SURVEY
OF ECONOMIC AND SOCIAL
DEVELOPMENTS
IN THE ESCWA REGION
2006-2007
ECONOMIC AND SOCIAL COMMISSION FOR WESTERN ASIA

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OF ECONOMIC AND SOCIAL
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IN THE ESCWA REGION
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Preface

The ESCWA region marked another year of robust economic expansion, with the exception of Iraq, Lebanon and Palestine where regional conflicts and political instabilities significantly reduced their economic potential. Favourable external economic conditions, which were created recently by high oil prices, continued to buoy the region. Specifically, growth of gross domestic product (GDP) stabilized in both the countries of the Gulf Cooperation Council (GCC) and those categorized as more diversified economies (MDEs). Despite a deceleration of growth rate, which was observed until the cut-off point of data collection for this Survey, the level of growth remained high in most ESCWA member countries in 2006. Average GDP growth for the ESCWA region is estimated at 5.6 per cent in 2006, compared to 6.9 per cent in 2005 and a predicted 5.1 per cent in 2007.

During the two decades that separate the first and the current 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 of the social infrastructure retreated, thereby causing a decline in the quality of education. Moreover, in the absence of progress in individual empowerment, many of the social gains were tied to an ideology of a merchant and rentier class and, therefore, shallow and token, particularly in the case of reducing the gender gap and empowering women. Additionally, investment rates fell to a low of 16 per cent in 2002, productivity per worker was on average between steady and declining, while intraregional trade remained low in the range of 7-8 per cent. On the whole, however, the ESCWA region remained an excess-saving region, whose extra funds continued to be channelled abroad. Typically, the circuit of capital is commercial and stems from the collusion of rentier and merchant interests, and that largely circumvents the agency of development at all levels.

The current oil boom represents a welcome occurrence that could, under a different policy setup, entrench the welfare gains of high growth. However, this boom comes with rising regional tensions and a larger role for a private sector that is deeply-rooted in commerce and rentierism. Comparatively few gains are seen in terms of public investment in the physical and social infrastructure, and of lowering unemployment rates. The pervasive threat of conflict also adds to the stresses of national institutions. There is a pressing need to enable those national agencies responsible for development to perform a policy turnaround in an effort aimed at averting effects of the “resource curse” (poor overall economic performance associated with the abundance of natural resources) in the long term, and of “Dutch disease” (overvaluation of the currency causing gradual de-industrialization) in the short term. While aspects of these negative externalities exist in the region, they cannot explain or be the cause of underdevelopment. Rather, the explanation lies in a peculiar dependent process whereby the agency of development re-circulates the region’s capital and labour outside the region as opposed to within. Indeed, the political will to carry out an integrative regional development policy appears to be lacking given that there is more to gain in the short term from shifting the region’s resources abroad than there is in reinvesting over the long term in the region.

This year’s Survey of Economic and Social Developments in the ESCWA Region draws lessons from the previous oil boom and charts the policy landscape in search of alternatives that can retain financial and human resources aimed at meeting the requisites of development as a human right and the Millennium Development Goals (MDGs). Consequently, this Survey sets out to examine the potential contribution of monetary and financial policy tools under conditions of a primary resource boom in order to promote employment creation and a more equitable distribution of income by articulating a new pro-poor and rights-based development strategy in the region in which the interest of all agents are served. This aspect of this Survey is closely related to and supplements last year’s Survey in which development policies were discussed under the heading of the right to development.
From a conventional standpoint, the role of monetary policy is primarily aimed at promoting macroeconomic stability, especially low inflation. By contrast, financial policy, usually in the context of open capital accounts of the balance of payments, is perceived to contribute towards development through the transfer of the mechanisms and processes of resource allocation from Governments to the private sector. The Survey questions these policy roles and claims that they do not offer the optimal policy framework for the achievement of high levels of employment, more equal distribution of income and wealth, poverty reduction, rapid growth, low inflation and macroeconomic stability in the ESCWA region. Moreover, they do not support the implementation of pro-poor and rights-based economic policies, or the democratic accountability of the State. The specific focus of this Survey is the interaction between monetary, financial, fiscal and distributive policies in ESCWA member countries under the current conditions of an oil boom and growing regional instability. Selectivity is essential in order to identify policy options for specific country groups within the region, and the institutional means to achieve the desired objectives under the concrete circumstances of these countries, with an effort aimed at converting commercial activity into sustainable and long-term industrial and employment generating activity. However, as always, the role of the State in the economy is best seen as simultaneously leading and complementary, and one in which guarantees related to the future spur investment in physical and social infrastructure.

This year’s Survey comprises six chapters as follows:

(a) Chapter I analyses the recent economic trends and the development record of ESCWA member countries within a global context, with special focus on the development of the global oil sector and its short-term effects on the region;

(b) Chapter II reviews the current oil price boom from two perspectives. First, it looks at the current structure and mechanism of the global petroleum market, and identifies the short- and long-term supply and demand factors that have contributed to the atmosphere of uncertainty that presently surrounds the international oil market. The second part focuses initially on the macroeconomic implications of oil-exporting countries caused by sudden increases in oil prices and, subsequently, concentrates on the effects of that commodity on the ESCWA region;

(c) Chapter III examines the main macroeconomic policies under conditions of primary resource booms in order to avoid the typical issues arising from the twin dangers of the Dutch disease and the resource curse. The ultimate objective is to offer advice to policymakers in the region aimed at tackling the challenges of growing poverty; low growth in employment opportunities, particularly for youth and women; and the widening gap in income distribution;

(d) Chapter IV investigates the empirical studies related to both the Dutch disease and the resource curse hypothesis. Using a standard framework under the assumption of the existence of two separate sectors, namely, tradable (oil) and non-tradable (non-oil), this chapter examines the impact of a large and sudden stream of oil revenues on the real exchange rate (RER) and output. The intention is to suggest possible alternatives for policymakers in the ESCWA region aimed at warding off the negative effects of overvalued exchange rates both in the short and long term;

(e) Chapter V provides a brief overview of the international petroleum market in the twentieth century, focusing on price instability and the changes that have occurred in market shares. Additionally, it outlines the economic performance of petroleum-exporting countries in North Africa and the ESCWA region with respect to other middle-income oil exporters in the developing world. In order to avoid the effects of the Dutch disease, this chapter explores the three main macroeconomic options that are available to the Governments of the region, namely, exchange rate, fiscal policy and public investment;
(f) Chapter VI summarizes the main policy tools available to ESCWA member countries and outlines development as a long-term strategy in which the role of the State grows under increasing geopolitical risks. It recommends a locking in of resources via a regional compact that attenuates risks and increases absorptive capacity.

This year’s Survey concentrates on macroeconomic issues pursuant to ESCWA resolution 270 (XXIV) of 11 May 2006 on macroeconomic policy for financial stability, which recognized the urgent need to analyse the short-term economic effects and the long-term possible consequence of the current oil boom. Moreover, the social aspects of recent economic development have emerged as a form of evolving social dynamics, which necessitate an integrated approach at the policy level. Within that context, ESCWA resolution 277 (XXIV) of 11 May 2006 on social development policies revitalized the secretariat’s role as an active participant in advocating the integrated approach in social issues. To that end, there is a firm appreciation that reporting on social issues, which were hitherto supplemental to studies on economic development, needs a more concentrated and independent approach.*

* Social issues for 2006-2007 are the subject of the forthcoming publication, entitled “Report on Integrated Social Policies, No. 2”, which reviews relevant legislative mandates and organizational priorities.
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<tr>
<td>AMF</td>
<td>Arab Monetary Fund</td>
</tr>
<tr>
<td>/b</td>
<td>per barrel</td>
</tr>
<tr>
<td>b/d</td>
<td>barrel per day</td>
</tr>
<tr>
<td>BIS</td>
<td>Bank for International Settlements</td>
</tr>
<tr>
<td>CFTC</td>
<td>Commodity Futures Trading Commission</td>
</tr>
<tr>
<td>CIS</td>
<td>Commonwealth of Independent States</td>
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<tr>
<td>CPI</td>
<td>consumer price index</td>
</tr>
<tr>
<td>DESA</td>
<td>Department of Economic and Social Affairs</td>
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<tr>
<td>DPD</td>
<td>domestic public debt</td>
</tr>
<tr>
<td>ECB</td>
<td>European Central Bank</td>
</tr>
<tr>
<td>EIA</td>
<td>Energy Information Agency</td>
</tr>
<tr>
<td>EU</td>
<td>European Union</td>
</tr>
<tr>
<td>FDI</td>
<td>foreign direct investment</td>
</tr>
<tr>
<td>FTA</td>
<td>free trade agreement</td>
</tr>
<tr>
<td>GCC</td>
<td>Gulf Cooperation Council</td>
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<tr>
<td>GDP</td>
<td>gross domestic product</td>
</tr>
<tr>
<td>ID</td>
<td>community indifference curve</td>
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<td>ILO</td>
<td>International Labour Organization</td>
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<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
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<tr>
<td>IPO</td>
<td>initial public offering</td>
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<td>ISS</td>
<td>import substitution strategy</td>
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<td>LNG</td>
<td>liquefied natural gas</td>
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<tr>
<td>MAFTA</td>
<td>Mediterranean Arab Free Trade Area</td>
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<tr>
<td>m/b/d</td>
<td>million barrels per day</td>
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<tr>
<td>MDE</td>
<td>more diversified economy</td>
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<tr>
<td>MDG</td>
<td>Millennium Development Goal</td>
</tr>
<tr>
<td>MENA</td>
<td>Middle East and North Africa</td>
</tr>
<tr>
<td>NAFTA</td>
<td>North American Free Trade Agreement</td>
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<tr>
<td>NEER</td>
<td>nominal effective exchange rate</td>
</tr>
<tr>
<td>NGO</td>
<td>non-governmental organization</td>
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<tr>
<td>NT</td>
<td>non-tradable sector</td>
</tr>
<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
</tr>
<tr>
<td>OPEC</td>
<td>Organization of Petroleum Exporting Countries</td>
</tr>
<tr>
<td>PNT</td>
<td>price of non-tradables</td>
</tr>
<tr>
<td>PPF</td>
<td>production possibilities frontier</td>
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<tr>
<td>PPI</td>
<td>producer price index</td>
</tr>
<tr>
<td>PPP</td>
<td>purchasing power parity</td>
</tr>
<tr>
<td>PT</td>
<td>price of tradables</td>
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<tr>
<td>QIZ</td>
<td>qualified industrial zone</td>
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<td>RBI</td>
<td>resource-based industry</td>
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<td>REER</td>
<td>real effective exchange rate</td>
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<tr>
<td>RER</td>
<td>real exchange rate</td>
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<tr>
<td>SGP</td>
<td>Stability and Growth Pact</td>
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<td>SOE</td>
<td>State-owned enterprise</td>
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<tr>
<td>UNCTAD</td>
<td>United Nations Conference on Trade and Development</td>
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<tr>
<td>UNDP</td>
<td>United Nations Development Programme</td>
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<tr>
<td>UNHCR</td>
<td>United Nations High Commissioner for Refugees</td>
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<td>WPI</td>
<td>wholesale price index</td>
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<tr>
<td>WTI</td>
<td>West Texas Intermediate</td>
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<td>WTO</td>
<td>World Trade Organization</td>
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References to dollars ($) are to United States dollars, unless otherwise stated.
I. RECENT ECONOMIC TRENDS AND DEVELOPMENTS IN THE ESCWA REGION

A. THE GLOBAL CONTEXT

1. World economic developments in 2006

The world economy kept its expansionary track in 2006, albeit at a decelerating rate of growth towards the end of that year. In real terms, the gross domestic product (GDP) of the world economy grew at 3.8 per cent in 2006 (see table 1). Despite the monetary tightening trend by central banks in developed countries, the continuous rise in world commodity and asset prices created an ample cushion in the world expansion of credit. Consequently, the growth of global liquidity, which had peaked in early 2004, bounced back in early 2006. This solid expansion of credit supported the consistent growth in world purchasing power. Moreover, the strong general demand level supported the expansion of production activities as well as of physical investments. Equally, it continued to enhance the stable growth in the world flows of goods, services and capital.

However, the pattern of growth was still not pro-poor, which, in the light of meeting the Millennium Development Goals (MDGs), needs special attention by policymakers across the world. Specifically, its linkage to employment creation from the current world economic expansion continued to be weak, particularly in developing economies (see table 2). Moreover, clear signs of inflationary pressures emerged in 2006. For some countries, this was comparatively benign, as a result of first-round effects of higher commodity prices, particularly of oil products. However, the general hike in commodity prices gradually increased the price of basic foodstuff. Some developing countries saw the rapid rise in housing prices and corresponding rents. The current pattern of inflation was felt in certain segments of society, particularly the poor, to an extent that was not accurately reflected or estimated by consumer price indices. The slow employment creation and the pattern of consumer price inflations constituted the negative signs of the current world economic expansion.

<table>
<thead>
<tr>
<th>TABLE 1. MAJOR ECONOMIC INDICATORS, 2004-2007</th>
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<td>Real GDP growth rate</td>
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<td>ESCWA region</td>
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<td>World</td>
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<tr>
<td>Developed economies</td>
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<tr>
<td>United States of America</td>
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<td>European Union</td>
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<td>Japan</td>
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<tr>
<td>Economies in transition</td>
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<td>Developing economies</td>
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<tr>
<td>Africa</td>
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<td>East and South Asia</td>
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<tr>
<td>Western Asiaa</td>
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<tr>
<td>Latin America and the Caribbean</td>
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Sources: Figures for the ESCWA region are calculated by ESCWA; other figures are from the Department of Economic and Social Affairs (DESA), the United Nations Conference on Trade and Development (UNCTAD) and the five United Nations regional commissions, *World Economic Situation and Prospects 2007*.

Notes: Parentheses () indicate negative numbers.
Two dots (..) indicate that data are not available.
a/ The figures for 2007 are forecasts.
b/ This regional classification of Western Asia includes the neighbouring countries of the ESCWA region, namely, Israel and Turkey, and excludes Egypt.
The current growth continued to be widespread in that it was positive for both developed and developing economies. The developed economies registered 2.9 per cent growth in real GDP in 2006 (see table 1), owing mainly to the rapid economic recovery of the European Union (EU) and to stable and robust growth of the economies of Japan and the United States of America. In developing economies, China and India continued to run their rapid growth paths in 2006. Specifically, the size and the rapidly emerging purchasing power of these economies became more evident in terms of the flows of goods, services and capital in the world. Moreover, the rise in commodity prices and in the level of world demand contributed towards sustaining economic growth of other developing economies. This occurred against the backdrop of ongoing institutional reforms of developing economies aimed at supporting the level of world demand through cross-border trade and investment. On average, developing economies marked a high growth rate in real GDP of more than 6.5 per cent in 2006.

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<td>East Asia</td>
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<td>South-East Asia and the Pacific</td>
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<td>South Asia</td>
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<td>Latin America and the Caribbean</td>
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<td>Middle East and North Africa (MENA)</td>
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<td>Sub-Saharan Africa</td>
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Note: Parentheses () indicate negative numbers.

The United States of America continued to record a robust growth in its economy at 3.2 per cent in 2006. Successive decisions by the Federal Reserve Board resulted in raising the interest rate, namely, the target Federal funds rate, in January, March, May and June from 4.25 per cent to 5.25 per cent (see figure 1-A). Cautious of inflationary pressures, these successive rises aimed at “soft-landing” the economy. While there is no evidence that this monetary tightening affected the level of domestic demand growth in 2006, the comparatively high policy interest rates started to impact mortgage owners and other debt holders towards the end of that year. The moderate effect of monetary tightening was caused by the increasing current account deficit from $791.5 billion in 2005 to $856.7 billion in 2006. In the investment-savings gap, both the private and public sectors have registered negative net savings since 2002. In 2006, this gap (deficit) of the public sector decreased modestly, while that of the private sector continued to increase.

However, the momentum of domestic demand expansion and the resulting investment-savings gap in the private sector were still well supported by the inflows of foreign capital. The yield of two-year and ten-year United States Treasury Bonds became lower than the Federal Funds rates in June 2006 (see figure 1-A). This can be partly attributed to the high foreign demand from developing and oil-exporting countries, which have been accumulating larger holdings of foreign reserves. While this expanding global imbalance represents an obvious risk factor, the probability of a sudden shortage of monetary liquidity in United States dollars was remote in 2006. Foreign capital inflows are expected to continue to finance the growth in
domestic demand to the level that is adjusted by a continuously cautious monetary policy. The economy of the United States of America is expected to grow at 2.2 per cent in 2007.

**Figure 1. Interest rates of the major currencies, 2005-2006**

A. United States dollar  
(B) Euro  
(C) Japanese yen  
(Percentage per annum)

![Graph of interest rates](image)

*Sources: Figure 1-A: Board of Governors of the Federal Reserve System, which is available at: www.federalreserve.gov; figure 1-B: Deutsche Bundesbank, which is available at: www.bundesbank.de; and figure 1-C: Bank of Japan, which is available at: www.boj.or.jp.*

In Germany, the strong economic rebound led the accelerating growth in real GDP of the European Union to 2.7 per cent in 2006, which represents a rise from 1.7 per cent in the previous year. Despite the appreciation of the euro (see figure 2-A), the rapid growth of external demands and physical investment contributed towards the robust economic performance of Germany. Moreover, the stable growth in domestic demands sustained the real GDP growth of other major European economies, including France, Italy, Spain and the United Kingdom of Great Britain and Northern Ireland. In 2006, the effect of fiscal policy was considered to have been moderately neutral in terms of stimulating domestic demand in EU countries. Following the amendment of the Stability and Growth Pact (SGP) in 2005, the renewed commitment to reducing and maintaining the level of public deficit below 3 per cent of GDP was well presented. Within that context, both the European Central Bank (ECB) and the Bank of England tightened their monetary policies in 2006, thereby showing their commitment to their inflation target of 2 per cent.

**Figure 2. Foreign exchange rates of major currencies, 2005-2006**

A. United States dollar/euro  
B. Japanese yen/$  
C. Chinese yuan/$

![Graph of foreign exchange rates](image)

*Source: Board of Governors of the Federal Reserve System, which is available at: www.federalreserve.gov.*
While the inflationary pressure from external factors receded in the third quarter of 2006 along with a decline in crude oil prices, the pressure remained from domestic factors of robust aggregate demand. ECB successively raised its policy rate, namely, the main refinancing operations minimum bid rate, in March, June, August, October and December from 2.25 to 3.5 per cent (see figure 1-B). The Bank of England raised its policy rate, namely, the Bank Rate, in two stages in August and December from 4.5 per cent to 5 per cent. With regards to the United States of America, there is little evidence that this series of monetary tightening by major EU monetary authorities has dented to any significant degree the growth in economic activities in the real sector, particularly of physical investment. However, a modest adjustment from the monetary tightening is expected in terms of a slowdown of investment and purchases of durable goods, thereby placing the growth rate of the region at 2.4 per cent in 2007.

The Japanese economy kept to its strong recovery path with a real GDP growth rate of 2.5 per cent in 2006. Taking advantage of a weaker Japanese yen (see figure 2-B), export growth was sustained in a current positive business cycle that has continued since 2002. Equally, in the area of domestic demand, there were strong physical investment activities in private sector firms, albeit with continuing weak and fragile domestic consumption. Recognizing the economy’s exit from the state of deflation, the Bank of Japan terminated the so-called “quantitative monetary easing” policy in March 2006. Subsequently, in July 2006, the Bank of Japan raised one of its policy interest rates, namely, the basic loan rate, from 0.1 per cent to 0.4 per cent (see figure 1-C), which brought an end to the “zero interest rate policy”. However, policymakers continued to face difficulties in demand management in the light of the fragile consumer sentiment and still substantially low consumer price levels. The Japanese economy is expected to grow at 1.7 per cent in 2007.

Given that the level of commodity prices remained high, the positive income effect from exports translated into a solid domestic demand growth in the economies of transition, which includes countries in South-Eastern Europe and the Commonwealth of Independent States (CIS). The region marked 7.2 per cent in real GDP growth in 2006, with signs of overheating given that the consumer inflation rate was an estimated 8.9 per cent in the same period. The fiscal balance of oil-exporting countries in the region has improved, and foreign capital inflows are expected to continue. Providing there is no abrupt decline in commodity prices, the economies of that region are forecast to mark a relatively high growth of 6.5 per cent in 2007.

Economies in Africa registered a GDP growth rate of 5.6 per cent in 2006. The high commodity prices buoyed export earnings for commodity exporting countries, particularly those exporting crude oil. In addition to the relative abundance of foreign capital, constraints to the growth in domestic demand, which had previously bound the majority of African economies, eased dramatically in the current economic expansion. However, the pattern of growth is uneven between oil-exporting and oil-importing economies in that region. Moreover, even for oil-exporting economies, the rate of growth is insufficient in terms of realizing MDGs through active fiscal interventions. Furthermore, the slow pace of economic diversification highlights the fragility of the economic structure in that region; and a reverse in the current trend of high commodity prices could have severe adverse effects. Despite those challenges for African economies, that region is forecast to grow at 5.9 per cent in 2007, assuming a low probability of a plunge in commodity prices.

East and South Asia remained strong with an economic growth of 7.4 per cent in 2006. Specifically, the strong domestic demand growth of China and the economies of East Asia led the export growth of South-East Asian economies. Moreover, the rapid growth of South Asian countries contributed to the robust growth of that region. The current economic growth has allowed a significant portion of the population in China and India to realize major gains in terms of purchasing power and status in the world. The investment potential of both economies continued to lead intraregional and interregional capital inflows. While the majority of
CHAPTER I. RECENT ECONOMIC TRENDS AND DEVELOPMENTS IN THE ESCWA REGION

Economies in that region are net oil importers, the effect of high oil prices was not felt substantially in 2006. Moreover, while inflationary pressures started to mount in some economies in the region, the actual price hikes were caused by domestic factors. Despite the robust momentum of domestic demand observed in 2006, managing this inflationary pressure is set to constitute a challenge in 2007. Equally, there will be a need to pay special heed to the adjustment in foreign exchange rates and their repercussions. Within that context, the Chinese yuan appreciated steadily against the United States dollar since its revaluation in July 2005 (see figure 2-C). Similarly, the Indian rupee appreciated moderately against the dollar. These appreciations occurred as other Asian currencies exhibited comparative stability against the dollar. Indeed, by contrast, the Japanese yen depreciated against the United States dollar. Overall, East and South Asia is projected to grow at 6.9 per cent in 2007.

High commodity prices and substantially improved external balances buoyed the domestic demand of the countries in Latin America and the Caribbean. The real GDP of that region grew at 5.0 per cent in 2006. Argentina’s increasing current account surpluses since 2002 have spearheaded the region’s improved external balance. Moreover, the weakening value of the dollar against the euro released devaluing pressures from national currencies in the region, thereby stabilizing exchange rates with healthy accumulations of foreign reserves at central banks. The improved macroeconomic balance continued to help the economies of that region to reduce external debt levels and induce physical investments by taking advantage of increased competitiveness in the manufacturing sector, particularly in the case of Argentina, Brazil and Mexico. That region is expected to grow at 4.2 per cent in 2007.

2. Implications for the ESCWA region

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 for growth in these ESCWA members. The recent favourable external economic conditions, owing to ample global monetary liquidity and high oil prices, continued to have an effect on the region. Specifically, this set of favourable 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. The ESCWA region’s economic expansion showed a moderate slowdown to 5.6 per cent in 2006.

The favourable external factors to the ESCWA region remained intact in 2006, with steadily high commodity and energy prices, including oil and oil-related products. The growth of global monetary liquidity accelerated in 2006, thereby constituting a reversal after the deceleration in the period since early 2004. Figure 3-A shows the movement in the average crude oil price and the growth of global monetary liquidity in terms of the total United States monetary base and foreign exchange reserves held by central banks across the world. The level of growth of global monetary liquidity peaked out in early 2004 and, towards the end of 2005, slowed down following the expectation of tighter monetary policy of central banks in developed economies. The rebound in the growth of global monetary liquidity in 2006 can be attributed to the historically high level of commodity prices, particularly of crude oil and other oil products. The change in the expectations on the future commodity price level resulted in a robust credit expansion and the rebound in global monetary liquidity. In major world currencies, ten-year yields on Government bonds remained low despite a tightening policy position by central banks (see figure 1). This suggested a lax credit ceiling in

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1 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.

2 Average crude oil price is derived from the average of representing brands of crude oil. For more details, see the International Financial Statistics database by the International Monetary Fund (IMF), which is available at: www.imfstatistics.org.
world major currencies wherein the series of hikes in policy interest rates had a limited effect in controlling the world credit expansion. While high oil prices had a direct income effect on oil-exporting countries in the ESCWA region, it was this ample monetary liquidity that supported the expansion of domestic demand in the region, including that of non oil-exporting countries.

Figure 3. Implications for the ESCWA region

A. Global liquidity growth and crude oil prices, 1996-2006

B. Oil export revenue and annual growth of stock market capitalization

C. Inflows of bank deposits: comparison between GCC and Asian countries

Sources: Figure 3-A: International Monetary Fund (IMF), International Financial Statistics database, which is available at: www.imfstatistics.org; figure 3-B: Arab Monetary Fund (AMF) for stock market capitalization, and ESCWA calculation for gross oil export revenue; and figure 3-C: Bank for International Settlements (BIS).

In early 2006, it was feared that downward adjustments of the region’s stock markets could have serious negative effects on the region’s economy. Figure 3-B shows the total annual incremental growth of stock market capitalization in the ESCWA region, which, in 2006, fell by $300 billion. In relation with oil revenues, the incremental increase in stock market capitalization surpassed annual gross oil export revenues in 2004 and 2005. This implies that the ample oil revenue alone does not explain the growth of stock market capitalization in both years given that more funds were placed in stock markets in the region than total oil revenues over the same period.

However, there was little sign of foreign speculators in the regional stock markets. Figure 3-C shows the net deposit (deposit minus lending) of the reporting banks for the Bank for International Settlements (BIS). For clients in East and South-East Asia, comprising Indonesia, Malaysia, the Philippines, Thailand and South Korea, the net lending amounted to $250 billion at the time of the Asian financial crisis in 1997. Subsequent to the collapse of the stock markets, the financial adjustment since 1997 has been evident in the rapidly declining international bank lending to that region. The countries of the GCC, however, continued as net depositors in those international banks. Despite the severe corrections in stock markets since early 2006, the net deposits in total reached $100 billion at the end of 2006. This implies that the downward adjustments of stock markets in the ESCWA region, particularly in the GCC, did not cause a contagious credit crunch across the region. Specifically, the favourable external factors that were observed in the current growth cycle have not been severely affected by the downward adjustment in the stock markets of the region.

The risk involved with the current set of favourable external factors to the ESCWA region is that both elements could turn unfavourable in the future. In other words, the high level of commodity prices has encouraged the expansion of world credit and the growth of global monetary liquidity, and the rapid growth

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3 The reporting banks for the Bank for International Settlements (BIS) are major banks in the world with international lending and deposit portfolios.
in monetary liquidity has supported the high commodity prices through their future markets. This linkage could engender a worse case scenario, when the present condition comes to an end, of lower commodity prices and a crunch in credit and monetary liquidity. The expectation of a sudden change in the external economic condition is still not high for 2007, with the global economy predicted to keep the current momentum and with a growth rate of 3.2 per cent. However, it is incumbent on policymakers in the ESCWA region to examine the development on the external economic factors carefully in order to promote sustainable macroeconomic growth.

B. DEVELOPMENT OF THE OIL SECTOR

1. World demand and supply

The world demand for crude oil continued to grow in 2006, albeit at a more modest growth rate than in 2005. According to the Organization of Petroleum Exporting Countries (OPEC), the world demand of crude oil in 2006 stayed at 84.1 million barrels per day (m/b/d), compared to 83.3 m/b/d in 2005.\(^4\) The rebound in growth rate was largely expected in 2006 from strong growth in demand from North America and China. However, the projection of demand growth was successively cut as a result of sustained weaker demand from North America and developed countries throughout 2006. The high oil prices encouraged those developed countries to promote the use of other fuel sources, including natural gas and ethanol. Consequently, the demand from countries in the Organisation for Economic Co-operation and Development (OECD) remained at 49.2 m/b/d in 2006, which was lower than 49.6 m/b/d reached in 2005. While strong demand growth was observed in China and other developing countries, overall demand growth in crude oil was modest in 2006.

The total world crude oil supply inched up to 84.7 m/b/d in 2006 from 84.1 m/b/d in 2005, which can be attributed to the supply from non-OPEC oil producers. Having allowed its members to produce at their maximum level in the last quarter of 2005, OPEC gradually shifted its policy in order to reduce the crude oil production of its members, thereby stabilizing the crude oil markets. The first official change in the crude oil production ceiling since July 2005 came into effect on 1 November 2006. With the exception of Iraq, the production ceiling of OPEC member countries was reduced by 1.2 m/b/d from 27.5 m/b/d to 26.3 m/b/d. In addition to this shift, OPEC decided to reduce the production ceiling by 0.5 m/b/d effective from February 2007. Total OPEC crude oil production was at 30.9 m/b/d in 2006, compared to 31.1 m/b/d in 2005. However, this change in the production ceiling did not affect the overall figures for 2006. The reduction in crude oil output was observed in a limited number of large producers with the flexibility in crude oil production capacity, namely, Iran, Nigeria, Saudi Arabia and Venezuela.

