Survey of Economic and Social Developments in the ESCWA Region

2009-2010

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Preface

The 2008 financial crisis of the United States of America, which started in the subprime market, has developed into the most severe global economic crisis since the Great Depression of 1929. What prevented an even more serious downturn was the introduction of unprecedented, coordinated fiscal and monetary stimulus packages in the more developed economies. However, the price tag for the crisis still remains at a record-breaking high. In addition to its severe effects in North America and the European Union countries, the crisis has put pressure on emerging markets worldwide, contributing to fast declines in their stock markets, gross domestic product (GDP) growth rates, oil prices and revenues, commodity exports, portfolio investment, foreign direct investment (FDI), tourism revenues and workers' remittances. While certain developed countries and a number of large emerging market countries are now showing some signs of recovery, the effect of the crisis on the member countries of the Economic and Social Commission of Western Asia (ESCWA) has not yet fully unfolded. It is possible that the negative economic and social consequences of the crisis, for example on employment, poverty, health, education, gender and growth will be felt for some time to come, especially given that, so far, the link between growth and employment generation and poverty alleviation in ESCWA member countries has remained weak, despite the recent oil boom period and related spectacular GDP growth performance prior to the crisis.

Weaknesses in the macroeconomic policies pursued, as well as still weak regional trade and financial integration linkages and heavy dependence on external resources to finance development in ESCWA member countries have channelled the global financial crisis into economies of the ESCWA region, severely undermining recent regional and international efforts to integrate those countries with the rest of the world. Moreover, lower growth prospects in more advanced economies, higher financing costs and a decrease in capital inflows are leading to soaring current account and budget deficits and may constitute further impediments to the sustainability of the public debt of ESCWA member countries and current exchange rate regimes in several of them. Certain ESCWA member countries still suffer from the absence of bond markets, a combination of inadequate financial sector supervision, poor assessment and management of financial risk and the maintenance of fixed exchange rates. These factors, among others, have accentuated the effects of the crisis in the region. Although trade and globalization issues and the integration of financial systems of ESCWA countries with the more mature financial markets of the European Union and the United States were among the main reasons why the effects were felt, it was accentuated by domestic macroeconomic, fiscal, monetary, financial and social issues, notably the lack of economic diversification and heavy reliance on oil exports and revenues for growth and development, persistently high unemployment rates, the existence of poverty and low levels of human development (mainly education, health and gender inequality) and limited fiscal space, due to accumulated public debt, in certain ESCWA member countries.

The global financial crisis has directly affected the ESCWA region, via trade and capital flow channels, as well as through declines in world oil prices and revenues.

Certain ESCWA member countries have experienced a sharp decline in world demand for their exports and decline in both domestic and international liquidity coupled with other aftershocks of the financial crisis, such as lower oil prices and revenues, have contributed to further macroeconomic imbalances. Non-oil export revenues declined by about US$75 billion between the years 2008 and 2009 in all ESCWA member countries, with related declines in remittances, portfolio and foreign direct investments. Thus, in addition to its temporary impact, the crisis may also cause a widening of the income gap between the more advanced economies and the ESCWA region and may subsequently slow the speed of the integration process. However, the low degree of financial integration with global capital markets achieved so far, limited exposure of the banking system of ESCWA member countries to derivative financial assets and spillover from increased public spending in the Gulf Cooperation Council (GCC) countries have helped prevent substantial fallout from the crisis.

The response of ESCWA to the global financial crisis was steadfast. The Damascus Forum on responding to the International Financial Crisis in the ESCWA Region, which was held on 7 May 2009, recommended adopting sustainable fiscal policy for boosting domestic demand; targeting infrastructure, agriculture, industry, health, education, environment and social protection mechanisms; encouraging the provision of liquidity to member countries facing its shortage; enhancing the regulatory framework in the financial sector; promoting greater regional integration, particularly in monetary and financial affairs; encouraging investment of the sovereign wealth funds of ESCWA member countries in the real economy; pursuing diversification to reduce dependency on the oil sector; facilitating intraregional flows of trade in goods and services, people and capital; promoting South-South cooperation; strengthening employment and social protection policies and ensuring more active participation of developing countries in managing the global economy.

Given sufficient fiscal space and independent monetary policies, certain ESCWA member countries have relied on monetary and fiscal adjustment measures to dampen the effects of the crisis on the region. A huge build up of foreign exchange reserves prior to the crisis in the less diversified economies (LDEs) during the oil boom period of 2002 to 2008 constituted the first line of defence. The second line was the introduction of colossal fiscal stimuli packages in LDEs, with potential for further fiscal and monetary interventions when warranted. Where there was exposure to global financial markets, especially in the GCC countries and limited fiscal space as in Lebanon, Jordan, the Sudan and Yemen, monetary authorities had to intervene directly, with the exception of Lebanon, in financial markets, to stabilize money and capital markets and actively protect the financial sector by such measures as capital injections and share purchases.

Even though certain ESCWA member countries have recently undertaken some financial reforms and pursued sound macroeconomic policies, the current exogenous financial crisis is disproportionately penalizing them and creating an additional hurdle that will have to be surmounted in the near future, as short-term capital may once again start flowing out of their financial markets back to those that are more mature. Recent financial data indicate that capital outflows have been registered as a result of recent political and social turmoil in Egypt and Tunisia. ESCWA member countries need to exert further intensive efforts to raise their share of global FDI and portfolio inflows, which have remained relatively low. Measures that could be taken, in addition to adequate macroeconomic policies to respond to the current financial crisis, include the acceleration of South-South economic, financial and trade integration efforts, coupled with enhanced reform programmes and stressing institutional and governance aspects in particular. Moreover, the unstable political environment and past and recent political and social turmoil in Egypt, Lebanon, Palestine, Tunisia and Yemen and the aftermath and implications of the global financial crisis have not been conducive to attracting capital and enhancing and improving the growth performance of ESCWA member countries. Capital accumulation and all types of FDI or portfolio investments have, until now, failed to bring any significant growth benefits to the area. The unstable political environment and conflicts that have plagued the ESCWA region have been a deterrent to investment, capital accumulation and the improvement of labour market conditions.

The growth outlook for 2011 remains relatively robust with forecast GDP growth rates averaging 4.2 per cent for the GCC countries and 5.7 per cent for the more diversified economies (MDEs) prior to recent political and social unrest. However, despite the positive growth and economic forecast, the social outlook remains bleak, with further expected deterioration in almost all social (poverty, employment and gender equality) and human development (health and education) indicators. While the ESCWA region appears to have weathered the global financial crisis well, social development in the region is expected to be widely and adversely affected by the crisis in the coming few years. ESCWA member countries will, therefore, need to introduce a new development strategy that strengthens the trickle-down effect between economic growth, employment generation and poverty alleviation to effectively deal with regional chronic unemployment and poverty hurdles.

As this survey was being finalized, the Jasmine Revolution erupted in Tunisia, followed by the Lotus Revolution in Egypt and the Cactus Revolution in the Libyan Arab Jamahiriya. These events are unprecedented in their dynamics and the potential change they will bring to the region. The consequences of this sea change will only become apparent as events unfold. At the same time, it is evidently clear that a new model of economic development in the region is emerging and it is critical that it responds to the aspirations of the people who have led these revolutions. Better economic policies to promote good governance and institution-building are urgently needed to create more and better jobs and to bring about the necessary change the region has aspired to.

The first chapter of the survey presents a general overview of the financial crisis and its implications both on a global level as well as on a regional level. This chapter also presents recent oil sector developments for the purpose of comparison with financial developments for a better understanding of the implications of the global financial crisis on ESCWA member countries.

The second chapter presents a detailed assessment and monitoring of the latest macroeconomic and financial developments in ESCWA member countries. It also highlights recent financial and economic trends for a better understanding of the recent macroeconomic policy developments, using the most up-to-date economic data collected on a daily basis by the Economic Analysis Section of the Economic Development and Globalization Division of ESCWA. This chapter provides an exposé of the macroeconomic policies in place, adequate macroeconomic exit strategies in the aftermath of the global crisis for ESCWA member countries and proposes exit strategies for future policies and prospects for economic and social development in the region. This chapter also provides an exposé of the social implications (unemployment, gender, poverty, health and education) of the global financial crisis for ESCWA member countries with related exit-strategy social policies to deal with its aftermath.

The third chapter highlights the latest developments in terms of Arab economic integration in the wake of the global financial crisis. Trade and financial integration are carefully explored for the purpose of proposing adequate macroeconomic exit policy strategies from the crisis and to further enhance economic integration between ESCWA member countries. It is argued that greater Arab economic integration could have dampened the effects of the financial crisis on ESCWA member countries.

The fourth chapter addresses developmental macropolicies, wherein it would have been better for the region to have incurred a slightly bigger shock from the financial crisis had it been more developed financially, than for it to have been cushioned by the underdevelopment of its market. Underdevelopment as a totality represents the worst of all crises. ESCWA member countries benefited only marginally from flows associated with the oil boom that concluded in 2008, due, again, to the missing link between growth and employment generation. Economic benefits that the region accrued as a result do not reflect renewed development toward sustainable growth. Rather, the pattern of aggregate resource flows signifies a missed development opportunity. Putting surpluses earned in the last oil boom to work in a framework for sustainable development will require stepping up demand injections that raise production in dynamic sectors, specifically, manufacturing. The purpose of this chapter is to identify manufacturing as a strategic dynamic sector, synonymous with development proper, sine qua non for the region to deviate from its current jobless growth trajectory and an ultimate antidote to any potential financial crisis.

The fifth chapter looks at how the recent financial and economic crisis has once again undermined trust in self-regulating markets and again increased expectations for regulatory interventions by the State. However, it is not clear whether member countries will be able to meet these expectations and successfully play the balancing, stabilizing and supporting role required. Thus, this chapter revisits the debate about the role of the State in social affairs, looks at the situation in the ESCWA region and brings up some of the questions regional policymakers might find of interest in the framework of ongoing debate about a new social contract and about social development.

The final chapter draws a set of conclusions and policy recommendations.

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ABBREVIATIONS

ASEAN	Association of Southeast Asian Nations
AMF	Arab Monetary Fund
BIS	Bank for International Settlements
CEDAW	Convention on the Elimination of All Forms of Discrimination against Women
CFTC	Commodity Futures Trading Commission
CIS	Commonwealth of Independent States
DESA	Department of Economic and Social Affairs
DFSF	Dubai Financial Support Fund
DOT	Direction of Trade Statistics
ECB	European Central Bank
EIA	Energy Information Administration
EGP	Egyptian Pound
FRB	Federal Reserve Board
FDI	Foreign direct investment
GAFTA	Greater Arab Free Trade Area
GCC	Gulf Cooperation Council
GDP	Gross domestic product
ISIC	International Standard Industrial Classification
IFS	International Financial Statistics
ILO	International Labour Organization/International Labour Office
IMF	International Monetary Fund
LIBOR	London Interbank Offered Rate
LDCs	Least developed countries
LDEs	Less diversified economies
LNG	Liquefied natural gas
MDEs	More diversified economies
MDG	Millennium Development Goal
MENA	Middle East and North Africa
MERCOSUR	Common Market of the South
NAFTA	North American Free Trade Agreement
NEER	Nominal effective exchange rate
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
QIZ	Qualifying Industrial Zone
RBOB	Reformulated blendstock for oxygen blending
REER	Real effective exchange rate
REO	Regional Economic Outlook
SDR	Special Drawing Rights
WEO	World Economic Outlook
WTI	West Texas Intermediate
TED	Spread between three-month LIBOR and three-month US treasury bill interest rates

CHAPTER I.

The Global Financial Crisis: an Overview

I. The Global Financial Crisis: an Overview

A. Global implications of the crisis

The last two decades witnessed monetary, financial and exchange rate crises in many emerging market countries: (a) in 1994, the Mexican crisis was triggered by a devaluation of the peso to correct for a real exchange rate overvaluation being behind contracting economic growth. The devaluation, however, led to a contraction in the economy and was followed by a debt crisis; (b) in 1997 the Asian crisis was triggered by a combination of poor financial governance, the maintenance of pegged exchange rate regimes, fast capital account liberalization and weaknesses in Asian financial systems; (c) in the 1998 Russian crisis, the steep devaluation of the rubble by about 260 per cent in December 1998 led to significant growth of the external debt of Russia and its service costs, the collapse of the treasury bill market, coupled with a commercial banking crisis which paralysed the payment system, a worsening of the budget deficit caused by reduction of the tax base and the impossibility of further debt financing of the budget deficit; (d) the 1999 Brazilian crisis and the 2001 Argentinean crisis were the result of many years of deficit financing by printing money in Brazil and Argentina, leading to hyperinflation and the subsequent default of Argentina on its external debt; (e) in the Turkish crisis of 2001, Turkey also experienced hyperinflation as a result of deficit financing, but managed to not default on its external debt obligations. Those financial and balance-of-payments crises culminated in the global financial crisis of 2008 and the 2010 Greek and Irish debt crises.

The credit crunch in the United States of America and the financial markets of the European Union since the summer of 2007, as well as low real estate prices and related derivative securities in the mortgage market turned into a global financial crisis after the collapse of major financial institutions in the United States in September 2008. Due to surging counterparty risks among financial institutions, the global financial sector faced an increasing systemic risk. International money and capital markets came to a complete standstill starting during the fourth quarter of 2008. The financial crisis forced a prompt downward adjustment of balance sheets, not only of the financial sector through deleveraging, but also of the corporate and household sectors in developed countries and in a segment of developing countries. Intensive balance sheet adjustments of the corporate sector resulted in prompt downward revisions in investment planning, corporate inventories, human resource allocations and consumption behaviour. This contraction in economic activities led to a shrinking of effective demand and surging unemployment rates worldwide, with subsequent declines in economic growth. However, by the second quarter of 2009, the US dollar money markets and world stock markets started to show signs of recovery. Rapid inventory adjustments and other cost control measures at the corporate level contributed to the recovery in terms of gross domestic product (GDP) growth rates. Active fiscal and monetary measures undertaken by developed economies have also contributed to sustaining global demand. In addition, the resilient positive economic growth in some emerging countries, particularly in China and India, has also kept world demand levels from further collapse. A series of coordinated efforts to cope with the financial crisis were implemented at the

Group of 20 Summit meetings in 2008 and 2009, which included representatives from developing countries within the vision of a new international financial architecture and coordinated fiscal stimulus action.

The 2008 global financial crisis affected emerging countries, including the Economic and Social Commission of Western Asia (ESCWA) member countries through: (a) the plunge of financial and real estate asset prices; (b) the collapse of commodity prices, including energy, metal and food items; (c) shortages of liquidity, particularly US dollar liquidity, in local and international money markets, as well as a drying up of other forms of capital flows, such as foreign direct investment (FDI), remittances and portfolio flows; (d) rapid declines in export demand and earnings; and (e) subsequent declines in real GDP growth rates (table 1), soaring current and budget deficits as well as difficulties in servicing previously-accumulated public debt. The repatriation of foreign funds started in the second quarter of 2008 in most emerging markets. This repatriation was a facet of international investment portfolio adjustments where risk-averse investors shifted their preference to safety and liquidity, leading to a gradual global liquidity squeeze and triggering a reverse in the trend of financial and real estate asset prices, including those of developing countries. The liquidity squeeze also triggered the collapse of commodity prices. As the extent of the global liquidity crunch became problematic in September 2008, exporters and importers in developing countries faced difficulties in obtaining funds to finance trade. Moreover, rapid decline in global demand reduced export earnings. Limited reliance on and exposure to financial derivatives of developed countries had helped insulate emerging countries, to some extent, from the financial crisis. However, linkages with global markets in terms of goods, services and financial assets affected developing economies during the fourth quarter of

Table 1. Growth and inflation rates, 2008-2011

	GDP growth rate (percentage)				Consumer inflation rate (percentage)			
	2008	2009	2010[a/]	2011[a/]	2008	2009	2010[a/]	2011[a/]
ESCWA region	6.4	2.0	4.5	4.7	11.9	4.7	5.2	5.0
World	1.6	-2.0	3.6	3.1	4.7	1.4	2.5	2.5
Developed economies	0.1	-3.5	2.2	1.9	3.3	0.1	1.4	1.5
North America	0.0	-2.6	2.6	2.2	3.8	-0.2	1.4	1.4
Asia and Oceania	-0.7	-4.2	2.8	1.5	1.9	-0.9	0.5	0.4
Europe	0.5	-4.1	1.6	-1.8	3.5	0.8	1.8	1.9
Economies in transition	5.1	-6.7	3.8	4.0	14.7	10.7	6.4	8.1
Developing economies	5.3	2.3	7.0	6.0	8.0	4.4	5.5	5.0
Africa	5.0	2.3	4.7	5.1	10.1	8.7	6.8	6.0
East and South Asia	6.1	4.9	8.3	7.1	7.2	3.0	5.0	4.5
Western Asia[b/]	4.4	-1.0	5.5	4.7	10.2	4.2	5.1	4.6
Latin America and the Caribbean	4.0	-2.1	5.3	4.0	7.8	6.1	6.2	5.9

Sources: Figures for the ESCWA region are ESCWA staff calculations (see table 6 for details). Other figures are from United Nations Department of Economic and Social Affairs (DESA), *LINK Global Economic Outlook, October 2010 and World Economic Situation and Prospects Report for 2011.*

a/ All GDP growth rate forecasts for 2010-2011 are from *World Economic Situation and Prospects Report for 2011.*

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

2008 and the first quarter of 2009. No serious balance-of-payments crises were observed in developing countries during or after the crisis. This is a distinctive feature in the present financial crisis that is different from the 1997 Asian financial crisis and all the other financial crises of the last two decades. Moreover, it is the resilient economies of China and India that have put the world economy back on a recovery path.

The global financial crisis impacted social development primarily through four transmission channels: (a) a lower effective income level, particularly of the poor; (b) rapidly rising unemployment rates with nearly 30 million jobs lost during the crisis; (c) a potentially significant change in demographic structures due to return migrations; and (d) the potential depletion of fiscal transfers for social safety nets. The rapid increase in consumer inflation rates mainly due to commodity price hikes (food items) during 2008 (table 1) had already eroded the purchasing power of the poor who usually devote a large proportion of their income to food-related items. Despite the fact that international commodity prices came down from their peak in 2008, recent severe droughts in many agrarian parts of the world are still causing serious concern about world food security and its effects on the poor. According to the International Labour Organization (ILO), the world unemployment rate was 6.6 per cent in 2009, increasing from 5.7 per cent in 2007.[1]

A significant share of the new unemployment figures originated in developed countries, with proportionally lower unemployment rate increases in developing countries (table 2). The effect on unemployment is more severe, however, in developing countries, a majority of which are going through a phase of demographic transition where a high fertility rate coexists with a decreasing mortality rate. It is well known that chronic unemployment rates are high among younger cohorts and the female population. The rapidly decreasing employment opportunities are expected to delay the process of social transition to a phase where increased social participation of youth and females materializes through labour markets. Moreover, the global financial crisis revealed a tendency toward nationalism with respect to job protection measures, particularly in developed countries.

Table 2. World unemployment rates, 2005-2009 (*percentage*)

	2005	2006	2007	2008	2009*
World	6.3	6.0	5.7	5.8	6.6
Developed economies and European Union	6.9	6.3	5.7	6.0	8.4
Central and Eastern Europe (non-EU) and Commonwealth of Independent States (CIS)	9.4	9.0	8.3	8.3	10.3
East Asia	4.2	4.0	3.8	4.3	4.4
South-East Asia and the Pacific	6.5	6.1	5.4	5.3	5.6
South Asia	5.3	5.1	5.0	4.8	5.1
Latin America and the Caribbean	8.0	7.4	7.0	7.0	8.2
Middle East	10.0	9.5	9.3	9.2	9.4
North Africa	11.5	10.4	10.1	10.0	10.5
Sub-Saharan Africa	8.2	8.2	8.0	8.0	8.2

Sources: International Labour Organization (ILO), 2010, *Global Employment Trends*, January 2010, table A2. Unemployment rate, world and regions, p. 46.
* Estimated figures by ILO.

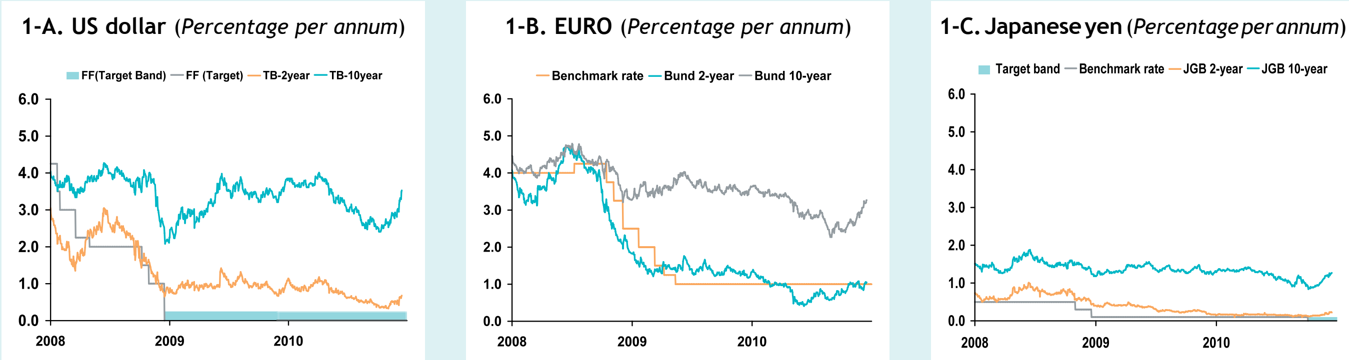
The economies of North America plunged into recession in the third quarter of 2008 and were estimated to have registered a further contraction of 2.6 per cent in 2009 (table 1). Through the pursuit of a countercyclical monetary policy, the Federal Reserve Board (FRB) introduced a series of interest rate cuts (figure 1-A) down to 1.25 per cent in December 2008. The FRB also injected liquidity by actively purchasing financial assets of commercial

Recent severe droughts in many agrarian parts of the world are still causing serious concern about world food security and its effects on the poor banks in order to stabilize financial markets at the onset of the financial crisis. In parallel with the ease in the monetary stance, the fiscal authority of the United States shifted to a comprehensive stimulus package for the 2009 fiscal year. Despite concerns over the rising level of national debt, yields on US Treasury Bonds have been stable (figure 1-A). However, the expectation of future inflation manifested itself through the widening of the gap between yields on two-year and ten-year Treasury Bonds (figure 1-A). The US economy has, however, shown signs of recovery since the second quarter of 2009, as the corporate sector completed the initial adjustment phase to the crisis. Moreover, the fiscal stimulus package that was introduced pushed up domestic demand and the export sector gained price competitiveness due to the devalued US dollar (figure 2-A). However, the overall state of the US economy has remained weak and recovery is expected to be unbalanced. The effect of monetary easing so far has been absorbed by the financial sector through several balance sheet adjustment measures. The unemployment rate has remained high during 2009 (box 1). The US economy is forecast to grow at 2.6 per cent in 2010 and 2.2 per cent in 2011 and is not expected to revert soon to the 2008 level of economic activity.[2]

The resilient economic performance of the 27 member countries of the European Union ended in 2008. Most European Union countries started to experience depressed economic activities and growth, including the major European economies of Germany, France, Italy and the United Kingdom of Great Britain, well into the second quarter of 2009. The real GDP of the European Union was estimated to have contracted by 4.1 per cent in 2009. The financial crisis mainly affected the real estate sector. The collapse of export markets, namely in the United States, Russia and Asian countries, forced a prompt cost adjustment in the corporate sector of the European Union. The sequence of downward adjustments of asset prices to that of industrial and commercial activities has been much shorter in the European Union than in the United States. Faced with lower domestic demand, European Union Governments were forced to introduce various fiscal stimuli packages, considered to be more conservative than the US package, constrained as they were by the growth and stability pact and the consequent strong commitment of European Union countries to fiscal sustainability. Following the easing monetary measures of the FRB, the Bank of England introduced similar but not as aggressive measures. However, despite the cautiousness of the European Central Bank (ECB) in introducing excessive monetary-easing measures, a series of monetary policy interest rate cuts were implemented during the period October 2008 to May 2009 (figure 1-B). The ECB has been facing a monetary policy dilemma of how to lower inflationary expectations. The potential for interest rate increases in 2009 led to an appreciation of the euro against the US dollar (figure 2-A). However, the weak price competitiveness of the eurozone corporate sector is expected to subdue growth in external demand. On this weak prospect, the 27 economies of the European Union are, on average, projected to grow by 1.6 and -1.8 per cent in 2010 and 2011 respectively.

The recovery path of the Japanese economy was dented in 2008, a dent which continued well into 2009 with a contraction of 5.6 per cent of the real GDP growth rate.[3] The collapse of external demand for Japanese exports, mainly to the United States, prompted cost adjustment measures at the corporate level, including inventories and investment plans. Adding

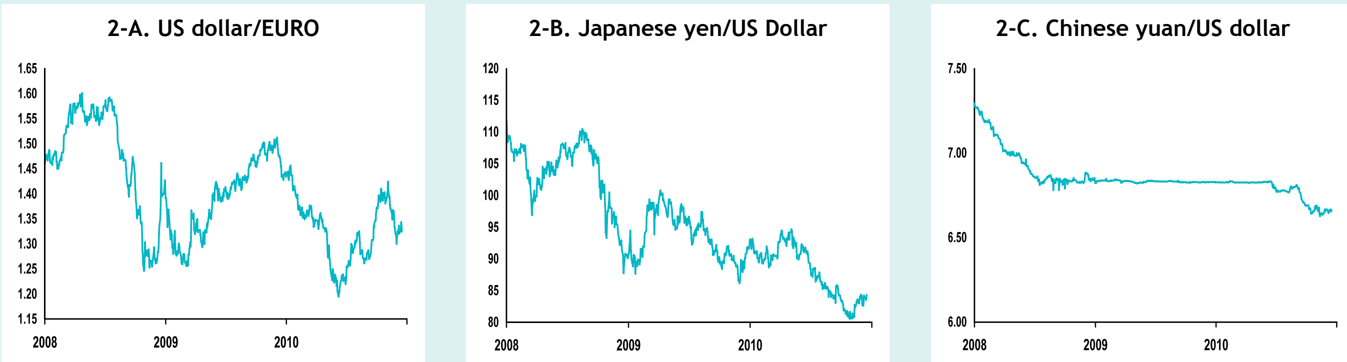
Figure 1. **Interest rates of major world currencies, 2008-2010**



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

Notes: FF: Federal Fund Rate, TB: Treasury Bonds, JGB: Japanese Government Bonds.

Figure 2. **Foreign exchange rates of major world currencies, 2008-2010**



Sources: European Central Bank and Reuters.

to that, weak domestic demand had devastating consequences on the overall level of economic activity. The Bank of Japan lowered interest rates in October and December 2008 (figure 1-C). Due to prevailing weak domestic demand, no change in inflationary expectation was registered, as is also clear from yields on Japanese Government bonds (figure 1-C).

Despite the 2009 fiscal stimulus package of the Government, the economy is still trapped in a state of deflation where domestic demand has not yet recovered. The Japanese economy is dependent on the economic performance of its major trading partners. However, the appreciation of the Japanese yen against the US dollar (figure 2-B) adversely affected export price competitiveness. Upon completion of the adjustment cycle of the corporate sector, economic activities started to recover slightly. The resilient economic performance of the Chinese economy is expected to positively affect exports from Japan. However, recovery was forecast to be moderate in 2010 at 2.7 per cent.

Box 1. The sequence of the financial crisis and the lagged economic impact

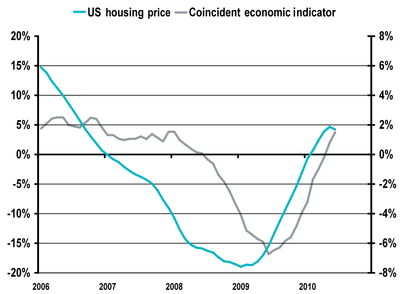
The global financial crisis has been marked by particular events such as the collapse of major US financial institutions in September 2008. What follows is the sequence of events which led to the crisis. Figure B1-A depicts growth in housing prices represented by Standard and Poor's Case-Shiller Composite Index of 20 major US cities and the growth in economic activity proxied by the Coincident Economic Indicators of the Conference Board during the 2006-2009 period. The housing price index turned negative in January 2007, while the economic activity index started contracting in July 2008. It thus took 18 months for the downward adjustment of housing prices to affect economic activities. Subsequently, the unemployment rate exceeded the 5 per cent level in July 2008 and the price level turned into deflation in March 2009 (figure B1-B).

In general, financial crises are triggered by the failure of various economic sectors in adjusting their respective balance sheets. In the present financial crisis, the collapse in housing prices triggered a chain of defaults among households, particularly in the category of subprime borrowers. Some financial institutions failed to adjust their balance sheets because of difficulties emanating from the stringent covenants and schemes of securitized financial products. As financial institutions utilized US dollar liquidity for balance sheet adjustments, the scarcity of liquidity led to tight lending conditions to the corporate sector, subsequently contracting their business planning, resulting in layoffs and in a lower level of business activities. As long as housing prices are in negative growth margins, the majority of economic entities, including households holding mortgages, are required to adjust their balance sheets.

What makes economic downturns in financial crises different from those of a regular business cycle is the extent of the required balance sheet adjustment process. During a crisis situation, the role of the Government is to facilitate a smooth balance sheet adjustment of economic entities, including commercial banks, corporations and households, while at the same time supporting domestic demand. A case in point is the present package of US fiscal and monetary policies. However, the core of the problem remains in depressed real estate prices that have, to some extent, started to slowly recover to their pre-crisis levels (figure B1-A).

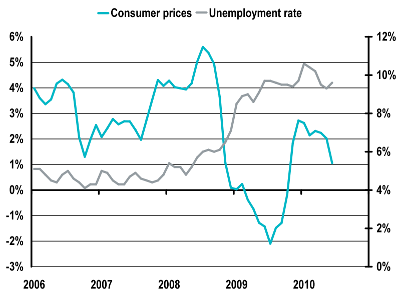
It is important to note that there exists a certain time lag between a significant downward adjustment in the value of assets and its adverse economic impact. During the 1990 Japanese crisis, it took 24 months for the collapse of the asset bubble to manifest its impact on economic activities. This time lag may vary, as is now the case in the European Union countries in the present global financial crisis, where this lag has been much shorter. For the ESCWA region, the downward adjustment in asset values, both in stock markets and real estate, materialized during the second quarter of 2008. The lagged impact may have surged during the period between the fourth quarter of 2009 and the second quarter of 2010. Despite the 2010 projected world economic recovery, this constituted a crucial factor that ESCWA member countries needed to think about when considering the 2010 economic prospects.

Figure B1-A. Housing prices and economic activities



Source: Standard and Poors, the Conference Board.

Figure B1-B. Consumer prices and unemployment rate



Sources: International Monetary Fund (IMF) and International Financial Statistics (IFS).

B. Regional implications of the crisis

Economies in transition, which include South-East European economies and the Commonwealth of Independent States (CIS), have been hit hard by the global financial crisis. The real GDP growth rates in these countries contracted by 6.7 per cent in 2009. The plunge in commodity prices as well as sudden shrinkage in domestic credit has led to weak domestic consumption and investment activities. However, no balance-of-payments crisis has been registered so far, pointing to the economic and financial resilience of the region. Accumulated foreign reserves have been sufficient to cushion the external financial shocks even though several countries had to resort to a smooth and limited devaluation of their respective national currencies. Moreover, a recovery in commodity prices in the second quarter of 2009 supported the external balance of those economies. Due to continued weak domestic demand, weak growth prospects are expected to prevail with forecast GDP growth rates of 3.8 and 4 per cent in 2010 and 2011 respectively.[4]

The African economies grew at a 2.3 per cent rate in 2009, mainly due to collapse in commodity prices. However, the region has once again shown some resilience, as no balance-of-payments crises have so far been observed. Fiscal and monetary authorities were able to sustain domestic demand of the respective countries while orderly controlling foreign exchange ceilings. Moreover, recent introduction of various reform programmes has made those economies much more attractive to foreign investments, even during the crisis. However, fundamental constraints for economic growth have remained; mainly the lack of supply-side capacity leading to a hovering inflation rate in the majority of those countries. Given the expected stable commodity prices, the region was forecast to grow at 4.7 per cent in 2010 and at 5.1 per cent in 2011.

The real GDP growth rate of East and South Asia registered 4.9 per cent in 2009. The economic performance of the region has been quite heterogeneous as several countries, namely Korea, Malaysia and Singapore, have entered into recession due to the collapse in external demand. Positive growth in the region has been led by China and India. Both countries experienced strong domestic demand resulting from the fiscal packages in place. While most Asian economies have experienced a moderate devaluation of their national currencies against the US dollar, the Chinese yuan has kept its parity against US currency since July 2008 (figure 2-C). Consequently, increased price competitiveness against all major currencies, including China, Japan, the United States and the euro area, has improved the general sentiment for an export-led recovery. Thus, Eastern and Southern Asia were projected to grow at 8.3 per cent in 2010 and at 7.1 per cent in 2011.

The economies of Latin America and the Caribbean experienced a 2.1 per cent contraction in 2009. Due to close linkages with the US economy, the Mexican economy was also affected by the crisis and subsequently entered into recession. Moreover, weakened commodity prices adversely affected commodity exporters of the region. However, unlike the previous Latin American financial crises, no signs of balance-of-payments difficulties have so far been observed. As was the case in other developing countries, the accumulated foreign reserves built up prior to the crisis cushioned the developed countries from its effect. Even though the fiscal stimuli

The global financial crisis brought down the majority of stock market indexes worldwide

packages that have been introduced were relatively limited, domestic demand is on a moderate recovery path. The region was therefore expected to grow by 5.3 per cent in 2010 and by 4 per cent in 2011.

The global financial crisis brought down the majority of stock market indexes worldwide. Subsequently, lower GDP growth prospects in the more advanced economies brought down the world average real GDP growth rate from 3.9 per cent in 2007 to -2.0 per cent in 2009. These negative rates were, however, expected to pick up again in 2010 to about 3.6 per cent, but with a further expected decline to 3.1 per cent in 2011 (table 1 and figure 3). Subsequently, the crisis directly affected ESCWA[5] member countries, mainly via trade and capital flow channels and through declines in crude oil prices and GDP growth rates of the main trading partners of the ESCWA region, as well as declines in commodity and asset prices and cross-border capital flows. However, relative to other emerging regions, the impact of the crisis has been limited on the more diversified economies (MDEs), with growth slowing modestly to a mere 5.2 per cent on average in 2009, from a peak of 6.0 per cent in 2008, but with more significant declines in the less diversified economies (LDEs), from a peak of 6.6 per cent in 2008 to 0.1 per cent in 2009. Overall, the ESCWA region has been adversely affected by the crisis because of its severe impact on the GCC countries with overall growth declining from 5.4 per cent in 2007 to 2.0 per cent in 2009 (table 1) and the subsequent spillover effects into MDEs. However, these growth rates were expected to improve again, up to 4.5 per cent in 2010 and to 4.7 per cent in 2011 (figure 3).

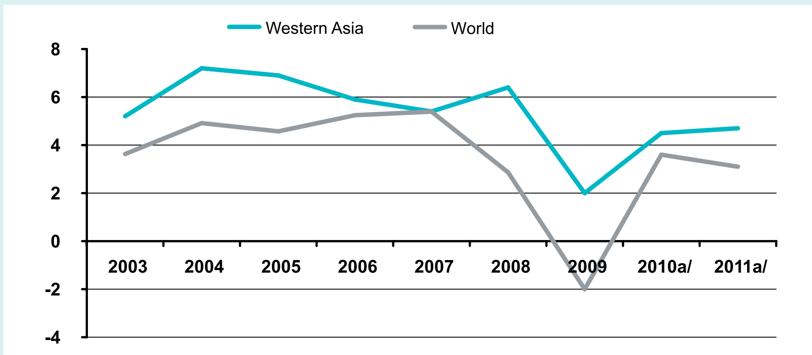
Crude oil prices are, in general, a clear indicator of growth prospects and business and consumer confidence in all ESCWA member countries, due to the positive intraregional spillover effects of oil revenues. Figure 4-A depicts movement in the West Texas Intermediate (WTI) crude oil price and the state of US dollar liquidity in terms of TED spread.[6] Concerns over more default rates on subprime mortgages and associated securitized financial products negatively affected US dollar liquidity in August 2007. The fragile liquidity situation continued until June 2009 when the TED spread came back under the historic 50 basis-point low. During the US dollar liquidity squeeze between August 2007 and June 2009, the price of crude oil experienced extensive volatility, reaching a peak of US$140 in July 2008 only to sink again by the end of 2008 and rise back to the range of US$60-80 after the second quarter of 2009. It is well known that financial speculation in crude oil futures can be highly volatile when liquidity is scarce. As the US dollar liquidity levels returned to normal, crude oil prices stabilized at around the pre-July 2007 level. Consequently, the external macroeconomic environment of the ESCWA region deteriorated abruptly during the fourth quarter of 2008, a period coinciding with extreme shortages of US dollar liquidity and the plunge of crude oil prices.

Figure 4-B depicts the annual incremental growth of stock market capitalization, current account surpluses and gross oil export revenues of ESCWA member countries. After a short-lived recovery in 2007, stock market capitalization plunged to a historic low in 2008. The growth of regional financial assets, as proxied by stock market capitalization, outpaced the level of oil export revenues in the period between 2003 and 2005. Despite the downward correction of the stock market, the value of real estate

assets continued to decline since the second quarter of 2008. Figure 4-B indicates that since July 2008 and in 2009, correction in the value of assets, both in stock and real estate markets, has been much more significant than the decrease in oil export revenues. Stock market capitalization was observed to have reversed its upward trend since the third quarter of 2008, mainly because of deleveraging. Consequently, the total current account balance of ESCWA member countries declined significantly from US$264 billion in 2008 to US$38 billion in 2009.

Figure 4-C highlights the inflow of capital through bank deposits in the ESCWA region, as reported by commercial banks for the Bank for International Settlements. A significant volatility in the flow of bank deposits in and out of the GCC countries was observed in 2009. This reflects the status of GCC countries being both major international investors through respective sovereign wealth funds and major international borrowers for development projects. Moreover, due to their high exposure to international capital markets, several GCC countries have been the target of speculative attacks. Despite their solid image and related oil wealth, GCC countries have shown signs of weakness and vulnerability to the global financial crisis. The MDEs, however, experienced capital inflows in the form of bank deposits since 2007. This international inflow of capital can partly explain the robust capital account positions of several MDEs, namely Egypt, Jordan and Lebanon.

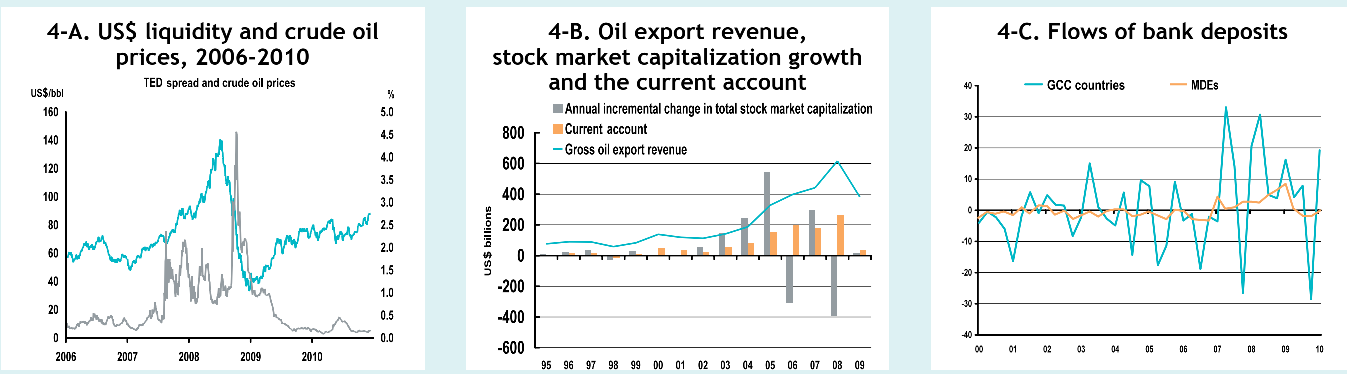
Figure 3. ESCWA countries real GDP growth rates, 2003-2011 (*Annual percentage change*)



Sources: National sources unless otherwise stated. Figures for the ESCWA region are ESCWA staff calculations (see table 6 for details). Other figures are from DESA, *LINK Global Economic Outlook, October 2009* and from the IMF, IFS, World Economic Outlook (WEO) Reports.

a/ November 2010 estimations.

Figure 4. Other macroeconomic and financial implications of the crisis



Sources: 4-A: Federal Reserve, British Bankers Association, US Energy Information Administration (EIA).
4-B: Arab Monetary Fund (AMF) for stock market capitalization, ESCWA calculations for gross oil export revenue and the total current account.
4-C: Bank for International Settlements (BIS).

Note: US$/bbl: US$ per barrel of oil.

If the world economy recovers in 2011, the macroeconomic environment of the ESCWA region will be expected to subsequently improve. However, despite the recovery in US dollar liquidity shortages since the second quarter of 2009 and relative oil price stability, it is believed that the full impact of the crisis on ESCWA member countries has not yet fully unfolded. This is mainly due to: (a) the ongoing deleveraging of the financial sector of the region for past excess leveraging; (b) the vulnerability associated with international financial exposure of several ESCWA member countries; and (c) the rapidly deteriorating current account positions of most ESCWA member countries. The first two factors are interrelated, as past leveraging and present deleveraging involves international investors. A smooth balance sheet adjustment with the parties involved will be the key to overcoming this interlinked adversity. From a macroeconomic perspective, such adjustment is deemed relatively easier as long as current account balances remain positive so that adjustment can be made internally.

