The Political Economy of Economic Reform in the Middle East: The Challenge to Governance

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Executive Summary

Governments of the Middle East confront grave economic challenges. These include: restoring economic growth, restraining population expansion, providing jobs, coping with urbanization, saving water, obtaining food, halting environmental destruction, and attracting money for investment. The challenges which these problems pose for governance in the region are briefly considered, and the prospects for successful adjustment are assessed. The reform experience of Egypt, Jordan, Iran, Saudi Arabia, and Syria are briefly reviewed, and the political implications are summarized.

The region has performed poorly during the past 15 years, largely thanks to excessively statist, inward-oriented economic policies. The standard remedy for these problems, the "Washington Consensus", sensibly argues that the only hope is to shift economic policies so that a more flexible, responsive, outwardly-oriented and private sector- led economy can provide the growth, jobs, and exports needed to cope with the main challenges. But the chances of this strategy either being adapted or working are not particularly good. The paper divides the countries of the region into three groups: the "NICs" (newly industrialized countries), the very poor “Fourth World” states, and the states of the GCC. It argues that "Washington Consensus" policies are unlikely to work in the last two sets of countries, and face significant obstacles in the first group.

Governments of the region have often (but not always) improved their economic management and enhanced the efficiency of their trade sectors. Critically, *none has stimulated a rate of growth which is rapid enough to create the huge numbers of jobs necessary to keep up with additions to the labor force*. Privatization has proceeded very slowly; to the extent that it has occurred, it has often substituted a kind of “crony capitalism”, Russian-style, for state ownership. Such change does little to enhance regime legitimacy. Strongly entrenched vested interests, weak leadership, and the presence of substantial economic and political rents are the most plausible explanations for this pattern of change. Finally, the country which has gone the farthest to embrace the Washington Consensus, Jordan, is often entirely at the mercy of negative external shocks, particularly those caused by regional political developments.

Despite this somewhat gloomy assessment, it is further argued that no simple formula relates economic problems to regimes' ability to govern. Although defective governance is both cause and consequence of the major economic challenges facing the region, regimes' ability to remain in power despite these problems has been surprisingly strong. But pressures are clearly building.

I. Introduction: The Political Economy of Stagnation

A man once fell from a 15th story window. As he passed the 10th story, he was heard to say, "So far, so good!"

1. "Global Losers"?

Many students of the world economy portray Middle Eastern[1] countries as "global losers", lagging seriously behind other major world regions (e.g., Friedman, 1999; Hufbauer, 1999). Looking ahead, the economic challenges facing the region are certainly severe, while the policy response appears limited. A comparison of the region's performance either with that elsewhere in the world, or with the severity of the challenges facing the region leaves little room for optimism. Economic stagnation undermines regime legitimacy and even, in some cases, the capacity to govern. The problem is particularly serious because stagnant economies cannot provide adequate jobs for the rising tide of young job seekers. The mixture of regime incapacity, rising unemployment and poverty, and very young populations is politically highly volatile.

At the same time, important changes in economic and social policy have been made in the last 5 to 10 years. Such changes, particularly when combined with a possible "silver lining" in demographic developments, offer a more hopeful perspective. Further, from the perspective of local ruling elites, these problems may be "disastrous, but not serious". Many of the economic problems facing Arab countries and Iran have been serious for at least a decade. In no case has the problem, however severe, posed a fundamental threat to the stability of the regime (with the arguable exception of Algeria). Although the lives of many young people in the region are significantly impoverished by their inability to obtain a job which meets their expectations, the political consequences have, so far, been contained by the "muddling through" approach of most governments to economic policy change.

The durability of this seeming stability is dubious. In particular, the mounting pressures outlined below may well have a cumulative effect. Economic policies have changed--but the changes which have occurred have not raised living standards significantly. One may be also be highly skeptical concerning the sustainability of such limited growth as has occurred. Evidence from sources such as the World Bank strongly suggests that problems of environmental degradation in the region are sufficiently severe that recent increases in "per capita income"--desultory as they are--may be entirely illusory. When ecological constraints (especially, those of water supplies) are included, the challenges facing the region during the medium term appear more daunting still.

