ECONOMIC AND SOCIAL COMMISSION FOR WESTERN ASIA

SURVEY OF ECONOMIC AND SOCIAL DEVELOPMENTS IN THE ESCWA REGION 2005

SUMMARY

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The theme of this year's *Survey* is "strategies for development out of crisis conditions". The *Survey* covers three developmental categories, namely: economic, social and sustainable development. The impact from the current oil boom on region-wide development remains significantly below potential because of comparatively low levels of economic integration and sub-optimal macroeconomic structures in most member countries of the Economic and Social Commission for Western Asia (ESCWA). A dynamic rise in productivity is further hampered by institutional inadequacy caused partly by the lack of internal creative or absorptive capacity in the small, fragmented markets of the region. Analyses based on long-term trends suggest that the ESCWA economies have performed well below potential since the early 1980s.

If the Millennium Development Goals (MDGs) are to be sustained in the region, an employment environment must be created by either an investment-growth nexus or by reshuffling resources. Being so rich in resources, change in the region could be readily achieved in a more regionally-integrative and tension-defused environment. In a more concrete sense, economic policy needs to centre on regional cooperation, investment facilitation and job creation; social policy should focus on citizen's needs and aspirations; and sustainable development policy must seek ways to offset the cost of environmental degradation.

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INTRODUCTION

1. With surging world demand for oil, particularly from China and India, rising oil prices and economic growth in the Economic and Social Commission for Western Asia (ESCWA) region (except for the disaster zones) continued in 2004, and for the second consecutive year. Increased by higher output and prices, gross oil revenues were estimated at $213 billion in 2004, a 29 per cent increase from 2003, representing some 40 and 55 per cent of ESCWA and the Gulf Cooperation Council (GCC) gross domestic products (GDP), respectively. Inflation was modest throughout and, given higher than usual fiscal surpluses, public debt levels in the Gulf States were in some instances slightly reduced. Unemployment rates, however, remained critically high, especially in the more diversified economies (MDEs).

2. GCC countries witnessed record growth rates offering an opportunity for them to be the locomotive of economic growth that fosters region-wide development. For that to occur, oil revenues should be directed towards more productive investments, while economic policies should promote intraregional employment generation and flow of funds. So far, the impact from the current boom on region-wide development remains significantly below potential because of comparatively low levels of economic integration and sub-optimal macroeconomic structures in most member countries.

3. The course of development could be changed and set on a higher path, pending sound policy sets. There is evidence pointing to an inverse overall relationship between instability and growth. While there is a tendency to overrate the impact of the oil windfall on current growth, analyses based on long-term trends suggest that the ESCWA economies have performed well below potentials since the early 1980s. Declining labour productivity and the long-term economic stagnation cannot be solely attributed to volatile oil prices, regional wars and conflict. While it is valid to assert that the revival of the region's economy requires, first and foremost, an end to the military and political conflicts and the creation of a stable environment conducive to both domestic and foreign investment, it is not terribly useful as a guide to understanding what happens in the interface between external shocks and economic activities, or why, when oil revenues rise, the quantity of effective or nationally retained savings falls. While economic contractions or expansions may be triggered by external shocks, the magnitude and duration of either is determined by the adequacy of economic policy and the efficacy of institutions. Based on long-term trends till 2002, the substantial economic contraction in ESCWA economies, therefore, raises serious questions regarding macroeconomic systems, institutions and policies.

4. The problem is to address the issue of managing the macroeconomy under a specific set of economic constraints, foremost among which is the development of regional institutions imbued and reproduced conjointly by a given risk or geopolitical risk level. Two main factors affect the course of development, namely, war, and the uncertainty created by political tension; and how well the income and wealth of a society is distributed between its different strata. The ESCWA economies largely grow "from without", being driven by commodity prices and political tensions. When oil prices plummet, growth follows suit.

5. Despite the fact that intraregional trade is 8 per cent of total trade and that risk profile differences between member countries can be immense, the region as a whole is perceived as comprising small, risky markets tied by geopolitical considerations and representing a meager 2 and 2.5 per cent of global income and population, respectively. Given that instability is unlikely to

wither away soon, regional resources must be allocated with due and equal consideration given to well-being and economic efficiency. Under conflict conditions and with a history of political instability, the region cannot afford the transitory social costs related to laissez-faire policy measures, particularly given the inherent weakness of its small size. National and regional inequities are very pronounced in the ESCWA region. Its oil-exporters were able to export $830 billion of capital in constant prices over the past 30 years, while other ESCWA member countries were in dire need for capital.

6. Being so rich in resources, change could be readily achieved in a more regionally-integrative and tension-defused environment. Issues of poor productive investment and policies for growth with equity, with special emphasis on expanding employment opportunities should be urgently addressed. If the Millennium Development Goals (MDGs) are to be sustained, an employment environment must be created by either an investment-growth nexus or by reshuffling scarce resources. Otherwise, the interlinking leverage between MDGs will not function to reduce poverty and hunger as stated under Goal 1.

7. In addition to covering macroeconomic and social developments, this year's *Survey* theme is "strategies for development out of crisis conditions". The *Survey* falls into three developmental categories: economic, social and sustainable. The objective rests on the choice of a battery of policy measures aiming to cushion the impact of economic and social downturns and surmount the stress of prevailing conditions. Given the inequities, there is plenty of room for redistributive policies. In a more concrete sense, macro policy should centre on regional coordination, investment facilitation and job creation; social policy should focus on citizens' needs and aspirations; and sustainable development policy should seek ways to offset the cost of environmental degradation.

