April 29th: the Arab World
• The region is important as a source of global energy supply.
• Important geopolitically.
• Above all, its development prospects are important for a region that will soon have 200 million workers and well more than half a billion residents.
There are a number of different definitions of the relevant region:

- Some discussions focus on the Middle East.
- The UCB course catalog uses the older terminology preferred by archaeologists and historians and dating from the 1890s (when there was also a Sino-Japanese conflict in the Far East), referring to the Near East.
- World Bank refers to MENA (Middle East and North Africa).
- Noland and Pack, in the book assigned for today, consider MENA ex Iran, Iraq and Kuwait.
- Others leave out Israel, either because its economic and political structure are so different or for reasons of political correctness.

- This is the UN’s version of the region.
Outlines of economic performance

• The region fell behind Western Europe and the United States during the 19th century (the period of their industrial revolution). Recall that this was the great divergence.

• The economy in this period was based on agriculture, some light (handicraft) industry, and large amounts of trade/commercial activity.
Outlines of economic performance

- Economic performance then improved slightly in the first half of the 20th century.
- Growth roughly matched that in the advanced industrial countries (which itself was less than superlative, as we have seen in previous lectures).
- Again, this is evident in the previous slide, where there is no more divergence vis-à-vis the US and Europe between 1913 and 1950.
Outlines of economic performance

• But the exceptional period is 1950-73, when per capita incomes grew by 4 per cent, outstripping the advanced countries and, indeed, any other region.

• So the idea that this region has some intrinsic inability to grow is at odds with the data.
Strong growth and after

- This favorable performance was based on a favorable global environment (strong global growth), exploitation of natural resources (oil exports increased greatly in volume, though not yet in price), import-substituting industrialization, and heavy state planning.
- But growth deteriorated subsequently, to barely 1% per annum in per capita terms in the fourth quarter of the 20th century. Only Africa, as we have seen, did worse.
This is not due to any decline in investment rates

- To the contrary, investment rates actually rose from 17% to 27% between the third and fourth quarters of the twentieth century, partly reflecting the use by governments of greater oil revenues.
- But neither does it reflect investment problems in non-oil exporters, which invested nearly as much as oil exporters.
- Investment rates are somewhat below those of East Asia (which is exceptional for its high savings and investment), but only modestly so.
• By process of elimination, we therefore know that the slowing growth of per capita income reflects the collapse of TFP growth.

• In conjunction with the rapid growth of the economically active population, this has meant stagnant real wages and high unemployment (averaging an astounding 50% among workers under 20 in countries for which data are available).
And most recently...

- The region has been helped by limited reforms and pulled along by robust global growth.
- High energy demand from, inter alia, China has clearly helped.
- But it continues to lag developing countries as a group.
- And it remains to be seen whether this improvement is permanent or transitory.

**Figure 1. Global real GDP growth**
MCD growth continues to outpace global growth.

(Annual change; in percent)

Sources: Data provided by authorities; and IMF staff estimates and projections.
A consistency check

• In other words, there are lots of explanations for the poor growth performance of the Middle East. You will have seen a long list of these from Noland and Pack.
• The multilaterals, in now-standard “Washington Consensus” manner, tell governments that achieving faster growth will require implementing a very long list of reforms.
• But any analysis of what is holding back economic growth and development progress now must also be consistent with the fact that it did not hold back economic growth and development progress in the third quarter of the 20th century.

  – Thus, one sometimes hears that Islam and economic growth are incompatible, or that conflict with Israel has caused leaders to externalize domestic pressures and to divert their attention from economic reform. But neither problem is new. Both already existed in the third quarter of the 20th century yet were compatible with very respectable economic growth.
Starting points

• Can we explain this using our standard extensive growth/intensive growth dichotomy? Did a state-led development model work relatively well in the earlier stages of development and in a less technologically complex environment, where it has now become part of the problem rather than part of the solution?

• Industrial sector is dominated by a small number of large firms that have benefited from protective policies, limiting the product market competition that is so important to efficiency advancement. There are also a large number of micro-enterprises that are too small to make a difference. (In this respect the distorted industrial sector is reminiscent of India, which also has a few large firms together with micro-enterprises protected by reservations.) Once upon a time, this model of state-led development was not a problem. But in the later stages of development and in a more technologically complex environment, maybe it now is.
Three more starting points

• Is the nascent manufacturing sector being squeezed by intensifying competition from East Asia and other developing regions, causing another “Great Divergence”?