Just because regional elites have maintained their power so far does not mean that they will be able to continue to do so in the medium-run. The easy (typically, budgetary and macroeconomic) changes have typically already been implemented, yet key problems such as unemployment and stagnant living standards persist. Many (e.g., the World Bank) advocate deeper changes in response. These may (or may not) produce the desired results; however, such changes do pose a greater

[1] In this paper, "Middle Eastern" means Iran and the Arab countries; the focus among Arab countries will be on Egypt and the Asian Arab countries, although some reference will also be made to North African countries.

challenge to existing habits of governance: greater reliance on the rule of law typically threatens the levers of state power; reduced reliance on public sector employment usually implies greater negotiation with significant private agents, etc. It is unsurprising that such changes are more strongly resisted, and it is far from clear that they can be implemented without profound political change.

2. The Checkered Course of the "Washington Consensus"

During the past twenty years, there has been something like a consensus on what economic policies ought to be adopted to improve economic management, and thereby to restore growth of incomes and job creation. This view holds that only a private-sector led, export oriented economic development strategy has a chance of coping with the development challenges facing the region. This consensus is best articulated by the World Bank and IMF,[2] but it has many other adherents, particularly in the United States government and in American academia and think-tanks. Key elements of this "Washington Consensus" include government budgetary balance, low inflation, market determined prices, and reduced reliance on direct, quantitative government regulation.

No one has formulated a more persuasive policy mix than that of the Washington Consensus for the Middle Eastern context. However, two important caveats deserve stress. First, there are reasons to fear that, although the Washington Consensus may be the best available strategy, it, too, may fail. This is especially so for two groups of countries, the very poor nations and the relatively rich states of the GCC. The best strategy may just not be good enough, given the magnitude of the challenges and some specific features of regional political economies. Second, the strategy also faces formidable obstacles in other countries of the region where the strategy might more plausibly work.

It may be argued, of course, that economic failure will not automatically translate into political disaster. There is no consensus on how deeply these economic challenges threaten existing regimes. Although mounting economic difficulties pose grave challenges to governance for all regimes, there is much uncertainty about how well various regional governments can manage these challenges. At one extreme, it is conceivable that these challenges may undermine not only governance, but governability--in some countries (particularly the poorest ones) the challenges may overwhelm any governmental structure, leading to the collapse of order, as in Afghanistan or Somalia. On the other hand, even very deep economic problems may not bring down regimes which can continue to funnel enough patronage to key supporters and to repress dissidents. There is no simple correlation between economic stagnation and governability.

Regional governments and elites have so far shown a marked preference for a gradual, even dilatory pace of reform. The reasons for this vary from case to case, but are typically a

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[2] e.g., World Bank, *Claiming the Future: Choosing Prosperity in the Middle East and North Africa* (1995), and IMF, B*uilding on Progress: Reform and Growth in the Middle East and North Africa* (1996).

combination of two factors: 1) regimes fear--with some reason--that the social dislocations which full-scale economic reform would entail run a high risk of being politically destabilizing. 2) Powerful vested interests either block reforms or ensure that the specific kind of reform yields disproportionate benefits to them, at the expense of other social groups. The result has been a very mixed picture, in which regimes have embraced some, often many, economic reforms(especially in macroeconomic policy) yet have postponed or evaded more complex reforms, such as privatization, reform of regulatory rules, and development of the rule of law. Whether as a result of the inherent difficulties facing any economic policy, or thanks to the uneveness of reform, the results have been relatively disappointing. Although in some countries economic performance in the mid-to-late 1990s was considerably better than that of the previous ten years, *in no country has growth as yet been fast enough to lower unemployment and to raise real wages and living standards*.

From an American political perspective, the performance of the past decade may offer the worst of both worlds. On the one hand, regimes are widely perceived as kowtowing to Washington and "embracing Western dictates". This makes them vulnerable to Islamist criticism, which, of course, transcends economic policy matters. On the other hand, the fact that the reforms have failed, so far, to deliver reduced unemployment and rising living standards makes World Bank appeals to "press on" with reform increasingly less persuasive to many people in the region.

The rest of this paper has three parts. In the first, the basic economic challenges facing the region are reviewed. I suggest that these problems/challenges pose challenges for governance and political stability in two ways: directly, since some challenges lead citizens to challenge governments (e.g., the youth unemployment problem) and indirectly via states' responses to the economic challenges (e.g., budgetary austerity). Second, the paper briefly reviews the reform performance of selected key countries: Egypt, Jordan, Saudi Arabia, Iran, and Syria. Third, the paper summarizes the implications of the interaction of economic challenges and policy responses for governability and political stability.

