	25.9
Middle East and North Africa	39.0	34.2	26.1	34.3
Far East and Central Asia	21.1	22.4	21.1	21.5

Chart 6
Central Government Wage Expenditure
(As percent of GDP, Average 1980-90)



Source: Hewitt D. and van Rijckenghem (1995).

Box 2: Privatization in Arab Countries

Status of privatization program

- **Egypt** The privatization program has involved majority divestitures in many companies ranging from industrial, agricultural and construction sectors. The government is also taking steps to privatize one of its four commercial banks. Since July 1996, a cumulative of 38 companies have been sold, mainly through the stock exchange and sales to anchor investors, accompanied by sales to employees shareholder associations. Two privatized stocks are now listed on the London Stock Exchange. Foreign investment has been channeled mainly through specialized funds. It is estimated that in 1996/97 about 26 percent of the original market value of state-owned enterprises will be divested, equivalent to about US\$5.4 billion, or 6 percent of GDP).
- **Jordan.** The Government has embarked on a comprehensive privatization/sales of assets program that covers public enterprises as well as government shares in companies listed in the stock market, the latter held through the Jordan Investment Corporation (JIC), the government's holding company. An Executive Privatization Unit has been created under the Prime Minister Office. Regarding public enterprises, both the electricity and the telecommunications companies have been transformed into shareholding companies with a view to future privatization. Prospective sales also include 33 percent of the Cement Factory. The JIC intends to divest its shares in companies in which it holds less than five percent of total equity. Legislative changes are being introduced to ensure that all divestiture proceeds revert to the government.
- **Kuwait.** The Kuwait Investment Authority has sold shares in 15 companies and banks. The next step will involve the privatization of a number of public enterprises, including public utilities, Kuwait Airways Corporation and other smaller entities. In this regard, required legislative measures are being taken. The government is also considering providing certain services through management contracts.
- **Morocco.** The privatization program, inaugurated in 1993, has so far been successful, with a large number of sales of public entities ranging from financial holdings to hotels and industrial companies. The program has called for domestic and foreign participation, through public offerings, issues of privatization bonds granting priority to buy shares in future public offerings, and global depository receipts (GDR). Domestic participation has substantially increased and the stock exchange capitalization has risen. In May 1997, controlling stakes in two oil refineries were sold. This sale represents the largest privatization to date, with participation of foreign capital. In the infrastructure and public utilities sectors, private sector participation has been encouraged through build-operate-transfer (BOT) and build-operate-own (BOO) schemes.
- **Oman.** Privatization of the electricity and telecommunications sectors is now being studied carefully. Private sector participation is encouraged in sectors such as water distribution, power plants, roads and other infrastructure, and through contracts for collection, billing and distribution of public utilities. According to the MEED source, Oman is the most advanced Arab state in giving the private sector a role in infrastructure.
- **Tunisia.** A number of government assets was sold in 1995, including 15 percent of Tunis Air, followed by a number of sales of small public enterprises in 1996. Preparation is underway to invigorate the process by granting concessions to the private sector to provide certain services in infrastructure and public utilities. a number of important sales is slated for 1997.
- **U.A.E.** Privatization is being considered for some utilities companies and municipal services. McKinsey was appointed to study prospects for privatization in the water and electricity sectors.

public sector, and the relaxation of restrictions on foreign participation, notably for non-Arabs. Lowering barriers to foreign investors would result in growing flows from industrial country investors. If the process is to continue at a greater scale and contribute to attract foreign capital, capital markets will need to be invigorated *pari passu* with the privatization process. The broadening of the stock market and concomitant increase in FDI would in turn facilitate the expansion of privatization programs, including the extension to large scale utilities. A reluctance to allow private participation in the latter, notably in the telecommunications sector, might constitute a severe hurdle to global integration (see Box 3).