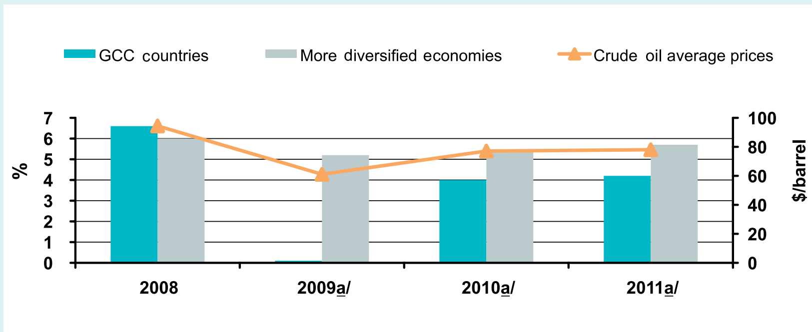
C. Oil sector development

Oil prices and revenues are, in general, a clear indicator of GDP growth prospects in all ESCWA member countries. Figure 5 indicates that when oil prices declined from US$94 in 2008 to US$61 in 2009, real GDP growth rate of LDEs fell to about 0.1 per cent from a high 6.6 per cent in 2008, underlining the fact that growth in LDEs is primarily driven by oil prices and revenues. With recovery of the average price of oil to US$80/barrel, LDEs were expected to grow by 4.0 per cent in 2010. The real GDP growth rates of MDEs appear to be much more resilient to the volatility in oil prices, but impact usually follows a lag of one or two years. According to the Organization of the Petroleum Exporting Countries (OPEC),[7] the 2008 total world demand for oil was estimated at 85.6 million barrels per day, while total supply of crude oil was 85.8 million barrels per day. In 2008, the demand for crude oil was estimated to have decreased by 0.3 million barrels per day relative to 2007. Given weak demand prospects, OPEC kept its reduced level production quota at benchmarks similar to those of the last quarter of 2005. OPEC decided to further cut its quota in October and December 2008 by 4.2 million barrels per day. Continued weak demand prospects for crude oil in 2009 and 2010, implied that OPEC would be expected to comply with the present production ceiling of 24.8 million barrels per day, with a possibility of further production cuts. Due to limited expansion capacity for exploration and production, crude oil production of non-OPEC countries in 2009 and 2010 was estimated to stay at the same 2008 level. Thus, demand and supply of crude oil hovered around 81.5 million barrels per day in 2009, which is 5 per cent lower than the 2008 level.

Crude oil prices surged during the first half of 2008 to an historic high, before plunging to the 2005 level (figure 6-A). The price of the forecast median crude oil price, the OPEC Reference Basket, peaked at US$140.73/barrel on 3 July 2008, but declined again to US$35.58/barrel by the end of the year. Prices recovered to the range of US$60 to US$80/barrel during the second quarter of 2009, followed by a continuous upward trend to US$90 by the end of 2010. It is now well known that financial speculation, mainly the buying of crude oil futures was behind the 2008 price surge. During the period of price hikes, the decreasing real demand for fuel products, namely gasoline and heating oil, caused a substantial decline in refining margins. The trend in refining margins, measured by a nine-month moving average of the spread between WTI crude oil price and the reformulated blendstock for oxygenate blending (RBOB) gasoline price, started to decline well before prices reached their peak (figure 6-B). The trend in refining margins recovered only in the second quarter of 2009. Figure 6-C indicates that international investors stayed 'long' in crude oil futures and option markets throughout the period of 2008 to 2009. Moreover, the number of long positions declined toward the end of 2008, but surged again to its previous level during the first quarter of 2009. However, an increasingly spare production capacity of crude oil, as well as enhanced world refining capacity, particularly in Asia, dampened the effects of speculation in 2009 relative to 2008. These forces are forecast to be a stabilization factor for crude oil prices rather than a contributing factor to increasing price volatility. The 2011 average OPEC Reference Basket price is projected to be in the range of US$54 to US$102/barrel with a median forecast of US$78/barrel (table 3).

The total crude oil production of ESCWA member countries reached 18.3 million barrels per day on average in 2009, constituting a 9.8 per cent decrease from the previous year

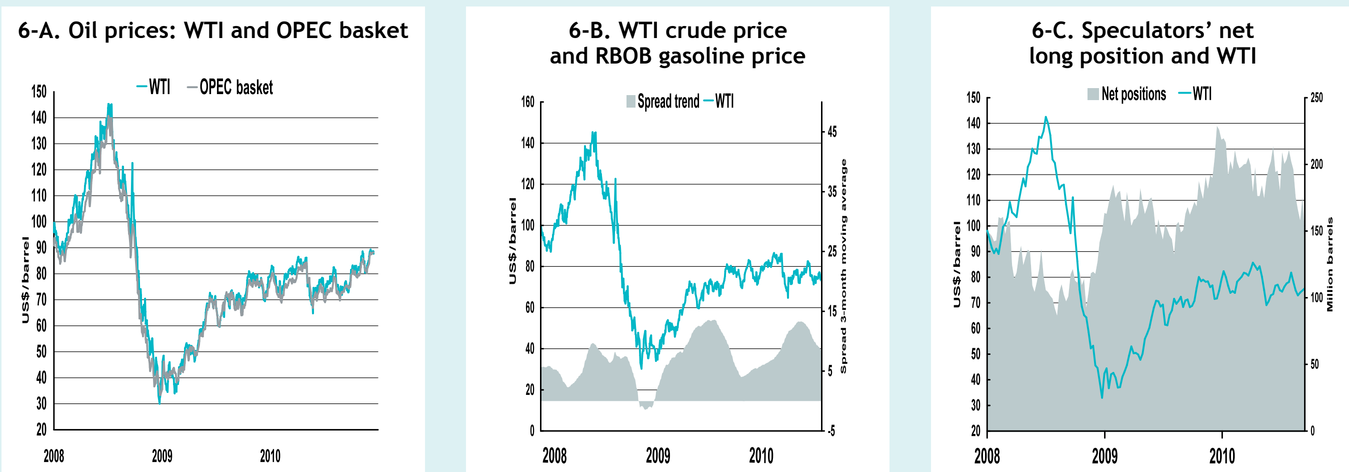
Figure 5. **Real GDP growth rates and average prices of crude oil of ESCWA member countries, 2008-2011**



Sources: Organization of Petroleum Exporting Countries (OPEC) for average crude oil price for 2008. For real GDP growth rates, see table 6.

a/ Oil prices for 2009, 2010 and 2011 are ESCWA staff forecasts as of December 2010.

Figure 6. **Oil sector development, 2008-2010**



Sources: 6-A: EIA and OPEC.
6-B: ESCWA staff calculation based on EIA data.
6-C: EIA and US Commodity Futures Trading Commission.

Note: RBOB: reformulated blendstock for oxygenate blending; WTI: West Texas Intermediate; OPEC Basket: OPEC Reference Basket.

(table 4). This is due to significant production level reductions in compliance with the OPEC quota set by the OPEC member countries of ESCWA. The production of GCC countries totalled 14.3 million barrels per day in 2009; the lowest level since 2003. Crude oil production by MDEs in Egypt, Iraq, the Sudan, the Syrian Arab Republic and Yemen, stood at 3.99 million barrels per day in 2009. In 2010, total crude oil production of ESCWA member countries was projected to be at 18.75 million barrels per day, with a forecast of 18.99 million barrels per day in 2011. Crude oil production of GCC countries was estimated at 14.59 million barrels per day in 2010 and the forecast for 2011 is at 14.70 million barrels per day. Recent investment in the oil sector is expected to enhance the crude oil production capacity of MDEs, estimated at 4.1 million barrels per day in 2010 and at 4.29 million in 2011. A continuously weak crude oil production position has been observed in the Syrian Arab Republic and Yemen. However, both countries are faring better in exploration and production of natural gas, particularly Yemen, which started to export liquefied natural gas (LNG) in November 2009. While Qatar has established itself as the largest global LNG exporter, development of the gas sector has also been active in other GCC countries, as well as in Egypt and the Sudan.

Table 3. Crude oil price estimation and forecast, 2008-2011 (*OPEC Reference Basket: US$/barrel*)

	Minimum	Maximum	Annual average	Forecast annual average for 2011		
				Lower	Median	Higher
2008	33.36	140.73	94.45			
2009	38.14	78.00	61.06			
2010	68.21	90.02	77.10			
2011				54.0	78.0	102.0

Sources: OPEC for 2008. Figures for 2009, 2010 and 2011 are ESCWA staff forecasts as of December 2010.

Table 4. Oil production in the ESCWA region, 2006-2011 (*Thousands of barrels per day*)

Country	2006	2007	2008	2009	2010[a]	2011[b]	Percentage change 2009/10	Percentage change 2010/11
Bahrain	183	185	185	182	178	180	-2.2	1.1
Kuwait	2 665	2 575	2 676	2 262	2 290	2 300	1.3	0.4
Oman	687	653	669	713	755	770	6.0	2.0
Qatar	803	845	843	733	790	800	7.8	1.3
Saudi Arabia	9 208	8 816	9 198	8 184	8 270	8 300	1.1	0.4
United Arab Emirates	2 569	2 529	2 572	2 242	2 310	2 350	3.1	1.7
GCC countries	**16 115**	**15 603**	**16 143**	**14 315**	**14 593**	**14 700**	**1.9**	**0.7**
Egypt	533	516	517	496	510	522	2.8	2.4
Iraq	1 957	2 035	2 281	2 336	2 480	2 580	6.2	4.0
The Sudan	364	484	500	510	515	525	1.0	1.9
Syrian Arab Republic	400	380	377	377	380	387	0.8	1.8
Yemen	357	313	286	272	277	282	2.0	1.8
MDEs	**3 611**	**3 729**	**3 960**	**3 991**	**4 162**	**4 296**	**4.3**	**3.2**
Total ESCWA region	**19 726**	**19 331**	**20 103**	**18 306**	**18 755**	**18 996**	**2.5**	**1.3**

Sources: OPEC except for the Sudan; Annual Statistical Abstract for the Sudan for 2006/07 and ESCWA staff estimation for subsequent years.
a/ ESCWA staff estimates based on official and other sources as of November 2010.
b/ ESCWA staff forecasts as of November 2010.

In 2009, total gross oil export revenues of ESCWA member countries stood at US$356.2 billion, decreasing by 41.8 per cent from the previous year (table 5). Revenues were expected to recover by 33.9 per cent to US$477 billion in 2010 with the OPEC Reference Basket price of US$77.10/barrel, with a slight forecast decline for 2011 to US$469.8 billion. For 2009, both the price decline and the production cuts of regional OPEC member countries set the regional trend. Moreover, production cuts resulted in significant oil export revenue declines in each of Kuwait, Qatar, Saudi Arabia and the United Arab Emirates (figure 7). In 2010, moderate expected growth in both production and price levels was forecast to have lead to a 35 per cent increase in GCC crude oil export revenues for a total of US$391.7 billion, with a slight forecast decline for 2011 to US$380.6 billion. Due to notably enhanced production capacity, the margin of decline is the lowest in Iraq and Oman, both of which were expected to have had the largest growth in oil export revenues in 2010.

Despite the 2008 crude oil price collapse, the subsequent 2009 recovery in the range of US$60 to US$80/barrel has placed oil producers in the ESCWA region at a comparative advantage. As has been repeatedly articulated by OPEC member countries, particularly Saudi Arabia, the US$70 crude oil price/barrel is deemed appropriate. The above price range is not too high to dent demand and not too low to hamper investment in exploration and development of crude oil production capacity. Moreover, at this price range, the oil producers of the region can ensure a better production margin compared with almost all oil producers in other regions, where exploration costs are more significant. With the stable 2010 crude oil price forecast, crude oil exporters of the ESCWA region are expected to consolidate their competitive edge in oil and energy sectors.

Table 5. Gross oil export revenues in the ESCWA region, 2006-2011 (*US$ billion*)

							Percentage change	
Oil exporting countries	**2006**	**2007**	**2008**	**2009**	**2010**[a/]	**2011**[b/]	**2009/10**	**2010/11**
Bahrain	9.2	10.8	13.8	8.9	11.7	12.1	31.5	4.3
Kuwait	53.2	59.0	80.7	46.3	57.8	56.7	24.9	-1.9
Oman	14.5	15.7	24.5	13.9	25.7	27.2	84.9	5.8
Qatar[c/]	16.0	19.2	25.8	11.7	19.5	19.0	66.7	-2.6
Saudi Arabia	188.2	205.3	281.0	163.1	215.0	205.0	31.9	-4.7
United Arab Emirates	58.1	61.2	85.4	46.5	62.0	60.5	33.3	-2.4
GCC countries	**339.2**	**371.1**	**511.1**	**290.3**	**391.7**	**380.6**	**34.9**	**-2.8**
Egypt	10.5	11.1	14.4	10.1	11.5	12.0	14.4	4.3
Iraq	29.7	37.8	61.9	39.0	52.7	55.0	35.3	4.4
The Sudan	5.2	8.4	12.2	8.7	10.6	11.0	21.9	3.8
Syrian Arab Republic	4.0	4.4	5.6	3.7	4.2	4.6	13.5	8.5
Yemen	6.7	6.1	7.7	4.4	6.3	6.6	42.1	4.8
MDEs	**56.2**	**67.9**	**101.8**	**65.8**	**85.3**	**89.2**	**29.6**	**4.5**
Total ESCWA region	**395.5**	**439.0**	**612.9**	**356.2**	**477.0**	**469.8**	**33.9**	**-1.5**

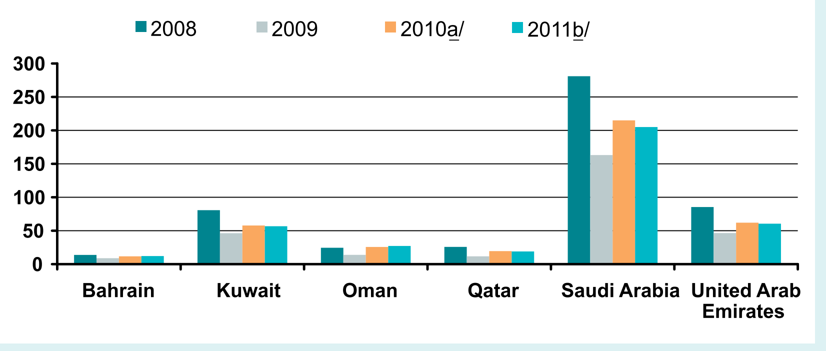
Source: Balance-of-payments data of national sources.

a/ ESCWA estimates based on official and other sources as of November 2010.

b/ ESCWA forecasts as of November 2010.

c/ Qatar has been experiencing substantial increase in non-crude oil exports, specifically liquefied natural gas (LNG), which are not accounted for here.

Figure 7. Oil export revenues in the GCC countries, 2008-2011 (*US$ million*)



Source: Balance-of-payments data of national sources.
a/ ESCWA estimates based on official and other sources as of November 2010.
b/ ESCWA forecasts as of November 2010.

The extraordinary rise in crude oil prices dampened the risks of a potential contagious effect emanating from US dollar liquidity shortages

Business and consumer confidence in the ESCWA region in 2008 and 2009, particularly in the GCC countries, remained robust, despite the negative implications of the global financial crisis. This resilient economic sentiment was surprising, given the adverse impact of the deteriorating external macroeconomic environment, coupled with challenges that lay ahead for the expected smooth adjustment of balance sheets of commercial banks, business entities and households. The resilience in economic sentiments may have been due to relative stability in oil and energy sectors. As discussed above, the extraordinary rise in crude oil prices dampened the risks of a potential contagious effect emanating from US dollar liquidity shortages between 2008 and 2009. The present stability of the oil and energy sectors will hopefully dampen another potential risk emanating from the expected balance sheet adjustment process.

CHAPTER II.

Recent Economic Trends and Developments in the ESCWA Region and the Global Financial Crisis

II. Recent Economic Trends and Developments in the ESCWA Region and the Global Financial Crisis

A. Introduction

As the world economy is slowly but steadilyrecovering from the 2009 recession, the economic sentiment of ESCWA member countries has shifted from pessimism to cautious optimism. The 2011 expected robust oil price recovery, in the range of US$54 to US$102/barrel, is certainly a contributing factor. Moreover, several worst-case scenarios that could have affected the output of the region, employment, banking and financial markets, have so far been averted. Balance-of-payments crises and associated currency devaluation did not yet unfold even in ESCWA member countries with huge current account deficits, significant foreign debt and fixed exchange rate regimes. The once-feared reverse mass exodus of expatriate workers from GCC countries to MDEs did not materialize. The monetary authorities of the region have so far successfully defended their respective local currencies and banking systems from the global spillover effects of the financial crisis by relying on the recently-accumulated chest of foreign exchange reserves and by preventing local banks from investing in the affected derivative financial assets. Where sufficient fiscal space was available, fiscal authorities in the ESCWA region have successfully taken an active stance to cushion the negative impacts emanating from the global recession. While the 2009 average real GDP growth rate of ESCWA member countries registered 2 per cent, compared with 6.4 per cent in 2008, constituting a contraction of about 4.4 per cent, the forecast for 2010 was at 4.5 per cent (table 6). The expected recovery of both external and domestic demand due to the introduction of the various fiscal stimuli packages is one important contributing factor to the recovery.

However, the downside risk remains. Despite the 2010 stable crude oil price forecast, oil prices may decline again to a low of US$54/barrel in 2011 (table 3). Regional commercial banks have so far weathered the global liquidity crisis, but now business entities and households are suffering from scarce liquidity. A low level of liquidity may depress asset prices which may, in turn, force commercial banks into further balance sheet adjustments. In fact, real estate prices in the ESCWA region are still weak and volatile and a strong recovery in 2011 is not assured even though the economy of the region is forecast to be on a recovery path.

Meanwhile, after the short-lived peak in consumer price inflation during the second half of 2008 at 11.9 per cent, price inflation has been on the decline since 2008 in several ESCWA member countries, where policymakers raised serious concerns about the potential risks of deflation in 2009, with a slight trend reversal in 2010 and 2011. The rapid decline in consumer inflation rates has been driven by the price of food and property rentals; the two factors behind the historically high 2008 consumer inflation rates. The anticipated second-round effects of the 2007-2008 inflationary pressures have not yet materialized. The upward wage adjustments of same period, particularly in the public sector, did not influence general prices as was previously anticipated. Traditionally, the region has experienced low inflation rates and the present situation may point to convergence back to this historic trend. The average 2010 consumer inflation rate of the ESCWA region is estimated at 5.2 per cent, compared with 4.7 per cent in 2009. The forecast for 2011 is at 5.0 per cent (table 6).

B. Real GDP growth, inflation and export rates

Table 6. Real GDP growth rate and consumer inflation rate, 2007-2011 (*Annual percentage change*)

	Real GDP growth rate					Consumer inflation rate				
Country	2007	2008	2009[a/]	2010[b/]	2011[c/]	2007	2008	2009	2010[b/]	2011[c/]
Bahrain	8.4	6.3	3.1	4.0	3.8	3.3	3.5	2.8	2.2	1.9
Kuwait	4.5	5.5	-4.6	4.4	3.6	5.5	10.6	4.0	3.5	3.2
Oman	6.8	12.8	3.6	4.3	3.9	5.9	12.6	3.5	2.4	1.8
Qatar	26.8	25.4	8.6	13.4	14.0	13.8	15.2	-4.9	-1.6	1.0
Saudi Arabia	2.0	4.2	0.6	3.4	3.8	4.1	9.9	5.1	4.9	4.5
United Arab Emirates	6.2	7.4	-1.9	2.7	3.2	11.1	12.3	1.6	0.3	1.0
GCC countries[d/]	**4.9**	**6.6**	**0.1**	**4.0**	**4.2**	**6.3**	**10.8**	**3.6**	**3.3**	**3.2**
Egypt[e/]	7.2	4.7	5.2	5.5	6.2	9.5	17.1	11.8	12.5	11.0
Iraq	1.5	9.5	4.2	5.0	5.5	30.8	2.7	-2.8	2.5	4.0
Jordan	8.5	7.6	2.3	3.1	3.5	4.7	13.9	-0.7	4.0	4.2
Lebanon	7.5	9.3	8.5	6.9	5.6	6.7	10.0	1.2	3.1	2.5
Palestine	5.4	5.9	6.8	4.5	4.7	1.9	9.9	2.8	3.2	3.5
The Sudan	10.2	6.0	4.5	6.2	6.0	8.1	14.9	11.2	13.2	11.0
Syrian Arab Republic	5.7	4.3	5.9	6.2	6.0	4.5	15.2	2.8	4.3	4.0
Yemen	4.7	4.5	4.7	3.5	3.2	7.9	19.0	5.4	8.5	8.9
MDEs[d/]	**6.3**	**6.0**	**5.2**	**5.4**	**5.7**	**11.5**	**13.8**	**6.7**	**8.7**	**8.0**
Total ESCWA region[d/]	**5.4**	**6.4**	**2.0**	**4.5**	**4.7**	**8.2**	**11.9**	**4.7**	**5.2**	**5.0**

Source: National sources unless otherwise stated.

a/ Estimated figures for Kuwait, Lebanon, Qatar, the Sudan, the United Arab Emirates and Yemen as of November 30, 2010.

b/ November 2010 estimations.

c/ November 2010 forecasts.

d/ Figures for country groups are weighted averages, where weights for each year are based on GDP in 2000 constant prices.

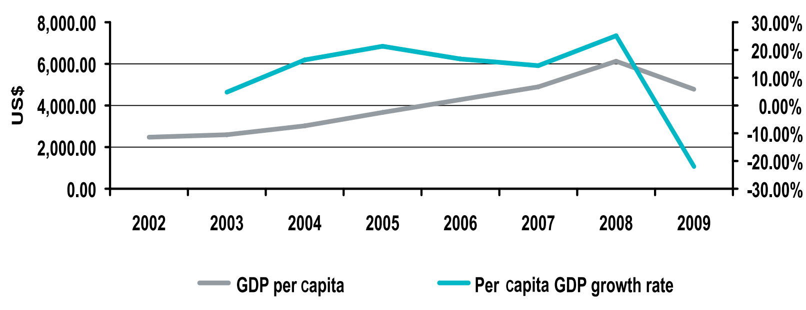
e/ For GDP growth rate of Egypt, the figures are for the country's fiscal year which starts in July and ends in June of the following year.

The global financial crisis brought down the average real GDP growth rate of the world from about 3.9 per cent in 2007 to -2.0 per cent in 2009. However, relative to other emerging regions, the impact of the crisis has been limited on MDEs of the ESCWA region, with growth slowing modestly to 5.2 per cent on average in 2009, from a peak of 6.0 per cent in 2008, but with more significant declines in LDEs, from a peak of 6.6 per cent in 2008 to 0.1 per cent in 2009 (table 6 and figure 9-A). Moreover, after a steady increase of average real per capita GDP in the period between 2002 and 2008, from US$2,200 to US$6,000 in ESCWA member countries, real per capita GDP fell to US$5,500 in 2009 as a result of the global financial crisis. The per capita GDP growth rate experienced a significant decline between 2008 and 2009, decreasing 12.4 per cent in just one year (figure 8).

Since the 2008 inflation hike to 11.9 per cent, consumer inflation rates have been on the decline. The average inflation rate in the ESCWA region was 4.7 per cent in 2009 but with a slight increase to an estimated 5.2 per cent in 2010. Among MDEs, Egypt and the Sudan have remained in the forefront with expected inflation rates of more than 10 per cent in each of 2009 and 2010, whereas among LDEs, Saudi Arabia and Kuwait have remained in the forefront with respective inflation rates of 5.1 and 4 per cent in 2009 and 4.9 and 3.5 per cent respectively in 2010 (table 6 and figure 9-B).

Figure 9-B shows that the inflation rate among LDEs peaked in 2008 at 10.8 per cent, increasing steadily from about 6.3 per cent in 2007. Strong increases in domestic demand and housing prices, the nominal US dollar depreciation against the euro, rising US dollar liquidity due to significant oil revenues and rising international commodity prices were all contributing factors. Subsequently, there was a significant gap between the GCC and US business cycles in 2007 and during the first half of 2008, which could not be bridged because of the exchange rate peg to the US dollar and the ineffectiveness of the monetary policy of GCC to deal with domestic macroeconomic imbalances, namely rising inflationary pressures. Since monetary policy was solely geared toward preserving the US dollar peg, domestic inflation started to rise, combined with appreciations in the real exchange

Figure 8. Real GDP per capita and per capita GDP growth rate in ESCWA member countries, 2002-2009

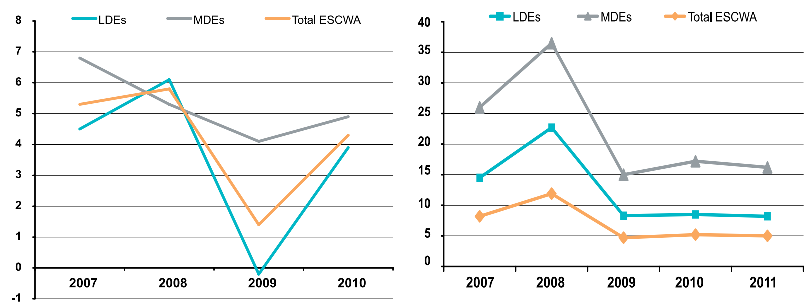


Source: World Bank, *Wold Development Indicators Database*.

Figure 9. Real GDP growth and inflation rates of ESCWA member countries, 2007-2011

9-A. Real GDP growth rates (*Percentage*)

9-B. Consumer inflation rates (*Percentage*)



Source: National sources of ESCWA member countries.

rate as a result of larger terms of trade gains, triggering speculative short capital inflows to LDEs and further exacerbating inflationary pressures. One by-product of the above macroeconomic imbalances was the exit of Kuwait from its long-standing exchange rate peg to the US dollar toward a peg to a basket of currencies, constituting a significant setback to the potential establishment of a GCC monetary union and the earlier agreement on the expected introduction of a GCC common currency in 2010. Finally, it should also be noted that the impact of rising inflation on the real exchange rate in GCC countries right before the crisis was largely offset by the nominal depreciation of the US dollar against the yen, which resulted in a significant depreciation of the GCC currencies against the currencies of their major trading partners in Asia.

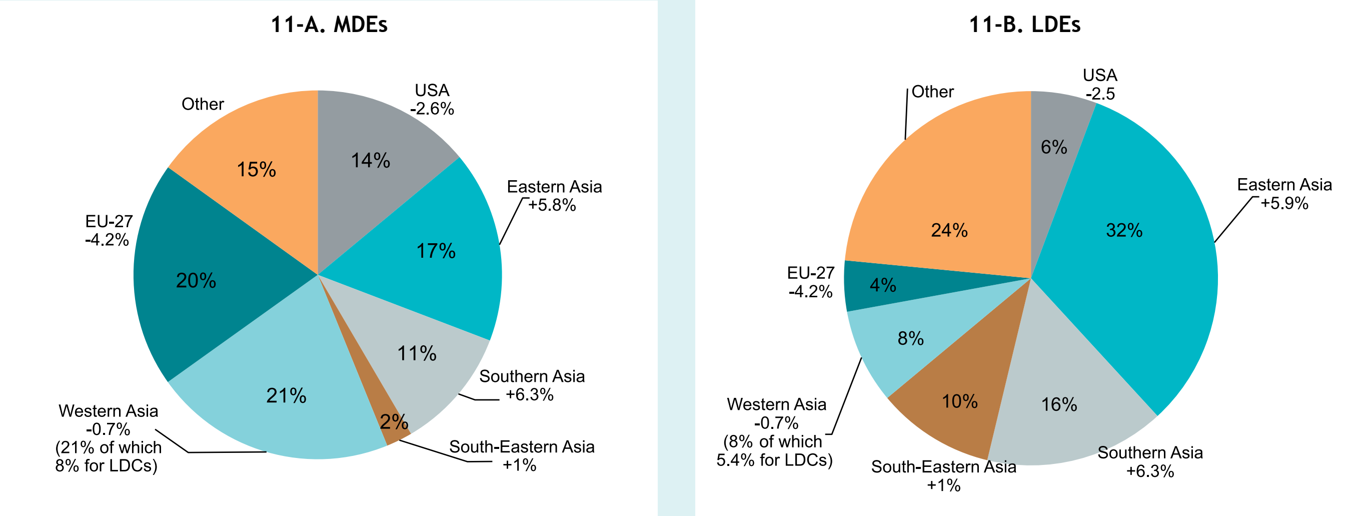
Figure 10 depicts specific 2009 total export destinations in percentage of GDP of ESCWA member countries. It is clear that while the major trading partners of MDEs are the 27 member countries of the European Union followed by LDEs and the United States (figure 10-A), Asia is the main trading partner of GCC (figure 10-B). The main affect on MDEs came from declining growth prospects in the United States, the European Union and LDEs because of their consequent lower demand for exports.

Figure 11-A shows that the real GDP growth prospects of MDEs in 2009 were negatively affected because of weak growth prospects (-4.2 per cent in the European Union and -2.5 per cent in the United States) in their major trading partners, namely the European Union which accounts for about 20 per cent of the total trade of MDEs, followed by the United States 14 per cent and GCC accounting for about 8 per cent. It is through this transmission channel that those member countries have been affected by the global financial crisis, an effect which has been mitigated, to some extent, by countercyclical monetary and fiscal policies. Figure 11-B indicates that 2009 real GDP growth prospects of LDEs were not negatively affected by weak growth prospects in the United States and the European Union, because most GCC trade has been with Asia, with slightly higher growth prospects for 2009 (6.1 per cent),

Figure 10. MDE and LDE export destinations, 2009

Sources: IMF, Direction of Trade Statistics (DOT), WEO and Regional Economic Outlook (REO) Reports, and Euromonitor International.

Figure 11. Growth in trading partners of ESCWA member countries, 2009 (*Percentage*)



Sources: IMF, DOT, WEO and REO Reports.

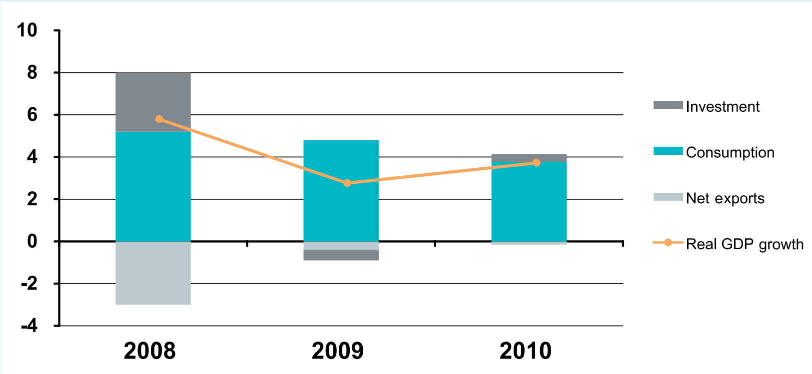
which accounts for about 48 per cent of the total trade of LDEs. It is clear that a low level of trade integration within the ESCWA region has increased the macroeconomic vulnerabilities of member countries to growth developments in the European Union, the United States and Asia. With a higher level of trade integration and less reliance on more mature markets, the trade transmission channel of the global financial crisis on the ESCWA region could have been mitigated to a great extent.

Weak growth prospects affected world demand for exports of MDEs, especially the demand of the European Union and the United States for exports of the region. Egypt, Iraq, Lebanon and the Syrian Arab Republic, are the MDEs most affected by low European Union growth prospects. Growth developments in LDEs have an impact on Jordan, Lebanon, the Syrian Arab Republic and Yemen, whereas the United States has an impact mainly on Iraq and Jordan (figure 11-A). GCC countries appear to have an impact on all MDEs with the exception of Iraq. Lower export earnings and the inability to impose countercyclical taxation measures due to limited fiscal space will have a direct bearing on the accumulation of foreign exchange reserves, with subsequent implications on pursued exchange rate regimes, accumulated foreign debt and related debt service. The picture is quite different in LDEs, where it is clear that GCC countries are not significantly affected by growth developments in either the United States or the European Union, but rather by developments in other regions worldwide such as China, India and Japan (figure 11-B). It is, thus, clear that the trade transmission channel did not constitute a major conduit, exposing LDEs to the global financial crisis, but other financial, real estate and oil-related factors constituted the main channels through which GCC countries have been affected.

The ensuing global recession has not only dried up US dollar liquidity but has also reduced financial inflows and export revenues, threatening the fiscal and current account balances and subsequently the

The ensuing global recession has not only dried up US dollar liquidity but has also reduced financial inflows and export revenues

Figure 12. Contribution by MDEs to real GDP growth (*Percentage*)



Sources: IMF, IFS and ESCWA staff estimates.

macroeconomic stability of several MDEs. Certain MDEs have been facing liquidity challenges since the beginning of the financial crisis, which may further exacerbate their already weak fiscal and monetary stance if appropriate stabilization policies are not implemented in a timely fashion. The level of US dollar liquidity is a contributing factor to the stability of the financial markets of ESCWA member countries, as the majority of them have pegged their national currencies to the US dollar. For MDEs with strong financial linkage with developed financial markets, the multiple external shocks have had detrimental effects on current fiscal and monetary sustainability, coupled with outflows of capital and a decline in foreign exchange reserves, putting further downward pressure on the currencies of those countries. With tight budgets, limited fiscal space, current account deficits and exports under pressure, future real GDP growth in 2010 and 2011 will hinge on private consumption which is expected to be the highest contributor to the real GDP growth rate of MDEs (figure 12).

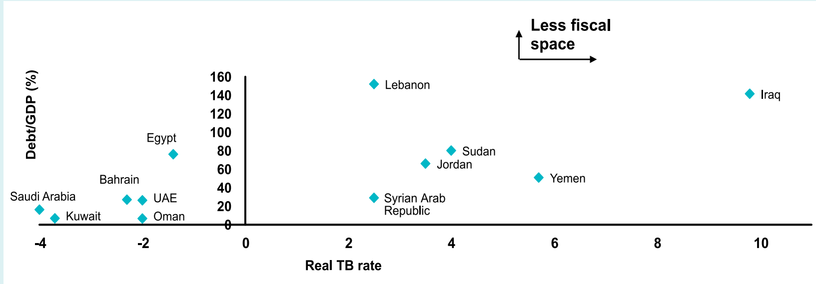
As stated above, most developed economies experienced massive output losses and a substantial increase in unemployment. Despite the Asia-led recovery of the world economy, production and consumption is still heavily supported by stimulus measures enacted to combat the previous economic downturn. However, private consumption and investment still trail behind as households and firms are rather cautious about spending and investing until the recovery gains further momentum. The recovery after the crisis remains fragile, as the United States and China are faced with the risk of lower growth in the medium run. The debt crisis in the euro area is still ongoing and fiscal and monetary policies are expected to implement exit strategies from the expansionary policy path.

C. Fiscal space

Certain ESCWA member countries, namely Bahrain, Kuwait, Oman, Saudi Arabia, the Syrian Arab Republic and the United Arab Emirates entered the crisis either with robust fiscal space or with a significant amount of accumulated foreign exchange reserves (figure 13). Those countries were able to implement countercyclical macroeconomic policies to dampen the effects of the crisis on their respective economies. On the fiscal side, this was achieved mainly through fiscal impulse[8] and automatic stabilizers.[9] For instance, Saudi Arabia introduced a stimulus package which was considered the highest among the Group of Twenty in percentage of GDP. This countercyclical stimulus package which is part of a five year US$400 billion investment plan is expected to boost the total demand of ESCWA member countries, including exports from MDEs. It is also expected to contribute positively in stimulating workers' remittances destined to MDEs. While Kuwait decided to increase Government spending by US$104 billion between 2010 and 2014, Egypt announced a stimulus package of EGP30 billion in 2009 to immediately deal with the implications of the global financial crisis. However, other ESCWA member countries, namely Iraq, Jordan, Lebanon the Sudan and Yemen with fixed exchange rate regimes and relatively high debt to GDP ratios (160 per cent in Lebanon, 150 per cent in Iraq, 80 per cent in the Sudan, 70 per cent in Jordan, and 60 per cent in Yemen) and high real interest rates (10 per cent in Iraq, 6 per cent in Yemen, 4 per cent in the Sudan and 3 per cent in Lebanon) were in a much weaker position and were not able to respond to the crisis with adequate macroeconomic/fiscal policy actions. As a consequence, the severity of the external shocks passed directly through to their economies, in particular to the economies of Iraq, Jordan, the Sudan and Yemen. Because of its significantly high debt to GDP ratio and real interest rate, Lebanon had little fiscal space to manoeuvre. However, Lebanon has been successful in benefiting from other sources of capital inflows, namely higher tourism and remittance revenues, GCC investments in real estate and FDI to service its rising public debt and current account deficits.

Figure 14-A indicates that the 2010 change in non-oil primary fiscal deficit was expected to be negative in each of Jordan, Lebanon and the Syrian Arab Republic, pointing to limited fiscal space. In addition, automatic stabilizers were expected to only contribute less than 1 per cent to GDP in each of those countries. The picture is quite different in LDEs where the 2010 non-oil primary fiscal deficit was expected to be positive in all GCC countries, pointing to robust fiscal space (figure 14-B). In Oman, Qatar and Saudi Arabia fiscal impulse alone is estimated at about 10 to 15 per cent of GDP, whereas automatic stabilizers are expected to contribute about 8 to 10 per cent to GDP. Lower contributions of fiscal impulse and automatic stabilizers to GDP are estimated in each of Bahrain, Kuwait and the United Arab Emirates due to more limited fiscal space.

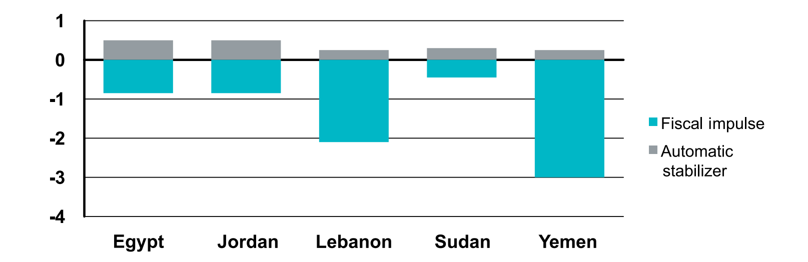
Figure 13. Real treasury bill rates and total public debt/GDP, 2009 (*Percentage*)



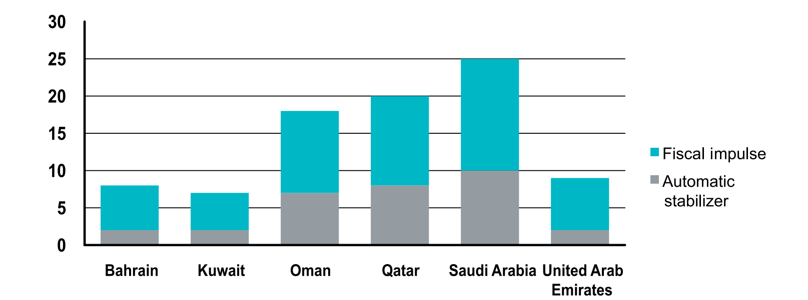
Source: IMF, IFS.
Note: TB: Treasury bill.

Figure 14. Change in primary fiscal deficit, 2010

14-A. MDE fiscal stance, 2010 (*Percentage of GDP*)

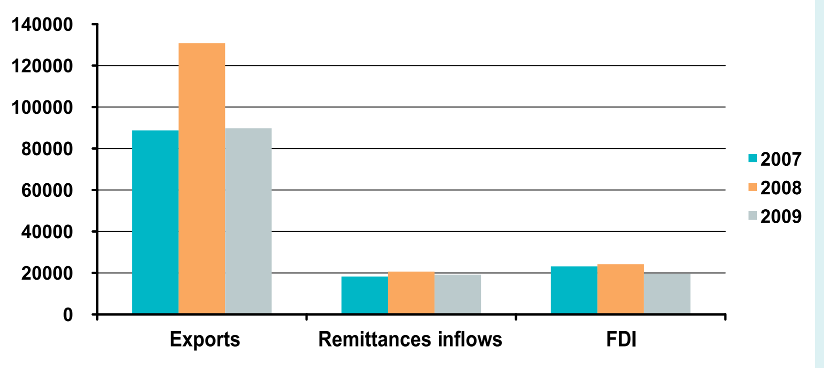


14-B. LDE fiscal stance, 2010 (*Percentage of GDP*)



Sources: IMF, IFS and ESCWA staff estimates based on national sources.

Figure 15. Capital flows to MDEs, 2007-2009 (*US$ million*)



Sources: World Bank, *World Development Indicators*, IMF, IFS and DOT, United Nations Conference on Trade and Development (UNCTAD), WEO, various issues and ESCWA staff calculations.

D. Capital flows

Capital flows to ESCWA member countries started to drop in 2008 for the first time since 2001 and the declining trend is expected to continue through 2011. In the wake of the global financial crisis, most MDEs suffered from negative spillover effects emanating mainly from the European Union, as well as from GCC countries. Capital flows from GCC and the European Union countries to MDEs have been hit primarily through lower FDI, portfolio flows and exports destined to the European Union (figure 15). Low real GDP growth rates in European Union countries lowered the demand for exports from MDEs, namely from Egypt, Iraq and the Syrian Arab Republic, with an overall decline in exports from US$130 billion in 2008, to US$85 billion in 2009. The total current account surplus of ESCWA member countries is estimated at US$38 billion in 2009, declining sharply from US$264 billion in 2008 and constituting an alarming contraction of 85 per cent.