I. RECENT ECONOMIC TRENDS AND DEVELOPMENTS IN THE ESCWA REGION

A. THE GLOBAL CONTEXT

8. In 2004, world economic recovery gained momentum and global output growth accelerated to 4 per cent, up from 2.5 per cent in 2003. Global economic expansion has not only been the highest for more than a decade, it was extraordinarily broad based with all major regions of the world, with the exception of the European Union (EU-15), reporting real GDP growth of more than 3.5 per cent. Oil production continued to expand in the ESCWA region soaring by 6 per cent from its 2003 level to 19 billion barrels per day (bp/d). GCC fiscal surpluses rose to new records, and internal debts were attenuated.

9. In the group of developed countries, the United States of America was once more the main engine for global growth, with real GDP increasing by more than 4 per cent. Japan recorded its highest annual growth rate since 1996, whereas EU-15 recovery remained sluggish. Developing countries achieved an average real growth rate of 6.2 per cent, while annual growth in the economies in transition amounted to 7.1 per cent. Growth was exceptionally strong in several large developing countries in Latin America, and South and East Asia, where China and India continued to be their fastest-growing economies and dynamic sources of global demand.

10. Most developing countries have benefited from the combined effects of the major macroeconomic developments of 2004. Those included strong price increases for oil and most non-oil commodities, relative stability in international financial markets, despite significant fluctuations in major currencies, and a generally favourable global investment and trade climate based on limited inflation in industrial countries. While the sharp rise in oil prices over 2004 led to windfall revenues for oil-exporting countries, its adverse impact on the global economy was limited. To date, neither the surge in oil prices nor the steep price increases in other commodities have triggered significant second-round effects on prices in the developed economies, where inflation rates remained relatively low, albeit rising, in 2004.

11. Given modest inflationary pressures, long-term real interest rates, while having risen, remained close to historical lows. Low costs of finance facilitated global investment, thereby contributing to the acceleration of global growth in 2004. In addition, higher degrees of macroeconomic stability in both developed and developing economies helped to limit the negative impact of global disturbances on individual countries, contributing to the observed stability of international financial markets. For most non-oil exporting developing countries, the improvement in commodity prices stimulated 2004 growth, outweighing the negative effects of higher oil prices.

B. DEVELOPMENTS IN THE OIL SECTOR

1. *World demand and supply*

12. In the context of a recovering world economy and given a sustained surge in demand from developing countries, particularly China, India, and Latin American countries, world demand for oil grew steadily in 2004. Continuing geopolitical tensions combined with refining and distribution industry bottlenecks caused tight supply conditions for light products, which were coupled with

high oil demand throughout 2004. Disruptions in oil production in the Gulf of Mexico region in September 2004 further tightened supplies, as did geopolitical tensions in Iraq, Nigeria and Venezuela. In view of the demand, the Organization of Petroleum Exporting Countries (OPEC) increased its production quota in the second quarter. With non-OPEC oil producers following suit, oil production is approaching full capacity in the first quarter of 2005, thereby heightening speculative pressures for price rises.

2. *Oil price development*

13. Oil prices rose throughout 2004, with accelerating fluctuation towards the two peaks of August and October. That price trend continued into the first quarter of 2005. The 2004 yearly average Texas Intermediate (WTI) Spot price was $41.51 per barrel (/b), and that of the OPEC reference basket $36.05/b. With production capacity stretched to the limit, oil prices remained liable to upward pressures. Furthermore, ample worldwide liquidity and the rise of other commodity prices induced market speculators to buy into oil futures. Security problems and disruptions in production also increase price volatility.

3. *Crude oil production in ESCWA: OPEC States, non-OPEC States and Iraq*

14. Oil production continued to expand in the ESCWA region and soared by 6 per cent from its 2003 level, generating 19 bp/d. With the exception of Iraq, OPEC members Kuwait, Qatar, Saudi Arabia and the United Arab Emirates produced on average 4 per cent more crude oil than in 2003. By making use of national and international oil companies and contractors, that group can exploit new oil fields, expand secondary fields and/or redevelop major infrastructure. Oil production in the non-OPEC countries, namely, Bahrain, Egypt, Oman, Syrian Arab Republic and Yemen, declined in 2004 by 5 per cent, and those countries are struggling to maintain their output. While Iraq's production is estimated to have increased significantly, insecurity renders upstream operations unstable.

4. *Oil revenue and the macroeconomic impact of oil windfalls*

15. While oil production performances varied, all ESCWA oil-exporters have experienced a boost in oil export revenue. Gross oil export revenue in the region is estimated at $213 billion in 2004, a 29 per cent increase over 2003. With the exception of Qatar, this led to an increase in the share of oil exports in total 2004 exports. Qatar's share of oil in total exports has continuously declined, while its exports of liquid natural gas (LNG) have increased substantially. The windfall was reflected in Government revenues, particularly in GCC countries, resulting in a historically high level of fiscal surpluses there. Saudi Arabia produced a pro-development expansionary Government expenditure package for 2005. Other GCC countries are on a more moderate expansionary path in their budgeted expenditure projections. Continuing economic diversification policies have made it possible for GCC countries to channel oil windfalls into expanding domestic demand. However, the long-term sustainability of their current expansionary economic phase is still in question, given that greater expansion in non-oil sectors is required.

C. PUBLIC DEBT IN THE ESCWA REGION

1. *Public debt in GCC countries*

16. In general, the GCC countries maintain low or modest external debt stocks and debt-to-GDP ratios, and have accumulated substantial foreign assets. Given the surge in oil revenues throughout 2004, and the currently prevalent upward price trend, significant budget surpluses are expected, leading to a further strengthening of their financial positions. In Saudi Arabia, the highest indebted GCC country, total Government debt increased to some 75 per cent of GDP in 2003, albeit only some 23 per cent of total debt is owed to external creditors. In 2004, a substantial part of the budget surplus was used to repay public debt. Accordingly, its total public debt is expected to decrease substantially from $176 billion at the end of 2003 to $164 billion by end 2004.

