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Arab Economies at a Tipping Point

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The Arab world is experiencing an economic boom of historic proportions. The tiny Persian Gulf emirate of Dubai is emblematic. Boasting the world's only 7-star hotel, its massive land reclamation project, allegedly the only manmade structure visible from the moon, is whimsically creating parcels shaped like continents and palm trees. With oil hovering around $90 a barrel and the Egyptian stock market up 1,800 percent in the last five years, one might ask what problems does World Bank President Robert Zoellick perceive that would justify making the economic revitalization of the Arab world one of the cornerstones of his new administration.[1] Look beneath the surface, however, and Zoellick's judgment might not seem so misplaced.[2]

The boom is being felt unevenly across the region. Two-thirds of Arabs do not live in major oil producing countries. Looking forward, the key issue over the next decade is the ability of these economies to generate jobs and rising living standards for the millions of young people joining the economy. Today the region has the world's lowest employment rate—less than half of adults are formally employed. Yet throughout the region, labor forces are growing at a rate of 3.5–4.0 percent annually, posing a significant challenge for job creation. The World Bank estimates that the Arab world will have to create something on the order of 55–70 million jobs over between now and 2020 to keep pace and bring the rate of unemployment down to the global norm.[3]

On the back of commodity boom of the last five years, growth in the region has accelerated, and measured unemployment has come down, dropping several percentage points to around 11 percent. But underneath this good news is cause for concern.

Estimated unemployment for young people aged 15–24 is more than 25 percent—roughly double the world average.[4] Moreover, unemployment is associated with educational attainment. In Egypt, for example, unemployment among college graduates is almost 10 times that of people with primary educations and appears to be increasingly an urban phenomenon. While this phenomenon of greater unemployment among the more educated has been documented for four decades and can be interpreted as a rational search for jobs that reward effort, the governments of the region cannot find solace in the rationality of the process—those not finding work may still pose a political risk. And as the locus of employment has shifted from the public to the private sector, female graduates appear to have had a particularly difficult time gaining a toe-hold in the job market.

The unemployment rate is down in most, though not all countries. But in some countries most of the new jobs have gone to foreigners. In the smaller Gulf countries, with their modest populations, this is not particularly surprising, nor necessarily a bad thing: It is unlikely that they could generate from the indigenous population all the specialized skilled labor to support the boom. But this phenomenon is not limited to the Gulf—in Jordan, most of the new hires have been non-nationals, as garment manufacturers import labor from South Asia rather than employing locals. And the prominence of foreigners in employment is higher in the private sector—the hoped for source of economic dynamism moving forward—since local nationals are employed disproportionately in the public sector.

The headline numbers disguise underlying labor market problems, particularly in the Maghreb. Much of the official job growth numbers are accounted for by public works employment, agriculture, where productivity is declining, and the liberal classification of informal home work and cottage industry activity as employment. With some exceptions, employment has not been growing in industries where productivity is increasing—that is, it does not appear to reflect an expansion of activity in rising dynamic sectors.

In short, the region faces a demographic imperative to create jobs. This is not a conjectural forecast—the members of this population cohort are already going through school and many have already entered the labor force. Given the brittleness of the region's political regimes, the mass of unemployed, educated young people represents a potential threat to political stability.

Yet the region is also currently experiencing the most rapid economic growth in a generation. In effect the region faces a contest between two opposing forces—the demographic pressure to create jobs and the capacity of the economy to absorb new entrants productively, and it is an open issue as to which will prevail. The key issue is how much of the recent growth acceleration—generated in large part by commodity and asset market booms—is permanent and how much is transitory. In short, will the future look more like the last five years or the last 50?

Opportunities and Challenges Posed by Globalization

One method of rapidly creating a sustainable increase in employment is through an expansion of labor-intensive manufacturing or services exports, often in conjunction with foreign investors or local entrepreneurs integrating into global supply networks.
The region's long-term track record on this score is not promising however, and with the rise of China, India, and others, the competitive pressures embodied in the global marketplace are increasing.

The data are spotty, but it appears that broadly speaking the region has experienced over the past few decades a secular decline in its global share of in almost every indicator of cross-border economic activity. In recent years the downward trend has been reversed on a number of indicators such as share of world trade, manufactured exports, or direct investment. Yet as in the case of the headline employment numbers, looking below the surface raises cause for concern: The turnaround largely reflects the increased energy prices.