Despite weaker than expected demand growth, the crude oil prices stayed in the range of a historic high (see figure 4-A). The yearly average spot price of West Texas Intermediate (WTI) was $66.05 per barrel (/b), compared to $61.08/b for the OPEC reference basket. Since the introduction of a new OPEC basket in the calculation of the reference price in June 2005, the spread between those two benchmark oil prices has been in the range of $4-7 (see figure 4-B). However, this spread started to narrow towards the end of 2006, thereby reflecting the weak demand from North America where WTI is the established brand. Owing to the ample global monetary liquidity, the speculative factor caused a rapid price hike until the summer of 2006, which was followed by a rapid plunge towards the end of that year. Data from the Commodity Futures Trading Commission (CFTC) of the United States of America reveal that “non-commercials” held long positions in crude oil futures and option markets in 2006 (see figure 4-C).\(^5\) This indicates a buying pressure on crude oil financial derivatives; and peak highs in crude oil prices


\(^{5}\) The participation of “non-commercials” in the United States future markets relates mainly to investment funds and banks.
corresponded to the mounting long positions of those speculative buyers. Rather than reflecting a less-than-expected current demand, the movement of crude oil prices in 2006 showed they were sensitive to and driven by the news that could affect current and future supply-demand conditions through speculative buying forces.

Figure 4. Development of the oil sector

A. Oil prices: WTI and OPEC Basket
B. Spread between WTI and OPEC Basket
C. Non-commercials net long position and WTI

Sources: Figure 4-A: Energy Information Administration (EIA) and OPEC; figure 4-B: ESCWA calculations; and figure 3-C: EIA and Commodity Futures Trading Commission (CFTC).

The OPEC reference basket is projected to average $55/b in 2007, owing to the following factors: (a) a solid expectation on the high level of crude oil prices in the light of robust demand growth from developing countries; (b) the bottleneck at refinery capacity, which is set to remain unresolved in the near future despite a recent increase in investments in refinery capacity; (c) the continuing growth of global monetary liquidity; (d) significant effects from crude oil futures and options market that will continue to be sensitive to geopolitical news on the Middle East and Africa; and (e) uncertain geopolitical situation in the Middle East and Africa. Despite these factors, the average price is expected to be below the level of 2006, once expectations are adjusted to take stock of the slowdown in the global economy. In parallel to the decelerating housing markets in several developed countries, the growth of global monetary liquidity could be slower in 2007.

2. Crude oil production in the ESCWA region

The total crude oil production of ESCWA member countries declined slightly to 19.4 m/b/d in 2006 from its level in 2005 (see table 3). Among OPEC member countries in the region, only Saudi Arabia reduced its annual output level in 2006.6 Despite the shift in policy on the production ceiling by OPEC, few member countries had a flexible capacity in adjusting the production level. Saudi Arabia managed a series of reductions in crude oil production level in October 2006, which was prior to the decision on the production ceiling. This shows that Saudi Arabia, which maintains the largest spare capacity in the current regime of near-maximum crude oil production, can control its output in a short space of time in both directions. The crude oil production of Saudi Arabia registered 9.1 m/b/d in 2006, which represents a decline by 0.2 m/b/d from 2005. Other OPEC member countries in the region recorded modest increases in their annual crude oil production in 2006, namely, 2.5 m/b/d for Kuwait, 0.8 m/b/d for Qatar and 2.5 m/b/d for the United Arab Emirates. In Iraq, despite security pressures and disruptions in the facilities, the crude oil production of that country registered a modest increase to 1.9 m/b/d in 2006.

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6 OPEC member countries in the ESCWA region comprise Iraq, Kuwait, Qatar, Saudi Arabia and United Arab Emirates.
CHAPTER I. RECENT ECONOMIC TRENDS AND DEVELOPMENTS IN THE ESCWA REGION

TABLE 3. OIL PRODUCTION IN THE ESCWA REGION, 2002-2007
(Thousands of barrels per day)

<table>
<thead>
<tr>
<th>Country</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>Percentage change</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2005/6 2006/7</td>
</tr>
<tr>
<td>Bahrain</td>
<td>190</td>
<td>210</td>
<td>210</td>
<td>210</td>
<td>210</td>
<td>210</td>
<td>0.0    0.0</td>
</tr>
<tr>
<td>Kuwait</td>
<td>1,746</td>
<td>2,108</td>
<td>2,344</td>
<td>2,504</td>
<td>2,505</td>
<td>2,305</td>
<td>0.0    (8.0)</td>
</tr>
<tr>
<td>Oman</td>
<td>900</td>
<td>820</td>
<td>790</td>
<td>780</td>
<td>760</td>
<td>730</td>
<td>(2.6)  (3.9)</td>
</tr>
<tr>
<td>Qatar</td>
<td>569</td>
<td>676</td>
<td>771</td>
<td>792</td>
<td>822</td>
<td>749</td>
<td>3.8    (8.9)</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>7,931</td>
<td>8,410</td>
<td>8,957</td>
<td>9,390</td>
<td>9,117</td>
<td>8,839</td>
<td>(2.9)  (3.0)</td>
</tr>
<tr>
<td>United Arab Emirates</td>
<td>1,900</td>
<td>2,248</td>
<td>2,360</td>
<td>2,447</td>
<td>2,538</td>
<td>2,420</td>
<td>3.7    (4.7)</td>
</tr>
<tr>
<td>GCC</td>
<td>5,305</td>
<td>14,472</td>
<td>15,432</td>
<td>16,123</td>
<td>15,952</td>
<td>15,268</td>
<td>(1.1)  (4.3)</td>
</tr>
<tr>
<td>Egypt</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>750</td>
<td>710</td>
<td>700</td>
<td>670</td>
<td>640</td>
<td>640</td>
<td>(4.3)  (4.5)</td>
</tr>
<tr>
<td>Iraq</td>
<td>2,127</td>
<td>1,378</td>
<td>2,015</td>
<td>1,830</td>
<td>1,932</td>
<td>2,288</td>
<td>5.6    18.4</td>
</tr>
<tr>
<td>Syrian Arab Republic</td>
<td>550</td>
<td>530</td>
<td>500</td>
<td>460</td>
<td>440</td>
<td>430</td>
<td>(4.3)  (2.3)</td>
</tr>
<tr>
<td>Yemen</td>
<td>460</td>
<td>440</td>
<td>420</td>
<td>410</td>
<td>390</td>
<td>400</td>
<td>(4.9)  2.6</td>
</tr>
<tr>
<td>MDEs</td>
<td>3,137</td>
<td>3,098</td>
<td>3,645</td>
<td>3,400</td>
<td>3,432</td>
<td>3,118</td>
<td>0.9    (9.1)</td>
</tr>
<tr>
<td>ESCWA region</td>
<td>8,442</td>
<td>17,570</td>
<td>19,077</td>
<td>19,523</td>
<td>19,384</td>
<td>18,386</td>
<td>(0.7)  (5.2)</td>
</tr>
</tbody>
</table>

Sources: Figures for Kuwait, Qatar, Saudi Arabia and United Arab Emirates are based on OPEC latest production cuts to its 28 m/b/d; figures for non-OPEC countries, namely, Bahrain, Egypt, Syrian Arab Republic and Yemen, are based on the estimated production in OPEC, “Monthly oil market report, February 2007”, table 32; and figures for Iraq in the period 2003-2006 are based on various issues of OPEC, “Monthly oil market report”, and the figure for 2007 is an estimation by ESCWA.

Notes: Parentheses () indicate negative numbers.

a/ Production in Kuwait, Qatar, Saudi Arabia and United Arab Emirates is based on the average of actual 2006 production and estimated production quota for 2007.

b/ Including Bahrain’s share of the Abu Safa oilfield.

c/ Including a 50 per cent share of the Neutral Zone.

Non-OPEC oil-exporting countries in the ESCWA region witnessed a gradual and continuous decline in their crude oil production in 2006, with the exception of Bahrain where the output level remained stable during that year. The declining trend was caused by the low investment in exploration and production activities in the 1990s. Moreover, the capacity upgrade was delayed during that decade owing to the low demand projections and low crude oil prices. New investment projects have been initiated in the area of exploration and production, with various forms of foreign partnerships. However, the additional production capacity is not expected to emerge until 2010.

While the current trend of high crude oil prices drives more oil-importing countries to diversify their energy policy, this diversification has also been visible in the oil-exporting countries of the ESCWA region, particularly in the area of natural gas. Additionally, there has been an increase in the production of liquefied natural gas (LNG) from the region. Specifically, Qatar became the largest LNG producer and exporter in the world; the production levels in Egypt and Oman increased in 2006; and Yemen is planning LNG production in the near future. The attraction of natural gas as a major alternative to oil products has been increasing in oil-importing countries. In the ESCWA region, the use of a regional gas grid is gaining support given the cost reductions related to the generation of electricity in oil-importing countries. Jordan’s import of natural gas from Egypt increased substantially in 2006; and Lebanon and the Syrian Arab Republic were negotiating on the supply of natural gas.

7 Non-OPEC oil-exporting countries in the ESCWA region comprise Bahrain, Oman, Egypt, Syrian Arab Republic and Yemen.
The production level of crude oil from the ESCWA region is expected to be reduced by 5.2 per cent in 2007, which takes into account the following: (a) OPEC’s shift in the production ceiling since October 2006 and a commitment to respect that ceiling by OPEC member countries; and (b) a long-term trend of decreasing production in non-OPEC countries. The exception is Yemen where a rebound in crude oil production is expected through seasoned investments in the areas of exploration and production. Despite the instability in terms of security, the crude oil production of Iraq is expected to increase to 2.2 m/b/d, with greater capacity upgrades in the exploration and production sector.

### 3. Oil revenue and its impacts in the ESCWA region

Higher oil prices and growing production led to the considerable increase in oil revenues in the ESCWA region in 2006. The gross oil export revenue in the region was estimated at $406.5 billion in 2006, which represents an increase of 26.1 per cent from 2005 (see table 4). Among the countries of the GCC, the United Arab Emirates achieved the highest increase in oil export revenue in 2006 compared to 2005, at 31.7 per cent, followed by Saudi Arabia, at 30.1 per cent. While Qatar showed a weak growth, this can be attributed to its shift in energy policy into LNG.

Equally, oil-exporting countries among MDEs experienced a substantial increase in their gross oil export revenues, with the exception of the Syrian Arab Republic where the reduction in crude oil production as well as the decrease in crude oil exports resulted in the substantial decline in oil revenue. For 2007, the projection was made upon the expected OPEC reference basket price of $55/b (yearly average). All oil-exporting ESCWA member countries are expected to experience declining gross oil export revenues; and total gross oil export revenue is expected to amount to $338.6 billion in 2007.

### TABLE 4. GROSS OIL EXPORT REVENUES IN THE ESCWA REGION, 2002-2007

(Thousands of United States dollars)

<table>
<thead>
<tr>
<th>Oil-exporting countries</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006(a)</th>
<th>2007(b)</th>
<th>Percentage change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bahrain(c)</td>
<td>5.6</td>
<td>6.6</td>
<td>7.9</td>
<td>11.0</td>
<td>13.0</td>
<td>10.6</td>
<td>18.5 (18.4)</td>
</tr>
<tr>
<td>Kuwait</td>
<td>13.0</td>
<td>17.4</td>
<td>24.1</td>
<td>37.6</td>
<td>45.7</td>
<td>35.2</td>
<td>21.5 (23.1)</td>
</tr>
<tr>
<td>Oman</td>
<td>7.3</td>
<td>8.3</td>
<td>9.1</td>
<td>13.2</td>
<td>14.4</td>
<td>14.0</td>
<td>9.0 (2.4)</td>
</tr>
<tr>
<td>Qatar(\text{d})</td>
<td>5.6</td>
<td>6.7</td>
<td>8.5</td>
<td>14.9</td>
<td>16.0</td>
<td>13.5</td>
<td>2.6 (11.3)</td>
</tr>
<tr>
<td>Saudi Arabia(e)</td>
<td>63.6</td>
<td>82.0</td>
<td>110.4</td>
<td>162.0</td>
<td>210.8</td>
<td>170.7</td>
<td>30.1 (19.0)</td>
</tr>
<tr>
<td>United Arab Emirates</td>
<td>16.7</td>
<td>22.1</td>
<td>29.6</td>
<td>43.5</td>
<td>57.3</td>
<td>49.7</td>
<td>31.7 (13.3)</td>
</tr>
<tr>
<td>GCC</td>
<td>111.9</td>
<td>143.1</td>
<td>189.6</td>
<td>282.2</td>
<td>356.4</td>
<td>293.7</td>
<td>26.3 (17.6)</td>
</tr>
<tr>
<td>Egypt</td>
<td>2.5</td>
<td>3.6</td>
<td>4.7</td>
<td>7.5</td>
<td>10.6</td>
<td>7.7</td>
<td>40.5 (27.5)</td>
</tr>
<tr>
<td>Iraq</td>
<td>11.3</td>
<td>8.4</td>
<td>17.5</td>
<td>23.2</td>
<td>30.0</td>
<td>28.9</td>
<td>29.3 (3.5)</td>
</tr>
<tr>
<td>Syrian Arab Republic</td>
<td>4.0</td>
<td>3.4</td>
<td>2.7</td>
<td>3.4</td>
<td>2.8</td>
<td>2.4</td>
<td>(19.2) (14.0)</td>
</tr>
<tr>
<td>Yemen</td>
<td>3.1</td>
<td>3.5</td>
<td>4.3</td>
<td>6.0</td>
<td>6.8</td>
<td>5.9</td>
<td>13.6 (13.0)</td>
</tr>
<tr>
<td>MDEs</td>
<td>20.9</td>
<td>18.7</td>
<td>29.2</td>
<td>40.1</td>
<td>50.1</td>
<td>44.9</td>
<td>24.9 (10.4)</td>
</tr>
<tr>
<td>ESCWA region</td>
<td>132.8</td>
<td>161.9</td>
<td>218.8</td>
<td>322.3</td>
<td>406.5</td>
<td>338.6</td>
<td>26.1 (16.7)</td>
</tr>
</tbody>
</table>

*Source*: Calculated by ESCWA.

*Notes*: Parentheses () indicate negative numbers.

\(a\)/ ESCWA estimates, based on official sources.

\(b\)/ ESCWA estimates, based on the assumptions of an OPEC price of $55/b, which is approximately equivalent to the assumption of $58/b for Brent crude in the *World Economic Situation and Prospects 2007*.

\(c\)/ Including Bahrain’s share of the Abu Safa oilfield.

\(d\)/ Qatar has been experiencing substantial increase in non-crude oil exports, namely, liquefied natural gas (LNG), which is not accounted for in this table.

\(e\)/ Including a 50 per cent share of the Neutral Zone.
CHAPTER I. RECENT ECONOMIC TRENDS AND DEVELOPMENTS IN THE ESCWA REGION

As a direct impact, the continuous surge in oil revenue resulted in another year of considerable fiscal surplus in the countries of the GCC. However, the role of public expenditure in domestic demand growth in the current oil boom has been limited until recently. Given that the economies of the GCC have become more diversified, compared to the structure in previous oil booms, the current income effect of oil revenues has been leveraged domestically through the asset markets. Those asset markets possess market-based linkages to the production activities of the emerging manufacturing, financial, construction and services sectors. Consequently, these production sectors have contributed to more value added GDP in the countries of the GCC, and the income generated by these production sectors has contributed to the consistent expansion of domestic demand. This robust growth trend in domestic demand formed a strong expectation for higher asset prices until early 2006.

The role of public expenditure is set to become more important in 2007 in order to compensate the capacity in the private sector and sustain domestic demand, which became weaker from early 2006 owing to the downward adjustments in the stock markets of the region. From that date, the expectation in share prices started to carry a more cautious note. Specifically, the leverage of the income effect through stock markets to domestic demand became weaker, and the inertia of growth expectation was borne by the tangible asset in property markets. The resulting intensification in investments into the construction activities and the rise in property prices have mounted inflation pressures throughout the region. Moreover, where investment sentiments remained weak, there is evidence that more funds were invested into foreign assets from countries of the GCC in 2006 as another alternative to domestic financial assets. Consequently, the income effect of oil revenues became less leveraged domestically given the following: (a) weak stock markets; (b) mounting inflation pressures; and (c) increasing investment in foreign assets. The countries of the GCC are expected to undergo this transition stage whereby the role of public expenditure and selective aggregate demand management increase in importance.

MDEs continued to benefit from the current oil boom in 2006. With the exception of the Syrian Arab Republic, oil-exporting countries in this subregion experienced a substantial increase in oil export revenue that also improved the fiscal balance. Furthermore, consistent positive income effects have been observed through trade and business with the countries of the GCC, workers’ remittances and intraregional investments. High fuel prices negatively impacted the oil-importing countries of Jordan and Lebanon. Jordan implemented additional cuts in fuel subsidies and shifted its energy policy in order to increase the use of natural gas. These policy measures released the Government of Jordan from the fiscal burden caused by the rise in crude oil price, while minimizing the impact of inflation. In Lebanon, the war in summer 2006 and the subsequent political instability made it difficult for the Government of Lebanon to implement a similar set of policy measures.

C. OUTPUT AND DEMAND

While a deceleration of growth rate was observed, the growth of GDP remained at a high level across the region in 2006, with the exception of the conflict-stricken countries and territories of Iraq, Lebanon and Palestine. The average GDP growth for the ESCWA region was an estimated 5.6 per cent in 2006, down from 6.9 per cent in 2005. Further slowdown is forecast in 2007 where the grow rate of real GDP is predicted to be 5.1 per cent (see table 5).

Equally, a robust growth in domestic demands was observed in the region in 2006, with the exception of Iraq, Lebanon and Palestine. The feared negative wealth effect, stemming from violent adjustments in regional stock markets in early 2006, has not been observed yet to a significant degree. Recent rapid

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8 See Chapters II-IV for further analyses and discussions on the lessons from current and previous oil booms.
increases in fiscal expenditures in most ESCWA member countries sustained domestic demands and offset factors that could have dented business and consumer confidence.

### Table 5. Real GDP Growth Rate and Consumer Inflation Rate in the ESCWA Region, 2003-2007

<table>
<thead>
<tr>
<th>Country/Area</th>
<th>Real GDP growth (Annual percentage change)</th>
<th>Consumer inflation rate (Annual percentage change)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bahrain</td>
<td>7.2</td>
<td>5.6</td>
</tr>
<tr>
<td>Kuwait</td>
<td>16.5</td>
<td>10.5</td>
</tr>
<tr>
<td>Oman</td>
<td>2.0</td>
<td>5.4</td>
</tr>
<tr>
<td>Qatar</td>
<td>3.5</td>
<td>20.8</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>7.7</td>
<td>5.3</td>
</tr>
<tr>
<td>United Arab Emirates</td>
<td>11.9</td>
<td>9.7</td>
</tr>
<tr>
<td>GCC</td>
<td>8.9</td>
<td>7.7</td>
</tr>
<tr>
<td>Egypt</td>
<td>4.1</td>
<td>4.5</td>
</tr>
<tr>
<td>Iraq</td>
<td>(33.1)</td>
<td>23.0</td>
</tr>
<tr>
<td>Jordan</td>
<td>4.2</td>
<td>8.4</td>
</tr>
<tr>
<td>Lebanon</td>
<td>3.0</td>
<td>5.0</td>
</tr>
<tr>
<td>Palestine</td>
<td>8.5</td>
<td>2.0</td>
</tr>
<tr>
<td>Syrian Arab Republic</td>
<td>1.1</td>
<td>8.6</td>
</tr>
<tr>
<td>Yemen</td>
<td>3.8</td>
<td>3.9</td>
</tr>
<tr>
<td>MDEs</td>
<td>(0.2)</td>
<td>6.4</td>
</tr>
<tr>
<td>Total ESCWA region</td>
<td>5.7</td>
<td>7.3</td>
</tr>
<tr>
<td>Conflict-stricken economies</td>
<td>0.2</td>
<td>6.4</td>
</tr>
</tbody>
</table>

**Sources:** Calculated by ESCWA, based on computations of growth rates from real GDP figures at constant 2000 prices. These are taken from national sources and official figures as provided by answers related to questionnaires for the National Accounts Bulletin of the ESCWA Region, 26th issue. Estimates for the consumer inflation rate in 2007 are based on International Monetary Fund (IMF), World Economic Outlook database (September 2006).

**Notes:** Parentheses () indicate negative numbers. Data for country groups are weighted averages whereby weights for each year are based on GDP in 2000 constant prices.

- c/ Estimates for 2006 are based on official preliminary figures.
- d/ Iraq rates are based on official sources except for 2005 and 2006, which are EAD estimates.
- e/ The average of Iraq, Lebanon and Palestine.
- f/ This regional tally excludes Iraq, Lebanon and Palestine.

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 a resilient growth in domestic demands. The manufacturing, financial services and construction sectors led the non-oil production growth, thereby creating more webs of linkages among the supply-demand structure of domestic economy. The development of these linkages was observed in most countries of the GCC, which is crucial in terms of maintaining the current growth performance. Consequently, future GDP growth for this subregion is dependent on the following: (a) the range of crude oil price level; (b) the trend in the growth of global monetary liquidity and the expansion in global credit; (c) the speed at which the economic effects of current
private and public investment can be materialized in terms of output levels, productivity and domestic production structure; (d) the strength of domestic demand growth; and (e) fiscal and monetary policies for selective demand management.

The first two factors are external to the countries of the GCC, whose effects are predicted to remain positive, albeit at more moderate levels. The effect of the rapid pace of investment has so far been limited to the demand side of the economies; there is therefore a need to wait some years in order to measure the extent to which these investment activities have transformed the economies of this subregion. As discussed above, the domestic demand growth is expected to be less robust in 2007, given less leverage effects from domestic asset markets subsequent to the downward adjustments of stock markets. While the fiscal and monetary authorities of the countries of the GCC have striven to push down inflation pressures without stalling domestic demand growth, selective demand management is difficult in principle. In the light of these factors, the average growth rate of real GDP for countries of the GCC is forecast to decline to 4.8 per cent in 2007.

A strong investment-led growth continued in Bahrain and Qatar, which registered real GDP growth of 6.1 per cent and 7.0 per cent, respectively. The trend is expected to continue in 2007 for those two countries at 5.5 per cent and 7.4 per cent, respectively. Qatar is the only country of the GCC where the current forecast predicts a rebound in the growth rate. This can be largely attributed to the strong external demand for that country’s expanding capacity in LNG exports and the continuing robust domestic demand growth upon the expectation of a lower inflation rate. While the forecast for Bahrain relates mainly to the slower domestic demand growth, that country is in the process of transforming its economic diversification, with evident strengths in its aluminium, finance and telecommunications sectors.

After three years of spectacular growth, the economy of Kuwait pursued a stable growth path at 6.5 per cent in 2006. There was a rapid demand growth both in consumption and investment during this transition phase, which replaced the role of external demand in the demand composition of that country. Specifically, there was active investment in the oil sector in addition to the construction, financial and telecommunications sectors, while consumption registered consistent and gradual growth. A slowdown in real GDP growth rate at 4.9 per cent is projected for Kuwait owing to lower crude oil prices and slower growth in domestic demand.

The real GDP growth of Oman was an estimated 6.4 per cent in 2006 as a result of a rebound in domestic demand growth. Additionally, increasing implementation of energy-related investment projects accelerated the economy of Oman in 2006, and the diversification of the economy continued in terms of expanding tourism sector and increasing LNG production. While consistent growth in domestic demand is expected, weaker external demand is set to slow down the economy. The real GDP growth rate of Oman is predicted to be 5.1 per cent in 2007.

Saudi Arabia grew at 4.2 per cent in 2006 and is set to grow at 3.8 per cent in 2007; and the United Arab Emirates registered a growth of 8.9 per cent in 2006 and is forecast to grow at 6.0 per cent in 2007. There was balanced growth in both consumption and domestic investment in both countries. Moreover, diversification efforts have gradually webed the linkages between non-oil production sectors and economic participants to the intermediate and final stages of consumptions. Consistent growth in construction, manufacturing, finance and business were observed in both countries. Specifically, while construction activities showed a rapid pace of growth in nominal terms, appreciating costs resulted in moderate growth in its contribution to the value-added aggregate in real terms. The strategic importance of the petrochemicals sector has anticipated increasing investments into this sector where both countries have advantages in terms of resource costs and of their relatively large home markets. The real GDP growth rates are projected to
slow down in both countries owing mainly to weaker domestic demand growth. Furthermore, both countries were affected to a greater extent by the downward adjustments of stock markets in 2006. While the immediate negative wealth effect has not been observed, the leverage mechanism from oil revenues to domestic demand growth was weakened. Given its large portion of the economy, the trend in domestic demand is set to dominate the economic performance in 2007, pending the economic and structural effects arising from the rapid physical investments undertaken in past years.

The average real GDP growth in MDEs was an estimated 5.1 per cent in 2006, after registering 6.0 per cent in 2005. In terms of fiscal and external balance, the macroeconomic balance is more important in this subregion as aggregate demand growth can easily be dented when it causes significant external or fiscal deficits. The domestic demand of the countries of this subregion was not noticeably constrained either fiscally or externally. However, the fragility in the production structure remained. Investment activities in construction, manufacturing, telecommunications, and financial and services sectors have transformed the production structure at varying rates across this subregion. However, recent robust economic growth has relied on more consumption growth than that of physical investment in terms of composition of domestic demand.

Consequently, future GDP growth for this subregion is dependent on the following: (a) the price range of crude oil; (b) the trend in global monetary liquidity and in global credit expansion; (c) capital inflows through both portfolio and foreign direct investment (FDI); (d) physical investment in manufacturing and services sectors aimed at increasing the potential for export growth; and (e) policy readiness aimed at fending off negative developments in external economic factors.

The first two factors are external to the countries categorized as MDEs, and represent essentially the same basic factors that affect the economies in the GCC subregion. However, export growth plays a pivotal role in MDEs in terms of ensuring sufficient macroeconomic balance for domestic demand growth. Within that context, the inflow of capital is crucial for short-term macroeconomic performances, and developing the export-oriented sector is equally important for long-term economic development. Additionally, policy readiness for adversary external factors of these countries is important. When the current favourable external economic conditions come to an end, namely, high growth of global monetary liquidity, global credit expansion and high commodity prices, the macroeconomic balance of those countries is expected to be affected directly. Taking these factors into consideration, the growth rate of real GDP for MDEs on average is predicted at 5.7 per cent in 2007. This forecast of a modest increase in the GDP growth rate can be attributed to expected recoveries in conflict-stricken countries in this subregion as well as robust economic performances of other countries. Abrupt changes in favourable external economic conditions are not expected in 2007 to the extent that these will severely affect the macroeconomic balances of MDEs.

In Egypt and Jordan, strong consumption and business confidence was equally evident in faster recoveries in the stock market performance of these two countries. In 2006, the GDP growth rate of Egypt and Jordan was 6.8 per cent and 6.4 per cent, respectively. Industrial development continued in both countries, which was particularly evident in the apparel and textile sector in the qualified industrial zones (QIZs) of both countries. In addition to this development, there was a consistent development in the steel sector in Egypt and the pharmaceutical sector in Jordan. Moreover, as with other ESCWA member countries, the construction, banking and services sectors were active. While domestic demand in both countries is believed to have been led by private consumption in line with recent trends, there is little evidence to suggest that consumption crowded out investment activities. A decline in GDP growth rate is expected for both countries owing to weakened consumption arising from inflationary pressures in 2006. Consequently, while solid and consistent investment growth is expected, it is not expected to compensate for the downturn
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in consumption. In 2007, Egypt is predicted to grow at 5.8 per cent, while Jordan is forecast to grow at 5.3 per cent.

The Syrian Arab Republic registered a growth of 5.0 per cent in 2006. Diversification of the production structure in that country continued, particularly in the manufacturing sector with the imminent launch of an automobile industry in 2007, which is set to have a substantial impact in the industrial structure. Given dwindling oil exports and revenue in recent years, the economy has become more dependent on domestic demand than external demand. In terms of domestic demand, consumption has led the recovery in GDP growth since 2003. The momentum of consumption growth is comparatively strong and the rising inflation is not expected to dent this momentum. Consequently, the Syrian Arab Republic is expected to grow at 5.6 per cent.

The real GDP growth rate for Yemen was 4.2 per cent in 2006. While efforts aimed at diversifying away from oil exports are crucial for the development of Yemen, that country witnessed little progress into industrial development in 2006. Rather, efforts focused on LNG, agriculture and fisheries sectors. While increased oil exports and revenue provided a space for the growth in domestic demand in both consumption and investment, the growth in domestic demand was unable to gain momentum given the high rate of inflation that weakened the supply structure. In 2007, there is set to be an increase in the contribution to the growth rate by external demand, whereas the composition of domestic demand growth is predicted to remain unchanged. In that light, the growth rate for 2007 is forecast to inch up to 4.3 per cent.