2. *Public debt in the more diversified economies*

17. The MDEs, in contrast, face larger public debt burdens and much greater challenges in maintaining sustainable levels of indebtedness. Overall, their 2004 public debt situation improved because of strong economic growth and the positive impact of regional and global interest rates. In Egypt, the level of external debt remained steady, amounting to $29.5 billion in September 2004. However, total domestic debt increased substantially in 2004, reaching 433.8 billion Egyptian pounds (LE) in September 2004, or 87.1 per cent of GDP. International observers estimated the external debt of the Syrian Arab Republic to be $22 billion by end 2004, almost equal to GDP, whereas official sources reported much lower figures. However, in January 2005, the Syrian Government reached an important agreement with the Russian Federation whereby 73 per cent, or $9.8 billion, of its net debt to that country was written off. In Yemen, total external debt has been rising as the result of substantial budget deficits. That process appears to have accelerated in 2004 and total external debt is estimated at some $6.6 billion.

18. In Jordan, total public debt increased slightly from 7,071 to 7,293 million Jordanian dinars (JD) in 2004. Due to strong GDP growth, the debt-to-GDP ratio decreased from 100.2 per cent to 95.1 per cent. The Government of Jordan continued its efforts to restructure the public debt stock, gradually replacing external by domestic sources with the external debt-to-GDP ratio declining from 76.4 per cent to 69.7 per cent during 2003-2004.

19. In Lebanon, persisting high levels of public debt forced the Government to direct much of its expenditure towards debt service. With the Lebanese pound (LL) pegged to the US dollar, the prevailing very high debt-to-GDP and debt-to-export ratios make that economy extremely vulnerable to adverse shocks. Owing to a strong increase in Government revenues and expenditure discipline, Lebanon’s primary budget surplus was LL 995.3 billion in 2004, or 3.3 per cent of GDP. However, the achieved surplus fell significantly short of the 6 per cent target specified under the Paris II Agreement, and gross public debt had increased to $35.9 billion by year end. Because of greatly expanded GDP in 2004, the public debt-to-GDP ratio declined slightly to 180 per cent, but is still very high. Following the assassination of Former Prime Minister Hariri in February 2005 and its effect on the short-term economic outlook, Lebanon faces enormous challenges in keeping public debt on a sustainable path, when high unemployment and political tensions permit little flexibility in policy-making.

20. In Iraq, excessive external debt levels and massive war reparations are major obstacles to reconstruction. The Paris Club Agreement of November 2004 represents a significant step towards long-term debt sustainability. It slashed total debt stock to that Club by at least 80 per cent, to $7.8 billion, reducible in three phases upon approval and completion of standard International Monetary Fund (IMF) programmes. The remainder of Iraq's total external debt stock, approximately $80 billion, is largely owed to official Arab bilateral and commercial creditors. The Iraqi Government must conclude further debt relief agreements and also find a comprehensive solution to the issue of reparation obligations, which significantly exceed the external debt stock.

D. ECONOMIC DEVELOPMENTS IN THE ESCWA REGION

1. *Growth and living standards in 2004*

21. While turbulent conditions prevailed in Iraq and Palestine, 2004 was another good year in terms of overall economic growth for Western Asia. The combination of high oil prices and production, low interest rates, ample liquidity in both public and private sectors and associated domestic demand expansion gave rise to strong growth. GDP in constant 2000 prices in the ESCWA region (excluding Iraq and Palestine) grew by 4.8 per cent, declining from the high 5.7 per cent achieved in 2003, but still a considerable improvement over growth in recent years.

22. The MDEs and GCC enjoyed an upturn in real GDP levels (see table). The 2004 cyclical upswing is expected to continue in 2005, where ESCWA forecasts indicate 5.2 per cent real growth, with the exception of Iraq and Palestine. For ESCWA as a whole (including Iraq and Palestine), 5.4 per cent is expected.

23. Per capita GDP (excluding Iraq and Palestine) increased by 2.3 per cent in real terms, while average population growth is estimated at 2.4 per cent. Living standards were distinctly different in the two sub regions: while MDEs enjoyed an increase of 2.7 per cent over the 2003 rate of 1.5 per cent, there was an increase in per capita income in the GCC cluster of 1.6 per cent, slightly lower than last year's growth. This is attributable to the lower rate of increase in real GDP. Of GCC countries, Qatar attained the highest, whereas the United Arab Emirates achieved a low per capita GDP. The huge surge in the GDP growth rate of MDEs brought overall per capita income up to its highest rate of 2.7 per cent. The best performers in that cluster during 2004 were Egypt, Jordan and Lebanon. Political instability and shocks to GDP in both Iraq and Palestine have, over time, led to massive unemployment, deteriorating living standards and widespread poverty.

2. *Growth in GCC countries*

24. In 2004, overall real growth in the GCC countries, which in 2003 had been 6.6 per cent, was only 4.7 per cent, largely because of high oil and natural gas production and revenues. Non-oil sectors performed well in 2004, particularly transport, telecoms, real estate, banking and finance. Other contributory factors were high domestic liquidity and low, albeit gently rising, interest rates, which enhanced domestic demand expansion. Given that the current situation is expected to continue, GCC economies are expected to grow by 5.3 per cent in 2005.

3. *Growth in the more diversified economies*

25. Favourable external factors, including low dollar interest rates, the expansion of regional tourism, and a sustained increase in worker remittances and other income transfers, resulted in

healthy domestic demand growth, which drove the real GDP growth rate up to 4.9 per cent, the highest since 2000. The outlook for real economic growth in 2005 remains strong with a preliminary 2005 forecast of 5 per cent (excluding Iraq and Palestine).

