

ECONOMIC AND SOCIAL COMMISSION FOR WESTERN ASIA

**SURVEY OF ECONOMIC AND SOCIAL DEVELOPMENTS
IN THE ESCWA REGION
2006-2007**

SUMMARY

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The ESCWA region marked another year of robust economic expansion, with the exception of Iraq, Lebanon and Palestine, where regional conflicts and political instabilities reduced significantly the economic potential of these ESCWA members. The recent favourable external economic condition, represented by high oil prices, continued to buoy the region. While a deceleration of GDP growth rate was observed, the level of growth was still high in most ESCWA member countries in 2006. Average GDP growth for the ESCWA region was an estimated 5.6 per cent for 2006, down from 6.9 per cent in 2005, which is forecasted to decrease to 5.1 per cent in 2007.

In the two decades between the first and this second oil boom, the region exhibited negative average real per-capita growth rates, rising unemployment rates, and a growing gap in income distribution within and across the countries of the region. With lower oil rents, the rate of funding to the social infrastructure retreated causing, in one instance, the quality of education to decline. Additionally, investment rates fell to a low 16 per cent in 2002, and productivity per worker was on average somewhere between steady and declining, while intraregional trade remained low between 7 and 8 per cent. On the whole, however, the ESCWA region remained an excess saving region where extra funds were continuously channelled abroad for reasons of low absorptive capacity or regional security considerations. While the current oil boom represents a welcome occurrence to entrench the welfare gains of high growth, it comes with rising regional tensions. This translates into a pervasive threat of conflict that could add to the stresses of national institutions, which represent the very institutions that are charged with the process of development. There is a pressing need to enable the national agencies for development to avert the long- and short-term effects of the “resource curse” whereby the abundance of natural resources undermines overall economic performance and the competitiveness of the tradable sector, and the effects of the “Dutch Disease”. The theme of the Survey this year is to draw lessons from the previous oil boom and to chart the policy landscape in search of alternatives capable of retaining financial and human resources in order to meet the requisites of development as a human right and to achieve the Millennium Development Goals (MDGs).

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I. RECENT ECONOMIC TRENDS AND DEVELOPMENTS IN THE ESCWA REGION

A. THE GLOBAL CONTEXT

1. The world economy kept its expansionary track in 2006, albeit at a decelerating rate of growth towards the end of the year. The current growth was broad-based as being positive for both developed and developing economies, though its linkage to employment creation has still been weak. The robust demand growth continued to enhance the stable growth in the world flows of goods, services and capital. Moreover, institutional reforms of developing countries have marked its impacts to support the level of world demand.
2. The growth of global liquidity, which had peaked in early 2004, bounced back in early 2006. Despite the monetary tightening trend by central banks in developed countries, continuous rise in world commodity prices created an ample cushion in the world expansion of credit. The narrowed spread between policy interest rates and long-term bonds was observed in most developed countries and some developing countries. The global imbalance, represented by expanding current account deficit of the United States of America, has continued to be supported by strong demand for the financial assets of that country. The demand for United States treasury bonds grew from China and oil-exporting countries, which accumulated their foreign reserves.
3. More signs of inflationary pressure emerged in 2006. For some countries, it was comparatively benign, first-round effects of higher commodity prices, particularly of oil products. However, the general hike in commodity prices caused moderate increase in the price of basic food stuff. Moreover, some developing countries saw the rapid domestic demand expansion with home-grown inflation stemmed from the rapid rise in housing prices and corresponding rents.
4. In this global context, the ESCWA region marked another year of robust economic expansion, with the exception of Iraq, Lebanon and Palestine, where regional conflicts and political instabilities reduced significantly the economic potential of these ESCWA members.* The recent favourable external economic condition, represented by ample global monetary liquidity and high oil prices, continued to have an effect on the region. Specifically, this set of external factors, together with various efforts of intraregional cooperation, helped to minimize adverse effects and consequences of conflicts and political instabilities that would otherwise have been more devastating to and increased the vulnerability of the region.