- **Deficient infrastructure**

Although policies of trade and investment liberalization are a necessary condition for increased integration, they are by themselves not sufficient. The drivers of globalization are companies, not governments.⁴⁸ Allowing foreign companies to operate in the domestic market implies making their business activities feasible. In this regard, the infrastructure of many Arab countries compares unfavorably to other fast-growing developing countries (see Table 7). Moreover, Arab countries have not been attracting new projects: between 1984 and 1995, 80 countries had about 600 new infrastructure projects, of which only 10 (mainly gas pipelines and communications) were in the Arab region.⁴⁹ To sustain growth, Arab countries will need to upgrade their infrastructure, especially in transportation, telecommunications and power supply. The challenge will be to do all this without unduly straining public finances or external positions. To this end, private sector participation can be very helpful, although some countries will need to increase the transparency of their regulatory regimes, break up monopolies and revise their pricing policies to phase out subsidies in order to attract substantial private interest in such investment. In this connection, Lebanon and Tunisia have started to implement build-operate-transfer (BOT) schemes with private investors in infrastructure, such as roads and power generation.

C. Institutional shortcomings

Institutional reforms are an essential complement to macroeconomic adjustment and structural reforms. Private investment needs a supportive and enabling environment where institutions are commercially oriented, and their activities are transparent, predictable, and sheltered from the political process. The lack of adequate institutions and legal framework for investment leads to a lack of transparency in the regulatory environment—which translates into a perception of higher risk and higher transaction costs. Arab countries suffer from substantial shortcomings in these areas (see Table 8). Similarly, investment and competition laws in the region are being overtaken by events. Economic globalization increases the impact

⁴⁸Riordan et al. (1995).

⁴⁹Smith et al. (1997).

Box 3: Arab Countries are Lagging Behind in Telecommunications

Only two Arab countries, Morocco and Tunisia, are party to the February 1997 WTO agreement on telecoms liberalization. The agreement, involving 69 countries, will open up 75% of the world telecoms market next year, and much of the remainder by 2003. With most governments in the region resisting telecoms liberalisation, Arab countries stand to lose significantly from the WTO agreement: telephone users in Arab countries not participating in the WTO market access arrangements will continue to pay high call charges, and network modernisation and expansion will be slow in comparison to the rapid developments elsewhere. Although telephone density is high in the Gulf, Arab countries as a whole account for less than 2% of world telephone revenue.

- **Egypt** The most populous Arab country has only 3 million telephone lines, equivalent to only five lines per 100 people, one of the lowest densities in the world outside sub-Saharan Africa. The National Telecommunications Organization (Arento), a state monopoly that has resisted calls for privatisation and liberalization, handles telephone provision. Instead of looking for private sector capital to expand and modernise the system, Egypt has relied on the United States Agency for International Development (USAID). USAID has provided US\$80 million to extend switching systems, much of it recycled to AT&T, which currently has two major contracts worth US\$50 million. Plans for a digital mobile phone GSM system were scrapped due to security concerns, although a more limited car- phone GSM system is being introduced. However, Arento has recently relaxed its monopoly position and allowed a new digital communications experiment in 200 Egyptian villages. A software-driven system, developed by Cyber Digital of New York, is being managed by a new Egyptian venture, the National Telecommunications Company, which is a subsidiary of the state-owned National Bank of Egypt. Although this remains second best to private provision, it does bypass the bureaucratic systems of Arento.
- **Morocco** was the first North African country to offer market access during the WTO discussions in April 1996. In Morocco, privatisation is well advanced and, as the country has only 1.2 million telephone subscribers out of a population of 26 million, there is much scope for telecoms expansion.
- **Tunisia** also made its offer to the WTO by February 1997. Until 1995, telephones were the responsibility of the Communications Ministry, but on January 1, 1996, an independent public company was formed, Telecoms Tunisie, which the authorities intend to privatise.
- **Jordan** intends to start selling shares in its telecommunications company that was transformed for this purpose into a shareholding company in 1996, but has been cautious in not giving a market access commitment to the WTO.
- **Saudi Arabia.** The posts, telegraphs and telephones Ministry is responsible for all developments, including the massive expansion of the digital network, with AT&T providing 1.5 million new lines under a 4 billion dollar scheme. Mobile handsets are expensive in Saudi Arabia, and the initial subscription fee is 800 dollars, one of the highest in the world.
- **United Arab Emirates** The Emirates Telecommunication Company (Etisalat) is already 40% privately owned by local nationals, who enjoy substantial dividends. There is a reluctance to see competition, but clients are generally satisfied with the level of service the monopoly utility provides, even though it is relatively expensive.

of national competition policies on international trade.⁵⁰ As successive rounds of trade negotiations have increasingly limited the scope for governmental measures that restrict or distort the conditions of international competition, attention now focuses on private sector measures which have a similar effect but are not subject to international rules.⁵¹ The issue concerns not just the treatment of goods at the border, but the treatment of foreign companies operating within the borders of a country.