II. The Key Economic Challenges Facing the Region

The key challenges facing Middle Eastern economies in the medium term include:

- Restoring economic growth
- Restraining population expansion
- Providing jobs
- Alleviating poverty
- Coping with urbanization
- Saving water and halting environmental destruction
- Obtaining food
- Attracting money for investment

Let us consider these in turn.

Restoring Economic Growth

The recent experience with economic growth has been dismal. During the past twenty years, OECD countries have seen their per capita incomes rise at some 1.4% per year. East Asia (excluding Japan) has, of course, grown much faster, at 5.8% per year, a rate which doubled per capita incomes in 12 and 1/2 years. Even Latin America, with its notorious "lost decade" of the debt-ridden 1980s, saw per capita incomes rise at just under 1% per year during the past two decades. By contrast, per capita incomes in the Arab states today are little different from what they were in 1980; some analysts would argue that per capita growth has actually been negative (Hufbauer, 1999; World Bank, 2000), which is clearly the case for some countries, notably the Kingdom of Saudi Arabia. Real wages and labor productivity today are about the same as in 1970. This performance the worst of any other major reason of the world except for the countries of the former Soviet Union. Even sub-Saharan Africa has done better.

Both geography and history have conspired to undermine growth. The region has been cursed by a geographical inheritance of little water, much oil, and highly strategic location. Despite the enormous sums of foreign exchange which oil revenues have supplied, oil has been a very mixed blessing. Most analysts concur that oil revenues weakened the competitiveness of non-oil traded goods and reduced pressures toward more accountable governance. Oil rents[3] encouraaged governments to deepen and extend already existing state-centered, inward-looking, import-substituting policies.Oil also contributed to a continuation of baleful 19th century legacies of strategic location, which, arguably, distracted elites from the task of economic development by forcing them to concentrate on national defense questions, and to continue traditions of dictatorial, arbitrary governance.

Oil price booms laid a weak foundation, and oil price collapse wreaked further damage. The decline of real international oil prices in the early to mid-1980s sharply shifted the terms of trade against the region. As the World Bank's analysts' put it, "oil prices and output go together". Oil prices were as important for non-oil countries like Yemen and Sudan as for oil exporters--though the mechanism of labor remittances, the entire region shared in the massive transference of oil rents which characterized the period of 1973-82. (The elasticity of remittances with respect to oil prices is about 0.6).

From a political perspective, poor growth performance matters only if measured growth (say, GDP or GNP) is a reasonably accurate measure of families' incomes and welfare. Although

[3] Rent is used throughout this paper in the orthodox economic sense: the difference between market price and the opportunity cost of production. For a further discussion in the Middle Eastern context, see Richards and Waterbury (1996), p. 17.

the overall impression of both "oil boom" and "oil bust" is valid, there are reasons for skepticism both about the speed of the boom and the depth of the bust. There was less growth, and certainly less sustainable development during the boom than the national accounting data suggest.

This is simply because of the key role of oil, a depletable natural resource, whose rents accrue directly to the government. From a long-term, development perspective, much of the measured "growth" of the oil boom years was not a sustainable income flow, but included receipts from the drawing down of an exhaustible resource. As El Sarafy (1993) demonstrates, correcting for this feature can have a substantial impact on adjusted GDP--e.g. by 5% for Egypt and Tunisia, over 13% for Oman. The boom years also overstate the development of these economies since the boom was, of course, based not on changes in quantities but on shifts in prices: unlike the East Asian case, incomes in the Middle East grew for reasons which were fundamentally exogenous to the difficult process of structural transformation. This matters, because the entrenched habits of rent-collection provide poor preparation for today's hyper-competitive international economy.

It is instructive to compare the stars of economic development, the East Asians, with Middle Eastern and North African (MENA) countries. The World Bank (1995) undertook the methodologically standard comparison of growth of the two regions from 1960 to 1985. They did this via a residual calculation, in which incomes per capita are a function of investment and education. Since these variables explain only 45% of the difference in East Asian and MENA growth, the authors asserted that "55% of the differences in growth are due to productivity differences". Such a conclusion is far too sanguine. For the Middle East, much of the change in the value of output was simply the result of price changes and not the fruit of *any* (efficient or inefficient) process of investment. Such considerations suggest that the gap between East Asian and MENA countries was even larger than the 55% calculated by the World Bank.