• Is the explanation the region’s demography? Starting in the 1980s, with the beginning of the demographic transition, there was a big increase in dependency ratios. With more young mouths to feed, there may have been fewer resources for other purposes. There is a suggestive parallel with East Asia, which experienced its own demographic transition in the late 1940s and 1950s and experienced a decade of slow growth, some would say as a result. We will talk more about this in a moment.

• Maybe those demographic pressures, intensifying competition, and exhaustion of easy growth prospects ratcheted up competition for rents and required painful adjustments. The argument would then be that institutions for containing rent-seeking and for sharing the burden of adjustment worked poorly in the Middle East. We will discuss this more as well.
• But the multilaterals, in typical Washington Consensus form, focus not on these factors but on the need for a long list of other reforms:
  – Macro policy in the region has been unstable.
  – Unproductive government spending (government consumption, transfer payments etc.) is a burden for growth.
  – The region is inadequately open to trade with the rest of the world.
  – It has done too little to capitalize on favorable aspects of its geography.
  – And above all, it is argued, growth-supporting institutions need to be strengthened.
• Many factors, many stories.
• But what are the binding constraints?
• And where should interventions be focused?
Lessons from cross-country regressions

• Elbadawi (2005)* looks at 85 countries over the period since 1965.*
• He finds that growth in the Arab countries is well explained by the same factors that explain growth in other regions (no need for a dummy variable for the region – recall the Sachs et al. result for Africa).

• His key findings are that growth increases with:
  – favorable geography (recall our discussion of Africa)
  – favorable demography
  – Stable macro policy
  – openness to trade and inward foreign investment
  – strong institutions
• So what does this imply for policy reform in the Middle East?

The region’s geography is not that unfavorable (but policy can help)

- Compared to East Asia, share of land with non-temperate climate and share with proximity to navigable waterways are not unfavorable.
- Main difference is low concentration of population and activity near coasts. And we know that such proximity is important for commercial activity and development success. Is this something that can be influenced by policy?
Nor is the region’s demography that unfavorable (although policy can help)

- We already flagged demography as a factor in the region’s changing growth performance. But the full story is more complex. What has been a demographic burden in the recent past will soon become a demographic bonus.
  - Because life expectancy has lengthened significantly (by eight years between 1980 and 2000) and infant mortality has declined.
  - But birth rates have been slow to decline (although they have fallen, by nearly 2 births per woman over the same period).
  - There is a high youth dependency ratio.
  - This looks like the typical demographic transition. If so, birth rates will continue to decline.
  - This will then mean a bulge in prime age workers.
  - Between 1990 and 2020, the growth of the economically active population will exceed the growth of the dependent population by more than in any other region.
• The labor force of MENA will rise from 100 million in 2000 to 150 million in 2010 and nearly 200 million in 2020.

• High share of economically active population will mean high savings rates, relatively few other mouths to feed.

• But the challenge will be to find productive employment opportunities for all these new workers. Low levels of schooling (limiting employment options and individual adaptability) and heavy labor market regulation (an inheritance of the earlier period of heavy state direction of the economy) are obstacles here.

• This is where there is a role for policy.
Macro policy is not that bad (although it can be improved)

• While inflation is higher than in East Asia, its level does not look that alarming, and the problem is not severe for every subregion.
• Government consumption is higher than in East Asia and even Sub-Saharan Africa, again the differential is not especially pronounced.

Table 3

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Sources: World Bank (2003), and Heston et al. (2002).
Note. All values are obtained by taking the median of each country’s average performance. The measure of openness is the volume of trade over GDP adjusted for the size of the country (area and population), for whether it is an oil exporter, and for the percentage of the country’s population living within 100 kilometers of coast/navigable rivers. The actual values used in the regressions are reported here in the form of an index ranging from 0 to 100.
Lack of openness looks like a first order problem

- The data in the preceding table confirm that the region has slipped significantly behind East Asia and even Sub-Saharan Africa in terms of trade openness.
  - Exports are dominated by fuels. Few private enterprises export. Few exports of manufactures.
Lack of openness looks like a first order problem

- The same is true of openness to FDI.
- And our previous analysis suggests that openness is important for growth.
  - Encouraging merchandise trade, inward FDI, intra-trade parts and components will facilitate technology transfer. Greater openness to trade expands the role of non-rent dependent exporters, who apply pressure for further institutional reform) should be the priorities.
  - Greater openness and trade also expose the workforce to the need for new skills and knowledge, creating another effective coalition for reform.
  - Finally, greater openness raises the payoff for reform, tipping the political balance.
Institutions are the other first-order problem (but what to do about this?)