Security tensions and pressures pushed down business and consumer confidence in the conflict-stricken countries and territories of Iraq, Lebanon and Palestine. Continuing violence and civil conflicts in Iraq delayed the reconstruction efforts, with exception of the region of Kurdistan. While the GDP growth was estimated at 8.0 per cent in 2006, this is largely dependent on external demand for its oil exports. The momentum for the growth in domestic demand has stalled and that figure may not accurately reflect the state of the domestic economy in this sense. While extremely high inflation precludes consumption growth, the adverse security situation rules out investment growth. Consequently, while real GDP growth rate is estimated at 7 per cent in 2007, domestic demand in real terms is expected to grow to a significantly lesser degree than GDP growth.

The economy of Palestine was severely weakened in 2006. Real GDP growth in the occupied Palestinian territories was estimated at minus (-) 6.9 per cent in 2006. The economic activities in the territories were severely disrupted by the sanction imposed by the Government of Israel on the Gaza Strip, and by closures around Palestinian cities and the “separation wall” in the West Bank. Business and consumer confidence were substantially weak in the light of unremitting violence in the territories throughout 2006. This confidence was further weakened by the decision of the Israeli Government to stop transfer payments and suspend foreign aid inflows from developed countries in the wake of the Palestinian elections in January 2006. While the economic outlook for 2007 is highly dependent on the political situation, a modest improvement is expected in the face of accelerated political dialogue. Palestine is predicted to grow at 1.0 per cent in 2007. This weak prospect for demand growth will put GDP growth projections at 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.

The war in the summer 2006 weakened the production structure as well as the general infrastructure of Lebanon. Civilian infrastructures and several industrial establishments were destroyed by Israeli military attacks. Moreover, the war negatively affected the country’s tourism sector, which had already been damaged by political instability since February 2005. Lebanon recorded an estimated minus (-) 5.0 per cent growth in 2006. In the first half of 2006, a positive and strong growth was expected as consumer and
business sentiment recovered and grew stronger. However, the war and the subsequent escalation of political instability severely weakened domestic demand. The contribution of reconstruction activities to the economy was unable to bring GDP growth into positive figures. However, the economy of Lebanon is expected to gain momentum in 2007 and to register 6.0 per cent in real GDP growth. Domestic demand is expected to return to the pre-war level along with continuing investments for reconstruction. However, business and consumer sentiment is fragile in Lebanon and is highly dependent on the political situation.

D. COST AND PRICES

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 (see table 5). Regionally, average consumer inflation rate registered 5.6 per cent in 2004, which showed a fluctuation in the regional average. However, the figure in 2004 reflected such country-specific trends as rapid domestic price hikes in Egypt and Yemen in conjunction with significant devaluations of the respective national currencies. The figures in 2006 reflected more international and regional trends of inflationary pressures. Within ESCWA member countries, the inflation rate ranged from a low of 2.0 per cent in Bahrain to a high of 53.2 per cent in Iraq.

The high international commodity prices raised the general price level of the region. The affected items included crude oil, metal, construction materials and crops. The characteristics of the current inflation trend reveal indices that are typically lower than the general consumer perception. Specifically, items that registered rapid price hikes related to property rent and foodstuff, which directly affect household budgets. The extent to which the international trend was amplified was largely determined by such domestic factors as the structure of markets and institutional settings.

There is little evidence of significant increase in labour cost in the region. Official and effective raises in the wage of public sector employees have been observed in countries of the GCC, most notably in Qatar in December 2006. Moreover, the minimum wage was introduced for nationals working in the private sector in Bahrain and the United Arab Emirates, while the minimum wage was raised in Jordan. Despite these institutional and policy settings, the level in nominal wages did not sufficiently catch up with the speed of the price hikes in property rent and foodstuff. This pattern of inflation implies a widening inequality in income distribution between proprietors and those who do not own properties. Consequently, the current inflation could have significant impacts on poorer segments of society that typically do not own property.

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

In 2007, the moderate economic slowdown and direct policy interventions in countries of the GCC are expected to level off the rate of inflation to an average of 2.7 per cent. By contrast, the rate of inflation across MDEs is expected to be 5.9 per cent in 2007. Inflation in Iraq is set to climb to 66.4 per cent in 2007 owing to the continuous supply bottlenecks that arise from the unstable security situation in that country.

E. LABOUR MARKETS

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 foremost
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challenge for policymakers in the region, with persistent difficulties facing both new entry and re-entry of women to labour markets. The chronic mismatches between skills required by employers and those provided by job applicants have not been significantly resolved in both the countries of the GCC and MDEs. Policymakers in the region are well aware of the problem, particularly in the light of existing demographical pressures; and employment creation remains the priority in most ESCWA member countries.

In 2006, official estimates of unemployment registered rates of 6.3 per cent in Saudi Arabia, 8.5 per cent in the Syrian Arab Republic, 10.0 per cent in Egypt, 14.0 per cent in Jordan and 23.6 per cent in Palestine (see table 6). For the majority of countries where data are available, there was a modest change in the unemployment rate in 2006, subsequent to significant improvements recorded between 2004 and 2005. While Egypt and Jordan registered a slight improvement, Palestine, Saudi Arabia and the Syrian Arab Republic marked a moderate increase in the unemployment rate. In Palestine, the employment situation in the Gaza Strip has been steadily deteriorating, with unemployment soaring from a high of 30.3 per cent in 2005 to 34.8 per cent in 2006. By contrast, the West Bank witnessed a modest improvement, with unemployment dropping from 20.3 per cent in 2005 to 18.6 per cent in 2006.

<table>
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<tbody>
<tr>
<td>Country/area</td>
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<tr>
<td>Bahrain</td>
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<td>Kuwait</td>
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<td>Oman</td>
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<td>Qatar</td>
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<td>United Arab Emirates</td>
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<td>Egypt</td>
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<td>Iraq</td>
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<td>Jordan</td>
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<td>Lebanon</td>
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<tr>
<td>Palestine</td>
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<tr>
<td>Syrian Arab Republic</td>
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<tr>
<td>Yemen</td>
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<tr>
<td>MDEs</td>
</tr>
<tr>
<td>Total ESCWA region</td>
</tr>
<tr>
<td>Conflict-stricken economies</td>
</tr>
<tr>
<td>ESCWA region except conflict-stricken economies</td>
</tr>
</tbody>
</table>

Source: Per capita GDP growth rates have been calculated by ESCWA, based on GDP data (rescaled at 2000 constant prices) and total population estimates are from the Department of Economic and Social Affairs (DESA), Population Division, World Population Prospects, 2004 Revision. Where these are available, unemployment rates are from national sources.

Notes: Parentheses () indicate negative numbers. Two dots (...) indicate that data are not available.

a/ ESCWA estimates, March 2007.
c/ This regional tally excludes Iraq, Lebanon and Palestine.
The importance of employment creation can be highlighted by the observed slow development in per capita GDP growth of ESCWA member countries (see table 6). On average, per capita GDP growth of ESCWA member countries has been on a declining trend since 2004 when it registered 4.7 per cent. In 2006, this regional per capita GDP growth was an estimated 3.3 per cent, which is projected to drop to 2.2 per cent in 2007. With the exception of Qatar, per capita GDP growth in real terms for the countries of the GCC is expected to decline in 2007 to an average of 1.6 per cent from 3.1 per cent in 2006. The average for MDEs in 2007 is expected to remain at the same level of 2006, namely, at 3.1 per cent.

Increasing unemployment rates and declining per capita GDP growth rates constitute a worrying trend in income distribution across different generations, which is the case of Saudi Arabia. Equally, relatively high real per capita GDP growth and chronic high unemployment rates, which represents the case of most MDEs, is another worrying trend in income distribution between those in stable employment and those seeking work.

Recognizing this situation, various reform measures were in process across the region, particularly among countries of the GCC. Specifically, workforce nationalization strategies were rendered more flexible, with greater emphasis on human resource development and vocational training of nationals than on the quota enforcement of those strategies. Within that context, a minimum wage for nationals working in the private sector was established in Bahrain and the United Arab Emirates. Saudi Arabia temporarily cut the quota rate of the employment of nationals for sectors where there was a shortage of qualified labour supply. Additionally, Bahrain, Kuwait and the United Arab Emirates continued to draft and review new labour laws for their adoption in the near future.

In 2006, there was greater focus on the rights issue of foreign workers in the region, particularly in the countries of the GCC and within the framework of labour law reforms. Specifically, the United Arab Emirates introduced new standard contracts aimed at regulating the rights and duties of foreign housemaids, which is set to be implemented in early 2007 and expected to be emulated in other countries of the GCC. Jordan enhanced labour inspections especially in order to protect foreign workers in QIZs, and decided to raise the minimum wage for nationals as well as foreign workers in 2006. Moreover, several countries that supply foreign workers to the ESCWA region, namely, India, the Philippines and Sri Lanka, initiated more cooperation with host countries in order to protect the rights of workers.

The security situation in conflict-stricken countries caused a reallocation of human capital and potential, thereby marking uneven development in the region. In Iraq, where unemployment was exceptionally high in the range of 30-50 per cent, the acceleration of emigration and outflows of skilled labour force became a major concern. In March 2007, the United Nations High Commissioner for Refugees (UNHCR) estimated that some 500,000 Iraqi refugees had sought asylum in Jordan, another 500,000 in the Syrian Arab Republic, 20,000 in Lebanon and 20,000 in Egypt. To a lesser degree, a similar phenomenon was observed in Lebanon in the aftermath of the war of summer 2006, given the insecure career prospects in the Lebanese private sector.

F. EXTERNAL SECTOR

The external sector performance of the ESCWA region was very robust in 2006. The current account balance became stabilized in positive figures in most member countries, while the trade activities of the region continued to expand. This can be attributed to strong export performance of oil-exporting ESCWA member countries, several crucial developments in industrial exports and robust trade in services represented

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by tourism. While Jordan, Lebanon and Palestine experienced current account deficits in 2006, with declining levels of deficits in terms of GDP in all three ESCWA members, Egypt, the Syrian Arab Republic and Yemen registered positive and robust current account surpluses; and the countries of the GCC recorded a historically high current account surplus.

While the trade balance surplus remained at a high level across the GCC, this surplus in terms of nominal GDP showed a mixed picture (see figure 5). The continuing surge in the exports of crude oil, natural gas and oil-related products contributed significantly to this surplus. Additionally, non-oil exports, including aluminium, steel and petrochemical products contributed to the growth in exports from the countries of the GCC. However, this growth in exports was overtaken by a growth in imports, which was driven by expanding domestic demand. This was the case of Oman, Qatar and the United Arab Emirates, which experienced declining trade balances in terms of GDP from the previous year. In 2006, the trade balance of goods in terms of nominal GDP was estimated at 20.4 per cent for Bahrain, 40.2 per cent for Kuwait, 33.5 per cent for Oman, 29.6 per cent for Qatar, 42.1 per cent for Saudi Arabia and 30.3 per cent for the United Arab Emirates.

Figure 5. Trade balance and current account balance in the GCC

Source: ESCWA, based on national sources.

Moreover, increasing deficits in the trade in services and outflows in current transfers, including workers’ remittance, led to a decline in the current account surplus in terms of nominal GDP in Kuwait, Oman, Qatar and the United Arab Emirates. Within that context, only Bahrain and Saudi Arabia witnessed modest growth in that figure. Despite efforts aimed at developing tourism in the countries of the GCC, the trade in services was in deficit in this subregion, with the exception of Bahrain. In 2006, the current account surpluses in terms of nominal GDP were estimated at 13.1 per cent for Bahrain, 39.6 per cent for Kuwait, 14.7 per cent for Oman, 11.6 per cent for Qatar, 32.3 per cent for Saudi Arabia and 16.3 per cent for the
United Arab Emirates. While the absolute level of the current account surplus marked an historic high in 2006, the level in terms of nominal GDP showed signs of tapering in the proportion owing to the rapid expansion of domestic demand. This trend is expected to continue in 2007.

Figure 6. Trade balance and current account balance in MDEs

Across MDEs, the trade balance of goods was in surplus in Iraq, the Syrian Arab Republic and Yemen in 2006. The magnitude of the surplus in terms of nominal GDP has been on an increasing trend in Iraq given its crude oil exports and weak domestic demand. In the Syrian Arab Republic, despite decreasing crude oil exports, the increase in manufacturing exports put the trade balance into surplus in 2006, subsequent to a deficit in the previous year. The trade balance surplus of Yemen has been on an increasing trend since 2003. While this can be largely attributed to the rapid increase of crude oil exports, this trend also reveals structural constraints on domestic demand in Yemen.

Source: ESCWA, based on national sources.
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Egypt and Jordan experienced continuous trade balance deficits, despite significant growth in exports of their respective manufacturing sectors. This trend indicates that development in the manufacturing exports of both countries led to an increase in imports for the intermediate inputs into domestic manufacturing production. Meanwhile, a small base of exports in goods put the trade balance deficits of Lebanon and Palestine at a high level. Owing to decreasing domestic demand in the light of violent conflicts in 2006, the magnitude of trade balance deficits remained stable in both these ESCWA members. In 2006, the trade balance in terms of nominal GDP was estimated at minus (-) 10.7 per cent in Egypt, 12.8 per cent in Iraq, minus (-) 36.8 per cent in Jordan, minus (-) 33.8 per cent in Lebanon, minus (-) 57.7 per cent in Palestine, 0.8 per cent in the Syrian Arab Republic and 13.6 per cent in Yemen.

The trade in services and current income transfer inflows contributed to a more solid picture in current account balance of MDEs. As a result, the level of current account deficits was significantly smaller than that of the trade balance of goods in Jordan, Lebanon and Palestine. Similarly, the magnitude of current account surplus was larger than that of the trade balance of goods in the Syrian Arab Republic. The contribution of tourism and the income from the Suez Canal contributed to the stable surplus in the current account of Egypt. In Yemen, the magnitude of current account surplus was smaller than that of the trade balance of goods owing to deficits in the trade in services. In 2006, the current account in terms of nominal GDP was estimated at 2.3 per cent in Egypt, 10.9 per cent in Iraq, minus (-) 13.8 per cent in Jordan, minus (-) 14.5 per cent in Lebanon, minus (-) 27.6 per cent in Palestine, 2.9 per cent in the Syrian Arab Republic and 9.6 per cent in Yemen.

Total outflows of workers’ remittances from countries of the GCC were estimated at $30 billion in 2006 (see figure 7). The level of outflows has continued to grow since 2001 to home countries of expatriate workers in South and South-East Asia and the ESCWA region. Total inflow of workers’ remittances into MDEs was an estimated $16 billion in 2006, which originated mainly from North America, Europe and the ESCWA region. This reliance on inflows of workers’ remittances continued to be significant in 2006 in Jordan, Lebanon and Palestine, which, in terms of GDP, were an estimated 16 per cent, 27 per cent and 18 per cent, respectively.

**Figure 7. Flows of workers’ remittances**

Estimated total outflows from countries of the GCC

Estimated total inflows into MDEs

*Source: ESCWA, based on national sources.*

As of 2006, the foreign exchange rates of ESCWA member countries were effectively pegged against the United States dollar, with the exception of Egypt, Iraq and Yemen. Kuwait revalued its national currency by appreciating it against the dollar by 1 per cent in 2006, albeit maintaining a stable exchange rate regime throughout the year. The national currencies of the region depreciated against the euro, owing to the
appreciation of that European currency against the United States dollar (see figure 2-A). By contrast, the depreciation of the Japanese yen against the dollar (see figure 2-B) caused the national currencies of the region to appreciate against the Japanese currency. Consequently, the development of the major world currencies in terms of nominal effective exchange rate (NEER) varied among ESCWA member countries according to the trading partners and the use of vehicle currency.\(^{10}\)

Figure 8 shows the estimated nominal and real effective exchange rate (REER) of countries of the GCC. NEER shows a modest depreciation in parallel to the move against the euro by the United States dollar. However, the magnitude varied largely according to the trade weight with Japan, whose national currency depreciated against the dollar. The estimated NEER of Kuwait has been very stable since 2000. Bahrain, Kuwait, Oman and Saudi Arabia exhibited lower levels of REER than NEER given lower inflation rates of those countries than the rates of major trading partners since 2000. However, Qatar and the United Arab Emirates experienced appreciating REER owing to inflation rates in both countries exceeding those of major trading partners. The development of NEER and REER shows that the current oil boom did not cause real appreciation in the countries of the GCC, with the exception of Qatar and the United Arab Emirates. However, previous oil booms raised the domestic price and cost level of countries of the GCC, which caused a loss of non-oil export sectors as a long-term phenomenon (see chapter II for more details). Moreover, there are signs that the rate of depreciation of national currencies in terms of NEER was not as rapid in 2006, compared to the period of 2003-2004 when the dollar depreciated against both the euro and Japanese yen.

Figure 8. Nominal and real effective exchange rates in the GCC

![Graphs showing nominal and real effective exchange rates for Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and United Arab Emirates.](image)

Source: ESCWA.

\(^{10}\) The nominal effective exchange rate (NEER) is an index of foreign exchange rates against major trading partners weighted by trading values; and the real effective exchange rate (REER) is a modified index of NEER with consumer inflation rates.
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Figure 9 shows the estimated nominal and real effective exchange rates of MDEs. While NEER of Egypt has been stable since 2004, REER shows the appreciation owing to rapid domestic inflation that has been faster than its trading partners. The nominal exchange rate of Iraq had been stable since 2004 until November 2006 when the Central Bank of Iraq decided to revalue its national currency. However, the real exchange rate showed a quick appreciation over three years, which can be attributed to the high inflation in that country. Jordan has shown stable development in both NEER and REER since 2000. Among countries that peg their national currency to United States dollars, Jordan has faced less pressure to revalue its national currency. Gradual devaluation in terms of NEER has taken place both in Lebanon and the Syrian Arab Republic, which experienced the appreciation in REER owing to rapid domestic inflation. Yemen’s NEER continued to depreciate as a result of the gradual devaluation of its national currency against the dollar, while its REER appreciated consistently owing to the chronically high inflation of that country.

The patterns of development in NEER and REER show that a nominal devaluation of national currencies against major currencies has only a partial effect as an inflationary pressure. While the simultaneous depreciation in NEER and appreciation in REER occurred in Egypt, Iraq, Qatar, United Arab Emirates and Yemen, it was not the case in other countries of the ESCWA region. This implies a diversified domestic market structure of the region through which the level of nominal exchange rate affects domestic demand and general price level. For example, a nominal revaluation could alleviate inflation by reducing the price of imported goods in terms of national currency; and, on the other hand, it could cause inflation by stimulating domestic demand. Equally, a nominal devaluation could cause inflation by increasing the price of imported goods in terms of national currency and, conversely, alleviate inflation given that the monetary authority can control money supply without creating excess liquidity to support a national currency against foreign currencies. In 2006, there was no evidence of a regional pressure for currency revaluation or devaluation even at subregional levels. The level of exchange rate remains specific to individual nations and more regional cooperation is expected in that regard.

Figure 9. Nominal and real effective exchange rates in MDEs

Source: ESCWA.

Note: Iraq’s REER and NEER are only weighted against the United States dollar; and only inflation data of Iraq and the United States of America are used to estimate REER.
In the area of institutional development, the United States of America was active at various stages of trade negotiations in the ESCWA region, within the framework of free trade agreements (FTAs) between the United States of America and various Arab countries. Specifically, Oman and the United States of America signed an FTA in January 2006; an FTA between Bahrain and the United States of America entered into effect in August 2006; and the United Arab Emirates was at the negotiation stage to establish an FTA with the United States of America.

In parallel to this development and within the framework of the Mediterranean Arab Free Trade Area (MAFTA) with the European Union (EU), the Agadir Agreement between Egypt, Jordan, Morocco and Tunisia came into effect in 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 aimed at establishing an FTA. Equally, the GCC considered setting up FTAs with China, India and Singapore. The trend of establishing such bilateral trade frameworks as FTAs continued, particularly given that the Doha Round negotiations of the World Trade Organization (WTO) failed to show significant progress in 2006, and the prospects of multilateral trade agreements remains uncertain.

G. ECONOMIC POLICY DEVELOPMENTS

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 policies for their fiscal year covering 2006. There was a clear prioritized increase in Government expenditure in the health and education sectors in most 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 maintained prudent fiscal policy stances. The oil price projections for revenue estimation were very conservative in the national budgets of countries of the GCC. Egypt and Jordan successfully met their targets in reducing budget deficits and public debts. In Yemen, while there was a need for an increase in Government expenditure on development, this was only executed once increased oil revenues were accumulated and stable international assistance was received.

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 formulated in Iraq for 2006, thereby stressing reconstruction and investment projects. However, the implementation of these projects was hampered by the adverse security situation. In Lebanon, the aftermath of the war of Israel in the summer 2006 added a severe constraint on fiscal policy. International support was pledged in August 2006 for reconstruction and, in January 2007, for a 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.

In 2006, inflation became increasingly a major policy agenda in the region as consumer prices were visibly on upward trends. Within pegged or well-targeted stable exchange rate regimes, central banks in the ESCWA region were denied the capacity of controlling domestic liquidity. This is only possible under a more flexible exchange rate regime. However, the effect was limited in forcing price levels given that the inflation stemmed from the hike in international prices of commodities, including construction materials, as well as from 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...
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demand. However, with the exception of Iraq, inflation rates in the ESCWA region were still in a manageable range, albeit at different levels (see table 5).

Monetary indicators showed signs of monetary tightening towards the end of 2006 in the countries of the GCC (see figure 10). In terms of narrow money, growth in the money supply declined in the countries of the GCC, particularly in Kuwait and the United Arab Emirates, where the year-on-year growth of narrow money even recorded negative growth at some points in 2006. However, the growth of broad money did not respond to the declining growth of narrow money. This contrast shows the difficulty for central banks in countries of the GCC in managing demand through the existing set of monetary policy options. Meanwhile, central banks in countries of the GCC accumulated foreign reserves; and foreign asset accumulation took place in other public accounts, including reserve funds and non-official foreign reserve account of central banks. For that reason, the growth in foreign reserves was comparatively modest, taking into account the surge in oil export revenue.

Figure 10. Monetary indicators in the GCC, 2005-2006

Bahrain

Kuwait

Oman

Qatar

Saudi Arabia

United Arab Emirates

Source: ESCWA, based on national sources.

Monetary tightening was observed in Jordan and the Syrian Arab Republic in 2006 whereby year-on-year growth rates of both narrow and broad money were in decline during that year (see figure 11). Subsequent to stringent monetary tightening policy in 2005, Iraq took a stable monetary stance in 2006. Similarly, Egypt has maintained its stable monetary stance for the past two years, thereby succeeding in keeping the growth of broad money in the range of 10-15 per cent. Lebanon switched its monetary stance in order to make it more expansionary in 2006, while gradually increasing the level of foreign reserves to $15 billion. Yemen accumulated foreign reserves rapidly to $7.5 billion, while adopting a clear stance of monetary expansion towards the end of 2006.
In order to alleviate an extremely high inflation rate, the Central Bank of Iraq has continuously revaluated the national currency since November 2006, thereby encouraging import prices to drop in terms of the national currency. In the last two months 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 the countries of the GCC were intensified in 2006, particularly in the light of the imminent GCC Monetary Union that is set for 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

Another cycle of the 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, are set to sustain domestic demand where consumer and business confidence indicate no signs 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.

A worrying economic factor for the region is a worldwide credit crunch, which could stall the growth of global monetary liquidity. With fewer 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 with a global credit crunch, it could damage the strongly emerging financial sector of this subregion. Despite a low probability of such a worldwide credit crunch occurring in 2007, there is a need to recognize the potential vulnerability of the region.

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 the distribution of human capital within the ESCWA region.
II. REGIONAL IMPLICATIONS OF THE OIL BOOM

This chapter reviews the current oil price boom from two main perspectives. First, it examines the existing structure and dynamics of the global oil market, and identifies both short- and long-term supply and demand factors that have contributed to the atmosphere of uncertainty that currently surrounds the global oil market. The second part concentrates on the macroeconomic implications that sudden increases in oil prices have had on oil exporters and, subsequently, focuses on the effects sustained by the ESCWA region. Particular attention is given to the widely varying impacts on the two subregions of ESCWA, namely, the countries of the GCC and MDEs. The ultimate purpose of this chapter is to examine the potential risks typically faced by Governments when a resource boom occurs, such as the prevailing one. In addition, it highlights the warning signs that have recently emerged in some economies in the region with the aim of raising awareness, thereby encouraging member countries to reap the full benefits of the current oil price boom.

A. THE CURRENT OIL BOOM

The price of crude oil has risen substantially since late 1998, when the OPEC oil price basket was just above $10/b. By early 2002, prices had doubled, and they continued to rise strongly albeit relatively smoothly. While benchmark oil prices reached a peak level of $75/b in mid-2006, they declined by approximately 20 per cent to a range of $50-60/b until January 2007, and bounced back during the first quarter of 2007 to some $65/b. This increasing oil price volatility in recent years has added an additional element to the atmosphere of crisis in the market (see box 1-B).

The recent rise in the price of crude oil owes to the confluence of several economic and geopolitical long-term factors that have contributed to exceptionally low elasticities of supply and demand (see box 1-A). These factors influence current market prices in the context of a highly oligopolistic market structure in which significant rents are available to low-cost producers, especially in the Gulf region. These factors are examined below.

However, the impact of uncertainty on the price of oil has been magnified by the changing structure of the oil market in the short term (see box 1-B). In reality, oil prices are not determined by the interplay of demand and supply on a uniform global market, or even exclusively by the strategic control of the market by a handful of cartelized suppliers. Instead, since the abandonment of the OPEC official selling price system and the oil price bands of the 1980s, prices have been determined in segmented markets for specific types of oil, on the spot market and, increasingly, in future exchanges and other derivatives markets where “paper oil”

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11 In this Survey, a resource boom is considered an increase in a country’s command of world output owing to a rise in the price of its exports of primary products. Considerably similar outcomes derive from any event leading to the increase in inflows of foreign currency. An example of this is a significant increase in the price of other exported goods or services, such as raw cotton or textiles, or even the hourly wages of expatriate workers. Within that context, see International Monetary Fund (IMF), World Economic Outlook (April 2005), chapter II. Alternatively, the increase in inflows of foreign currency could arise from the following factors: (a) an increase in aid or foreign investment; (b) the deliberate appreciation of the domestic currency; (c) indirectly, in the case of a country following a fixed exchange rate system, through the appreciation of the United States dollar; and (d) through the decline in the price of imported goods and services.


13 In this Survey, rents are defined as the returns of a factor of production above the amount necessary to bring that factor into use. Depending on the context, this can imply that rents are the returns higher than those accruing from the next-best alternative use of that factor, for example, the production of one crop rather than another in a given piece of land. Alternatively, they are the returns that exceed the competitive cost of production, for example, selling oil in the international market above the domestic cost of extraction.
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is traded. These prices respond to a whole host of determinants beyond the state of supply and demand in the long term (see box 1-B).

Box 1. Some structural features of the current oil boom, 2002-2007

Some of the structural factors that can explain the current escalations of global oil prices are set forth below.

A. Medium and long term

In terms of medium and long term, the following observations can be made:

(a) There has been a persistent increase in oil demand in the Asia and Pacific region since the mid-1980s, particularly in China and India, as well as the continuing pressure from the United States of America. While the increase in world oil demand in the years before 2004 was some 1.2-1.5 m/b/d, the annual increase in 2004 alone was approximately 2.7 m/b/d, which represents the highest rate of growth since 1976 at approximately 3.3 per cent;\(^a\)

(b) Severe constraints on production (upstream) capabilities have arisen, particularly in OPEC member countries and infrastructural and supply problems in several large oil exporters in the countries of the GCC. Consequently, they cannot be removed rapidly, thereby implying that the oil market is likely to remain tight for a significant period given the limited spare capacity;

(c) The market is stretched downstream (petrochemicals and refining) given that the expansion of world oil refinery capacity has lagged consistently behind oil demand, which has created bottlenecks in several markets, including, most famously, petrol in the United States of America;

(d) Concerns regarding the notion that “peak oil” production is imminent or has already occurred combined with the gradual exhaustion of reserves owing to the failure to discover significant new reserves.

B. Short-term source of oil price rises, 2002-2007

In addition, there is no doubt that several short-term factors have been responsible for the increasing volatility of oil prices in the past years. While a number of these have limited impact, for example, decreasing inventories, they have played a crucial role in the growing environment of uncertainty that characterizes at this time the oil trading worldwide. In terms of short term, the following observations can be made:

(a) Increasing demand towards light and sweet crude oil, which is relatively low in sulphur content and, therefore, less polluting, which conforms to new environmental laws and regulations mainly in the EU and the United States of America. However, the existing surplus capacity, primarily in Saudi Arabia, comes from heavy and sour crude oil;

(b) Oil companies have been steadily reducing their inventories of petroleum and derivates in the past years in order to cut costs and release capital for operational reasons. Moreover, they have been reducing their precautionary stocks that are maintained in cases of sudden increases in demand. These can result, for example, from exceptionally severe winters in the northern hemisphere or supply disruptions caused by storms, strikes, accidents and maintenance work, all of which implicitly transfer risks from the oil industry to Governments and consumers;

(c) Increasing political uncertainty, for example in Nigeria and Venezuela, and mounting security concerns in Iraq are associated with the higher sensitivity of the oil market, including the enhanced threat of terrorism since 2001;

(d) Some estimates of the required safety margin range from 2.5-5 per cent. Given that global oil output is approximately 80 m/b/d, a productive capacity of 2-4 m/b/d needs to be kept idle at all times.\(^b\) In the absence of this level of spare capacity, it can become impossible to moderate the impact of price rises through adjustments in supply. Unfortunately, the desirable safety margin is unlikely to arise any time soon. At the end of 2003, global spare capacity for oil production was a very modest 2 m/b/d, and it fell further during 2004 to only 1.5 m/b/d. This was lower than at any time since 1991, when it was only some 1 m/b/d. While it has since increased, it remains insufficient to withstand the impact of sudden changes in supply or demand conditions in any major market player.\(^c\)

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\(^a\) See IMF, Oil Market Developments and Issues (March 2005), p. 9.