Arab countries must improve the legal and regulatory frameworks to encourage competition, reduce market segmentation and oligopolistic structures, strengthen agencies responsible for enforcing property rights, and enhance antitrust and prudential regulations. Regional institutions and initiatives could also play important role, as illustrated by the EU Mediterranean strategy, by providing and anchor for participating Arab economies, providing incentives for “deep integration” in a number of areas, and enhancing policy coordination among the countries in the region.

D. Socio-political obstacles

A number of socio-political factors inherent to the Arab region have also contributed to the poor growth performance. First, demographic developments matter, and the high population growth rate of the region strongly conditions policies.⁵² Second, despite the relatively high expenditure on education, it has not been very efficient.⁵³ If a low quality of education prevented the rapidly growing labor force from being internationally competitive, it could prove a serious constraint on the adaptive capacity of the Arab countries to participate in the global system. While primary and secondary school enrolment rose during the 1970s and 1980s, progress since then has not been even, with dropout rates from secondary school at around 25 percent. According to UNESCO, only 11 percent of people in Arab region aged between 18 and 23 are enrolled in universities, compared with 76 percent in the U.S. Illiteracy rates remain high, especially for females. The creation of well-targeted social safety nets that protect the most vulnerable sectors of the population, and expenditures on basic health and education, not only contribute to improve human capital and thus facilitate integration, but

⁵⁰ Ruggiero (1995).

⁵¹The link between trade and competition policy is under discussion by WTO members in the basic telecommunication negotiations.

⁵² According to Levine and Renelt (1992), one percentage point increase in the growth rate of population reduces per capita GDP growth by about half a percentage point. On the other hand, the rate of population growth may decline with an increase in the rate of output growth.

⁵³Shafik (1992), and van Eeghen (1997).

Table 7. Infrastructure in Arab Countries

	Electric power (kwh per person)	Phone lines (per 1,000 persons)	Road density (km per million persons)	Rail traffic units (per thousand US\$ GDP)
1992				
Egypt	849	39	633	465
Morocco	383	25	179	125
Jordan	1,120	71	1,767	74
Tunisia	731	45	2,080	119
Algeria	701	37	2,403	76
Oman	2,729	74	2,992	...
Saudi Arabia	4,417	93	3,601	...
Kuwait	8,924	245
UAE	9,917	321	2,706	...
Singapore	6,353	415	993	...
Chile	1,646	94	808	...
Argentina	1,670	123	1,856	120
Thailand	1,000	31	841	48
Korea	2,996	357	1,090	146
Malaysia	1,612	112	...	30
United States	12,900	565	14,553	344
Japan	7,211	464	6,426	147

Source: World Bank Development Report (1995).

Table 8. Arab Countries: Liberalization of International Financial Relations.

Countries	Investment Code		Article VIII status	Capital account Liberalization 2/
	Year of last revision	Adequacy assessment 1/		
Algeria	1994	Moderate	No	Few
Djibouti	1994	Moderate	Yes	None
Egypt	1997 3/	High/Moderate	No	Few
Iran	1996	Low	No	Many
Jordan	1996	Moderate/High	Yes	None
Kuwait	--4/	High	Yes	None
Morocco	1995	High	Yes	Few
Saudi Arabia	1959	Moderate	Yes	None
Sudan	1995	Moderate	No	Many
Tunisia	1993	Moderate	Yes	Many
United Arab Emirates	1991-1996	High (Dubai) Low (Abu Dhabi)	Yes	Few

1/ The assessment reflects whether the investment code is appropriate to attract foreign investment (high, low and moderate). In particular, a qualification of "Low" indicates that high restrictions are imposed on foreign investors.