Moreover, decreases in 2009 crude oil prices negatively affected the growth outlook in all ESCWA member countries. Lower oil revenues generated low US dollar liquidity in LDEs, with negative spillover effects into MDEs and contributed to further increasing interest rates in the region and in lowering worker's remittances, portfolio and FDI inflows. The sharp decline in oil prices has had a ripple effect on foreign reserves, coupled with declining capital inflows and shrinking export markets in all GCC countries. This is mainly due to having a low export base concentrated in a few commodities, lack of economic diversification and significant reliance on oil export revenues for growth and development, domestic consumption, debt servicing and Government expenditures. Higher real interest rates have so far led to lower GDP growth rates, real exchange rate appreciation, losses in international competitiveness, large trade and budget deficits, the accumulation of sizeable external debt and in some instances have increased the potential for a balance-of-payments crisis. Implications have also been felt on the balance sheets of corporations in the private sector.

Despite the accelerating growth of money supply through central banks of ESCWA member countries extensively increasing net credit to the banking sector during the crisis, little impact has so far been realized on the credit crunch in most GCC countries and there has been no increase in bank lending because of the ongoing private sector balance sheet adjustment process. During the crisis, financial markets that previously fuelled growth in ESCWA member countries dried up, seriously constraining those countries at a time when external capital inflows were most needed to stimulate economic growth, employment and roll over public debt. Private flows (including financial flows and remittances) to ESCWA member countries have also fallen since 2008. GCC countries have been directly hit by the financial crisis through a sharp decline in oil prices and revenues, but the impact has been mitigated to a great extent by countercyclical monetary and fiscal policies, gigantic fiscal stimuli packages, coupled with substantial reserves built up prior to the crisis, during the oil boom period of 2003 to 2008.

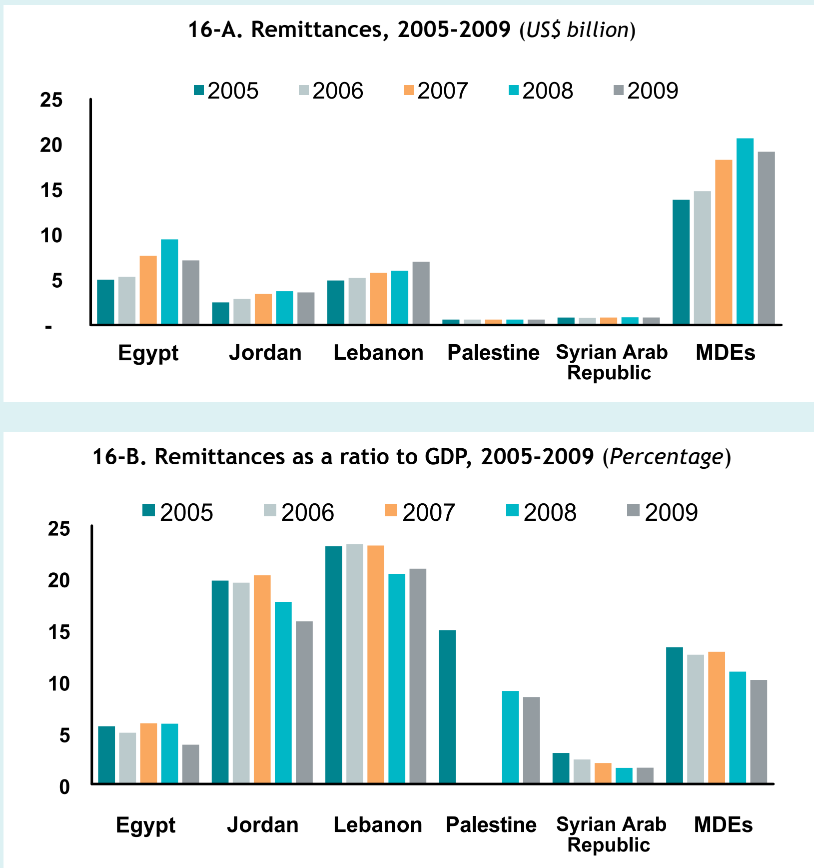
1. Workers' remittances

Labour markets in the ESCWA region are highly integrated relative to other integrated regions worldwide. Large intraregional labour movements have been the main vehicle for financial integration of the region, triggering substantial financial flows in the form of workers' remittances. To a large extent, intraregional labour movement has been from MDEs to LDEs. In the early 1990s, foreign labour in the GCC countries reached six million workers and accounted for about two thirds of the total GCC labour force; of these, 60 per cent originated in MDEs. This share has been on the decline since the mid-1990s, while the share of Asian labour has been increasing. The labour force from MDEs in GCC countries is expected to further decline as policies of substituting nationals for foreign labour are gradually being implemented by the GCC countries.

The flow of labour from MDEs to the GCC countries has been beneficial for both the exporting and importing countries. For the GCC economies, it provides needed skilled and unskilled manpower in various fields. For MDEs, it is a source of financial capital and employment for often unused factors of production. Moreover, capital flows in the form of labour remittances have a direct positive balance-of-payments impact and account for much of the private investment in certain countries in the region, namely Egypt, Jordan and Lebanon. Remittances have recently amounted to about 15 per cent of total exports of MDEs. In 2007 and before the eruption of the global financial crisis, workers' remittances were equivalent to about 6 per cent of GDP in Egypt, 23 per cent in Lebanon and 21 per cent in Jordan and have averaged 15 per cent in MDEs (figure 16-B). Therefore, any further decrease in remittances, resulting from the crisis, will have a detrimental effect on the real GDP growth rate of MDEs, debt service capabilities and may trigger a balance-of-payments crisis due to the fact that Jordan, Lebanon, the Sudan and Yemen are still adopting a fixed exchange rate regime to the US dollar.

Capital flows in the form of labour remittances have a direct positive balance-of-payments impact

Figure 16. **Remittance inflows to MDEs, 2005-2009**



Sources: World Bank: *World Development Indicators* and IMF.

Table 7. Workers' remittances, 2005-2009

	Remittances (US$ million)					Remittances/GDP (percentage)				
Country	2005	2006	2007	2008	2009	2005	2006	2007	2008	2009
Egypt	5 017	5 330	7 656	9 476	7 150	5.6	5.0	5.9	5.8	3.8
Jordan	2 500	2 883	3 434	3 737	3 604	19.7	19.5	20.2	17.6	15.7
Lebanon	4 924	5 202	5 769	6 000	7 000	23.0	23.2	23.1	20.3	20.8
Palestine	598	598	598	598	598	14.9	..	..	9.0	8.4
Syrian Arab Republic	823	795	824	850	828	3.0	2.4	2.0	1.6	1.6
Total MDEs	**13 862**	**14 808**	**18 281**	**20 661**	**19 180**	**13.2**	**12.5**	**12.8**	**10.9**	**10.1**

Sources: World Bank: *World Development Indicators* and IMF.

Table 8. FDI inflows by emerging region, 2007-2009 (*US$ million*)

Region	2007	2008	2009
World	2 099 973	1 770 873	1 114 189
Developing countries	564 930	630 013	478 349
Africa	63 092	72 179	58 565
Latin America and the Caribbean	163 612	183 195	116 555
South, East and South-East Asia	258 830	282 440	233 050
South-East Europe and CIS	90 968	122 588	69 948
Total ESCWA	**70 083**	**84 350**	**70 453**

Sources: UNCTAD, *World Investment Report 2010*. Data for the ESCWA region are based on the following sources: Bahrain: Central Bank of Bahrain, *Statistical Bulletin* (June 2010), Balance of Payments available at: www.cbb.gov.bh; Egypt: Central Bank of Egypt, Balance of Payments 2009 available at: www.cbe.org.eg; Jordan: Central Bank of Jordan, *Annual Report 2009*, Balance of Payments available at: www.cbj.gov.jo; Kuwait: Central Bank of Kuwait, *Quarterly Statistical Bulletin*, Balance of Payments available at: www.cbk.gov.kw; Lebanon: Central Bank of Lebanon, Balance of Payments available at: www.bdl.gov.lb; Oman: Central Bank of Oman, *Annual Report 2009* available at: www.cbo-oman.org; Palestine and Qatar: UNCTAD, *World Investment Report 2010*; Saudi Arabia: Saudi Arabian Monetary Agency, *Forty-Sixth Annual Report* available at: www.sama.gov.sa; The Sudan: Central Bank of Sudan, *Economic and Financial Statistics Review* available at: www.bankofsudan.org; The Syrian Arab Republic: Central Bank of Syria, *Quarterly Bulletin (2009)* available at: www.banquecentrale.gov.sy/index.html; The United Arab Emirates: Central Bank of the United Arab Emirates, *Annual Report 2009* available at: www.centralbank.ae; Yemen: Central Bank of Yemen, Balance of Payments available at: www.centralbank.gov.ye/mbop.pdf and UNCTAD, *World Investment Report 2009 and 2010*.

Revenues from remittances constitute an important source of foreign exchange and contribute to economic growth in all MDEs. They provide valuable foreign exchange that is used to finance current account deficits and foreign debt service payments, not to mention meeting the consumption demand of the domestic market. In Egypt, for instance, remittances have increased from US$5 billion in 2005, to US$9.4 billion in 2008. However, this flow decreased by one third in 2009, as a result of the financial crisis, to reach US$7.1 billion. Lebanon, however, fared much better; in spite of the crisis, remittances increased from US$4.9 billion in 2005, to US$7 billion in 2009, followed by Jordan where remittances have also increased from US$2.5 billion in 2005, to US$3.6 billion in 2009. No significant change in the inflow of remittances to Palestine and the Syrian Arab Republic was registered over the period under consideration (table 7 and figure 16).

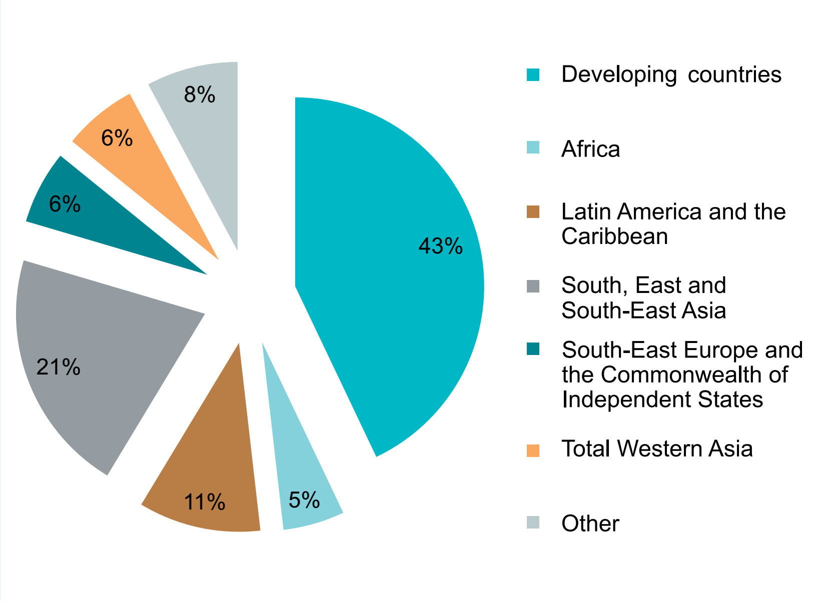
2. *Foreign direct investment*

World FDI flows experienced significant decline in 2008 and 2009 as a result of the ensuing global financial crisis. Relative to US$84.3 billion in 2008, FDI inflows to ESCWA member countries declined to US$70.4 billion in 2009 (table 8). The share of global FDI inflows for the ESCWA region has remained low relative to other emerging regions worldwide. Figure 17 indicates that the share of total FDI inflows for the ESCWA region has remained at 6 per cent in 2009. While South, East and South-East Asia ranked first in terms of FDI inflows with a 21 per cent share, followed by Latin America and the Caribbean region with a 10 per cent share and South-East Europe and CIS with a 6 per cent share. Africa ranked last with a 5 per cent share.

Figure 18 indicates that despite the fact that the share of FDI inflows to developing countries has increased significantly between 2007 and 2009, from 27 to 44 per cent, the share of total FDI inflows to ESCWA member countries has marginally increased from 3 per cent in 2007 to about 6 per cent in 2009. Besides short and medium-run impacts, the crisis has affected long-run growth prospects in many ESCWA member countries. FDI plays a crucial role in this regard. It can boost economic development by technology transfer and improvements in labour productivity. FDI can also complement national investment projects and signal a rise in the confidence of investors. However, many empirical studies have failed to establish a robust link between FDI and growth, probably due to endogeneity and reversed causality problems. For example, FDI may not only contribute to higher GDP growth, but could also be triggered by a rise in production. Moreover, the growth-enhancing effect of FDI is not obvious; as new technologies need to be absorbed and domestic investment may be crowded out. The Dutch Disease literature assumes that foreign investments often take place in natural resources as opposed to manufacturing. The latter sector is more relevant for sustainable growth, as it can promote export diversification and lower the dependency on natural resources.

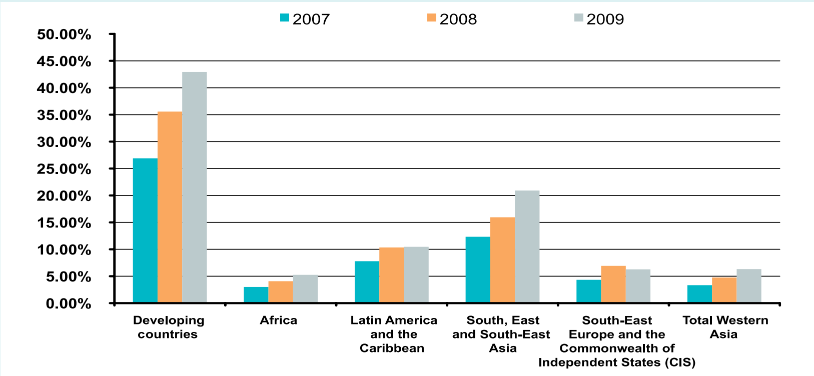
Compared with other emerging market economies, the attractiveness of ESCWA member countries to international investors was quite modest before the crisis, including the better-performing member countries of Egypt, Lebanon, Saudi Arabia and the United Arab Emirates. Certain ESCWA member countries, namely Egypt and Jordan have recently liberalized investment regulation more than others, removing

Figure 17. FDI inflows to various emerging regions, 2009 (*Percentage*)



Source: UNCTAD, *World Investment Report 2010*.

Figure 18. FDI inflows by emerging region as a share of total FDI inflows, 2007-2009 (*Percentage*)



Source: See table 8.

FDI can boost economic development by technology transfer and improvements in labour productivity

ownership restrictions as well as trade and capital flow barriers. The availability of adequate and well-organized institutions can reduce investment transaction costs, making projects more profitable. Since FDI flows to ESCWA member countries may involve large sunken costs, they are very sensitive to current instability and the lack of security in ESCWA member countries. FDI is also affected by the efficacy of the legal system and enforcement of property rights. Based on the stylized facts, the decrease in FDI flows to ESCWA member countries is related to either internal institutional factors or to global financial flow conditions emanating from the financial crisis.

Inflows of FDI to MDEs witnessed a sharp decline in 2009 relative to 2008, when they dropped from US$24.18 to US$19.60 billion, constituting a 23 per cent decline (table 9). MDEs are currently facing tighter international capital markets and a drying up of external financing, as global deleveraging and increasing risk aversion curtailed the interest of international investors in these economies. If these declining trends continue in the foreseeable future, MDEs may be deprived of their main growth engine, which may also translate into more pressure on respective balance of payments, with similar pressures on exchange rates. These declining trends may jeopardize the recent integration efforts of ESCWA member countries through a widening of the income gap between them and more developed economies. Similar declines in FDI inflows have been observed in LDEs where FDI declined alarmingly in 2009 relative to 2008, dropping from US$60.06 billion to US$50.85 billion and constituting an 18 per cent decline (table 9).

Table 9. **FDI inflows to ESCWA member countries, 2005-2009**

	FDI inflows (US$ million)					FDI/GDP (percentage)				
Country	2005	2006	2007	2008	2009	2005	2006	2007	2008	2009
Bahrain	1 049	2 915	1 756	1 794	257	7.8	18.4	9.5	8.5	1.3
Kuwait	234	122	116	(51)	145	0.3	0.1	0.1	0.0	0.1
Oman	1 688	1 688	3 332	2 359	2 211	5.5	4.6	8.0	3.9	4.1
Qatar	1 298	3 500	4 700	4 107	8 722	3.1	6.2	6.6	4.1	10.4
Saudi Arabia	12 097	18 293	22 821	38 151	35 514	3.9	5.1	5.9	8.0	9.6
United Arab Emirates	10 900	12 806	14 187	13 700	4 003	8.4	7.8	6.8	5.2	1.7
GCC countries	**27 266**	**39 324**	**46 912**	**60 060**	**50 852**	**4.5**	**5.4**	**5.6**	**5.6**	**5.9**
Egypt	5 376	10 043	11 578	9 495	6 712	6.0	9.4	8.9	5.8	3.6
Iraq	515	383	972	1 856	1 070	1.5	0.9	0.9	2.1	1.6
Jordan	1 774	3 268	2 622	2 829	2 385	14.0	22.1	15.4	13.3	10.4
Lebanon	2 791	2 675	3 376	4 333	4 804	13.0	11.9	13.5	14.7	14.3
Palestine	47	19	28	52	33	1.2	..	..	0.8	0.5
The Sudan	2 305	3 541	2 436	2 601	3 034	8.3	9.7	5.2	4.5	5.5
Syrian Arab Republic	500	659	1 242	1 467	1 434	1.8	2.0	3.1	2.7	2.7
Yemen	(302)	1 121	917	1 555	129	(2.0)	5.9	4.2	9.2	0.5
MDEs	**13 006**	**21 709**	**23 171**	**24 188**	**19 601**	**5.6**	**7.8**	**6.9**	**5.6**	**4.4**
Total ESCWA region	**40 272**	**61 033**	**70 083**	**84 248**	**70 453**	**4.8**	**6.0**	**6.0**	**5.6**	**5.3**

Source: UNCTAD, *World Investment Report*, various issues.

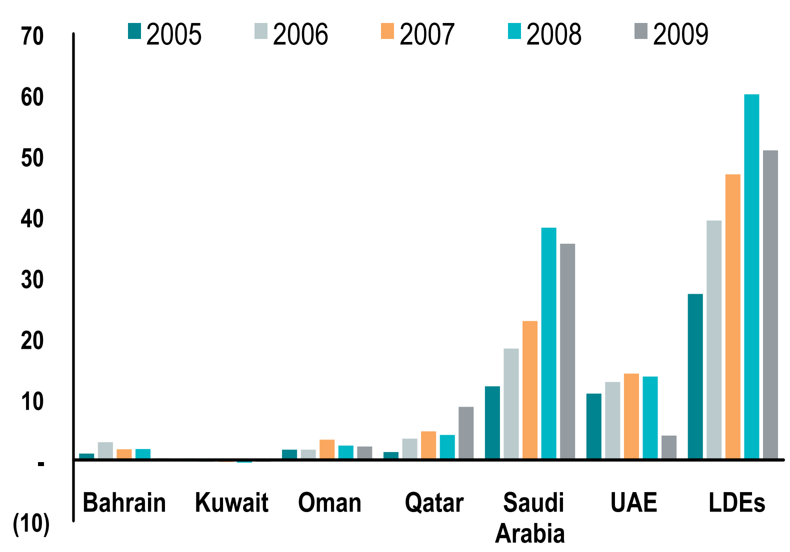
ESCWA member countries may be divided into two subgroups with regard to attracting FDI. The first group comprises those countries that managed to achieve considerable growth in FDI inflows, regardless of the negative spillover effects of the global financial crisis. Lebanon, Qatar and the Sudan fall into that category, where FDI inflows increased from US$2.79 billion US$1.29 billion and US$2.30 billion respectively in 2005 to reach US$4.80 billion, US$8.72 billion and US$3.03 billion in 2009. However, the magnitude of the increase in Oman and the Syrian Arab Republic was less significant increasing from US$1.68 billion and US$0.50 billion in 2005 to reach US$2.21 billion and US$1.43 billion respectively in 2009.

The second group includes those ESCWA member countries that achieved significant FDI growth prior to the 2008 financial crisis, but have been adversely affected by it: Bahrain, Egypt, Iraq, Jordan, Saudi Arabia, the United Arab Emirates and Yemen. In Egypt, FDI inflows peaked in 2007 at US$11.57 billion, but then experienced a significant decline to US$6.71 billion in 2009. This serious decline in the inflow of FDI to Egypt could have had detrimental consequences on the economy of Egypt and could have triggered a balance-of-payments crisis had Egypt continued pursuing a rigid fixed exchange rate peg to the US dollar. The 2002 move to a flexible exchange rate system helped Egypt to stimulate exports, service its accumulated foreign debt and use monetary policy more effectively to deal with internal and external macroeconomic imbalances. In the United Arab Emirates, FDI inflows peaked in 2007 at US$14.18 billion, but then experienced a significant decline to US$4.0 billion in 2009. This serious decline in FDI inflows to the United Arab Emirates could have had detrimental consequences on its economy and could have triggered a balance-of-payments crisis, had they not accumulated a significant amount of foreign exchange reserves prior to the crisis and during the 2003-2007 oil boom period. The continued pursuit of a rigid fixed exchange rate peg to the US dollar may become problematic if those declining trends persist in the foreseeable future in the above ESCWA member countries. By shifting to a flexible exchange rate system, the United Arab Emirates may be able to use monetary policy more effectively to deal with internal and external macroeconomic imbalances.

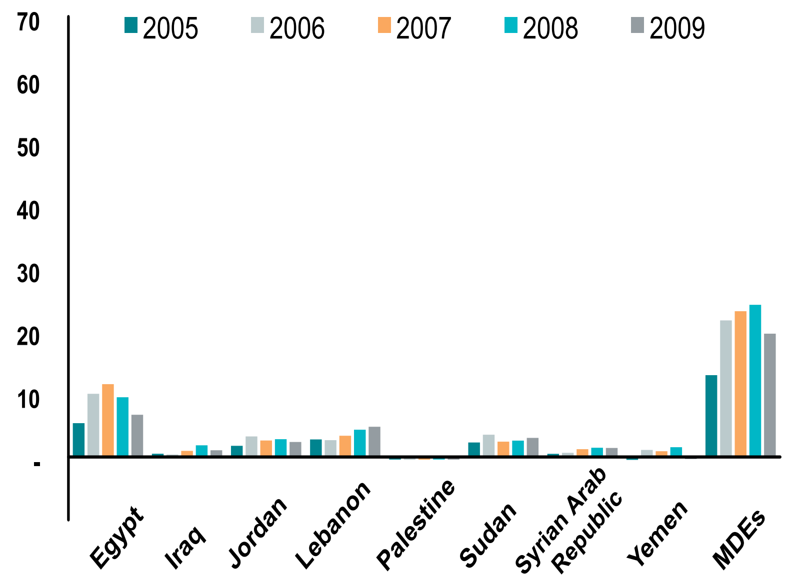
In Jordan and Saudi Arabia, FDI inflows rose to US$2.82 billion and US$38.15 billion respectively in 2008, but declined subsequently to US$2.38 billion and US$35.51 billion in 2009. Jordan is in a much tighter position than Egypt due to the still-prevailing rigid exchange rate peg to the US dollar and its limited fiscal space. If this declining trend in FDI inflows continues, Jordan may well experience a balance-of-payments crisis, forcing its Central Bank to move to a free float. Much more serious FDI declines have been registered in Yemen, where FDI inflows reached the US$1.55 billion level in 2008, to decline to US$0.129 billion in 2009. This alarming decline is having detrimental consequences on its domestic economy and may trigger a balance-of-payments crisis. Yemen is the only ESCWA member country that has already experienced a forced devaluation of its domestic currency casting serious doubts on the continued pursuit of a rigid fixed exchange rate peg to the US dollar. Further controlled devaluations may, however, help Yemen stimulate exports, service its accumulated foreign debt and use monetary policy more

Figure 19. FDI inflows to ESCWA member countries, 2005-2009

19-A. FDI inflows to LDEs (*US$ million*)



19-B. FDI inflows to MDEs (*US$ million*)



Source: UNCTAD, *World Investment Report*, various issues.

effectively to deal with the negative consequences of the global financial crisis. No major change in FDI trends has been observed in Palestine.

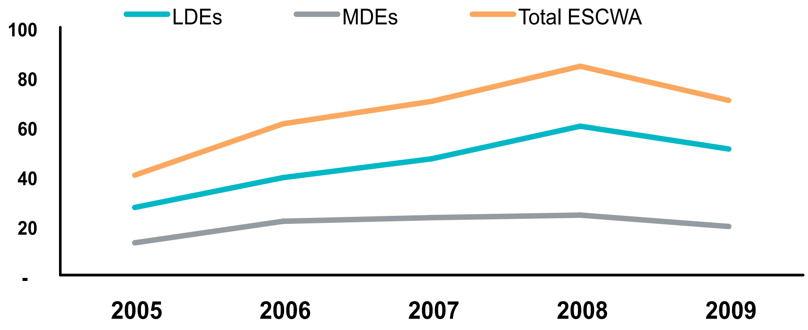
Figure 19 indicates that Saudi Arabia accounts for about 50 per cent of total FDI inflows to ESCWA member countries on average and over the period under consideration, followed by the United Arab Emirates, Egypt, Qatar and Lebanon with an average share of 30, 15, 10 and 8 per cent respectively. From the low end and with a lower than 10 per cent share of total FDI to the ESCWA region, are Bahrain, Iraq, Jordan, Kuwait, Oman, Palestine, the Sudan and Yemen who are still not able to attract enough FDI to stimulate domestic growth.

Table 9 sheds more light on the contribution of FDI to real GDP in ESCWA member countries. With the exception of Jordan and Lebanon, the data indicate that the ratio of FDI stocks to GDP in the remaining twelve ESCWA member countries did not exceed the 10 per cent level over the 2005 to 2009 period. This clearly indicates that FDI inflows, considered as the main engine of economic growth to the ESCWA region, are not yet able to contribute significantly to growth and development in ESCWA member countries. In 2009, this ratio varied from a high of 14.3 per cent in Lebanon, 10.4 per cent in each of Qatar and Jordan, to a low of 0.5 per cent in Yemen, 1.3 per cent in Bahrain, 3.6 per cent in Egypt, but stood at 0.1, 4.1, 9.6, 1.7, 1.6, 0.5 and 2.7, in each of Kuwait, Oman, Saudi Arabia, the United Arab Emirates, Iraq, Palestine and the Syrian Arab Republic respectively.

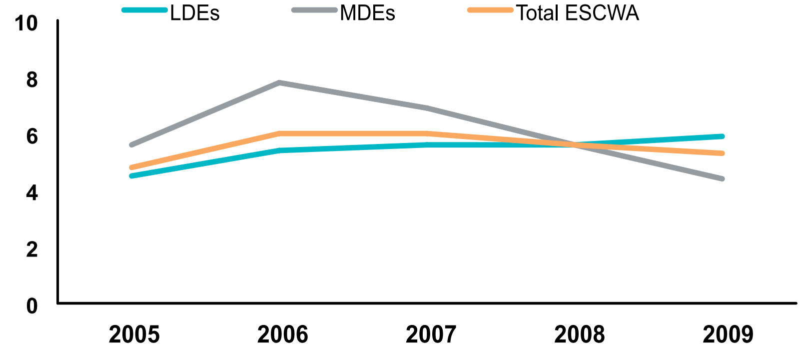
Even though certain ESCWA member countries have recently undertaken some financial reforms and pursued sound macroeconomic policies, the current financial crisis, which is not of their making, is disproportionately penalizing them and creating additional macroeconomic hurdles that will have to be overcome in the near future, as FDI inflows have been on a declining trend. Figures 20-A and B indicate that FDI inflows have been seriously affected by the global financial crisis with related declining trends since 2008 in both MDEs and LDEs. The ratio of FDI to GDP in ESCWA member countries has also been on a declining trend since 2006, mainly due to a combination of lower FDI inflows and lower GDP growth rates. ESCWA member countries need, therefore, to exert intensive efforts to raise their share of global and regional FDI inflows which has remained relatively low. Measures that could be introduced, in addition to adequate macroeconomic policies to respond to the current financial crisis, include the acceleration of South-South economic, financial and trade integration efforts, coupled with enhanced reform programmes while stressing institutional and governance aspects in particular. Moreover, these countries need to accelerate implementation of the privatization process, which represents an important factor in promoting the inflow of FDI at the global level, particularly privatization of the services sector. ESCWA member countries also have to fight financial and administration corruption and eliminate bureaucracy, strong impediments to the inflow of FDI. The political instability that has plagued the region as a result of the failure to achieve comprehensive peace continues to exert a negative influence on the ability of ESCWA member countries to attract FDI.

Figure 20. **FDI inflows and as a ratio to GDP in ESCWA member countries, 2005-2009**

20-A. FDI inflows (*US$ billion*)



20-B. FDI inflows as a ratio to GDP (*Percentage*)



Source: UNCTAD, *World Investment Report*, various issues.

3. *Portfolio flows*

The scenario of portfolio flows to ESCWA member countries is quite similar to the FDI scenario. Private capital and portfolio flows to the region have also been relatively limited. While cross-border capital flows between the financial markets of GCC countries increased significantly in recent years, they remained negligible with respect to MDEs. Intraregional portfolio

ESCWA member countries have to fight financial and administration corruption and eliminate bureaucracy, strong impediments to the inflow of FDI

investments have been made mainly in those ESCWA member countries that have implemented policies conducive to strengthening the operational framework of the domestic financial market, namely Egypt and Jordan. It should also be noted that the capital markets of ESCWA member countries have traditionally been less important in channelling capital flows. A fairly developed commercial banking system has taken the lead in attracting and distributing capital and in stimulating portfolio investments in the ESCWA region. Table 10 indicates that portfolio flows have remained negligible and below the US$1 billion level in MDEs under consideration. Between 2008 and 2009 and as a result of the financial crisis, portfolio flows have declined in Egypt and Jordan from US$1.11 billion and US$0.573 billion to US$0.691 billion and US$0.35 billion respectively. Total portfolio flows to MDEs have also declined from US$1.75 billion in 2008, to US$1.10 billion in 2009, constituting a 33 per cent decline.

Table 10 indicates that Egypt seems to enjoy the highest portfolio inflows, followed by Jordan and Lebanon. Egypt accounts for about 63.2 per cent of total portfolio inflows to MDEs on average over 2008-2009, followed by Jordan and Lebanon with an average share of about 32.20 and 4.6 per cent respectively.

With the possible exception of Egypt, equity markets of ESCWA member countries have only come to the fore in the 1990s and, despite their small market capitalization during the past ten years, have exhibited performance characteristics parallel to other emerging markets in similar stages of financial development. Record market capitalization growth rates were noted in Egypt, Jordan and, to a lesser extent, in Kuwait, Oman and Qatar over the 2005-2007 period (table 11) prior to the financial crisis. This was due to massive privatization plans introduced in those countries, the extensive sale of Government assets to private firms and considerable efforts recently devoted to enhancing the efficiency, depth, integration and liquidity of the five stock markets. However, stock market capitalizations of both Egypt and Jordan declined significantly between 2007 and 2009 as a result of the global financial crisis, from US$134.90 billion and US$41.29 billion in 2007, to US$86.26 billion and US$31.98 billion respectively in 2009. In addition, it should be noted that the recent open access of foreign investors to almost all stock markets of MDEs has contributed significantly to growth performances of their stock market capitalization.

Stock market capitalizations in LDEs have also declined significantly between 2007 and 2009 as a result of the global financial crisis. In Bahrain the decline was from US$26.79 billion in 2007 to US$16.14 billion in 2009; in the United Arab Emirates it went down from US$250.85 billion in 2007 to US$131.79 billion in 2009, whereas in Kuwait, stock market capitalization went down from US$193.51 billion in 2007 to US$104.22 billion in

Table **10.** **Portfolio inflows to selected MDEs, 2005-2009 (*US$ million*)**

	Portfolio inflows				
Country	**2005**	**2006**	**2007**	**2008**	**2009**
Egypt	132	152	679	1 118	691
Jordan	313	540	840	573	350
Lebanon	64	70	75	60	64
Total MDEs	**508**	**762**	**1 594**	**1 751**	**1 105**

Source: IMF, IFS.
Note: The remaining MDEs have been excluded due to lack of data.

Table 11. Stock market capitalization in ESCWA member countries, 2005-2010 (*US$ million*)

	Market capitalization					
Country	**2005**	**2006**	**2007**	**2008**	**2009**	**2010 June**
Bahrain	17 364	21 123	26 796	19 955	16 141	16 285
Kuwait	123 893	141 923	193 513	113 527	104 226	111 394
Oman	12 062	13 037	22 767	15 643	18 362	18 742
Qatar	87 143	60 913	95 518	76 657	87 932	103 812
Saudi Arabia	646 121	326 364	522 721	246 810	318 785	321 881
United Arab Emirates	244 406	158 561	250 857	127 105	131 798	119 295
GCC countries	**1 130 989**	**721 921**	**1 112 173**	**599 697**	**677 244**	**691 409**
Egypt	79 508	93 601	134 904	83 185	86 267	76 326
Jordan	37 639	29 785	41 298	35 984	31 985	28 066
Lebanon	4 917	8 304	16 093	14 789	18 298	17 910
Palestine	3 157	2 712	2 404	2 105	3 200	3 408
The Sudan	3 242	4 624	4 931	4 931	3 033	--
MDEs	**128 462**	**139 026**	**199 630**	**139 867**	**142 783**	**125 709**
Total ESCWA region	**1 259 451**	**860 947**	**1 311 803**	**739 564**	**820 027**	**817 118**

Source: AMF, *Joint Arab Economic Report*, various issues and Federation of Euro-Asian Stock Exchange.

2009. Stock market capitalization in Saudi Arabia has also experienced a significant decline during and after the global financial crisis, decreasing from US$522.72 billion in 2007 to US$318.78 billion in 2009, a spectacular decrease of about 39 per cent.

The spillover effects of the global financial crisis on ESCWA member countries and its effects on their stock markets varied according to their degree of financial integration with the more mature stock and bond markets. Given their strong linkages with global stock and bond markets, the stock markets of Bahrain, Kuwait and the United Arab Emirates were the most affected by the global financial crisis. Oman, Qatar and Saudi Arabia were not that affected by the crisis due to the fact that financial markets in all three countries have remained relatively closed to foreign investors and their degree of financial integration has remained low. Financial linkages of the Saudi stock market with global equity markets are still insignificant, despite recent efforts to further enhance its intraregional integration with stock markets of the remaining ESCWA member countries. Egypt, Jordan, Bahrain, Oman and the United Arab Emirates, with large exposure to European Union/United States banks, bonds and equity markets, were the first to suffer. These countries have faced a four-edged sword of plunging asset prices, higher cost of borrowing, a slowdown in capital inflows and a decrease in exports. Other ESCWA member countries, namely Saudi Arabia and Qatar, have become more resilient with respect to past crises, owing to the build up of adequate foreign exchange reserves and a robust fiscal stance.

The spillover effects of the global financial crisis on ESCWA member countries varied according to their degree of financial integration with the more mature stock and bond markets

Box 2. The global financial crisis and the banking system of ESCWA member countries

Following the outburst of the global financial crisis, individual banking institutions in the ESCWA region encountered financial difficulties, but their problems did not seem correlated enough to raise serious concerns about systemic risk. Financial institutions exhibited overall resilience to the crisis and were only mildly affected by global events for at least three reasons. First, ESCWA member countries had been strengthening their foreign currency and liquidity positions prior to the unfolding of the financial crisis. The rise in oil prices in the GCC countries and the increase in remittances in MDEs allowed the respective economies to build up substantial foreign reserves prior to the crisis. Second, banks in the ESCWA region had limited exposure to complex financial derivatives.[a/] Third, all forms of financial institutions had generally reinforced their equity base, building up adequate levels of capitalization. For these reasons, banking sectors in ESCWA member countries were in a solid position to withstand the financial crisis.

However, similarly to other parts of the world, the financial crisis took its toll on the banking sectors of the ESCWA region, albeit to a lesser extent. Generally, three broad types of financial institutions operate in the ESCWA region; commercial, Islamic and investment banks and each type of institution was affected differently during the crisis. First, of all commercial banks, only one institution collapsed and was recapitalized using public funds.[b/] Other commercial banks did have direct exposure to the subprime market and to credit derivatives (even though few have publicly admitted so) and as a result, they suffered direct losses to their portfolios.[c/] Second, whereas the charter of Islamic banks forbids them from investing in credit derivatives, *shari'a*-compliant institutions were nonetheless affected by a second round of the crisis, mostly in 2009, as a result of their exposure to the real estate market. Islamic banks across the region recorded a reduction in profits, primarily because they had to write down the value of real estate investments. Also, two leading firms in Islamic finance in the United Arab Emirates providing *ijara* instruments, *amlak* finance and *tamweel*, were merged by the federal Government pending restructuring.[d/] Third, of all types of financial institutions, investment banks were the most affected by the financial crisis. They even presented some systemic risk in Kuwait, where the size of these institutions exceeds 100 per cent of GDP and cross-sectoral linkages with commercial banks prevail. With most of their activity involving proprietary trading, some investment banks defaulted on their debt but no further repercussions ensued because of the high initial capitalization levels of these institutions.

In addition to spillovers from the global financial crisis, banking sectors in the region were subject to two endogenous financial shocks related to uncertainties surrounding the default of two large Saudi-owned family groups and the announcement, from Dubai World, of standstill on its debt. Following the default of the two prominent Saudi corporations, two wholesale banks in Bahrain were placed under the administration of the authorities and provisioning for bad loans increased at a leading bank in Oman.

In sum, among all types of financial institutions, commercial banks were the least affected by the global financial crisis, followed by Islamic banks which had a direct exposure to the real estate market and investment banks which deal directly in financial markets for their own account. Further, financial institutions that encountered problems as a result of the global financial crisis are mostly located in the GCC region and not in the remaining ESCWA member countries. This could be due to the greater financial integration and linkages that GCC countries have with the rest of the world in comparison with the remaining MDEs. Indeed, countries like Bahrain, Qatar and the United Arab Emirates have long established financial centres and they are competing to take a leading regional role in the provision of financial services.

a/ Ahmed (2009).

b/ International Monetary Fund (IMF) (2010a). The second largest bank in Kuwait, Gulf Bank, reported losses of US$1.3 billion in derivatives and it was capitalized through a rights issue.

c/ Hasan and Dridi (2010). Examples of direct losses include the US$272 million of Abu Dhabi Commercial Bank, the US$1.3 billion impairment charges by Gulf International Bank, the US$230 million loss by the Arab Banking Corporation, the US$446 million write-downs by Gulf Investment Corporation, subprime losses by Qatar Insurance Company and credit derivative write-downs by seven Saudi banks.

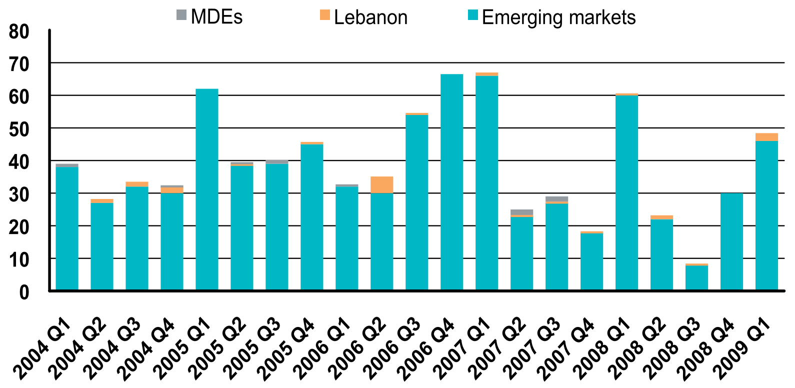
d/ IMF (2010b).

E. Bond markets

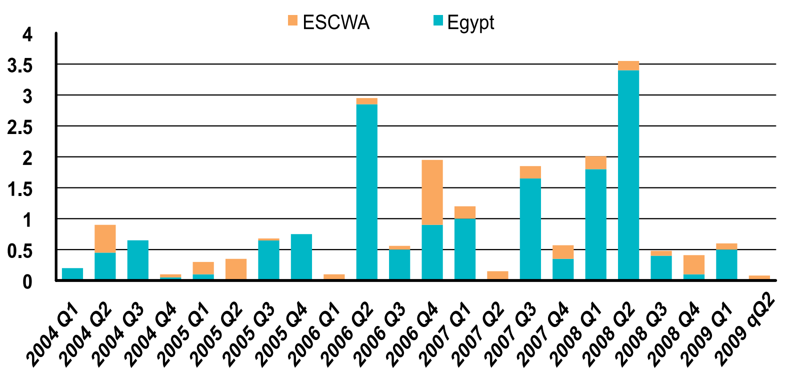
While some ESCWA member countries have been hit by the worst exogenous financial shock in decades, other member countries were ill-equipped to fight the financial consequences of the crisis given their poor financial markets, especially their bond markets. Alleviating the low liquidity flows of those countries and providing them with the fiscal space needed to combat the financial crisis would also help stabilize world demand and should thus be regarded as an integral component of the stimuli packages of the more advanced economies. However, limited reliance on international financial flows in the majority of ESCWA member countries, with the exception of perhaps Egypt and Jordan, has prevented the full disruption of local financial markets. The bond markets of MDEs are still primitive and their bond issuance constitute a relatively very small portion of bond issuance of other emerging markets, with the exception of Lebanon (figure 21-A). Similar stylized facts are noted for cross-border loans between ESCWA member countries, where cross-border financial flows have remained relatively low, with the exception of Egypt (figure 21-B). Levels of cross-border liquidity in the form of loans have remained low and, in some, instances totally insignificant in all ESCWA member countries which to some extent, contained the financial fallout.

Figure 21. Bond issuance of MDEs and cross-border loans between ESCWA member countries, 2004-2009

21-A. Bond issuance, 2004-2009 (*US$ billion*)



21-B. Cross-border loans, 2004-2009 (*US$ billion*)



Source: IMF, REO Report 2009.

