

Executive Summary

Augusto Lopez-Claros

The Arab world finds itself at a critical crossroads. Population growth has pushed unemployment rates to some of the highest levels in the world, and brought into sharp relief the urgent need for a reorientation of economic policies. Reforms are essential to engender a process of sustained job creation, well into the next decade, if the region is to avoid the inefficiencies associated with poor utilization of human resources, to say nothing of the social and political costs. The call for urgent action is underscored not only by the burgeoning pressures on labor markets, but also the resurgence of other major emerging economies—in China, India, and central and eastern Europe, to name a few—whose presence in the global economy is quickly expanding, against a background of sustained improvements in per capita incomes, institutional development and international competitiveness. To remain viable in the global economy in areas other than the energy sector, it is vitally important that the Arab countries improve the overall quality of governance, significantly raise their levels of competitiveness, improve macroeconomic management, institute reforms to enhance the efficiency of public sector institutions and, facilitate the absorption of new technologies.

The *Arab World Competitiveness Report 2005* is a contribution to the debate on the policy requirements for implementing a new vision for the Arab world. In centuries past, the Arab world was a thriving centre of knowledge, learning and innovation. Its peoples long ago demonstrated their capacity for enlightened, creative engagement with the rest of the world, in ways that left an indelible mark on the course of civilization. A gradual return to that golden age requires a clear comprehension of the problems and challenges, which the region faces today, an acceptance of the need for change, and the formulation of viable paths of reform. In their own ways, the various articles contributed to this Report may be seen as part of that process of search for creative solutions. Written by experts with particular insights into the region, they aim to enlighten us and to point the way, each speaking in his or her own voice.

Governance, Competitiveness and the Arab Future

Ismail Serageldin is a leading academic, who, in an earlier incarnation as a Vice-President of the World Bank made seminal contributions to the identification of the

fundamental intellectual building blocks of good governance, and who deserves credit for attempting to persuade the development community of the central importance of accountability, the rule of law, and participation to successful development. In his paper “Governance, Competitiveness and the Arab Future,” he brings his expertise to bear on the formulation of a new vision for the Arab world. He examines the meaning of *governance*, its ten key components of transparency, accountability, pluralism, participation, the rule of law, the free flow of information, democracy, respect for human rights and gender equality, and a learning environment that respects and nurtures the innovative spirit of young people. Serageldin outlines his concept of *sustainability as opportunity* and the importance of social capital for good governance. He draws our attention to the mistakes made during another period of globalization, the industrial revolution, and shows how it is possible not to repeat them.

As a well-informed and enlightened advocate, he argues the case for the Arab world, and illustrates the multi-dimensional processes aimed toward political, social, and cultural reforms, offering a number of recommendations for Arab governments to effect change. These include, among others, establishing credible macro-management of the economy, developing flexible institutions, investing far more in human and social capital, facilitating the flow of knowledge and information, enhancing inter-Arab cooperation, and passing enabling legislation which allows civil society to flourish. Concise, coherent, imbued with a sense of idealism, and firmly anchored in practical experience, Serageldin presents nothing less than a new vision for the Arab world. He devotes particular attention to the importance of a revitalized and mobilized civil society, and to demonstrating how it is gradually becoming conscious of its role, and beginning to work side by side with government to bring that vision to life.

The Arab Economic Reform Agenda

Mustapha K. Nabli, Chief Economist at the World Bank for the Middle East and North Africa, is singularly well-qualified to write about economic reform in the Arab region. The World Bank is a rich source of insight and experience on the policy requirements of successful development. Its counsels are not always heeded, but its prescriptions, based on decades of empirical observation in virtually every corner of the globe, deserve careful consideration. In his paper “Restarting Arab Economic

Reform,” Nabli begins by arguing that the development community has come to appreciate how difficult structural reform really is. Economic policy reform is a deeply political issue, affecting the balance of power between actors in society, identifying the economic rents that have built up over the years and cutting them back, attacking the economic privilege that certain segments of the population have enjoyed for generations and continue to reap from the status quo.