B. OIL SECTOR DEVELOPMENT

5. The world demand for crude oil continued to grow in 2006, albeit at a more moderate growth rate than in 2005. The rebound in growth rate was largely expected from strong demand growth from North America and China at the beginning of the year. However, the projection of demand growth was successively cut as a result of sustained weaker demand from North America and developed countries throughout the year. The high oil prices encouraged those developed countries to switch their fuel sources to natural gas. Moreover, while strong demand growth was observed in China and other developing countries, overall demand growth in crude oil was moderate in 2006.
6. Despite the weaker than expected demand growth, the crude oil prices stayed in the range of a historical high. The crude oil price of the Organization of Petroleum Exporting Countries (OPEC) reference basket averaged at \$61.08 per barrel in 2006, compared to \$50.64 in 2005. The tight supply-demand condition in fuel products remained as the bottleneck at refinery capability stayed unresolved. Moreover, owing to the ample global monetary liquidity, the speculative factor caused a rapid price hike till the

* The ESCWA region consists of two subregions, namely: (a) countries of the Gulf Cooperation Council (GCC): Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and United Arab Emirates; and (b) countries and territories categorized as more diversified economies (MDEs): Egypt, Iraq, Jordan, Lebanon, Palestine, Syrian Arab Republic and Yemen.

summer, which was followed by a rapid plunge towards the end of 2006. The OPEC reference basket is projected to average at \$55 per barrel in 2007.

7. The total world crude oil supply inched up to 84.7 million barrels per day in 2006, from 84.1 million barrels per day of the previous year. This increase can be attributed to the production of non-OPEC oil producers. Having allowed its members to produce at maximum in the last quarter of 2005, OPEC shifted its policy to reduce the crude oil production of its members. Total OPEC crude oil production was at 30.9 million barrels per day in 2006, compared to 31.1 million barrels per day of the previous year.

8. Following this trend, the total crude oil production of ESCWA member countries declined slightly in 2006 from the level of 2005 to 19.4 million barrels per day. However, as oil prices stayed high, this resulted in an increase of 25.7 per cent in gross oil export revenues to \$401 billion as a total for the ESCWA region.

C. OUTPUT AND DEMAND

9. The growth of growth domestic product (GDP) stabilized at a high end in both subregions that form ESCWA, namely the countries of the Gulf Cooperation Council (GCC) and the more diversified economies (MDEs). While a deceleration of growth rate was observed, the level of growth was still high in most ESCWA member countries in 2006. Average GDP growth for the ESCWA region was an estimated 5.6 per cent in 2006, down from 6.9 per cent in 2005, and is forecasted to be 5.1 per cent in 2007.

10. A robust growth in domestic demands was observed in the region in 2006, with the exception of the conflict-stricken countries and territories of Iraq, Lebanon and Palestine. The feared negative wealth effect, stemming from violent adjustments in stock markets in the region in early 2006, has not been observed yet to a significant degree. Recent rapid increases in fiscal expenditures in most ESCWA member countries sustained domestic demands and offset factors that dented business and consumer confidence.

11. On average, GDP growth in the countries of the GCC was estimated at 5.9 per cent in 2006, after registering 7.3 per cent of 2005. While crude oil production and exports were the key factor for economic growth in the GCC, the development of non-oil sectors contributed to stabilizing overall economic performance. The development of non-oil sectors has been crucial for resilient growth in domestic demands in those countries in the present oil-boom. Financial services and construction sectors led the non-oil production growth, thereby creating more linkages among supply-demand structures of the economy. The development of these linkages was observed in most countries of the GCC, which contributed to stabilizing GDP growth rate in this subregion.

12. Average GDP growth in MDEs was an estimated 5.1 per cent in 2006, after registering 6.0 per cent in the previous year. MDEs continue to remain well away from potential foreign exchange constraints that could otherwise hamper the growth of domestic demands. In Egypt and Jordan, the strong confidence in business and consumption was also proved in faster recoveries in stock market performance. Industrial sector has been developing at a constant pace, mainly in the apparel sector in Egypt and Jordan. Construction sector was strong in this subregion, thereby reflecting high inflows of foreign capital as well as an increase in fiscal capital expenditures.

13. The trend was not shared by the conflict-stricken countries and territories of Iraq, Lebanon and Palestine, where security pressures pushed down business and consumer confidence. This weak prospect for demand growth will put GDP growth projections to a lower range. While additional economic activities related to reconstruction efforts were expected, their contribution to overall GDP growth are set to be limited in those ESCWA members in 2007.