F. Public debt

The 2008 global financial crisis has to some extent reversed the gains made during the past decade in reducing the debt burden of certain MDEs and may also carry the risk of new debt/exchange rate crises because of a dangerous combination of fixed exchange rates, negative external financial sh1cks, higher cost of debt servicing and lower exports. Moreover, the structure of public debt of ESCWA member countries highlights the extent of vulnerability of its debt burden to abrupt movements in capital flows and exchange rates, as was the case during the latest global financial crisis. The sustainability of debt that is denominated in foreign currency goes beyond domestic conduct of fiscal and monetary policy mix per se to become dependent, as well, on the outcomes of exchange rate policies and the extent of capital flows (exports, remittances, FDI and portfolio flows) to the individual member country. ESCWA member countries need to closely coordinate the optimality of their fiscal and monetary policy mix, which will have important implications on the existent exchange rate arrangements and on how countries can, in the future, be more resilient to potential external financial crises similar to the 2008 global financial crisis.

The proportions of the public debt of Egypt, Jordan and Lebanon that are denominated in domestic currency are subject to a variable interest rate. Therefore, the decision of the respective monetary authority to raise or lower interest rates may have consequences on debt and exchange rate sustainability, especially when the central bank is not fully independent, as has been the case for the above ESCWA member countries. This means that the ability of the central bank to respond to external/internal shocks such as those emanating from the latest global financial crisis using the interest rate, its most effective monetary tool, was limited because of possible concerns about the implications of higher interest rates for the servicing of domestic public debt in the presence of fixed-exchange rates and an open capital account.

Table 12 indicates that with the exception of the Syrian Arab Republic and perhaps Iraq, the public debt of MDEs has continued to increase over the last five years. Moreover, it is clear that the debt burden in Egypt, Jordan, Lebanon, the Sudan and Yemen has been adversely affected as a result of the financial crisis and the subsequent drying up of capital flows to MDEs. In Egypt, total public debt has increased from US$113 billion in 2007 to reach US$143 billion in 2009, constituting a near 26 per cent increase in just two years. Similar scenarios are observed in each of Jordan, Lebanon, the Sudan and Yemen where debt has increased from US$12.6 billion, US$41.9 billion, US$38.2 billion and US$8.7 billion in 2007, to US$15.1 billion, US$51.1 billion, US$43.8 billion and US$12.8 billion in 2009, respectively. The public debt burden of both the Syrian Arab Republic and Iraq appear to have been contained over the period under consideration, despite the current financial crisis.

Table 12 also indicates that with the exception of Kuwait and Saudi Arabia, public debt of LDEs has continued to increase over the last five years. Moreover, it is clear that the debt burden in Qatar and the United Arab Emirates has been severely and adversely affected as a result of the financial crisis, the declining financial flows, the real estate crisis in Dubai (box 3) and several weaknesses in both financial sectors. The significant bailout package Abu Dhabi introduced to boost the economy of Dubai and prevent total economic and financial fallout is also a contributing factor. The total public debt of the United Arab Emirates has increased from US$3.9 billion in 2007 to reach US$13.8 billion in 2009, constituting a near 325 per cent increase in just two years. Similar increases are observed in Qatar, with debt increasing from US$6.6 billion in 2007 to reach US$33.14 billion in 2009 and in Bahrain and Oman,

Table 12. Public debt of ESCWA member countries, 2005-2009

	Public debt (US$ million)					Public debt/GDP (percentage)				
Country	2005	2006	2007	2008	2009	2005	2006	2007	2008	2009
Bahrain	4 100	3 729	3 551	3 222	5 474	30.6	23.6	19.3	15.2	27.1
Kuwait	9 534	8 433	7 714	8 385	7 680	11.8	8.3	6.9	5.3	6.9
Oman	2 926	3 533	3 162	2 995	3 578	9.5	9.6	7.6	5.0	6.7
Qatar	8 755	7 511	6 674	15 060	33 141	20.6	13.2	9.4	15.0	39.5
Saudi Arabia	122 720	97 352	71 262	63 268	60 261	39.6	27.3	18.5	13.3	16.3
United Arab Emirates	2 603	3 384	3 938	8 230	13 860	9.5	10.1	9.7	15.1	26.4
GCC countries	**15 063**	**123 941**	**96 301**	**10 116**	**12 399**	**20.3**	**15.4**	**11.9**	**11.5**	**20.5**
Egypt	10 048	106 111	11 349	12 439	14 325	111.9	98.8	87.1	76.6	76.2
Iraq	71 165	89 478	99 921	93 853	93 173	211.8	198.4	175.3	108.5	141.6
Jordan	10 605	11 455	12 614	13 208	15 137	83.5	77.4	74.2	62.3	66.1
Lebanon	38 413	40 298	41 950	47 053	51 106	179.5	179.9	167.8	159.5	152.1
The Sudan	29 435	32 505	38 270	40 484	43 869	105.5	89.3	82.3	69.8	80.2
Syrian Arab Republic	78 180	82 832	84 078	79 727	66 901	60.0	50.6	40.5	30.5	29.1
Yemen	7 053	7 793	8 767	9 792	12 801	46.4	40.8	40.4	36.4	51.0
MDEs	**33 533**	**370 473**	**39 909**	**40 851**	**42 624**	**114.1**	**105.0**	**95.4**	**77.7**	**85.2**
Total ESCWA region	**48 597**	**494 413**	**49 539**	**50 967**	**55 023**	**70.8**	**63.6**	**56.8**	**47.1**	**55.3**

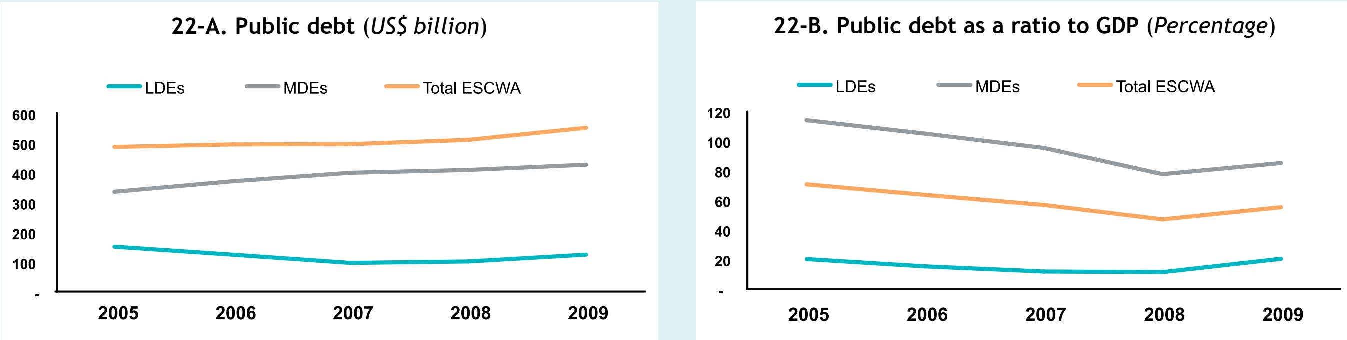
Sources: World Bank, *World Development Indicators*, IMF, IFS.

although the magnitude of the increase there has been less significant, increasing from US$3.5 billion and US$3.1 billion in 2007 respectively, to reach US$5.4 billion and US$3.5 billion in 2009 (figure 22-A).

However, increases in real GDP growth rates have, in certain cases and to some extent, dampened the effects of increased public debt on respective MDEs, even though the general trend in all MDEs remains on the upward side (figure 22-B). In Egypt, although debt has increased in absolute terms, it is on a declining trend relative to GDP (table 12). Between 2007 and 2009, the debt to GDP ratio declined from 87.1 per cent to 76.2 per cent. Similarly in Iraq, Jordan and Lebanon, where the debt to GDP ratio also declined from 175.3, 74.2 and 167.8 per cent in 2007 to 141.6, 66.1 and 152.1 per cent, respectively in 2009. These noted improvements in the debt to GDP ratios of MDEs may, however, be adversely affected in the medium term if appropriate debt management policies are not swiftly introduced. Yemen stands alone with an increasing debt to GDP ratio from 40.4 per cent in 2007 to 51 per cent in 2009, while no significant change in the debt to GDP ratio has been observed in the Sudan (table 12).

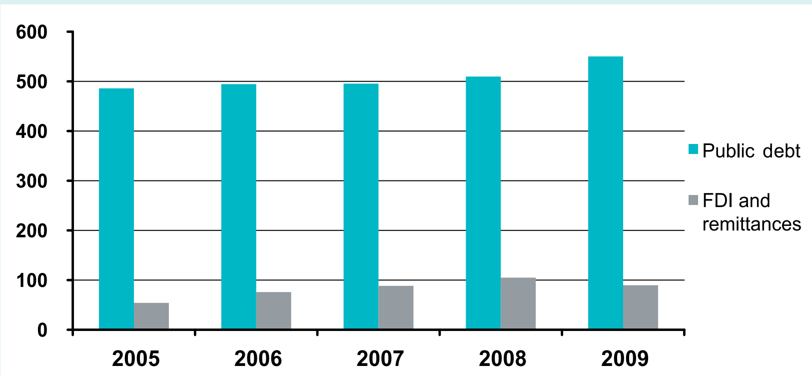
Among LDEs, Bahrain, Qatar and the United Arab Emirates stand alone in experiencing increases in total public debt both in absolute and relative terms. While in 2007, the debt to GDP ratio was 19.3, 9.4 and 9.7 per cent in each of Bahrain, Qatar and the United Arab Emirates, this ratio reached 27.1, 39.5 and 26.4 per cent in 2009 in each member country respectively. Between 2007 and 2009, the debt to GDP ratio declined in Oman

Figure 22. Public debt of ESCWA member countries, 2005-2009



Source: World Bank, *World Development Indicators*, IMF and IFS.

Figure 23. Contribution of capital flows to public debt of ESCWA member countries (*US$ million*)



Sources: IMF, IFS, World Bank, *World Development Indicators and UNCTAD, World Investment Report*, various issues.

Note: Total capital flows are the sum of FDI and remittance flows.

Any potential further decline in capital inflows to ESCWA member countries would indicate a tough road ahead

and Saudi Arabia from 7.6 and 18.5 per cent to 6.7 and 16.3 per cent respectively. Kuwait stands alone with no significant change in its debt to GDP ratio over the period under consideration. The noted deteriorations in the debt to GDP ratios of several LDEs are, however, expected to be positively affected during the next two years when real GDP growth rates start to pick up again on the back of higher expected oil prices, revenues and improvements in the price of real estate in several LDEs. The generally increasing trends, whether in public debt levels or as ratio to GDP in all LDEs, remain on the upward side, despite recent increases in oil prices and revenues (figure 22-B).

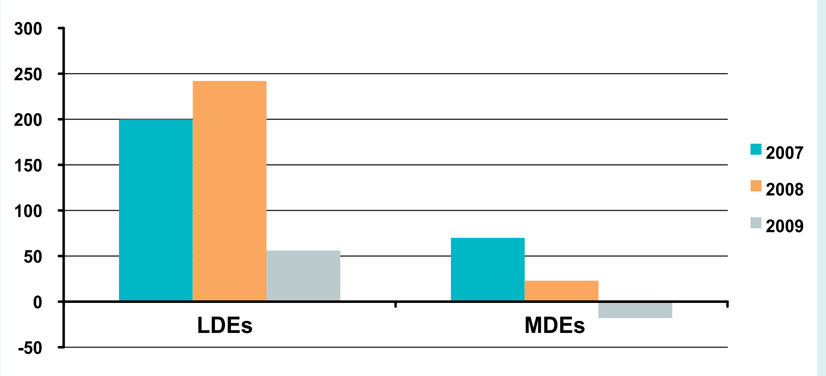
Figure 23 highlights the contribution of capital flows, namely remittances and FDI flows, to the total public debt of ESCWA member countries and its service. For the 14 member countries under consideration, total capital inflows have remained below US$100 billion over the 2005-2009 period, during which total public debt has been hovering between US$500 billion and US$600 billion. While it is clear that these capital flows have been rather insignificant when considered in relative terms to total public debt, they are in some cases (for example in Lebanon, Egypt, Jordan and Yemen) crucial in covering the service of the respective debt. Any potential further decline in capital inflows to ESCWA member countries would indicate a tough road ahead, not only in terms of paying off debt but also in meeting debt-service obligations. This may threaten their respective economies and may perhaps trigger a debt and balance-of-payments crisis in those ESCWA member countries that are still pursuing a fixed exchange rate regime, namely Lebanon, Jordan and Yemen.

G. External balance and exchange rate policies

The current account balance of ESCWA member countries has been deteriorating since 2008. Their total current account surplus was estimated at US$38 billion in 2009, declining sharply from US$264 billion in 2008 and constituting a significant decrease of about 85 per cent. However, 2009 growth performance was not affected even in member countries with huge current account deficits, primarily because current account deficits were mitigated to a great extent by capital account surpluses with no subsequent impact on the balance of payments or on exchange rates. By the end of November 2009, the import/cover ratio of foreign reserves was estimated at 8.0 months for Egypt and at 11.2 months for Jordan, based on the position of net reserves of both countries. The ratio is estimated at 21.5 months for Lebanon and 14.8 months for Yemen, based on their gross reserves position. Net exports from the region were projected to grow modestly in 2010 relative to 2009, given the potential recovery in external demand. ESCWA member countries with current account deficits in 2009 were Egypt, Jordan, Lebanon, the Sudan, the Syrian Arab Republic, the United Arab Emirates and Yemen. However, the Syrian Arab Republic and the United Arab Emirates stood alone in registering an expected current account surplus in 2010.

As oil prices and exports fell and Government spending rose, current account surpluses fell sharply in 2009. The total current account surplus of GCC in 2009 was estimated at US$56 billion, declining from US$242 billion in 2008 and constituting a significant decrease of about 77 per cent (figure 24). The decline in crude oil prices from the 2008 level caused a substantial decrease in exports with subsequent negative impacts on the current account. Consequently, past registered trade balance surpluses in goods relative to nominal GDP also declined (figure 25). Moreover, weak global asset markets also contributed to weak income account surpluses. Subsequently, the current account surpluses relative to nominal GDP also declined across the board in all GCC countries.

Figure 24. Current account balance of ESCWA member countries, 2007-2009 (*US$ billion*)

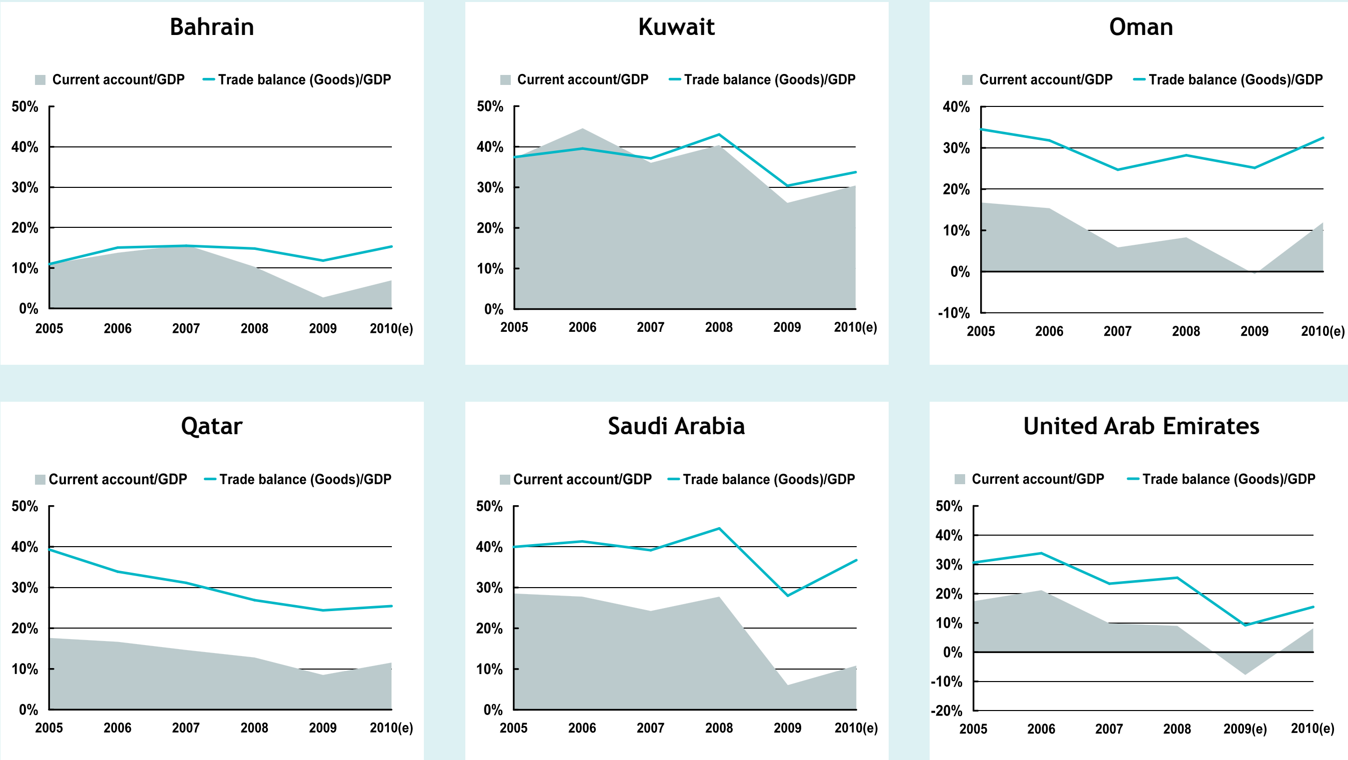


Source: ESCWA staff calculation based on national sources.

With the exception of Bahrain, net trade in services of GCC countries was also expected to register deficits. Although 2009 GCC outflows of current transfers, including workers' remittances of foreign labour declined, they remained above the 2007 level. Income from GCC investment abroad has also declined, contributing to the narrowing down of the current account surplus of GCC countries. The 2009 current account surplus relative to nominal GDP was estimated at 3.3 per cent in Bahrain, 24 per cent in Kuwait, 0.0 per cent in Oman, 9.0 per cent in Qatar and 7.8 per cent in Saudi Arabia. The United Arab Emirates stood alone with a 4.6 per cent deficit.

Current account deficits were mitigated to a great extent by capital account surpluses

Figure 25. Trade balance and current account balance, GCC countries, 2005-2010



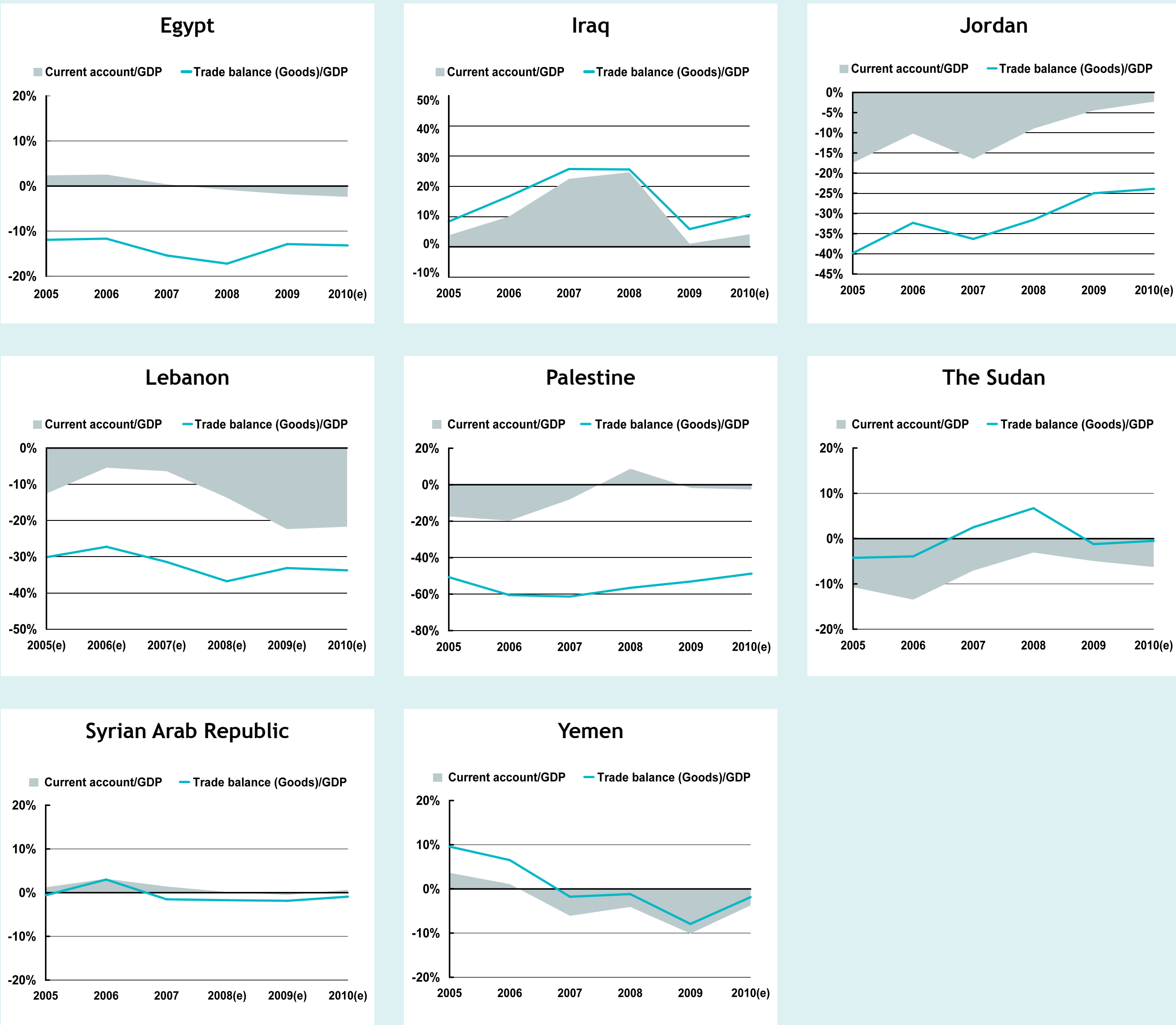
Source: ESCWA staff calculation based on national sources.

Note: (e) estimated figures.

The 2009 current account balance of MDEs registered a deficit of US$18 billion, relative to the 2008 US$23 billion surplus (figure 24). The sharp current account surplus decline of Iraq in 2009 relative to 2008 and the rapid widening of the current account deficit of the Sudan are, for sure, contributing factors. While the 2009 current account deficits of Jordan and Yemen in percentage of nominal GDP are estimated to have improved, they have remained stable in the remaining MDEs (figure 26). With the exception of Iraq and Palestine, the trade balance and current accounts of MDEs have registered deficits in 2009 and 2010. The surplus in Palestine is the result of the amount of foreign assistance received in 2008 and 2009.

Despite the global financial crisis, no foreign exchange crises have so far been registered in any of the MDEs. This indicates that those ESCWA member countries did not run out of foreign reserves to either sustain their fixed exchange rate regimes or to import necessary goods and services to sustain domestic demand even in the presence of current account deficits. This scenario is likely to continue in 2011, with no balance-of-payments crisis expected to unfold, in spite of the potential vulnerability resulting from weak current account positions. For Egypt, Jordan and Lebanon, the high level of accumulated foreign reserves could mitigate the negative impact of any potential external shock. For the Sudan and the Syrian

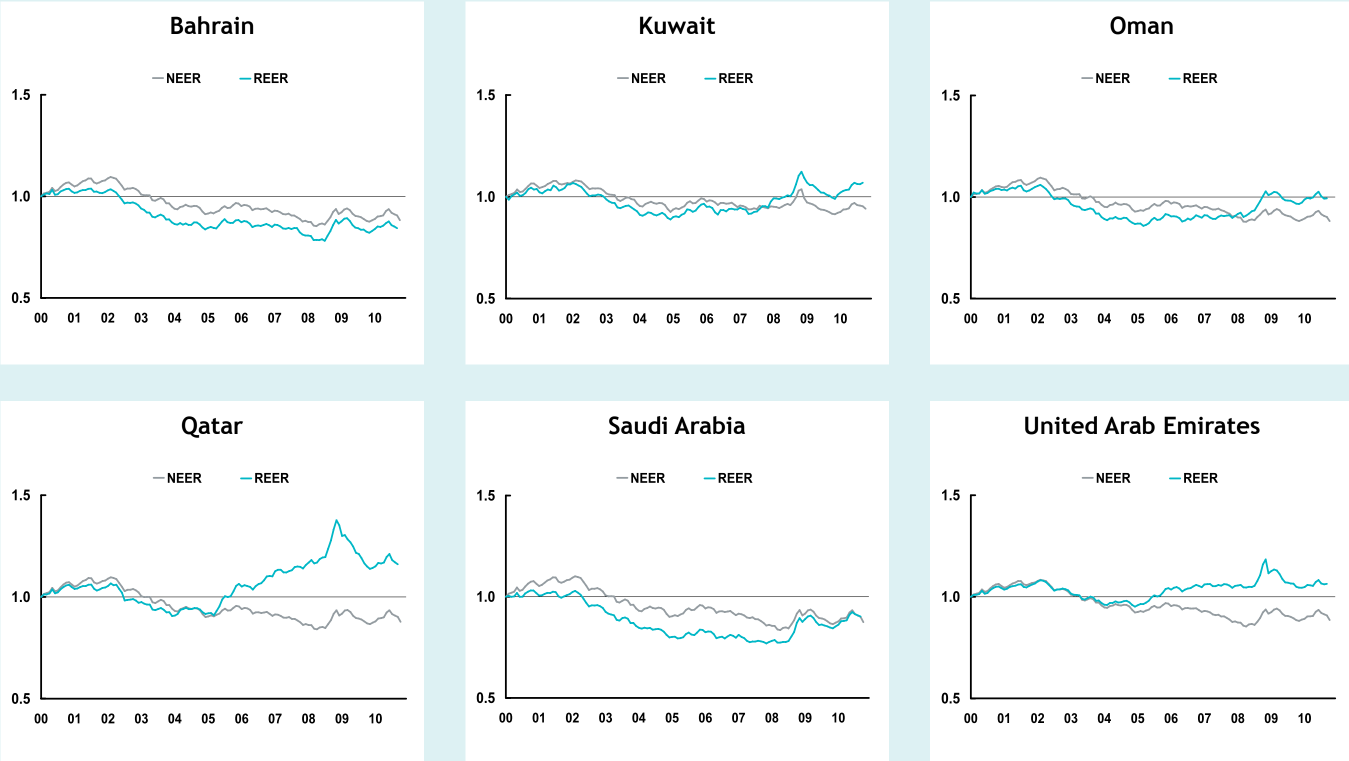
Figure 26. Trade balance and current account balance, MDEs, 2005-2010



Source: ESCWA staff calculation based on national sources.
Note: (e) estimated figures.

Arab Republic, an orderly restriction on foreign currency transaction will preserve stability. The current account position of Yemen is expected to improve as a result of LNG exports, with the first shipment initiated in November 2009. With the exception of Iraq and Palestine, with a 10 and 0.1 per cent current account surplus respectively, all MDEs registered current account deficits relative to nominal GDP in 2010. In Egypt, the deficit was estimated at 1.0 per cent, in Jordan at 3.8 per cent, in Lebanon at 22.7, in the Sudan at 7.3 per cent, in the Syrian Arab Republic at 0.5 per cent and in Yemen at 5.7 per cent (figure 26).

Figure 27. Nominal effective exchange rate and real effective exchange rate, GCC countries, 2000-2010



Source: ESCWA staff estimation.

Note: NEER: nominal effective exchange rate; REER: real effective exchange rate.

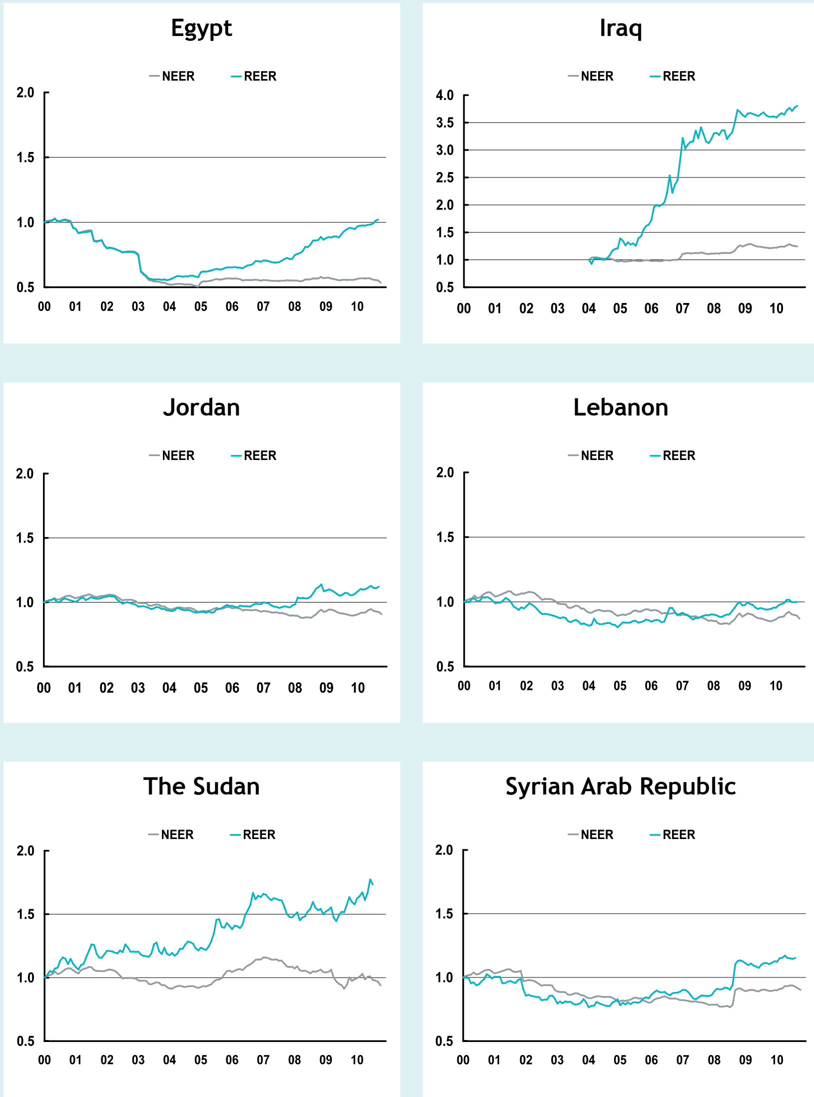
The nominal exchange rates of ESCWA member countries have remained stable during and after the 2008 global financial crisis. With the exception of Kuwait, which shifted to a basket of currencies peg, all GCC countries have continued their rigid exchange rate peg to the US dollar. Jordan and Lebanon have also maintained their US dollar peg, while the Syrian Arab Republic has maintained its peg to the Special Drawing Rights (SDRs). Yemen stands alone among all ESCWA member countries in having depreciated its national currency against the US dollar by 2.5 per cent in early 2009. Despite the 2008 summit decision of the GCC to create the GCC Monetary Union in January 2010, further hurdles are still obstructing its inception. Both Oman, in 2006, and more recently, the United Arab Emirates in 2009, opted out of the currency union. Policymakers in GCC countries had hoped for a gradual introduction of the currency union, balancing its technical feasibility with its potential economic merit, highlighted in the course of the global financial crisis.

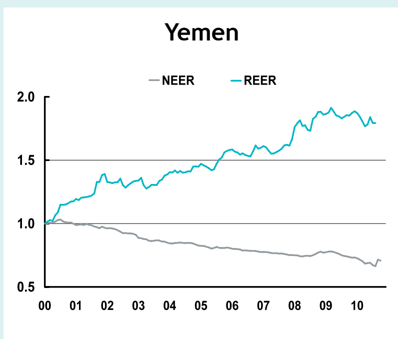
Figure 27 depicts the estimated nominal and real effective exchange rates of GCC countries. The nominal effective exchange rate (NEER) is a foreign exchange rate trade-weighted index. The real effective exchange rate (REER) is altered to also include consumer inflation rates.[10] The 2008-2009 NEER volatility points to its movement in tandem with the volatility of the US dollar against the euro (see also figure 2-A) for those ESCWA member countries with a US dollar peg. More stability was observed in Kuwait because of its recent peg to a basket of currencies. After the 2008 REER appreciation, a trend reversal was observed in 2009 in all GCC member countries due to the rapidly declining price level against that of their major trading partners, pointing to an improvement in price competitiveness of non-oil GCC exports in 2009. With the exception of Kuwait and Qatar, REERs of all GCC countries appear to be on a converging trend for the first time since 2006.

Figure 28 depicts the estimated nominal and real effective exchange rates of MDEs. Since 2004, Egypt's NEER has stabilized, despite the recent appreciation of the currency against the US dollar while REER has been appreciating throughout 2009 and 2010 due to the rapid increase in domestic inflation. After a series of revaluations of the Iraqi dinar, REER of Iraq has been appreciating since 2007. Since 2008, REER of Jordan has been appreciating despite the NEER depreciating trend. A similar trend was also observed in the Syrian Arab Republic. Lebanon has experienced a slight REER appreciation from the 2007 level. The nominal and real effective exchange rates of the Sudan have been volatile during the period under consideration. Depreciation of Yemen's NEER has continued throughout the period, while REER has remained on an appreciation trend with a slight trend reversal after 2009.

With the exception of Iraq, the Sudan and Yemen, NEERs and REERs of ESCWA member countries have recently exhibited converging trends. In the GCC countries the converging trend constitutes a positive factor in favour of further economic and

Figure 28. Nominal effective exchange rate and real effective exchange rate, MDEs, 2000-2010





Source: ESCWA staff estimation.

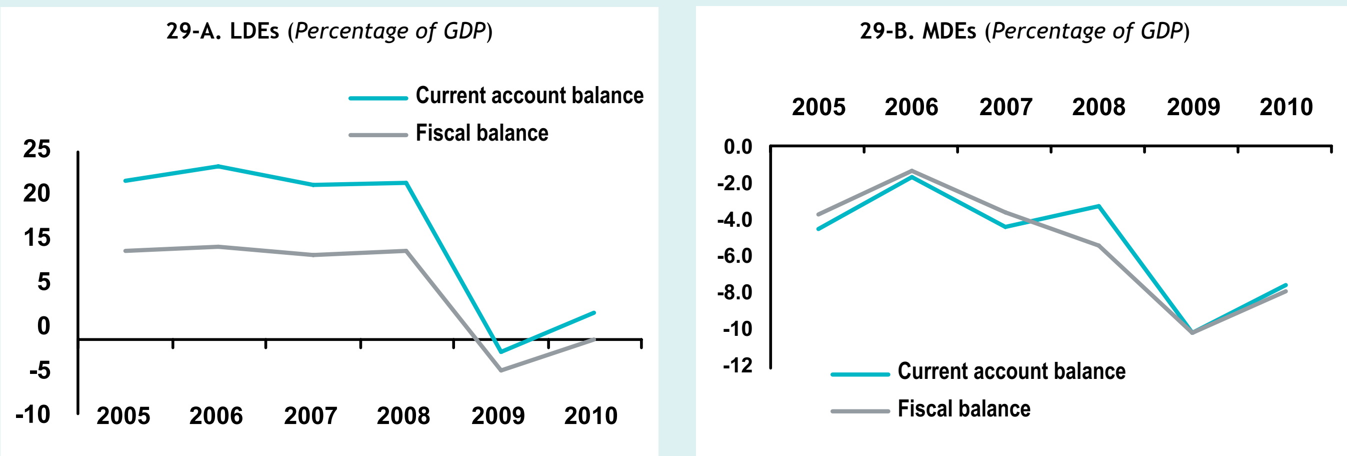
Note: Iraq's REER and NEER are only weighted against US dollar and only inflation data of Iraq and the United States are used to estimate REER.

monetary integration, including a potential GCC Monetary Union. In MDEs, the appreciation of REER may be problematic for Egypt, Jordan, the Syrian Arab Republic and Yemen, because of subsequent export price competitiveness losses. The recent REER appreciation in most ESCWA member countries points to a significant potential loss of non-oil exports being vital to the economic diversification process of GCC and for further economic development of MDEs.

H. Fiscal and monetary policy

The fiscal policy response to the global financial crisis varied among ESCWA member countries. Expansionary fiscal policies were adopted in 2009 in GCC countries which had accumulated sizeable fiscal surpluses since 2002. The result has been further deterioration in the fiscal balance of almost all GCC countries. From an average fiscal surplus of 12 per cent of GDP in 2008 in GCC countries, the fiscal balance moved into a 5 per cent deficit in 2009 (figure 29-A). In their latest budget formation, infrastructure investment, health, education and social provisions were emphasized. For the 2009 fiscal year, central Government expenditure in terms of nominal GDP was estimated at 25.2 per cent in Bahrain, 38.0 per cent in Kuwait, 43.0 per cent in Oman, 33.0 per cent in Qatar, 40.6 per cent in Saudi Arabia and 27.0 per cent in the United Arab Emirates. However, MDEs adopted more conservative fiscal policies due to limited fiscal space, weak Government revenue prospects as well as public debt constraints (figure 29-B). Fiscal austerity measures were introduced in the 2010 fiscal year, particularly in Iraq, Jordan, the Sudan and Yemen, in order to keep the fiscal deficit under control. These austerity measures are expected to negatively affect social developments in MDEs, namely health, education and labour markets in 2011. For the 2009 fiscal year, central Government expenditure in terms of nominal GDP was estimated at 36.0 per cent in Egypt, 40.1 per cent in Jordan, 36.8 per cent in Lebanon, 24.0 per cent in the Sudan, 25.4 per cent in the Syrian Arab Republic and 30.2 per cent in Yemen.

Figure 29. Current account and fiscal balance of ESCWA member countries, 2005-2010

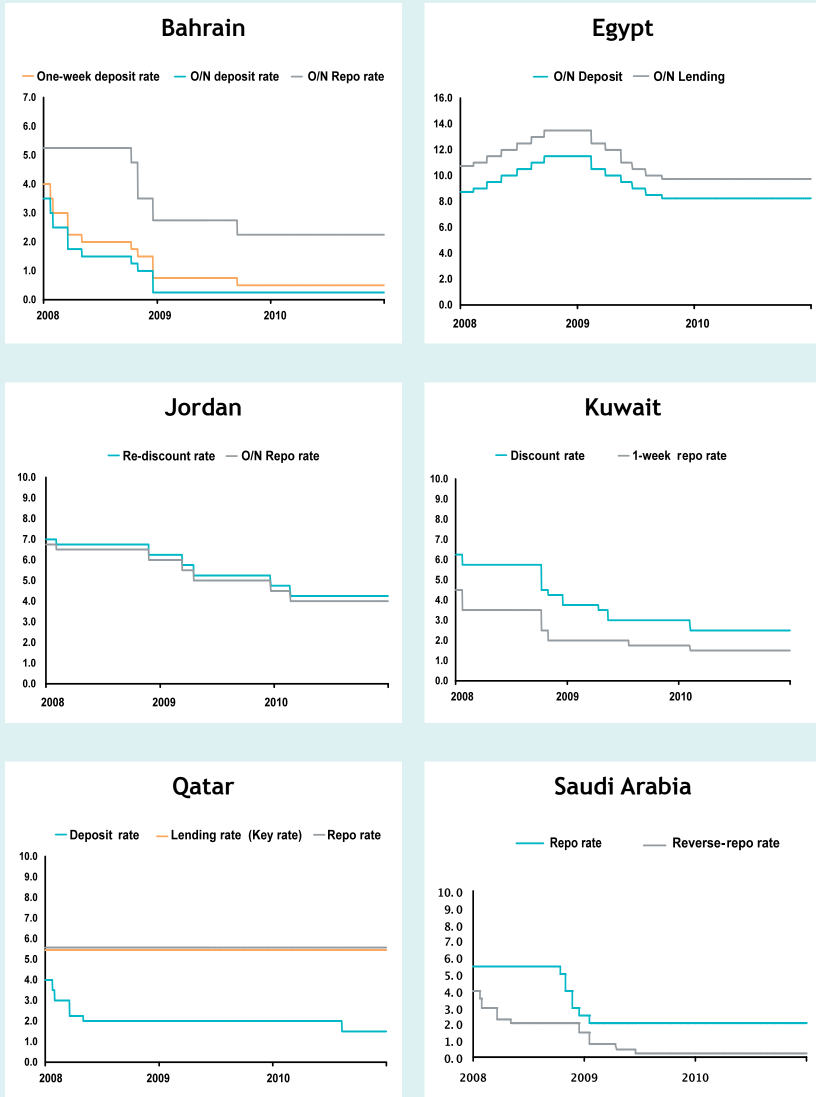


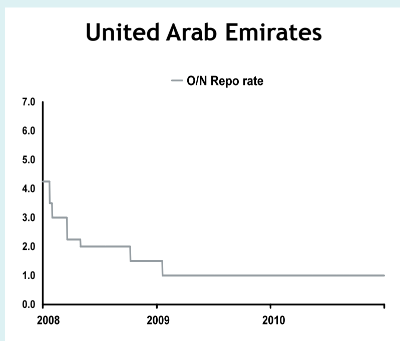
Sources: IMF, IFS, national sources and ESCWA staff estimates.

With the exception of Qatar, where inflation remained high until the end of 2008, the response of the monetary authorities of ESCWA member countries to the global financial crisis through monetary easing translated into a series of reductions in policy interest rates since September 2008, coupled with reduction in reserve requirements of commercial banks to stimulate bank credit, investment and the provision of extra liquidity facilities (figure 30). The significant easing in the monetary stance was in line with other measures introduced to protect the banking systems of ESCWA member countries from financial turmoil. One exception is Egypt, where its central bank had not lowered its policy interest rates before confirming a lower inflation figure in February 2009. Another is Qatar, which did not resort to monetary policy easing during or after the crisis to dampen the effects of the crisis on its domestic economy. However, authorities in Qatar intervened directly in the financial market to contain the effects of the crisis through capital injections in banks and the purchase of their portfolios. In addition to the monetary easing stance, other policy measures to deal with the global financial crisis were introduced, including fiscal and institutional support to the financial sector. Kuwait, Qatar and the United Arab Emirates introduced direct fiscal support to enhance the balance sheets of commercial banks. Moreover, Bahrain, Egypt, Jordan, Kuwait, Saudi Arabia, Qatar and the United Arab Emirates introduced several measures to guarantee bank deposits.