TABLE. REAL GDP AND GROWTH RATES ESTIMATES IN THE ESCWA REGION AT CONSTANT 2000 PRICES, 2001-2005
(*Millions of US dollars and percentages*)

						Percentage change			
Country/area	2001	2002	2003	2004[a/]	2005[b/]	2002	2003	2004[a/]	2005[b/]
Bahrain	8 340	8 772	9 367	9 835	10 524	5.2	6.8	5.0	7.0
Kuwait	37 084	36 943	39 160	40 334	42 553	(0.4)	6.0	3.0	5.5
Oman	21 333	21 826	22 232	23 032	24 069	2.3	1.9	3.6	4.5
Qatar	18 561	19 923	20 908	22 162	23 270	7.3	4.9	6.0	5.0
Saudi Arabia	189 726	189 973	203 613	214 404	225 124	0.1	7.2	5.3	5.0
United Arab Emirates	72 666	74 061	79 245	82 415	87 360	1.9	7.0	4.0	6.0
GCC countries	347 710	351 498	374 524	392 183	412 900	1.1	6.6	4.7	5.3
Egypt	101 358	104 500	108 785	114 768	121 654	3.1	4.1	5.5	6.0
Jordan	8 862	9289	9 591	10 119	10 624	4.8	3.3	5.5	5.0
Lebanon	16 785	17121	17 634	18 516	18 886	2.0	3.0	5.0	2.0
Syrian Arab Republic	20 295	21156	21 714	22 300	23 081	4.2	2.6	2.7	3.5
Yemen	9 967	10326	10 729	11 083	11 437	3.6	3.9	3.3	3.2
More diversified economies	157 267	162391	168 453	176 785	185 683	3.3	3.7	4.9	5.0
ESCWA region (except Iraq and Palestine)	504 977	513889	542 976	568 968	598 582	1.8	5.7	4.8	5.2
Iraq[c/]	21 579	19788	15 474	24 790	27 343	(8.3)	(21.8)	60.2	10.3
Palestine[d/]	4 153	4003	4 247	4 315	4 332	(3.6)	6.1	1.6	0.4
Total ESCWA region	530 709	537 680	562 697	598 073	630 257	1.3	4.7	6.3	5.4

Source: ESCWA staff calculation involving rescaling and estimation, based on national and international sources.

Note: Parentheses ( ) indicate negative growth.

a/ Revised ESCWA estimates.

b/ ESCWA forecasts.

c/ Data for Iraq are based on official figures up to 2001; and estimates for 2002-2005 are based on the Ministry of Planning of Iraq, *Iraq National Development Strategy*, 2005-2007 and *Economist Intelligence Unit Country Report*, March 2005.

d/ Data for Palestine are based on official figures up to 2002 from Palestine Central Bureau of Statistics. Growth rates for 2003-2006 are taken from the World Bank Report, "Disengagement: the Palestinian Economy & the Settlements", June 2004.

26. Decomposition estimates of GDP expenditure growth in 2004 indicate that Egypt, Jordan and Yemen experienced consumption-led growth. While that growth pattern is fragile, if physical capital formation is insufficient, the economies of Egypt and Jordan are expected to expand further in 2005. The expected increase in exports will sustain domestic demand in both countries, and the manageable level of inflation that is predicted may sustain consumer confidence, thereby gradually increasing investment. However, it will be difficult for Yemen to sustain the present growth of domestic demand because of its decreasing oil production and weak non-oil exports. Lebanon and the Syrian Arab Republic experienced investment-led growth in 2004. In the latter, the contribution of investment expenditure growth to GDP growth was moderate, but impressive in the former. However, the rapid expansion in domestic demand resulted in remarkable trade deficits. Recent domestic demand expansion in Lebanon is not likely to be sustained at the pace of 2004, especially after the more recent loss of confidence. Regional security and political tensions have also affected

the Syrian economy at a time when its oil production and exports are declining. However, consistent growth in physical investment is expected to improve moderately its 2005 performance.

4. *Conditions in Iraq and Palestine*

27. Tension and political instability will continue to overshadow prospects for steady economic growth and development in conflict zones, namely, Iraq and Palestine. The current shocks to GDP have led to falling levels of per capita income and brought widespread poverty. The Iraqi economy showed signs of recovery from a very low base. Furthermore, its per capita GDP improved immensely reversing the decline of preceding years. Rehabilitation efforts require substantial financial and technical input, which currently cannot be met by oil revenues and donors combined. Saddled with debt, reparations and oil capacity constraints, and with the security situation highly uncertain, Iraq has yet to achieve self-sustaining economic growth despite the reduction in the debt to the Paris Club.

28. The Palestinian economy is restricted, with access only to Israeli goods and labour markets. As a result, real GDP grew at 1.6 per cent in 2004 from 6.1 per cent in 2003. The building of Israeli settlements and the “separation wall” has split the local market and made all forms of economic activity difficult. Economic growth remains severely hampered by the occupation and its constrictive security measures, and the current stagnation may well continue in 2005. There is, however, a pending hope that negotiations with the new Government may create opportunities for improved Palestinian economic activity.

5. *Economic policy*

29. With favourable external conditions in 2004, economic policy in the region focused on demand management and on development with weaker financial constraints. Most members, with the exception of Egypt, Palestine and Yemen, peg national currencies to the dollar, which has brought inflation down to industrial country levels, and kept it at manageable levels in the face of the rapid domestic demand expansion. A solid foreign reserve position brought greater economic stability to Egypt, Jordan and Lebanon, where external vulnerability remained. Although when a national currency is pegged, the role of monetary policy in demand management is limited, the indirect effect it had of creating healthy domestic demand could be observed in 2004.