ECONOMIES OF THE ESCWA REGION: RATES OF ECONOMIC GROWTH AND INFLATION, 2003-2007
(Annual percentage change)

Country/area	Real GDP growth ^{a/}					Inflation rate ^{b/}				
	2003	2004	2005	2006 ^{a/}	2007 ^{b/}	2003	2004	2005	2006 ^{c/}	2007 ^{d/}
Bahrain	7.2	5.6	7.8	6.1	5.5	1.6	2.4	2.6	2.0	3.0
Kuwait	16.5	10.5	10.0	6.5	4.9	1.0	1.3	4.1	3.6	3.0
Oman	2.0	5.4	5.8	6.4	5.1	0.2	0.4	1.2	3.1	2.0
Qatar	3.5	20.8	6.1	7.0	7.4	2.3	6.8	8.8	11.1	8.0
Saudi Arabia	7.7	5.3	6.6	4.2	3.8	0.6	0.3	0.7	2.3	1.0
United Arab Emirates	11.9	9.7	8.2	8.9	6.0	3.1	5.0	6.2	7.7	5.0
GCC countries	8.9	7.7	7.3	5.9	4.8	1.3	1.9	2.9	4.2	2.7
Egypt	4.1	4.5	6.8	6.8	5.8	4.2	16.5	4.8	7.7	6.2
Iraq ^{e/}	-33.1	23.0	10.0	8.0	7.0	33.6	27.0	37.0	53.2	66.4
Jordan	4.2	8.4	7.2	6.4	5.3	1.6	3.4	3.5	6.3	5.7
Lebanon	3.0	5.0	0.0	-5.0	6.0	3.0	1.7	-2.6	4.5	3.0
Palestine	8.5	2.0	4.9	-6.9	1.0	4.4	3.1	3.5	3.8	1.8
Syrian Arab Republic	1.1	8.6	4.5	5.0	5.6	4.8	4.6	7.9	10.0	14.4
Yemen	3.8	3.9	4.6	4.2	4.3	10.8	12.5	11.8	15.5	13.1
More diversified economies	-0.2	6.4	6.0	5.2	5.7	6.5	13.3	7.5	12.0	12.5
Total ESCWA region	5.7	7.3	6.9	5.6	5.1	3.0	5.6	4.4	6.7	5.9
Conflict affected economies ^{d/}	-13.9	11.4	4.6	0.4	6.0	14.6	12.2	15.2	26.9	32.9
ESCWA region except conflict affected economies	7.4	7.0	7.0	6.0	5.0	2.2	5.1	3.7	5.4	4.1

Source: ESCWA, based on computations of growth rates from real GDP figures at constant 2000 prices. The latter are taken from national sources and official figures as provided by answers to questionnaires of *National Accounts Bulletin of the ESCWA Region*, number 26.

a/ ESCWA estimates, February 2007.

b/ ESCWA projections, February 2007.

c/ Iraq rates are based on official sources except for 2005 and 2006, which are EAD estimates.

d/ The average of Iraq, Lebanon and Palestine.

e/ 2006 estimates are based on official preliminary figures.

f/ IMF, World Economic Outlook Database, September 2006.

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

D. COSTS AND PRICES

14. The increase in the general price level accelerated in 2006. The average inflation rate for the ESCWA region stood at 6.7 per cent in 2006, representing an increase from 4.4 per cent in 2005. The high international commodity prices raised the general price level of the region. The items affected included crude oil, metal, construction materials and crops. Despite the modest contribution of these items to the cost of living in 2006, the price increase in these basic items had significant impacts on poorer segments of society in the region. Moreover, the increase in rental prices for accommodation became significantly high in some countries of the GCC. While the hike in rental prices reflected partly a demand in respective domestic economies that had grown excessively, it also reflected such non-economic factors as legal structures concerning the ownership of accommodation.

15. Iraq continued to suffer from high inflation rate, which was estimated at 53.2 per cent in 2006. The shortage of goods and services under severe security pressures, the changes in price system and international factors contributed to the high inflation rate of that country, despite sound monetary and fiscal policies. Other conflict-stricken ESCWA members, namely, Lebanon and Palestine, experienced moderate inflation rate, despite severe supply shortages during the conflicts in 2006.

E. LABOUR MARKETS

16. Despite the overall continued economic growth, the issue of unemployment and underemployment remained the major socio-economic issue of the ESCWA region. Youth unemployment remained a major challenge for policymakers in the region, with persistent difficulties facing both new entrants and older female workers to labour markets.

17. In Iraq, where the estimation of unemployment was exceptionally high, the acceleration of emigration and outflows of skilled labour force became a major concern. To a lesser degree, the same phenomenon was observed in Lebanon after the war in the summer in that country. The security pressure caused a reallocation of human capital and potential for uneven development in the region.