\(^b\) This is an imprecise estimate; supply and demand data are singularly difficult to gather in the oil market.

\(^c\) See IMF, Oil Market Developments and Issues (March 2005), p. 9; and WTRG Economics, “Oil price history and analysis”, which is available at: www.wtrg.com/prices.htm.

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In particular, “paper trading” has largely replaced speculative holdings of oil. While in the past speculators expanded their inventories if they expected oil prices to rise, currently they purchase futures contracts, options or other derivatives in order to achieve similar outcomes at a lower cost. However, the markets for “paper oil” are highly speculative and very fickle, and this often leads to perverse outcomes such as exaggerated swings on the market price. Finally, the recent devaluation of the United States dollar and the appreciation of the euro have without doubt contributed to higher nominal oil prices even if, based in different monetary areas, these prices affected traders very differently. It is also important to highlight that while producers in the ESCWA region are paid in United States dollars, an increasing trade flow with the EU has occurred in the past decade.

Furthermore, concerns over “peak oil” and the gradual exhaustion of reserves have contributed to the atmosphere of uncertainty that currently surrounds oil trading. These concerns are likely to be misplaced. This owes partly to the fact that world reserves of oil depend on the state of technology and the current price of crude and partly to the reality that the exhaustion of oil will only gradually put pressure on prices. Much more significant in the short term are the limitations in production and the demand growth that are experienced in the global market (see box 1-B). Within that context, the upward drift of prices is not the reflex of peak oil; rather, it represents the elimination of the buffer that was previously provided by surplus capacity in an international context of structurally higher volatility. In other words, the oil market is largely being driven by a deficiency of supply and by the fear of future shortages.

The rise of oil prices in the recent period is certainly substantial. However, it needs to be kept in historical perspective. Specifically, while the nominal price has recently exceeded the record levels set by the previous oil shock in the 1970s, the peak prices in real terms in early 2006 were significantly lower than their crisis level reached twenty-five years ago. Moreover, the recent price changes are relatively modest and much more gradual when compared to the oil shocks of 1973, when oil prices quadrupled; and in 1979, when the price doubled in a matter of weeks. Nothing of comparable magnitude or intensity has happened over this recent period. Finally, the oil intensity of production (oil consumed per dollar of GDP) has declined by approximately one-third in rich and poor countries alike, since the early 1970s.

B. MACROECONOMIC EFFECTS OF THE BOOM

1. Worldwide

The factors mentioned above suggest that the macroeconomic impact of the recent oil price rise is likely to be significantly less than that of the previous oil shock as long as oil prices continue to stabilize or even decline in the near future. This mitigated impact owes to the following: (a) as indicated above, the real price of oil remains lower than it was in the early 1980s; (b) the depreciation of the United States dollar vis-à-vis the euro has helped to cushion the impact of the oil price increases to a large part of the world economy; (c) the world economy is in a moderately expansionary phase, which is in stark contrast to the recessionary tendencies that existed in 1973 and 1979, thereby reducing the severity of a given oil price rise; (d) the oil intensity of production has declined in most countries; (e) inflationary pressures are firmly contained almost everywhere, and there are only marginal cost pressures at work in the world economy; and (f) there is significant spare capacity and unemployment of labour in most countries of the world, which will help to protect economies against the inflationary impact of oil price increases.

16 Within that context, the euro hit a two-year high against the dollar in April 2007.
18 Ibid., p. 20.
The final issue to be raised in this part concerns OPEC strategy. For several years, conventional wisdom held that it was in the interests of OPEC and particularly of Saudi Arabia to stabilize the oil market at a relatively low price in order to maximize their long-term revenues. While this could be the case at an abstract or conceptual level, in the current situation of low spare capacity and extensive “financialization” of the oil market there is little that OPEC or any other body or group can do to stabilize or reduce oil prices.\(^{19}\) At another level, there is not one price or production strategy that is optimal to all members of OPEC. Indeed, optimum levels of price and output differ both within and between countries, depending on the size and composition of their reserves and the urgency of their social welfare and developmental needs.

Equally, conventional wisdom indicates that relatively well-off countries with large reserves and few economic alternatives should prefer low oil prices in order to create a disincentive to non-conventional oil sources, including, for example Canadian tar sands; fuel substitution; and structural reductions in demand. While this strategy is rational, it is being continuously eroded by the decline in the price of alternatives and growing concerns about global warming. For these reasons, a strategy of low oil prices will cause financial duress without necessarily securing the long-term future of the market. Despite these limitations, ESCWA members of OPEC can help to stabilize the market through the coordinated expansion of the production capacity, and the simultaneous expansion of their refining capacity and their rapidly growing petrochemicals sector. This will help producers and consumers of oil and, moreover, will help to deflect the twin dangers of resource curse and Dutch disease (see box 2). This level of coordination requires a more extensive integration of research, planning and construction capabilities and, at a further remove, fiscal and monetary policy in the large oil producers. The exception is Iraq that cannot be included into this programme initially for obvious reasons; however, that country can benefit greatly from the stabilization of the oil market.

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**Box 2. Definitions of the resource curse and the Dutch disease**

**A. The resource curse**

The “resource curse”, which is equally referred to as the “paradox of plenty”, has been extensively employed by economists and political scientists since the mid-1980s to describe how abundant natural resources can deform a country’s economy to such an extent that, rather than being a blessing, it can become a curse in the long term. In effect, this expression refers to the inverse association between economic growth and natural resource abundance, regardless of whether the mineral is oil or, for example, natural gas. According to the extensive empirical literature on that subject over the past three decades, one of the most baffling recurrences of economic growth is that well-endowed economies relative to other factors of production have grown slower than other, non-mineral economies over the long term and, in some cases, have actually experienced a “growth meltdown” owing to a broad range of motives.

**B. The Dutch disease**

“Dutch disease” was initially suggested to describe the short-term adverse effects that the Netherlands experienced following the discovery in 1959 of the giant Groningen gas field in the North Sea. While the resource boom that occurred between the 1960s and the 1980s brought considerable resources into that country and supported the expansion of public spending, it caused a real appreciation of the national currency (then, the Dutch guilder). Consequently, export competitiveness declined and the other tradable sectors of the economy contracted to the extent that the manufacturing sector shrank and the economy deindustrialized to a degree. This phenomenon has become a famous example described by the Rybczynski theorem; and other probable examples that have been cited by the related literature include Mexico between the late 1970s and early 1980s, and Norway since the 1970s. Current cases include the Russian Federation and more recently Azerbaijan.

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\(^{19}\) While the neologism “financialization” has been used differently by various authors, including top management financial advisers and most political economists, it is worth emphasizing that the literature focuses on macroeconomic outcomes. For the purpose of this Survey, the term “financialization” refers to the increasing dominance in terms of size and significance of financial markets, financial control in management and financial assets among total assets of the oil industry worldwide. The term describes the changes that have taken place in the past decades in the relationship between the oil industry and the increasing importance of the financial sector for this sector’s outcome.
2. The ESCWA region

At the end of 2005, Arab countries held 56 per cent of the oil reserves and 30 per cent of the gas reserves in the world. Moreover, they produced 25 m/b/d and 30 billion cubic feet of gas per day, which corresponds to 32 per cent and 12 per cent of global output, respectively; and are responsible for 43 per cent of oil exports and 15 per cent of gas exports in the world. The counterpart of the international importance of the oil (and gas) sectors in these countries is their dominance in domestic economies, especially in the GCC. Specifically, the petroleum sector in these countries accounts for a large share of output, namely: 28 per cent in Bahrain, 48 per cent in Kuwait, 42 per cent in Oman, 62 per cent in Qatar, 42 per cent in Saudi Arabia and 33 per cent in the United Arab Emirates. It is also highly important in Yemen, where it accounts for 32 per cent of GDP. However, it is less important in Egypt, at 12 per cent, and the Syrian Arab Republic, at 21 per cent, and insignificant in Jordan and Lebanon.

Indeed the two subregions that together constitute the ESCWA region, namely, the GCC and MDEs, reflect the varying sizes of the oil sectors. Evidently, the current oil boom impacts these economies differently; and the overall effect of the boom can be gauged by inspecting national statistics related to the balance of payments.

The additional earnings of the world’s oil-exporting countries, compared to the baseline prices of 2003, were as high as $200 billion in 2004 and $280 billion in 2005. This is equivalent to the range of 8-12 per cent of GDP in most countries, from 1 per cent of GDP in Mexico to 30 per cent in Chad and Equatorial Guinea. In 2006, the total surplus of oil-exporting countries is expected to reach $505 million, which is higher than the expected surplus of Asia at $462 billion. As a result, the current account of oil-exporting countries improved by an average of 3.5 per cent of GDP (refer to figures 5 and 6 in chapter I).

Despite its significance, the current oil shock is much smaller than previous price spikes (see annex table 1). Correspondingly, recycling oil revenues is likely to be less problematic and, so far, it has been absorbed smoothly within the international financial system. This can be attributed both to a less substantial windfall as a percentage of global GDP, as a proportion of the national income of oil-exporting countries, and to the value of world financial assets. This is also in view of the fact that the absorptive capacity of the petroleum exporting countries is much higher than it was in the previous oil boom, and the oil dependency of the importing countries has been reduced significantly. Subsequent to the previous oil shock, much of the windfalls were deposited in international banks and later lent to oil-importing developing countries, thereby eventually contributing to the international debt crisis of the 1980s. However, with the current boom, there

21 Ibid., p. 14.
22 Among MDEs, Egypt, the Syrian Arab Republic and Yemen are marginal oil producers; and Jordan, Lebanon and Palestine are oil importers.
23 IMF, Oil Market Developments and Issues (March 2005), pp. 6, 25, 27.
25 IMF, Oil Market Developments and Issues (March 2005), p. 27.
26 For example, “the impact of the oil price increase in 2004 on the trade balance for advanced countries is estimated at around -0.3 per cent of GDP, which is less than 1/10 of the average effect attributable to the two oil price shocks in the 1970s”. IMF, Oil Market Developments and Issues (March 2005), p. 21.
has been relatively little accumulation of bank deposits and a much more significant increase of portfolio investment flows.27

While relevant information is imprecise, it is estimated that OPEC countries invested only $1.5 billion in treasury securities of the United States of America per month in 2004 out of total monthly investments of $30 billion. Moreover, out of the total monthly inflows into the United States of America of $76 billion, a modest $2.5 billion originated in oil-exporting countries, while $30 billion came from Asia.28 These figures are likely to underestimate total flows for the following reasons: (a) they exclude flows originating in London, where similar data are not collected; and (b) they do not take into account the growing diversification of financial investment by oil-exporting countries, especially in the aftermath of the terrorist attacks of 11 September 2001 and the implementation of the Patriot Act by the United States of America.

Currently, a much larger proportion of the windfalls are estimated to have been invested within ESCWA, as well as being directed to other regions of the globe. The flows into the United States of America have declined significantly after September 2001. At that time, major oil exporters in the Middle East and North Africa (MENA) region invested some $18-25 billion in the Government of the United States of America and corporate securities, while at the same time channelling substantial funds through the banking and non-banking financial systems of the United States of America. However, in the last quarter of 2001, there was a net withdrawal of $4.3 billion by these countries, which was followed by substantial sales of long-term securities of the United States of America in 2002-2003. The proportion of deposits held in dollars fell from 75 per cent prior to September 2001 to approximately 60 per cent.29

A large part of these resources has been transferred to alternative markets. In general, most oil-exporting countries have been using that windfall carefully, especially in contrast to the previous oil boom. Specifically, only some 25 per cent of the total windfall has been spent in the current boom, compared to nearly 60 per cent after the oil price increase in 1973.30 The additional resources have largely been saved in the form of international reserves (see figures 9 and 10 in chapter I and annex table 2), or have been used to reduce outstanding external and domestic public debt of exporting countries (see below). The reduction in external debt is especially significant in the case of Oman and in such marginal oil producers as the Syrian Arab Republic and Yemen, which reduced their foreign debt as a percentage of GDP between 1998 and 2002 by 22, 40 and 35 points, respectively.31 In addition to this, the windfall has been deployed in order to address long-standing structural issues, especially education and employment creation. Moreover, there are ambitious plans in the ESCWA region to expand downstream manufacturing capacity, especially in the petrochemicals sector.

International reserve growth, where it exists, is especially important for oil-exporting countries of the ESCWA region given that it can provide a buffer against declines in oil prices and insulate these countries against the Dutch disease (see box 2-B). This effect has also been supported by the devaluation of the dollar against other reserve currencies, especially the euro.

30 Ibid., p. vii.
31 Ibid., p. 35.
It is especially important to note the expansion of this sector given that it responds both to the resource endowments of the countries of the GCC and to the opportunity opened by the decline in profitability of the petrochemical industries of the United States of America, EU and Japan. In response to these pull and push factors, production has tended to shift towards the GCC, where production capacity has expanded strongly in recent years. The countries of the GCC and Iran currently account for nearly 10 per cent of the global production of such basic petrochemicals as ethylene. By 2010, these expect to provide nearly 50 per cent of the world’s growth in ethylene capacity, thereby amounting to approximately 20 per cent of global output. Exports of liquid chemicals from these countries reached 16.6 million tonnes in 2004 and 18.4 million tonnes in 2005. This is expected to rise to 32 million tonnes by 2007 and 48 million tonnes by 2008.

The economic volatility in the ESCWA region could be reduced by addressing some of the long-standing bottlenecks to growth in the region and profiting from existing opportunities, especially in the processing and manufacturing sectors. However, particularly in MDEs with insignificant oil sectors, the most important macroeconomic policy challenge is to adjust to the deterioration in terms of trade and the corresponding worsening of the current account. For example, the current account of Jordan shifted from a surplus of 11.6 per cent of GDP in 2003 to a deficit of nearly 18 per cent of GDP in 2005. Another significant implication of the oil boom is the steep rise in regional tourism. This was encouraged by the new income flows into the region, as well as the adverse repercussions of the terrorist attacks of 11 September 2001 on the United States of America and subsequent attacks in Europe. This development has especially favoured those countries with the most developed tourism infrastructure in the region, namely, Egypt and Lebanon. However, within the context of the latter, it is important to note that the tourism sector of Lebanon was substantially damaged by the Israeli military invasion in summer 2006.

Since the start of the boom, while there has been a significant acceleration in the GDP growth rate of oil-rich countries, this has not been on par with the growth spurts associated with the previous oil price shocks. By contrast, the macroeconomic impact of the shock in MDEs is much less clear-cut, which owes to conflicting sectoral implications for the individual countries that make up this subregion. This impact incorporates, among others, the following issues: (a) repercussions from higher fuel prices, which are marginally positive in small oil exporters and negative in oil-importing countries; (b) regional migration patterns, including labour transfers; (c) regional tourism; and (d) impacts on aid and financial and real estate markets. Egypt, for example, has gained from higher revenues from the Suez Canal; and Jordan has benefited from the delayed pass-through of higher oil prices. Despite these gains, MDEs have not benefited from the boom in the GCC to the same extent that they did after the previous oil shock.

The acceleration of growth has gone hand-in-hand with a significant improvement in the fiscal balance of most countries of the GCC (see annex table 3). This has been common across several oil-exporting countries. It has been estimated that the revenue of Governments in the MENA region more than doubled in

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three years, from $202 billion in 2002, to $433 billion in 2005. Moreover, oil-exporting countries have saved some two-thirds of their extra oil revenues, estimated at 50-60 per cent of the total windfall, including taxes and royalties. Fiscal improvements in the ESCWA region include a large repayment of the domestic public debt (DPD) in several countries, especially in Saudi Arabia, which reduced the stock of DPD from 97 per cent of GDP in 2002 to only 41 per cent in 2005. Equally, Kuwait and Oman witnessed significant declines of their DPD; and DPD across all oil-exporting countries generally declined by 3.0-4.5 per cent of GDP in 2004.

Despite these abovementioned positive effects, the oil boom has been associated with a mild acceleration of inflation across the ESCWA region both in the oil-rich countries and MDEs (see table 1 in chapter I). This can be partly attributed to the dollar peg of most currencies in the region and in the light of the international depreciation of that currency. The ESCWA region is not traditionally an area of high inflation. Inflation is more usually associated with severe economic crises in MDEs, including, for example, Lebanon in the late stages of its civil war and its immediate aftermath, the Syrian Arab Republic in the late 1980s and, sporadically, Yemen. By contrast, oil-rich economies traditionally exhibit relatively low rates of inflation, compared to other developing countries and member countries of OECD. Given the volatility of the price of oil during the past two decades, the shifts in the international economy and the multiple economic, political and security problems in the Middle East, relatively low inflation rates have been a significant achievement. However, it is important to underscore that these rates have been higher than those in OECD countries since 2004.

Two of the most striking macroeconomic differences between ESCWA economies in the recent period concern the developments in their monetary sectors and their distinct labour market performances. Not surprisingly, the oil boom has been associated with a very strong growth of the supply of broad money in oil-exporting countries (see figures 9 and 10 in chapter I, and annex tables 4 and 5). This differs starkly from the performance of the monetary sector in MDEs where money supply has grown at a lower pace, with the notable exception of Jordan owing primarily to recent developments in Iraq. The extraordinary expansion of the monetary assets in oil-rich countries has fuelled a potentially destabilizing speculative boom.

Symptoms of this boom include the strong expansion of bank deposits and bank credit throughout the region, and the booming construction and real estate sectors in most countries. Specifically, bank credit has “flowed into a series of gargantuan real estate, tourist, and commercial ventures. Project finance has also boomed, with banks competing to supply long-term finance to a wave of new industrial and infrastructure initiatives, largely in the Gulf. In the process, bank profitability has reached record levels”.  

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41 This was expected for reasons examined in section A of this chapter. See IMF, *World Economic Outlook: globalization and inflation* (April 2006), p. 71.

For example, in Bahrain the annual value of traded land permits increased by more than 70 per cent between 2002 and 2004, while in Kuwait annual building permits rose by 40 per cent between 2002 and 2003. Equally, construction has boomed in Dubai given the State-sponsored investment in that sector; and in Jordan, with the arrival of many Iraqi civilians fleeing the conflict in their country.43

Consumer credit has also expanded rapidly. In Saudi Arabia, for example, consumer lending grew by an annual 57 per cent in 2004-2005, while private sector credit increased by 39 per cent.44 Moreover, there is a speculative stock market bubble in the region. The stock market index in the MENA region increased fivefold between 2002 and 2005, and the markets in Egypt and Dubai rose more than tenfold. In 2003, share prices increased by 70 per cent in the GCC; and, in 2004, they rose by 80 per cent in Saudi Arabia and 95 per cent in the United Arab Emirates.45

On average, market capitalization increased from 26 per cent of GDP to 110 per cent (and, in some cases, 300 per cent). At the same time, traded volumes rose from an average of $1 billion per day to more than $6 billion per day.46 Initial public offerings (IPOs) were particularly prone to speculative excesses. In 2004, for example, the IPO of a telecommunications company in Saudi Arabia attracted bids of 50 billion Saudi riyals for an issue valued at 200 million Saudi riyals; and in early 2005, that country’s new Islamic bank, namely, Bank Albilad, attracted the interest of half the total population of Saudi Arabia, which resulted in a fourfold oversubscription of its 30 million shares. Similarly, the sale of a petrochemical company in the United Arab Emirates in 2005 was more than 800 times oversubscribed and attracted more than $100 billion, which is almost equivalent to that country’s annual GDP, for an issue valued at $135 million.47

The stock market bubble burst at least partly in early 2006, when stock prices fell by 25-50 per cent, albeit with a limited macroeconomic impact.48 Both the bubble and its aftermath send worrying signals given that they suggest that a large part of the oil windfall has become locked into financial and primarily speculative circuits that have had minimal implications for employment generation and welfare provision (see table 6 in chapter I). For example, it is estimated that 75 per cent of private firms in the MENA region as a whole are financed purely through retained earnings, rather than bank credit.49 Moreover, the balance sheets of several banks in the region could have become too heavily dependent on share and real estate prices, and could be adversely affected by an economic downturn, an adverse shift in expectations or a swing in international financial circumstances. Unfortunately, all three of these circumstances are expected to take place in the most volatile region in the world. It is therefore essential for Governments to intervene in these overblown speculative circuits in order to consolidate the financial sector and reverse the growth in its vulnerability.

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43 Ibid., p. 45; and M. Davis, “Fear and money in Dubai”, New Left Review, No. 41 (September-October 2006), pp. 47-68.
46 Ibid., p. 47.
47 Ibid., p. 47.
CHAPTER II. REGIONAL IMPLICATIONS OF THE OIL BOOM

C. CONCLUDING REMARKS

The current oil boom in the global petroleum market, now in its fifth year, differs from the oil shock of the 1970s for several reasons that were mentioned above. Moreover, it points to a number of regional implications, which can be summarized as follows:

(a) There is a need to emphasize that the price increase, albeit significant in nominal terms, has not reached the levels in real terms of the previous price spikes, and, moreover, that this increase has been comparatively steady despite exhibiting a fairly erratic pattern;

(b) This increase stems from the convergence of short- and long-term factors from both supply and demand. These long-term factors affecting the market include, among others, the continual expansion of demand on petroleum and its derivatives in Asia; capacity constraints (upstream) of production in OPEC member countries; and limited refinery distillation capacity (downstream) for medium and heavy oil at an international level. The short-term factors that have been identified include, among others, increasing demand for light oil; lagging reduction of inventories by oil companies; and increasing “financialization” of the market, in other words the growth of “paper oil”. In addition to the intrinsic geopolitical concerns regarding stability of the Middle East, all these interconnected aspects have contributed to the atmosphere of uncertainty that currently surrounds the oil market;

(c) The impact on the rate of economic growth in the real global economy has been relatively moderate compared to the negative effects that materialized in the 1970s in both developing and developed countries;

(d) In the ESCWA region, higher oil prices have boosted growth predominantly in the countries of the GCC, while MDEs have had a mixed result given the conflicting sectoral implications. Many countries in the region have improved their fiscal balance and strengthened international reserves, simultaneously trimming down their debt. However, there is a need to highlight several disturbing signs, including, for example, the modest rise of inflation; the soaring expansion of bank deposits and credit for conspicuous consumption; and a bubble in the stock market, which burst in early 2006, that was clearly speculative in nature.

These points underscore the need for a judicious deployment of oil rents in social and physical infrastructure investment. On the social side, it is wise to redeploy resources in order to reduce the current knowledge and gender gaps by spending on education, health and information technology. On the economic side, it must be noted that the unrestrained liberalization of the economy cannot be deemed a prudent policy given that it will certainly raise income distribution inequalities in the region. There is a need to reaffirm that development is the long-term strategic goal and to emphasize that social infrastructure remains the principal and indisputable policy goal. In the light of the abundance of resources, the short-term fiscal and monetary balances must aim to invest in building the capacity of citizens, with particular emphasis on closing the gender divide and on generating meaningful jobs for the youth. These remain crucial tasks that can and must be reached in this region given the large gender gap and very high rates of youth unemployment. At a seminal level, the approach to development has often been built on the pursuit of an active industrial policy that ushers in decent employment opportunities for women and youth, and the region is yet to follow suit.
III. MACROECONOMIC POLICY TOOLS UNDER A RESOURCE BOOM

This third chapter briefly reviews the principles underpinning the policy framework aimed at achieving the main strategic goals of alleviating poverty; increasing employment opportunities, especially for youth and women; and reducing income distribution inequalities in the region. These goals and the economic strategy associated with them were examined in detail in last year’s Survey. Rather than revisiting these goals and by way of a variation on last year’s theme, this Survey analyses the potential contribution of the main macroeconomic policy tools, both monetary and financial policies, aimed at sustaining growth and development under conditions of primary resource booms. In addition, it considers short- and long-term fiscal policies and other mechanisms, including the exchange rate, capital controls and the oil funds, in order to tackle successfully the frequent difficulties that arise when an oil boom occurs. The ultimate purpose of the analysis is to contribute towards capacity-building for policymaking in the context of a resource boom, which, under inappropriate policy settings, can result in the Dutch disease and the resource curse, thereby thwarting the course of development (see box 2).

A. STRATEGIC GOALS

In order to maintain current levels of employment in the region, ESCWA countries need to generate 100 million new jobs in the next 20 years. This requires annual GDP growth rates in the region of 6-7 per cent, which represents twice the growth rate achieved during the 1990s. These performances will be required even if oil revenues falter, which is expected to happen at some point in the future, thereby implying that current economic strategies in the region are unlikely to suffice unless they are supplemented with specific measures that guarantee growth and reduce income distribution inequalities.

International experience shows that sustained economic growth can be achieved through two basic approaches, namely, (a) by capturing rents from international trade, which has traditionally been the case in the countries of the GCC; and (b) by internalizing vertical chains of economic activities, including the production, circulation and distribution of increasingly complex goods and services; the corresponding inter-sectoral linkages that could create complementarities and synergies between different sectors; and the development of domestic technological capability. This last approach is the only alternative that is available to MDEs, while the oil rents that they are able to capture could add to this long-term growth strategy.

In the countries of the GCC, continuing exploitation of oil and gas reserves is likely to continue to form the basis of any economic growth strategy for at least several decades. However, the countries in this subregion have realized that raw material exports are insufficient, and they have taken great strides aimed at diversifying their economies and deepening their manufacturing capacities.

The sustained internalization of priority value chains requires a consistent and coherent industrial policy encompassing several areas, including coordination of economic activity by the State; imposition of performance standards; creation of backward linkages; elimination of bottlenecks; and a concerted effort aimed at addressing structural balance of payments, and fiscal and financial hard constraints. These outcomes cannot generally be achieved merely through horizontal (non sector-specific) industrial policies, given that these tend to lead to a misallocation of dynamic resources, lack of investment coordination and divergent development patterns of economic sectors, thereby creating and even exacerbating sectoral and macroeconomic imbalances. In addition to this, experience shows that successful late industrialization did not derive from the diffusion of technical change or the spontaneous diversification of the economy. Rather, it stemmed from the deliberate addition of modern production units to those already in place, either in order to satisfy pent-up existing demand or to produce for export. In either case, large-scale production is required

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50 ESCWA, Survey of Economic and Social Developments in the ESCWA Region, 2005-2006 (E/ESCWA/EAD/2006/2).
Rights-based social and economic development strategies depend even more strongly on the adopted long-term integrated industrial and social approach. However, these are crucial in order to support economic growth, which in turn can produce additional resources, create employment, reduce economic heterogeneity and support greater equality of income distribution, all of which are essential conditions for social inclusion. It follows that these policies need to be nested in a consistent and enabling pro-poor macroeconomic environment. Specifically, this environment must focus on expanding complementary sectors, achieving stability in the balance of payments and developing non-traditional competitive advantages in key sectors that can effectively support efforts for reducing poverty in the ESCWA region.

These objectives cannot be easily achieved in MDEs for several reasons that can be classified within the following four labels: (a) social demands on the State are too great; (b) the international environment is frequently hostile; (c) the available financial resources are meagre; and (d) the institutional framework is not always conducive to the achievement of socially desirable goals. By contrast, the issues in the GCC are of a different order and are related to the current limitations of the political environment within this subregion, and to the strategic demands and limitations imposed externally upon it, particularly given its strategic geopolitical importance. Achieving these goals has been complicated by the introduction of certain policy reforms over the past two decades that have retrenched the skeletal welfare system which existed in several ESCWA member countries, and that have dismantled to a certain extent the capacity of the State to implement purposeful economic policies across the region. There are many examples of such policy reforms, including, among others, privatization, closures of specialist State agencies and reduction of expenditures of the civil service.

The policy suggestions offered in this chapter aim to combine internal and external balance under the current circumstances of a resource boom, namely, low inflation, domestic debt sustainability, real exchange rate stability, balance of payments equilibrium and the reversal of dollarization in ESCWA member countries, while at the same time protecting the region against adverse external shocks. Moreover, these suggestions aim to transfer policy levers to the domestic authorities and policymakers, increase the degree of inter-sectoral policy coordination, and link macroeconomic stability with the achievement of rights-based goals, thereby delivering economic prosperity and higher living standards for the majority of the population in the region. The achievement of these goals will require additional policy space for individual countries to select their own priorities and identify the most suitable tools in each case.

Within that context, policy ownership must come from within. Ownership and good governance efforts cannot be limited to or merely measured by the incorporation of goals and methods selected by the international financial institutions and donor agencies in the West. Rather, they need to include domestic issues; true ownership and good governance require effective control over projects, budgets and modes of delivery, and the ability to select the most desirable policies in the light of local majority interests.