The rising price of oil almost tautologically results in a growth in the region's share of world trade. But even the manufacturing and investment figures are oil-linked. The region accounts for less than one percent of global manufactured exports. This figure has been rising for the last several years, but its growth is driven largely by Gulf countries moving downstream into energy intensive products such as refined oil, fertilizer, and aluminum smelting. These may be regarded as positive developments for those economies. The concern is that these activities are among the weakest employment generating industries because of their reliance on almost totally automated production processes. And from a regional perspective, this development is occurring in relatively small population countries where many of the jobs will be filled by labor imported from outside the region.

To put the good news in some broader perspective, oil-producing Indonesia, the world's largest Muslim country, has roughly twice as many people employed in manufacturing today as the entire Arab world, though having 100 million fewer people. Thailand exports more manufactures than the Arab countries—despite having one-quarter the population.

Similarly, the growth in investment is largely due to intraregional petrodollar recycling, possibly boosted by an increase in "home-bias," or preference for one's own region, in the wake of the 9-11 attack, and concerns about potential Western restrictions on Arab investment. Egypt, after experiencing a 12-fold increase in foreign direct investment (FDI) between 2001 and 2006 became the first Arab country to sign the Organization for Economic Cooperation and Development's (OECD) Declaration on International Investment and Multinational Enterprises. Yet Sweden, population 9 million, continues to attract more direct investment than Egypt or any other Arab country. Much of this intraregional investment has gone into hotels, real estate, and other internationally nontradable sectors, however, and this kind of investment is less likely to bring in new technology or help local firms integrate into global supply networks than industrial investment derived from more heterogeneous sources might convey.

Finally, the run-up in energy prices has implications even for the nonoil producers in the region. Named for the discovery of natural gas in the North Sea off the coast of the Netherlands in the 1970s, "Dutch disease" refers to the tendency of the real exchange rate to appreciate during commodity price booms rendering traditional industries internationally uncompetitive. What appears to be occurring in the Arab countries is that educated young people are in effect playing the lottery—remaining at home unemployed waiting to either land a high-paying job in the oil patch or a visa which would permit emigration to Europe or North America. The rise in oil prices confers "Dutch disease"–like effects on the nonproducers in the region through the labor market, putting a floor underneath wages. Local employers cannot hire labor at what would otherwise be the normal local rate because of the prospect of higher income employment elsewhere.

In short, the indicators are pointing the right direction—but are rising from a modest base. A growth of per capita income of 5 percent implies an increase of $200 if you have a typical Egyptian's income of $4,000, while an increase of 1.5 percent yields a $450 increase in an EU nation whose income is $30,000 per person. The absolute gap among nations increases and in the presence of satellite TV, the Internet, films, and a large emigrant population already living abroad and phoning or visiting home, the relative disparities are noted and painful and underline the perceived plight of these nations. Things are heading in the right direction, but there is an awful lot of catching up to do—and the demographic clock is ticking.

Reform with Arab Characteristics

The key issues involve a nexus of microeconomic issues, policies, and practices, centered on globalization, technology transfer, and local adaptation and diffusion of technological innovations from abroad. Governments throughout the region are grappling with these challenges with varying degrees of enthusiasm and success. Egypt, for example, exhibited a major jump in the World Bank's most recent "Doing Business" survey, but still ranks in the bottom third of the sample.[5]

The region has weak links to global technology whether through the importation of capital goods (which embody technological advances from abroad), cross-border investment, integration into transborder supply networks, technology licensing, or the indigenous production of internationally recognized intellectual achievements. Relatively weak intellectual property rights protection and state domination of the oil industry have retarded technology transfer and absorption. The Philippines, roughly the size of Egypt, reports more technology royalty payments—an indicator of technology importation—than all Arab countries combined. The emigration of homegrown talent, the "brain drain" as it is colloquially known, is a major issue. Outside of the extractive industries and tourism, where geology or special attractions like the Pyramids confer unique and irreproducible advantages, the neural synapses that would link the latent productive possibilities of the Arab people with the goods and services demanded in the global market are attenuated.

Strengthening these linkages is a formidable challenge. Yet a significant characteristic in the growing documentation of this phenomenon are the large intraregional variations in many institutional and microeconomic indicators. For example, according to World Bank data, it takes three times as long to start a business in Saudi Arabia as it does in Morocco and nearly three times as long to enforce a contract in Egypt as it does in Jordan.[6] This heterogeneity has two important implications. First, it suggests that whatever the causes that are generating these outcomes, they are unlikely to be "deep," residing in Islam, the dominant religion of the region, or Arab culture as some have suggested. Second, the payoffs to achieving "best practices" regionally defined could be quite large in some cases. Of course, ultimately one wants to meet a globally defined standard. But as a first step, much may be gained by simply matching one's immediate peers. Egypt does not have to turn into Norway.