18. Reform measures were in process, particularly among countries of the GCC. Diversity in measures and flexibility in operations have been observed in workforce nationalization strategies. Moreover, human resource development and vocational training of nationals were more emphasized in those strategies. Within that context, a minimum wage for nationals working in the private sector was established in Bahrain and the United Arab Emirates; and Saudi Arabia exercised a flexible decision on required quota rates of the employment of nationals by cutting the quota rate temporarily for sectors where there was a shortage of qualified labour supply. Additionally, Bahrain, Kuwait and the United Arab Emirates have been drafting and reviewing new labour laws for their adoption in the near future.

19. In 2006, there was greater focus on the rights issue of foreign workers in the region, particularly in the countries of the GCC, within the framework of labour law reforms. Specifically, the United Arab Emirates could introduce new standard contracts aimed at regulating the rights and duties of foreign housemaids in early 2007. Jordan enhanced labour inspections especially in order to protect foreign workers in its qualified industrial zones (QIZs), and decided to raise the minimum wage for nationals as well as foreign workers in 2006.

F. EXTERNAL SECTOR

20. The external sector performance of the ESCWA region was very robust in 2006. It was observed that current account balance became stabilized in the positive area in most member countries, while the trade activities of the region continued to expand. This could be attributed to strong export performance of oil-exporting ESCWA member countries, several crucial developments in industrial exports and robust service trade represented by tourism. While Jordan, Lebanon and Palestine experienced current account deficits in 2006, the level of deficits declined in all three ESCWA members in terms of GDP. Egypt, the Syrian Arab Republic and Yemen registered a positive and robust current account surplus; and the countries of the GCC recorded a historically high current account surplus.

21. Based on the United States-Middle East Free Trade, the United States was active at various stages of trade negotiations in the ESCWA region. In January 2006, a free trade agreement (FTA) was signed between Oman and the United States; an FTA between Bahrain and the United States entered into effect in August of that year; and the United Arab Emirates was at the negotiation stage to establish an FTA with the United States. In parallel to this development and within the framework of the Mediterranean Arab Free Trade Area (MAFTA) with the European Union (EU), the Aghadir Agreement between Egypt, Jordan, Morocco and Tunisia came into effect in July 2006 aimed at establishing an FTA among the four Arab Mediterranean countries with benefits of preferential access to EU markets. Moreover, the GCC was actively engaged in trade negotiations with its important trading partners and held several rounds of negotiations with the EU to establish an FTA. Equally, the GCC considered setting up such FTAs with China, India and Singapore.

G. ECONOMIC POLICY DEVELOPMENTS

22. With the exception of conflict-stricken economies of Iraq, Lebanon and Palestine, the high oil revenues in the GCC and the robust economic performance of MDEs enabled the Governments in the region to form active fiscal expenditure policy for their fiscal year covering 2006. The prioritized increase in Government expenditure in the health and education sectors was observed in most of these countries. Moreover, urban development projects, particularly in the countries of the GCC, attained the priority together with their economic diversification efforts. Despite the significant increase in Government expenditure, ESCWA member countries kept their prudent fiscal policy stance. The oil price projections for revenue estimation were very conservative in the national budgets of GCC countries. Egypt and Jordan successfully met their targets in reducing budget deficits and public debts. While development needs spurred Government expenditure in Yemen, it was executed upon the increased oil revenue and stable international assistance.

23. In the conflict-stricken countries and territories of Iraq, Lebanon and Palestine, fiscal policies were subject to security pressures and to uncertain political situations. The largest ever budget was formed in Iraq for 2006, stressing on reconstruction and investment projects. However, the implementation of these projects was hampered by security situations. In Lebanon, the aftermath of the war of Israel in the summer of 2006 added a severe constraint on fiscal policy. International support was pledged in August 2006 for reconstruction and in January 2007 for comprehensive development plan, in line with the reduction of its external public debt. In 2006, Palestine lost its fiscal control when Israel withheld tax revenues that were collected on behalf of the Palestinian Authority. With the suspension of development aid to Palestine from developed countries since January 2006, the institutional base for conducting fiscal policy was severely weakened.

24. In 2006, inflation became increasingly a major policy agenda in the region as consumer prices were visibly on upward trends. Under pegged or well-targeted stable exchange rate regimes, central banks in the ESCWA region were active in controlling domestic liquidity. However, the effect was limited in forcing price levels as the inflation stemmed from the hike in international prices of commodities, including construction materials, as well as the rapid growth in domestic demand. Moreover, given that fiscal policy was on an expansionary stance, it proved difficult for monetary policy alone to control selectively the level of domestic demand. However, with the exception of Iraq, inflation rates in the ESCWA region were still in a manageable range, albeit at different levels.