30. It is a challenge for oil-exporters amongst ESCWA member countries to combine sustainable domestic demand creation with economic diversification. Oil windfalls alone are not necessarily responsible for domestic demand, given that oil revenue can migrate into foreign asset accumulation. Ongoing economic reforms and liberalization contributed to healthy demand expansion in most GCC countries during 2004. However, in order to sustain long-term economic growth, active development strategies are required. In line with the forecasted revenue increases, most GCC countries took prudent stances for their 2005 budget formation; boosting demand without overstretching their budgets. Other oil-exporting ESCWA member countries are not inclined towards rapid Government expenditure increases. However, in the United Arab Emirates, public investment is largely generated at the Emirate level and investment has been significantly expanded in Abu Dhabi and Dubai. While most budgets have become more development-oriented, policy outcomes are likely to remain dependent on external oil-revenue related conditions.

6. *Employment conditions*

31. Because of demographic pressure and female entry, the region has one of the highest rates of new entrants into the labour market. In MDEs, unemployment rates are expected to remain high because job creation is slow. The GCC countries will only be able to absorb limited numbers of surplus workers from labour exporting countries because of current "work-nationalization" policies. Estimates of unemployment in Iraq indicate that the absolute number of unemployed rose dramatically in 2004 to 3.2 million. In Palestine, unemployment remained high at an estimated 28.6 per cent in the second quarter of 2004.

32. Employment creation remains a challenge for almost all ESCWA member countries. In MDEs, unemployment will remain high and it remains difficult to retain educated and skilled nationals. In GCC countries, the priority is developing human resources of nationals to match private sector skill requirements.

7. *External sector*

33. In 2004, the total merchandise exports of ESCWA member countries reached $297 billion, while total imports reached $194 billion. Of those exports, 86 per cent were from the GCC, which also accounted for 70 per cent of all ESCWA imports. Crude oil and other oil-related products remained the main commodities exported. Total gross exports from the region increased by 24 per cent from 2003 largely because of the increase in oil export values, but exports from MDEs, notably Egypt, Jordan and Lebanon, also showed an impressive rise. Expansion in domestic demand resulted in an increase of 22 per cent in imports.

34. With respect to institutional development in trade, Bahrain signed a Free Trade Agreement (FTA) with the United States in September 2004, while Oman, Qatar and the United Arab Emirates are negotiating similar agreements. However, Bahrain's FTA with the United States was contested by GCC States because of the uncertainty of its effect on their customs union. Reversing a former position, Egypt concluded an agreement with the United States concerning Qualifying Industrial Zones (QIZs). However, before the expiration of the World Trade Organization Agreement on Textiles and Clothing (WTO/ATC) at the end of 2004, textile exports with QIZ status had a greater advantage in the American market. Accordingly, the removal of quotas on textile imports in developed country markets will shift QIZ activities into other lines.

II. STRATEGIES FOR DEVELOPMENT OUT OF CRISIS CONDITIONS

35. The ESCWA region is not on target with respect to achieving MDGs. Several countries are either in conflict situations or emerging from conflicts. In addition to the inherently slow rate of progress typical of a developing, small, risky market, the fragility of development tends to be associated with the prospect of conflict. From the long-term perspective, underachieving entities are precarious economies that principally "grow from without", driven by the incongruous forces of oil prices and political tensions and, consequently, they cannot fully exploit their internal resources for overall human development. Their macroeconomic structure has not greatly changed and the dynamic rise in productivity is yet to make a marked contribution to economic growth. In a growth mechanism where the external "oil windfall" component weakens, the internal component, which is dependent on higher productivity, technology and an adequate articulation between physical and human capital, would be best employed in offsetting the fall in oil rents. Overall, productivity per

worker, which is the major element of “the growth from within” component, has consistently declined. That begs the question why an internal momentum for growth, based on financial and human capital of which there is no overall shortage, has failed to materialize.

36. While geopolitical risks can be daunting, some other explanation is needed for the failure of existing resources to account for the risk factors and the institutions developing on that basis. There are plenty of examples of economies that continued to function even in conflict or potential conflict situations. The aim, therefore, is to suggest the prelude to a new macroeconomic configuration that may help the region to overcome the problem of unemployment and break out of low growth and development, even under the prevailing conditions of instability. Failure to do so will forfeit the current opportunity offered by the relative abundance of capital in the region to a short-term gain which starts to erode when oil prices fall. The issue is addressed here on the basis of three interrelated elements: the macroeconomic context, trade and industrialization, and employment and income distribution. The major findings are outlined below.

A. THE MACROECONOMIC CONTEXT

37. The existing exchange rate arrangements in most member countries incorporate negative aspects of the two polar-type exchange rate regimes. Pegging local currencies to the dollar renders monetary policy completely ineffective, as in a fixed exchange rate regime. On the other hand, dollar oscillations increase costs and uncertainties that are associated with fluctuations in exchange rates.

38. The combination of fixed exchange rates, a system heavily reliant on indirect taxes, increasing pressure from external debt and free capital mobility renders the contribution of fiscal policy to growth negligible. However, insofar as public investment grows, aggregate demand correspondingly increases, some growth is generated and a cushion against recession is created.

39. The prolonged contraction of economic activity, combined with chronically high rates of both unemployment and underemployment, has discouraged investment and, consequently, reduced labour productivity. Furthermore, it has exacerbated income inequalities and the incidence of poverty, disempowering a sizeable tract of society and helping to create a fertile environment for political unrest. In a region beset by a very regressive income distribution profile, both within and across countries, political unrest should not be treated entirely as an external factor. Rather, political unrest should be seen partly as endogenous to the economic system. Salient experiences elsewhere have demonstrated that success in development efforts was partly due to their linking growth to income redistribution and increased social equality, thereby helping reduce social tensions and contributing to political system reform.