The Arab reform experience exemplifies the difficulties in actually implementing structural reform. Beginning in the mid-1980s, when several early reformers in the region, Egypt, Jordan, Morocco and Tunisia, all embarked on a broad range of macroeconomic policy and structural reforms, there was great optimism for change in the region. These hopes were heightened when other countries in the region followed suit. Now, however, two decades after the nascent reform movement, observing the subsequent slowdown in the pace of change, and the inability to tackle deeper and more fundamental social and political arrangements and distortions of governance which inhibit growth, those in the development community must contend with the myriad background forces which are slowing the pace of policy reform.

In Nabli’s view, many factors have stalled the reform effort in Arab economies. Soft budget constraints and weaknesses in governance have both contributed to a lack of momentum in carrying forward reforms needed for higher and sustained growth. The region’s continued reliance on oil, aid and other strategic rents has allowed it to delay implementing deeper and more difficult reforms. Moreover, the lack of accountability and inclusiveness in governance mechanisms has prevented the emergence of coalitions for reform in the region, a central element of successful reform programs. International experience can provide helpful insights into how to lock in reforms and build on successes. Echoing the broad vision offered by Serageldin, Nabli points to the importance of the structural and procedural reform of governance in the Arab world, which will release the potential of effective coalitions to unite behind change.

Private Sector Development

Tarik M. Yousef’s contribution “Structural Reforms, the Investment Climate and Private Sector Development in the Arab World,” is an excellent complement to the paper

by Nabli, with its focus on the role of government in furthering the economic reform agenda. Yousef's paper focuses on the prerequisites for nurturing the development of a more active private sector, one that is capable of making a larger contribution to employment and growth. He notes that the 1990s provided the Arab economies with a window of opportunity to rebound from the oil bust of the 1980s, onto a new trajectory of rapid economic growth, founded on market-oriented development strategies. Economic stabilization was either complete or far advanced in the majority of countries. What remained to be implemented or accelerated was the structural reform agenda, with the principal goal of reinvigorating the private sector, enabling it to become the engine of economic growth, job creation, and integration into the global economy. Reforms included many that are now familiar markers of economic restructuring: privatization of state-owned enterprises, fiscal reform and trade liberalization, and strengthening of the institutions of a market-led economy.

As Yousef explains, however, the implementation of reforms has been uneven, hesitant, and incomplete. The expected emergence of a vibrant private sector was stifled by the size and scope of government intervention, weak systems of governance, and limited progress in integrating the region into the world economy. Thus, it is the slow pace of economic reforms in general, coupled with a poor investment climate, which largely explains why the contribution of the private sector to output, investment and employment has been so disappointing. As a result, the economic recovery of the 1990s did not bear fruit, labor productivity remained low, and unemployment rates continued to soar. The inaction of Arab governments during the critical period of the 1990s now makes immediate acceleration of the reform agenda even more imperative; the need to reinvigorate the private sector, he says, is even more pressing today than it was a decade ago. In his welcome review of the basics of private sector development, Yousef concludes that, if the transition from public sector- to private sector-driven economies is to take place, there will have to be major improvements in the investment climate, and better governance throughout the region.

Foreign Direct Investment in Arab Countries

There is broad consensus among students of the Arab world that a key component of addressing the grave

unemployment problem in the region is a major boost to trade and investment liberalization. Not only is there evidence that these have been a central source of growth and job creation for the global economy in past decades, but there now exists a large body of helpful and relevant practical international experience showing how countries can best go about doing it. In their paper "Foreign Direct Investment in the Arab World: Exploiting the Potential," Andrea Goldstein and Ludger Odenthal tackle one aspect of this issue: the extent to which Arab countries have yet to fulfil their potential in attracting adequate levels of FDI.

Affiliates of global transnational corporations (TNCs) play a much less visible role in their economies, as compared to those of other regions. The relative stagnation of FDI flows is even more remarkable against the backdrop of the long-standing Arab tradition of hosting foreign TNCs—especially those from the United States—many of which were attracted by the region's natural resources, and invested in the region much earlier than in other parts of the world, in particular in the Gulf States. However, this early presence did not set the stage for later promotion of FDI in the 1980s and 1990s, and its low levels are not helping the countries to modernize and steer their economies away from an undue dependence on oil and gas resources.