Fixed exchange rate regimes and open capital accounts pose difficulties for the respective central bank in conducting effective monetary policies and in the daily management of liquidity. While fixed exchange rate regimes in ESCWA member countries served their purpose in the past

Figure 30. Policy interest rates, selected ESCWA member countries, 2008-2010 (*Percentage*)





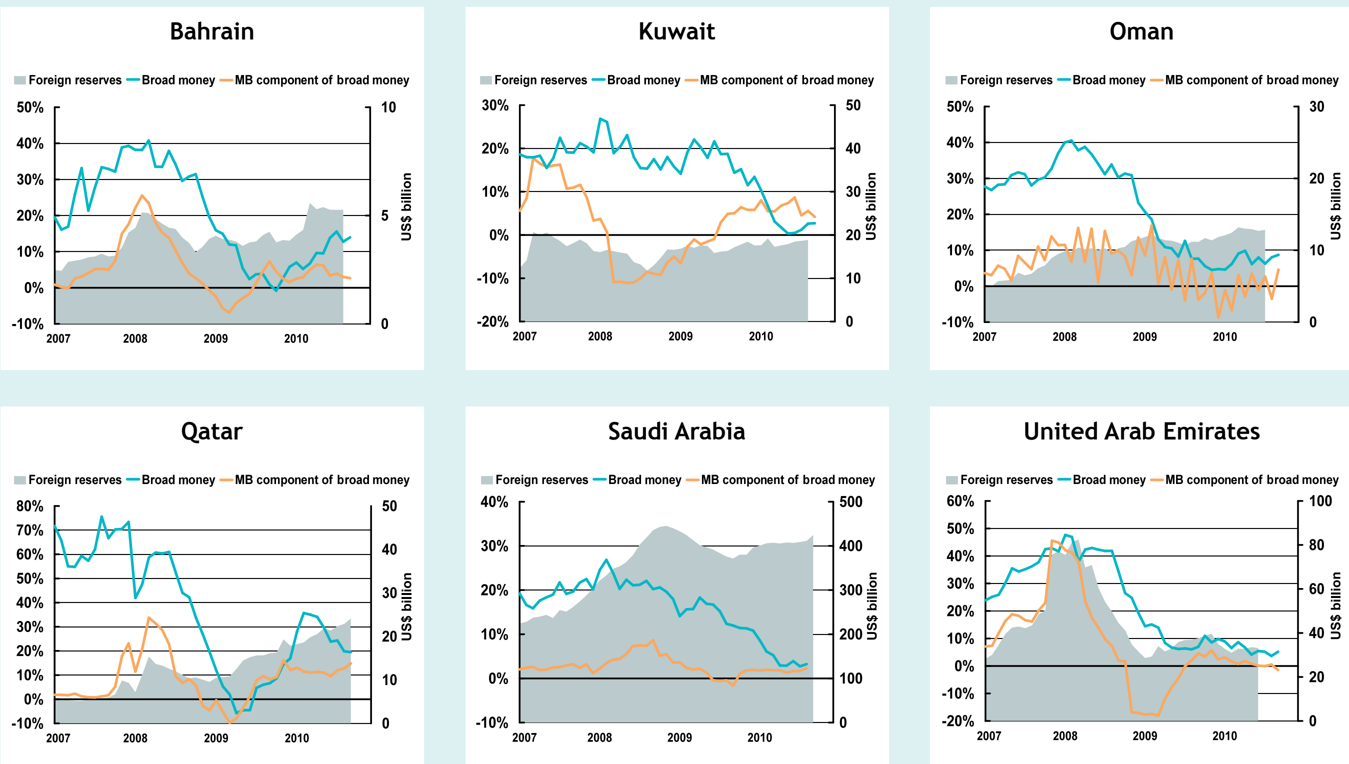
Source: Central Bank of Bahrain, Central Bank of Egypt, Central Bank of Jordan, Central Bank of Kuwait, Qatar Central Bank, Saudi Arabia Monetary Agency and the Central Bank of the United Arab Emirates.

Note: Repo rate: repurchase agreements rate.

by ensuring stability in foreign exchange transactions involving trade, finance and investment, they are now becoming problematic with further liberalization of the capital account. Enhanced capital account liberalization renders it more difficult for the monetary authority to manage domestic liquidity and money supply, since the monetary authority has less control on the monetary base, the total of the amount of cash in circulation plus deposits of commercial banks at the central bank. The central bank can only control the monetary base via indirect measures to control the extent of monetary expansion.

Figure 31 depicts the growth in the stock of broad money, the growth of the monetary base in terms of broad money growth and the level of foreign exchange reserves in GCC countries[11] between 2007 and 2010. While the growth in broad money has decreased significantly in each of Bahrain, Kuwait, Oman, Qatar and the United Arab Emirates since the fourth quarter of 2008, it has remained constant in Saudi Arabia. A trend reversal has been observed, however, in Bahrain and Qatar since the third quarter of 2009. Moreover, with the exception of Saudi Arabia and Oman, there is an obvious correlation between the level of foreign reserves and growth in the monetary base, indicating that the outflow of funds translated into weaker growth of the monetary base well before the fourth quarter of 2008, the peak of the global financial crisis.

Figure 31. **Monetary indicators, GCC countries, 2007-2010**

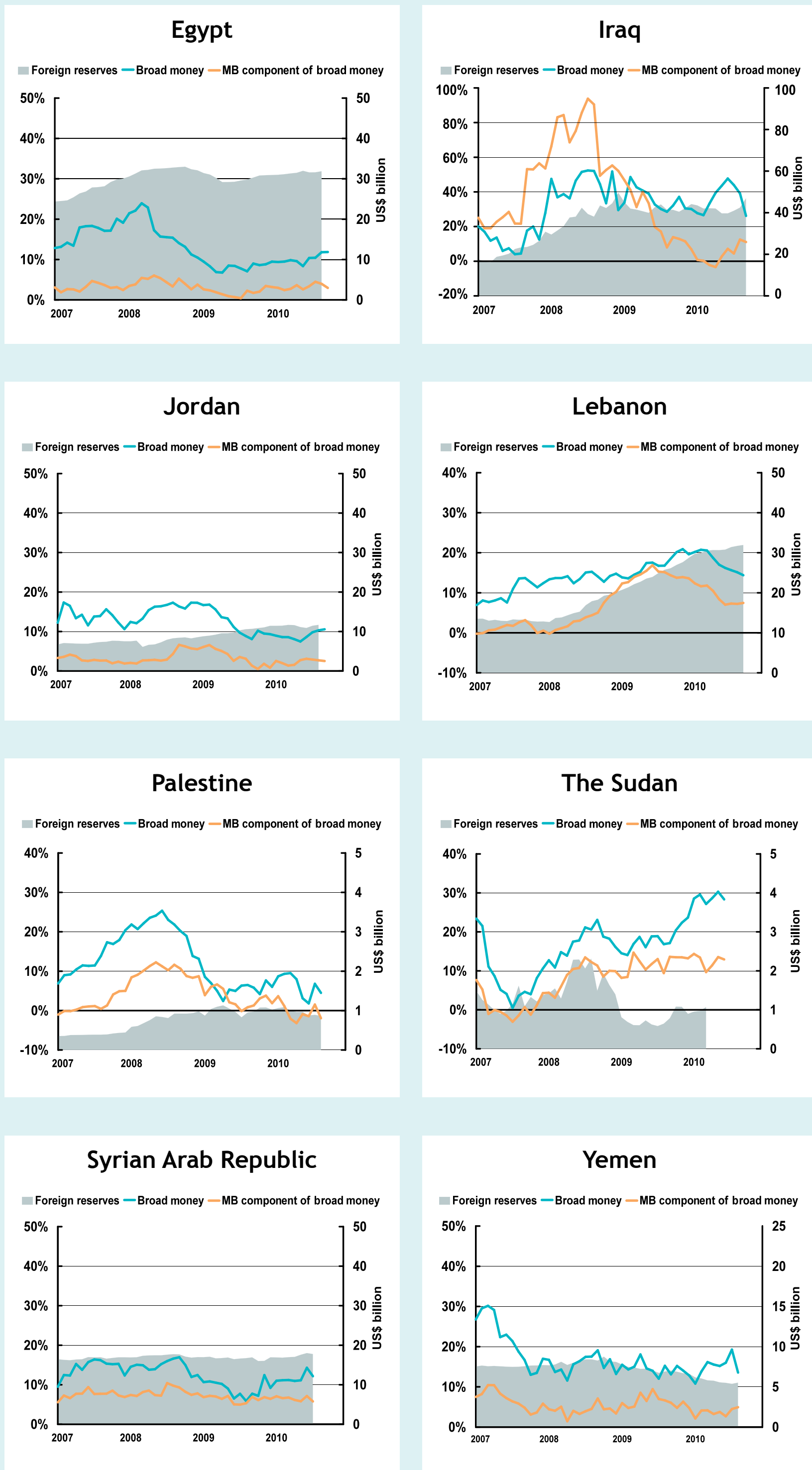


Source: ESCWA staff calculation based on national sources.

With the exception of Kuwait and Saudi Arabia, domestic monetary contraction in the remaining GCC countries may become problematic in the immediate future. Figure 32 depicts the narrowing difference between the growth of broad money and the growth of the monetary base in terms of broad money, an indication of weak lending activities of the banking system and a tightening of credit conditions in GCC countries. It appears that the monetary easing measures introduced and additional liquidity and fiscal support provided to the banking sector have all been absorbed by its balance sheet adjustment measures leaving no observed trickle-down effects, so far, onto domestic demand. The main problem remains in depressed asset prices, namely real estate prices, for which the banking sector has to continue adjusting its balance sheet.

The growth of broad money stock in MDEs, the growth of the monetary base in terms of broad money growth and the level of foreign reserves are highlighted in figure 32 for the period from 2007 to 2010. With the exception of the Sudan, foreign reserves have remained at sound levels in all MDEs. A significant accumulation of foreign reserves in Jordan and Lebanon is noticeable, with the build up of reserves in Lebanon mainly due to the inflow of foreign capital. Domestic monetary expansion has been weak in Iraq and the Sudan even though both countries started to experience moderate growth in 2009. In the remaining MDEs, however, domestic monetary contraction was observed in 2009. However, there is clear trend reversal in the build up of reserves since January 2010 in Yemen. If that declining trend continues, coupled with the recent political turmoil, then Yemen may well experience further difficulties in meeting its debt service obligations and in maintaining

Figure 32. Monetary indicators, MDEs, 2007-2010



Source: ESCWA staff calculations based on national sources.

its fixed exchange rate peg to the US dollar. The by-product would then be a balance-of-payments crisis. The MDEs, therefore, need to take a cautious stance with regard to the global financial crisis. The limited monetary easing measures introduced have had little effect on the private sector. Due to relatively moderate downward asset price adjustments in MDEs, the banking sector has not yet been induced to introduce balance sheet adjustment measures. However, if the severe asset price adjustment measures of commercial banks introduced in the GCC countries turn out to be contagious, then MDEs will encounter further macroeconomic imbalances in addition to already being burdened by heavy public debt, current account deficits, limited fiscal space, no oil revenues and fixed exchange rate regimes.

I. General overview and prospects

Despite the weak performance of the stock market and real estate sector in GCC countries, the delay in implementation of private sector projects and the rapid decline in commercial and residential rental prices, some policymakers still consider the economic fundamentals pertaining to LDEs to be sound and robust. While this optimism may not be well founded, it constitutes a crucial drive for forward-looking consumption and investment decisions of economic agents. In 2009, GCC countries registered an average real GDP growth rate of 0.1 per cent, with an estimated rebound to 4.0 per cent in 2010 and 4.2 per cent in 2011. Weak 2009 growth performance was partly due to prompt compliance with the significant cut in the OPEC production quota of the ESCWA member countries of OPEC, namely Kuwait, Qatar, Saudi Arabia and the United Arab Emirates. Due to the strong readiness of the fiscal authorities for fiscal support, domestic demand of GCC countries did not shrink in parallel with declines in GDP growth rate estimates. GCC countries that are not OPEC members showed more modest declines in growth performance in 2009 and 2010. Resilient business and consumer confidence has been observed in the GCC economies despite weaknesses in certain economic sectors, namely real estate and finance. The prospects for 2011 will depend on: (a) a recovery of external and internal demand and crude oil prices; (b) a continuously active fiscal stance; and (c) a smooth balance sheet adjustment of the various economic entities, namely commercial banks, business entities and households.

Despite the negative spillover effects of the global financial crisis, MDEs experienced a resilient 2009 growth performance, registering, on average, a 5.2 per cent real GDP growth rate in 2009. Despite potential vulnerabilities in their respective current accounts with deficits registered in most MDEs, domestic demand continued to grow, with capital account registering robust surpluses in several MDEs. Moreover, the oil exporters among them, namely Egypt, Iraq, the Syrian Arab Republic, the Sudan and Yemen, were not bound by the OPEC production quota and were, therefore, able to avert a sharp decline in their crude oil production. The low level of financial integration of MDEs, coupled with reduced reliance on manufacturing exports and international capital markets insulated this subregion from the initial impact of the global financial crisis. Exports to the United States and European Union were sharply affected, but the overall economic and financial impact on MDEs was limited. Due to limited exposure to international money markets, liquidity remained available in most MDEs, although in limited supply. The real estate sector was moderately affected, with the exception of Lebanon, where real estate prices maintained their upward trend in 2009 and well into 2010. Furthermore, growth and development of MDEs will depend on structural measures to be introduced to deal with issues like chronically high unemployment rates, low productive capacity and more private sector-led growth. The prospects for 2011 will depend on: (a) a recovery in internal and external demand, namely from the United States, the European Union and the GCC economies; (b) a sufficient margin against potential foreign exchange constraint; and (c) active fiscal measures with international and regional support. The real GDP growth rates forecast for MDEs in 2010 and 2011 were 5.4 and 5.7 per cent respectively.

1. *Less diversified economies: a country assessment*

Qatar is in the forefront of the GCC countries in terms of growth performance, with an estimated GDP growth rate of 8.6 per cent in 2009. Continuous investment activities in the energy sector and urban infrastructure sustained high real GDP growth rates. In addition, Qatar is the world's largest LNG exporter. This has contributed to maintaining the positive margin of Qatar in net exports. The 2010 real GDP growth rate was forecast at 13.4 per cent, based upon expected active investments, strong net exports and active support for balance sheet adjustments of commercial banks, with further improvement forecast for 2011 at 14 per cent. Relative to 2008, a rapid fall in the general price level was registered, with the 2009 consumer inflation rate estimated at -4.9 per cent, compared with 15.2 per cent in 2008. The decrease in the price level was driven by food and rental prices. The 2009 deflationary trend was expected to continue well into 2010 with an estimated inflation rate of -1.6 per cent and a trend reversal expected for 2011 to 1 per cent.

Kuwait, Saudi Arabia and the United Arab Emirates experienced a contraction in their respective real GDP growth rates in 2009. However, the contraction was not due to weak domestic demand but rather to the reduction in oil production capacity under the OPEC production quota. The real GDP growth rate of Kuwait registered -4.6 per cent in 2009. In addition to the reduction in crude oil production levels, the weak refinery margin for fuel products and declining profit margins of the financial sector are all contributing factors to weak growth performance. However, as a result of the resumption of active investment activities in the energy sector and sustained growth in domestic demand, the 2010 real GDP growth rate was forecast at 4.4 per cent, with a slight expected deterioration to 3.6 per cent in 2011. The consumer inflation rate was estimated at 4.0 per cent in 2009, compared with 10.6 per cent in 2008. The 2010 inflation rate was forecast at 3.5 per cent, riding on the back of the anticipated full economic recovery, with rates expected to remain the same at 3.2 per cent in 2011.

The real GDP growth rate of Saudi Arabia registered 0.6 per cent in 2009, mainly due to the reduction in the production of crude oil in order to meet the OPEC production quota. However, stable domestic demand growth continues to be registered, sustained by the exceptionally significant fiscal stimulus package introduced by the Government. Moreover, the real estate sector of the country has been resilient and was not affected by real estate developments in the other GCC countries. Saudi Arabia was among the few ESCWA member countries that did not experience a decline in residential rental prices during 2009. The financial sector remained relatively active in response to recent liberalization of the financial market, giving more access to foreign investors. The economy was forecast to recover in 2010 and 2011 with estimated real GDP growth rates of 3.4 and 3.8 per cent, respectively. The Saudi economy also experienced a decline in the general price level in 2009, where the consumer inflation rate was estimated at 5.1 per cent, compared with 9.9 per cent in 2008. The decline is in line with the trend decline in international and regional commodity prices. A further decline in the price level is forecast for 2010 and 2011 with consumer inflation rates estimated at 4.9 and 4.5 per cent respectively.

The United Arab Emirates recorded a real GDP growth contraction of -1.9 per cent in 2009. The decline in net exports as a result of the reduction in crude oil production, in line with the OPEC production quota, was a contributing factor. In parallel, an active fiscal stimulus package was also introduced and was implemented in 2009 and 2010. The fiscal support for domestic demand was especially important in Abu Dhabi. Dubai was particularly affected by the global financial crisis due to its linkages and exposure to international macroeconomic developments, leading to a subsequent sudden slow down in the activities of the financial and real estate sectors and a sharp reduction in construction activity. However, 2010 business and consumer sentiment appeared to be resilient, which could constitute a main driving force behind the expected recovery. The economy was forecast to recover with a growth rate of 2.7 per cent in 2010 and 3.2 per cent in 2011. Due to rapid decline in residential and commercial rents, as well as the international declining trend in commodity prices, the 2009 consumer inflation rate was at 1.6 per cent, compared with 12.3 per cent in 2008, with further expected declines in 2010 and 2011 to an estimated 0.3 and 1 per cent respectively.

Box 3. “Dubai shock” and the asymmetric perception

The announcement of Dubai in November 2009 authorizing the Dubai Financial Support Fund (DFSF) to initiate the restructuring of Dubai World caused a shockwave throughout world financial markets. This was mainly due to information that the restructuring plan would include a request to bondholders for “debt standstill” for a six-month period. Dubai succeeded in raising US$15 billion in 2009 through the issuance of bonds which were purchased by the Central Bank of the United Arab Emirates and commercial banks of Abu Dhabi. The establishment of DFSF in July 2009 was part of the effort undertaken by Dubai to restructure its flagship business entities in an orderly way and meet the challenges resulting from the global financial crisis. These efforts became well known in the region and debt rescheduling was acknowledged as an option to consider. The “Dubai shock” revealed the existence of asymmetric information, where expectations of the Government of Dubai and international bondholders appeared to be on a diverging path. The best option would have been for the Government of Dubai to emphasize its long-term business goals with confidence and to articulate a comprehensive restructuring package. However, for international bondholders, any suspension of debt repayment constitutes a sign of weakness and uncertainty. From the point of view of bondholders, even a small possibility of delay in debt repayment can increase the legal risk of default. Although significant in magnitude, the “Dubai shock” was not equivalent to the 2008 “Lehman shock”.

Bahrain and Oman, GCC countries which are not part of OPEC, experienced a modest real GDP growth rate in 2009. Bahrain registered a 3.1 per cent real GDP growth rate on the back of a moderate crude oil production increase. Investment in energy and aluminium sectors is still ongoing, boosting depressed activities in financial and real estate sectors. Moreover, recovery in domestic demand is forecast to further enhance growth. The real GDP growth rate was forecast at 4.0 per cent in 2010 and 3.8 per cent in 2011. The 2009 consumer inflation rate was 2.8 per cent, compared with 3.5 per cent in 2008, reflecting some stability in the general price level. The stable trend was forecast to continue well into 2010 with a forecast consumer inflation rate of 2.2 per cent and 1.9 per cent in 2011.

Oman registered a modest 3.6 per cent real GDP growth rate in 2009. A consistent increase in crude oil as well as LNG production is contributing to the positive growth outlook. Moreover, the expansion in domestic demand continued on the back of the fiscal stimulus package introduced by the Government. Given the limited exposure of the financial sector to international/regional financial markets, the impact of the global financial crisis has been rather limited and the domestic economy was able to weather the negative spillover effects of the crisis. With continuous increase in crude oil and LNG production and continuing active fiscal policy measures, the economy was forecast to grow at 4.3 per cent in 2010 and 3.9 per cent in 2011. The consumer inflation rate was 3.5 per cent in 2009, compared with 12.6 per cent in 2008. The declining trend was forecast to continue well into 2010 with a 2.2 per cent consumer inflation rate and a 1.9 per cent rate in 2011.

2. More diversified economies: a country assessment

The Central Bank of Egypt should be careful in managing aggregate demand in order to keep inflation closely under control

Egypt registered a 5.2 per cent real GDP growth rate in 2009. The fiscal stimulus package of EGP15 billion that was introduced has insured the stable expansion of domestic demand. Despite a sharp decline in the export of goods to Egypt's largest trading partners, the United States and the European Union, and the decline in trade in services from the proceeds of the Suez Canal, the potential weakness of the current account position was offset by growing exports of natural gas and a relatively robust capital account position, with no subsequent negative effects on the balance of payments or exchange rate. Foreign reserves continued to grow without renewed pressure on EGP throughout 2009 and well into 2010. The recovery of external demand and stable domestic demand growth, with a second fiscal stimulus package introduced for the 2010 fiscal year, has contributed positively and a real GDP growth rate of 5.5 per cent was forecast for 2010. However, the recent political/social turmoil that Egypt is currently witnessing led to a revision in the forecast of the 2011 real GDP growth rate from 6.2 per cent to about 3.7 per cent. Egypt's consumer inflation rate registered 11.8 per cent in 2009, compared with 17.1 per cent in 2008. Weaknesses of EGP against the euro are behind the hikes observed in the inflation rate, coupled with sustained growth in domestic demand. The Central Bank of Egypt should be careful in managing aggregate demand in order to keep inflation closely under control/supervision. However, on the back of continued growth in domestic demand, consumer inflation was forecast at 12.5 per cent in 2010 and 11 per cent in 2011.

Iraq registered a real GDP growth rate of 4.2 per cent in 2009. Crude oil production maintained its recovery course due to continued investment in its production capacity. Iraq was not affected by the production quota imposed by OPEC in 2009. Therefore, the drop in oil export revenues was not as severe as it was for the other OPEC member countries. The improved security situation, albeit still fragile, positively impacted economic activity, supported by active fiscal stimuli measures. Moreover, the Iraqi economy started to diversify its production capacity through non-oil trading activities, particularly with Jordan. The real estate sector has been increasingly active and the financial sector experienced consistent, albeit still limited, growth. Fragile economic conditions, including increasing fiscal deficits, were expected to prevail in 2010, but the recovery in crude oil production, domestic demand and the resumed inflow of foreign investment ensured positive growth in 2010, forecast at 5.0 per cent and at 5.5 per cent in 2011. Consumer inflation rate registered -2.8 per cent in 2009 in line with the regional declining trend. With an expected robust growth in domestic demand, the inflation rate forecast for 2010 was at 2.5 per cent and 4 per cent in 2011.

Jordan registered a real GDP growth rate of 2.3 per cent in 2009. The decline in activity in the mining and financial services sectors and a slowing growth in domestic demand led to modest growth rates, compared with the 7.6 per cent growth rate of 2008. The Government was active in supporting domestic demand by increasing capital spending during the first half of 2009. Exports of apparel products through the Qualifying Industrial Zones (QIZs) to the United States experienced a sharp decline, but the export performance in general was boosted by the growth in exports to Iraq. The decline in energy prices and raw material imports through QIZs reduced the level of total imports. Subsequently, the current account deficit relative to GDP narrowed to its 2008 level. The real estate sector has been resilient on the back of a Government tax exemption to households purchasing residential real estate. However, Jordan is still considered an economy with very limited fiscal space given its high accumulated public debt, high real interest rates and the pursuit of fixed exchange rates. The Government is, therefore, considering austerity measures in order to maintain fiscal stability. The recent decline in foreign grants has become another concern in the light of the inability of the Government to introduce a comprehensive fiscal stimulus package in order to stimulate domestic demand. A moderate growth of 3.1 per cent was forecast for 2010 with the same performance in 2011 at 3.5 per cent. The general price level rapidly declined in 2009, where the consumer inflation rate registered -0.7 per cent, compared with 13.9 per cent in 2008. The consistent growth in domestic demand and external factors such as the weakness of the national currency against the euro was forecast to push up the price level. The consumer inflation rate was forecast at 4.0 per cent in 2010 and 4.2 per cent in 2011.

Lebanon registered a real GDP growth rate of 8.5 per cent in 2009. Political/security improvements since May 2008 continued to attract foreign capital in the form of FDI, remittances and tourism revenues. Even though construction activity remained robust, a modest decline in real estate prices was registered in the second half of 2010. The current account and trade deficits relative to GDP have continued to deteriorate, but the once-feared decline in inflows of workers' remittances resulting from the global financial crisis and negative spillover effects from the GCC countries did not materialize. Current account deficits were offset by robust capital account surpluses and by workers' remittances, coupled with a remarkable growth in foreign reserves throughout 2009 and well into 2010. This subsequently translated into a series of balance-of-payments surpluses. However, further slowdown in economic activity should not be excluded due to a deteriorating fiscal position and limited fiscal space, coupled with the continued pursuit of a fixed exchange rate system and renewed political turmoil. There are also fears of an expected price correction in the real estate sector. Nevertheless, the economy is expected to maintain a positive growth outlook at the forecast real GDP growth rate of 6.9 per cent in 2010 with a slight deterioration in 2011 to 5.6 per cent. The general price level declined sharply in 2009 with the consumer inflation rate registering 1.2 per cent, compared with 10.0 per cent in 2008. As was the case in Jordan, continued growth in domestic demand and the continued weakness of the national currency against the euro was expected to translate into higher prices. The consumer inflation rate was thus forecast to be at 3.1 per cent in 2010 and 2.5 per cent in 2011.

Palestine registered a real GDP growth rate of 6.8 per cent in 2009. The physical blockade and continued hostilities have imposed severe constraints on economic activity. Moreover, a sharp deterioration in economic conditions in Israel led to devastating consequences on the economic situation in Palestine. The intensity of military action that Israel conducted against the Gaza Strip over a 22 day period in December 2008 and January 2009 caused devastating destruction to human and physical capital. Reconstruction efforts have so far been hampered by unpredictable flows of international development aid and weak fiscal infrastructure. Non-economic factors, such as security considerations, still dominate Palestine's economic situation and prospects. However, as reconstruction efforts are expected to resume with regional and international support, the economy was forecast to register a further recovery to 4.5 and 4.7 per cent real GDP growth rates in 2010 and 2011 respectively. Consumer price inflation declined to 2.8 per cent in 2009, compared with 9.9 per cent in 2008. Following international trends, the general price level was forecast to increase to 3.2 per cent in 2010 and 3.5 per cent in 2011.

Non-economic factors, such as security considerations, still dominate Palestine's economic situation and prospects

The Sudan registered a real GDP growth rate of 4.5 per cent in 2009. The steady growth in crude oil production coupled with a stable agricultural sector contributed to the positive growth outlook despite decline in crude oil prices and oil export revenues. Moreover, an increase in capital inflows in the form of FDI in agriculture and energy was registered. On the monetary side, however, the Central Bank of Sudan introduced certain restrictions on foreign currency transactions. Growing services and activity in the real estate sector were recently registered in Khartoum and Juba. However, the overall economy is still operating well below potential, due to other domestic non-economic factors. Thus, the real GDP growth rate forecast for 2010 remained modest at 6.2 per cent in light of moderate growth in crude oil prices and at 6 per cent for 2011. The consumer inflation rate was estimated to have remained relatively high in 2009 at 11.2 per cent, a general trend forecast to continue, with a consumer inflation rate forecast at 13.2 per cent in 2010 and 11 per cent in 2011.

The Syrian Arab Republic registered a real GDP growth rate of 5.9 per cent in 2009. Decline in crude oil production levels as well as crude oil prices constituted one hurdle to be surmounted by the growth performance of the economy. However, a steady growth in domestic demand coupled with swift introduction of economic/ financial liberalization measures, namely the inauguration of the Damascus Securities Exchange in March 2009, boosted economic expectation for 2010. A set of reform measures gradually increased the effectiveness of policy measures of fiscal and monetary authorities. Nevertheless, the economy is still under foreign exchange constraint where the restriction on foreign currency transactions is still in place. While restrictions have, perhaps, defended the local currency against various negative external financial shocks, they have also limited the scope for rapid growth in domestic demand. With an expected recovery in crude oil prices, real GDP growth rate was forecast at 6.2 per cent in 2010 and 6 per cent in 2011. The resilient domestic economy is in a position to attract FDI, the extent of which would still depend on the extent and speed of economic liberalization measures. The consumer inflation rate has decreased from 15.2 per cent in 2008 to 2.8 per cent in 2009 and was forecast to go up to 4.3 per cent in 2010 and 4 per cent in 2011. It should be noted that the 2008 high inflation rate was attributed to the reduction in fuel subsidies.

Yemen registered a real GDP growth rate of 4.7 per cent in 2009. Despite the recovery in crude oil prices since March 2009, the decline in crude oil export revenues relative to 2008 limited the scope for domestic demand growth. The national currency of Yemen is the only ESCWA currency that experienced a significant depreciation against the US dollar. The reduction in crude oil export revenues is one contributing factor which added to the already deteriorating fiscal situation. However, the disbursed level of international and regional support has not been sufficient to relax foreign exchange and fiscal constraints in order to pave the way for sustainable growth in domestic demand. The real GDP growth rate forecast for 2010 was at 3.5 per cent and 3.2 per cent in 2011. The consumer inflation rate has come down from 19.0 per cent in 2008 to 5.4 per cent in 2009, a decline attributed to the fall in commodity prices. The 2010 forecast of consumer inflation was at 8.5 per cent due to the existence of supply constraints against growing domestic demand and to a continuing gradual depreciation of the national currency against major international currencies, with a further increase to 8.9 per cent expected in 2011.

J. Social dynamics

The global financial crisis and the ensuing economic crisis, coupled with the steep decline in oil prices and revenues, had wide social implications in ESCWA member countries, especially since the region was also hit by two other nominal shocks, namely food and fuel price hikes. It is, rather, the longer term impact of recessionary conditions in the real economy and the weak growth conditions of this recent crisis that are expected to generate additional social hurdles. Although extensive empirical data assessing long-term repercussions of the recession remain insufficient to draw firm conclusions, it is well known that external shocks impact society disproportionately, more significantly affecting the most disadvantaged groups. In ESCWA member countries, these social groups are mainly the working poor, youth, migrant workers (specifically in GCC) and women, who cross cut all other vulnerable groups. This section will provide a snapshot of one dimension of the social impact of the crisis, namely the employment effect on the relatively disadvantaged.

The impact of the crisis on migrant workers can take different forms. It could be through lower remittances or reverse migration due to the varied impacts of the crisis on different sectors and occupations. During tough times, migrant workers are the most vulnerable to lay-offs and hence face a stronger sense of insecurity. This represents another manifestation of the social impact that will ultimately affect the social integration of migrants in host countries.

In the GCC countries, the issue of migrant labour is prominent. Prior to the crisis, GCC countries expanded their foreign workforce. In the latest national data, the share of foreign nationals in the total population was estimated at 49 per cent in Bahrain (2007), 69 per cent in Kuwait (2008), 29 per cent in Oman (2007), 27 per cent in Saudi Arabia (2008), 81 per cent in the United Arab Emirates (2008) and the share of foreign nationals in the population segment "15-years old and above" stood at 89 per cent in Qatar (2006). Despite heavy investment in human resource development to promote employment of a national workforce in the private sector, the dependency of GCC countries on expatriate workers has remained significant for private sector development and its expansion during the last few years had boosted the demand for expatriate workers.

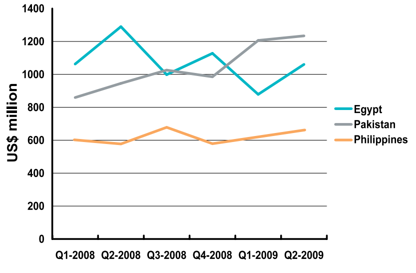
Since the global financial crisis initially impacted core activities in the private sector of the region, namely finance and construction, analysts had anticipated massive job losses and the exodus of expatriate workers from the GCC countries, affecting the host countries, labour-exporting MDEs and countries in Asia. Despite what several media reports had mentioned about the repatriation of expatriate workers, no sign of a large scale exodus was observed as of the third quarter of 2009. A case in point is Lebanon, which is significantly dependent on employment opportunities in GCC countries and workers' remittances. No substantial number of returning expatriates was recorded and gross foreign reserves continued to increase in the country well into 2009 and 2010. For other major labour-exporting countries where data are available, it is clear that while remittances from the GCC countries to Pakistan have been increasing, those destined to the Philippines remained stable in 2009. Meanwhile, remittances destined to Egypt decreased during the first quarter of 2009, but recovered shortly after, during the second quarter of the same year (figure 33-A).

With the exception of a few ESCWA member countries, the stylized facts clearly indicate that the financial crisis has not affected remittance outflows of GCC countries in either 2008 or 2009. Data indicate that remittance outflows increased from US$50 billion in 2008 to reach US$63 billion in 2010 (figure 33-B). However, the inflow of workers' remittances to MDEs declined from US$20.6 billion in 2008 to US$19.18 billion in 2009, with a slight trend reversal in 2010 to US$21 billion (figure 33-C). This is due to a steep decline in remittances from the United States and the European Union both of which constitute an important source of remittances to MDEs. Still, the 2009 size of the inflow of workers' remittances was estimated to remain high at 13 per cent of GDP in Jordan and 24 per cent of GDP in Lebanon.

The most disadvantaged groups are mainly the working poor, youth, migrant workers and women, who cross cut all other vulnerable groups

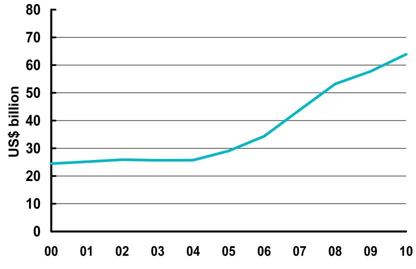
Figure 33. Flows of workers' remittances

33-A. Workers' remittances from GCC countries, 2008-2009



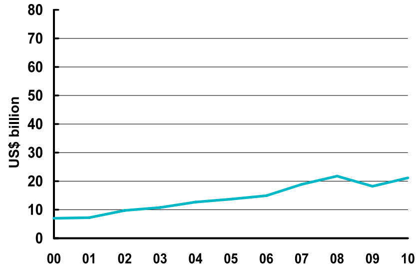
Source: Central Bank of Egypt, State Bank of Pakistan, Bangko Sentral (ng) Pilipinas.

33-B. Estimated total outflows from GCC countries, 2000-2010



Source: ESCWA staff estimations based on national balance-of-payments data.

33-C. Estimated total inflows to MDEs, 2000-2010



Source: ESCWA staff estimations based on national balance-of-payments data.

Box 4. Reform of the sponsorship system of Bahrain

The concentration of working-age population, partly due to demographic transition and partly due to the immigration of foreign workers, is potentially beneficial, as it is known as the demographic window of opportunity. However, as employment opportunities quickly became scarce, the sustainability of the sensitive balance of population between national and foreign expatriate workers, particularly of working age, has become a major social concern in GCC countries. In order to preserve social coherence and cultural identity, the policy of GCC countries toward foreign expatriate workers has been restrictive. However, a recent trend has emerged in GCC countries to reform the issue of foreign expatriate workers by accepting certain flexibility in their contractual status with rigid limitation on the period in which foreign expatriate workers can continuously stay in the country. Whereas no conclusion has been reached so far on the limit of the stay, several member countries, particularly Bahrain, have implemented reform of the sponsorship system. The reform measure was announced in May 2009 and came into effect in August 2009. The reform in effect allows foreign expatriate workers to switch jobs without consent of the employer. This move was opposed by the business community, arguing that it would push up wages and subsequently cause a loss of cost competitiveness. Against this opinion, the Labour Minister of Bahrain, Majeed Al Allawi expressed his confidence concerning the positive effects the reform would have on Bahraini jobseekers and elaborated that the problem in Bahrain, rather than stemming from a lack of jobs, of which there were plenty, was rooted in the low wage scale. He noted that as long as the sponsorship system was in place, Bahrainis would not obtain salary increases.*

* Gulf News, 5 May 2009 "New Bahrain labour law stirs hornet's nest", available at: http://gulfnews.com/ news/gulf/bahrain/new-bahrain-labour-law-stirs-hornet-s-nest-1.1963.

GCC countries manage expatriate workers under the sponsorship system, whereby a transfer of expatriate workers from one employer to another is restricted. An expatriate worker must leave the host country once they are laid off and have lost the sponsoring employer. The GCC countries have recently been actively engaged in labour market reforms. Bahrain, Kuwait, Qatar and Saudi Arabia introduced measures to reform the sponsorship system in 2009. Particularly, Bahrain decided to allow expatriate workers to shift jobs without the permission of the sponsor. Soon after, Kuwait followed suit. At the same time, it is worth highlighting that with the threat of unemployment of locals resurfacing following the crisis, policymaking is refocusing on "nationalization" strategies. In 2008, the unemployment rate among Saudi nationals stood at 9.8 per cent, while that for foreigners stood at 0.4 per cent. In the United Arab Emirates, the unemployment rate for the national workforce was 13.8 per cent whereas that for foreigners was 2.6 per cent.

These observations imply that the status of expatriate workers in GCC countries has so far been relatively steadier than previously feared. Four possible observations may be made on the present situation. First, despite a possible contraction in GDP in major crude oil exporting ESCWA member countries, moderate expansion of domestic demand on the back of active fiscal measures that have been introduced have so far lessened the impact of the crisis on the labour market and on unemployment rates. All GCC countries committed to an active fiscal policy for the years 2009 and 2010. Second, employers are expecting an imminent positive upturn in economic activity and are, therefore, maintaining their pool of expatriate workers to avoid the possible future hiring costs of new recruits. Third, relocations of expatriate workers within the GCC countries have been toward cities that have been less affected by the financial crisis. The remittance data of the State Bank of Pakistan in 2009 show an increase in remittances from Abu Dhabi and a decline from Dubai. Moreover, other evidence suggests a move of expatriate workers to Qatar and Saudi Arabia. Fourth, flexible wage adjustments may take place for the mutual interest of employers and employees.

Despite the relatively stable employment conditions of the GCC countries, the issue of unemployment and underemployment has remained the major socio-economic concern of the region (table 13). Chronically high unemployment rates persisted, despite moderate improvement recently observed in the Syrian Arab Republic and Yemen, but with further deteriorations in each of Egypt, Jordan and Saudi Arabia (figure 34). The 2009 economic slowdown has added further strains on the labour market as evidenced in the latest unemployment figures, namely for Jordan. After a decline in those rates from 13.1 per cent in 2007 to 12.7 in 2008, they increased again to 12.9 per cent in 2009.

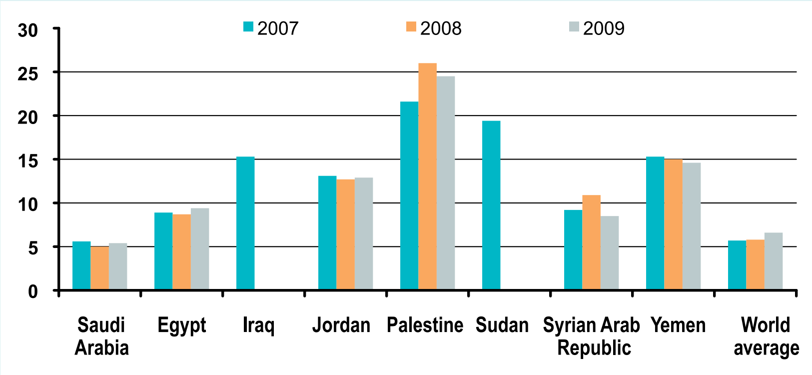
In its Global Employments Trends 2011, ILO reconfirms these observations, noting a very limited drop in pre-crisis unemployment in the Middle East region (1 per cent from 2004 to 2008), with the rate hovering thereafter at 10.3 per cent and still considered relatively high.

Table 13. Unemployment rates in ESCWA member countries, 2004-2009 (*Percentage*)

Country	2004	2005	2006	2007	2008	2009
Bahrain	9.0	..	..	..	..	..
Egypt	10.3	11.2	10.6	11.2	10.6	10.6
Iraq	26.8	18.0	17.5	18.0	17.5	17.5
Jordan	14.7	14.8	14.0	14.8	14.0	14.0
Kuwait	..	..	..	..	..	..
Lebanon	..	..	..	..	..	..
Oman	..	..	..	..	..	..
Palestine	26.8	23.5	23.6	23.5	23.6	23.6
Qatar	..	..	0.9	..	0.9	0.9
Saudi Arabia	5.8	6.1	6.3	6.1	6.3	6.3
The Sudan	16.3	17.1	17.3	17.1	17.3	17.3
Syrian Arab Republic	12.3	8.0	8.3	8.0	8.3	8.3
United Arab Emirates	..	..	..	..	..	..
Yemen	16.2	16.0	15.7	16.0	15.7	15.7

Source: Unemployment rates are from national sources.

Figure 34. Unemployment rate in ESCWA member countries, 2007-2009 *(Percentage)*



Source: Unemployment rates are from national sources.