25. In order to alleviate an extremely high inflation rate, the Central Bank of Iraq has continuously revaluated the national currency since November 2006 so that import prices could go down in terms of national currency. In two months till the end of 2006, the Iraqi dinar appreciated against the United States dollar by 12 per cent. To a different extent, the Central Bank of Kuwait revaluated its national currency by appreciating it against the dollar by 1 per cent in order to quell inflation pressures that stemmed from the depreciation of the dollar against other major currencies. While other central banks of the GCC did not follow this move, policy discussions on the exchange rates of GCC countries, which are pegged to the dollar, were intensified in 2006, particularly in the light of the imminent GCC Monetary Union that is set at 2010. Moreover, Oman announced in December 2006 its decision not to join the GCC Monetary Union by 2010, which stirred discussions over processes and schedules for the single currency of the GCC.

H. PROSPECTS

26. Another cycle of oil-boom is set to end in 2007 as oil prices move to a declining trend. However, the ESCWA region is projected to grow at 5.1 per cent in real GDP. Government economic policies, both fiscal and monetary, will sustain domestic demand where consumer and business confidence indicated no sign of weakening, with the exception of the conflict-stricken countries and territories of Iraq, Lebanon and Palestine. The inflation rate in the region is expected to be contained at current levels and to turn into a gradual reduction in the cost of living.

27. A worrying economic factor for the region is a world-wide credit crunch where the growth of global monetary liquidity stalls. With less inflows of capital, MDEs could face foreign exchange ceilings on their domestic demand growth. This could cause severe macroeconomic imbalances and, possibly, inflation. While the countries of the GCC are not expected to face foreign exchange ceilings even in such a circumstance of world economy, these could damage the strongly emerging financial sector of this subregion. Despite a low probability of such a world-wide credit crunch occurring in 2007, there is a need to recognize the potential vulnerability of the region.

28. Policy discussions on institutional developments and arrangements concerning regional economic cooperation are set to be intensified in 2007. The outcome of such discussions, particularly on the GCC Monetary Union, will be crucial for the ESCWA region and for the international financial architecture. Moreover, labour market reforms will increasingly be on the agenda in relation to trade negotiations for FTAs with trading partners of developed countries. The implications of such reforms influence national human resource development as well as distribution of human capital within the ESCWA region.

II. LESSONS FROM THE PREVIOUS OIL BOOM

A. THE ISSUES

29. The current oil boom affects ESCWA countries in very different ways. Given the persistence of relatively high oil prices, the region will continue to enjoy higher than average growth rates. However, the downfall of oil prices and its impact on welfare are of major concern. This year's Survey examines the monetary and financial policy implications of the boom for different country contexts, especially the GCC and MDEs; and how, when they are available, these resources can be deployed in order to foster the achievement of lasting pro-poor and rights-based goals. The specific focus of the Survey is the interaction between monetary, financial, fiscal and distributive policies in the ESCWA member countries under conditions of oil boom. The work aims to identify policy options for specific country groups within ESCWA, and the institutional means to achieve the desired objectives under the concrete circumstances of ESCWA member countries.

30. Managing the boom hinges on the outcome of Government policy decisions and on whether or not these policies are adequate. While the resource curse is presumed to plague natural resource-rich countries in the long-run, the "Dutch Disease" is supposed to affect these countries in the short-run, when export markets are exceptionally favourable. The consequent inflow of foreign exchange resulting from the oil boom is supposed to trigger a range of adverse economic outcomes, including inflation and deindustrialization. The latter partially occurred in the case of the nascent industries of MDEs, while oil rents may have favoured industrial developments in the GCC. The ESCWA region has been subjected to elements from both types of negative externalities. However, none of these issues is inevitable or unavoidable given the right policy mix, and the possibility exists for making durable welfare gains.

31. The case may be that some misguided macroeconomic policies and the resource curse are not the only explanations for the weak macroeconomic performance in between oil booms in most ESCWA member countries. The resource boom appeared initially through the improvement of national balance of payments. This improvement enabled the regional and national economies to command additional resources in the world economy, including imports, investments abroad and remittances to other parts of the world, at no immediate or apparent cost to itself. In addition to this, additional spending in domestic currency becomes possible once part of the new foreign currency inflows is internalized and exchanged for local currency. Through these diverse channels, the extraordinary currency inflows tend to induce a higher level of activity in the domestic economy, which, in turn and in some cases, can trigger the real appreciation of the currency. This appreciation can become a source of difficulty for the economy if it hinders export diversification or erodes the competitiveness of traditional areas of activity. This can increase the structural fragility of the balance of payments or reduce the ability of the economy to cope with adverse shifts in resource inflows. In the ESCWA region, economic diversification has been sluggish.