40. A new macroeconomic environment should be created that is capable of autonomously adopting an economic policy with a low rate of unemployment as its main objective, a more important objective than the mere prevention of inflation. Such an environment cannot be created unless two important tasks are successfully undertaken, namely, fiscal and financial reform at the national level, and monetary coordination and fiscal harmonization at the regional level.

41. Fiscal reform should enhance Government legitimacy by paying greater attention to equity. The tax system should be reformed by increasing reliance on income-progressive taxes, restructuring the property tax and introducing reasonably progressive taxes. Government activity

efficiencies could be increased by the imposition of hard budget constraints on public enterprises. Reform in the financial sector should aim to remove all institutional impediments responsible for the financial repression that currently exists in some countries, and to create properly functioning and better-integrated capital markets. Such markets can stimulate investment and encourage new private sector enterprises to emerge and prosper.

42. In addition to having a sub-optimal exchange rate arrangement, more vulnerable ESCWA member countries are unable to defend their currencies under the current conditions of free capital movement and intensified international speculative activities. After considering all other options, including various fixed exchange rate arrangements, a unilateral free exchange rate, integration into a single currency area and dollarization, it was found that monetary coordination between the ESCWA members, aimed at adopting a unified exchange rate regime is the most promising option. Such coordination could begin by linking the various currencies in the region in a common bloc, floating vis-à-vis the rest of the world. That would achieve two objectives. First, it would stabilize intraregional trade by pre-empting relative shifts in the intraregional exchange rate structure. Secondly, it would insulate domestic economies from external developments, thereby permitting monetary policy to focus on redressing unemployment. Monetary coordination could then move gradually towards the ultimate goal of creating a common currency.

43. Monetary coordination cannot succeed in the absence of fiscal harmonization. As other barriers to trade are removed by the Greater Arab Free Trade Area (GAFTA), the expansion of joint-venture investment and intraregional trade has become increasingly dependent on the abolition of tax obstacles to cross-border activities. Capital tax differences among countries would induce capital to flow from the high-tax to the low-tax economies. Such tax-induced distortions would lead to an inefficient regional allocation of investment and possible tax competition. Tax harmonization between ESCWA members is necessary if those distortions are to be removed.

44. Successful coordination in fiscal and monetary affairs would enable the region to manage external shocks successfully. A regional stabilization fund could provide countries with a self-insurance scheme. If contributions to the fund are made in times of prosperity, Governments need not cut spending in bad periods. By stabilizing expenditure, such funds help to stabilize relative prices and aggregate demand. The fund could also be used to transfer risk abroad by taking advantage of the world hedging market, which, for a fee, provides insurance against unexpected revenue fluctuations.

B. Regional coordination

45. A core finding is that scarcely one country is capable of carrying out the above-mentioned regional reforms alone. Ideally, the region should create an environment for itself in which financial intermediation is facilitated and fiscal stability ensured in order to mobilize and attract investment and reduce the impact of negative shocks. Creating such an environment requires either the combined effort of all countries or a new phase of regional coordination. Several previous attempts at regional integration failed in part because of a faulty view of the sequence of integration. It has often been assumed that integration should first cover trade in goods and services, then movements in capital and labour; and that the harmonization of economic policy should be the final step. In that view, the primary emphasis in regional integration is on trade liberalization involving across-the-board removal of tariffs through the formation of an FTA or customs union (CU). The standard test of success for such schemes is the extent to which "trade

creation" between member countries outweighs "trade diversion" from other markets, and the extent to which the scheme moves the region towards freer and greater trade. However, that test critically depends on assumptions which include the full employment of labour, full capacity utilization and, apart from tariffs, the absence of serious distortions in member country markets. Under such conditions, prices reflect real opportunity costs, and market forces can be relied upon to provide the benefits contingent on a move towards freer trade.

46. Such assumptions are not applicable to most ESCWA member countries, which suffer from chronic unemployment and underemployment, excess capacity, inadequate utilization of resources and widespread market distortions. In this context, the effects of regional integration based mainly on trade liberalization are at best limited and at worst harmful; without adequate compensatory mechanisms, such a path to integration may accentuate economic disparity between member countries in a phenomenon known as polarization, whereby the more developed and stronger members of the FTA/CU can reap the benefits of liberalized trade at the expense of the weaker partners. Disillusionment with the negative consequences of polarization was one of the main reasons for the less than optimal performance of many regional schemes in Africa and Latin America. On the other hand, the success of regional integration in the Association of Southeast Asian Nations (ASEAN) countries and post-apartheid Southern Africa is attributable at least in part to the fact that the architects of both schemes rejected trade liberalization as the chief organizing principle. From the outset, ASEAN adopted a detailed agreement for establishing designated new plants or industries, coupled with the adoption of tariff or other policy measures to ensure implementation. The financing constraint was dealt with by the creation of the Asian Development Bank.

47. The implications for the ESCWA region are that the design of an effective regional scheme calls for a more deliberate approach in which cooperation and coordination between member countries are emphasized with a view to creating an enabling environment better suited to tackling the fundamental economic problem of the region, namely, unemployment. In that light, it is reasonable to say that the success of the recent effort to establish an Arab free trade area will largely depend on the success of regional coordination aimed at rationalizing production structure at the regional level, creating new opportunities for profitable domestic and foreign investment, and ensuring macro stability through coordination of the monetary and fiscal policies. Closer integration will require joint indemnity schemes as well as regional finances.