Once again, Goldstein and Odenthal echo the warning that if the Arab countries are to become more attractive to FDI, they must be proactive in making themselves investor-friendly, by making the business environment more open, and stepping up structural and institutional reforms. Particular attention should be paid to the creation or improvement of adequate market institutions, as well-sequenced reform in these areas would help bridge the Arab world's "private investment gap," facilitate the influx of new technologies, increase access to international markets, and create desperately needed new employment opportunities. Since the governments in most Arab countries now acknowledge the need for such a strategy, they must take the lead, in partnership with the private sector. The success that some have already achieved proves that Arab countries can reverse the negative trend and become attractive targets for FDI. In this process, the authors argue, the Arab countries could receive considerable support from the multilateral institutions with the relevant technical expertise, including the OECD, UNCTAD, and the World Bank.

Women in the Arab Region: Preparing for the Future

Over the past two decades, Arab societies have undergone dramatic transformations in demography, politics, culture, and economic development strategies. The population has almost doubled in number; national identities have taken shape, and a growing number of educated, middle class men and women are questioning the nature of their engagement in the public space, grappling with the distinction between modernity and Westernization. At the same time, new economic and political realities, particularly in the aftermath of September 11, pose unprecedented challenges to the region. No issue epitomizes this dilemma better than gender relations, which, in the Arab region more than anywhere else, are highly politicized, and must be addressed if the region is to reach its full potential.

In an insightful and admirably argued paper, “Women in the Arab Region: Learning from the Past, Preparing for the Future,” Shaha Ali-Riza makes a persuasive case that empowering Arab women, by reforming repressive and discriminatory laws, and encouraging and facilitating their participation in economic and political life, will yield benefits that go beyond women and benefit Arab societies far more broadly. Quite apart from their contribution in the labor force, women’s active participation in state, social, and economic institutions helps to introduce new ideas and innovation into the region’s development process, and contributes to overall better governance by increasing institutional responsiveness and accountability. At the same time, denying or restricting the participation of women—half of the region’s population—legitimizes inequity, and reinforces restrictions on the population as a whole by denying citizens the opportunity to participate in shaping their country’s and their own future. Addressing the participation of women in the public sphere, therefore, has to become an integral part of the broader measures considered by the governments for developing the region and modernizing the state and society.

It is noteworthy that the Middle East and North Africa region has invested impressively in women’s education in recent years, increasing their productive potential and earning capacity. However, obstacles to women’s increased participation in the labor force—which still remains the lowest in the world—suggest strongly that the

region is not benefiting from the potential returns on this investment. The author surveys the complex subject of gender equality in three interconnected sections, first outlining women’s current social, economic, and political status in the Arab region, and following this with a review of how some Arab governments and organizations have attempted to influence the status of women, pointing to several noteworthy achievements, as well as setbacks. In the third section, she identifies the relationship between good governance, with its emphasis on inclusiveness, transparency, accountability and the rule of law, and emphasizes the critical role of civil society in helping to achieve gender equality. Ali-Riza concludes that women’s participation has become a critical part of the much-discussed broader reform agenda. By showing how releasing the potential of half the population in Arab countries will contribute to the betterment of their societies, she makes a valuable contribution to understanding one of the fundamental challenges facing the region.

Government Expenditure and the Economic Development of Women

The paper by Nicole Laframboise, entitled “The Impact of Government Expenditure on the Economic Development of Women in the Middle East and North Africa,” is an excellent complement to the insightful analysis carried out by Ali-Riza. Laframboise begins by noting that the under-utilization of Arab women’s capabilities has been cited as an important factor in the region’s poor economic performance. Evidence of the negative effects of gender inequality in education and health on economic growth and development has been documented significantly in the literature. Empirical studies have shown that investment in human capital is associated with improved economic performance, and that population growth depresses it. The aim of her study is to examine the effect of public social spending specifically on the health and education status of women in the MENA region. Her comparison of the MENA region with other country groups highlights strongly the opportunity costs of *not* exploiting the economic and human potential of women. She presents a survey of descriptive data on government social spending and health and education indicators (aggregated by geographic region), showing that the health and educational status of women in the MENA region are not only among the lowest in the world, but, most notably, not consistent with data on income in the

region, and not explained by the amount of government spending in the region.