In order to maximize the scope for success, regional coordination of production is likely to be essential, especially in the manufacturing sector. This requires the development of supranational institutions with the authority to regulate such business practices as, among others, accountancy rules, business registration, tax policies, cross-country claims and labour regulations. These institutions can influence the allocation of investment funds and determine the production priorities in the region, which will require them

\[52 \text{ The diversification of the economy in the United Arab Emirates represents the most remarkable example in the ESCWA region. See M. Davis, “Fear and money in Dubai”, } \textit{New Left Review}, \text{ No. 41 (September-October 2006), pp. 47-68.}\]
to have access to financial resources and regulatory powers. Within that context, there will be an essential need for public investment and directed credit aimed at supporting infrastructure development and increasing regional economic integration (see section B below). In addition, regional coordination of fiscal, monetary and exchange rate policies and infrastructure development will provide the essential level playing field for the success of integration efforts. In the absence of policy convergence within a negotiated framework, the potential gains from the economic integration of the ESCWA region are likely to be limited and even insignificant.

Undoubtedly, this is set to be a long and costly process. However, if successful, it could build the conditions for stable and rights-based development in the entire region in the twenty-first century. Greater integration will help to shield the oil economies from the impact of oil price volatility, support economic diversification and protect the region from potentially adverse developments in the international economy. For MDEs, regional integration offers the prospect of secure access to larger and wealthier markets, improved infrastructure, better conditions for workers employed in neighbouring countries, and secure access to petroleum and derivatives. Moreover, regional integration can give access to additional aid while at the same time increasing security of food and fuel supplies for the poorest countries in the region. Integration can also support the construction of efficient bureaucracies within each State, which is an essential aspect of democratic governance. In itself, this represents an important gain for the whole region, in view of the fact that it could assist the dilution of the power of the elites and support the assertion of popular sovereignty and Government accountability to the citizenship. All of these points enhance democracy and the rule of law, thereby improving governance as a basis for prosperity among the entire population.

B. RIGHTS-BASED POLICIES

International experience during the past 30 years shows that the conventional economic development strategy, which focuses primarily on price stability and static, market-based allocative efficiency, is problematic and insufficient from both the conceptual and empirical sides. The standard approach is plagued by inconsistencies at several levels, and its assumptions are at variance with the realities faced by poor countries, especially in the ESCWA region. These shortcomings help to explain the continuing failure of traditional policies aimed at achieving their stated aims of rapid economic growth, poverty reduction and balance of payments sustainability. The inability of the conventional framework to contribute to rapid welfare gains for the poor is a severe indictment of mainstream economics, especially in the light of the substantial resources currently available in the world economy, and those that could be generated through faster growth and more equitable distribution. Consequently, the standard approach is no longer suitable for informing Governments both in the GCC and in MDEs on the problems of managing a resource boom.

In the light of the abovementioned shortcomings, rights-based policy alternatives deserve to be considered carefully. These policies aim to facilitate the achievement of MDGs and link their achievement with broader human development targets.53 These policies include some of the distributive elements present in Keynesian macroeconomics that are enriched by a clear assessment of the role of public policy in the current era and aimed at achieving human development objectives as rapidly as possible.

53 Currently, there is greater universal recognition of the need to place poverty reduction as the central objective of the process of development. It is, therefore, essential to search for a national development strategy that seeks to achieve human development that is secure, sustainable, equitable and empowering for the bulk of the population. Perhaps the most powerful manifestation of a global commitment to poverty reduction is the United Nations Millennium Declaration of 8 September 2000. The concern for pro-poor policies is the consequence of a deep-rooted disillusionment with the development paradigm, which placed exclusive emphasis on the pursuit of growth in many situations such that the process of growth was accompanied by rising inequality, with weak or non-existent trickle-down effects. See H.A. Pasha, “Pro-poor policies” (Regional Bureau for Asia and the Pacific, United Nations Development Programme (UNDP), 2002).
CHAPTER III. MACROECONOMIC POLICY TOOLS UNDER A RESOURCE BOOM

1. Fiscal policy

Fiscal policy can play a key role by transferring rent gained from trade and productivity to strategic non-export sectors. This includes the development of linkages between existing areas of activity and support for the emergence of new economic sectors that can help to develop new competitive advantages and offset the trend towards an excessive dependence on traditional exports. As a general principle, fiscal policy needs to support the broader macroeconomic objectives, including macroeconomic stability, balance of payments sustainability, low inflation, control over DPD, sustainable levels of taxation, robust economic growth and substantial improvements in welfare standards across all the countries of the region.

In the case of oil-rich countries, fiscal policy is recommended to be the primary tool for short-term economic stabilization, including smoothing the impact of the windfall on public expenditures in a highly uncertain environment; and promoting income equality through expenditures on health, education, welfare and employment opportunities. Moreover, this strategy needs to incorporate the development of large-scale infrastructure and even such productive facilities that the private sector is unable or unwilling to accomplish. In these countries, a pro-poor and rights-based fiscal policy must target the non-oil sector through Government guidelines that focus on medium-term goals aimed directly at seeking to reduce poverty and indirectly at raising productivity and growth. This can allow the adequate discrimination between the relatively volatile and relatively permanent components of public finances, and help to minimize pro-cyclical spending swings. Smoothing these swings is especially important, given their severely destabilizing impacts on employment, investment climate and, consequently, welfare.

In order to achieve these outcomes, it could be useful to establish a domestic oil stabilization fund in addition to the external oil fund (see subsection 5 below). Specifically, the fund could build on temporary oscillations of oil rents; and royalties and taxes in the form of private and public sector securities that could include, among its goals, the repurchase of DPD, mass housing that could be rented at “fair value” commercial rates, and other modalities of anti-cyclical saving in local currency. These could be traded when oil prices decline in order to facilitate the stabilization of public sector finances in the short term. Alternatively, they could provide a long-term stream of revenue aimed at alleviating and compensating the exhaustion of oil revenues in countries with limited reserves or as a precaution procedure against technological changes or international treaties that could reduce the scope for oil sales in the world economy. This is especially important given that Government revenue in the countries of the GCC tends to be highly volatile owing to the acute fluctuations of oil prices worldwide.

Indeed, there is ample evidence that oil prices exhibit volatility in the short run and large fluctuations over the medium term. According to a recent study, the oil market will be faced with the prospect of a monthly price change greater than 8 per cent one-third of the time. At current oil prices, this translates into a one-in-six chance that the spot oil price could drop by some $2/b in any given month. Certainly, the experience of the past few years has shown that large annual price movements can take place in either direction, with an annual average increase of oil prices of nearly 30 per cent in 1995-1996, a decline by 36 per cent in 1997-1998, and more than doubling in 1999-2000. Moreover, these fluctuations are often difficult or even impossible to predict. The volatility of oil prices leads to corresponding volatility in the fiscal cash flow.


The challenges are of a different order in MDEs, namely, to build fiscal sustainability in economies with more diversified sources of income, albeit poorer than the countries of the GCC. Moreover, MDEs are buffeted by a host of uncertain ties that include at least four major sources as follows: (a) the intrinsic volatility of oil prices; (b) geopolitical tensions; (c) domestic political unrest; and (d) acute fluctuations in workers’ remittances. These are similar to the economic policy issues faced by other poor and middle-income countries.56

2. Monetary policy

While fiscal policy needs to be the cornerstone of any Government strategy, particularly within the fixed exchange regimes in the region, monetary and financial policies can still play important roles mainly in terms of short-term stabilization plans aimed at complementing a long-term pro-poor and rights-based development strategy in the region.57

Monetary policy refers essentially to the Government’s regulation of the supply of money and the level of interest rates.58 Consequently, it affects the level of economic activity, the composition of output, the structure of employment, the distribution of income and the direction of economic transfers. Moreover, monetary policy influences fiscal policy given that the level of interest rates affects the servicing of DPD, savings rates and the exchange rate. The exchange rate works through the influences of the balance of payments, RER, the level and direction of the flows of international capital, and the stability of the domestic financial system given that the central bank is the regulator of financial institutions and the lender of last resort. Through these channels, monetary policy affects the outcome of short-term stabilization policies, and influences the policy remit of the State and the long-term rate of economic growth. Potentially, it can therefore contribute significantly to a rights-based development strategy for the ESCWA region.

The importance of monetary policy for determining output and employment, and the rate of economic growth is self-evident and does not need to be reviewed here. However, monetary policy is also important given that it influences the composition of output and employment, the level and direction of economic transfers, the distribution of income and wealth, and the modalities of State intervention in the economy. While these implications of monetary policy are often ignored, they are in fact crucial for the comprehensive analysis of this region. Through the prism of traditional macroeconomics, monetary policy highlights the social and distributive implications of macroeconomic policy; in other words, it reveals the degree to which economic policy is pro-poor.

56 This issue was addressed within a pro-poor and rights-based framework in ESCWA, Survey of Economic and Social Developments in the ESCWA Region, 2005-2006 (E/ESCWA/EAD/2006/2).
57 The general principles of these policies were described in last year’s Survey. Ibid.
Box 3. Two definitions of the real exchange rate (RER)

Among the numerous operational definitions of the real exchange rate (RER), there are two that are extensively used, namely:

(a) The ratio of domestic prices of tradable commodities to domestic non-tradable commodities. Within that context, tradable goods comprise all merchandise that is actually or potentially imported or exported, while non-tradable are products that are not traded across national boundaries either owing to prohibitive transport costs on the global market or to the nature of the good in question, including, for example, land, services and residential infrastructure, which are not traded or are highly perishable;

(b) Absolute comparison of external and domestic prices of the same commodities. This measure can either include only traded commodities; or traded and non-traded commodities, which, in principle, measures purchasing power parity (PPP).

The first definition takes into consideration the relative price of tradables and non-tradables within a country as an indicator of the competitiveness in foreign trade. Under the assumption that the prices of tradables will be the same in all markets when converted at the nominal exchange rate supported on the law of one price. This law states that in the absence of transportation and other transaction costs, competitive markets will equalize the price of an identical good in two countries when the prices are expressed in the same currency. The assumption is that all sellers will flock to the highest prevailing price, and all buyers to the lowest current market price. In an efficient market the convergence on one price is instant. There are three necessary conditions for this law, namely: (a) transportation costs, barriers to trade and other transaction costs cannot be significant; (b) there must be competitive markets for the goods and services in both countries; and (c) it only applies to tradable goods given that such immobile goods as houses and many local services are naturally not traded between countries. This version of RER is calculated as depicted in equation (1) as follows:

\[ RER = \frac{P_t}{P_n} = \frac{e P^*_t}{P_n} \]  

Equation (1)

\( P_t \) and \( P^*_t \) are the domestic and international prices of tradables, respectively; \( P_n \) denotes the prices of non-tradables; and \( e \) is the nominal exchange rate. In this definition, a decline in RER represents an appreciation of the domestic currency.

The second option is based on the definition of PPP that estimates the ratio of the price index of a country and its trading partners, multiplied by the nominal exchange rate. The typical calculation uses the consumer price index (CPI) or producer price index (PPI) for a given country and its partners. If the former is used, it is a PPP measure given that non-tradables are included; while if the wholesale price index (WPI) is employed, the measure excludes transport and some other services and is closer to a comparison of traded commodities. Whatever index is used, this definition is a relative measure in that it uses composite indices. Algebraically, this is represented by equation (2) as follows:

\[ RER = \frac{e P^*_t}{P} \]  

Equation (2)

If the price index of the trading partners is in the numerator, as above, a decline in RER corresponds to a real appreciation. There are conditions under which the tradable/non-tradable measure of RER exactly tracks the PPP definition. Since the nominal exchange rate is on the right-hand side in both definitions, if the price ratios in each measure remain unchanged in relation to the nominal exchange rate, which represents a likely outcome given they are both relative prices, then the two real exchange rates will move in similar ways. However, if one takes the ratio of the two RER, then the nominal exchange rate drops out, as does the domestic price index of tradables, since these appear in both definitions. Consequently, the ratio of RER will be stable only if the price index of domestic non-tradables and price index of foreign non-tradables move together.

Specifically, while all forms of aggregate demand control can be effective at the macroeconomic level, they can stimulate (or, alternatively, curtail) different types of expenditure, and bring gains (or losses) to distinct groups within the society. The composition of output and employment, the distribution of income and the structure of employment are correspondingly different depending on the monetary policy adopted by the State. For example, demand contraction through high interest rates can create unemployment, which can be exemplified by workers producing tradable goods in highly competitive markets, such as those in MDEs, where there is little scope to increase prices in response to adverse cost pressures. Nonetheless, it can bring windfall gains for others, especially those living off interest payments. Alternatively, the same shift in aggregate demand can be obtained through a fiscal contraction, rather than from expenditure cuts as
traditionally suggested by some international organizations in the past. This could aim at increasing capital gains taxes without a corresponding increase in Government spending. The gains and losses will be significantly different in each case within different income groups. Specifically, those living off interest payments lose out in the first round, while in the second round foreign and domestic producers of luxury goods consumed by the rentiers will also tend to lose. However, it is essential to investigate the distributive implications of alternative monetary policy measures within the context of a pro-poor strategy that seeks to stabilize and promote development under a resource boom, rather than merely to generate growth or general stability.

3. Financial policy

Financial policy represents a subset of monetary policy that can affect poverty in two principal ways, namely: (a) directly, through its impact on productive activity and, therefore, the generation of income and employment and the distribution of income and assets; and (b) indirectly, through its effect on the stance of a Government’s fiscal and monetary policies. In turn, these have an impact on the growth of employment and output, the social sector and on poverty-reducing public expenditures.

By convention, the study of financial policy for development focuses on its capacity to mobilize resources, to expand resource availability over time and to help to address the balance of payments or other constraints to growth. Within this framework, if the financial sector is left unregulated, market signals from the market-based financial system would determine the allocation of resources and, therefore, the demand for and the allocation of savings intermediated by financial enterprises. While this approach may or may not be suitable for developed countries, it is necessary to highlight that this strategy could result in special difficulties in developing countries. These difficulties are typically associated with a situation whereby private rather than social returns determine the allocation of savings and investment. An obvious way in which this happens is through insufficient or lack of investment in infrastructure, which is often characterized by lumpy investments, long gestation lags, higher risk and lower profit rates. Given the externalities associated with such industries, inadequate investments in infrastructure could constrain the potential for sustained long-term growth. This could aggravate the financial market tendency to direct credit to non-priority (real estate speculation) and import-intensive and more profitable sectors, speculative activities; or to concentrate funds in the hands of a few large players and developed centres of economic activity. This would worsen income distribution and dampen the pace of poverty alleviation.

The direct effects of these financial sector policies on growth, employment and poverty can be mediated in different ways, including through the cost and other conditions for access to credit, the level and pattern of private investment and the cost of financing public sector deficits. If the economy is characterized by segmented markets, it is expected to see a hierarchy of rates of return. For example, big capital with access to areas offering higher returns may not be willing to enter areas that offer low or lower returns, while medium and small capital may be unable to make investments given inadequate access to credit. In such a case, certain markets could be inadequately serviced by private investors. Moreover, the cost of credit could distort growth by influencing the choice of products and technologies in a manner that affects the elasticity of employment with respect to output. Financial policies can also adversely affect poverty reduction if they fail to address the lack of credit to such structurally disadvantaged sectors as agriculture, the urban small-


scale sector and rural non-agricultural activities, which are vital for the creation of employment opportunities.

In the light of these financial constraints, accepted policies of financial liberalization can lead to financial growth and deepening, and to a greater role by financial agents in the economy (see subsection 2 above). While some of these developments are pro-growth, they could contravene growth, including, for example, the observed tendency that invariably compels the State to adopt a contractionary monetary policy stance in order to appease financial agents and interests. These are normally against State deficit spending for several reasons, including as follows:

(a) Deficit financing is perceived as increasing the liquidity overhang in the system and, therefore, as being potentially inflationary;

(b) Given that Government spending is “autonomous” in character, the use of debt to finance such spending introduces into financial markets an arbitrary player that is not driven by the profit motive and whose activities can render more unpredictable the interest rate differentials that determine financial profits;

(c) If deficit spending leads to a substantial build-up of the State’s debt and interest burden, it could intervene in financial markets in order to lower interest rates or restructure the stock of the public sector debt, with adverse implications for financial returns.

Financial liberalization tends to increase the fragility of the financial sector and the likelihood of financial bankruptcy. Indeed, the record shows that it renders the financial system more prone to large-scale crises. For example, the financial crisis in Southeast Asia in the late 1990s was felt more severely in South Korea, which had adopted financial liberalization, and considerably less in Taiwan, which had adopted a more regulated approach to financial liberalization. These features create a deflationary environment and can have negative consequences for poverty reduction. This suggests that liberalizing the domestic financial sector and easing cross-border flows of capital are not necessarily the best options for countries with significant problems of poverty, acute income distribution inequalities and lack of economic diversification, as is the case of some ESCWA member countries.

In order to enforce pro-poor monetary and financial policies, Governments in the region are best advised to select an appropriate institutional framework and an adequate regulatory structure for the financial sector. Central to such a policy structure in low- and middle-income countries are policies aimed at fostering bank credit for such selected sectors as agriculture and small-scale industries that are labour intensive. Another important financial intervention adopted by several successful low- and middle-income countries is the creation of development banks with the mandate to provide discounted or subsidised credit to selected industrial establishments and priority economic sectors. The principal motivation for the creation of such financial institutions is to make up for the failure of private financial agents to provide particular sorts of credit to certain types of clients, owing to elevated default risks that cannot be covered by high enough risk premiums given that such rates are not viable. In other instances, failure can stem from the unwillingness of financial agents to take on certain types of risk or because anticipated returns to private agents are much lower than the social returns in the concerned investment.

Furthermore, industrial development banks help to deal with the fact that local industrialists often possess inadequate capital in order to invest in more capital-intensive industries that are characterized by significant economies of scale. Similarly, agricultural development banks can advance subsidized credit to the agricultural sector, especially in MDEs, and in particular to small and marginal farmers that do not possess the means to undertake much-needed investments. Given their low credit rating, these farmers are usually excluded from the normal lending of commercial banks and are forced to rely on informal sources,
including moneylenders, landlords and traders, at rates of interest that far exceed those charged by commercial banks. Finally, directed credit can have positive fiscal effects. In contrast to subsidies, such credit reduces the demand placed on the Government’s own revenues, which makes directed credit an advantageous option in poor countries faced with chronic budgetary difficulties.

A rights-based development strategy will also require incentives for investment in priority sectors, especially non-traditional exports; and in public housing, particularly with the goal of closing the investment gap in infrastructure. While these needs are more evident in MDEs than in the GCC, equal attention must be paid to these goals across the entire ESCWA region in order to balance growth and stabilize the long-term economies. Investment, especially in infrastructural projects, can have a significant impact on the composition of growth and the direction of the development process. By the same token, economic growth can support investment projects that otherwise may not be viable. While this does not imply that all projects can be equally profitable, investment coordination can improve loan performance and contribute to the achievement of socially desirable goals. Directed credit and differential interest rates are important instruments of any development trajectory led or influenced by the State, especially if it is pro-poor. Put differently, even if financial policies do not directly help to increase the rate of savings and ensure that the available ex ante savings are invested, they can be used to influence the pattern of investment.

4. Balance of payments and exchange rate policy

Interest rates should not play a key role in securing equilibrium in the balance of payments. A rights-based development programme requires a specific strategy for the balance of payments that comprises policies for export promotion, the discrimination of imports and the regulation of capital flows, including capital controls (see box 4), FDI transfers and foreign aid. The determinants of these flows are far too subtle to be addressed successfully merely by manipulating interest rates.

Box 4. Capital controls: panacea or pitfall?

Capital controls are policy tools designed to restrict the free movement of both capital inflows and outflows. It was a common procedure worldwide until recently; indeed, very few countries in the world allowed the free capital mobility and unrestricted convertibility with regard to foreign exchange after the Second World War. As a matter of fact, even in such industrialized countries as France, Germany, Greece, Norway, Spain, Sweden and United Kingdom of Great Britain and Northern Ireland, exchange controls were a common procedure until the 1980s; and in the case of Portugal and Ireland, they were only lifted in the early 1990s. While there are probably a few countries that still practise currency controls, these represent the exception and not the rule.

Currency convertibility has only recently been allowed in the capital account. While some analysts argue that introducing this agreement allows to finance current trade and direct investment transactions, it must be pointed out that countries expose themselves to autonomous inflows and outflows of funds (capital) by foreigners as well as locals. Consequently, by accepting per se greater risks associated with currency speculation, the amplified exchange rate volatility, increasing size and volatility in capital flows can all be attributed to the expanding global economy and the so-called globalization process. Presently, currency controls have given way to capital controls that many countries use to thwart speculation and short-term capital flows (hot money).

Generally, there are two main kinds of capital controls, namely: (a) “administrative” or direct controls; and (b) “market-based” or indirect controls.

Controls on capital flows can play an important role in stabilizing the balance of payments, while freeing up interest rates. They can also be employed to cope with capital flight and to limit the downward pressure on their currencies; and can be effective in countering hot money that threatens to undermine the stability of exchange rates and deplete foreign exchange reserves. Furthermore, given that in the case of ESCWA member countries, the behaviour of the capital account tends to be pro-cyclical and highly volatile, this scheme can become an effective instrument for policymakers in the region.

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CHAPTER III. MACROECONOMIC POLICY TOOLS UNDER A RESOURCE BOOM

One of the most important aspects of a pro-poor strategy for the balance of payments is the control of capital flows. Stated bluntly, it is difficult to implement a rights-based development strategy with an open capital account of the balance of payments. Capital controls can help to secure balance of payments stability while freeing up the interest rates to pursue developmental goals; and unbridled liberalization of the capital account can be destabilizing for several reasons (see box 5).

Box 5. Why can an unrestricted capital account be harmful?

For developing economies, including those in the ESCWA region, an unrestrained liberalization of capital flows and the absence of controls of the capital account can be incompatible, particularly within a pro-poor and rights-based development strategy. Moreover, it can be mostly destabilizing for the following six reasons:

(a) It can allow speculative inflows that will most likely be employed to finance consumption rather than investment. In addition, it fosters the accumulation of foreign debt, especially by private banks. By the same token, it can facilitate capital flight and increase the country’s vulnerability to balance of payments crises arising from short-term capital flows (hot money);

(b) Implementing an autonomous monetary policy is a challenge. For example, under a regime of free capital flows, it is virtually impossible to lower interest rates beneath those that are compatible with balance of payments equilibrium;

(c) Given that direct investment and other resource flows to growth-promoting and poverty-reducing goals are required by the State, this strategy can conflict with the short-term interests of the private domestic financial sector;

(d) Capital flows, particularly those for the short term, can disrupt private domestic investment in potentially profitable areas while, at the same time, being less amenable to State direction and meeting social needs;

(e) It could represent an incentive for tax evasion, particularly if domestic tax rates are higher than those prevailing abroad, especially in the so-called “tax havens”. This in turn can decrease the funds available to finance pro-poor programmes;

(f) The difficulties in managing their exchange rate will almost certainly be amplified, most of all in aid-dependent countries. Moreover, it will be more acute if their financial markets are insufficiently developed as is often the case in the poorer countries of the region.

5. Oil funds

In recent years, several countries within this region and elsewhere have set up oil savings and stabilization funds in foreign currency (see annex table 6).

Oil stabilization funds can be highly useful for several reasons. First, they can cushion the balance of payments of oil-exporting countries against fluctuations in the oil market, thereby preventing Dutch disease symptoms (see box 2-B). Moreover, oil stabilization funds operate essentially under permanent income assumptions whereby a baseline price for oil is estimated and surpluses are saved in the fund. By contrast, when the oil price is below the baseline, withdrawals from the fund can help to smooth consumption and investment in the country.

Secondly, oil savings funds can provide an alternative source of income when the country’s oil reserves are exhausted or if its competitive advantages are eroded in the medium- and long-term by technological or other changes in the world economy.

In most cases, oil funds are normally based on conservative assumptions related to oil prices. For example, in 2005, the Qatar fund was based on prices of $19/b. However, in the case of Saudi Arabia, while

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a formal fund does not exist, budgets have been erected on conservative assumptions of $25/b, thereby allowing that country to save the difference. In fact, Saudi Arabia was reported to have accumulated more than $100 billion in assets.\textsuperscript{63} It was only in 2005 that higher oil prices led to the rapid accumulation of assets in these funds, and that significant oil price reductions led to withdrawals from the fund.

However, it must be stressed that both types of funds have been criticized on conceptual and operational grounds, including as follows:\textsuperscript{64} (a) the baseline for setting the oil price or the proportion of oil revenues to be set aside is essentially an arbitrary decision; (b) these funds cannot substitute for a responsible fiscal policy stance, given that Governments can draw down future income by borrowing, for example, in which case the fund is useless and could even be counterproductive; and (c) the trusts can be ineffective unless they are governed by clear and transparent rules, which are audited independently and protected from short-term manipulation.

Despite their shortcomings, both types of oil funds can be strategically relevant for rights-based economic policy strategies, given that they can contribute to the stabilization of the balance of payments in the short term, while at the same time providing long-term alternative sources of income for oil-rich countries. In the current conditions of the oil boom, a rapid replenishment of these funds in the ESCWA region is underway, which has contributed to the smooth absorption of the higher oil prices in several countries.

C. CONCLUDING REMARKS

A selection of macroeconomic policy tools are available to policymakers in the ESCWA region under a resource boom, which can be summarized as follows:

(a) Development remains a significant challenge for the ESCWA region in the light of the high rates of unemployment in some countries, particularly of youth; the wide gender divide; lingering poverty and income inequalities; and, more broadly, widespread political and social exclusion. The creation of employment opportunities remains the key to surmounting these barriers, which needs to be approached as a long-term strategic goal by the State aimed at adopting social efficiency criteria as opposed to one that is determined by short-term price and profit considerations;

(b) In order to accomplish the above tasks, rights-based policies represent the appropriate steps that need to be put in place.\textsuperscript{65} Specifically, economic policies must be developed such that they remain central to macroeconomic policies and in which social investment holds primacy in the process of development and, moreover, that welfare gains must not be a residual outcome of strict balancing of Government accounts as per the advice of international financial institutions;

(c) Development can best be served in a regional integration context. Macroeconomic policy coordination in fiscal, tax, monetary and exchange rate policies at the regional level encourages long-term domestic physical investment (plants and equipments) instead of financial investment. The point of


\textsuperscript{64} See M. al-Moneef, op. cit., p. 33.

\textsuperscript{65} Rights-based policies were elaborated at length in the last year’s Survey. See ESCWA, \textit{Survey of Economic and Social Developments in the ESCWA Region, 2005-2006} (E/ESCWA/EAD/2006/2).
emphasis rests on a sound industrialization strategy and on the role of public investment as a hedge against uncertainty and instability;

(d) The pursuit of active industrial policies and the development of a domestic manufacturing sector, particularly those activities that are labour intensive, represent a priority for some poor countries of the region. Within that strategy, public expenditures on health and education, and public investment accompanied by an active financial policy through credit supporting schemes represent appropriate macroeconomic tools, rather than the traditional approach that relies solely on private investment and interest rates;

(e) Governments could also make use of relative and selective capital controls to curb speculative capital movements and are best advised to steer clear of unrestricted capital accounts that can be detrimental to the economy for several reasons, including speculative inflows of capital, the difficulties of maintaining an autonomous monetary policy, inducing tax evasion and increasing the difficulties of managing appropriately the exchange rate;

(f) Oil funds, including those created by several member countries, can be very useful in terms of isolating sudden inflows of capital that can have inflationary effects, while at the same time serving as an alternative source of income for adverse periods in the oil market. Moreover, excess funds can be redeployed within the region, thereby attenuating some of the negative outcomes of the neighbourhood effect in the presence of security concerns.

In a rights-based development strategy, the State is advised to play the role of investment coordinator and to use monetary policy and the financial system in order to direct investment to sectors and technologies that are considered appropriate and necessary for sustainable development. Consequently, in order to influence the allocation and cost of investment, support poverty alleviation and redistribute incomes and assets, it is essential for Governments to adopt financial regimes and policies that are more nuanced and effective in mobilizing and allocating resources to socially and economically desirable objectives.
IV. ECONOMIC STRATEGIES UNDER A RESOURCE BOOM

This chapter examines concisely both the Dutch disease and the resource curse. The analysis starts by highlighting some of the best-known empirical studies in the literature regarding the resource curse and indicates that any short- or long-term dire implications of a sudden drop or rise in commodity prices, particularly oil, is contingent upon the policies in place. Subsequently, it employs a standard framework under the assumption of the existence of two separate sectors, namely, tradable (oil) and non-tradable (non-oil) in order to examine the impact of a large and sudden stream of oil revenues on RER and output. Moreover, this chapter discusses the options for exchange rate management and other macroeconomic issues that frequently arise during oil booms. The aim is to suggest possible alternatives for policymakers in the ESCWA region through which these difficulties can be managed, thereby avoiding both short- and long-term negative effects that frequently draw the attention of academics and policymakers.

A. EVIDENCE OF THE RESOURCE CURSE

A brief review of the literature indicates that conventional accounts of the resource curse are based on questionable evidence of a relationship between resource abundance and poor growth. These strands of the literature have also offered explanations for the presumed existence of a causal relationship between natural resource availability and economic growth that are both static and deterministic. Given the diverse economic performances of many resource-abundant countries, an endowment of petroleum reserves and other minerals has been viewed differently. Specifically, while some analysts perceive such an endowment as a blessing, most researchers have labelled it as a curse (see box 6).