32. In some member countries, the impact of the real appreciation of the currency was felt in two sectors, namely: (a) the non-tradable sector, including retail trade, most services, construction and many staple foods, which tends to expand as it benefits from demand growth and can pass on to consumers the impact of any cost increase; and (b) the non-booming tradable sector, which tends to contract following a resource boom given its exposure to foreign competition in the context of a rising real exchange rate. This process of adjustment is called “Dutch Disease”. Given that the non-booming tradable sector tends to be associated with manufacturing industry, natural resource booms have often been associated with deindustrialization, which was not the case in the GCC. However, higher inflows into MDEs, in combination with what sometimes seemed as an eagerness for trade liberalization, have adversely affected some economies. In the ESCWA region, there is an increasing dependence of the economy on the booming sector as the non-booming tradable sector contracts gradually. This makes it even harder to counteract the effects of the Dutch Disease, and to limit the drift towards economic specialization and, consequently, volatility, which can also harm the economy and contribute to the reduction in investment rates.

33. Left unattended, the long-term growth consequences of Dutch Disease can be severe. At the very least, it has been argued that it can create rich countries with poor people. By contrast, a diversified economic base (including manufacturing and services production for domestic consumption and for export) generally involves a more refined division of labour and higher levels of employment. Additionally, it can lead to increasing returns and stronger externalities, which can more easily support a rights-based and pro-poor development strategy, as the abovementioned development objectives of this Survey.

34. The case could be made that the Dutch Disease and the resource curse are not the only explanations for the weak macroeconomic performance in between oil booms in most ESCWA member countries. Tensions between the transformative demands of economic development and the conservative impact of traditional social structures, which are supported by the capture of export rents, have also triggered negative externalities in many countries. Moreover, the extraordinary prosperity of the oil economies in the 1970s and early 1980s, in the context of strong geopolitical conflicts in the ESCWA region, generated widespread social tensions. In MDEs, economic “modernization” has also generated standard tensions associated with processes of rapid growth. However, conditions in MDEs are complicated to some extent by the fact that these economies are heavily conditioned by the circumstances in their oil-rich neighbours, as well as by geopolitical concerns in the Middle East. These tensions and displacements explain why the ESCWA region exhibits potentially high long-term economic risks and high inequality, especially in the oil-rich countries.

B. THE TRANSMISSION MECHANISMS

35. The Survey notes that certain inter-boom period shortcomings in ESCWA member countries owe only partly to the resource curse and Dutch Disease. However, neither the rich oil countries with small populations nor the poorer and relatively more populated non-oil countries in the ESCWA region have been able to internalize the complex chains of economic activities that could have permitted their sustained and autonomous economic development. In addition to this, the nature of social cohesion and the concentration of income and wealth tend to favour predatory accumulation strategies, in which the export gains are mostly retained by a small section of the population and, subsequently, transferred abroad either directly or through the State. In this case, overly optimistic expectations of resource revenues can be used to alleviate pent-up social tensions, while a large part of the net resource inflows (plus external loans secured on future export income) can be misallocated by financing distorted or socially undesirable policies and projects. These outcomes are more likely in unequal and conflictive societies, which is often the case in the ESCWA region. In order to avoid these adverse outcomes, it is important to look beyond the availability or otherwise of natural resources, and to focus on institution-building, democratization of the State and the design of consistent, socially legitimate and ambitious industrial policies.

36. The macroeconomic outcome of windfalls is heavily dependent on the objectives and policy choices of individual ESCWA members. It is largely within the power of policymakers to decide whether there will be Dutch Disease, as well as its extent and consequences, given that they can avoid its effects by implementing

coordinated and purposeful fiscal, monetary, financial and exchange rate policies. In that sense, Dutch Disease is both avoidable and a policy outcome; it is the unintended consequence of Government policy choices and private sector behaviour.

C. POLICY GUIDELINES

37. In order to avoid Dutch Disease effects, individual member countries need to coordinate monetary, exchange rate and fiscal policies. In this coordination, direct exchange rate management is key to success, given the limited ability of monetary instruments to manage the exchange rate indirectly. Financial markets are underdeveloped in the ESCWA region, which implies narrow and limited market for Government paper, the buying and selling of which is the mechanism by which the exchange rate is indirectly managed. In the absence of effective monetary mechanisms for exchange rate management, avoiding Dutch Disease effects implies managing a pegged exchange rate, which is the case of all the oil producers in the ESCWA region.