- We have seen in other contexts that strong market-supporting institutions are important for growth.
- But we have also seen that institutions are resistant to change and that economists know relatively little about policies for fostering stronger institutions (although the preceding arguments about openness are one thing on which many agree).
- There is also the observation that institutional development is endogenous to growth. If institutional problems will solve themselves in the course of growth and development, maybe the solution is to cut into the growth problem elsewhere.
Recall our two fundamental views of economic development (from week 1)

• The Acemoglu-Johnson-Robinson view that institutions shape growth. Among these are political institutions, which provide democratic accountability, diffuse distributional conflicts, etc.
  – In this view the other good things that contribute to growth, like an educated labor force, result from the presence of strong institutions.

• The Glaeser-Shleifer view that productive resources, and in particular, human capital shape growth.
  – In this view, those other good things, including good governance, democracy, press freedom etc., are corollaries of economic development, not fundamental causes. Thus, there are many examples of strong states, South Korea for example, in which autocratic rulers put in place the relevant growth promoting policies (exceptional investments in education, for example), from which flowed growth and, ultimately, stronger institutions, including democratic political institutions.

The obvious caveat

• Yes, South Korea and Taiwan’s authoritarian governments found legitimacy in promoting economic growth. But nothing guarantees that they will behave in this way. In the Middle East they have instead tended to “encourage the externalization of discontent associated with economic underperformance and to pursue quixotic pan-Arab projects” (in the words of Noland and Pack).

• Why this difference is not clear. It is tempting to say “an absence of natural resources and security threat left South Korean and Taiwanese regimes no alternative, whereas neither imperative was as compelling in the Middle East.” But the explanation is ad hoc.

• We should also be aware that this issue is loaded politically. Saying that democracy may be good for economic development under certain circumstances is not the same thing as saying that democracy can be transplanted at the barrel of a gun.

• Be this as it may, for many Western analysts, strengthening institutions supportive of growth is key to stimulating better economic performance in the Middle East.

• And, for many, strengthening institutions involves increasing political freedoms, increasing the flow of information (press freedom) etc.

• On what basis is this argued?
  – Political freedoms and the free flow of information strengthen the accountability of the public sector and the efficiency of delivery of public services.
  – Such freedoms limit rent seeking and the problems associated with resource abundance.
  – Such freedoms make it easier for societies to cope with disturbances and adjustment challenges.
There is, clearly, a problem with the efficient delivery of public services in the region

- Nearly three in five adults in Morocco are illiterate, equivalent to Mozambique, even though incomes in Morocco are much higher.
- Infant mortality rates are twice as high in Egypt as Indonesia, where Egypt has twice the per capita income.
• The World Bank’s view is that you get efficient delivery of public services (health care, education, infrastructure investment, other growth-promoting policies) when you have effective governance of the public sector.

• Effective governance depends on two things: efficiency of the bureaucracy (control of corruption, enforcement of contracts, burden of regulation) and accountability of the bureaucracy (transparency of government, press freedom, political rights).

• The problem is that both measures are endogenous to income (they improve with development).

• Still, the evidence is suggestive that the Arab economies lag along both dimensions.
Governance = efficiency of bureaucracy x accountability of bureaucracy

Compared with Other Regions, MENA Shows a Clear Governance Gap

Index of governance quality

Notes: OECD includes Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, the United Kingdom, and the United States. Central European countries (CE6) include Bulgaria, the Czech Republic, Hungary, Poland, Romania, and the Slovak Republic. Latin American countries (LA6) include Argentina, Brazil, Chile, Mexico, República Bolivariana de Venezuela, and Uruguay. East Asian countries (EA6) include Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Vietnam. MENA15 includes Algeria, the Arab Republic of Egypt, Bahrain, the Islamic Republic of Iran, Jordan, Kuwait, Lebanon, Morocco, Oman, Qatar, the Republic of Yemen, Saudi Arabia, the Syrian Arab Republic, Tunisia, and the United Arab Emirates. Sources: Authors’ calculations, which are based on the index of governance quality, covering 173 countries worldwide.
Quality of administration (MENA countries are outliers)
Public accountability (MENA countries are outliers)
And then there is the region’s natural resource endowment
iClicker question: countries with abundant natural resources grow:

A. Faster than other (otherwise comparable) countries
B. Slower than other (otherwise comparable) countries
C. Neither faster nor slower on average
Mechanisms

• One popular argument is that the easy extraction of minerals or fuels encourages rent seeking behavior. Easier to scramble for rents in this setting than to pursue market work. This is the so-called *the resource curse*.

• Another popular view is that abundant foreign exchange receipts causes the currency to become overvalued, which crowds out the production of other traded goods (a problem known as *the Dutch disease*).
Yet there are also exceptions

• In 1989 diamonds accounted for 80% of Botswana’s exports, yet between 1970 and 2001 the country grew by 6.4% in pc terms.
  – (As we discussed last week.)