Yet while Islam may not explain economic outcomes in a direct sense that does not mean it is irrelevant. It is the spiritual lens through which many of its people comprehend reality. And it is relevant to how the people of the region assess globalization.

Moreover, unlike issues of macroeconomic policy management—where policy change can be implemented by a relatively small number of centrally placed technocrats and is subject to relatively straightforward feedback mechanisms to facilitate benchmarking progress—addressing the institutional weaknesses requires a much more prolonged and uncertain slog. By implication what is required is a customized reform agenda (and associated political strategy) for each country—the opposite of cookie-cutter economics.

One commonly used tactic around the world today to achieve such goals is to make use of international agreements, either to influence the domestic debate over economic policy, or as a binding mechanism to enhance the credibility of domestic reforms. However, historically Arab governments have made little use of such tactics—trade opening itself was disfavored insofar as import licenses, monopoly rights, and other state interventions were a convenient way to generate rents which could be used to build domestic political coalitions. (In this regard the energy exporters have been advantaged—resource extraction was a natural source of rents and the creation of distortions which could be used to confer favors was unnecessary.) A shift in attitudes has been evident recently, yet Arab governments remain relatively hesitant to grasp the opportunities offered by the global economy.

In part this reflects the ambivalence of both elite and popular opinion with respect to globalization. Polling conducted by the Pew organization found that while popular attitudes in the Arab world do not appear to be “anti-market” as some have alleged, they are not particularly supportive of the process of globalization on existing terms.[7] To be sure, Arab publics are not unique in having qualms about globalization. Support for globalization is fading among Americans at both the elite and popular levels as well. But Arabs appear to exhibit greater skepticism than any other group, and what is at issue is how these attitudes may constrain policy, even in authoritarian political systems.

In a poll conducted by Zogby International in Egypt, Jordan, Lebanon, Morocco, Saudi Arabia, and the United Arab Emirates, majorities in four of the six countries supported governing business by sharia law, with pluralities in all six countries agreeing that sharia required further interpretation to enable businesses in the Muslim world to integrate into the global economy.[8] Such considerations are not of mere theoretical interest: Perceived inconsistencies between World Trade Organization (WTO) rules and local interpretation of sharia played an important role in delaying eventual Saudi Arabia’s accession to that organization.

The views elicited in the Zogby poll could be interpreted as forming a coherent basis for adapting the demands of globalization to local values, and one can imagine an alternative set of institutions and practices that would deliver the benefits yielding reform with Arab characteristics, to paraphrase the Chinese experience. Islamic finance might be an example. But the Washington Consensus it is not.

The signal extraction problem is complicated by the region's pervasive political authoritarianism: It is not clear how the policies and practices embodied in the status quo map to the true underlying preferences of the citizenry. Such considerations presumably explain at least partly why the region has been relatively slow to grab the external anchors offered by global and regional institutions.

At issue is how to manage alternative policy options. The polling data reveals modest public support for the WTO and more for intra-Arab agreements. The problem is that the WTO is becoming unwieldy, and while membership may act as a policy anchor, it is unlikely to spur much additional reform in the foreseeable future. Intra-Arab agreements are more popular but they have a limited capacity to deliver benefits: The extent of intraregional economic integration is modest, and such agreements may not confer the degree of credibility that an enforceable agreement with a larger partner would.

That leaves the European Union and the United States as the remaining significant potential partners. Both have entered into preferential agreements with Arab countries, but the nature of those agreements differs significantly. The European agreements tend to be relatively vague and focus on access issues with respect to merchandise trade. In contrast, the free trade agreements signed with the United States are detailed documents covering not only merchandise trade, but also services, investment, government procurement, intellectual property rights, and other issues and establishing mechanisms for enforcement. A sense of the differences between the two approaches can be gleaned by simply comparing the length of the comparable documents: The American free trade agreements with Jordan and Morocco are more than four and ten times longer respectively than those countries' equivalent agreements with the European Union. The difficulty of course for the Arab governments is "no pain, no gain:" the relatively intrusive agreements with the United States may have the biggest economic payoffs but may also be the most problematic in domestic political terms.

Where's the Beef?

Suppose requisite policy changes were effected, implemented through local initiative, perhaps tethered by external anchors. The proof of the pudding is in the eating. From where will the supply response come? For heuristic purposes one can think of three potential channels: local entrepreneurs, foreign investors, and returnees from abroad.