Although one might logically argue that, if national income data overstate the growth of regional economies during the oil boom, then these same data should understate the extent of the decline of the economies during the past 15 years. However, particularly from a political perspective, there is an asymmetry here. First, oil export quantities have fallen little, if at all--there has been little change in the depletion of the depletable resource. Second, the informal economy, which by definition is not measured, is surely not only large today, but larger than it was in the past. As the measured economy shrinks or stagnates, many have shifted their activities to unmeasured activities.

Fundamentally, the problem is that from a political perspective, what matters is the consumption level of households, whether relative to others or to the recent past. Consumption levels have fallen in many cases, and are under considerable strain everywhere, but the informal economy and household networks have probably protected household incomes more than national accounting data would suggest. The "windshield survey" technique suggests that incomes have fallen less than national data suggest.

On the other hand, what really counts politically are *perceptions*.[4] And here there is little doubt that regional perceptions are of stagnation and declining income standards. Certainly most indigenous observers of the region, local residents, economists, pundits and the like concur that "times are hard". There is a widespread perception that the oil boom years presented opportunities, and that these opportunities are now gone. Often, such observers are not slow to blame national governments for these perceived failures.

In summary, regional (and national) growth performances have been, at a minimum, unimpressive during the past 15 years. The dominant impact of oil rents has confused the situation to some extent, but there is little doubt that the region has performed poorly, and that many people are no better off, and many worse off, than they were 15 years ago. Governments helped to create this situation: understanding the current crisis in the region requires recognizing that the oil boom, coming historically on the heels of post-independence import substituting industrialization strategies, spawned the same vested interests, fostered the same mind-sets, and underwrote the very social contracts which today block policy adaptation. Oil price declines created pressure to reform, but so far, governments have been unable to overcome the baleful legacies of recent history.

Restraining population expansion

The key demographic facts of the region are 1) the rate of population growth remains high, and 2) fertility rates have been falling rapidly during the past decade. On the one hand, the population of the Middle East and North Africa is now growing at about 2.7% per year. At this rate, the population will double in about 26 years. *This is the fastest rate of growth in the world*, exceeding even that of sub-Saharan Africa. On the other hand, population growth rates have fallen quite sharply in the past 10 years (from 3.2% in the mid-1980s to 2.7% in 1990-95). Sharp fertility declines caused this change; there are reasons to expect further falls.

This generalization hides substantial variation across countries and regions. Although population growth rates and total fertility rates have fallen markedly in, Egypt, Iran, and Tunisia, they have remained stubbornly high in Gaza and Yemen. Indeed the total fertility rates in Gaza (7.5) and Yemen (7.4) are among the highest in the world. The Gazan rate is also very high in relation to per capita income.

Even countries whose fertility rates are falling rapidly will continue to experience population growth, both because fertility remains well above replacement levels and because past population growth ensures that there are many women who will soon enter their child-bearing years (so-called

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[4] "Men in general are as much affected by what a thing appears to be as by what it is, indeed they are frequently influenced more by appearances than by reality". Niccolo Machiavelli, *Discourses on Livy*, I.25

"demographic momentum"). The population of the region may reach roughly 600 million by 2025, some six times more people than in the 1950s. Such growth poses numerous economic challenges, from areas ranging from food and water to jobs and housing.

Rapid past population growth combined with sharp falls in fertility have two major implications. First, most Middle Easterners are young. In Iran, for example, half of the population is less than 15 years old. By 2025, the number of people aged 0-14 years will roughly double. Second, as Williamson and Yousef(1999) have argued, the rapid fall in fertility may lead to a rapid decrease in the "dependency ratio" (the number of people under 15 and over 65 to the working-age population). When this has happened elsewhere, as in East Asia in the 1970s and 1980s, dramatic increases in national savings rates ensued. For Williamson and Yousef, the demographic change caused the savings change (this is the natural result of their life-cycle savings model). They are quick to note, however, that whether or not such savings find their way into productive and job-creating investment depends on many other factors, however.