A breakdown of unemployment by category highlights another labour problem in the region, youth unemployment, which currently stands at four times the adult unemployment rate. With such a weak starting point, young people face even lower chances of finding work in the future if the post-crisis economy fails to create jobs. Relatively low levels of skills and professional experience, and limited financial resources and networking ability combine to put young people at a disadvantage in the job market compared with older groups.

ILO also notes that vulnerable employment and working poverty figures in the Middle East had been improving slightly, with vulnerable employment down by 3 per cent between 2000 and 2009, leaving around a third of all workers in vulnerable jobs at the end of that period. The "working poor" are defined as those who are employed, but live in households where individual members subsist on less than US$1.25 a day. Vulnerable employment is often characterized by low-productivity work and since the global financial crisis has resulted in declining output per worker, working poverty was likely to have increased as well. The situation is even worse when considering working poverty by taking the US$2/day definition of "working poor", under which the working poverty rate was at 18.7 per cent in 2009, still a significantly high level.

National statistics on this type of poverty are scarce. However, looking at poverty rates in a broader sense, the Third Arab Report on the Millennium Development Goals 2010 suggests that when using national lines to measure poverty, the region shows almost no progress. Taking the US$1.25-a-day international poverty line, the region fared better up until 2006, when any progress that had been achieved stalled. Thus, by different measures, poverty conditions definitely did not improve post-crisis. The most critical situation has been that of Yemen. The 2007-2009 food, fuel and financial/economic crisis has largely reversed the gains in terms of poverty reduction recorded over the 20 previous years in Yemen, bringing up the 2009 poverty rate back to its mid 1990s level (42.8 per cent of the total population was considered poor in 2009).[12]

A number of positive developments in the area of gender equality were registered in ESCWA member countries

Regarding women, a vulnerable group that crosscuts with all others in the ESCWA region, pre-existing inequalities are still strongly prevalent, despite progress achieved recently. A number of positive developments in the area of gender equality were registered in ESCWA member countries. In February 2009, Jordan decided to lift its reservations on paragraph four of Article 15 of the Convention on the Elimination of All Forms of Discrimination against Women (CEDAW). This measure gave Jordanian women the freedom of mobility and the choice of residence without the consent of their husbands or other male family members. Also in February, Saudi

Arabia appointed its first female minister as the Deputy Education Minister for female affairs. In the 2009 Kuwait general election, four female candidates were elected Members of Parliament. However, these steps remain modest as compared with mounting challenges facing gender equity in the ESCWA region, particularly in employment and labour markets. In this area, women suffered from pre-crisis structural inequalities, keeping them among the more vulnerable to external shock repercussions.

The ILO Global Employment Trends 2011 shows that female unemployment in the Middle East has been rather constant at around 17.3 per cent over the last three years, versus 8.2 per cent for men. The female employment-to-population ratio also seems to be very slowly improving from 20.3 per cent in 2008, 20.5 per cent in 2009 to an estimated 20.7 per cent in 2010, versus a figure going up from 67.7 per cent in 2008 to an estimated 68 per cent in 2010 for males. More importantly the female labour force participation rate is as low as 24.5 per cent in 2007 going up to 24.8 per cent in 2009, yet remaining way below that of men at 75.5 per cent and 75.6 per cent respectively.

The gender gaps stretch to differences in pay, female/male segregated labour markets and economic activity, the strong presence of women in the informal sector and vulnerable employment, not to mention the cultural norms and legislative gender inequalities. The role of women in decision making is still weak, be it at the public level (political realm), middle or even at the micro or household level. This power imbalance can easily translate into an economic disadvantage especially in times of crisis.

To introduce a gender perspective into analysis of the impact of the crisis, it is essential to look further, beyond the transmission mechanism from the macro economy to the intermediate level of economic variables, like employment, and look into the role of specific policy response in the light of pre-existing inequalities affecting women.

In general, social policy reforms were introduced in ESCWA member countries over the period 2008 and 2009. In the budget formation for the 2009 fiscal year, the fiscal priority of Governments of the region accounted for socio-economic development spending in education and health care in parallel with the economic stimuli packages aimed at coping with the global financial crisis. Against the 2008 consumer inflation hikes, wage adjustments were implemented in several ESCWA member countries, including Jordan, in the form of minimum wage revisions and in Lebanon in the form of public sector wage revisions. Moreover, Jordan is planning to reform their Social Security Corporation in order to establish an unemployment fund and insure wider population coverage. The Social Fund for Development in Yemen has been active in implementing social projects. Despite the commitment of the Government to spending in areas of social development, certain concerns still remain in most MDEs, due to an anticipated deterioration in the respective fiscal positions which may further curtail and reduce Government spending on social development. In addition, as important as the pre-crisis social reforms were, they lacked a gender component. The same applies for post-crisis countercyclical strategies.

Within this context, the combined effects of the crisis and policy response would easily widen the gender gap. For

No post-crisis measures targeted the informal sector and the possibility of increased informalization and vulnerable employment

example, no post-crisis measures targeted the informal sector and the possibility of increased informalization and vulnerable employment. According to ILO, the share of women in vulnerable employment was 43.7 per cent in 2009, versus a ratio of 29.6 per cent for men. In fact, the slower job creation environment pushed workers into informal precarious jobs also driving wages down in this sector. Particularly, it is informalization of the workforce participation of women that is expected to increase as policy intervention targets male-dominated activities like construction and industrial labour-intensive sectors. In addition, the fact that private sector employment in the Arab world remains "women-unfriendly", due to cultural perceptions and legal hurdles, further accentuates the situation in dire times. Deeply entrenched gender norms and roles in Arab society likewise put further pressure on women, especially poorer women, as they struggle with their dual roles in the productive and reproductive economies. In fact, without introducing a gender perspective to analysis of the crisis and continuing on to intrahousehold dynamics and the reproductive economy, where unremunerated activities to reproduce, care and develop families and labour take place, assessment of the crisis impact remains abridged.

In conclusion, the previous analysis was intended to provide a general understanding of the impact that the crisis had on social dynamics, from the perspective of the most vulnerable social groups and adding as well a gender lens. These cases reflect only one dimension of the hardship that people can face in dire economic times. As such, economic policymaking in response to economic shocks cannot ignore the social realm. Economic growth, fiscal and monetary stability should not be considered as ends in themselves, but only in as much as they translate into well-being for people. Economic and social policies thus cannot be separate but must intertwine in a development strategy that prioritizes human rights norms.

K. Macroeconomic policy priorities and exit strategies

In the wake of the global financial crisis, ESCWA member countries are bound to be facing the following macroeconomic/ social hurdles in 2011: (a) relatively lower GDP growth rates and subsequently higher unemployment rates, lower Government revenues and further budget deficits; (b) relatively lower levels of capital inflows/FDI; (c) lower level of exports and subsequently, further current account deficits and more difficulties in servicing the portion of debt that is denominated in foreign currency; and (d) further social and political unrest. The current financial crisis has accentuated the current account and budget deficits of several ESCWA member economies. With a fixed exchange rate system in place, the explicit implication is that those countries will have to generate foreign currency from sources other than exports in order to: (a) cover a huge widening gap between exports and imports; (b) service a fast growing external debt; and (c) maintain their pegged exchange rate regime. If such hard currency is not generated, in the aftermath of the global financial crisis, then the by-product will be the continuous accumulation of unsustainable external debt and a subsequent exchange rate crisis. In all cases, if, for whatever reasons these countries still opt for maintaining fixed exchange rate arrangements, they will have to implement crisis-prevention measures, namely by exercising fiscal discipline, managing their debts and foreign reserves properly and avoiding future real exchange rate appreciation.

At the end of 2010, the world economy was diagnosed to be recovering slowly but steadily even though fears of a double dip recession still loomed in the horizon. Despite strong Government support and the introduction of gigantic fiscal stimuli packages, the United States, the European Union and Japan, as well as some emerging economies started experiencing deflation. While declining price levels may improve income in real terms, such declines point to weak domestic demand, despite the pursuit of active expansionary fiscal and monetary policies. The decline in the general price level has also led to real wage increases with a subsequent rise in world unemployment rates. While the prompt cost-adjustment measures introduced, including substantial layoffs, could contribute to improving growth rates, the huge unemployment cost is not to be neglected. Furthermore, the declining general price level may also further increase public and private debt burdens and those of commercial banks in real terms, adding to earlier burdens of now-devalued real estate and financial asset prices. The massive and intensive balance sheet adjustments, which have been at the core of the global financial crisis, are expected to continue, albeit at a lesser extent. A sustainable recovery can only be achieved through smooth balance sheet adjustments of commercial banks, business entities and households. The most important challenge facing policymakers is the facilitation of a smooth balance sheet adjustment process without denting domestic demand.

The ESCWA region is expected to face similar macroeconomic/financial hurdles in 2011. As the world economy is slowly but steadily recovering from recession since the third quarter of 2009, the economic sentiment of the ESCWA region has also improved from pessimism to cautious optimism. This is partly due to a firm improvement in oil prices and revenues. Given the deterioration in property and associated rental prices, the balance sheets of certain ESCWA member countries will require substantial adjustment to account for deterioration in asset prices. The monetary authorities of the region have repeatedly claimed that there are no shortages in liquid assets, despite the fact that commercial banks and business entities have often pointed out that the lack of liquidity still constitutes the major challenge to potential economic recovery. It is worth noting that what monetary authorities refer to as "liquidity" is "outside liquidity" for commercial banks, through which commercial banks are able to borrow funds. Whereas, what commercial banks and the business sector refer to as "liquidity" is the "inside liquidity" represented by cash reserves and by an assured projection of future cash inflows. The shortage of outside liquidity of commercial banks is one early symptom of a financial crisis usually coupled with increases in the systemic risk of the financial sector. The remedy for this systemic risk is central bank liquidity injection into the banking system. However, against the shortage of "inside liquidity" of commercial banks and business entities, a different set of policy interventions is warranted. This is because the shortage of inside liquidity requires a balance sheet adjustment by which commercial banks and business entities can wind down their indebtedness in line with the value of assets. The existence of divergent views on "liquidity" between central banks of the ESCWA region, commercial banks and business entities is proof of the need for further balance sheet adjustment.

The lack of liquidity still constitutes the major challenge to potential economic recovery

Past experience from Japan and the United States has shown that a time lag of 18 to 24 months exits for downward asset price adjustment to trickle-down to the real economy. The downward adjustment of asset prices in the ESCWA region started in the second quarter of 2008 and the lagged impact may have manifested itself during the period extending from the fourth quarter of 2009 to the second quarter of 2010. With this possible contingency, Governments of ESCWA member countries should have intervened and supplied the necessary liquidity support warranted. So far, monetary and fiscal authorities in the ESCWA region have successfully defended the banking sector, despite the credit turmoil of the global financial crisis. This achievement should be sustained and extended to alleviate the core weakness stemming from the global financial crisis through a smooth facilitation of balance sheet adjustments which, in most cases, requires strong fiscal support. Any further monetary stimulus at this stage is likely to be absorbed by the needs of the various economic sectors for further balance sheet adjustments as opposed to boosting domestic demand. Therefore, a strong fiscal stance is still necessary to sustain domestic demand for the purpose of achieving consistent growth. The fiscal stance and fiscal constraints vary significantly across ESCWA member countries. Therefore, the effect of the fiscal stimulus of certain member countries could be severely limited as it is to take place without regional or global leverages. Efforts at the national level must be strengthened to prevent any fiscal contraction on economic and social spending, including economic infrastructure, social protection, social safety nets, employment, education and health. A set of additional frameworks of global and regional cooperation is, therefore, warranted to strengthen such national fiscal efforts, which will overcome the problem of balance sheet adjustment in order to achieve development goals in the aftermath of the global financial crisis.

ESCWA member countries with fixed exchange rate regimes, limited fiscal space and underdeveloped financial markets, namely Bahrain, Jordan, Lebanon,[13] the Syrian Arab Republic, the United Arab Emirates and Yemen, may face further macroeconomic imbalances in the near future if the global economy does not recover fully from the crisis. Such macroeconomic imbalances are: (a) potential losses of foreign reserves in trying to maintain their pegged exchange rate regime; (b) further current account deficits with subsequent pressure on the balance of payments and exchange rates; and (c) inability to effectively use monetary policy to absorb the effects of external future shocks emanating from the crisis, since monetary policy is totally geared towards preserving the exchange rate peg, instead of being used to effectively deal with domestic macroeconomic imbalances such as renewed inflationary pressure. The exchange rate literature argues that under a fixed exchange rate regime, the sole objective of monetary policy is the maintenance of the pegged regime. If, for whatever reason, the monetary authority fails in maintaining its peg, then a sudden devaluation may lead to a debt/currency crisis similar to the Russian crisis of 1998.[14] In this case, domestic macroeconomic policies alone will not be sufficient and a balance-of-payments crisis will be inevitable. The above ESCWA member countries may face an exchange rate crisis and subsequent default on foreign debt and may also experience a balance-of-payments crisis due to potential renewed terms of trade shocks, further declines in export demand and the reduction in tourism, FDI and remittances inflows and real exchange rate appreciations, as was the case in Jordan, Lebanon, the Syrian Arab Republic, Yemen and several GCC countries. There is also the potential of bank failure depending on the exposure of commercial banks to public debt, which is most significant in Lebanon and to the real estate sector, as was the case in some GCC countries, or due to bad performance of outstanding loans (non-performing loans) all coupled with the considerable difficulty posed in tapping international financial markets.

A case in point is Egypt which was able to adequately absorb the shock effects emanating from the global financial crisis, although its stock market could not avoid incurring significant losses due to the integration of its financial market with more developed ones. The 2004 transition to a flexible exchange rate has rendered monetary policy more effective, easing up the pressure on domestic interest rates and subsequently contributing to lowering debt service and containment of the recurrent budget and current account deficits. Through a series of controlled devaluations prior to the global financial crisis, Egypt was able to stimulate exports and generate enough foreign currency to reduce the levels of its foreign debt. As a result of the effective use of monetary policy to absorb effects of external financial shocks emanating from the crisis, Egypt had more room to manoeuvre domestically with countercyclical monetary policies, relative to Lebanon, Jordan, Yemen and the Syrian Arab Republic. Instead of being used primarily towards defending the pegged exchange rate regime, foreign reserves were available as a first line of defence to weather the negative effects of the crisis. The recent success of Egypt in adopting flexible exchange rates has paved the way for a smooth transition to targeting inflation in the future.

With the further integration of ESCWA member countries regionally and internationally, increased regional and intraregional monetary and financial economic integration and fast liberalization of the respective capital account, Central Banks of Jordan and Lebanon should consider shifting to more flexible exchange rate regimes if they wish to render their monetary policy more independent and at the same time deal more effectively and swiftly with any future potential financial or monetary shock. An independent monetary policy constitutes an important prerequisite that needs to be implemented before inflation targeting can be adopted. Moreover, given the high debt levels that both countries have accumulated, monetary policy set by their respective monetary authority should, in the future, optimally interact with public debt policy determined by the fiscal authorities, in order not to undermine any potential decision to shift to a monetary policy regime which targets inflation.

In a post global financial crisis situation, some ESCWA member countries may have to start implementing a monetary policy regime shift known as inflation targeting as an explicit monetary policy objective. This shift would be justified by the difficulties posed in implementing effective countercyclical monetary policies during the latest financial crisis. At the same time, this move will pave the way for those countries to control the post-crisis inflationary pressures and to make their monetary policies more transparent and effective. Given the various fiscal and monetary stimuli packages introduced as a result of the crisis, inflation in all ESCWA member countries has started to

ESCWA member countries need to closely coordinate the optimality of the fiscal and monetary policy mix

pick up again since early 2010, despite its containment during the financial crisis.

One ESCWA member country that is very close to explicitly adopting inflation targeting as its main monetary policy goal is Egypt. Other ESCWA member countries should at least start to implicitly target inflation and move slowly towards an inflation-targeting regime. One way to do that is to target the real exchange rate rather than the nominal rate in order to maintain competitiveness and avoid currency overvaluation, while opening up capital markets to international capital flows. Jordan, Lebanon and the Syrian Arab Republic and some GCC countries will have to introduce more flexibility into their exchange rates before they can shift to an inflation-targeting monetary policy regime.

In the wake of the global financial crisis, it is now well established that an inflation-targeting regime might have improved the effectiveness of monetary policy in sterilizing the effects of the global financial crisis, as opposed to discretionary monetary policies aiming at targeting the nominal exchange rate, which has increased uncertainty in several ESCWA member countries and which turned out to be ineffective on the real side of all economies of the ESCWA region due to the existence of time lags and other monetary and macroeconomic imbalances.

The structure of public debt of ESCWA member countries highlights the extent of vulnerability of their debt burden to abrupt movements in the exchange rate and hence is crucial when assessing future debt sustainability. The sustainability of debt that is denominated in foreign currency goes beyond the domestic conduct of fiscal and monetary policy mix per se to become dependent, as well, on the outcomes of exchange rate policies. ESCWA member countries need to closely coordinate the optimality of the fiscal and monetary policy mix, which will have important implications on the existent exchange rate arrangements and on how those countries can be more resilient to potential external financial shocks in the future.

For ESCWA member countries with a debt structure that is mostly domestic, smooth transition to a flexible exchange rate regime may be one way to dampen future negative effects emanating from the crisis. In the short run, those countries will have to keep fiscal policy tight if they seek to continue reducing their large Government debt and ensure its sustainability. Before introducing more flexibility into the exchange rate, those countries will need to introduce proper fiscal adjustment measures and debt management policies to reduce the level of their external debt. They will also have to continue strengthening financial and banking sectors to further address fiscal imbalances and to further mitigate any potential for a future debt or currency crisis.

The enhancement of local capital markets, especially stock markets is also another way to dampen the effects of the crisis and will help reduce the exposure of private corporations to currency mismatches due to foreign borrowings. Those corporations will be able to raise funds locally and reduce their exposure to external financial shocks. They will also reduce any currency mismatch (exchange rate risk) in their balance sheets and dampen the implications of any sudden outflows of capital emanating from the current crisis.

Due to its impact on long term growth, the global financial crisis has limited the scope for macroeconomic stabilization policies, especially if ESCWA member countries suffer from high external deficits and limited fiscal space, as was the case in each of Lebanon, Jordan, the Sudan and Yemen. A fall in long term growth prospects might reduce the solvency ratings of member countries in international capital markets and could subsequently lead to a forced devaluation of the domestic currency. Moreover, an increase in foreign debt and tighter conditions to obtain credit can lower the impact of policy measures even further and may translate into a debt crisis. Therefore, the fiscal authorities responsible for future stabilization policies in ESCWA member countries should adopt proper strategies to attain internal and external macroeconomic balances. The sustainability of fiscal and current account policies should also be taken into account.

The global financial crisis has limited the scope for macroeconomic stabilization policies

CHAPTER III.

Regional Economic Integration and the Global Financial Crisis

III. Regional Economic Integration and the Global Financial Crisis

In order to obtain robust macroeconomic policy recommendations to support economic growth and integration within the ESCWA region, transmission channels of the global financial crisis have been carefully explored and identified. This chapter will continue this investigation and elaborate on how economic integration within the ESCWA region could have helped dampen the negative transmission effects of those shocks. This includes contagion effects arising through the financial and goods markets. Although financial integration of ESCWA member countries is still relatively weak, it has significantly improved over the past few years. This explains how financial shocks in one GCC stock market were swiftly propagated into the remaining GCC capital markets. Also shocks disseminate through intra- and interregional trade agreements. Interregional trade agreements, namely Euro-Mediterranean Trade Agreements, as well as intraregional trade agreements between ESCWA member countries, such as the Greater Arab Free Trade Area (GAFTA) and GCC trade agreements, have potentially played a crucial role in determining the size of spillovers. But they did not act as a catalyst for higher spillovers per se, since some ESCWA member countries still have low degrees of trade and financial integration and the magnitude of intra-ESCWA trade has remained significantly low despite recent efforts devoted to enhancement. Insights into the quantitative dimension of the transmission channels are scarce but may contribute to a better design of macroeconomic policy management. For example, they might be helpful in determining countercyclical and coordinated policy measures such as the extent of fiscal stimulus, the size of interest rate cuts and real exchange rate changes required to maintain stability. These issues will be dealt with in detail in the following sections.

Shocks disseminate through intra- and interregional trade agreements

A. Intraregional trade integration

The ESCWA region, as a whole, has lagged behind other emerging regions in terms of regional trade/financial integration, despite a stronger level of integration achieved by a limited number of individual member countries with the world economy. ESCWA member countries appear to be relatively open, with a total average trade-to-GDP ratio of 76 per cent, high relative to other economically integrated regions (table 14). However, this indicator is clearly biased by the particular factor endowments of the area, being rich in oil and poor in water, resulting in sizeable oil exports and food imports and a comparatively high traded goods ratio. This does not necessarily reflect greater integration or competitiveness in global markets. In fact, the ratio of manufactured exports to total exports, a good indicator of the competitiveness of a country in foreign markets, technological progress and production diversification is below the average for least developed countries (LDCs). Over the past few years, this ratio has been slightly on the rise for MDEs, but not for the remaining LDEs. For most GCC countries, Iraq, the Syrian Arab Republic and Yemen, the bulk of foreign export earnings is still comprised of fuel exports. Only a limited number of member countries, Bahrain, Egypt, Jordan and more recently,

Table 14. Economic openness of ESCWA member countries, 2005-2009 (*Percentage*)

Country	2005	2006	2007	2008	2009
Bahrain	164	172	179	194	160
Kuwait	63	62	68	66	59
Oman	89	88	95	97	79
Qatar	83	88	91	83	82
Saudi Arabia	69	75	78	88	72
United Arab Emirates	152	145	138	151	117
GCC countries	**90**	**92**	**96**	**102**	**86**
Egypt	34	32	33	49	36
Iraq	91	90	88	90	89
Jordan	117	113	112	110	84
Lebanon	55	60	66	73	61
The Sudan	41	38	38	38	28
Syrian Arab Republic	90	86	85	80	64
Yemen	68	77	77	21	58
MDEs	**59**	**58**	**58**	**67**	**52**
Total ESCWA region	**85**	**86**	**88**	**95**	**76**

Source: IMF, DOT.
Note: Economic openness is defined by exports plus imports over GDP.

Oman, have a significant ratio of non-fuel exports to total exports.

A similar measure of concentration in exports is the Herfindahl-Hirschman Index. This Index points to very little diversification in exports for ESCWA member countries compared with developing countries. In comparison with Eastern Asia, for example, where the Index has ranged between 0.10 and 0.15, the Index for ESCWA member countries ranged between 0.5 and 0.8 in 2009 with only slight improvements compared with 1995 in the concentration of exports (figure 35-A). These improvements have mainly been realized in Bahrain, Egypt, Oman, Qatar, the Syrian Arab Republic and the United Arab Emirates. The subsequent implication of high concentration in exports has been greater volatility in export and GDP growth rates. Figure 35-B points to the relatively low contribution of the manufacturing sector to GDP, being lower, at around 10 per cent, than the 14 per cent average contribution for developing countries.

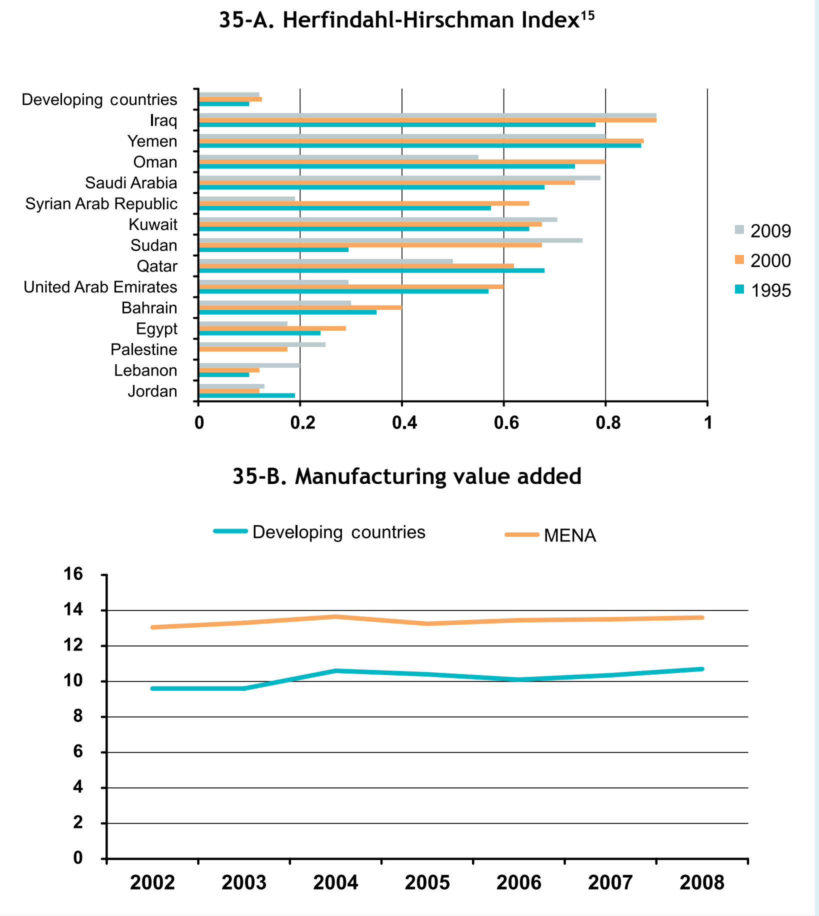
Even though ESCWA member countries continue to trade significantly with the rest of the world, the share of intra-Arab country trade in the total trade of ESCWA member countries has remained below 12 per cent and for the GCC countries it registered a mere 6.3 per cent in 2007. This can be compared with other trade-integrated regions worldwide; in 2007, the share of trade within the Association of Southeast Asian Nations (ASEAN) countries, for example, was 25.4 per cent, that of Latin America, 14.4 per cent, within the North American Free Trade Agreement (NAFTA) area, 41 per cent and between the Member States of the European Union, 66 per cent of their total trade (table 15 and figure 36-A). Between 2005 and 2009, the share of intra-GAFTA trade registered a mere 2 per cent increase from 9 to 11 per cent, while intra-GCC trade decreased from 6 per cent in 2005 to 5.5 per cent in 2009, compared with MERCOSUR (the 'Common Market of the South') and ASEAN with average trade shares in total trade of 16 and 25 per cent respectively (figure 36-B). Moreover, the speed of regional trade integration of ESCWA member countries diminished. The annual average growth rate of intraregional imports dropped from 14 per cent during the period 1986-1989, to 7 per cent during the period 1990-1996, bouncing back to 10 per cent during the 1997-2003 period, after GAFTA agreements were ratified, to drop again to 8 per cent during the 2003-2009 period.[16]

The relative negative performance of the ESCWA region was evident in 2000, when most other emerging economies witnessed a surge in trade integration. For example, Bahrain, Egypt, Kuwait and the Syrian Arab Republic exhibited relatively very low growth rates in their trade-to-GDP ratios over several years. Moreover, the share of exports in total world exports for the ESCWA region decreased by more than half since 1995, from about 6 per cent in 1995 to nearly 3 per cent in 2009. The export share of Eastern Asia, on the other hand, increased from 5 per cent to almost 8 per cent over the same period. Similarly, the share of imports from ESCWA member countries in total world imports dropped from 6.5 per cent in 1995 to 1.5 per cent in 2009.[17]

Trade barriers in ESCWA member countries have been dismantled to some extent in recent years, but they remain relatively high in many LDEs. While most LDEs, such as Bahrain, Oman and the United Arab Emirates, have open trade regimes with average tariff levels below 12 per cent, the levels are close to or above 15 per cent for most MDEs (compared with 8 per cent in Latin America and 6 per cent in Asia in 2009). More recently, a number of ESCWA member countries, namely Egypt, Jordan and Lebanon, have pursued greater trade liberalization policies by dismantling systems of quantitative controls, cutting tariff levels and streamlining tariff systems and introducing export promotion schemes and current and capital account convertibility. Policies to promote non-oil, non-mineral exports were also implemented in some ESCWA member countries that relied heavily on primary commodities.

As mentioned above, ESCWA member countries continue to trade significantly with the rest of the world. Between 2005

Figure 35. Concentration in exports: the Herfindahl-Hirschman Index and manufacturing value added as a percentage of GDP



Source: UNCTAD.

Note: MENA is defined as Middle East and North Africa countries.

and 2009 total imports to LDEs registered a 55 per cent increase from US$201.1 billion to US$313.5 billion. During the crisis, imports to LDEs, however, declined significantly from US$403.8 billion in 2008 to US$313.5 billion in 2009. Whereas imports to MDEs have nearly doubled between 2005 and 2009, they have been slightly affected during the crisis decreasing from US$157 billion in 2008 to US$140.5 billion in 2009. However, total imports to ESCWA member countries decreased significantly during the crisis, from US$560.9 billion in 2008 to US$454.1 billion in 2009 (table 16).

Between 2005 and 2009, total exports from LDEs registered a 24 per cent increase, from US$346.6 billion to US$430.5 billion. During the crisis, exports from LDEs, however, declined significantly from US$694.9 billion in 2008 to US$430.5 billion in 2009, constituting a 61 per cent decline.

Whereas exports from MDEs have more than doubled between 2005 and 2008, they have significantly declined during the global financial crisis from US$130.8 billion in 2008 to US$89.7 billion in 2009, a decrease of about 46 per cent. Total exports from ESCWA member countries have significantly decreased as a result of the crisis, from US$825.7 billion in 2008 to US$520.2 billion in 2009, constituting an overall decline of about 60 per cent (table 17).

Table 18 indicates that total trade of ESCWA member countries registered a significant increase between 2005 and 2008, increasing from US$682 billion to US$1,386.7 billion, an increase of about 100 per cent. However, as a result of the global financial crisis, total trade between the ESCWA region and the world decreased significantly in 2009 from US$1,386.7 billion in 2008 to US$974.3 billion in 2009, constituting a 42 per cent decrease in just one year. Although intra-ESCWA trade nearly doubled between 2005 and 2008, increasing from US$77.8 billion to US$152.2 billion, it subsequently declined to US$113.3 billion in 2009 as a result of the global financial crisis.

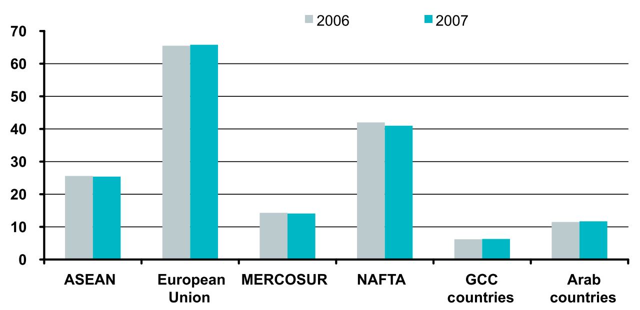
Table 15. Intraregional trade of selected trade-integrated regions, 2006-2007

	Intraregional trade		Intraregional trade as a percentage of foreign trade	
	(US$ billion)			
Region	2006	2007	2006	2007
ASEAN	378.9	432.6	25.6	25.4
European Union	6 054	7 111	65.5	65.8
MERCOSUR	63.4	79.1	14.3	14.1
NAFTA	1 788.6	1 860	42	41.0
GCC countries	40.2	48	6.2	6.3
Arab countries	118.6	143	11.5	11.7

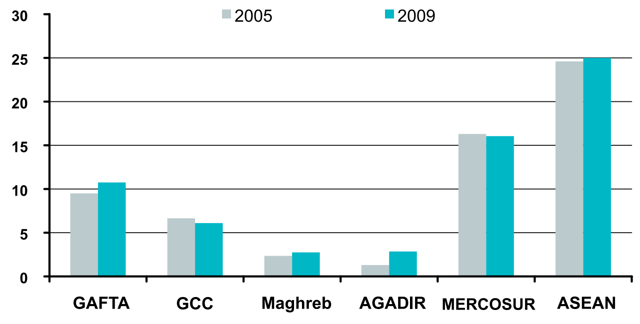
Source: ESCWA, *Annual Review of Developments in Globalization and Regional Integration in the Arab Countries 2008 and 2009*, E/ESCWA/EDGD/2008/4 and E/ESCWA/EDGD/2009/7.

Figure 36. Intraregional trade of selected trade-integrated regions, 2005-2009 (*Percentage*)

36-A. 2006-2007



36-B. 2005 and 2009



Source: ESCWA, *Annual Review of Developments in Globalization and Regional Integration in the Arab Countries 2008 and 2009*, E/ESCWA/EDGD/2008/4 and E/ESCWA/EDGD/2009/7 and *Joint Arab Economic Report*, 2010.

Table 16. Total imports of ESCWA member countries, 2005-2009 (*US$ million*)

	Total imports				
Country	2005	2006	2007	2008	2009
Bahrain	6 109	7 219	8 584	11 894	9 152
Kuwait	15 237	16 574	21 294	25 693	19 088
Oman	8 827	10 897	15 977	22 923	17 851
Qatar	10 060	16 433	23 403	27 874	22 801
Saudi Arabia	59 510	70 128	90 439	114 248	92 934
United Arab Emirates	101 359	118 571	150 260	201 210	151 774
GCC countries	**201 101**	**239 822**	**309 957**	**403 841**	**313 599**
Egypt	19 812	20 594	27 033	52 772	44 934
Iraq	12 832	13 268	14 832	21 468	23 639
Jordan	10 498	11 548	13 531	16 987	14 236
Lebanon	9 695	10 931	13 129	17 487	17 198
The Sudan	6 690	8 074	8 742	10 074	8 487
Syrian Arab Republic	14 960	17 307	21 552	27 334	22 431
Yemen	4 800	7 934	9 840	10 973	9 610
MDEs	**79 286**	**89 654**	**108 658**	**157 095**	**140 535**
Total ESCWA region	**280 388**	**329 476**	**418 615**	**560 936**	**454 133**

Source: IMF, DOT.

Table 17. Total exports of ESCWA member countries, 2005-2009 (*US$ million*)

	Total exports				
Country	2005	2006	2007	2008	2009
Bahrain	15 932	19 940	24 369	29 145	23 142
Kuwait	35 852	46 871	54 193	77 951	47 117
Oman	18 462	21 462	23 480	35 100	24 114
Qatar	25 332	33 622	41 488	55 709	46 205
Saudi Arabia	154 804	196 106	209 106	303 706	172 097
United Arab Emirates	96 313	118 551	136 244	193 325	117 854
GCC countries	**346 696**	**436 551**	**488 879**	**694 935**	**430 530**
Egypt	10 646	13 720	16 168	26 233	23 099
Iraq	17 624	27 461	35 196	56 538	35 083
Jordan	4 301	5 204	5 535	6 243	5 041
Lebanon	2 172	2 488	3 265	3 952	3 257
The Sudan	4 824	5 657	8 867	12 062	7 029
Syrian Arab Republic	9 793	11 386	12 885	16 349	11 350
Yemen	5 611	6 691	6 796	9 462	4 863
MDEs	**54 971**	**72 606**	**88 711**	**130 840**	**89 722**
Total ESCWA region	**401 667**	**509 157**	**577 590**	**825 775**	**520 251**

Source: IMF, DOT.

Table 18. **Total and intraregional trade of ESCWA member countries, 2005-2009 (*US$ million*)**

	Total and intraregional trade				
ESCWA region	**2005**	**2006**	**2007**	**2008**	**2009**
Total trade	**682 054**	**838 633**	**996 205**	**1 386 711**	**974 384**
Intraregional ESCWA trade	77 800	94 406	114 299	152 289	113 314
Intraregional trade as a percentage of total trade	11.4	11.3	11.5	11.0	11.6

Source: IMF, DOT.

Table 19. **Total and intraregional exports of ESCWA member countries, 2005-2009 (*US$ million*)**

	Total and intraregional exports				
ESCWA region	**2005**	**2006**	**2007**	**2008**	**2009**
Total exports	**401 667**	**509 157**	**577 590**	**825 775**	**520 251**
Intraregional exports	37 258	45 275	54 801	73 383	54 588
Total intraregional exports as a percentage of total exports	9.3	8.9	9.5	8.9	10.5

Source: IMF, DOT.

As a share of total ESCWA trade, intraregional trade has remained at 11 per cent over the period under consideration, registering a slight improvement, however, over the 1997-2004 period where, on average, intra-ESCWA trade as share of total trade was 9 per cent.[18]

The ratio of intra-ESCWA trade to total ESCWA trade during the period 2005-2009, the twelve years that followed the establishment of the Greater Arab Free Trade Area, has remained relatively low and has only averaged 11.4 per cent, relative to an average of 8.5 per cent between 1997 and 2004.[19] This highlights the need for the intensification of trade integration efforts by ESCWA member countries as one exit strategy from the global financial crisis to overcome the stumbling blocks obstructing liberalization of intra-ESCWA trade and further enhance South-South trade integration.

As mentioned above, total exports of ESCWA member countries have nearly doubled between 2005 and 2008, increasing from US$401 billion to US$825 billion. This was mainly due to significant increases in oil prices and exports. However, as a result of the global financial crisis and the subsequent declines in oil prices, total exports from the ESCWA region experienced a significant decline to US$520 billion, also due to the deteriorating macroeconomic conditions in the major trading partners of ESCWA member countries, namely the European Union and the United States, subsequently lowering the demand for exports of the ESCWA region.

Total ESCWA intraregional exports have increased steadily from US$37.2 billion in 2005 to US$73.3 billion in 2008, to revert to US$54.5 billion in 2009. In relative terms, however, the share of intraregional exports of ESCWA member countries in total exports has increased between 2005 and 2007, but then declined between 2007 and 2008, to revert back to 10.5 per cent in 2009, averaging 9.4 per cent (table 19). The decline is not due to a real decline in intra-ESCWA exports but can rather be attributed to the increase in total exports of the ESCWA region due to the world rise in oil prices during that period, given that oil accounts for the bulk of ESCWA region exports. Tables 18 and 19 indicate that with the exception of the 2008-2009

Table 20. Intraregional imports of ESCWA member countries, 2005-2009 (*US$ million*)

	Intraregional imports				
Country	2005	2006	2007	2008	2009
Bahrain	2 039	2 432	2 873	3 796	2 613
Kuwait	2 249	2 720	3 141	4 255	3 019
Oman	2 852	3 404	4 918	7 426	5 522
Qatar	1 562	2 405	3 638	4 446	3 266
Saudi Arabia	4 750	5 209	5 992	8 570	6 649
United Arab Emirates	6 891	8 919	10 724	12 869	9 170
GCC countries	**20 343**	**25 089**	**31 285**	**41 362**	**30 241**
Egypt	2 335	3 186	4 191	6 502	4 336
Iraq	4 113	4 625	5 429	7 449	5 578
Jordan	3 484	4 085	4 504	5 522	4 472
Lebanon	2 042	2 473	3 127	3 786	3 261
The Sudan	1 734	1 795	1 889	2 426	1 871
Syrian Arab Republic	4 593	5 543	6 433	8 377	6 451
Yemen	1 899	2 335	2 641	3 482	2 515
MDEs	**20 199**	**24 042**	**28 213**	**37 544**	**28 485**
Total ESCWA region	**40 542**	**49 131**	**59 498**	**78 906**	**58 726**

Source: IMF, DOT.

period during and after the global financial crisis and since GAFTA came to force in 1997, total intra-ESCWA trade and intra-ESCWA exports appear to be on the rise. Thus, one can argue that there is evidence that this regional trade agreement is having a positive impact on ESCWA intraregional trade. However, in percentage of total trade, intra-ESCWA total trade and total exports have remained below the 11 per cent level, indicating that this agreement is still not able to intensify ESCWA trade and stimulate further trade integration in the region.

Table 20 indicates that total intraregional imports of GCC countries nearly doubled between 2005 and 2008, increasing from US$20.3 billion to US$41.3 billion, pointing to significant intraregional trade between LDEs in the wake of the ratification of the GCC trade agreement. However, as a result of the financial crisis, intraregional imports sharply declined to US$30.2 billion in 2009. The growth rate of intraregional imports over the period under consideration averaged 10 per cent, considered low relative to other trade-integrated emerging regions. Similar dynamics were observed in MDEs, where total intraregional imports nearly doubled between 2005 and 2008, increasing from US$20.1 billion to US$37.5 billion, pointing to improvements in intraregional trade between MDEs. However, as a result of the financial crisis, intraregional imports of MDEs sharply declined to US$28.4 billion in 2009. The growth rate of intraregional imports of MDEs over the period under consideration averaged 11.3 per cent, a little higher than that of LDEs.

Total intraregional exports of GCC countries have almost doubled between 2005 and 2008, increasing from US$25.9 billion to US$51.5 billion, pointing to

Table 21. Intraregional exports of ESCWA member countries, 2005-2009 (*US$ million*)

	Intraregional exports				
Country	2005	2006	2007	2008	2009
Bahrain	1 448	1 663	2 079	2 845	1 855
Kuwait	1 889	2 347	2 801	3 643	2 662
Oman	2 099	2 733	3 874	5 664	3 762
Qatar	1 409	1 736	1 806	854	712
Saudi Arabia	11 954	14 667	17 251	22 567	15 525
United Arab Emirates	7 161	8 705	11 542	15 992	10 847
GCC countries	**25 959**	**31 851**	**39 353**	**51 566**	**35 363**
Egypt	1 657	1 797	1 798	5 020	5 869
Iraq	521	600	710	1 001	774
Jordan	1 708	2 009	2 291	2 345	2 378
Lebanon	1 223	1 516	1 950	2 405	2 127
The Sudan	376	536	412	509	369
Syrian Arab Republic	5 276	6 331	7 523	9 580	7 004
Yemen	537	636	765	957	705
MDEs	**11 298**	**13 425**	**15 448**	**21 817**	**19 225**
Total ESCWA region	**37 258**	**45 275**	**54 801**	**73 383**	**54 588**

Source: IMF, DOT.

significant intraregional trade between LDEs. However, as a result of the financial crisis, intraregional exports sharply declined to US$35.3 billion in 2009. The growth rate of intraregional exports over the period under consideration averaged 11.4 per cent, considered low compared with other emerging regions with similar regional trade agreements. Similar dynamics, although with much less trade intensity, are observed in MDEs, where total intraregional exports have nearly doubled between 2005 and 2008, increasing from US$11.2 billion to US$21.8 billion, pointing to relatively low intraregional trade between MDEs. However, as a result of the financial crisis intraregional exports of MDEs declined to US$19.2 billion in 2009. The growth rate of intraregional exports over the period under consideration averaged 15.8 per cent, a little higher than the rate pertaining to LDEs (table 21).