At present we do not have a very good systematic grasp of entrepreneurship in Arab economies. Survey work is ongoing at the World Bank, and our own analysis suggests that there is no reason to believe that the Arab world suffers from a dearth of entrepreneurs, though there are outstanding issues regarding their technical aptitude and the business environments in which they operate. Specifically we do not know if the tendency of local entrepreneurs to concentrate in internationally nontraded sectors, such as retailing and real estate, reflects an lack of technological skill that would allow them to enter industrial activities, or whether it reflects aspects of local policies and practices that may effectively discourage high-value fixed investment which could be subject to expropriation, formally or informally.

The absence of technical skills hypothesis is not implausible: Arab students have generally not performed well in a variety of international comparisons of educational achievement, including the most recent Trends in International Mathematics and Science Study, a quadrennial survey of achievement among eighth graders. No Arab university makes the *Times of London* ranking of the world's top 200 universities; in the most recent Shanghai Jiao Tong University ranking, Cairo University was the only university in the Arab world to make the top 500.[9]

Such weaknesses have not gone unnoticed: Emirate of Abu Dhabi, for example, has reached an agreement with Singapore's National Institute of Education to provide teacher training. Improving teacher quality is a particular concern insofar as the prevalence of gender-segregated education in the Gulf means that there are sometimes shortages of male teachers for boys, with a consequent lowering of standards. In terms of higher education, there has been a proliferation of subscale Western university branch campuses in the Gulf many of which may well not survive the next downturn in energy prices, as well as the initiation of massive projects to create new universities and science cities. The latter could conceivably become centers of commercialized science along the lines of Taiwan's Hsinchu Science Park or Institute for Technical Research and Innovation or California's Silicon Valley, attracting scientists from across the Arab world lured by the modern facilities and the safe and congenial environment. But even if these initiatives successfully come to fruition, their impact is years away.

However, if the particular manifestations of entrepreneurship are due not to a lack of skills, but rather reflect an endogenous response to concerns about predation, this could set up a dynamic in which the traded-goods sector is dominated by foreign investors, for whom local operations in the host country are but one component of a more diversified asset portfolio, and as a consequence may be less risk averse than indigenous entrepreneurs. This relatively reduced sensitivity to risk may be further reinforced if the foreign investor has political clout through their own governments that indigenous entrepreneurs lack. It may also be the case that that foreign investors pose less of a threat to incumbent political regimes precisely because as foreigners they have less of a stake in local politics.

All of these considerations would generate expectations of relatively high levels of foreign involvement in the industrial sector, but in fact we observe the opposite. The region as a whole appears to be characterized by relatively high subjective risk assessments on the part of investors, driven by a variety of concerns. Yet there is considerable intraregional variation across the relevant indicators, implying that for a number of the region's economies, simply meeting the best practice standard, regionally defined, could imply substantial increases in foreign investment. For example, one counterfactual calculation suggested that reducing the perceived political risks to "best-practice" levels observed in other developing areas outside the Middle East, would imply a near doubling of FDI for Jordan and Lebanon.[10]

A final source of supply response could be through a reversal of the brain drain, a development that could benefit Arab economies in two ways. First, returnees who received training or work experience in more advanced institutions abroad represent a potential synaptic link between local economies and the opportunities presented by the global economy. Second, even if returnees do not establish new high-technology firms, simply reversing the brain drain, as has occurred in Ireland, for example, over the past generation, would amount to raising the social rate of return on educational investment, conceivably by a significant margin.

Is this plausible in the Arab context? US and Canadian census data depict highly accomplished North American Arab communities, exceeding their neighbors in educational attainment and wealth, sometimes by considerable margins. The share of Canadian Arab women with college educations is twice that of Canadian women as a whole, for example.

Yet while the North American Arab community is highly accomplished, it is not representative of the countries of the region. Lebanese and Egyptians are disproportionately represented, as are Christians. The Arab community in Europe is larger, and, given geographical proximity, might be a more natural source of stimulus. Unfortunately, this group appears to be much less educated and professionally distinguished than its counterpart community in North America.

The existence of a pool of potential returnees is a necessary, but not sufficient, condition for this conduit to jump-start economic activity. To reverse the brain drain potential returnees must be convinced that they and their families will be physically safe and not subject to economic predation. Taiwan, where the modern high-technology sector was in significant part established by returnee scientists and engineers, actively sought to reverse the brain drain, by providing overseas nationals incentives to return home and establish high-technology businesses. How would Arab governments today welcome an influx of skilled people who had spent significant time abroad?