The empirical research reported in Laframboise's paper tested the explanatory power of public social spending on key social indicators for women. She tests the intuitive policy assumption that higher social spending correlates with a better social outcome. In line with earlier research, she found that the effect of government social spending on women's social indicators was not statistically significant when country specific social and economic factors were introduced. Together with the descriptive data, she concludes that since the poor performance in women's social indicators in the region, particularly in the area of education, is not explained by the amount of government spending, the answer must lie in the effectiveness and reach of existing spending. Consequently, any policy efforts to raise the social outcomes for women should consider first how to allocate existing resources more efficiently and equitably. Laframboise's study is an excellent example of how good empirical research can help us gain a better understanding of a key public policy issue, and we are very pleased to present her findings in this volume.

Labor Markets in the Gulf States

As noted at the outset of this Summary, job creation remains the key economic challenge facing Arab countries. In his paper "Labor Markets in the Gulf States: Prospects for Reform" Peter Cappelli starts by arguing that all economies face a challenge in creating enough jobs for their population, but the challenge facing the Gulf countries in this regard are especially complex. These countries experienced a period of unprecedented growth based on oil revenues over the past 50 years, suggesting to some that the usual rules of economic development need not apply. They imported labor, low-paid and low-level, to take over many of the jobs that their booming economies created. However, recent population increases are far in excess of the ability of oil revenues to sustain the labor markets in these countries, and all of them are rethinking the prospects for the future.

Exactly how to create the jobs that are needed in a society is, in part, a question of economic development, but growth rates alone are unlikely to be able to meet the demand. These countries are also wrestling with the question of expatriate labor and the distortions it has

produced in labor markets over time. In his paper, Capelli, who writes with considerable authority on this subject, considers approaches for expanding job opportunities in the Gulf States by shifting jobs away from expatriate workers and toward natives, in addition to the more general changes required to enhance competitiveness by opening labor markets. His is an important contribution to what is likely to be at the center of policy discussions in the Arab world in coming years: how to formulate labor market policies to boost job creation to the point that it begins to make a tangible difference on unemployment levels.

The Gulf Cooperation Council and Regional Integration

No doubt reflecting the experience of the EU over the past five decades—including the successful inclusion of ten new countries in May of 2004—regional integration has come of age. The forces of globalization have enhanced international interdependence, such that there is increasing recognition that a growing share of the problems confronting governments can no longer be solved at the level of national policies, but require formal mechanisms of cooperation linking nations. The paper "Yemen and the Gulf Cooperation Council: Prospects for Regional Integration," by Saade Chami, Selim Elekdag, and Ivan Tchakarov, attempts to assess the long-run economic implications of Yemen's accession into the Gulf Cooperation Council (GCC). To quantify these implications, the authors use a variant of the IMF's Global Economy Model (GEM), which posits monopolistic competition in both the goods and labor markets in the region. Monopoly power is represented by different mark-ups, which are inversely related to the substitutability across goods, and hence the underlying degree of competition. After calibrating the GEM to Yemen and the GCC, they investigate how regional integration, by intensifying competition, affects long-term economic performance.

Although quantifying these long-term benefits is subject to a great degree of uncertainty, their simulations indicate that the potential gains from regional integration could be substantial. Taking into account the salient features of the region—a more rigid labor market in the GCC and a more concentrated goods market in Yemen—economic integration could increase real GDP in Yemen and in the GCC by up to 12 and 6 percent, respectively, in the long

run. Moreover, increased market competition would lead to sizable positive spillovers, raising consumption, investment, and employment throughout the region. These results are highly significant, and lend support to the thesis that the benefits of integration—so clearly evident in the EU—12 out of 20 of whose member countries have the highest per capita income in the world—are likely to benefit other country clusters as well, regardless of their stage of development.

Investing in Entrepreneurship

In her paper “Leveraging Liquidity in the Arab World: Investing in Entrepreneurship,” Florence Eid presents some creative proposals for tackling the region’s pervasive job shortfalls. Echoing the concerns expressed by Cappelli, Ali-Riza and other authors about the gravity of this problem, she begins by arguing that the Arab world, due to a host of factors, is experiencing a period of high liquidity growth that is likely to be sustained over several years, and that this period coincides with the urgent need for job creation in the region, and the need to significantly boost FDI inflows, to allow the region to benefit from the technology transfer and the know-how that it brings. Meanwhile, efforts to develop private equity finance in some countries in the region—admittedly from a low base—are yielding job creation rates up to *five times* the average rate of labor market growth in those countries. She argues that Arab countries can best leverage the current period of high liquidity by creating sustainable institutions for financing entrepreneurship at all levels of the labor market, from low- to high-skilled.