• Norway depends heavily on natural gas exports, yet its has grown rapidly by OECD standards.
In principle, then, the resulting problems can be managed

- Agreement can be reached on how to share the rents. Thus, Norway agreed to sequester the rents in an oil fund charged with investing them for future generations.
- Real overvaluation can be avoided by prudent fiscal and monetary policies, as in Botswana.
- There is some evidence (Korhonen 2006) that countries with strong political competition and encompassing coalition governments are good at managing these problems and avoiding the resource curse.
  - Norway is a highly developed democracy.
  - AJR acknowledged that Botswana is an outlier in Africa in terms of the strength of its political institutions.

Institutions for managing conflict and sharing adjustment costs

- Oil prices have gone not only up but down. Earlier oil shocks (1973, 1979) were reversed relatively quickly.
- There is little problem getting growth going when oil prices are high (witness the region’s recent experience).
- The problem, rather, is keeping it going by making sensible decision when oil prices go down and the pie shrinks.
- Different (ethnic, religious and economic) groups have to agree on sensible economies that share the pain and avoid gutting investments in infrastructure, education, etc.
- Where social arrangements for reaching such decisions are missing, there may be ethnic conflict, efforts to solve the problem through cross-border aggression, etc.
- And these events discourage inward foreign direct investment, disrupt the labor market experience of prime age males, distort the pattern of government expenditure, and disrupt economic activity generally.
Rodrik (1998) has an empirical model of this

- His conflict variable is designed to capture external shock $\times$ [latent social conflict/institutions of conflict management]
- This is operationalized as follows:
  - External shock = terms of trade deterioration/openness
  - Latent social conflict = ethnic fractionalization
  - Conflict management capacity = strength of democratic institutions as measured by Polity.

- Many Arab countries rank low by this measure. All experience large shocks. Some are characterized by significant ethnic fractionalization. Almost all rank low in terms of democracy.

• This discussion also begs the question of why institutions, political institutions in particular, tend to be underdeveloped in the region.

• You have to be a better political scientist than I to offer a convincing answer to this question.

• The best analysis I know is by the same Marcus Noland who is coauthor of today’s book, in “Explaining Middle East Authoritarianism,” Institute of International Economics Working Paper no.05-05 (June 2005).
Noland finds that the following factors mainly “explain” the incidence of democracy

- **British colonial heritage**
  - There are those “colonial origins” again…

- **Taxes as a share of government revenues**
  - Here the argument is that not having to tax relieves governments of having to be accountable. Also, that rents furnish governments with resources for patronage and undercut the development of civil society.

- **Neighborhood effects**
  - Peer pressure or regional norms appear to matter.

- The MENA region is arguably under-endowed in all three respects (the British during their period of control did little to foster indigenous institutions of self-governance, countries in the region have few neighboring democracies, taxes account for a small share of revenues).
  - It is also important to note variables that do not appear to be associated with democracy: religion (not surprising that share Muslim is insignificant, given experience of inter alia Indonesia), interstate conflict, and conflict (or non-normalized relations) with Israel.
Note also the possibility of positive feedbacks and therefore multiple equilibria

- Noland and others suggest that poorly managed resource rents lead to the underdevelopment of democratic political institutions.
- Korkonen and others suggest that the absence of democracy facilitates poor management of resource rents.
- Sounds discouragingly like a self-reinforcing low-level equilibrium trap...
Bottom Line

• Noland and Pack dismiss a number of conventional explanations for poor growth performance in the Middle East as second order or simply wrong.
  • These include religion, poor macroeconomic policy, unfavorable geography, unfavorable demography.

• They point to East Asian experience in suggesting that limited interventions could effectively stimulate growth. It is not necessary to do everything, Washington Consensus I, II and N, to achieve significantly faster growth. They recommend:
  • Investing in education
  • Freeing up the operation of labor markets and encouraging commercial activity along the coasts (to create employment opportunities for new workers)
  • Strengthening linkages with the rest of the world.
• In the longer run, there is the question of whether such reforms can be sustained in the face of shocks.
  
  • Notice that Noland and Pack do not emphasize the need for democratization or dramatic institutional improvements, on Day One, as essential for initiating faster growth.
  • What is needed in their view is not a comprehensive increase in political freedom but rather greater freedom to engage in market transactions and international transactions in particular.
  • As in China – and following Glaeser and Shleifer – they argue that the relevant institutions of conflict management and good governance/democratic accountability, which are essential in the long run, will develop along with the economy and with its opening to the rest of the world in particular.
  • The question is whether they will develop fast enough.