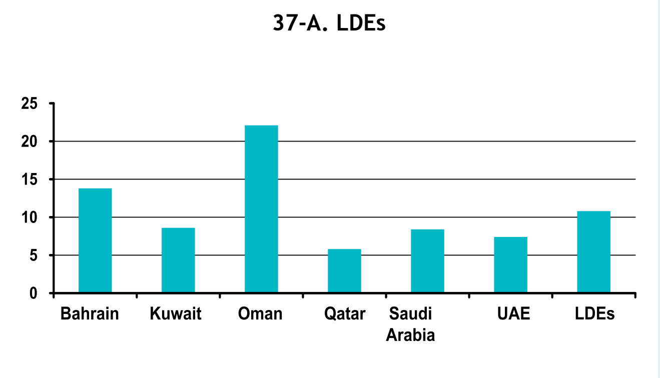
Total intraregional trade of GCC countries as a percentage of total trade has hovered around the 8 per cent level over the 2005-2009 period, pointing to significant stagnation and low intraregional trade between LDEs relative to total trade. Similar dynamics, although with a little more intensity, are observed in MDEs, where total intraregional trade in percentage of total trade has hovered around the 22 per cent level over the 2005-2009 period, pointing to more significant intraregional trade between MDEs relative to total trade (table 22 and figure 37). However, total intraregional ESCWA trade as a percentage of total trade has hovered around the 11 per cent level over the 2005-2009 period, pointing to relatively low levels of intraregional trade between ESCWA member countries despite GCC, GAFTA and other bilateral, regional trade agreements that have been ratified over the past two decades.

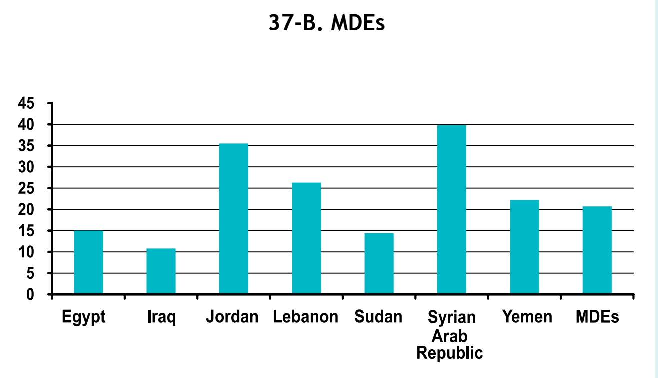
Table 22. Intraregional trade of ESCWA member countries as a percentage of total trade, 2005-2009 (*Percentage*)

	Intraregional trade as a percentage of total trade				
Country	2005	2006	2007	2008	2009
Bahrain	15.8	15.1	15.0	16.2	13.8
Kuwait	8.1	8.0	7.9	7.6	8.6
Oman	18.1	19.0	22.3	22.6	22.1
Qatar	8.4	8.3	8.4	6.3	5.8
Saudi Arabia	7.8	7.5	7.8	7.5	8.4
United Arab Emirates	7.1	7.4	7.8	7.3	7.4
GCC countries	**8.5**	**12.8**	**12.3**	**10.8**	**10.8**
Egypt	13.1	14.5	13.9	14.6	15.0
Iraq	15.2	12.8	12.3	10.8	10.8
Jordan	35.1	36.4	35.6	33.9	35.5
Lebanon	27.5	29.7	31.0	28.9	26.3
The Sudan	18.3	17.0	13.1	13.3	14.4
Syrian Arab Republic	39.9	41.4	40.5	41.1	39.8
Yemen	23.4	20.3	20.5	21.7	22.2
MDEs	**23.5**	**23.1**	**22.1**	**20.6**	**20.7**
Total ESCWA region	**11.4**	**11.3**	**11.5**	**11.0**	**11.6**

Source: IMF, DOT.

Figure 37. Intraregional trade as a percentage of total trade, 2009 (*Percentage*)





Source: IMF, DOT.

Figure 37-A indicates that among LDEs, Oman enjoys the highest intraregional trade integration ratio, of about 23 per cent, followed by Bahrain with a 14 per cent ratio of regional trade in total trade. Among MDEs, the Syrian Arab Republic and Jordan appear to enjoy the highest trade integration within the ESCWA region with ratios of intraregional trade in total trade of 40 and 36 per cent respectively in 2009. Lebanon ranks third with a trade integration ratio of 25 per cent (figure 37-B).

Table 23. Intraregional trade of ESCWA member countries as a percentage of GDP, 2005-2009 (*Percentage*)

	Intraregional trade as a percentage of GDP				
Country	2005	2006	2007	2008	2009
Bahrain	26.0	25.9	26.9	31.3	22.1
Kuwait	5.1	5.0	5.3	5.0	5.1
Oman	16.1	16.7	21.1	21.9	17.4
Qatar	7.0	7.3	7.7	5.3	4.7
Saudi Arabia	5.4	5.6	6.0	6.5	6.0
United Arab Emirates	10.8	10.8	10.7	11.0	8.7
GCC countries	**7.6**	**7.8**	**8.5**	**8.6**	**7.6**
Egypt	4.4	4.6	4.6	7.1	5.4
Iraq	13.8	11.6	10.8	9.8	9.7
Jordan	40.9	41.2	40.0	37.1	29.9
Lebanon	15.3	17.8	20.3	21.0	16.0
The Sudan	7.6	6.4	4.9	5.1	4.1
Syrian Arab Republic	36.0	35.4	34.4	32.9	25.6
Yemen	16.0	15.6	15.7	26.3	12.8
MDEs	**13.8**	**13.4**	**12.9**	**13.8**	**10.8**
Total ESCWA region	**9.3**	**9.3**	**9.7**	**10.1**	**8.6**

Source: IMF, intraregional trade data from DOT and GDP data from IMF, WEO.

Table 23 indicates that total intraregional trade of GCC countries as a percentage of GDP has remained relatively very low, hovering around the 8 per cent level over the 2005-2009 period, pointing to the insignificant contribution of intraregional trade to the growth performance of LDEs. Similar dynamics, although with a little higher intensity are observed in MDEs, where total intraregional trade in percentage of GDP hovered around the 13 per cent level over the 2005-2009 period, pointing to some contribution of intraregional trade to the growth performance of MDEs.

Total ESCWA intraregional trade as a percentage of GDP has also remained very low, hovering around the 9 per cent level over the 2005-2009 period, pointing to the insignificant contribution of intraregional trade to the growth performance of ESCWA member countries. It appears that existent regional trade agreements and related trade openness measures recently introduced in ESCWA member countries are not yet able to stimulate growth as originally sought from these agreements. Therefore, policymakers need to devote more effort to further enhance trade integration within the ESCWA region, for better growth performance in the future.

Looking at GCC countries individually, specific country contributions to intra-ESCWA trade appear to be higher than is the case for MDEs. Saudi Arabia has maintained its leading position, with its trade with the remaining ESCWA member countries in 2009 reaching US$22.1 billion, followed by the United Arab Emirates and Oman with US$20 billion and US$9.2 billion, respectively (table 24). The combined intra-ESCWA trade of these

Table 24. Total and intraregional trade, GCC countries, 2005-2009 (*US$ million*)

		Total and intraregional trade in LDEs				
Country		2005	2006	2007	2008	2009
Bahrain	Total trade	22 040	27 158	32 953	41 039	32 294
	Intraregional trade	3 487	4 095	4 952	6 641	4 468
	Intraregional trade as a percentage of total trade	15.8	15.1	15.0	16.2	13.8
Kuwait	Total trade	51 089	63 445	75 487	103 644	66 204
	Intraregional trade	4 137	5 068	5 942	7 898	5 682
	Intraregional trade as a percentage of total trade	8.1	8.0	7.9	7.6	8.6
Oman	Total trade	27 289	32 359	39 456	58 023	41 965
	Intraregional trade	4 952	6 137	8 791	13 090	9 284
	Intraregional trade as a percentage of total trade	18.1	19.0	22.3	22.6	22.1
Qatar	Total trade	35 392	50 055	64 891	83 583	69 006
	Intraregional trade	2 971	4 141	5 444	5 300	3 978
	Intraregional trade as a percentage of total trade	8.4	8.3	8.4	6.3	5.8
Saudi Arabia	Total trade	214 314	266 234	299 545	417 954	265 031
	Intraregional trade	16 704	19 876	23 243	31 138	22 174
	Intraregional trade as a percentage of total trade	7.8	7.5	7.8	7.5	8.4
United Arab Emirates	Total trade	197 672	237 122	286 504	394 535	269 628
	Intraregional trade	14 052	17 624	22 265	28 861	20 017
	Intraregional trade as a percentage of total trade	7.1	7.4	7.8	7.3	7.4
LDEs	Total trade	547 797	40 728	50 028	78 007	58 722
	Intraregional trade	46 303	5 225	6 138	8 450	6 351
	Intraregional trade as a percentage of total trade	8.5	12.8	12.3	10.8	10.8

Source: IMF, DOT.

three countries totalled US$53.4 billion in 2009, representing around 53 per cent of total intra-ESCWA trade in that year. At the lower end of the scale stand Bahrain, Kuwait and Qatar with intra-ESCWA trade values of US$4.4 billion, US$5.6 billion and US$3.9 billion, respectively, in 2009.

For MDEs, the Syrian Arab Republic has maintained its leading position, with its trade with the remaining ESCWA member countries in 2009 reaching US$13.4 billion. The Syrian Arab Republic is, however, a peculiar case, ranking first because of its relatively low levels of total trade compared with its intraregional trade. While the Syrian Arab Republic is a relatively closed economy with respect to the rest of the world, it is relatively open to the remaining ESCWA member countries. Then come Egypt and Jordan with US$10.2 billion and US$6.8 billion in trade with the remaining ESCWA member countries respectively. The combined intra-ESCWA trade of the

Table 25. Total and intraregional trade, MDEs, 2005-2009 (*US$ million*)

Country	Total and intraregional trade in MDEs	2005	2006	2007	2008	2009
Egypt	Total trade	30 458	34 314	43 201	79 005	68 032
	Intraregional trade	3 992	4 984	5 988	11 522	10 205
	Intraregional trade as a percentage of total trade	13.1	14.5	13.9	14.6	15.0
Iraq	Total trade	30 456	40 728	50 028	78 007	58 722
	Intraregional trade	4 634	5 225	6 138	8 450	6 351
	Intraregional trade as a percentage of total trade	15.2	12.8	12.3	10.8	10.8
Jordan	Total trade	14 799	16 752	19 066	23 231	19 277
	Intraregional trade	5 193	6 094	6 795	7 867	6 850
	Intraregional trade as a percentage of total trade	35.1	36.4	35.6	33.9	35.5
Lebanon	Total trade	11 867	13 420	16 393	21 439	20 455
	Intraregional trade	3 264	3 989	5 077	6 190	5 388
	Intraregional trade as a percentage of total trade	27.5	29.7	31.0	28.9	26.3
The Sudan	Total trade	11 514	13 730	17 609	22 136	15 516
	Intraregional trade	2 110	2 331	2 301	2 935	2 240
	Intraregional trade as a percentage of total trade	18.3	17.0	13.1	13.3	14.4
Syrian Arab Republic	Total trade	24 753	28 692	34 437	43 683	33 781
	Intraregional trade	9 869	11 874	13 956	17 957	13 455
	Intraregional trade as a percentage of total trade	39.9	41.4	40.5	41.1	39.8
Yemen	Total trade	10 411	14 624	16 635	20 435	14 473
	Intraregional trade	2 436	2 971	3 406	4 440	3 220
	Intraregional trade as a percentage of total trade	23.4	20.3	20.5	21.7	22.2
MDEs	Total trade	134 257	162 260	197 369	287 935	230 256
	Intraregional trade	31 497	37 467	43 661	59 361	47 710
	Intraregional trade as a percentage of total trade	23.5	23.1	22.1	20.6	20.7

Source: IMF, DOT.

above three countries totalled US$30.4 billion in 2009, much lower in absolute terms when compared with the top three GCC countries. At the lower end of the scale stand Iraq, Lebanon, the Sudan and Yemen with intra-ESCWA trade values of US$6.3 billion, US$5.3 billion, US$2.2 billion and US$3.2 billion, respectively, in 2009 (table 25).

The Syrian Arab Republic, Jordan, Lebanon, Oman, Yemen, Bahrain and Egypt come first with respect to the ratio of intra-ESCWA trade to total foreign trade of individual ESCWA member countries, with ratios reaching 39.8 per cent, 35.5 per cent, 26.3 per cent, 22.1 per cent, 22.2 per cent, 13.8 per cent and 15 per cent respectively, in 2009. In connection, it is worth noting that the share of intraregional trade in total trade of Jordan diminished after 1997 to reach 11.6 per cent in 2001, influenced by the coming into effect of the free trade agreement with the United States (table 25).

Table 26 ranks ESCWA member countries by average absolute and relative value of intra-ESCWA trade during the period 2005-2009. In terms of absolute values, Saudi Arabia occupies the highest rank on the list followed by the United Arab Emirates, the Syrian Arab Republic, Egypt, Oman and then Jordan in that order; whereas Qatar, Yemen and the Sudan occupy the last three positions. In terms of the relative importance of intraregional trade in total trade, the Syrian Arab Republic, Jordan, Lebanon, Yemen and Oman occupy the five top positions in that order, whereas the United Arab Emirates and Qatar occupy the last two positions.

Table 26. Ranking of ESCWA member countries by average absolute and relative value of intra-ESCWA trade, 2005-2009

Ranking in terms of absolute values		Ranking in terms of share of intraregional trade in total trade	
1	Saudi Arabia	1	Syrian Arab Republic
2	United Arab Emirates	2	Jordan
3	Syrian Arab Republic	3	Lebanon
4	Egypt	4	Yemen
5	Oman	5	Oman
6	Jordan	6	Egypt
7	Iraq	7	The Sudan
8	Kuwait	8	Bahrain
9	Lebanon	9	Iraq
10	Bahrain	10	Kuwait
11	Qatar	11	Saudi Arabia
12	Yemen	12	United Arab Emirates
13	The Sudan	13	Qatar

Source: IMF, DOT, 2005-2009.

B. Intraregional financial integration

The financial integration of the ESCWA region has remained relatively low. Intraregional capital flows are primarily in the form of workers' remittances, mainly from LDEs, Kuwait, Qatar, Saudi Arabia and the United Arab Emirates to MDEs, Egypt, Jordan, Lebanon and Yemen, a direction highly correlated with the business cycle of respective ESCWA member countries and thus with fluctuations in world market prices of oil. During the period 1993-1995, intra-ESCWA transfers averaged between 4 and 7 per cent of GDP of individual MDEs, however these low ratios improved significantly after the recent hikes in oil prices to reach the 20 per cent level in 2003, only to revert back to 10 per cent in 2010. Private capital flows within the region have been relatively limited. While cross-border transactions between financial markets of the GCC countries increased significantly in recent years, from 5 per cent of their total global transactions in 1992 to 40 per cent in 2002, down to 25 per cent in 2008, they remained negligible with the other ESCWA member countries, at 2 per cent of total transactions. Intraregional investments have been made mainly in those ESCWA member countries that implemented policies conducive to strengthening the operational framework of the domestic financial market, namely Egypt and Jordan.

Over the 25 year period 1980-2004, intra-ESCWA investment amounted to US$22.5 billion or the equivalent of an average of US$1 billion a year, only. However, in 2008 alone, the value of intra-ESCWA investment flows reached US$24.1 billion pointing to significant improvement relative to previous years.

Table 27. INTRAREGIONAL ESCWA INVESTMENT, 2008 (*US$ million*)

	Receiving countries							
Investing countries	Jordan	Egypt	The Sudan	Syrian Arab Republic	Yemen	Saudi Arabia	Lebanon	Total ESCWA
	2008	2008	2008	2008	2008	2008	2008	2008
Bahrain	21.1	35.7		584.1		1 003	99.8	1 743.7
Kuwait	1.5	595.1	720.1	71.3	22.8	4 461	649.3	6 521.1
Oman								
Qatar	1.4	217.1	1 109.3	3.1	2.8	25	117.3	1 476.0
Saudi Arabia	127.6	440.3	302.3	404.5	166.5		616.2	2 057.4
United Arab Emirates	16.4	748.8	9.7	211.9	10.1	5 873	1 151.2	8 021.1
GCC countries	**168**	**2 037**	**2 141.4**	**1 274.9**	**202.2**	**11 362**	**2 633.8**	**19 819.3**
Egypt	2.8		126.8	212.9	1.1	164		507.6
Iraq	93.4		23.4	37.8	3.9			158.5
Jordan		82.7	117.8	4.1	0.7	582		787.3
Lebanon	3.4	35.3	1 881.7	7.4	81.5	279		2 288.30
Palestine	57.1			2.4	0.8	109		169.3
The Sudan		2				11		13
Syrian Arab Republic	0.2		140.8		0.9	168	63.3	373.2
Yemen		15				66		81.00
MDEs	**156.9**	**135**	**2 290.5**	**264.6**	**88.9**	**1 379**	**63.3**	**4 378.2**
Total ESCWA region	**324.9**	**2 172**	**4 431.9**	**1 539.5**	**291.1**	**12 741**	**2 697.1**	**24 197.5**

Source: The Arab Investment and Export Credit Guarantee Corporation, Investment Climate in Arab Countries 2008 and 2009.

Of a total intra-ESCWA investment of US$24.19 billion in 2008, Saudi Arabia received the largest inflow of US$12.7 billion, then came the Sudan with US$4.4 billion, followed by Lebanon with US$2.69 billion (table 27). As a source of intra-ESCWA investment in 2008, the United Arab Emirates came first with investment of around US$8 billion, benefiting some seven ESCWA countries, with Saudi Arabia receiving US$5.8 billion (table 27). Kuwait ranked second with around US$6.5 billion, the bulk of which went to Saudi Arabia, Lebanon and Egypt in that order, with smaller amounts going to other ESCWA member countries. Saudi Arabia occupied third place with around US$2 billion that went mainly to Egypt and Lebanon.

Intra-ESCWA investments were concentrated in the services and real estate sectors, which received around 50 per cent of the total, followed by industry and agriculture in that order. Notwithstanding the many negative effects, the global financial crisis nevertheless had some positive implications for intra-ESCWA investment as was evident in the case of Lebanon, where arrivals of large numbers of tourists from ESCWA member countries, especially in 2009, led to a noticeable increase in investments in real estate and improvement in the balance of payments.

In the aftermath of the global financial crisis, several GCC countries experienced significant financial/economic slowdowns. Stock markets of GCC countries tumbled, real estate asset prices crashed, loans to the private sector dried up, GDP growth rates turned negative, spreads on sovereign bonds soared and risk aversion increased dramatically. In Southern and Eastern Asia, the economies in transition and those of Latin America and the Caribbean, the fallout of the global crisis was devastating, measuring two times that of the impact on GCC countries, primarily because of greater financial and economic integration. Yet, despite these negative contagion effects, regional integration of financial markets should remain the policy objective of all ESCWA member countries in general and the GCC countries in particular, where there is a push for greater deregulation and accelerated liberalization. However, as the crisis began to unfold and the financial contagion effects were spreading fast to their markets, GCC countries began to question whether the benefit of financial integration had been overestimated and its potential harmful consequences concealed and underplayed.

In the aftermath of the global financial crisis, as was the case in several GCC capital markets, it is now well established that greater financial integration combined with financial innovation and deregulation may increase vulnerability and create systemic risks. Before the global financial crisis, financial markets of GCC countries were developing at a rapid pace amid significant aspiration to integrate regionally and globally. Specifically, complex financial derivatives were designed and introduced and innovative securitization techniques were pioneered, all in an environment of excessive liquidity emanating from hikes in oil prices and revenues, subsequently fuelling a real estate bubble. It is important to point out that the GCC countries were not unique in this venture since globally, an encouraged sense of risk-creation and risk-taking behaviour was taking over, which, as we now have come to realize, increased the scope for contagion across countries and financial markets. However, as these dynamics were unfolding, corporate governance, risk management and prudential supervision in the GCC regulation were failing to keep up with rapid transformation of the financial systems, often deliberately in the spirit of greater liberalization and less Government regulation. In this context, Dubai is a case in point. These financial developments amplified the negative consequences of financial integration which combined with financial innovation and deregulation increased vulnerabilities in the GCC capital markets and created heightened systemic risks.

In the aftermath of the global financial crisis, stock markets tumbled, real estate asset prices crashed, loans to the private sector dried up, GDP growth rates turned negative, and risk aversion increased

C. Policy recommendations and conclusions

It was argued above that the trade channel has constituted a major conduit of the global financial crisis into MDEs. In addition, still-weak regional trade and financial integration linkages and heavy dependence on external resources to finance development have also constituted another important transmission channel of the global financial crisis on the economies of the ESCWA region. Greater Arab trade/financial integration could have helped the ESCWA region avert the negative effects of the crisis on its economies and could have dampened the effects of the trade channel conduit. Closer Arab trade links emanating from GAFTA since 1997 and from the GCC since 1981, have implied greater economic links among Arab countries in general and those of the ESCWA region in particular and greater prospects for enhanced trade integration in the future among those member countries. However, those trade integration efforts/initiatives appear to have been limited in stimulating

One exit strategy from the global financial crisis would be an integrated ESCWA capital market

and enhancing intra-ESCWA trade. Enhancing South-South trade and financial integration is the optimal macroeconomic policy option for preventing future financial/economic crises from affecting the ESCWA region. Had the amount of intraregional trade been significant, the trade transmission channel of the global financial crisis could have been averted. Before enhancing trade integration with the rest of the world through WTO and other bilateral trade agreements namely the Euro-Mediterranean Free Trade Agreements and other bilateral free trade agreements, such as the Jordan-United States free trade agreement, ESCWA member countries need to enhance and strengthen trade integration at the regional level and enhance intra-ESCWA trade flows to strengthen local markets and subsequently enhance trade with the rest of the world.

A trade-integrated ESCWA region would benefit ESCWA member countries as follows: (a) enhance the productive capacity of domestic industry by improving the use of comparative advantage in the production process; (b) enhance the economic diversification process by improving specialization in the production process; (c) enhance and stimulate growth and development in member countries; (d) improve access to cheaper goods for member countries; and (e) lower transportation costs of traded goods. The ESCWA region is already subject to region-specific financial/economic exogenous shocks, such as oil price volatility, unemployment, lack of productive capacity and other geopolitical factors. The recent global financial crisis has created an additional hurdle for the region which could have been easily averted had the region been financially and economically integrated. Reliance on the European Union, United States and other Asian countries for local consumption was the main factor affecting the region. Industry in ESCWA member countries will be better able to compete through an integrated local market with the rest of the world. Moreover, using available comparative advantage in ESCWA member countries will effectively reduce reliance on developed markets for local consumption.

One exit strategy from the global financial crisis would be an integrated ESCWA capital market which would lower interest rates of the region, thereby reducing the vulnerability of those economies to interest rate shocks and benefiting those countries burdened with high levels of debt. Specifically, a larger, integrated regional financial market would reduce the huge costs associated with servicing the accumulated public debt and would lower the cost of raising capital, allowing companies in the region to rely increasingly on the local market rather than the world market for economic development resources with lower capital-raising costs translating into higher investment and GDP growth rates. Enhanced financial integration would also substantially improve the attractiveness of the ESCWA region to all types of FDI. However, the global financial crisis has shown that private capital, whether short-term or long-term capital flows, have not, so far, been a reliable source of financing for development and growth in ESCWA member countries, namely because short-term capital flows such as portfolio investments are very volatile and speculative and because financial integration may lead to an increase in short-term speculative flows. On the other hand, long-term private capital flows, namely FDI, are concentrated in a number of emerging-market economies other than ESCWA member countries. While most ESCWA member countries have a significant demand for external financing for development needs and have relied in the past on such flows, they have so far received relatively small amounts of such overall FDI and other types of financial flows.

Another exit strategy from the global financial crisis would be full monetary integration through the adoption of a single currency by ESCWA member countries. Among the GCC economies, the exchange rate peg to the dollar has proven to be instrumental in facilitating the potential formation of a regional monetary union. The establishment of a GCC-based monetary union will eliminate regional exchange rate misalignments and their negative impact on intra-GCC and intra-ESCWA trade flows which have remained significantly low. As long as GCC countries maintain fiscal discipline and can count on substantial regular inflows of hard currency from oil exports, a fixed exchange rate peg to the dollar will remain sustainable and can be justified as a stepping stone for the adoption of a common currency. The adoption of a common currency in the near future will protect ESCWA member countries from future potential balance-of-payments crises and financial pressure on the respective domestic currencies and financial markets as was the case during the latest global financial crisis.

Overall, ease in transmission of the recent financial external shocks into ESCWA member countries can be explained by their higher overall trade openness and by mismanagement in domestic financial and macroeconomic policies. Therefore, the size and impact of future external shocks and their persistence in GCC countries will depend on the future domestic fiscal/financial policy responses and on the success of efforts to prevent the transmission of these shocks into domestic economies. This may be achieved through, for instance, implementation of appropriate fiscal reform measures and through active reforms of the financial sector.

Finally, GCC countries should continue their efforts for diversification away from the oil sector into the services and industrial sectors. This will reduce their vulnerability to external shocks, their excessive trade openness and their heavy reliance on the contribution of oil and oil-related products to their current and fiscal accounts. Recent GCC efforts to integrate into the global economy, which were enhanced by the accession of its largest economy, Saudi Arabia, to the World Trade Organization in December 2004 and the expected ratification of European Union/GCC Free Trade Area agreements, contribute to further enhancement of trade and investment climates in the region. Other initiatives to enhance regional and international integration efforts such as harmonizing investment laws and stock market regulation are also contributing factors towards the realization of a monetary union in the foreseeable future.

CHAPTER IV.

Development Policy and the Global Financial Crisis

IV. Development Policy and the Global Financial Crisis

The ESCWA region remains underdeveloped despite abounding resources and potential

The ESCWA region remains underdeveloped despite abounding resources and potential. A principal impediment to development lies in certain geopolitical constraints that distinguish the region. At the interface between developmental policies and their desired outcome such constraints need to be taken into consideration when aiming at achieving welfare-enhancing developmental objectives. However, in a narrower sense, industrialization and the culture that springs up around manufacturing activity continues to reinforce the road to development along lines originally observed by Verdoorn.[20] Industrialization and the way it relates to the environment is an essential component of development policy. With harmony and continuity of development goals, economic growth can be attained without damaging the prospects of future generations.

ESCWA member countries benefited only marginally from flows associated with the oil boom that concluded in 2008. Economic benefits that accrued to the region as a result do not reflect a trend toward sustainable patterns of growth. Rather, the fashion of aggregate resource flows signifies a missed development opportunity. Putting surpluses earned in the last oil boom to work in a framework for sustainable development will require stepping up demand injections that raise production in dynamic sectors, specifically, in manufacturing. As argued above, one macroeconomic policy priority is for ESCWA member countries to enhance their respective productive capacity. Addressing unemployment calls for greater private sector-led growth. Therefore the purpose of this chapter is to identify such issues by focusing on manufacturing as a strategic dynamic sector and *sine qua non* for the region to deviate from its current jobless growth trajectory.

A. Hurdles facing manufacturing: lack of economic diversification

The issue facing manufacturing is how to attain sustained levels of demand for the potential output of manufacturing sectors of the region. This requires a sector of buyers that accumulatively form a market. Buyers require an income flow to create demand. Private income flows are basically divided into profits from business, which lead to demand for investment goods, as well as wages and salary incomes which lead to demand for consumer goods. In addition to private domestic demand, Governments of ESCWA member countries, because of oil income earned and taxes collected, are also a source of demand if they spend. Those are the sources of demand within the region. Another demand injection comes from outside the region to purchase exports. Income that supports the demand for exports is also external to the region and constitutes a free type of demand in that no regional income flow is needed behind it. But as the global economy remains in recession, recovering slowly but steadily from the global financial crisis, income flows supporting demand for exports of the ESCWA region, particularly oil, dissipate.

Economic policy measures to improve growth by capturing demand created by

If the ESCWA region diversifies its base of production it can capture lost income flows and edge its way into global supply chains

income flows of ESCWA member countries are essential. Therefore, recognizing the patterns of domestic income flows and whether they can be influenced in a way that increases growth is a key issue. If uses of incomes can effectively lead to greater demand and thereby induce greater investment, then a dynamic spillover effect is sustained. For this to happen, any increase in spending from domestic incomes must be met and supplied by local production of goods. However, in the absence of domestic supply and production, as is the case in the ESCWA region which has a thin production base, domestic income flows seep out to be captured by external producers supplying consumer goods. As a result, growth in the ESCWA region has become solely determined by volatile oil exports which are strong when oil prices are high, but rapidly become evanescent due to the absence of regional manufacturing production, as a result of lack of diversification of production in general.

If the ESCWA region diversifies its base of production by building capacity in manufacturing, it can capture lost income flows and edge its way into global supply chains. The target for policymakers, then, is to first consider the possibilities of offsetting import purchases and capturing the demand of the region.

Policymakers can then consider the possibilities of facilitating higher productivity. Greater surpluses will ensue when productivity increases are matched by greater demand.

B. Status quo in economic diversification

Many ESCWA economies are pursuing diversification strategies, however these efforts fall short of providing dynamic feedback effects; linkage-based expansion is minimal, import rates remain unaffected and productivity growth for the region is estimated at less than 1 per cent per year. The effects have been flat in recycling income and have not generated rising sectoral surpluses. In some of the fastest growing countries of the region, which are GCC members, productivity growth has been negative. This suggests that for the region as a whole, structural change is needed for sustainable growth, but more careful examination of sectoral manufacturing output is needed and taken up below.

It is notable that certain leading sectors exist for oil exporting ESCWA member countries, which, despite being highly oil dependent, as are petrochemical industries, lack potential as growth engines. First, such sectors do generate vast income resources to Governments. They nevertheless exhibit high capital/labour ratios and as such are poor employment generating mechanisms. Moreover, these sectors are highly globalized and in turn have little bearing on domestic demand. They exist geographically in the region, but because they have negligible linkages to other sectors within regional economies and because they have no tertiary input from other industries, the know-how associated with these industries is incompatible with the broader knowledge base of the economy and in terms of productive capacity their impact is static.

C. The cycle of income, imports and losses

Imports are essential to the ESCWA region and fall into four main categories: (a) intermediate inputs for production of existing output; (b) common household consumption of perishable and durable goods; (c) luxury consumer items for the affluent; and (d) investment in fixed capital, such as machinery. The lack of economic diversity regionally results in substantial leakage of demand through imports across these four broad categories by income flows from profits, salaries and wages. The thinner the regional production base is, the greater is the demand for these items; as regional income levels rise, the gap between income and domestic demand injection widens. This leakage becomes more significant in relative terms as the income of people increases and their consumption behaviour changes increasingly in favour of capital intensive goods. Therefore, the share of the average income of a consumer is increasingly leaked as per capita income rises; as the poor earn higher incomes, they spend a smaller share of it on domestically-produced food items.

Weak cyclical dynamism in the ESCWA region of the sort described here is highly prevalent as spillover effects from the dominant income source, oil, have raised consumer preferences without affecting the regional productive base. It is likely, then, that the scope for increasing profitability and productivity in the ESCWA region will remain severely constrained by established global supply chains. Regional investment opportunities possess little attractiveness relative to those outside. As world incomes rise, ESCWA investors are lured to send their capital abroad where supply augmentation is in need of those resources. Local activity remains constrained, therefore, because the ESCWA region as a whole does not have a broader policy that encourages internal investment. Furthermore, geopolitical uncertainty underwrites the institutional fragility that characterizes regional status quo. Such preconditions to development in the ESCWA region present unique and formidable challenges to the growth process.

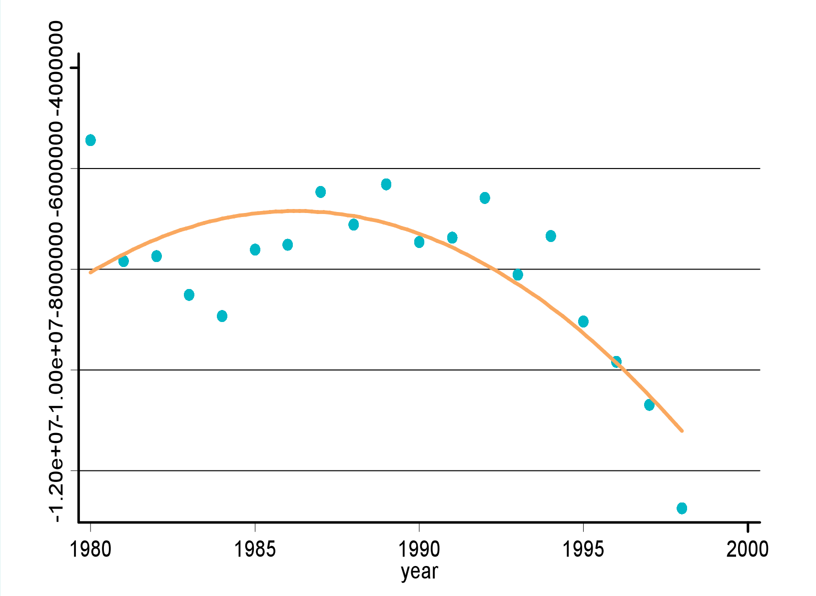
The magnitude of import leakage for ESCWA member countries is contrasted with that of other regions. The Americas, Asia and Europe respectively import 19, 29 and 44 per cent of their total

Table 28. **Manufacturing imports and exports by region, 1999 (*Percentage*)**

	Imports		Exports	
	Own region	All other regions	Own region	All other regions
Americas	18.80	81.17	23.88	76.08
Asia and Oceania	28.91	71.09	22.74	77.26
Europe	44.33	55.67	46.27	53.73
Middle East	3.77	96.23	4.26	95.74

Source: Nicita, A. and Olarreaga, M., 2007, Trade, Production, and Protection Database, 1976-2004, *The World Bank Economic Review* 21(1), pp. 165-171.

Figure 38. **Egypt's Foreign Trade Multiplier, 1980-1998**



Source: ESCWA staff estimates.

Unfavourable trade patterns and leakages characterize the status quo of manufacturing in ESCWA member countries

manufacturing imports from their own regions. The Middle East only imports 4 per cent of its manufacturing imports from its own region. Similarly, countries of the Americas, Asia and Europe respectively export 24, 23 and 46 per cent of their manufacturing exports to their own region. The Middle East only exports 4 per cent of its manufacturing exports to its own region. These numbers constitute a snapshot for one year, 1999 (table 28). To observe change over time, calculation of the foreign trade multiplier for manufacturing suggests continued deterioration.[21] Data issues preclude accurate estimation of the foreign trade multiplier for the region as a whole. However, data do exist for Egyptian manufacturing production and trade by trading partner. Figure 38 shows that the Egyptian foreign trade multiplier in manufacturing has been plummeting from the late 1980s onward, even though Egypt is one of the MDEs of the region with import dependency growing at least as steadily as in other ESCWA countries.

To be clear, the negative foreign trade multiplier is just another way of examining leakage in the cycle of income. A leakage of this magnitude makes real growth with sustainable productivity advances and employment generation unlikely.

D. The way forward

Unfavourable trade patterns and leakages characterize the status quo of manufacturing in ESCWA member countries. Initial conditions and barriers to development and growth in the ESCWA region are structural and longstanding and present challenges for economic development policies and regional integration. Yet industrialization can allow for broad-based growth and higher wage income and is, therefore, prerequisite for rights-based economic growth. Policies for development in the ESCWA region must confront the following stylized facts: (a) regional growth is elusive because of massive leakage in the cycle of income due to extreme dependency on industrial imports; (b) manufacturing production takes place regionally but is marginalized due to existing global supply chains and lack of regional industrialization strategy; (c) expansion in production has taken place in certain export sectors but neglect dominates the most strategic sectors of the region; and (d) manufacturing activities have declined over time and dependence continues to grow.

In order for economic policy to respond appropriately to the circumstances of the ESCWA region and respond to the challenge of such deep-rooted initial conditions, a governmental role at the country level is imperative to identify how regional and global production patterns and trade have disadvantaged sectoral production in manufacturing. Reliance upon private sectors to undertake investments which are not underscored by national development programmes would be a self-defeating economic policy. Governments, in partnership with private sector and labour organizations can be instrumental to the development process through allocation of credit programmes, loan and export guarantees and other protections that help higher productivity sectors establish themselves to a level where they are able to face global competition.

Well-placed subsidies and bilateral agreements can directly raise private investment in strategic sectors. Channelled private investment can activate those activities that are linked to dynamic markets. Without Government mediation, the methodological individualistic agent is too risk averse to operate in certain sectors despite rationale that shows greater returns for the region as a whole. Activities in those sectors only become "rational" to the individual firm when a regionally cooperative trade and production system is in place.

In the short run, increased propensity to invest can result from higher domestic demand and production. In the long-run, offsetting imports of fixed capital goods would vastly accelerate growth. There are many uncertainties in global economic production. However, broad-based and employment-generating growth is available, not by finding some magic formula for entry into global markets, but merely by recapturing the region's own incomes and satisfying the demand of its own markets, which in turn, would partially insulate regional economies from the vagaries of the global market and recurrent crisis.

CHAPTER V.

Social Policy, Social Security and the State

V. Social Policy, Social Security and the State

A. Introduction

At the beginning of the twentieth century, the devastating experience of political, financial and economic crises gave birth to a new concept of social protection, labelled as the (European) Welfare State. At that time, the combined effects of two world wars and the global economic crisis of 1929 had left Europe in ruins and spread poverty and despair throughout its societies. Common destitution increased popular support for broad-based public solidarity systems, far beyond conventional charity for the poor.

Towards the end of the same century, the collapse of the socialist block and transition towards market-based systems, since 1989, marked a shift in the opposite direction. Sustained high growth rates brought back 'laissez-faire' ideas of individual responsibility at a time when global economic integration and competition increased pressure on public budgets and business companies alike; inequality was on the rise.[22]

The recent financial and economic crisis has once again undermined trust in self-regulating markets and again increased expectations for regulatory interventions by the state. However, it is not clear whether states will be able to meet these expectations and successfully play the balancing, stabilizing and supporting role required.

This chapter reviews the history of the role of the State in the Arab world, looks at its current status and brings up some of the questions regional policymakers might find of interest in the framework of ongoing debate about a new social contract and about social development.

B. Development in the Arab world

During the 1960s and 70s the region fared well in terms of development with economic performance close to the Eastern Asian Tigers.[23] During that boom period, most countries expanded social security systems, partly in line with socialist orientations, but largely following the objectives of nation building and the formation of a national identity.[24] Public pension schemes were established starting from the 1950s (socialist countries) and through the 1970s (GCC countries).[25] Public health care provision and infrastructure were expanded and especially public education was considered important for the formation of an independent bureaucracy and a skilled workforce.[26] Most countries introduced some sort of indirect social transfers in the form of subsidies for such essential commodities or services as food, electricity, oil, petrol and public transport.

Starting from a very low base of human development after the Second World War with large rural-urban disparities, the region made impressive progress.[27] Rapid urbanization transformed economic structures. Generous transfers to large parts of the population successfully reduced poverty and infant mortality and increased life expectancy by ten years over the period

Despite economic stagnation during the period of low oil prices social indicators continued to improve

of 1960 to 1985.[28] Poverty fell to one of the lowest levels in the developing world.[29]

High oil revenues reduced the pressure to open up markets and also the need to compete for capital inflows. Public expenditure-based development strategy, high expenditures on health, education and subsidies and an emphasis on state-owned enterprises pushed the share of Government expenditures to an average of about 42 per cent of GDP in the 1970s.[30] Public sector employment increased rapidly in line with the growing role of the state.

Falling oil prices in the mid 1980s put this development model under pressure. The collapse of growth and regional capital markets eroded macroeconomic balances and increased the burden of public debt, limiting the capacity of Governments to invest in social infrastructure and in industry. Regional labour markets collapsed with declining growth rates, high population growth and reverse migration when GCC countries started to replace Arab migrants with migrants from other regions.[31]

Around the same time that conservative Governments in Great Britain and the United States presented a new vision for the role of the state and downsizing the public sector was seen as a solution to economic crisis, rising unemployment and high budget deficits, the response of Arab Governments was markedly different.