Drawing on insights delivered by a regional private equity industry survey, she presents a series of recommendations, intended to advance a new generation of reforms to promote entrepreneurial finance, building up its high job-creation potential for emerging markets. Requisite reforms include proactive new financial institutions and incentives, financial instruments such as private equity funds, and an array of complementary educational programs, bringing the business and educational sectors into closer cooperation. The task of providing the right macroeconomic and regulatory environment for the private sector is no less important, but, as she states convincingly, it is no longer sufficient. Her paper also shows how positive developments in entrepreneurial finance in several countries in the region have awakened strong interest in recent years at leading

business schools and in the international financial sector in fostering innovation and creativity in the upcoming generation of entrepreneurs, in furthering ideas, designing educational programs, and creating funds that promote the study and practice of entrepreneurship. These factors explain the growing attention to the arguably “old” concept of entrepreneurship, despite the recent weakness in equity markets.

Confronting the Challenges of Liberalization and Reform in Bahrain

The paper “Confronting the Challenges: Liberalization and Reform in Bahrain” by Sulaf Zakharia is an excellent overview of how the political leadership in a country not otherwise known for vast natural resource endowments can, through sustained policy implementation, make major strides in improving its business environment and overall levels of competitiveness. Zakharia notes that the high oil prices of the 1970s and 1980s shaped the Arab economies, either directly through oil revenues—as in the case of the oil-exporting countries—or indirectly, through worker remittances and intraregional aid, resulting in rapid economic growth in the region lasting over two decades.

Arab economies are characterized by state-led economies, with governments investing heavily in infrastructure development, large industrial projects, and the provision of services to the public. The oil price decline that began in the mid-1980s and continued well into the 1990s placed fiscal and political pressures on many Arab governments, with their one-sided dependence on hydrocarbons. With underdeveloped private sectors and declining integration in the global economy, Arab countries were forced to think about political and economic reform. Zakharia describes how Bahrain, a small, relatively resource-poor country in an otherwise oil-rich region of the world, made particularly impressive efforts to tackle political and economic reform. While these issues are in no way unique to Bahrain, that country’s assertive stance in dealing with them, employing a rigorous, fast-track approach to reform implementation, has particular significance for the rest of the region.

Bahrain began by implementing a process of political reform, through which it rapidly transformed itself from a sheikdom to a constitutional monarchy. Its approach to economic development has been equally assertive, and

this small country has already implemented fundamental labor market reform, fully liberalized its telecommunications market in a record 18 months, realized a privatization program which is still in full swing, and continued to open its market through multilateral and bilateral trade agreements. Zakharia's paper gives readers cause for intelligent optimism: policies matter a great deal for economic outcomes, and Bahrain's example is an encouraging message for the region.

Economic Freedom

The paper by Salem Al Ismaily, Amela Karabegović and Fred McMahon, "Economic Freedom of the Arab World," is an attempt to particularize to the Arab countries earlier work done at the Fraser Institute on the creation of an Economic Freedom Index for the world, which has been published annually since 1996. While the latter index has already included several Arab countries in its coverage, the authors cast the net wider and, reflecting data limitations and other factors intrinsic to the region, adapt the methodology to an index that measures economic freedom in a set of 16 Arab countries. They do this in a way that is very respectful—in methodological terms—of the original work done for the broader index. The motivation for doing this is obvious: empirical studies have shown that economic freedom promotes growth, prosperity, and leads to other positive outcomes. The index presented is, thus, a useful benchmark for tracking progress over time, both in terms of each country's individual prior history, and in relation to the progress made by others in the categories tracked by the index. We are pleased to include this new index in this *Report* and regard it as a useful and practical tool to focus the attention of policymakers, the business community, and the general public on the tasks ahead.