Providing Jobs

These savings will need to be channeled into job-creating investment, if unemployment and/or falling wages and rising poverty are to be averted. For at least the past decade, the supply of labor has outrun the demand for workers every year. Past high fertility levels, combined with rising female participation rates (from very low levels) have created *the most rapidly growing labor forces in the entire world* (3.4% per year, 1990-98; World Bank, 2000). In some countries, the situation is even more serious: Algeria (4.9%), Syria (4.8%), Yemen (5.6%). [5] Although the rate of growth attributable to past population growth will decelerate in some countries (e.g., Tunisia) during the next 10-15 years, the decline in fertility is, as always, accompanied (plausibly, largely caused by) rising female education--which also and simultaneously leads women to seek to enter the labor market. It is highly unlikely that the growth of the supply of labor will decelerate within the medium term.

At the same time, the demand for labor has grown sluggishly. Simple economics tells us that, given such a mismatch between the growth of demand and supply, either the wage will fall, unemployment will rise, or (most likely) some combination of both will occur, with the precise mix varying with specific labor market structures. Government policies have not only reduced the rate of growth of the demand for labor, but have also fostered inflexible labor markets. Decades of government job guarantees for graduates have induced students to seek any degree, regardless of its utility in the production, since a degree, by itself, has long been a guarantee of a government job. Governments cannot now provide the necessary jobs, but statist policies impede private sector job creation. Meanwhile, the educational system has produced large numbers of young people with enough education to be unwilling to work at manual labor jobs, but insufficient skills to be productive in today's world economy.

[5] By way of comparison, the labor supply has grown at 0.8% in the U.S., 0.4% in the E.U.

Despite data difficulties, several generalizations may be made. Current levels of unemployment are high (See **Table 1**), and the problem will probably get worse in the near to medium run. Unemployment primarily affects young, semi-educated, urban people, whose anger fuels political unrest. Unemployed youth provide fertile fishing ground for Islamist radicals throughout the region. The problem posed to governance is severe.

Table 1: Unemployment in the Middle East: A Compendium of Estimates

Country	Unemployment Rate	Remarks
Algeria	**30%**	**1999.**
Egypt	**12%**	**2000. Some estimates show 20%**
Iran	**20-25%**	**2001**
Jordan	**15%**	**official rate. CIA gives 25%-30% (1999)**
Lebanon	**18%**	**1998**
Libya	**29 %**	**2000**
Morocco	**15%-22%**	**2000**
Saudi Arabia	**14-18%**	**Higher among graduates**
Syria	**12-15%**	**1999**
Tunisia	**16%**	**1999**
Yemen	**35%**	**1999**

Sources: Saudi Arabia, US Embassy, Riyadh, and NYT, 8/26/01; Iran, Eric Rouleau, *Le Monde Diplomatique*, www.en.monde-diplomatique.fr/2001/06/05iran; **all others: MEDEA Institute (European Institute for Research on Mediterranean and Euro-Arab Co-operation), and CIA World Fact Book.**

The problem is made particularly acute since the remedy to the long-run problem has, and in many cases will continue, to worsen the problem in the short-run. Demand for labor has grown sluggishly both because output growth has lagged, and also because of specific policy biases against labor-intensive, job-creating growth. Not only do the statist, inward-looking policies sketched above retard growth; they also raise the capital-intensity--and reduce the job-creating impact--of whatever growth does occur. But changing these policies requires laying off workers in state-owned enterprises and the bureaucracy, a move which frightens many leaders.

The employment problem is the most politically volatile economic issue facing the region during the medium term. Unemployment encourages relatively educated, young, urban residents to support radical Islamist political movements. There are, of course, *many* complex cultural forces behind these movements; no "economic determinism" is implied here. The Ayatollah Khomeini is reported to have said that, "the revolution is about Islam, not the price of melons". Much deeper issues of identity and legitimacy are at stake. For example, we should remember that although young, unemployed, frustrated young men throughout the region can turn to Islamism, they can also turn to drugs and crime, to apathy, indifference, muddling through, dogged hard work, or any number of other, personal "coping" strategies. The decision to join a revolutionary movement is a deeply personal, idiosyncratic one. Socio-economic contexts are important for understanding these movements, but they hardly provide a full explanation for them. Neverthless, huge numbers of discontented young men (and women) is a major threat to internal stability throughout the region.