2/ This reflects the number of restrictions that remain on financial capital movements (many, few, none).

3/ Currently before Parliament (as of April 1997)

4/ There is no investment code.

may also promote growth directly.⁵⁴ Investing in human capital, especially of the poor, would pay high dividends in terms of both growth and welfare.⁵⁵

⁵⁴Alonso-Gamo and El-Erian (1996) discuss this issue in relation to Arab countries. See also UNDP (1997b).

⁵⁵UNDP (1997a).

Third, political tensions in the region have hampered trade.⁵⁶ Progress in the regional peace process can play an important role, by fostering political stability and promoting regional projects.⁵⁷ The rediscovery of the Middle East by tourists in 1995, when it became the fastest growing tourism destination in the world, can be linked to the improvement in the political climate. Although tourist arrivals to the region represent only about 2 percent of international tourist arrivals, they grew by 11.8 percent in 1995, while receipts increased by nearly 30 percent. In Egypt, with 80 percent of tourists to the region, revenue increased by 95 percent to US\$2.7 billion and arrivals to 2.8 million, a growth rate of 27 percent. Large gains in tourism were also reported by Jordan, Bahrain and Lebanon, while the Gulf states continued to diversify their economies through tourism.⁵⁸ A more cooperative environment would contribute to regional integration as a first step to multilateral integration.

Finally, the lack of the necessary political will to bear the short-term costs of trade liberalization, including the unavoidable restructuring, has been an important impediment to reforms.

VI. CONCLUDING REMARKS

Globalization is a complex phenomenon that is shaping our future. While it offers unprecedented opportunities for countries that act swiftly to grasp them, it simultaneously heightens the opportunity costs for countries that are lagging behind and thus risk becoming marginalized. Globalization has important implications. First, as distinctions between international and domestic policies become less relevant, sound domestic policies acquire key importance. With greater reliance on private sources of finance it is essential to retain the confidence of international capital markets. Second, managing globalization represents a challenge in social terms: globalization causes tensions between the market and broad sectors of society, those who bear the initial costs or are less well equipped to benefit. Governments face the task of managing the transition and dealing with the distributional consequences of change, given that attempting to stay away from the world marketplace is not a viable option. Since globalization is unavoidable, the only issue is what domestic policies to adopt in order to adapt to the realities of change while minimizing the social costs.

In this new environment, Arab countries must make important choices: they have much to gain from globalization, but in order to reap a proportion of the worldwide welfare

⁵⁶Conflicts related to interest and security concerns have significantly undermined progress in economic cooperation—including in trade—within the region, and with the rest of the world. For details on the political economy of Arab economic cooperation see Perthes (1996). Shafik (1994) discusses the reasons underlying the disappointing progress in promoting regional cooperation and suggestions for achieving success in the future.

⁵⁷El-Erian and Fischer (1996)

⁵⁸World Tourist Organization Annual Report, 1996.

enhancing benefits of such global integration, they will need to act rapidly to adopt more outward-oriented policies and increase the flexibility of their economies. In order to rise to the challenge of globalization, Arab countries should:

- foster sustainable, noninflationary growth by pursuing appropriate macroeconomic policies, to ensure that the region remains competitive and is able to attract investment for the development of a more diversified productive structure;
- adopt other supportive structural reforms to increase the efficiency of the productive sector, with special emphasis on the development of a modern telecommunications and transport infrastructure and open and efficient financial markets. Globalization demands more of governments. Firms face more competition. They need clear rules, a stable environment, access to imports, efficient infrastructure, and freedom from red tape;
- seek to promote investment, particularly FDI, Measures that liberalize trade need to be accompanied by complementary policies that liberalize FDI. by increasing the transparency of the domestic economic and regulatory environment, including by adopting investment codes that conform to international standards, while eliminating restrictions that inhibit the efficient allocation of resources among sectors;
- participate fully and actively in multilateral initiatives, especially by making substantive pledges to implement trade liberalization. Full participation in the WTO, including ambitious commitments to roll back protectionist barriers in areas going well beyond trade, would contribute to lock in reforms and enhance credibility;
- achieve greater intra regional integration and policy harmonization by promoting FTAs among Arab countries. Such agreements would help to avert the adverse impact of the hub-and-spoke structure of trade that could develop under the EU-MED initiative, and would boost merchandise trade, enhance service flows, and encourage intra regional investments;
- endeavor to promote confidence in their economic environment and reduce risk perceptions by adopting appropriate external debt management strategies with a view to reducing the debt and debt-service burden, including through prudent new borrowing on favorable terms and agreements on debt-equity and debt for nature swaps; and, finally,
- strive to minimize the short-term transition costs of global integration by undertaking complementary reforms, especially the establishment of well-targeted social safety nets and measures to enhance human capital. Policies that contribute to increase the number of “winners” would not only facilitate trade liberalization and structural reforms, but also promote social cohesion and foster growth.

If Arab countries are willing to implement these policies, they will be able to improve resource allocation, attract investment, and achieve higher productivity levels and accelerated economic growth. The ability of Arab countries to garner the potential gains from globalization will depend primarily on the quality of their domestic policies. Such quality will indeed be critical to the speed of both integration and growth, given the mutually reinforcing

relationship between the two, since policy reforms designed to increase an economy's growth and stability are likely to influence a country's speed of integration both directly and through the effect on growth. However, the global community may also take steps that would facilitate such integration by: entering trade agreements that would stimulate exports from Arab countries and intra regional trade; encouraging transfers of technology; and granting financial assistance, including through debt swaps. The Euro-Med initiative of the European Union represents a significant step in this direction. A successful integration of the Arab countries into the world economy would help them to achieve their objectives of reducing unemployment, increasing job opportunities for new entrants to the labor market, and improving the living standards of their populations.

REGRESSION METHODOLOGY

The regressions estimated postulate a relation between long-term per capita growth rates and a number of variables assumed to be proxies for the main growth determinants. This approach is therefore different from the standard growth accounting methodology used for a single country which relates growth to the production factors (capital and labor) under some assumptions on the production function (generally a Cobb-Douglas) that prevails in the economy. Under the accounting methodology, the estimation of the production function and the actual value of production generates a residual that is called the total factor productivity or Solow residual. This residual is extremely important in the growth process since it is the ultimate growth determinant and explains how countries incorporate technological progress. However, the estimates of the residual are very fragile, and small changes in the value of parameter in the production function may have a great influence on its value (see Sarel 1995). Moreover, the accounting framework does not say anything about the macroeconomic determinants that affect total factor productivity.

Some studies, in an attempt to shed some light on the factors that could influence the evolution of total productivity or Solow residual, have directly regressed the residual on some variables thought to affect the technological process. This is the approach of Coe et. al. (1995) in their study on the spillover effect of R&D in industrial countries on developing countries.

The approach adopted in this paper tries to capture at once the effect of *all the major* growth determinants in a group of countries, on the assumption that there is a theoretical model that fits the reduced equation. This approach—used in many recent studies—also allows us to examine the role of policies in stimulating growth.¹ The estimated relation is as follows:

$$y_{it} = \gamma_i + Bx_{it} + e_{it}$$

where i represents a country and t each observation for the five-year averages. γ is a parameter specific to each country. The dependent variable, y is the GDP per capita growth rate and x is the vector of the explanatory variables including the intercept.

The method used to estimate the parameter was the error components model or random effects model, in which γ_i is supposed to be a random variable. The estimation was then performed using the GLS (General Least Squares) technique to obtain the best linear unbiased estimators. However, it is important to test for the good foundation of the specification: in particular, if γ_i were to be correlated with x_i , the GLS estimators would be biased. Accordingly, a Hausman test was performed to verify that γ_i was uncorrelated with the regressors and in most of the regressions the null hypothesis was not rejected—e.g the hypothesis of random effects was not rejected at the usual significance levels (in the equation shown in Table 4, the P value was 20 percent).

¹See, for instance, Barro and Sala-i-Martin (1995).

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