An Arab Renaissance

In their paper "Partnership for Global Integration and an Arab *Renaissance*: The Role of the Arab Business Council," M. Shafik Gabr and Khalid Abdulla-Janahi present an eloquent overview of the key problems confronting the region, and the role that the Arab Business Council is playing in helping to address them. They state at the outset that poor governance, education and investment are hampering progress in the Arab region. There are deficits in knowledge creation and

dissemination, freedom and women's empowerment. Moreover, per capita incomes have stagnated, underperforming all regions except sub-Saharan Africa. Unemployment rates stand at 15 per cent—perhaps 30 per cent for those under 24. Weak technology, innovation, and governance have discouraged entrepreneurship and investment.

Despite this, and in view of the region's rich cultural and scientific heritage, the authors see no reason to regard this condition as inevitable. In earlier times, the Islamic world sustained and advanced ancient learning and laid the foundations for the Italian *Renaissance*. The authors note that publication of the first *Arab World Competitiveness Report* in 2002 shocked the Arab business community and prompted the birth of an Arab Business Council (ABC), for the express purpose of promoting greater competitiveness in the region. As evidence of its achievements in furthering this goal, the ABC now has 77 members from 16 Arab countries, and hopes to reach 100 members from the foremost companies in all 22 countries.

Council Members have developed a *Blueprint for Economic Reform* and helped launch an Egyptian National Competitiveness Council. They are working with Jordan, Bahrain and Morocco to create similar bodies and joined the Alexandria Library in organizing a Conference on Reform that led to the *Alexandria Declaration*. The ABC has been received well by Arab political leaders, who have appointed ministers to coordinate policies with the Council. It has engaged with Asian business leaders, the G-8 and the OECD. Several of its members presented an *Agenda for Development* to the *G-8 Forum for the Future*, and the Council is working with the G-8 and OECD on a regional Investment Task Force. Aiming to become an engine for the promotion of better policies, the ABC has called for an Arab *Renaissance*. It argues, convincingly, that Arab leaders must themselves develop the skills, policies and institutions to compete globally. They urge Arab business and civil society leaders to work with their governments to bring about change, and welcome the assistance of the G-8 and OECD in making the region peaceful, competitive and prosperous. The paper by M. Shafik Gabr and Khalid Abdulla-Janahi is a compelling description of the challenging agenda, and presents an impressive example of the success that effective partnership can achieve.

Measuring Competitiveness in the Arab World

In their chapter “Measuring Competitiveness in the Arab World: Current Prospects and Obstacles to Growth,” Jennifer Blanke and Augusto Lopez-Claros of the World Economic Forum assess the competitive performance of 12 Arab countries: Algeria, Bahrain, Egypt, Jordan, Lebanon, Morocco, Oman, Qatar, Saudi Arabia, Tunisia, United Arab Emirates (UAE) and Yemen. The authors use the well-established *Growth Competitiveness Index* (GCI), which aims to gauge the ability of economies to attain sustained economic growth over the medium to long term, controlling for present levels of income. This chapter thus provides insight into the growth prospects for Arab world countries, identifying the strengths as well as the obstacles to making sustained improvements in competitiveness. The study is an early attempt to present indicators of competitiveness for Arab countries, and to assign them an international ranking.

The economics literature identifies a number of factors which contribute to a country’s ability to grow on a sustained basis. Taking these insights into account, the GCI measures three areas that are critical to the growth process: the macroeconomic environment, the quality of public institutions, and the state and usage of technology. Of the 12 countries assessed according to these criteria, Qatar is ranked first in the region, followed closely by UAE and Bahrain. In other words, as measured by the GCI, the small Gulf States are found to be the most competitive of the countries under assessment, with healthy macroeconomic environments, strong public institutions, and governments that seem to be well launched on the path to modernization.

The authors conclude that while much still remains to be achieved to improve the competitive performance of the region as a whole, there is reason for cautious optimism. Within several countries in the region, good policies are rapidly taking root, with tangible benefits increasingly in evidence. These countries can serve as benchmarks for other economies in the region, as points of reference in their efforts to improve their business environments, as part of a process of healthy competition, which may well involve many positive synergies to improve their competitiveness.

The *Report* ends with a section containing detailed country profiles for the economies covered in our *Growth Competitiveness Index*, as well as data tables for the variables that are used as inputs in their construction. A brief section, explaining how the information contained in the country profiles and the data tables may be interpreted, is an essential companion to this section, as are technical notes clarifying the meaning of many variables, and listing relevant data sources.