Box 6. Some empirical evidence of the resource curse

- Nankani (1979) argued that mineral economies performed poorly in terms of agricultural growth, export diversification and earnings instability, inflation, savings, technological and wage dualism, unemployment and external debt compared to non-mineral economies.
- Davis (1995) considered the top mineral countries in the developing world between 1970 (before the first oil boom) and 1991 (after the mineral boom of the 1970s was over) according to a modified mineral dependence index. By contrast to the widespread pessimist view, he found that out of the top 43 mineral economies analysed, 22 appeared to have done comparatively well, which made him conclude that their mineral exploitation did not have detrimental effects on their long-term development and thus “the resource curse thesis is not a widespread and general phenomenon”.
- Sachs and Warner (2000) examined the growth experiences of a large number of resource-abundant economies in the period 1970-1990, and found that resource abundance was negatively correlated with growth.
- Auty (2001) found that GDP per capita of resource-poor countries grew much faster than their resource-abundant counterparts in the period 1960-1990.
- Neumayer (2004) examined “genuine” income growth (GDP growth minus the depreciation of produced and natural capital) and found that it was also negatively correlated with resource abundance.

From a purely economic viewpoint, the resource curse has also been associated inaccurately with a well-known series of effects, labelled the Dutch disease (see box 2). However, it is vital to reiterate that the Dutch disease is a process wherein large inflows of foreign exchange, which are usually associated with natural resource booms, generate changes in the economy that undermine the production of internationally traded commodities. These short-term effects can be organized into the following three categories: (a) the spending effect; (b) the resource transfer effect; and (c) the expenditure-switching effect (see box 7).

Both separately and in combination, these effects tend to cause an appreciation of RER (see box 3). As a result, the appreciation can have a powerfully negative effect on the production of non-oil traded commodities, thereby resulting in a shift in the composition of aggregate output away from agriculture and manufacturing towards services.

The classic symptoms of the Dutch disease have manifested themselves in petroleum-exporting countries in all the regions of the developing world. There is no doubt that oil-producing countries of the ESCWA region have suffered in the past from similar types of effects. The challenge for policymakers is to design a macroeconomic framework that minimizes these effects in order to achieve diversification into non-oil exports through an efficient import substitution strategy (ISS). Alongside the prevalence of countries afflicted by Dutch disease, there are some oil-exporting countries that have achieved export diversification and broad industrialization.

B. THE ANALYTICAL FRAMEWORK OF THE DUTCH DISEASE

For analytical purposes, it is assumed that there are two sectors, namely:

(a) A tradable sector (T) that comprises almost exclusively hydrocarbons, as is the case of the petroleum exporters of the ESCWA region. Moreover, the economy is assumed to be small, and foreign goods are postulated to be perfect substitutes for domestically produced goods, thereby fixing the price of tradables (PT) with the world price;

(b) A non-tradable sector (NT), which includes construction, real estate and transport in addition to goods for which world supply and demand are effectively zero. Consequently, the price of non-tradables (PNT) is determined solely by domestic supply and demand.

The well-known Salter-Swan model is represented in the lower right quadrant of the figure in box 7. The quantities of tradable and non-tradable goods are represented on the axes of this quadrant. In line with standard practice, it is assumed that an initial equilibrium exists whereby the community indifference curve (ID) is tangent to the production possibilities frontier (PPF) of non-oil tradables and non-tradable goods (represented by point A, see the box below). This basic approach reduces the whole nation to one representative agent. Additionally, it assumes that the nation is on its production possibilities curve (full employment of every resource).

In the upper left quadrant of the figure in box 7, the market for domestic supply of non-oil tradable goods equals domestic demand at point QT; and the trade balance is therefore zero. The lower left quadrant is a “transfer” quadrant in which T = T; and in the upper-right quadrant, which represents the market for non-tradable goods, the economy is at point Z. Consequently, the resource boom (oil inflows) affects the
exporting economy and creates the above-mentioned three separate effects, namely, spending, resource
transfer and expenditure-switching (see box 7).68

The analysis presented in box 7 provides a bleak image of the macroeconomic consequences of a
sudden increase in oil revenues as a result of exogenous factors. Moreover, it is important to note that these
factor movements can be costly, particularly if they lead to a reduction in the long-term growth rate of the
economy.69

The stagnation or closure of traditional industries, even when accompanied by the expansion of other
sectors of the economy, entails job losses that can lead to the devaluation of skills and bankruptcies.70 While
this does not necessarily represent a significant loss to the economy, especially if the resource boom is
permanent, it could almost invariably be costly to many and difficult to manage.71 Moreover, it can be more
serious if the boom proves to be temporary. Specifically, if the price returns to its initial level or if the
resource becomes exhausted, the economy could find itself with reduced diversity, lost foreign markets and a
more precarious balance of payments position than previously. It can have even more adverse effects if the
squeezed sectors include those that can generate positive externalities and learning.

However, the explicit and implicit assumptions used in the above model make this a special case. For
example, assuming a given country is initially producing at less than full employment, in other words inside
the PPF, and that imports are not perfect substitutes for domestically produced goods, then the demand for
tradables is no longer perfectly elastic. This implies that domestic manufacturers have certain scope to
increase production and price in non-oil tradables sector. As a result, the trade deficit following the inflow of
oil revenues can be comparable if not less to the pre-inflow period given the expansion of the supply of both
tradables and non-tradables. In that case, oil inflows can generate employment and increase the use of other
domestic factors of production. This benign outcome can be fostered by appropriate policy measures that are
discussed below in detail.

The assumption of full employment is crucial in the standard model. Consequently, when assessing its
policy implications, policymakers in the ESCWA region must determine whether or not their national
economy can be treated as operating at full employment. This could be the case for skilled manpower,
thereby underscoring the importance of Government expenditure on education, training and skill formation
among nationals. Where labour shortage arises from the isolation of communities or underdeveloped
transport, public expenditure on rural infrastructure and urban housing can facilitate the transfer of rural
surplus labour to urban activities. Given that unemployment continues to plague the region, especially
among youth and women, the immobility of labour does not constitute a serious problem.72

68 These channels were initially described by W.M. Corden and J.P. Neary, “Booming sector and de-industrialisation in a
small open economy”, The Economic Journal, vol. 92, No. 368 (December 1982), pp. 829-831. For an overview, see C. Ebrahim-
Neumayer, “Does the ‘resource curse’ hold for growth in genuine income as well?”, World Development, vol. 32, No. 10 (Elsevier,
October 2004), pp. 1627-1640.

69 Within that context, one of the most blatant examples is the case of Nigeria. See N. Shaxson, “New approaches to

70 See O. Barder, “A policymakers’ guide to Dutch disease”, Working Paper Number 91 (Center for Global Development,

71 See J.P. Neary, “Deindustrialization and the Dutch disease”, Bulletin Issue No. 4 (Centre for Economic Policy Research,
August 1984), which is available at: www.cepr.org/pubs/Bulletin/004/Neary.htm.

72 ESCWA, Survey of Economic and Social Developments in the ESCWA Region, 2003-2004 (E/ESCWA/EAD/2004/4),
chapter II.
Box 7. The Salter-Swan framework: an economy with tradable and non-tradable sectors

A. The spending effect

Under the spending effect, which begins with an inflow of foreign exchange from oil exports, national income increases from \( Y \) to \( Y' \) (see figure above). As income increases, the demand for non-tradable goods increases, which is represented by the shift from \( DNT \) to \( DNT' \) in the upper right quadrant. The demand for tradables also increases, which is satisfied by an increase in imports financed by oil revenues. The law of one price implies that the price of tradable goods is fixed at \( PT \). As a result, RER appreciates when the price of non-tradables rises, which represents an evident outcome within a fixed exchange rate regime (see box 3). * The net impact is an increase in imports and an appreciation of the currency that reduces the competitiveness of non-oil tradables.

B. The resource transfer effect

The resource transfer effect is the result of the boom in the oil sector that increases demand for non-tradable goods (see box 3). As a result, the marginal products of mobile factors increase, and factors shift away from other tradable goods, including, for example, agricultural commodities and manufactured products. This shift of resources follows from the assumption that the economy is operating at full capacity, in other words that it lies on its production possibilities frontier (PPF). The extent of the resource transfer effect depends on the extent that resources from the non-oil tradable sectors can be used by the oil and non-traded goods sectors, in other words the degree of labour and capital substitutability across sectors; and on the relative factor intensities between sectors. This model makes the standard assumption that labour is the only factor of production that is mobile. Consequently, labour would be drawn away from the non-oil traded goods sector towards the oil sector and the non-traded goods sector in order to meet increased demand. The resource transfer effect results in deindustrialization and a decline in the agriculture sector (deagriculturalization). This is summarized by a shift from \( A \) to \( P \) on the domestic PPF in the lower-right quadrant, which is associated with a contraction in the supply of tradables (\( ST \) to \( ST' \)) and an expansion in the supply of non-tradables (\( SNT \) to \( SNT' \)).

C. The expenditure-switching effect

The expenditure-switching effect stems from the higher consumption level \( C \) on the indifference curve \( ID' \), which is consistent with higher national income \( Y' \), and is associated with an increase in the demand for tradable goods from \( QT \) to \( QDT' \) in the upper left quadrant. The increased consumption of tradable goods, combined with a decrease in domestic supply (to \( QST' \)) results from the spending and resource transfer effects, thereby leading to a deterioration of the trade balance (the trade balance having moved from zero to \( QDT' \) minus \( QST' \)).

* The slope of the income line \( Y \) is less steep than the slope of \( Y' \). The slope of the income lines represents the tradable and non-tradable RER definition; and from this definition, RER appreciates given that tradable goods become cheaper relative to non-tradable goods.
In order to investigate how Dutch disease effects change production and consumption possibilities, households are initially assumed to prefer a combination of non-tradable and tradable goods (represented by point A, see box 7). Again, total income increases owing to foreign exchange inflows from oil. As a result, consumption possibilities change from the solid PPF to one that would represent income at the level $Y'$. The vertical distance between the consumption and output possibilities indicates the foreign currency income. Increased consumption possibilities imply that households consume more of both tradable and non-tradable goods (represented by point C in the lower right quadrant). In order for households to consume at point C, production must adjust to point P, in other words the output of non-tradable goods must be the same as at point C given that these cannot be imported.

Consuming as many tradable goods as at point C requires the country to produce only at point P given that the rest is financed by oil revenues. Consequently, spending oil revenues shifts output to lower production of tradable goods. At point P, the potential supply of non-tradable goods (production possibilities) has not increased; and non-tradable goods therefore become more expensive relative to tradable goods, thereby leading to an appreciation of RER. This appreciation is necessary in order to adjust the economy to higher production of non-tradable goods. For this to be profitable, the price of non-tradable goods in relation to tradable goods must rise. Specifically, manufacturers receive the market signal to use more inputs in the production of non-tradable goods and less in the production of tradable goods. As capital and labour shift into the production of non-traded goods in order to meet the increase in domestic demand, the manufacturing sector contracts.

Consequently, these Dutch disease effects depend on the division of the economy into tradable and non-tradable sectors. While this division has been accepted uncritically for the purpose of the model, the empirical difference is often ambiguous. Moreover, this analysis refers to trade in “final” products, household consumption or capital investment. However, if a country’s manufacturing sector requires the import of components that are then used to assemble the final product prior to subsequent export, the appreciation of RER could have more mixed effects in the domestic economy.

C. EXCHANGE RATE REGIMES

While the analysis in section B above showed that increased oil revenues can lead to an appreciation of RER, it did not make a distinction of the outcome between fixed and floating exchange rate regimes. The mechanism through which real appreciation takes effect depends on the country’s exchange rate regime; and while most ESCWA member countries have some version of a fixed exchange rate (see table 7), there is a vital need to bring to light the advantages and disadvantages of each system in order to optimize policy decisions.

In a fixed exchange rate regime, in which the price of the domestic currency is fixed or pegged by the central bank in terms of a key foreign currency or basket of currencies, the conversion of foreign currency from oil revenues into local currency increases the country’s money supply unless oil funds and domestic currency funds are in place. Pressure from domestic demand can push up domestic prices, which is equivalent to an appreciation of RER, thereby requiring the central bank to sell foreign exchange in order to defend the fixed nominal exchange rate that can fuel capital outflow in the short term (hot money). If the exchange rate is flexible, in other words there is a floating regime in place, oil companies sell the foreign exchange accruing from petroleum sales to the central bank. As a result, it increases Government revenues when the oil sector is controlled totally or partly by the State, which causes a nominal (and real) appreciation in the exchange rate. In both cases, appreciation of the local currency is inevitable given that this is how increased inflows of foreign capital are absorbed by the domestic economy. The non-oil trade deficit widens owing to increased imports that stem from increased income. This logic indicates that an appreciation of RER must not always be interpreted as a manifestation of Dutch disease. There is a cause for concern if the
widening in the trade gap arises from falling exports, which are caused by the real appreciation of the exchange rate, as was the case of the Netherlands in the 1960s (see box 2).73

Moreover, the appreciation of RER can bring costs as well as benefits. For example, it can make possible higher consumption or public investment. However, it can also lead to a balance of payments deficit, particularly when the decline in net exports stems from a short-lived boom.

If oil revenues fall as a result of declining world prices, RER becomes overvalued. It could therefore prove impossible to recover the short-term losses in non-oil export markets that result from this appreciation, even if the real overvaluation is corrected by a subsequent depreciation of the nominal exchange rate. In addition, adjustments to RER are unlikely to be smooth. It is possible to offset the impact of the real appreciation on exports by spending oil revenues on productivity-enhancing investment. Equally, a Government can attempt to take advantage of such commercial policies as export subsidies in order to prevent a deteriorating balance of payments. However, this implies that policymakers are best advised to examine carefully the implications of rapid trade liberalization and unrestricted membership in WTO. Moreover, given that out of the 13 ESCWA members, eight were full members of WTO and three were observers in 2006, this option is not accessible to all ESCWA members (see table 7).

However, under a fixed exchange rate regime and in the presence of idle resources, as is the case in the ESCWA region, the central bank must intervene in the foreign exchange market when the external account moves into surplus in order to maintain the exchange rate at its pegged level. The rationale for intervention is as follows: assuming no capital flows, if a country is running a balance of payments surplus, the demand for foreign exchange is smaller than the amount being supplied by private markets. The central bank must buy the difference. This action has a direct monetary impact given that the purchase of foreign exchange releases domestic currency into the market, thereby driving up the high-powered money and, in turn, the money supply. This has the effect of increasing aggregate demand.

### Table 7. Exchange Rate Regimes in the ESCWA Region (in 2001) and WTO Membership (in 2006)

<table>
<thead>
<tr>
<th>Country or territory</th>
<th>Exchange rate regime</th>
<th>WTO member</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bahrain</td>
<td>Fixed peg</td>
<td>Yes</td>
</tr>
<tr>
<td>Egypt</td>
<td>Fixed peg</td>
<td>Yes</td>
</tr>
<tr>
<td>Iraq</td>
<td>Fixed peg</td>
<td>Observer</td>
</tr>
<tr>
<td>Jordan</td>
<td>Fixed peg</td>
<td>Yes</td>
</tr>
<tr>
<td>Kuwait</td>
<td>Fixed peg</td>
<td>Yes</td>
</tr>
<tr>
<td>Lebanon</td>
<td>Fixed peg</td>
<td>Observer</td>
</tr>
<tr>
<td>Oman</td>
<td>Fixed peg</td>
<td>Yes</td>
</tr>
<tr>
<td>Palestine</td>
<td>Not applicable</td>
<td>Not applicable</td>
</tr>
<tr>
<td>Qatar</td>
<td>Fixed peg</td>
<td>Yes</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>Fixed peg</td>
<td>Yes</td>
</tr>
<tr>
<td>Syrian Arab Republic</td>
<td>Fixed peg</td>
<td>Yes</td>
</tr>
<tr>
<td>United Arab Emirates</td>
<td>Fixed peg</td>
<td>Yes</td>
</tr>
<tr>
<td>Yemen</td>
<td>Independently floating</td>
<td>Observer</td>
</tr>
</tbody>
</table>

Source: S. Fischer, “Exchange rate regimes: Is the bipolar view correct?”, which was presented at the meetings of the American Economic Association (New Orleans, United States of America, 6 January 2001) and is available at: www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm.

73 Gelb and associates analysed a sample of six oil-exporting countries and found that the average real effective exchange rate (REER) had risen by nearly 50 per cent between 1970 and 1984, which represents the period of the first two oil booms. Given that real appreciation was not offset by equal improvements in productivity, this severely hampered the domestic manufacturing sector. A.H. Gelb and associates, Oil Windfalls: Blessing or Curse? (Oxford University Press, 1988).
If the foreign exchange from oil is converted to local currency and spent on domestic goods and services, this is analogous to using oil revenue for deficit financing. This raises the high-powered money and domestic demand, and tends to drive up mainly the output prices of domestic non-tradables because Government expenditure is generally biased towards expenditure on non-tradables. The spending is potentially inflationary unless there is spare capacity in the economy and the economy is at less than full employment, in other words inside the PPF. Moreover, a rise in the prices of non-tradables relative to tradables causes an appreciation of RER. Consequently, inflation is a risk associated with an oil boom, including the current boom. Countering this inflationary tendency is the anti-inflationary role that a fixed or pegged exchange rate can accomplish.

The so-called sterilization is a mechanism by which the link between the external imbalance and the changes in the money stock can be broken. This procedure involves open-market operations aimed at offsetting the increase (or decrease) in the money supply that results from foreign exchange flows (or fiscal deficits). While persistent external deficits or surpluses are possible within this system, there are limits. Specifically, excessive sterilization can drive interest rates up to a level that could have a recessionary impact on the domestic economy. Sterilization itself could therefore lead to a nominal appreciation and an overshooting of the desired RER, particularly if domestic goods prices are sticky, albeit with flexible asset prices.

While in theory sterilization can be used to counter exchange rate appreciation, in practice it will be ineffective in most if not all ESCWA member countries. It requires that the central bank has an active participation in the financial market in terms of buying and selling Government securities. However, in the ESCWA region, financial markets are narrow and underdeveloped. Specifically, domestic secondary markets for Government securities hardly exist, which are essential for effective open-market operations of which sterilization is a special case.

D. ADDITIONAL MACROECONOMIC ISSUES DURING OIL BOOMS

The section above considered the macroeconomic implications of exchange rate management within the context of a high level of oil revenues. Protecting against the appreciation of RER is a top priority given that it undermines all other tradable sectors both for export and import substitution. Consequently, it represents a major challenge for petroleum-exporting countries. However, there are a number of other macroeconomic dangers, including as follows:

(a) Unsustainable external borrowing: Given that petroleum exporters tend to have comparatively strong currencies, their Governments tend to be viewed by international commercial banks as substantially creditworthy. If the Government of an oil-exporting country uses monetary policy to manage the exchange

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74 In fact, Ghosh et al. maintained that there was a strong link “between fixed exchange rates and low inflation. This results from a discipline effect (the political costs of abandoning the peg induce tighter policies) and a confidence effect (greater confidence leads to a greater willingness to hold domestic currency rather than goods or foreign currencies). In part, low inflation is associated with fixed exchange rates because countries with low inflation are better able to maintain an exchange rate peg. But there is also evidence of causality in the other direction: countries that choose fixed exchange rates achieve lower inflation.” A.R. Ghosh et al., “Does the exchange rate regime matter for inflation and growth?”, Economic Issues, No. 2 (IMF, September 1996), pp. 1-2.

75 Reviewing the conditions of the financial markets, last year’s Survey underscored the regional disparities in terms of the degree of financial deepening of the domestic economy and of integration with the world markets. Specifically, while some countries in the ESCWA region, particularly those in the GCC, are quite mature, others are still in the infant stage. Reform in the latter markets, particularly in MDEs, must aim at removing all the institutional impediments responsible for financial repression and at creating a well-functioning capital market. Such a market can stimulate both saving and investment and encourage new private sector enterprises to emerge and prosper. ESCWA, Survey of Economic and Social Developments in the ESCWA Region, 2005-2006 (E/ESCWA/EAD/2006/2).
rate, as described above, this can push domestic interest rates above rates in such international financial centres as London and New York. This combination of eager foreign lenders and relatively high domestic interest rates can tempt or induce Governments to borrow internationally. Consequently, an apparently perverse situation of many oil countries arises whereby large foreign exchange windfalls are accompanied by large foreign debts and poor economic growth results (see box 7 for additional explanations);

(b) Excessive credit expansion: Spending oil revenues in the domestic economy increases the amount of currency in circulation and leads to an increase in money deposited in commercial banks. Before imports have risen sufficiently to offset some of the increase in money supply, the increase in commercial bank deposits can result in rapid growth in bank credit, which can exacerbate, for example, a real estate boom. The expansion of credit and money by way of the money multiplier can therefore accentuate the boom if it is not prevented by higher reserve requirements or credit ceilings. This is predicted by the Minsky model, which argues that in prosperous times, corporate cash flow rises beyond the level needed to pay off debt. A speculative euphoria develops and lending increases beyond what the borrowers can pay from their incoming revenues. The oil boom equivalent of this can be seen in inflation in real estate prices;

(c) “Crowding out” effects: Government investment could compete and therefore “crowd out” private sector competition for scarce domestic factors of production and financial resources, which can generate higher interest rates and produce credit rationing. This can therefore exert a negative influence on private investment, at least in the short term, if the Government gives priority over its own claims on the economy. However, if the Government carries out investment expenditure on public infrastructure, including electricity, water, sewage, roads, transportation systems and irrigation projects, this can increase or enhance the production and distribution of goods and services throughout the economy, thereby “crowding in” or promoting private domestic investment by lowering the costs faced by this sector.

It is important to note that, in theory, the “crowding out” argument is only valid when an economy is near full employment. When there are unused resources, there is space for an increase in all types of expenditure both public and private. These “crowding in” effects can be moderately significant in an oil-rich country because the public sector typically carries out large investment projects, particularly in infrastructure. Designing these public sector projects to “crowd-in” private investment rather than “crowd-out” can make a major contribution to long-term sustainable growth. This issue is treated in more detail in chapter V.

Box 8. The poor economic growth of resource-abundant countries

- Gelb and associates (1988) argued that a sudden boom affects the way Governments behave as a result of becoming extremely confident regarding future revenues from oil wealth and other minerals. The boom increases public spending that can induce them to borrow in excess from abroad by assuming that windfalls will continue in the foreseeable future. In most cases, this borrowing is more than proportionate to the size of the boom itself. Once the additional revenues do not continue and come to a halt, the economy moves into recession and stagnation.

- Auty (1988) claimed that augmented foreign revenues affect the way that people act and, moreover, shape how Governments react. Governments tend to create grand plans and ideas that lead them to pursue wasteful prestige investment projects. At the same time, they produce conspicuous consumption among a small elite, which is usually connected to the Government and indulged in lavish spending and a cosmopolitan lifestyle while work ethics are undermined and productivity sinks.

76 Ibid.
• Karl (1997) claimed that dependence on oil revenues has led to the emergence of “petro-States”, which are heavily geared towards the political distribution of oil rents rather than the promotion of investment and output growth. These outcomes are especially likely when the expansion of the oil industry is concurrent with the process of State formation, in which case the State tends to become unaccountable, structurally distorted and unable to deliver developmental outcomes.

• Tornell and Lane (1999) alleged that rich countries that lacked efficient legal protection of private property rights typically grew more slowly than resource-poor countries. The reason is that multiple power groups exist and are able to exploit the earnings from the export sector, which has superior technology and is highly productive, through the fiscal process of the economy as a distributive mechanism to appropriate resources for themselves. However, the main issue, which the authors describe as “voracity effect”, is that capital stock privacy diminishes, thereby leading to a proportionally larger fiscal redistribution of resources than originally generated by an improvement in terms of trade. By contrast and despite inferior technology and less productivity, the non-export sector is free from taxes and exploitations by other groups.

• Leite and Weidmann (1999) argued that resource abundance is correlated with higher levels of corruption. The concentration of fiscal resources from an oil boom encourages disproportionate and careless investment decisions that can lead to the inappropriate distribution of resources and a drop in productivity.

• Atkinson and Hamilton (2003) argued that the countries most directly affected by the resource curse tend to have lower growth rates overall and are those where the combination of natural resource availability, macroeconomic and public expenditure policies have led to a low rate of genuine saving (that is, net adjusted for resource depletion).

• Mehlum, Moene and Torvik (2006) argued that the performance of natural, resource-rich countries depends on the quality of institutions, especially in terms of whether they are “grabber friendly” or “producer friendly”.


E. CONCLUDING REMARKS

The main findings of this chapter can be summarized as follows:

(a) Most of the available empirical evidence is clear regarding the long-term negative effects caused by resource abundance in most developing countries. However, these effects can be changed under an appropriate policy setting;

(b) The Dutch disease effect is not unique and an unavoidable outcome; rather, it depends on various factors. However, it is most pressing when the economy is operating at full employment and where a clear division into tradable and non-tradable sectors exists, which is not the case in the ESCWA region. Consequently, ESCWA policymakers can take advantage of a resource boom while at the same time
avoiding its negative effects by pushing through a regional integration agenda. Any persisting symptoms of the Dutch disease can be attributed to policies of the past three decades that have been based on the mainstream approach and that, specifically, do not take into account the peculiarities of each developing country and the political and economic concerns of more advanced countries within the relationship with the South. A sound policy framework needs consensus both at the regional and international levels on an industrial policy agenda that favours employment generation and increasing returns in industry;

(c) While the appreciation of RER can be an outcome that can have adverse consequences on the domestic economy, it can also be a blessing depending on the chosen exchange rate regime. The exchange rate policy is best set in relation to the major trading partners. Consequently, it is recommended to maintain a fixed exchange rate that employs different currency anchors such as, for example, one weighted in terms of a basket of hard currencies, including regional currencies. This needs to be supplemented within a trade policy on a regional basis, with preference to the stabilization of the currencies in the ESCWA region;

(d) Other macroeconomic issues, including unsustainable external borrowing (in the case of MDEs), excessive domestic credit expansion and rising inflation are warning signs that the boom has not been dealt with appropriately and that amendments to the economic policy are required, especially in terms of fully supporting a fixed exchange rate regime, selective capital controls and the deepening of funds at national and preferably regional levels.

Finally, it must be stressed that the Governments of oil-exporting countries in the ESCWA region can meet the challenge of overcoming these effects with a reformed institutional framework that favours development in a context of regionalism. The optimal macroeconomic framework is best set against a fixed exchange rate, which the Governments in the region have already established; an oil fund aimed at accumulating foreign exchange and revenue reserves; a monetary policy that focuses on fostering domestic investment; and a fiscal policy that is countercyclical or that stresses on public investment rather than on public expenditure. Public investment is the primary instrument by which Dutch disease effects can be overcome in the short term; and, subsequently, resource curse symptoms can equally be avoided in the long run by raising productivity and lowering costs in the tradable sectors. Governments are advised to proceed cautiously with trade liberalization, given the threat of transitory Dutch disease effects that could undermine competitiveness of the non-oil tradable sectors.78

78 That point was underscored in last year’s Survey: see ESCWA, Survey of Economic and Social Developments in the ESCWA Region, 2005-2006 (E/ESCWA/EAD/2006/2).
V. DEVELOPMENT EXPERIENCE AND POLICY ISSUES FOR THE ESCWA REGION

This chapter identifies the main policy obstacles currently faced by oil-exporting economies in the region. To that end, it starts with a brief overview of the international petroleum market in the twentieth century by focusing on price instability and the changes that occurred in the market shares during the past century. Subsequently, the analysis focuses on the growth performance since 1960 of oil exporters in North Africa and the ESCWA region, compared to other middle-income countries in the world, including major petroleum exporters in Latin America and sub-Saharan Africa. Finally, it employs a theoretical framework aimed at analysing more meticulously three main macroeconomic options, namely, exchange rate, fiscal policy and public investment, which are within reach of the Governments of the region and in order to avoid some unwanted symptoms of sudden resource inflows.

A. THE WORLD PETROLEUM MARKET

An important characteristic of the international oil market has been the rapid change in the shares of the export market by country. From the 1930s to the 1950s, Venezuela dominated the world market and held just over 50 per cent in 1960. While its share fell sharply during the 1960s, that country continued to be the biggest oil producer for the West until 1970, when it was displaced by Saudi Arabia and Iran, and subsequently dropped below 10 per cent two decades later. In the 1970s, the share of ESCWA member countries increased sharply and the largest producer in the region, namely, Saudi Arabia, represented nearly 13 per cent of the global oil market by 1975. In the subsequent decade, Mexico, Norway and the United Kingdom emerged as major exporters, and towards the end of the twentieth century and into the next, several other countries claimed substantial shares, including Canada, Nigeria and the Russian Federation. Despite these developments, it is important to highlight that during the past quarter of a century, 1980-2006, Saudi Arabia has retained the leading role as the largest oil producer and exporter in the world.

However, with the diversification that has occurred in the international petroleum market, the market power of OPEC members has diminished over time, thereby implying that the Governments of ESCWA petroleum exporters have less control over the fluctuations in revenues and are set to have less influence in the foreseeable future as discussed in chapter II.