38. Fixed or pegged exchanged rates are sometimes subject to the so-called “impossible trinity”, which refers to the combination of a liberalized capital market, a fixed exchange rate and effective monetary policy. According to this logic, if a capital market is liberalized, the domestic interest rate must be used to maintain the fixed exchange rate by balancing a trade deficit with capital inflows. This implies that the interest rate cannot also be used to manage the money supply. This logic is only of some relevance to the ESCWA region for several reasons. First, given that financial markets are underdeveloped, the buying and selling of Government paper is not an effective policy instrument whether the exchange rate is fixed or flexible. Secondly, the “impossibility” requires the assumption that external capital flows are perfectly elastic with respect to the margin between the external and domestic rates of interest. The same underdevelopment of financial markets that makes open-market operations ineffective implies that capital flows are not perfectly elastic in the ESCWA region. Thirdly, there are many degrees of capital account liberalization and regulation such that the alternatives are not a “free” and a “closed” capital account. Finally, the accumulation of foreign exchange reserves arising from an oil price boom can be separated from the domestic economy through a number of mechanisms that do not require open-market operations. One such mechanism is an “oil fund”, which has been established by many oil producers.

39. Adopting a fixed or pegged exchange rate, as is the case of oil producers in the ESCWA, represents an already effective way to prevent the nominal appreciations that can undermine the competitiveness of non-oil tradables. Furthermore, there is no economic justification for a flexible exchange rate given that it does not facilitate an effective monetary policy. The primary function of exchange rate flexibility is its role in stabilizing short-term balance of payments and allocating resources in the long term. Given that the exports of oil producers are not determined by domestic prices, the exchange rate plays no significant short-term adjustment role. While it can affect the allocation of resources in the long run, this is an argument against flexibility arising from Dutch Disease effects. Within that context, the role of monetary policy is one in which the domestic interest rate is used to prevent inflationary pressures or, in the absence of such pressures, to facilitate credit to the private sector. It is on the latter issue that ESCWA member countries are advised to focus.

40. Fiscal policy in the ESCWA region must have four objectives in order to avoid symptoms of Dutch Disease, namely: (a) to reduce the variability of growth (the short-term countercyclical function); (b) to raise the growth rate (the long-term supply function); (c) to affect the composition of growth by economic activity; and (d) to make growth more equitable. It is relevant in this context to reemphasize, as suggested in the Survey of 2005, that presumptive taxes on income and short-term capital gains are preferable to a heavy reliance on indirect taxes. While indirect taxes are generally less income elastic than direct ones in the ESCWA region, this is not a serious constraint on the accounting side. Moreover, the stabilizing function need not be carried out on the revenue side, particularly in oil-exporting countries. Creating an oil fund, for example, allows a Government to set aside petroleum revenues when international prices are high (and the economy is expanding), and to use when prices fall in order to offset recessionary conditions. However, the purpose of progressive taxation is not simply in terms of accounting, rather it is to introduce fiscal reforms

that can also provide feedback into institutional reform, thereby encouraging development in all sections of society.

41. The appropriate policy combination to avoid Dutch Disease effects and the instability associated with a volatile international market for petroleum is as follows: (a) a fixed or pegged exchange rate managed to make non-oil tradables competitive, with a preference for a basket of currencies to reflect the trade shares of the concerned country; (b) an accommodating monetary policy, with objectives consistent with its limited effectiveness; and (c) an active fiscal policy that maintains the economy near its non-oil potential in the short run and reduces supply constraints faced by the tradable sectors. In that light, Governments are advised to proceed cautiously with trade liberalization, given that transitory Dutch Disease effects could undermine competitiveness of the non-oil tradable sectors.

42. On the investment side, countries in the region are advised to avoid a repetition of the inter-boom period, namely, a cycle that began in the late 1980s with low oil prices, followed by a poor investment performance. The private investment promotion arrangements of the inter-boom period were not sufficient to raise growth because they did not deal with risk and market size issues, despite providing the partial and to varying degrees the institutional framework and guarantees on repatriation. Moreover, these policies were built on the implicit understanding that the private and the public sector compete for the same resources. Experience shows that they do not; indeed, there is plenty of slack in the economy for both sectors to use in a complementary fashion. Consequently, an initial capital injection is required so that public and private investments rise simultaneously and set the economy on a new growth footing. However, as a precursor to this, the risk to long-term private investments must be minimized, and public investment must be made accountable and efficient. Market size and economic integration represent the impetus for investment and the ensuing returns. The political risk undercurrent, upon which long-term private investments depend, remains an issue of the shape of the regional security arrangement and the capacity, implicit or explicit, of the public sector to provide a quasi-insurance scheme for local or foreign investors.