Alleviating Poverty

There is a large and growing debate about the extent and severity of poverty in the region. Since the definition of both is inherently subjective, such debate is hardly surprising. With the exception of a few countries, the debate rages in the absence of good data. This analyst offers the following generalizations[6] on the state of poverty in the region.

- Only three countries--Jordan, Morocco, and Tunisia--have estimates of poverty based on detailed household surveys. The available data suggest that poverty in Jordan rose sharply from 1987 to 1991, improved until the mid 1990s, and may have increaed since then. . Poverty declined in both Morocco and Tunisia in the late 1980s. There is some evidence that poverty increased in Morocco during the 1990s, when the economy was hammered by repeated droughts. Such a performance is particularly discouraging, because Morocco implemented more far reaching economic reforms, and did so earlier, than most other countries in the region.

- Some data for the first half of the 1990s exist for Egypt, Algeria, and Yemen, although the studies are less comprehensive and rigorous. There has been a clear increase in poverty in all three cases, but there is sharp disagreement over the magnitude of the increase.

- Poverty is clearly a growing problem is some countries (Iraq, Somalia, Sudan) where there is very poor/non-existent documentation.

[6]The information in this section is based on Assaad, et. al, 1997.

- Very little is known reliably about poverty in Libya, Syria, and Lebanon.

The World Bank presents the most optimistic perspective on regional poverty (e.g.van Eeghen, 1995). This study asserts that, when compared with other regions of the developing world, the Middle East and North Africa (MENA) has "relatively limited" poverty. The number of poor persons (defined as those with yearly incomes less than PPP$365 per year) was 5%, and the depth and severity of poverty was low.

One can easily object to this rosy picture. In the first place, the Bank's "absolute poverty line" is simply too low to be meaningful for most countries of the region, particularly from a political perspective. Poverty is, inescapably, a relative concept, especially if we are concerned with politics and policy. "Poverty lines" are the modern equivalent of "subsistence" in classical political economy, and, then and now, subsistence has a relative, social element. The report's poverty line ($370 PPP per person) is far below average $PPP per capita incomes for most countries: the ratio of per capita GNP to the poverty line, both in PPP dollars, is unreasonably high when compared with a similar calculation for the U.S. In the U.S, GNP per capita is about 6.5 times greater than the poverty line, whereas corresponding MENA figures are: Egypt (9.9), Jordan (11.4), Morocco (8.8), and Tunisia (13.8). (Danzinger and Weinberg, 1994 for US poverty line of $14,335 for a family of four in 1992).[7]

From a political perspective, what counts is the relative, social definition of poverty. Poverty is always and inevitably partly relative: poor people in Egypt, Jordan, or Algeria (and those who sympathize with their plight) do not compare themselves with the poor in Bangladesh or Madagascar; they feel "poor" relative to their fellow Egyptians, Jordanians, or Algerians. It is the higher estimates of poverty which are more politically relevant.

Other reports and studies confirm this rather less sanguine picture. The Mashreq Report (1995) estimates the rate of poverty for the region to be 33%, and argues that poverty is growing in the region. Ali (1996) uses a relative poverty line, and finds the incidence of poverty to be some 1.5 to 1.9 times higher than the World Bank's estimate, depending on the country. families according to the 1991 census fell below the poverty line (Korayem, 1996).

What are the political consequences of poverty? Poverty provides a fertile recruiting ground for opponents of regimes (and therefore poses a challenge to governance) in at least two ways. First, some poor people, particularly younger ones with some (often limited) education, join violent opposition movements. The basic profile for today's violent militant is a young person with some education, who may also have recently moved to the city. Such young people are often unemployed or have jobs below their expectations. In North Africa, they are colorfully

[7]It is worth noting also that the 95% confidence interval around the Bank's point estimates for poverty in MENA are 13 and 51: No estimate of the poor as a percentage of the population between 13% and 51% can be ruled out.

known as the "*hetistes*". [8] Some evidence from Egyptian arrest records suggests that many of those arrested for violent activities against the regime come from the shanty-towns surrounding large cities--that is, from some of the poorest urban areas of the country.