The public sector took over a compensating role, expanding employment through over-recruitment. In the 1990s, the average share of Government employment in total employment as well as Government wages as percentage of GDP were both above the Organisation for Economic Co-operation and Development (OECD) levels.[32] In Bahrain, Egypt, Kuwait, Oman and Saudi Arabia, public sector employment even grew throughout the 1990s and its contribution to total employment growth ranged from about 4 per cent in Saudi Arabia to close to 40 per cent in Egypt.[33] In addition, the financial volume of social protection programmes was substantial during this period, with total costs amounting to 5.7 per cent of GDP in Lebanon, 11.2 per cent in Yemen, 12.9 per cent in Egypt and 17.9 per cent in Jordan.[34]

These efforts may have contributed to the fact that despite economic stagnation during the period of low oil prices and despite substantial shocks to the labour markets, social indicators continued to improve. Income inequality, which was among the highest in 1970 came down significantly to a Gini coefficient of 0.357 in 2000.[35] Many countries in the region made significant progress towards achieving universal primary education. An extended infrastructure allowed for access to schools even in remote areas. Female illiteracy plunged from 79 per cent in the 1970s to 23 per cent in 2000.[36] Large vocational training programmes were part of active labour market policies. By 2000, the immunization rate against measles was close to 90 per cent in Western Asia.[37]

Major concerns arose, however, related to the rapidly growing labour force, which could not be absorbed by the public sector or otherwise find gainful employment. Labour force growth accelerated from 2.4 per cent in the 1960-1980 period to 3.2 per cent in 2002 for the MENA region as a whole, which was higher than for any other region[38] and put societies as well as the social security systems under severe pressure. There was also a very visible gender gap. The share of working age population employed in the Middle East in 2009 was 20.5 per cent for women and

67.7 per cent for men, low compared with other developing regions.[39]

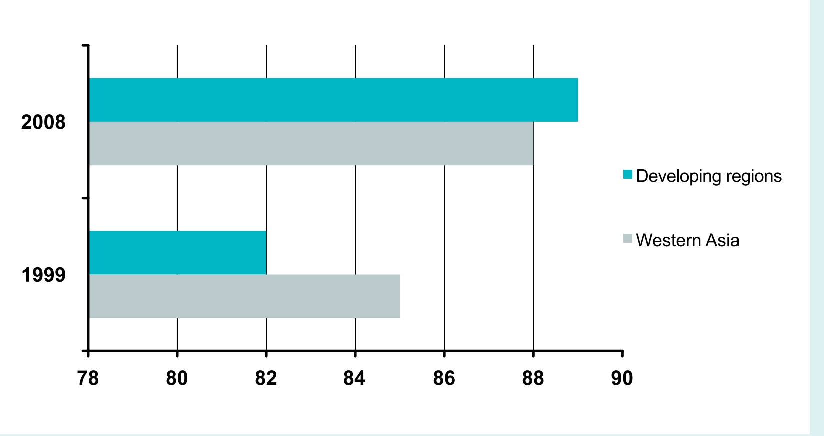
The picture brightened again with the onset of the recent period of high oil and gas prices and the highest growth rates since the 1970s. The unemployment rate in the Middle East dropped to 8.1 per cent in 2008. Growing employment together with declining birth rates resulted in lower dependency ratios, presenting a window of opportunity for the region to make decisive development progress.[40]

With increasing public and especially private investment, the private sector was slowly becoming the main source of new jobs. FDI including intraregional investment grew with an improving business environment and tariff reforms. Government employment continued to grow in several countries, but on a lower scale.[41] The size of the public sector wage bill as share of GDP was falling. In 2005 it was ranging from about three per cent in the United Arab Emirates to five per cent in Qatar, 5.5 per cent in Jordan, 7 per cent in Lebanon, 7.5 per cent in Oman, 8 per cent in Egypt, 9.5 per cent in Kuwait, 11 per cent in the Syrian Arab Republic, 12 per cent in Bahrain and 13 per cent in Saudi Arabia.[42]

Despite this success in employment creation and improved prospects for thousands of people, a number of structural concerns are dominating discussion about social policy in the region. These are mainly related to: (a) the sustainability of prevalent formal security systems; (b) insufficient coverage of large parts of the population; and (c) poor targeting of assistance to the poorest and most vulnerable parts of population.

Health systems suffer from fragmentation, weak institutional capacity, substantial risk of cost inflation and insufficient coverage. Public spending on health care accounts, on average, for about half of total health spending in the region while the other half is directly covered by households, an indication of gaps in the insurance systems.[43] Pension systems tend to be fragmented into multiple schemes with different conditions and benefits. Most systems are accumulating large implicit public pension debts that may threaten macroeconomic stability.[44] Education systems are geared towards public sector employment and do not provide the skills needed in the private sector, thereby generating a problematic mismatch between demand and supply on the labour markets. Classes are often overcrowded and educational attainments remain below expectations. Although public expenditures on education as share of GDP are very high by international standards, illiteracy remains higher than in most other developing regions.[45]

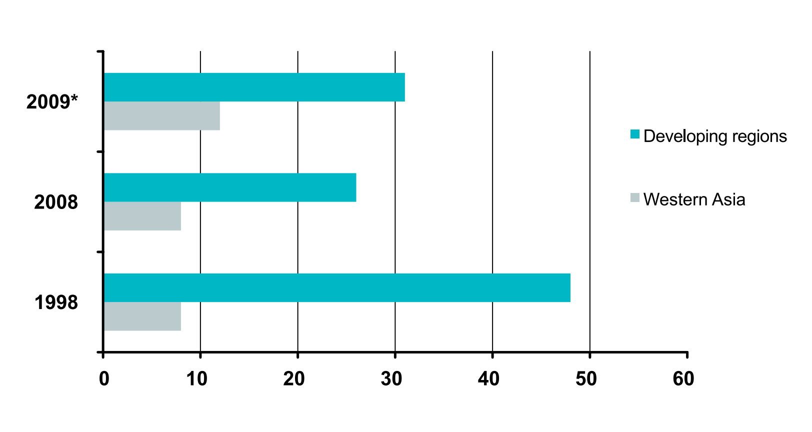
Figure 39. **Total net enrolment ratio in primary education* in Western Asia, 1999-2008 (*Percentage*)**



Source: *The Millennium Development Goals Report 2010*, United Nations, New York, 2010.
Note: Western Asia in this figure includes Turkey and excludes Egypt and the Sudan.
* Defined as the number of pupils of the theoretical school age for primary education enrolled in either primary or secondary school, expressed as a percentage of the total population in that age group.

Health systems suffer from fragmentation, weak institutional capacity, substantial risk of cost inflation and insufficient coverage

Figure 40. Proportion of employed people living below US$1.25 per day, 1998 and 2008-2009 (*Percentage*)



Source: The Millennium Development Goals Report 2010, United Nations, New York, 2010.
Note: Western Asia in this figure includes Turkey and excludes Egypt and the Sudan.
* Data for 2009 are based on ILO's second scenario. Details available at: mdgs.un.org.

When the public sector was stretching its limits, acting as an employer of last resort,[46] a growing informal sector offered vital additional opportunities to an ever growing workforce. Around the year 2000, the share of informal sector employment in total non-agricultural employment was estimated to be above 40 per cent for men and women.[47] A big share of new private sector jobs also now appears to be in the informal sector and in the more volatile services and construction businesses.[48] In these cases, security systems hardly apply as most public insurance systems and many pension funds are limited to employees in the public and private formal sector and do not reach out to people in informal sectors and in unprotected employment.[49] Region-wide an estimated ten per cent of the elderly is currently receiving pension payments and only about 30 per cent of the workforce is thought to be enrolled in any of the existing pension schemes.[50] Of the countries in the region only Bahrain has so far established unemployment insurance.

The low averages mask high regional as well as in-country disparities

Social assistance programmes such as food subsidies, cash transfers, social housing and social funds suffer from inadequate targeting, ineffective distribution, administrative inefficiencies and lack of coordination. They also barely extend to the rural population, which is more dependent on remittances, family support and non-governmental organizations.[51] Soaring food and energy prices in 2007 and 2008 increased the overall welfare costs of Governments. In 2007, food subsidies alone ranged below 0.5 per cent of GDP in Lebanon, Kuwait and Saudi Arabia and between 1 and 2 per cent in Egypt, Jordan, Yemen and the Syrian Arab Republic.[52] The share of subsidies in Government expenditure shows the same trend, ranging from below 1 per cent in Kuwait, Lebanon and Saudi Arabia to about 1.5 per cent in Yemen, 4 per cent in Egypt, 4.5 per cent in Jordan and about five per cent in the Syrian Arab Republic. Adding energy to food subsidies brings the combined share to between 3 and 15 per cent of GDP, consuming 10 per cent of GDP in Yemen and close to 9 per cent of GDP in Egypt.[53] The fiscal space of many countries, however, has been deteriorating over a number of years and may come under increased stress with the unfolding global economic crisis.

While poverty rates are still among the lowest in the developing world there are worrying trends of a rising proportion of employed people living below US$1.25 per day.[54]

There is wide-spread opinion that the region should do better, given the enormous wealth concentrated in this part of the world. The low averages mask high regional as well as in-country disparities; the absolute number of people living in poverty is not declining and vulnerability to economic and political shocks is very high.

Rapid urbanization is limiting the capacity of rural communities to compensate for failing public safety nets. Non-governmental organizations, which in several countries are also important employers, are not adequate substitutes. For large parts of the population, insufficient or absent coverage amounts to de facto privatization of social services, which especially poor social groups can hardly afford. Income from remittances seems to be the most common safety net for these parts of society.

Looking at this side of the picture raises the question of how far the prevalent approach to social policy has really reached out to the entirety of the population and built the human as well as institutional capacities needed for sustaining growth and development in an uncertain environment.

C. Time for policy debate?

Governments in the region are aware of these weaknesses, but are also facing difficult constraints. While financial limitations certainly play a role, political restrictions are equally important and Governments may find it hard to steer away from the established mix of public employment, subsidies and reliance on remittances. Although a number of countries are facing similar challenges, a policy debate about the role of the state in social policy and about available options has yet to take place. The paternalistic welfare state still seems to be the preferred model and neither the market-based nor the rights-based discourse has found vivid response from regional Governments.

In the context of human security, social policy is designed to fulfil a wide range of functions. It addresses freedom from want by ensuring that especially the poor and vulnerable have access to public services and find the necessary assistance to manage economic shocks and long term risks. It supports the freedom to take action on one's own behalf by assisting people in developing their human potential through the provision of public services and by ensuring that people have equal access to opportunities and are included in the economy and society. Social Policy should contribute to freedom from fear through building inclusive societies, reducing discrimination and social tensions and by granting a sense of stability.

Arab countries have so far succeeded in extending social safety nets to large parts of their population and achieved a respectable degree of equality. They have made significant development progress in an environment marred with instability, conflict and violence, which not only spoils the economic climate but also puts additional strain on society. The Arab region is home to one of the biggest refugee populations in the world.[55]

The question is how existing achievements can be improved and extended to the entire population and how equality can be translated into equity.

One direction of policy might be to improve existing systems. A readjustment of contributions and benefits, better enforcement and monitoring of contributions, optimized investment of capital, reduction of administrative costs, as well as better targeting of assistance would certainly lead to gains of financial efficiency.[56]

The Arab region is home to one of the biggest refugee populations in the world

A second priority would consist of finding policy solutions and instruments for expanding social security systems to the vast number of people in informal sectors. While the current type of assistance through subsidies can be an appropriate instrument in some respects, direct cash transfers are sometimes seen to better support peoples' agency by allowing them to access medicine, food or other services depending on individual situations and priorities. Subsidies are sometimes seen as administering poverty rather than developing human potential and the capacities needed for economic and social development.

In the same line, it is often highlighted that social security systems play an important economic role in the way they function as 'quasi automatic stabilizers' in times of economic crisis: by alleviating social hardship and supporting consumption, they help by smoothing the business cycle and cushioning adverse market effects which the lack of protection in the informal economy does not allow for.

Thirdly, Governments may wish to develop stronger partnerships, both inside their countries and in the region. Although the principal responsibility to protect will always remain with the state, other actors may have specific advantages over Governments to access vulnerable groups of population, to contribute to increased efficiency in service delivery or to cooperate in building an enabling environment.

Regional cooperation could improve the protection of labour migrants, who are making invaluable contributions to economic and social development in the receiving countries as well as in their country of origin. Migrants are not always included in social protection schemes and work years spent abroad are not always counted towards retirement benefits.

Some Governments are already working with civil initiatives and non-governmental organizations and may share important experiences for the development of suitable policies and an appropriate regulatory framework. Governments may also wish to expand their information systems and their capacity to monitor and evaluate policy outcomes in order to better target interventions and oversee the activities of partners. The private sector does not participate broadly in formal social protection beyond limited contributions to social insurance schemes.

Although the concept of social responsibility of private property is also deeply rooted in Arab history and culture, it seems to be regarded as a matter of private rather than public concern. A debate over different values and concepts, advantages and disadvantages, rights and responsibilities of public versus private action in the field of social policy in the Arab region could have much to offer. Is poverty seen as a private or as a public concern? Is social policy to equalize incomes, outcomes or opportunities? What do people think about agency or dependency? What about equality and equity? What are the most adequate social policy objectives in face of often limited fiscal space? What are the financing options?

The most important objective of regional cooperation, however, may be the creation of an enabling environment for economic development as well as for social protection. Reducing political rivalries and tensions and nurturing the culture of cooperation and compromise would reduce present social and economic costs of conflict and violence and free essential resources to be invested in social development.

Global challenges like climate change, global warming, health pandemics or the financial crisis are currently strengthening the sense and concept of collective responsibility. The Arab region might take this up and explore its collective potential for advancing the social development of its people.

CHAPTER VI.

Conclusions and Policy Recommendations

VI. Conclusions and Policy Recommendations

Recently, ESCWA member countries have generally exhibited encouraging growth performance relative to other emerging regions, despite the global financial crisis. The main contributors to high GDP growth rates have been hikes in oil prices and revenues and local private and public consumption. However, policymakers have come to realize that the high growth rates achieved so far have not yet translated into job creation, poverty alleviation, human development or into lowering unemployment rates in ESCWA member countries, which have remained chronically high since the early 1990s. In addition, FDI, the main engine of economic growth and other forms of capital flows into the region are still relatively very limited. Moreover, the unstable political environment, the recent political and social turmoil in Algeria, Bahrain, Egypt, The Libyan Arab Jamahiriya, Tunisia and Yemen and the aftermath/implications of the global financial crisis have not been conducive to attracting capital and enhancing and improving labour market conditions and growth performances of ESCWA member countries. Capital accumulation and investment, whether FDI or portfolio investment have yet to bring any significant growth benefits to member countries. Inadequate governance, corruption and other bureaucratic impediments to the inflow of capital have reduced the attractiveness of the region to various capital flows. In addition, the lack of economic diversification and integration within the ESCWA region is still a main factor behind the low level of FDI. Intraregional capital flows are primarily in the form of workers' remittances which are highly correlated with the macroeconomic conditions of host countries and thus with fluctuations in world market prices of oil and other financial/macroeconomic factors such as business cycles and financial/currency crises.

Like other emerging economies, ESCWA member countries have been affected by the global financial crisis, but at varying degrees. The survey has shown that MDEs have been moderately hit by the global financial crisis and have, so far, weathered the global recession well, whereas the impact on LDEs has been much more significant. A relatively low degree of integration of MDE financial sectors with international capital markets was instrumental in preventing a severe financial crisis in the region. In addition, limited exposure of the banking systems of MDEs to derivative products and positive spillovers from increased public spending by GCC countries have so far helped ESCWA member countries to avoid debt and balance-of-payments crises. Negative spillover effects from the advanced economies have been in the form of reductions in capital flows including exports, FDI, portfolio investment and remittances. MDEs have been highly exposed to the slowdown in the European Union, their main partner for trade and remittances and in the GCC region, mainly through trade, workers' remittances and FDI transmission channels. A slow recovery in the more advanced economies and the emergence of several regional conflict areas, combined with limited scope for further countercyclical Government policy action, imply that growth in the

The global economy is beginning to recover

ESCWA region, projected at 4.7 per cent, will remain relatively flat in 2011. Policymakers in ESCWA member countries need to focus more on supply-side reforms that help boost the productive capacity of the industrial sector, increase employment and enhance competitiveness. As a result of the rebound in crude oil prices, revenues and production, LDEs will see significant improvements in their fiscal and external balances in 2011, with positive spillover effects into MDEs. Going forward, further efforts at financial sector development and economic diversification should top the economic agenda of policymakers in the ESCWA region.

The global economy is beginning to recover, but the rebound is likely to be slow with fears of a double dip recession still looming in the horizon. Limited monetary policy support in some ESCWA member countries as a result of present fixed exchange rate regimes, high inflation rates and low accumulated foreign reserves will render the reliance on fiscal stimulus even more important in the short term. In those ESCWA member countries with flexible exchange rates, any further monetary stimulus may be absorbed by the ongoing balance sheet adjustment process and may not trickle down to enhance domestic demand. Sustained fiscal support is therefore still warranted in the majority of ESCWA member countries but more so in LDEs with more fiscal space and with more acute financial and real estate hurdles in the post crisis situation. Any premature withdrawal of Government fiscal support could wipe out the progress achieved so far. It is, however, important to have macroeconomic exit strategies in place to be adopted now that the crisis is officially over, in order to deal effectively with the resulting inflationary pressures, the ongoing balance sheet adjustment processes and increasing unemployment rates.

Given the fragility of the recovery after the recent financial crisis, policymakers in the ESCWA region should pay special attention to how premature termination of fiscal stimuli for the sake of balanced budgets may jeopardize recovery and lead to a worsening of human development indicators, namely, health, education, unemployment and gender equality, which may culminate in further social unrest of the type we are currently experiencing in certain ESCWA member countries, namely Egypt, Jordan and Yemen. Greater attention must be given towards poverty alleviation in ESCWA member countries and towards improving social services. Policymakers in the region have, so far, failed in tackling the social issues behind the low levels of human development and should, therefore, better coordinate macroeconomic and social policies for the purpose of alleviating unemployment and poverty which remain acute in several parts of Western Asia.

Expansionary monetary and fiscal policies have continued to underpin the recovery in all ESCWA member countries in 2010. However, in 2011 this scenario is likely to change with additional constraints, less room for expansionary Government policies and subsequently limited fiscal/ monetary support. Therefore, to safeguard price and financial stability and the soundness of the banking system, credible macroeconomic/ financial exit strategies are urgently warranted. Two key factors for immediate implementation are enhancing private demand in conjunction with public demand and introducing macroeconomic supply-side policies to enhance production capacity and growth, as well as a greater role of the private sector in growth and development. However, given the unstable political environment and the existence of several conflict-affected countries/areas, relying on the private sector for growth and development may prove to be a difficult goal to achieve.

In the short run, ESCWA member countries with fiscal space and flexible exchange rates need to maintain Government spending and strengthen the orderly working of financial deleveraging and corporate balance sheet adjustment effects of asset price falls on the one hand while promoting financial market development on the other. Commercial banks in ESCWA member countries are generally well capitalized, but non-performing loans remain high in certain cases. Clearly, low integration with advanced stock markets has contained fallout, coupled with a huge build up of foreign exchange reserves during the oil boom period prior to the crisis and effective monetary and fiscal policy responses. However, in certain ESCWA member countries, limited fiscal space, real exchange rate appreciation, huge current and budget deficits and sluggish external receipts suggest that recovery will be slow. As the recovery is taking place, policy focus needs to shift towards private sector development. However, if private demand and consumption fail to pick up, coupled with limited scope for continued Government policy stimulus, deteriorating growth and unemployment problems are expected.

In the long run, focus needs to shift toward raising regional productive capacity. Addressing unemployment calls for greater public spending and for a greater role of the private sector. Low integration regionally and with the more advanced economies means losing out on the upside potential. Now that the financial crisis is over, the focus of Government policy in the ESCWA region will need to shift towards enhancing productivity of public and private sectors. Moreover, enhancing financial market integration should remain a priority and promoting bond markets of ESCWA member countries will reduce the reliance on international financial flows and short-term speculative capital and contain the exchange rate risk.

Potential risks for 2011 are as follows: further social and political unrest in several ESCWA member countries, weaker exports, further deterioration in current budget deficits, weaker tourism and remittances revenues, higher unemployment rates and sudden stops or reversals in FDI and portfolio flows. Moreover, potential slowdown in the European Union, United States and GCC countries will continue to impact MDEs, while slowdowns in Asia and the United States will continue to impact LDEs. In 2011, all ESCWA member countries are likely to suffer the impact of slower growth which will hamper "growing out of debt" while Government debt increases due to spending in the context of fiscal stimuli packages and lower receipts from LDEs.

The development of the financial sector of the ESCWA region should be a top priority on the reform agenda. The role of the banking sector has been crucial to economic growth, because it has constituted the main source of financing activity of the private sector. Stock and bond markets are sometimes virtually absent and firms cannot raise capital domestically. Increased financial integration within the ESCWA region is expected to bring considerable benefits to investors by rendering capital more mobile across borders. As a result, a more liquid capital market would offer

As the recovery is taking place, policy focus needs to shift towards private sector development lower borrowing costs for the ESCWA corporate sector wishing to raise funds locally and would lower exposure to short-term speculative capital inflows.

Enhanced financial and trade liberalization within the ESCWA region is expected to promote regional intermediation of financial and economic resources through close integration of financial and goods markets and increased access of ESCWA economic agents to them for improvement of production, finance investment and the subsequent stimulation of growth. In addition, increased liberalization within the ESCWA region is expected to attract significant FDI inflows for diversification and growth purposes.

The enhancement of local capital markets in the ESCWA region, especially stock markets, is another way to dampen the effects of the global financial crisis and will help reduce exposure of private corporations to currency mismatches due to foreign borrowing. Those corporations will be able to raise funds locally and reduce their exposure to external financial shocks. They will also reduce any currency mismatch (exchange rate risk) in their balance sheets and dampen the implications of any sudden outflows of capital emanating from the current crisis or from other financial shocks.

On the other hand, an important part of financial/trade integration is the increase in cross-border loans and trade through the lifting of trade and capital barriers as provided for in the various regional trade agreements, the GCC and the GAFTA agreements and other ESCWA-specific trade agreements. Regional trade agreements should have emerged from the global financial crisis as a way for middle and low-income ESCWA member countries to increase trade, spur growth and lower unemployment rates. However, these regional trade agreements have so far failed in assuming this function and their contribution to growth and development in ESCWA member countries has been rather disappointing. Moreover, given the unstable economic and social environment in several member countries, the pursued macroeconomic/financial policies may not provide the required stability for increasing financial integration on a regional scale. It is well known that financial/macroeconomic instability has so far been a detriment to further integration in the ESCWA region. As regional and global liberalization proceeds, policies formed under former macroeconomic conditions will increasingly become pressured to provide the stability needed for sound economic development in the new context of regional integration. Macroeconomic policy coordination, as an integral part of multilateral free trade agreements in the ESCWA region, may therefore prove indispensable for successful economic integration in the region.

Following the signing of the GAFTA and GCC trade agreements, most ESCWA member countries have been aiming for increased regional and intraregional monetary, trade and financial economic integration. A significant part of economic integration is the liberalization of the capital account and the enhancement of cross-border capital flows. However, when capital becomes increasingly mobile across national borders and nominal exchange rates are fixed, monetary policy becomes increasingly subordinated to defending the nominal exchange rate peg. In the extreme case, free capital movement and pegged exchange rates render the independence of monetary policy obsolete, as interest rates have to shadow the interest rate of the anchor currency to which national currencies are pegged, irrespective of whether this foreign interest rate level suits the economic situation of the country. It is now well established that fixed exchange rate regimes have prevented several ESCWA member countries from effectively using countercyclical monetary policies to dampen the effects of the global financial crisis on their respective economies. Under these circumstances and with further integration of the ESCWA region into the world economy, increased regional and interregional monetary and financial economic integration and fast liberalization of the respective capital account, certain ESCWA member countries, namely Jordan and Lebanon should consider shifting to more flexible exchange rate regimes if they wish to render their monetary policy more effective and independent and at the same time deal more effectively and swiftly with any potential financial or monetary shock. Subsequently shifting to inflation as a target of monetary policy in those ESCWA member countries would constitute the appropriate monetary policy regime shift.

However, flexible exchange rate regimes may not currently be a viable alternative for the majority of ESCWA member countries, given the virtual absence of independent monetary policies and well-developed capital markets. Another consideration is that underdeveloped monetary, political and policymaking institutions tend to undermine the effectiveness of discretionary monetary policy. For now, some type of fixed arrangement may be the safest option for most of these countries. For ESCWA member countries engaged in a significant amount of trade with the European Union, a euro peg may be more appropriate than a dollar peg. In all cases, those countries maintaining fixed exchange rate arrangements must implement crisis-prevention measures, namely by exercising fiscal discipline, managing their debts and foreign reserves and avoiding real exchange rate appreciation. As ESCWA member countries improve their monetary and fiscal infrastructure and become more integrated with global capital markets, they should opt for a currency union. Despite the hurdles still obstructing the establishment of a GCC monetary union, GCC countries need to devote further effort in that direction with the purpose of paving the way for the introduction of a common GCC currency in the near future. The GCC, as one unified monetary block with a single currency, will be able to better withstand future financial shocks whether emanating from the current global financial crisis or not.

The establishment of a GCC-based monetary union will eliminate regional exchange rate misalignments and their negative impact on intra-GCC and intra-ESCWA trade flows which have remained significantly low. As long as GCC countries maintain fiscal discipline and can count on substantial regular inflows of hard currency from oil exports, a fixed exchange rate peg to the dollar will remain sustainable and can be justified as a stepping stone for the adoption of a common currency, protecting ESCWA member countries from future potential balance-of-payments crises as was the case during the latest global financial crisis.

Central banks in the ESCWA region should improve financial and monetary policy coordination to allow them to deal more effectively with financial and monetary imbalances. One way this may be achieved is through enhanced regional financial integration and macroeconomic policy coordination. The formation of an integrated ESCWA capital market, for instance, would lower interest rates in the region, benefiting those

Fixed exchange rate regimes have prevented several ESCWA member countries from effectively using countercyclical monetary policies to dampen the effects of the global financial crisis

Enhancing South-South trade and financial integration is the optimal macroeconomic policy option

ESCWA member countries burdened with high levels of private and public debt. Specifically, a larger and more integrated regional capital market would: (a) reduce the huge costs associated with servicing the accumulated public debt and lower the cost of raising capital, allowing companies in the region to rely increasingly on the local rather than the world market for economic development resources, which would result in higher investment and GDP growth rates; and (b) increase the available fiscal space in some ESCWA member countries and subsequently render countercyclical fiscal policies more effective in dealing with potential future financial crises and in weathering the effects of the current one. Enhanced financial integration would also substantially improve the attractiveness of the ESCWA region to all types of FDI.

Even though certain ESCWA member countries have recently undertaken some financial reforms and pursued sound macroeconomic policies, the current financial crisis, which is not of their making, has disproportionately penalized them and constructed additional macroeconomic and financial hurdles that will have to be overcome in the near future, as financial capital may once again leave their financial markets. ESCWA member countries need, therefore, to exert further intensive effort to raise their share of global FDI inflows which has remained relatively low. Measures that could be taken, in addition to adequate macroeconomic policies to respond to the current financial crisis, include the acceleration of South-South economic, financial and trade integration efforts, coupled with enhanced reform programmes that stress institutional and governance aspects in particular. Moreover, these countries need to accelerate the implementation of the privatization process, which represents an important factor in promoting inflows of FDI at the global level, particularly privatization of the services sector. ESCWA member countries also have to fight financial and administration corruption and eliminate bureaucracy, strong impediments to the inflow of FDI. The political instability the region has been facing as a result of a failure to achieve comprehensive peace continues to exert a negative influence on the ability of the ESCWA region to attract FDI.

It was already argued that trade has constituted a major transmission channel of the global financial crisis onto MDEs. In addition, the still weak regional trade and financial integration linkages and the heavy dependence on external resources to finance development have also constituted another important transmission channel of the global financial crisis on the economies of the ESCWA region. Greater Arab trade/financial integration could have helped to avert the negative effects of the crisis on ESCWA member economies and could have dampened the effects of the trade channel conduit. Closer Arab trade links emanating from GAFTA since 1997 and from GCC since 1981, have implied greater economic links among Arab countries in general and those of the ESCWA region in particular and greater prospects for enhanced trade integration in the future among those member countries. However those trade integration efforts/initiatives appear to have been limited in stimulating and enhancing inter-ESCWA trade. Enhancing South-South trade and financial integration is the optimal macroeconomic policy option for averting future financial/economic crises from affecting the ESCWA region. Had the amount of intraregional trade been significant, the trade transmission channel of the global financial crisis could have been averted. Before enhancing trade integration with the rest of the world through WTO and other bilateral trade agreements, namely the Euro-Mediterranean Free Trade Agreements and other free trade agreements such as the Jordan-United States free trade agreements, ESCWA member countries need to enhance and strengthen trade integration at the regional level and enhance intra-ESCWA trade flows to strengthen the local markets and subsequently enhance trade with rest of the world.

The recent global financial crisis has shown that in the case of the GCC capital markets, greater financial integration combined with financial innovation and deregulation can increase vulnerability and create systemic risks. Weak corporate governance and risk management, as well as inadequate supervision in GCC regulation failed to keep up with rapid transformation of the financial systems, often deliberately, in the spirit of greater liberalization and less Government regulation. In this context, the Dubai financial crisis is a case in point. These financial developments have demonstrated the negative consequences of financial integration which combined with financial innovation and deregulation increased vulnerabilities in GCC countries and created heightened systemic risks. Yet, despite these negative contagion effects, at least the regional integration of financial markets should remain a priority policy of all ESCWA member countries in general and GCC countries in particular, where there is a push for greater deregulation and accelerated liberalization.

A trade-integrated ESCWA region would benefit ESCWA member countries as follows: (a) enhance the productive capacity of the domestic industry by improving the use of comparative advantage in the production process; (b) enhance the economic diversification process by improving specialization in the production process; (c) enhance and stimulate growth and development in member countries; (d) improve access to cheaper goods for member countries; and (e) lower transportation costs of traded goods. The ESCWA region is already subject to region-specific financial/economic exogenous shocks, such as oil price volatility, unemployment, lack of productive capacity and other geopolitical factors. The recent global financial crisis has put an additional hurdle on the region which could have easily been averted had the region been financially and economically integrated. Reliance on the European Union, the United States and other Asian countries for local consumption was the main factor affecting the region. Regional industry will be able to better compete with the rest of the world through an integrated local market. Moreover, using available comparative advantage in ESCWA member countries effectively will reduce reliance on developed markets for local consumption.

Overall, the ease in transmission of recent financial external shocks to certain ESCWA member countries can be explained by their higher overall trade openness and by mismanagement of domestic financial and macroeconomic policies. Therefore, the size and impact of future external shocks and their persistence in GCC countries will depend on future domestic fiscal/ financial policy responses and on the success of efforts to prevent transmission of these shocks into domestic economies. This may be achieved through, for instance, implementation of appropriate fiscal reform measures and through active reforms of the financial sector.

GCC countries should continue with their diversification efforts away from the

Industrialization can allow for broad-based growth and higher wage incomes

oil sector into the services and industrial sectors. This will reduce their vulnerability to external shocks, their excessive trade openness and their heavy reliance on the contribution of oil and oil-related products to their current and fiscal accounts and to the real GDP growth rate. The recent GCC efforts to integrate into the global economy, which were recently enhanced by the accession of its largest economy, Saudi Arabia, to the WTO in December 2004 and the expected ratification of the European Union/GCC Free Trade Area agreements, are all contributing factors to further enhancing trade and investment climates in the region. Other initiatives to enhance regional and international integration efforts such as harmonizing investment laws and stock market regulation are also contributing factors towards the realization of the monetary union in the foreseeable future.

Initial conditions and barriers to development and growth in the ESCWA region are longstanding and structural and present challenges for economic development policies and regional integration. And yet, industrialization can allow for broad-based growth and higher wage incomes and constitutes one way to dampen the effects of future crisis on the region. Industrialization is, therefore, a prerequisite for rights-based economic growth. Policies for development in the ESCWA region must confront the following stylized facts: (a) regional growth is elusive because of massive leakage in the cycle of income due to extreme dependency on industrial imports; (b) manufacturing production takes place regionally but is marginalized due to existing global supply chains and lack of regional industrialization strategy; (c) expansion in production has taken place in certain export sectors but neglect dominates the most strategic sectors of the region; and (d) manufacturing activities have declined over time and dependence continues to grow. It is clear that ESCWA member countries benefited only marginally from financial flows associated with the oil boom that concluded in 2008. Economic benefits that the region accrued as a result do not reflect renewed development toward sustainable patterns of growth. Putting surpluses that were earned in the last oil boom to work in a framework for sustainable development will require stepping up demand injections that raise production in dynamic sectors, specifically, manufacturing, considered a strategic dynamic sector synonymous with development proper and sine qua non for the region to deviate from its current jobless growth trajectory and an ultimate antidote to any potential financial crisis.

The outlook forthe coming two years remains gloomy with a double dip recession still looming in the horizon

The recent global financial crisis will most likely change world financial architecture as well as the international monetary system which many economists blame as its root cause. The outlook for the coming two years remains gloomy with a double dip recession still looming in the horizon, coupled with potential currency wars and balance-of-payments imbalances in the developed economies. Emerging economies are expected to continue to suffer from volatile capital flows, weak world demand for their exports and less fiscal and monetary space to deal with further macroeconomic imbalances.

Endnotes

1 International Labour Organization (ILO), 2010, *Global Employment Trends*, January 2010, p. 46.

2 United Nations Department of Economic and Social Affairs (DESA), *World Economic Situation and Prospects Report for 2011*.

3 2008 real gross domestic product (GDP) growth rate and 2010 forecast from DESA, *LINK Global Economic Outlook*, October 2010.

4 All GDP growth rate forecasts for 2010-2011 are from DESA *World Economic Situation and Prospects Report for 2011*.

5 The ESCWA region consists of two subregions where its member countries are located. Member countries of the Gulf Cooperation Council (GCC) are: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates, henceforth referred to as the less diversified economies (LDEs). Non-GCC countries of the ESCWA region are henceforth defined as more diversified economies (MDEs), including Egypt, Iraq, Jordan, Lebanon, Palestine, the Sudan, the Syrian Arab Republic and Yemen.

6 TED spread is the spread between the three-month London Interbank Offered Rate (LIBOR) and the three-month US treasury bill interest rate. TED spread is a measure of liquidity, as it indicates a relative borrowing cost of private entities to the US Treasury. Historically, it stood at 50 basis points (0.5 percentage points). Higher TED spread implies a shortage of US dollar liquidity in the private sector as the funding cost of the US dollar in international money market rises more than that of the US Treasury.

7 Organization of the Petroleum Exporting Countries (OPEC) Monthly Oil Market Report, October 2009.

8 Fiscal impulse is a quantitative indicator used to gauge the direct expansionary impulse that fiscal policy causes. It is designed to measure the magnitude of change in the budgetary stance, whether budgets are moving towards expansion or contraction.

9 Automatic stabilizers are changes in fiscal policy that stimulate aggregate demand (Government expenditures and taxes).

10 The nominal effective exchange rate (NEER) falls when the value of the national currency depreciates against the weighted sum of the values of the currencies of the major trading partners. The real effective exchange rate (REER) falls when the exchange rate-adjusted inflation of trading partners is increasing faster than domestic inflation. The difference between NEER and REER depicts the extent to which the nominal devaluation of a national currency (NEER) has affected the inflation rate of a country in comparison with its major trading partners (REER). NEER and REER will exhibit the same path when the exchange rate does not affect the inflation rate and a diverging path when the exchange rate correlates with the price level. It is well known that exporters will lose price competitiveness by a real exchange rate appreciation while importers may face rising import prices in terms of national currency.

11 In figures 31 and 32, broad money is in accordance with the classification of International Monetary Fund (IMF), International Financial Statistics. It is M2 in all countries with the exception of Saudi Arabia and Lebanon where M3 is classified as broad money. Growth stands for year-on-year growth. The growth of the monetary base in terms of broad money is calculated as (Monetary base at t+1 - Monetary base at t)/(broad money at t) where t is month. The purpose of this calculation is to decompose the factor of broad money growth into the contribution of monetary base and the contribution of domestic monetary expansion. A difference between the growth of broad money and the growth of the monetary base in terms of broad money depicts the extent of domestic monetary expansion.

12 Breisinger, Collion, Diao and Rondot (2010), p. 18.

13 However, Lebanon was able to weather the effects of the crisis through the achievement of political stability and the consequent inflow of tourists, together with the fact that the majority of assets of commercial banks were in the form of Government treasury bills as opposed to investments in structured financial instruments.

14 The steep devaluation of the rubble led to significant increases in Russia's external debt and in its related service costs.

15 The Concentration Index, also named Herfindahl-Hirschman Index, is a measure of the degree of market concentration. It has been normalized to obtain values ranking from 0 to 1 (maximum concentration), according to the following formula:

$$H_j = \frac{\sqrt{\sum_{i=1}^{n}\left(\frac{x_i}{X}\right)^2 - \frac{1}{n}}}{1 - \sqrt{\frac{1}{n}}}$$

where Hj = country or country group index; xi = value of exports of product I and

$$X = \sum_{i=1}^{n} x_i$$

where n = number of products (SITC Revision 3 at 3-digit group level).

16 IMF, Department of Trade Statistics (DOT).

17 IMF, DOT.

18 Ibid.

19 Ibid.

20 In 1949 Verdoorn discussed the relationship between productivity and output growth. The importance of the law is that it suggests that a substantial part

of productivity growth is endogenous to the growth process, being determined by the rate of expansion of output through the economies of scale. A major tenet of the law is that it reflects both static and dynamic economies of scale. The former is a function of the volume of output and the gains in productivity from this source are reversible. Dynamic factors on the other hand represent ‘learning by doing’ and are usually ascribed to the growth rate of output. A more rapid expansion of production will also lead to (and result from) a greater rate of innovation and a climate more favourable to risk taking. The implications of Verdoorn’s Law are far reaching. It suggests that there is an inherent tendency for growth to proceed in a self-reinforcing manner and provides an economic rationale for Myrdal’s (1957) notion of ‘cumulative causation’. Provided all gains are not absorbed by increased real wages, countries (or firms) will experience an increasing cost advantage over their competitors.

21 The main cause behind low productivity growth is associated with a lack of demand regionally and massive leakages in the cycle of income via imports show up in the multiplier as the share of imports and stocks of monetary capital circulate the income of the region abroad. Mathematical analysis of the aggregate supply and demand balance, the sum of private consumption, private investment, Government spending and exports can be illustrated to show how leakage parameters are defined relative to aggregate output. The private savings rate as Sp= (Yp-C)/X; the import propensity as m=M/X and the tax rate t=T/X. From these relationships, one gets a typical Keynesian income multiplier function:

(1)
$$X = \frac{1}{s_p + t + m}(I_p + G + E)$$

which can also be written as

(2)
$$X = \frac{s_p}{(s_p + t + m)} \cdot \frac{Ip}{s_p} + \frac{t}{s_p + t + m} \cdot \frac{G}{t} + \frac{m}{s_p + t + m} \cdot \frac{E}{m}$$

In this version of the Keynesian multiplier illustrated by Taylor (2000), the direct “own” multiplier effects (or “stances”) Ip/Sp, G/t and E/m are scaled by their respective “leakages”. Each stance can be observed relative to X in order to see which components of aggregate demand are contractionary and which provide stimulus to the economy.

22 “The gap between rich and poor and the number of people below the poverty line have both grown over the past two decades. The increase is widespread, affecting three-quarters of OECD countries. The scale of the change is moderate but significant”. Organisation for Economic Co-operation and Development (OECD) (2008), table 11.1: Summary of changes in income inequality and poverty.

23 World Bank (2000), p. 4.

24 United Nations Research Institute for Social Development (UNRISD) (2006), p. 4.

25 With the latest establishment in Oman in 1993.

26 With the exception of the oil exporting Gulf States where education was not compulsory and which partly relied on foreign imported labour. UNRISD (2006), p. 4.

27 Ibid., p. 5.

28 Nasr (2001), p. 32.

29 World Bank (2000), p. i.

30 Ali and Fan (2007), p. 5.

31 World Bank (2009), p. 16.

32 World Bank (2004), p. 95. This refers to the MENA region according to the World Bank definition, which is broader than the ESCWA region. However, since public sector employment was small or declining sharply in the Maghreb, the overall picture would not change drastically were they to be excluded.

33 Jordan, however, presents an exception to this trend, where the public sector share declined from 45 per cent in 1987 to 36 per cent in 1996. World Bank (2004), p. 98.

34 World Bank (2002), p. 64.

35 Adams and Page (2001) as quoted in: World Bank (2004) p. 121. See also: ILO (2008), p. 11. For a sharply different view on inequality see: University of Texas Inequality Project, available at: http://utip.gov.utexas.edu/ about.html.

36 UNRSID (2006), p. 10.

37 United Nations (2008), p. 21.

38 UNRISD (2006), p. 12.

39 ILO (2011), table A5, p. 64.

40 ESCWA (2008b), p. 3.

41 World Bank (2007a), pp. 58 and 59.

42 Ibid., p. 59.

43 World Bank (2010) and Tzannatos (2000), p. 14.

44 World Bank (2005), p. 10. Only Jordan and Yemen have implemented far reaching pension reform in 1995, 2000 and 2003. See also Loewe (2009), p. 18.

45 According to UNESCO, Southern and Western Asia have the lowest regional adult literacy rates (58.6 per cent), followed by Sub-Saharan Africa (59.7 per cent). The estimated figure for the Arab States is 62.7 per cent. UNESCO (2006), p. 286.

46 For a comprehensive analysis of the employer of last resort approach see: ESCWA (2008a), p. 73.

47 World Bank (2004), p. 107.

48 World Bank (2007a), p. 61.

49 Egyptian social insurance is an exception as all citizens are eligible to enrol. Participation, however, remains low because many people are not aware of this possibility. See Loewe (2009), p. 23.

50 World Bank (2005), p. 1.

51 United Nations Development Programme (UNDP) (2008), p. 12.

52 World Bank (2008), p. 22.

53 World Bank, (2007b), Energy subsidies for electricity and gas to the top 40 industrial producers in Egypt are scheduled to be phased out over the next three years

and subsidies for non-energy-intensive industries shall continue until 2013. BuisnessIntelligence Middle East (BI-ME), 7 October 2007.

54 United Nations (2008), p. 6. The World Bank, with its newly adjusted poverty line, counted around 3.5 per cent at the US$1.25 and around 17 per cent at the US$2 poverty line in 2005. For a different calculation see Ali and Fan (2007), p. 13.

55 United Nations (2008), p. 7.

56 Loewe (2004).

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