C. TRADE AND INDUSTRIALIZATION ISSUES

48. Emphasis on trade liberalization without simultaneous market access and capacity-building investment is premature; and a policy package aimed at a stronger regionalization of national economies is required. Given primary sector domination, intraregional trade accounts for only 7-8 per cent of total ESCWA trade, albeit different countries differ considerably in their reliance on intra-ESCWA trade. Priority, however, has to be placed on industrial capacity-building rather than on global trade development. Market fragmentation in MDEs is often due to intraregional investment priorities in non-tradable sectors, particularly real estate. Similarly, higher per capita incomes generated by oil rents do not foster interest within the Gulf economies in seeking deeper regional integration with MDEs.

49. Because international investors perceive the region as a patchwork of many separated markets interlinked by geopolitical risk, it is essential that intraregional industrial business opportunities and

capacities are developed in order to reap greater welfare benefits from economic policy cooperation, industrial modernization and geopolitical risk amelioration.

50. Development is essentially related to industrialization. A more successful industrial capacity-building campaign should be coordinated by a supranational authority. That authority should initiate new laws and regulations on which, ideally, regional consensus would rapidly be reached before becoming binding. The region must further commit itself to a co-investor role, mixing private and public investment in the physical, technological and institutional infrastructures. Regionally-funded investment guarantees and non-discriminatory region-wide tax incentives would also impact favourably on the region's investment climate. The ESCWA region may further consider launching special economic zones, which often serve as a role model for further integration.

51. Stronger regional governance structures may be the only effective means of reducing exogenous geopolitical risk. Drastic legal and institutional reforms must be undertaken in order to facilitate the free flow of regional capital and trade by modernizing procedures, laws and arbitration systems.

D. Income distribution and unemployment issues

52. High underemployment and public sector employment in the region have functioned as economic stabilizers and partly helped avert chronic pro-cyclical unemployment. However, more can be done by redeploying underemployed public sector resources into disadvantaged regions. Apart from that, the following policies should be considered.

(a) Greater labour intensity is needed in MDEs in order to increase the responsiveness of unemployment rates to economic growth with more incentives and greater support for employment-intensive manufacturing and/or manufacturing processes, while the GCC cluster must reduce labour intensity to ameliorate the large scale importation of labour from outside the ESCWA region;

(b) Income disparities measured in terms of assets such as the distribution of land represent a serious barrier to many skilled individuals who wish to access the credit market but do not possess collateral, lead to lower stocks of human and physical capital and can influence public policy through the preferential tax treatment of asset owners. Redistributive policies and/or creating new assets will activate latent domestic demand and increase supply capacities;

(c) Adjustments must be made between educational system outputs and labour market needs. The mismatch between labour market demand and supply is partly due to educational policies. Educational programmes should take greater note of labour market indicators using collected data; school-to-work training programmes; and the greater sensitivity of vocational training to market needs;

(d) Financial reforms to encourage employment creation should cover banking, the non-bank financial sector, monetary policy, financial openness and the institutional environment. Reforms should focus mainly on longer loans to investors at concessionary rates, fewer monopolies, greater liquidity, credible financial information, the promotion of domestic and intraregional investment, insurance companies, investment funds, and on direct and optimally progressive taxation;

(e) To that end, innovative modalities and increased cooperation are needed. More fully-integrated capital markets to provide project capital and investment funds are required in order to improve the whole infrastructure of the region.

III. SOCIAL CONDITIONS AND SOCIAL POLICIES

53. In the social sphere, the region is still trapped in a vicious circle of poverty, unemployment and violent conflict. Each is reinforcing the other and interacting with other negative parameters, including, inter alia, weak and/or waning social protection systems, non-participatory modes of governance, segmentation, modest growth and a shock therapy approach to economic reform, resulting in serious social aggravation and vulnerable conditions for large parts of the population.

54. Poverty, in its different conceptual configurations, is a serious challenge to both policy and decision-makers. Household surveys reveal clear symptoms of widespread poverty. Proportions of population living below the poverty line were 16.7 per cent in Egypt (1999/2000 survey) and 11.6 per cent in Jordan (1997 survey). In Yemen, a 1998 survey indicated that 17.6 per cent of its population live below the food poverty line, whereas 41.8 per cent are below the consumption poverty line. In Iraq, a 2003 World Food Programme (WFP) survey categorized 54 per cent of households in 16 of Iraq's 18 governorates as poor. It was estimated that 23 per cent of Palestinian households fell below the poverty line in 1998, with an additional 14 per cent in deep poverty.

55. Non-money metric measures of poverty provide a different lens on living conditions other than the income measure. Most ESCWA member countries perform quite well when judged by life expectancy at birth and by infant and under-five mortality rates. However, the literacy rates of the region are still low at only 67.1 per cent for its adult population and 75 per cent for its youth.

SOCIAL POLICIES FOR CONTAINING POVERTY

56. In the space allotted, it is difficult to describe the full spectrum of policies required for the fight against poverty. In the summary below, a two-track approach is provided:

(a) *The personal income channel*: Employment-generating growth presupposes a labour-intensive growth path, with the emphasis on public works programmes and investment in infrastructure, including public housing schemes. It also presupposes creating an environment that enhances remunerative and rewarding employment opportunities through self-employment and micro-enterprises. If employability and/or integrability are to be enhanced, special focus must be given to the improvement of the occupational mobility of unemployed and poor persons; and improved time-space accessibility at minimum cost to emerging job opportunities. For the former, illiteracy eradication and skill development are central. For the latter, essential measures include ensuring structural improvement in employment services; developing an enabling housing infrastructure; paying serious attention to regional inequalities in job opportunity distribution; and reducing barriers to intraregional and intranational labour mobility;

(b) *The social provisioning channel*: Growth- and redistribution-generated resources should be utilized by society in order to provide services for poor and vulnerable persons that enhance their various capabilities. Public protection systems must deal effectively and innovatively with the current realities of high unemployment, widespread poverty, extensive informal employment, recurrence and persistence of macro and/or collective shocks; address risk in both its ex-ante and ex-post form; and regard as interlinked and/or complementary the key programmatic areas of social protection, namely, labour market regulations, contribution-financed social insurance, safety nets and free basic services for all. Revitalizing redistribution through optimally progressive taxation or voluntary transfer will increasingly be an imperative of expanded social protection schemes.