After relative stability during the 1950s and 1960s, the international price of petroleum displayed high volatility after the oil crisis of 1973-1974 (see figure 12). The striking characteristic of this volatility was the instability of both nominal and real price of oil, which in fact displayed very similar patterns with quarterly coefficients of variation at 0.101 and 0.095, respectively (at 1974-2006 moving averages, see figure 13). This is somewhat surprising given that the deflated price would be expected to be less volatile in a case where petroleum prices and the world rate of inflation were closely correlated. This volatility translates into unstable revenue flows for oil-exporting countries and, therefore, into increasing macroeconomic instability that policymakers in the region have to address adequately.

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79 See, for example, E.J. Medina-Smith, “Four essays on economic growth in Venezuela, 1950-99” (University of Sussex, July 2003).

80 Canada was both an exporter and importer of crude oil. Canadian companies exported some 60 per cent of its domestic production in 2005, the vast majority of which went to the United States of America. While some Canadian agencies estimate that petroleum reserves are second only to Saudi Arabia, recent estimates place Iraq oil reserves even above those in Saudi Arabia, with the evident reservations given the lack of reliable geological data on Iraq. See, for example, “Study: Canada’s crude petroleum industry”, The Daily (11 September 2006), which is available at: www.statcan.ca/Daily/English/060911/d060911b.htm.

81 Specifically, if petroleum prices and the world rate of inflation were perfectly correlated, the deflated price would be constant.
CHAPTER V. DEVELOPMENT EXPERIENCE AND POLICY ISSUES FOR THE ESCWA REGION

Figure 12. Quarterly nominal and deflated crude petroleum prices, 1973-2006
(United States of America crude import, United States cents per barrel)

Source: Energy Information Agency (EIA), which is available at: www.eia.doe.gov/emeu/international/prices.html.

Note: The deflator is the producer price index (PPI) in the United States of America.

Figure 13. Quarterly moving coefficient of variation, nominal and deflated petroleum price, 1974-2006

Source: Energy Information Agency (EIA), which is available at: www.eia.doe.gov/emeu/international/prices.html.
B. GROWTH PERFORMANCE AND ECONOMIC DIVERSIFICATION

From the brief review of the world petroleum market outlined above, it becomes apparent that most market shares of individual countries have changed in the past decades, which have been accompanied by increasing instability of oil prices. Consequently, the economic performance of oil exporters can be considered properly. Moreover, the purpose of this review is to place oil exporters in the ESCWA region in a comparative international context and to seek lessons that are relevant for the region. This section focuses on the repeated failure of petroleum-exporting countries in the developing world to diversify their economies. In order to place the issue of economic diversification in context, the starting point of this analysis inspects the growth experience of these countries.

Without exception, oil exporters in the ESCWA region have been considered middle-income countries. Within that definition, figure 14 compares the growth rates of all the major petroleum exporters in Latin America and the Caribbean, namely, Colombia, Mexico, Venezuela and Trinidad and Tobago; and the petroleum exporters in North Africa and the ESCWA region. Over the period 1961-2002, the rate of growth for the petroleum exporters in Latin American and the Caribbean was below the prevailing rate for all middle-income countries in the world, while it was modestly higher for North Africa and the ESCWA region, at 4.6 per annum compared to 4.3. However, the average for the four decades obscures substantial declines for all three groups of countries. For example, in the first two decades, 1961-1979, the annual growth rate for oil exporters in North Africa and ESCWA was almost 8 per cent per annum, which fell to slightly over 2 per cent during the subsequent two decades, 1980-2002. This decline of some six percentage points was almost twice that witnessed for the oil exporters in Latin America and the Caribbean.

Figure 14. GDP growth rates of all middle-income oil exporters in Latin America and the Caribbean, and North Africa and the ESCWA region, 1961-2002


Note: The key in figure 14 provides the country category, average growth rate and coefficient of variation of the growth rate.
CHAPTER V. DEVELOPMENT EXPERIENCE AND POLICY ISSUES FOR THE ESCWA REGION

In addition, the bare statistics understate the poor performance of the ESCWA region, given that a considerable part of the decline in growth for Mexico and Venezuela resulted from stabilization programmes during the 1980s, which were associated with the debt crisis in developing countries and in particular Latin America. In other words, given the demand compression policies implemented by the Governments of Mexico and Venezuela in the 1980s, the so-called “lost decade”, growth performance of the ESCWA region after 1980 should have been better not worse than for other middle-income petroleum exporters from Latin America and the Caribbean.

Moreover, the volatility of the growth rate as measured by the coefficient of variation was twice as high for North Africa and the ESCWA region than for all middle-income countries, and substantially higher than for oil exporters in Latin America and the Caribbean. Over time, growth became more unstable in the entire region. Indeed, during the period 1961-1979 when the annual average growth rate for petroleum exporters in North Africa and ESCWA reached nearly 8 per cent, the coefficient of variation of the growth rate was a mere 0.43. Nevertheless, a growth rate of 2 per cent over the following two decades was associated with a coefficient of variation of 1.25, compared to 0.85 for oil exporters in Latin America and Caribbean.

A fundamental cause of the growth instability of petroleum-exporting countries is the lack of diversification of their exports. Figures 15-17 show share of fuel products in export earnings for the ESCWA region, Latin America and Caribbean, and sub-Saharan Africa. Specifically, out of the seven ESCWA member countries for which relevant data are available, the share of fuel products in export earnings was substantially more in 2000-2002 than in the 1960s, with the exception of Bahrain, where that share remained close to 70 per cent (see figure 15). Bahrain’s export diversification experience is of limited relevance to the other countries of the region in which diversification would be in agriculture and manufacturing rather than in services.82 The only oil exporter with less than two thirds of its export revenues from oil was Egypt, at about 40 per cent from the second half of the 1980s.83

This concentration of exports in petroleum and derivatives is both the cause and the consequence of the Dutch disease effects, which were discussed in detail in the previous chapters. On the one hand, the appreciation of RER associated with oil revenues creates powerful disincentives for the production of domestic tradable goods. Moreover, the absence of diversification perpetuates the dominance of the economy by the petroleum sector in terms of exports and as a source of fiscal revenues.84

82 This owes to the fact that Bahrain is the smallest country in the region in terms of total surface area, at barely 70 square kilometres, and with a very modest population.

83 The concentration of exports in the region is a well-known challenge. Specifically, crude oil and other oil-related products remain the main commodities exported from the ESCWA region. It is estimated that crude oil, gas and related products comprised 70.9 per cent of total exports in 2004. Egypt’s non-oil exports were stimulated by its robust performance in the export of metal products, particularly steel. While Lebanon’s export growth remains weak, an impressive rise was seen in the electronic instruments sector. Apparel and clothing continued to lead export growth in Jordan in 2004. See ESCWA, Survey of Economic and Social Developments in the ESCWA Region, 2005-2006 (E/ESCWA/EAD/2006/2).

84 Most of the diversification of MDEs takes place in primary and non-tradable goods, and manufacturing industries remain underdeveloped. In the oil economies, the primary sector is even more and manufacturing even less represented than in MDEs. Ibid.
While the lack of diversification in the ESCWA region is extreme, it is not unusual. Figures 16 and 17 illustrate the share of fuel products with respect to total exports for the major oil exporters in Latin America and the Caribbean, and in sub-Saharan Africa. In Colombia, despite increasing petroleum exports, that sector has never become dominant and, to a certain extent, Colombia has succeeded in maintaining a diversified export structure. In the case of Mexico, petroleum overwhelmed all other exports by the mid-1980s in a classic manifestation of Dutch disease effects. However, by the 1990s, even as petroleum exports grew, their relative importance declined dramatically. While Mexico is an encouraging example of finding an exit from the Dutch disease syndrome, this was largely achieved through its membership in the North American Free Trade Agreement (NAFTA). Given its geographical and strategic importance for the United States of America, the diversification strategy of Mexico offers few lessons for the ESCWA region.

By contrast, the export performances of Venezuela and Trinidad and Tobago show a different performance from those of Colombia and Mexico, with patterns that are very similar to the petroleum exporters of the ESCWA region. Indeed, Venezuela ranks high in terms of the most consistently undiversified country of all major petroleum exporters. For almost 90 years, petroleum and related products have generated the overwhelming share of that country’s exports and fiscal revenues. Petroleum has been so dominant in Venezuela that when its export share moved towards 80 per cent in the second half of the 1980s, it actually represented a historic low that has since never been repeated. However, an active ISS was put in place from 1960 until 1989, with a degree of success.  

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CHAPTER V. DEVELOPMENT EXPERIENCE AND POLICY ISSUES FOR THE ESCWA REGION

Figure 16. Share of fuel products in export earnings in Latin America and the Caribbean, 1960-2002


Note: Within this context, fuel exports include natural gas and petroleum.

Figure 17. Share of fuel products in export earnings in sub-Saharan Africa, 1962-2002

Source: Energy Information Agency (EIA), which is available at: www.eia.doe.gov/emeu/international/prices.html.
The experience of exporters in sub-Saharan Africa has been consistently non-diversified, with petroleum accounting for more than 80 per cent of export revenue in Angola, Gabon, Republic of Congo and Nigeria (see figure 17). Only in the case of Cameroon has the share of petroleum been below 50 per cent since the 1980s. The lack of diversification in sub-Saharan African countries can be largely attributed to underdeveloped non-oil sectors, with low skill levels and rudimentary technology in the agricultural and manufacturing sectors. Given these limitations, implementing a diversification strategy in this region remains a challenge, albeit essential.

The conditions are fairly different in the ESCWA region, where a considerably higher level of education and skill could provide the potential for both the diversification itself and the design of policies aimed at overcoming Dutch disease effects. Some analysts claim that, owing to various reasons, the experience of petroleum-exporting countries in the twentieth century has overwhelmingly been one of failure in terms of overcoming the resource curse (see box 7).

However, there are examples of countries that succeeded in diversifying and, moreover, in using their petroleum revenues to facilitate that process. Within that context, Indonesia represents perhaps the clearest example, particularly when compared to the other extreme, namely, Venezuela (see figure 18). From the early 1960s to the early 1980s, petroleum revenues rose from some 30 per cent of total exports to more than 80 per cent. During the subsequent 20 years and particularly up to the Asian financial crisis of 1997, petroleum continued to decline in relative importance from 80 per cent to 20 per cent, and was replaced by manufactured products.

Governments of petroleum-exporting countries in the ESCWA region face the following stark choice: (a) they can allow current trends to continue and, as Venezuela, remain locked into petroleum dominance whereby the development pattern is restricted to resource-based industries (RBIs); or (b) they can diversify, as Indonesia, into manufactured products where petroleum plays a supporting role. The policies that could achieve the latter outcome are set forth below.

**Figure 18. Share of fuel products in export earnings in Indonesia and Venezuela, 1962-2001**

C. The Effects of the Dutch Disease: A Framework

Governments of petroleum-exporting countries have three policy areas that provide instruments with which to combat Dutch disease effects. The effective use of such instruments requires coordination across policies and focus on well-defined objectives aimed at fostering economic diversification and sustainable growth. These instruments are as follows: (a) using monetary and exchange rate policies to maintain relative prices such that non-oil tradables remain competitive; and (b) designing public investment in order to lower the cost of tradable production.

Chapter II explained the fundamental problems arising from a petroleum boom. That discussion can be adapted to consider the broad policy alternatives for oil-exporting countries in the ESCWA region, which are summarized analytically in figure 19. The economy of an oil-exporting country is assumed to have four commodities, namely: petroleum, non-oil exportables, non-oil importables and non-tradables. As the exchange rate depreciates, importables become competitive with exports.86

Figure 19 can be interpreted as follows: given the international price of oil, the axes measure the relative price of non-oil exportables to the price of non-tradables (vertical axis), and the relative price of importables to non-tradables (horizontal axis). The straight line $X=X_o$ represents all the values of the two relative prices for which the quantity of non-oil exportables is equal to $X_o$. This is the value of $X$ that would be produced for the given international price of oil and with no tariffs, non-tariff barriers or subsidies. Similarly, the line $M=M_o$ represents importables (potential import substitutes).

**Figure 19. Policy alternatives for an oil-exporting country**

Source: ESCWA.

Notes: World price of petroleum is assumed constant. $P_x$ is the domestic currency price index of non-oil exportable commodities; $P_m$ is the domestic currency price index of non-oil importable commodities; and $P_n$ is the domestic currency price index of non-tradable commodities.

86 Within that context, exportables are tradable commodities that become competitive on the international market; importables are also tradable goods; and non-traded commodities are those that are neither exported nor substitutes for imports.
In order to maintain $X = X_0$ at the higher relative price of importables ($P_m/P_n$) at a point above where the lines intersect, it is necessary for $P_x/P_n$ also to be higher. The same relationship applies for line $M = M_0$. The two lines divide the chart into four zones. In zone I, interventions by the Government through subsidies, for example, move the relative price of exportables above its non-intervention price, and the relative price of importables below its non-intervention price. The policy package increases the quantity of exportables by shifting resources away from importables. In the strictest sense, this represents a strategy aimed at promoting exports. The policy package that underlies zone III achieves the opposite, namely, it increases importable production and decreases the production of exportables through an active ISS.

The area between these two, or zone II, is reached by a combination of policies that foster exports and ISS simultaneously. For example, subsidies could be used to raise the profitability of non-oil exports and tariffs in order to make importables competitive with commodities from abroad. In practice, it is possible to apply both to the same product. Consequently, promoting non-oil exports and fostering substitutes for imports can be done simultaneously. This area could be called the “industrial policy” zone.

Unfortunately, most petroleum-exporting countries in the ESCWA region are in zone IV. This area represents the Dutch disease segment wherein oil revenues generate distortions through spending, resource transfer and expenditure-switching effects (see box 7). This reduces the outputs of both exportables and importables below their non-interventionist levels. If the international price of petroleum rises, the lines $X = X_0$ and $M = M_0$ shift upwards, thereby increasing this Dutch disease zone by requiring higher values of $P_x$ and $P_m$ in order to achieve the same levels of output for $X$ and $M$.

Figure 19 provides several insights that are relevant to petroleum-exporting countries in the ESCWA region, and provides the policy implications for the above-mentioned discussions on Dutch disease effects. First, in the context of rising oil prices, a non-interventionist trade policy is set to result in a declining production of tradables, both non-oil exports and import substitutes, given that the effects will increase the price of non-traded goods relative to traded goods. In the non-oil economy, this policy regime can result in the growth of services and construction, a process of deindustrialization or, for a country without an industrial sector, the failure to industrialize. Secondly, there are policy packages that can avoid this, as the experience of Indonesia has shown. The optimal strategy is to foster both non-oil exports and import substitutes through a process in which the latter lays the basis for the former.

D. MACROECONOMIC POLICIES

In order to avoid the Dutch disease effects, Governments are advised to coordinate exchange rate and fiscal policies. Direct exchange rate management is the key to success within such a coordinated framework given the limited ability of monetary instruments to manage the exchange rate indirectly, particularly in ESCWA member countries, and that financial markets are underdeveloped in the region as was pointed out in chapter III. This situation implies the existence of a narrow and limited market for Government bonds, whose transactions provide the indirect mechanism of managing the exchange rate. Consequently, in the absence of effective monetary mechanisms, exchange rate management is a crucial tool aimed at avoiding Dutch disease effects, which implies that a fixed or pegged exchange rate is the best option for policymakers of petroleum exporters in the region.

1. **Exchange rate**

By contrast to fixed exchanged rates, the so-called “impossible trinity” is frequently cited, which refers to the combination of a liberalized capital market, a fixed exchange rate and effective monetary
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policy. The logic is that if the 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 of limited relevance to the ESCWA region for the following reasons: (a) given that financial markets are so underdeveloped, buying and selling Government bonds is not an effective policy instrument whether the exchange rate is fixed or flexible; (b) 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, and the same underdevelopment of financial markets that renders ineffective open-market operations implies that capital flows cannot be perfectly elastic in the ESCWA region; (c) there are many degrees of capital account liberalization and regulation such that the alternatives are not a “free” or a “closed” capital account (see box 4); and (d) the accumulation of foreign exchange reserves arising from the oil price boom can be separated from the domestic economy through a number of mechanisms that do not require open-market operations.89

Consequently, the adoption of a fixed or pegged exchange rate, as is the case of oil producers in the ESCWA region, represents the only effective way for preventing 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 the short-term balance of payments stability and long-term resource allocation. 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 could affect the long-term allocation of resources, this is an argument against flexibility in the light of Dutch disease effects. Within that context, the role of monetary policy emerges wherein the domestic interest rate is used to prevent inflationary pressures or, in the absence of such pressures, to facilitate credit to the private sector.

2. Fiscal policy and public investment

Fiscal policy in the ESCWA region needs to have four objectives, 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.

Before considering all these objectives, it is necessary to investigate the structural constraints on fiscal policy. Last year’s Survey suggested that the countries of the region relied heavily on indirect taxes, thereby handicapping fiscal policy given that it impeded the automatic stabilizer function of taxes.90

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87 The “impossible trinity” is cited as an argument for flexible exchange rates in the ESCWA region. The concept is concisely explained by P. Krugman, “O Canada: A neglected nation gets its Nobel”, which is available at: www.pkarchive.org/global/canada.html. For the ESCWA region, this impossibility can be summarized as follows: (a) a government can fix its exchange rate and retain the use of monetary policy, but only by maintaining control on capital flows; (b) it can leave capital movement free and the capacity to use monetary policy, but only by letting the exchange rate fluctuate; or (c) it can choose a fixed exchange rate system and free capital mobility, but only by allowing any ability to use monetary policy aimed at protecting the economy from internal or external shocks. Clearly, most ESCWA member countries have been adopting the last option. See ESCWA, Survey of Economic and Social Developments in the ESCWA Region, 2005-2006 (E/ESCWA/EAD/2006/2).

88 The assumption of perfectly elastic capital flows may not be valid for most economies.

89 Within that context, one such mechanism is an oil fund, such as has been adopted in Norway and countries of the GCC. See section B in chapter III. For more details, see J.M. Davis, R. Ossowski and A. Fedelino (eds.), Fiscal Policy Formulation and Implementation in Oil-Producing Countries (IMF, 21 August 2003), part II.

90 ESCWA, Survey of Economic and Social Developments in the ESCWA Region, 2005-2006 (E/ESCWA/EAD/2006/2).
While it is generally true that indirect taxes are less income-elastic than direct ones, this is not necessarily a serious constraint on fiscal policy in the ESCWA region given that when investment rises, thereby creating the necessary virtuous circle, the ratio of taxation changes to reflect the new structure. Specifically, for the ESCWA member countries covered, the share of direct taxes was an average of 19 per cent in 1990 and 16 per cent in 1999. However, these averages are distorted by the inclusion of Kuwait, whose revenue stemmed almost entirely from various levies on petroleum; and a modest 3 per cent and 4 per cent, respectively, from direct and indirect taxes combined. With the omission of Kuwait, the averages climb to 23.19 per cent, which equals or exceeds averages for all middle-income countries and all lower middle-income countries.

Furthermore, using this ESCWA average, the share of indirect taxation was lower in the region than for middle-income countries. While it is true that indirect taxes represent a greater share of public revenue than direct taxes, which is a common characteristic for all middle-income countries, the difference was smaller in the ESCWA countries.

Perhaps more importantly, the stabilizing function does not need to be undertaken on the revenue side, particularly in oil-exporting countries. By creating an oil fund, as discussed above in chapter III, Governments can set aside petroleum revenues when international prices are high and the economy is expanding, which they can subsequently use when prices fall in order to offset recessionary conditions.

Public investment needs to be the central aspect of an active fiscal policy, particularly for petroleum-exporting countries. As shown in chapter III, unless managed carefully and designed soundly, public expenditure can be the major cause of Dutch disease effects. The expenditure of the large revenues from oil must be managed in line with several basic guidelines, which are set forth below.

The absolute level of revenues must be consistent with robust growth and macroeconomic stability. Achieving the appropriate level of expenditure is an issue of aggregate demand management. An oil fund needs to be the main mechanism in order to achieve this management, thereby accumulating funds when revenue flows are high and releasing funds when inflows decrease (see section B in chapter III).

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

Much greater scope exists to use public investment in order 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 reduce cost for the tradable sectors. An obvious example is transport infrastructure that lowers the costs of exporters. Other examples are the improvement in telecommunications, including Internet services; and the creation of public or private sector institutions for research and development.

Ibid.
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The emphasis on public investment rather than on current expenditure could reduce the danger that a public budget enhanced by an oil revenue would “crowd out” private investment. There are two aspects of crowding out, namely, the aggregate expenditure aspect and the complementarity aspect. In the abstract, public investment tends to crowd out private investment when an economy is near full employment and when public investment projects are equally undertaken by the private sector. 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 or “crowd in” the latter.

If public and private investments are complementary, crowding out is unlikely to be complete. In other words, the elasticity of private investment with respect to Government expenditure of any type is less than minus one. Consequently, public investment could induce growth and raise productivity in its capacity effect.

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, where foreign investment in non-oil sectors is significant, it is typically not financed from domestic financial markets.

E. CONCLUDING REMARKS

The principal aspects of the development experience and the policy issues that ESCWA member countries currently face can be compressed into the following points:

(a) It is clear that the global petroleum market has changed significantly since the end of the Second World War. While Venezuela was the major exporter of oil, this picture changed in the late 1960s; and by 1970, Saudi Arabia became the largest oil producer and exporter in the world, which is a pole position it has since retained;

(b) Market shares have changed significantly worldwide for such OPEC member countries as Nigeria and such non-OPEC members as Canada, Mexico, Norway, the United Kingdom and, more recently, the Russian Federation, all of which became major players in the international oil market in the past decades. These changes imply that the power of OPEC countries has decreased to the extent that any single country controls the petroleum market, particularly given the increased significance of “paper oil” in the world market since the mid-1980s;

(c) Growth performance of the oil exporters in the region has been below optimal in the past four decades, particularly in the light of the considerable revenues from oil exports, compared to other middle-income countries worldwide, including those in Latin America and the Caribbean and in sub-Saharan Africa. This outcome can be largely attributed to the fact that the region has not gone through an aggressive strategy of economic industrialization and diversification in a regional context, particularly in the export sector. Consequently, it is clear that the volatility in the international petroleum market has been the main source of an unbalanced rate of growth so far;

(d) Taking into consideration the lack of effective monetary mechanisms available in the region and the existence of an underdeveloped financial system, policymakers in ESCWA member countries are best advised to make use of a coordinated exchange rate and fiscal policy that places the accent and priority on public investment in infrastructure rather than on current expenditures;
(e) Increasing expenditures on education and health complements rather than crowds out private investment, while at the same time avoiding the negative effects associated with the Dutch disease and resource curse. These twin dangers can be avoided within a reformed institutional framework if the appropriate actions are undertaken by increasing the participation of economic agents and citizens in general.

On the basis of these points and in addition to those cited in chapter IV, there are further measures that can provide a policy outline aimed at averting the negative effects of a resource boom. These are as follows: (a) a fixed or pegged exchange rate that is managed in order to make non-oil tradables competitive; and (b) an active fiscal policy that maintains the economy near its non-oil potential in the short terms and reduces supply constraints faced by the tradable sectors. Consequently, an effective use of foreign exchange flows requires a coordinated strategy by the Government in order to manage the economy and aimed at achieving the basic objectives of sustainable development, economic diversification and poverty reduction. A hedging strategy for the ESCWA region becomes critical when these inflows are the result of oil and natural gas exports, mainly owing to the instability of the international petroleum market. This implies that a regional cooperation framework is essential in order to develop the absorptive capacity.
VI. RESITUATING THE ISSUES AND POLICY REMARKS

This chapter surveys development from the start of the current oil boom from two main perspectives. First, it examines the role that natural resources can play in the long-term development process, particularly as a tool aimed at raising the growth potential of the region; and highlights the most important arguments in the literature concerning the challenges posed by a resource-led strategy for growth in developing countries. Subsequently, it underscores the shortcomings both from a theoretical and empirical point of view, and shows why policymakers are best advised to avoid taking policy decisions employing the standard macroeconomic framework. Moreover, it examines the existence of the resource curse phenomenon that is supposed to affect natural resource-rich countries (see box 2-A).

The second part of this chapter examines the short-term macroeconomic effects that a resource boom can have in an economy, including that of an oil exporter; and, subsequently, it focuses on the effects that the current oil boom is having in the ESCWA region. Particular attention is given in the final section to the significantly different effects experienced by the countries of the GCC and MDEs, and to the policy options available to these two subregions of ESCWA.

A. RESOURCE ABUNDANCE AND ECONOMIC GROWTH

Until the mid-1980s and particularly in the wake of the first oil shock, many economists and most policymakers agreed that natural resource abundance offered significant economic advantages for developing countries. In the ESCWA region, domestic production of primary products allowed many member countries to consume agricultural goods, and to use agricultural and mineral raw materials in manufacturing, regardless of their ability to gain foreign exchange from other activities and exports. In certain circumstances, these countries were in a position to manipulate the global supply of particular goods, which allowed them to maximize their revenues in foreign currency. The development of the primary sector supported urbanization, the growth of domestic markets and the provision of infrastructure; and permitted the capture of rents that increased domestic savings and investment. This positive appreciation of natural resource availability was substantiated by the conventional theory of international trade, which states that specialization in areas of comparative advantage offers the most efficient avenue to economic development. However, the question remains as to the negative effects that economists have associated with rentier economies.

International commodity prices, particularly oil, are highly unstable; and this volatility tends to generate pro-cyclical fiscal, employment, consumption and investment responses in resource-abundant developing countries, which in turn increase business risk and hamper economic diversification in these economies. The resource-abundant economies of the ESCWA region tend to develop “enclave” features whereby insufficient backward and forward linkages exist within the domestic economy such that the value of the intermediate inputs and the returns to the other factors of production represent a small proportion of the value of the final output. These features are detrimental to sustained, broad and equalizing development given that they are associated with low-employment multipliers that usually include a relatively small number of well-paid workers and larger numbers of poorly paid ones on unstable employment patterns, and significant imports of inputs and consumption goods. This economic structure contributes to income inequality and long-term stagnation. Moreover, there are many issues related to overvalued currencies, the increase in the prices of non-traded goods, the shift in resources away from traded goods, inflation, the severing of fundamental links between effort and income, consumption from production and the debasement of traditional values.

1. Weaknesses of the resource curse evidence

Specialization in the export of primary products in the ESCWA region is identified with natural resource abundance, which in turn is presumed to be determined by an exogenously given endowment of natural resources. It follows that a large part of the ensuing export revenues are tainted by association with
such words as “rents” and “windfalls”. In other words, these incomes are unearned and, consequently, undeserved and, perhaps, even perceived as aberrant. In that case, slow growth rates and institutional distortions can be seen (implicitly) as just rewards. However, this interpretation fails at several levels that are worthy of special emphasis, including as follows:92

(a) The precise meaning of “resource abundance” is normally left unexplained. It is especially significant that different measurements of resource abundance have led to distinct outcomes; in most cases, the resource curse has been confirmed, while in others no such confirmation has been forthcoming (see box 7). For example, measurements of abundance that focus on the ratio of natural resource exports to total exports or to total GDP have tended to confirm the resource curse hypothesis. By contrast, measurements in some studies related to total output of primary products, total reserves, reserves per capita or exports per worker have not supported such a hypothesis. In addition to this, while the adverse outcomes stem from the rents generated by primary product exports, rent-based measurements of resource abundance have not support the resource curse hypothesis.93 These issues have been further confused by claims that the curse is more commonly associated with specific types of natural resource abundance, especially such “point source” resources as oil, copper and coal, rather than with such “diffuse” resources as wheat, rice, cocoa and coffee. In the ESCWA region, issues related to the colonial past and geopolitical concerns tend to stand above other reasons in explaining the curse side of the argument;

(b) Related to the first point is the suggestion that the resource base, if it could be measured unambiguously, could exercise an overwhelming influence over the social, political and institutional variables that ultimately determine the economic outcomes. This approach is clearly misguided;

(c) Most analyses of the curse tend to be based on the conflation between resource abundance and comparative advantage. For a poor country, the concentration on primary product exports could stem from the existence of abundant and relatively cheap supplies of specific commodities or, alternatively, from the absence of other internationally competitive sectors in the economy. Simply stated, this constitutes the reality of underdevelopment;

(d) Most studies that support the notion of a resource curse contend that, independently of how it is measured, natural resource abundance is correlated with poor growth performance. However, there is insufficient proof to demonstrate the existence of any causal relationship between these variables. Even in such cases where a thin and often controversial correlation has been established, the proof is usually circumstantial in nature and causality could just as plausibly run the other way. For example, poverty, poor economic performance or the lack of viable alternatives can lead to the continuing reliance on primary product exports. In that case, specialization in primary product exports is simply a symptom of underdevelopment rather than its real cause as these studies would suggest. Finally, it is also possible that any existing correlation between resource abundance and poor economic performance could simply be a spurious result or stem from a third and as yet unidentified variable.

2. Beyond the resource curse

The shortcomings identified above suggest that the conventional viewpoint is unable to conceptualize the context-specific nature of the political and social institutions in each country; the innate flexibility of

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resource endowments in the real world; and the related albeit analytically distinct process of creating a competitive advantage in international trade. These issues are briefly examined below.