43. Public investment could be a central aspect of an active fiscal policy, which is particularly important for petroleum exporting countries. Unless managed carefully and designed appropriately, public expenditure can be the major cause of Dutch Disease affects. The expenditure of the large revenues from oil needs to be managed in line with the following two basic guidelines:

(a) The absolute level of revenues needs be consistent with robust growth and macroeconomic stability. Achieving the appropriate level of expenditure is an issue of aggregate demand management. An oil fund is the mechanism aimed at achieving this demand management, accumulating funds when revenue flows are high and releasing funds when flows are low, preferably, with infrastructure investment on the regional level being a priority;

(b) The distribution of public expenditure between consumption and investment is crucial to overcoming Dutch Disease effects. The vast majority of public expenditures are for non-traded goods and services. As a result, public expenditure by raising the demand for non-traded goods and services tends to increase their prices and exacerbate pressures towards real exchange rate appreciation. Little can be done to overcome this tendency in the short term, which increases the need for direct exchange rate management. In the long term, careful design of public expenditure can mitigate its Dutch Disease effects by reducing the cost of tradable goods and services. Outlays on education and health can achieve this to some degree by raising the productivity and skills of the labour force. However, the extent to which such outlays can be targeted for their productivity increasing effect is limited by the commitment to provide these services for the entire population.

44. The objective here is to minimize the negative impact of short-term fluctuations resulting from abrupt capital flows and low oil price shocks, and to maximize the long-term contribution of technology and other knowledge-based factors to growth. The latter outcome alone is in itself a relative buffer against erratic capital or price movement. However, in the initial stages, this requires steady investments in research and

development, human capital and the institutional framework that are independent of movements in capital flows and oil price fluctuations. These investment flows could create the sort of public/private partnership that can increase long-term private sector competitiveness and public sector efficiency. Moreover, there is empirical evidence to suggest that investments of that sort tend to exhibit much higher returns than purely physical investments. However, such a scenario also requires a higher level of regional integration and an investment/growth stabilizing fund. In short, a regional stabilization fund requires regional cooperation. Calls for integration in the past, which were based on the supposed benefits of integrating oil with non-oil producers, have made little progress. Ironically, however, it appeared that as a result of increasing common geopolitical concerns and capital mobility, measures towards cooperation were undertaken not so much in order to reap the benefits of integration, rather to prevent the common woes of collapse resulting from geopolitical considerations. Indeed, recent trends indicate that currency stabilization measures in the region were carried out on various bilateral levels in what amounts to a de facto monetary cooperation. Clearly, this needs to be taken one step further by expanding or instituting a de facto Arab monetary cooperation framework.

45. Much greater scope exists to use public investment to foster the non-oil tradable sectors. By definition, construction itself is a non-traded activity. However, the provision of infrastructure can be targeted to cost reduction for the tradable sectors. An obvious example is transport infrastructure that lowers costs of exporters. Other examples are improvement in communications, including Internet services, and the creation of public or private sector institutions for research and development.

46. An emphasis on public investment rather than on current expenditure could reduce the danger of “crowding out” private investment caused by a public budget that is buoyed by oil revenues. There are two aspects of crowding out, namely, the aggregate expenditure aspect and the complementarities aspect. In the abstract, public investment tends to crowd out private investment when an economy is near full employment and when the public investment projects are those that the private sector could also carry out. When there are unused resources, there is economic space for an increase in all types of expenditure, both public and private. In addition, if the public sector investment projects complement private sector investments, the former can stimulate the latter (“crowd in”). As a final observation on crowding out in the ESCWA region, a substantial part of private sector investment either does not borrow for investment, or does not do so in the financial markets that would be affected by Government borrowing. Investment by small rural and urban producers is often self-financed or financed from indigenous lenders with little connection to the formal banking system. In addition, foreign investment in the non-oil sectors, to the extent that it is important in individual countries, is not typically financed from domestic financial markets.

47. Finally, Governments and central banks can modulate the potentially adverse impact of windfalls using fiscal, monetary and exchange rate policy tools, as well as capital controls and balance of payments management techniques. Moreover, they can use industrial policy tools to direct the resource inflows, thereby allowing Governments to address strategic economic needs and capacity bottlenecks. Adequate policy tools can help to transform the windfall into sustained growth or, at least, avoid the destructive threat of Dutch Disease.