IV. SUSTAINABLE DEVELOPMENT ISSUES

57. Natural resource crisis conditions prevail particularly with respect to water, land and energy. The main factors impeding the sustainable development of water are chronic scarcity, deteriorating quality and unsustainable water utilization, especially in agriculture. For land resources, more than 90 per cent of land in the region is hyper-arid or desert, while the remaining area is classified as "dry". As a result, cultivated land resources comprise a mere 5 per cent of the total land area, representing 22 million hectares of land, with very limited scope for expansion. Land degradation is a major threat with some 73 per cent of the land being lightly to very severely degraded as the result of overgrazing, wind and water erosion, the inefficient use of water resources and political tensions.

58. The region has access to tremendous conventional and renewable energy resources. However, in addition to the likely depletion of such resources, prevailing energy production and consumption patterns in the region are inefficient, and some 20 per cent of the population in rural and urban poor areas do not have adequate access to energy services, which hinders their development opportunities. The region also suffers negative environmental impacts from prevailing practices in energy and water, in addition to those generated by instability.

59. In view of the major environmental constraints, sectoral and intersectoral policies and actions must be promoted in order to reduce the environmental impact of the natural resource sectors. Those may include the following:

(a) Countries should be encouraged to adopt integrated water resource management, including demand management, develop renewable and non-conventional resources, and involve stakeholders in planning and implementing water policies;

(b) Capacities should be built and institutional set-ups improved in order to manage effectively land and water resources and protect biodiversity. There is also a need to intensify efforts to develop water and land-related technologies for irrigation and water desalination, using solar energy technologies, and to develop pollution control measures, including integrated programmes for pest management and the control of chemical pollution. Countries should establish surface and groundwater quality monitoring networks at the national level in order to protect their scarce water resources;

(c) Coastal and marine resource issues should be addressed through the adoption of integrated coastal area management for the sustainable development of the marine environment and resources, including fisheries and aquaculture at national and regional levels;

(d) There is a need to improve and/or establish air quality monitoring and control programmes for mobile and stationary emission sources, and to secure financial resources and state-of-the-art air quality measurement equipment and qualified personnel for data analysis and interpretation. Furthermore, national strategies must be established to improve fuel consumption and energy efficiency and to promote cleaner production schemes in industry;

(e) Governance for sustainable development must be improved through institutional reforms, legal instruments, national and regional agreements and the integration of social, economic and environmental agendas.

V. CONCLUSIONS

60. ESCWA was established with the mandate of enhancing regional economic cooperation. Further integrative measures will attenuate risk and emphasize badly-needed investment in infrastructure development and creating opportunities for generation of economic activities, particularly employment. The institutional barriers to economic cooperation, however, are serious, given combined national, regional and extraregional interests. The fact that little effective progress was made in enhancing the intraregional supply and demand components implies that the interdependency of private and public interest has contributed little to regional market expansion and welfare.

61. A sound policy framework should approach reform holistically: the development challenge should be tackled as a positive sum game to regional players, and achievements should be built on in order to promote a dialogue by which regional tensions are defused. Poor development and the potential for conflict may be mutually reinforced. Member countries clearly stand to benefit more from the political stability and security dividend than they do from a one-time rise in oil prices. Overall, regional policy is best set by emphasizing economic issues aimed at bridging the divide between the private and the public spheres, making the public sector more accountable, encouraging private initiative and investment and rendering institutions more democratic. On the whole, it would be prudent to approach the issue of institutional reform within the sovereign framework of member countries. Nonetheless, the point remains that the contribution to regional welfare from the interdependency of various interest groups must be increased through reallocation and redistributive policies and by streamlining outmoded legal and institutional frameworks.

62. It is indicated that action must begin with investment or with an intraregional treaty that affords extraterritorial rights and protection for regional capital and labour. While an accountable public sector should continue to act as a quasi guarantor of private investment, growth should not be the sole point of emphasis, especially under unstable circumstances. Rather, an integrated approach to development which takes into account the social and sustainability needs is necessary. If current levels of low investment and high unemployment continue, especially in the MDEs, they may prove difficult to reverse when the social consequences become evident.

63. Real or perceived political instability has represented the principal deterrent to the plant and equipment component of foreign and regional investment. Knowledge and technology have contributed less and less to economic growth as the result of lower investment rates. In circumstances of political instability and the consequent institutional underdevelopment, economies have not captured the core element of rising productivity and have become more susceptible to ad hoc shocks and fluctuations. Political instability, moreover, has focused development efforts on stabilization, drawing resources away from social and economic capital into “political capital” in order to attain greater political stability, which may have distorted income distribution and wealth. Accordingly, a development policy is needed that emphasizes reconstruction, one that promotes

both physical and human capital for development, and institutional modernization for greater efficiency. The optimal strategic policies should be based on common welfare gained through economic integration and redistributive social policies. The translation of overall development into greater stability and security is one modality upon which economic policy should be based. If institutions are reformed and the region made more receptive to intraregional capital and labour flows, investment rates will increase, economic growth will accelerate and some surplus labour will be absorbed. The current oil price boom represents an opportunity for reform and for greater financial and economic development that could resolve the region's long-term crisis with respect to employment and low growth, as well as providing opportunities for appropriate conservation schemes for the region's natural resources and its latent wealth endowment.