Political Risk

Lurking beneath the surface with respect to nearly all of these issues is politics. While the region’s contemporary economic performance may not be distinctive, its enduring political authoritarianism is. Obviously, the denial of freedom to local residents is the most fundamental concern. But the possibility of abrupt political changes has implications for economic performance as well, by raising the risk premium on investment in the region, and impeding the development of deeper ties with the global economy.

The situation is ironic in certain respects. Over the last two generations the region has achieved improvement on a wide range of social indicators, such life expectancy, infant mortality, literacy, and educational attainment, spectacularly so in some cases. Neither absolute poverty nor inequality (in the nonoil countries) is high by global standards.

Despite these achievements polling data from a variety of sources does not depict a particularly contented population. The pattern of responses suggests that this discontent relates principally to concerns over employment and a lack of political voice. The former reflects not only apprehensions about the respondents' material well-being but deeper anxieties relating to the importance of gainful employment to both self-respect and one's public status. The latter reveals frustration over an inability to effect improvements.

The region's apparent stability may mask brittleness, however. A common tactic by incumbent governments of weakening the possibility of moderate, secular dissent has contributed to delivering an opposition with an increasingly religious cast, presumably on the calculation that confronted with such a choice, the public's reaction will be "better the devil you know." Paradoxically, this lack of political dynamism in the face of underlying social change together with the increasingly religious orientation of the political opposition raises the possibility of abrupt transitions.

Such deep political uncertainty discourages behavior that involves irreversibility—from fixed investment to a decision to give up established positions in the West and return home—and creates the possibility of a self-reinforcing downward spiral. Intermittent terrorist incidents, such as the assassination attempt against Algerian leader Abdelaziz Bouteflika, allegedly by an al-Qaeda affiliate, or bombings in Morocco and Algeria, further elevate the risk premium. For countries like Algeria, Morocco, and Egypt, reducing the business costs of terrorism to Jordan's level, could boost foreign investment 20–30 percent.[11] The United Arab Emirates, which has been in the forefront of many reforms, is the US Navy's most frequent foreign host. This military cooperation together with the social openness of freewheeling Dubai presumably pose an affront to the jihadis and make even these bright spots potentially vulnerable. And it goes without saying that Iraq and the Palestinian territories face profound challenges.

Conclusions

In sum, the central economic challenge confronting the Arab world today is how to provide employment for the large numbers of young people entering the labor force. Achievement of this objective requires the rapid expansion of labor-intensive activities on a sustainable basis which in turn necessitates a more successful integration into the global economy than has been witnessed to date.

That process of successful globalization is inhibited by the region's reputation as a risky business environment, due in part to deep uncertainty about the future of many of the region's political regimes. Economic and political uncertainty and risk thus lie at the heart of the region's challenge. The critical unknown is the future trajectory of energy prices. It is possible that if energy prices remain sufficiently high and global growth remains sufficiently robust, then the inflow of petrodollars could be so large that sheer volume of capital circulating within the region would be sufficient to enable the challenges outlined to be papered over. Adequate rents would exist to keep everyone happy, and problems could be addressed by simply throwing money at them. We doubt that this Panglossian outcome will obtain, particularly for the two-thirds of Arabs who are not citizens of major oil producers, but cannot dismiss its theoretical possibility.

Instead, we are more likely to confront an environment in progress on nexus of institutional and microeconomic issues relating to local technological capacity and links with rest of the world is key. The underlying issues are multifaceted, and given the uncertainty with respect to the payoffs to specific changes, reforms may be relatively difficult to "sell" politically. The process of reform in the Arab economies is likely to be prolonged with many people and groups making many incremental changes, rather than a program that can be implemented decisively by a small group of technocrats.

If progress is insufficiently rapid to address the underlying imperative to create jobs, it is not difficult to envision the region caught in a vicious circle where impoverishment, discontent, militancy, and repression feed upon one another, deterring reform and impeding growth. The risks of internal political violence or the externalization of discontent are obvious. Even without upheaval, a widening economic gap between the Arab world and the industrial countries, particularly nearby Europe, would create enormous incentives for transborder migration, much of it illegal, and contribute to tensions with and among the countries of the European Union.

Yet this is not the only possible future path. If the region's daunting employment challenge can be successfully addressed, the region's demographics could turn from a potential liability to a valuable asset. The Arab world could reap a demographic dividend as the new generation enters its most productive working years—a phenomenon that contributed to the outstanding performance of East Asia over the past four decades or so. Growing prosperity, confidence, and optimism about the future could underpin movement toward greater political openness and social tolerance. The region's young demographic could then turn from a potential liability to a bonus.

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