First, institutions in the ESCWA region need to be viewed within the historical context. Specifically, at particular historical junctures, social and political forces shaped the exploration and development of natural resources for specific goals, including, among others, self-enrichment, debt repayment, the development of infrastructure and poverty alleviation. Conversely, the availability of natural resources influences institutional and economic development in ways that cannot be fully anticipated. In order to draw textured and context-specific relationships between natural resource abundance and economic growth outcomes, and to understand the successes of certain resource-rich countries, it is essential to examine the process of formation, development and change of the social, political and economic institutions in each country. This is the complete opposite of limiting the analysis to bland cross-country regression analysis and historical generalizations.

Moreover, resource endowments are flexible. It is generally known that predictions concerning the imminent exhaustion of non-renewable resources are usually wide of the mark (see section A in chapter II). These erroneous outcomes stem from the extension of the natural resource frontier to previously unexplored regions and, equally, from the development of new resources within previously explored areas, with growth in the extraction of presumed “exhausted” resources in nearly every country. In general, the expansion of the resource base, including known reserves, has tended to exceed the growth of demand. This suggests that at the global level the “endowment” of supposedly exhaustible resources is significantly large and possibly unlimited, especially if the impact of technological changes is incorporated. This certainly does not suggest that unbridled consumption of natural resources is either justified or unproblematic, that the carrying capacity of the planet comports such a strategy, or that there are no absolute limits to any resources, especially for individual countries rather than the world as a whole. Instead, the argument is that the concept of “endowment” of natural resources is intrinsically flexible, rather than rigid as conventional literature would suggest. As a matter of fact, it depends largely on policy decisions related to exploration, infrastructure provision, mining development and technological change, as well as on global environmental constraints, which probably constitutes the greatest constraint.

Additionally, competitive advantage is created through industrial policy. Historical evidence shows that the long-term macroeconomic performance of resource-rich countries depends heavily on the economic policies that surround the exploration and export of natural resources. The availability of resources cannot be gauged without exploration and the deployment of technology, which is a dynamic process that requires expertise and financial and other resources, the development of infrastructure and the availability of transport facilities and markets. All these links in the supply chain depend heavily on State action. Once resources are known to exist, their exploration also depends heavily on economic policy that, in large measure, will determine the quantity of resources that can be extracted; their marketability; and the volume of rents that depend on the interaction between natural conditions and such policy-determined variables as the availability of infrastructure and the Government’s tax policies. Finally, the use of the ensuing revenues, especially the resource rents, equally depends heavily on the adopted policies by a host of State institutions at different levels.

Furthermore, countries that rely too heavily on the export of a single product fail to diversify their sources of supply, neglect the development of supporting infrastructure, and are unable to internalize the technologies and skills required for the expansion of their most important economic sectors. In such cases, sustainable avenues for accumulation and economic diversification are unlikely to be successful, regardless of the availability of natural resources.

94 Within that context, a notable exception is the extraction of oil in marginal ESCWA producers.
3. Is there such a thing as resource curse?

From the above arguments, it is clear that there is no such thing as a resource curse per se in the ESCWA region or elsewhere. There are, however, misguided policies of development in a very unstable regional context; and the instability stems from the vectors of political forces acting in the region. Several interlinked economic factors do exist, namely: (a) the concentration in the export of goods carries significant rents, which in turn can be allocated more freely than other segments of the national income; (b) there are misguided macroeconomic policies; and (c) as a result of the above, there is misallocation of resources, which are likely to lead to poor growth performance regardless of the availability of natural resources.

Alternatively, the abundance of natural resources can provide the basis for the deployment of policies and strategies that can support the expansion of the resource sector in addition to economic diversification, learning, technological development and rising levels of welfare in the economy. The outcome is more likely to occur under adequate social, political and institutional contexts in which economic policy is formulated and implemented. In sum, the macroeconomic performance of resource-rich economies is closely dependent on the policy environment in which resource development and extraction takes place.

B. THE DUTCH DISEASE

In the early and mid-1980s, a new strand of criticism appeared from within the conventional economics that claimed that economies having experienced a resource boom were highly susceptible to the type effects referred to as Dutch disease (see box 2-B). This literature was subsequently reinforced by extensive research claiming that natural resource abundance could lead to a wide range of adverse developmental outcomes, including poor growth performance, authoritarianism, corruption and greater vulnerability to civil war. These claims have become widely accepted by mainstream economists, international financial organizations and several non-governmental organizations (NGOs).

1. Containing the Dutch disease: policy options

The Dutch disease can be difficult to neutralize and costly to correct. Moreover, if an economy borrows in order to sustain its customary levels of consumption during a downturn or, even worse, if it borrows in anticipation of export revenues that fail to materialize, when an economic downturn does arrive it can become difficult to avoid a severe recession and a painful adjustment to the new (relatively depressed) state. Another problem can compound this already bleak situation, namely, that natural resource prices and, sometimes, the quantities exported tend to be volatile. If the economy is heavily geared towards the production of a single or narrow range of goods, as in the case of some countries of the GCC, the interaction between the overvaluation of RER in the boom periods, the volatility of resource prices, and the scant linkages between the export sector and the rest of the economy can lead to high uncertainty, chronically low rates of domestic investment, inadequate skill levels and significant difficulties in terms of diversifying away from the dominant sector through market processes.

The long-term growth consequences of the Dutch disease can be severe; it has been argued that it can create “rich countries or regions with poor people”. By contrast, a diversified economic base that includes a manufacturing and service production for domestic consumption and for export generally involves a more refined division of labour and higher levels of employment. Moreover, it can lead to increasing returns and stronger externalities, which can more easily support a rights-based and pro-poor development strategy.

CHAPTER VI. RESITUATING THE ISSUES AND POLICY REMARKS

The processes leading to Dutch disease and its modalities depend on the exchange rate regime (as described in section D, chapter V). Under a fixed exchange rate regime, the conversion of the additional inflow of foreign currency into domestic currency normally expands the central bank’s currency reserves and, simultaneously, the domestic money supply. This increase in high-powered money is magnified by the money multiplier, thereby leading to a total increase in money supply that is greater than the domestic currency equivalent of the windfall. The outcome represents an increase in domestic demand for non-tradables and, correspondingly, an inflation bubble, as well as exerting pressure on the trade balance given the growing demand for imports. This in turn forces the central bank to sell part of its additional foreign exchange holdings in order to defend the parity. The shift in relative prices owing to the rise in the price of non-tradable goods relative to the price of tradables leads to the appreciation of RER described above, some loss of economic diversity and a loss of competitiveness of the country’s non-booming exports.

By contrast, under a floating exchange rate regime, the central bank does not intervene in the foreign exchange market, and the supply of domestic money does not change. Instead, the conversion of the windfall into domestic currency leads to its nominal appreciation. In other words, in this type of exchange rate regime, the real appreciation of the local currency happens through its nominal appreciation, rather than from the increase in the price of non-tradables. At a later stage, the nominal appreciation of the currency increases the demand for imports given that tradable goods have become cheaper in terms of domestic currency. This in turn leads to the same income, resource movement and expenditure switching effects examined above (see box 7). If the monetary authorities fail to accommodate the extra spending induced by the resource boom, then the currency appreciation can generate a severe pressure on domestic prices and wages. This can lead to a profit squeeze, unemployment and, at least potentially, to a recession.

2. Beyond the Dutch disease

Moving beyond the Dutch disease requires policymakers in the ESCWA region to be particularly aware of two issues, namely:

(a) Economic growth in developing countries is normally associated with a more than proportionate increase in the demand for money. As the economy expands, more areas of activity are brought into the market; financial depth grows; and the monetary and financial needs of households and businesses expand, sometimes rapidly. The need for currency, demand deposits, savings and other financial assets grow. Given that the income elasticity of demand for money is likely to exceed unity, the economy needs to be able to absorb to a certain extent a rising money supply without undue inflationary pressures or Dutch disease type effects;

(b) The conventional Dutch disease model ignores the supply-side effect of the windfall. The economy is assumed to be perfectly competitive that includes complete labour market flexibility and operating at full employment accompanied by external balance. In that case, the additional demand induced by the windfall generates both domestic inflation and balance of payments pressures, thereby leading to structural economic shifts (as described in section B, chapter V). Moreover, the model assumes that productive capacity and output respond only slowly to the increase in demand. Given that it takes time for


See M. al-Moneef, op. cit., p. 15.
output to grow in the three economic sectors under consideration, namely, booming tradables, non-booming tradables and non-tradables, the adverse effects of the shock are likely to be persistent.

In addition, the standard frame ignores the vast number of unemployed, underemployed and informal sector workers in some ESCWA member countries. While these workers are often willing to work at the current wage, which is generally too low to lift them out of poverty, they are frequently unable to find jobs given the persistent mismatch between the demand and supply in labour markets, which in turn owes to the lack of human capital development and a lack of educational orientation linked with market requirements. Structural unemployment often coincides with spare capacity in several branches of industry and in the services sector, thereby indicating that output in poor countries is normally well within the production possibilities frontier. This represents a social malady and a serious economic problem; moreover, it corroborates the assertion that the tools and models of mainstream economics cannot adequately capture essential aspects of the reality of developing countries. Finally, the model tends to ignore the potential positive impact that greater provision of education, health and infrastructure can have on aggregate medium- and long-term supply.

Even in those countries where the labour market is apparently tight, the supply of workers remains flexible given that it is always possible to import additional workers and, often, to deport large numbers of workers when the prospects are less optimistic. This has been the case of countries of the GCC for long periods. While these human flows are sufficiently vigorous to increase the flexibility of the labour market in labour-scarce ESCWA member countries, they are too small to dent unemployment in the labour-exporting countries of the region. This owes partly to the large proportion of labour flows that originate from outside the ESCWA region, and partly to the substantial size of the unemployed and underemployed populations in the region.

For all the above-mentioned reasons, it is unreasonable to expect that the labour market will clear in ESCWA member countries, both exporters and importers of labour, either spontaneously or through downward adjustments in real wages. Specifically, the continuing operation of the free market is likely to reproduce the problem of structural unemployment in larger MDEs, while allowing the rich strata of the population in oil-rich and labour-importing countries to thrive on the basis of a highly segmented and exploitative labour market. By the same token, it is wrong to attribute the problem of unemployment in the labour-surplus countries to excessively high real wages. It is more likely that persistent unemployment and underemployment stem from the lack of demand and low levels of investment and growth over long periods.

Productive capacity normally expands slowly, thereby leaving bottlenecks that can trigger realignments of relative prices or even bouts of inflation. A resource boom can enable exporting countries to address these localized problems through additional imports until the expansion of productive capacity takes hold. Moreover, windfalls can help developing countries to address simultaneously three constraints that limit their economic growth prospects, namely: the availability of foreign exchange, the availability of domestic savings and the sustainability of the Government budget.


101 The labour market in Dubai in the United Arab Emirates represents perhaps the most extreme case in the region. For a critical review, see M. Davis, “Fear and money in Dubai”, New Left Review, No. 41 (September-October 2006).

102 That point was raised in last year’s Survey: see ESCWA, Survey of Economic and Social Developments in the ESCWA Region, 2005-2006 (E/ESCWA/EAD/2006/2).

103 Within that context, the expansion of productive capacity can also be financed by the windfall.
C. BALANCE OF PAYMENTS AND RESOURCE ALLOCATION

In the context of the current oil boom in the ESCWA region, particularly in the countries of the GCC, the increase in unearned revenues is peculiar given that it stems almost entirely from higher rent inflows, with the exception of a small number of oilfields that are largely limited to marginal producing areas and that become viable only with relatively high international prices. Under the current circumstances in ESCWA, the oil boom takes the closest possible appearance to a shower of (additional) unearned resources on oil-exporting countries.

Despite a superficial similarity with the well-known monetarist scenario referred to as “helicopter money”, there are two significant differences between the two situations, namely: (a) oil-exporting countries are being showered with international money, rather than domestic currency, which raises specific issues that are explained below; and (b) the additional resources are not distributed equally or randomly across society; rather, they are internalized and distributed through specific channels that are highly sensitive to influence by the Government and, recently, the private sector, which has been more involved than during the oil boom of the 1970s.

Within that context, the resource boom appears initially through the improvement of the country’s balance of payments. This improvement enables the economy 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, extra spending in domestic currency becomes possible given that 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 also tends to trigger the real appreciation of the currency. This appreciation can become a source of difficulty for the domestic economy if it hinders export diversification or erodes the competitiveness or even extinguishes traditional areas of activity, including the agricultural sector. 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, including, for example, future declines in the price of oil. This reasoning implies, paradoxically, that resource booms can be harmful in the long term owing to their cumulative adverse impact on the non-booming sectors of the economy, which are equally referred to as the lagging sectors.

Moreover, this impact relates to the real appreciation of the currency on two sectors (see box 5). These are as follows: (a) the non-tradable sector, including, among others, 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 increasing foreign competition in the context of a rising real exchange rate.

This process of adjustment is called the Dutch disease. While the non-booming tradable sector tends to be associated with manufacturing (or agriculture), natural resource booms have often been associated with deindustrialization. While the Dutch disease can trigger another vicious circle on top of the process of deindustrialization, it can also be deagriculturalizing: that is, an increasing dependence of the economy on the booming sector causes the gradual contraction of the non-booming tradable sector. This makes it even harder to counteract the effects of the Dutch disease, particularly in the tradable sector, and to limit the drift towards economic specialization and, consequently, volatility. Analytically, however, despite the long-term consequences, it is important to bear in mind that the Dutch disease is a short-term problem, which may or may not be related to long-term problems associated with the natural resource curse (see box 2).

104 Additionally, this volatility harms the economy and contributes to the reduction in investment rates.
Given that the assumptions underpinning the resource curse hypothesis were found to be wanting, policy conclusions associated with this hypothesis are therefore necessarily qualified. An alternative set of industrial, policy-based strategies is perceived to be more relevant to the ESCWA region; and the State is best placed to support industrialization in employment-intensive industries.

Indeed, in the case of ESCWA member countries, counterproductive macroeconomic policies and the resource curse are not the only explanations for the disappointing macroeconomic performance of the past 25 years until the current boom, and for their continuing economic vulnerability. Specifically, turbulences in many countries have also been triggered by 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. Within the context of strong geopolitical conflicts in the region, the extraordinary prosperity of oil-exporting economies in the 1970s and 1980s also generated widespread social tensions. In MDEs, economic modernization has generated standard tensions associated with processes of rapid growth. However, they are complicated by the fact that these economies are heavily conditioned by circumstances in their oil-rich neighbours and by the intrinsic geopolitical instability of the Middle East. The presence of huge oil reserves and these tensions and displacements explain why this region has some of the highest levels of internal and external conflicts in the world, some of the highest economic risks and significantly high income inequality, especially in oil-rich countries.

The macroeconomic impact of a resource boom is likely to depend on circumstances of time and place, and on the economic policies adopted by the Government. It is impossible to say ex ante whether a boom is likely to lead to the Dutch disease, inflation or to sustained economic growth. The outcomes are likely to depend heavily on the policy mix implemented by the Government, the choice of priorities and the Government’s capacity in terms of implementing consistent policies. It is now widely accepted, even by the IMF, that windfalls do not necessarily have an adverse impact on the exchange rate, that they can be associated with export growth and the expansion of capacity, rather than deindustrialization and the Dutch disease; and that they can support improvements in welfare provision, rather than promote corruption and sloth.105

The focus of analysis must shift away from the attempt to bridge the gap between the two extremes represented by measurements of the resource base and macroeconomic outcomes. Rather, it needs to concentrate on the socially, politically and historically specific mediations between these two issues. In part, this is because the standard literature has shown a remarkable lack of interest in terms of the context in which resource abundance arises and influences economic growth, and most policy recommendations ensuing from this literature therefore ring hollow. At one extreme, these implicitly suggest that some countries are best advised to ignore potential sources of wealth, especially point-source natural resources. This is clearly absurd given that natural resources, as any other economic resource, can offer tools aimed at tackling the difficult problems of poverty and deprivation in poor countries. At the other end of the spectrum, conventional literature suggests that there is relatively little that can be done to ameliorate the grip of the resource curse, which is undifferentiated and affects all resource-rich countries equally. This is simply untrue given that such reasoning completely ignores the intrinsic differences between primary products, for example, bananas, coffee, oil and copper; and downplays the extraordinary economic success of such resource-rich countries as Australia, Botswana, Canada, Chile, Indonesia, Malaysia, Norway and the United States of America, in addition to the economic achievements of several oil-rich countries in the ESCWA region.

As a minimum, the availability of natural resources depends as much on good fortune as it does on large-scale investment in technological development, exploration, extraction, transportation, refining and marketing. In that sense, natural resource abundance is the outcome of industrial policy and, at least

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CHAPTER VI. RESITUATING THE ISSUES AND POLICY REMARKS

potentially, the source of funds for continuing economic growth and improvements in social and welfare standards. On the face of it, economic failures in several resource-rich countries, including ESCWA member countries, do not stem from the resource curse or the Dutch disease. This is a much broader phenomenon. Specifically, neither the oil-rich 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 boosted their sustained and autonomous increasing returns, industrialization and economic development.

Additionally, the lack of social cohesion and the concentration on income and wealth and weak institutions tend to favour a predatory accumulation strategy, which has been labelled the “voracity effect” (see box 8). Under this scenario, export gains are mostly retained by a small section of the population and, subsequently, are transferred abroad as capital flight either directly or through the State. In that case, overly optimistic expectations of resource revenues can be used to alleviate pent-up social tensions and frustrations, while a large part of the net resource inflows (plus external loans secured on future export income) can be wasted by financing distorted or socially undesirable policies and projects. These outcomes are more likely in unequal and conflictive societies, as 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; deliberate decrease of the power of elites; and the design of consistent, socially legitimate and ambitious industrial policies that create employment opportunities.

Finally, the policy recommendations suggested by the mainstream literature, when such are available, tend to be excessively general and are often irrelevant or unfeasible.

Several economic policies can be considered in order to avoid the Dutch disease and address the macroeconomic problems associated with it, namely:

(a) **Sterilization**: This breaks the link between the balance of payments and the domestic supply of money through changes in the non-monetary liabilities of the central bank. Moreover, sterilization allows the Government to neutralize the impact of swings in resource prices for extended periods, albeit with limits and incurring costs. Sterilization requires a minimum degree of financial market development in order to be fully effective, and it is optimal only when there is a wide choice of securities available. On the other hand, sterilization requires frequent adjustments of domestic interest rates, which can have adverse macroeconomic implications. However, as long as sterilization is reasonably well managed, its adverse implications are likely to be minor compared to the destabilizing potential of resource booms and busts;

(b) **Balance of payments management**: If part of the windfall is not internalized by the Government or diverted to State-owned enterprises (SOEs), it will not put pressure on the exchange rate, the domestic money supply or the non-monetary liabilities of the Government. This can be done in different ways, including, for example, (i) the straightforward build-up of the country’s international reserves; (ii) financial investment abroad, for example through an oil fund (see section B in chapter V); (iii) anticipated debt repayment; and (iv) imports of non-competing goods and services. In the last case, the internalization of the windfall does not affect relative prices, dislocate domestic producers or change economic incentives; and it either satisfies current necessities or removes bottlenecks to the expansion of capacity. This can be complemented with capital control over capital inflows, which can play an important role in stabilizing the

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106 This demand must not be exaggerated given that sterilization is used extensively even by very poor countries. See A. Chowdhury and T. McKinley, op.cit., p. 13.
balance of payments (see box 6). In all these cases, the windfall does not necessarily bring any adverse macroeconomic consequences; and this strategy is especially important for short-term resource booms.

D. CLOSING COMMENTS

The Arab region experienced a poor and protracted economic performance between the oil booms. The principal economic reasons behind the slowdown can be identified as follows:

(a) Lower investments or a lower investment to GDP ratio: specifically, the retreat in public investment since the late 1980s was not offset by an equivalent or more-than-equivalent increase in private investment;

(b) Poor trade integration in the regional and global economy, with persistent problems of market access and insignificant expansions in agriculture and industry;

(c) Continuing volatility, with fluctuating oil prices in oil-exporting countries and, more recently, a growing risk of currency devaluation as a result of capital-flow variations in non oil-exporting countries that are overly exposed;

(d) Relatively minor contributions of technology and other knowledge-based factors to the generation of growth;

(e) Crises and political instability that afflict the region, thereby distorting priorities, increasing risks, lowering investment, misallocating resources, and destroying assets and opportunities.

Poor growth does little to alleviate poverty. With the onset of the poor growth period, progress in many social areas, including education, gender equality and developments in civil society, have either stagnated or declined. Consequently, degeneration in the social domain contributes to poor growth in a vicious circle. The ESCWA region currently has a chance to break that spiral. Principally, this requires an increase in the rate of economic growth that generates employment wherein rising labour demand brings more men and women into an industrious and participatory life. With regard to the more immediate policy recommendations, the following points can be seen as a preliminary outline for jump-starting the economy:

(a) Increasing public and private investments. While mainstream theory tends to hold these two forms of investment at odds, there is evidence that the economy is operating below full capacity and that public and private investments can be complementary. Measures need to be taken in order to bolster private investments by reducing risk through public safeguards, and by raising returns through market expansion or regional macroeconomic management and integration, thereby attenuating the dire consequences of the neighbourhood effect;

(b) Promoting a gradual and selective approach aimed at trade integration that is preceded by concrete measures in order to accede into the global economy as a regional block;

107 For a comprehensive survey of the literature, see G. Epstein, I. Grabel and K.S. Jomo, “Capital management techniques in developing countries: An assessment of experiences from the 1990’s and lessons for the future” (April 2003), which is available at: www.g24.org/epstetgm.pdf.

(c) Bringing volatility under control by deepening the de facto functions of the Arab macroeconomic and monetary cooperation frameworks. Recently, the potential woes, particularly in terms of financial risks and currency collapse, resulted in concrete progress towards monetary cooperation. Steady investments and growth require strong monetary stabilization and macroeconomic coordination;

(d) Emphasizing investment in research and development and human capital. The criterion for efficient public investments rests on the degree of economic progress that is made as a result of increasing returns from knowledge-based factors in the economy.

The region needs a type of “Marshal Plan” that emphasizes increasing returns from industrialization. If owing to risks, national private resources cannot be garnered for that purpose, then official sources need to fill the gap.

1. Requisites for poverty alleviation

Economic growth that generates employment is essential for poverty alleviation. Specifically, under constant or improved distributional conditions, the annual average growth rate over the next ten years must be in the range of 6-7 per cent in order to lift half the number of poor people from poverty in the ESCWA region.

2. Investment and trade policies prior to the boom

The retreat in investments in the 1990s could be partly explained by lower oil revenues. However, the emphasis on promoting private investment and trade openness, which were undertaken at different speeds and to varying degrees across the region under structural adjustment programmes, resulted in poor investment and trade performances. As cited above, the investment to GDP ratio fell and such basic sectors as agriculture or industry either declined or stagnated.

3. Causes of decline in investment, and in plant, equipment and export performances

These policies were implemented piecemeal without due regard to the particularities of the region, especially its small fragmented markets and political instability. Indeed, market access problems persisted in areas where the region displayed a comparative advantage, including, for example, textiles and agriculture. More importantly, the risks on the investment side were considerable given the underlying small domestic market size, poor regional integration and, ultimately, a precarious political cycle. Consequently, while it was supposed that policies aimed at promoting returns to the private sector could lift private investments, an absence of the type of insurance that offsets the risks to long-term physical investment continued to limit investor confidence.

4. Consequences of another cycle of poor growth if the oil price plummets

Clearly, poor growth with a distributional bias towards the rich does little to alleviate poverty. It has been recently estimated that some 20-30 per cent of the population in the Arab region lives at below 2 United States dollars a day. Moreover, since the mid-1980s, there has been a general deterioration or stagnation in the areas of education, gender equality and political openness. This regression in social areas stems initially from poor economic performance, which in turn contributes to poor growth in a cyclical manner.
5. Policy formulation and objectives for the new boom

In the current boom, sound policies and objectives can be categorized under three headings, namely: (a) investment; (b) the external sector; and (c) volatility and knowledge-based economies. These are set forth below.

(a) **Investment**

There is an urgent need to break the cycle of low oil prices, poor growth, and poor social conditions, thereby leading to poor growth. This cycle began in the late 1980s, with a poor investment performance in the wake of falling oil prices. The private investment promotion arrangements of the 1980s and 1990s were insufficiently adequate in terms of raising growth given that, while they provided institutional frameworks and guarantees on repatriation to varying degrees, they did not deal with risk issues and market size.

Moreover, these policies were built on the implicit understanding that the private and the public sectors compete for the same resources. However, 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 that promotes industries with increasing returns is required, thereby allowing public and private investments to rise simultaneously and setting the economy on a new growth path. 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 sizes and economic integration represent an impetus for investments in plant and equipment, and ensuing returns. In the area of political risk, upon which long-term private investments depend, that remains an issue related to the shape of the regional security arrangement; and the capacity, implicit or explicit, of the public sector to provide some kind of insurance scheme for local or foreign investors.

(b) **The external sector**

Sharpening competitiveness and diversifying exports represent marked elements in this category. Currently, there exists a short albeit dense experience with regard to the economic outcome of trade openness, of which selectivity and gradualism come to the fore as balanced policy guidelines. Moreover, monitoring short-term capital flows has become vital in the light of increasing public or private sector debt and capital market liberalization, and in order to manage the risk exposure of the financial sector that could result in a dire bust situation.

(c) **Volatility and knowledge-based economies**

The objective is to minimize the negative impact of short-term fluctuations that stem from abrupt capital flows and oil price shocks; and to maximize the long-term contribution of technology and other knowledge-based factors to growth. On its own merit, this latter outcome represents a relative buffer against erratic capital or oil price movement. However, in the initial stages, this requires constant investments in research and development, human capital and the institutional framework, which would be independent of movements in capital flows and oil price fluctuations. These investment flows could create the type of public-private partnership that increases private sector competitiveness and public sector efficiency, albeit in the long run.

Moreover, it has been shown empirically that this type of investment tends to exhibit much higher returns than pure physical investments. However, such a scenario also requires a higher level of regional integration and/or an investment or growth stabilizing fund; in other and more obvious terms, 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 on the ground. However, in an odd twist of fate, measures towards cooperation were undertaken as a result of increasing capital mobility and joint political risk. Indeed, rather than aiming to reap the benefits of integration, these measures have sought to prevent the common political woes of currency collapse, contagion and economic failure. Recent trends indicate that currency stabilization measures in the region were carried out at various bilateral levels in a de facto monetary cooperation framework. Naturally, this needs to be taken one step further in order to expand and formally institute an Arab monetary cooperation framework.
### Annex

#### ANNEX TABLE 1. IMPACT OF OIL PRICE INCREASES

(United States dollars)

<table>
<thead>
<tr>
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<th>Oil prices</th>
<th>Direct impact on net trade balance of advanced countries</th>
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<td>2003-2004</td>
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^a Average price in the first year of each episode.

^b Average price in the last year of each episode, except 1990 (average for the second half of the year).

#### ANNEX TABLE 2. INTERNATIONAL RESERVES OF ESCWA COUNTRIES, 2000-2005

(Months of imports)

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#### ANNEX TABLE 3. FISCAL BALANCES IN ESCWA REGION

(Percentage of GDP)

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^a For Lebanon and Qatar, the first two columns are the averages for 1995-1999 and 2000-2002, respectively.
**Annex Table 4. Growth Rate of Broad Money Supply**  
*(Percentage)*

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*Source: ESCWA.*

**Annex Table 5. Real Growth Rate of Broad Money Supply**

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<td>5.4</td>
<td>9.1</td>
<td>8.2</td>
<td>12.8</td>
</tr>
<tr>
<td>Lebanon</td>
<td>3.1</td>
<td>4.6</td>
<td>11.8</td>
<td>13.0</td>
<td>-2.6</td>
</tr>
<tr>
<td>Syrian Arab Republic</td>
<td>18.2</td>
<td>13.8</td>
<td>6.6</td>
<td>17.5</td>
<td>..</td>
</tr>
<tr>
<td>Yemen</td>
<td>6.4</td>
<td>7.2</td>
<td>7.5</td>
<td>3.2</td>
<td>-1.1</td>
</tr>
</tbody>
</table>

*Source: ESCWA.*

**Annex Table 6. Oil Stabilization and Savings Funds in the ESCWA Region, 2004**

<table>
<thead>
<tr>
<th>Country</th>
<th>Year</th>
<th>Source</th>
<th>Expenditure</th>
<th>Assets (% GDP)</th>
<th>DPD (% GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kuwait</td>
<td>1976</td>
<td>Percentage of oil revenues</td>
<td>n.a.</td>
<td>208</td>
<td>234</td>
</tr>
<tr>
<td>Oman</td>
<td>1980</td>
<td>Oil revenues in excess of budget forecast</td>
<td>When revenues are below budget level</td>
<td>21</td>
<td>23</td>
</tr>
<tr>
<td>Qatar</td>
<td>2000</td>
<td>Oil revenues in excess of budget forecast</td>
<td>None, but may lend to government if oil price is below budget forecast</td>
<td>3.6</td>
<td>114</td>
</tr>
</tbody>
</table>