The spread of violent opposition in Upper Egypt is also plausibly related to poverty. The *Sa'id* (Middle and Upper Egypt) is the poorest region in the country. Moreover, there, as elsewhere in the country, poverty has been rising during the past ten years. The poverty situation deteriorated during the past decade, thanks to the collapse of unskilled wages. These had risen over 350% in real terms from 1973 to 1985, largely thanks to emigration for work in the Gulf States (public job creation also played a role). With the collapse of the regional oil in the war-related migration to Iraq, and in the ability of the public sector to create jobs, wages for unskilled workers fell by over 50%. As Sai'idis increasingly move to cities, they "export" the problem of Islamism to more visible locations, such as the major cities of Egypt.

As the profile of the militants suggests, there is a second, indirect way in which poverty breeds opposition. Most people find the presence of widespread poverty and human degradation offensive. We are thinking, reasoning beings: we look around us, and then draw our own conclusions. The presence of widespread poverty delegitimizes regimes in the eyes of those who spend a lot of time thinking about what they see, such as intellectuals, journalists, and students.

Throughout history, most revolutionaries have not come from poor families. Revolutionaries, whether of the Leninist or Islamist variety, can usually "pronounce their haitches" (are from privileged backgrounds), as George Orwell famously remarked in the 1930s. However, they did find the appalling poverty of their societies to be morally outrageous, and took action accordingly. *The wide-spread perception of regional regime's failure to provide adequate standards of living contributes to the often noted "crisis of legitimacy" in the region.*

Even relatively "invisible" poverty, such as that in rural areas, has important political implications. In some cases, small towns and rural areas do provide recruits and support for militants. However, regimes are typically more concerned with urban opposition. But rural poverty exacerbates the problems of cities. Rural poverty, of course, fosters rural to urban migration. As rural poverty is "exported" to the cities, not only do the number of potential militants rise, but also the difficulties of regimes' in dealing with urban problems mount. Rapidly growing numbers of poor urban dwellers multiply the demands on urban administrations. In an age of increasingly scarce governmental resources, meeting these demands becomes increasingly difficult. Such government failure further de-legitimizes governments in the eyes of both the poor urbanites themselves and those who reflect on their societies, such as intellectuals and students. Rural poverty does not stay "politically invisible" for long.

The Jungle of Cities

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[8] A Maghrebi word which blends the Arabic *heta* (wall), with the French suffix *-iste*: "one who leans against the wall".

The number of urban dwellers is growing much more rapidly than populations as a whole. The number of urban Middle Easterners has increased by about 100 million in the past 35 years. Roughly half of the population of the region now lives in cities. The numbers of urban dwellers is expected to rise from its current level of over 135 million to over 350 million by 2025. From 1985 to 1990, the most rapid growth was in secondary cities--6%--compared with a growth rate of 3.8% for the nineteen largest cities with populations over 1 million in 1990. This trend has continued during the 1990s. Public services and utilities are already overwhelmed; In Jordan and Morocco, for example, one-third of the urban population lacks adequate sewerage services. Urban water supplies are often erratic. Governments attempt to provide urban services through heavy subsidies. These strain government budgets, and thwart the necessary investments to extend and improve services.

The rapid urbanization of the region challenges governance in at least three ways. First, the rapid growth of cities strains infrastructure--and government budgets. Governments' perceived inability to cope with mundane problems like housing, sewerage, potable water supply, and garbage collection further weakens already strained regime legitimacy. Second, the process of migration from rural to urban areas is always disorienting for many migrants. Whether in Ayachuco or Asyut, the mix of rural-urban migration with discontented provincial intellectuals has proved highly toxic to existing governments. The disoriented recently arrived rural migrants to cities provide fertile fishing ground for Islamic militants, particularly when the (allegedly) decadent mores of the cities shock the sensibilities of the newcomers. The problems are also made more acute by the difficulties which migrants sometimes find in obtaining work (e.g., in the Maghreb). Third, urban discontent is clearly more politically volatile and dangerous to regimes than rural in the region. Rapid urbanization strains budgets, legitimacy, and governance, while swelling the ranks of regime opponents.

The magnitude of the problems dwarfs available resources to cope. Managing these problems adequately will be expensive. The World Bank estimates that solving the problem of municipal solid waste collection for the region as a whole will require $4-6 *billion* of investment over a ten year period (World Bank, 1995b), while solutions to water distribution and air pollution will be still more expensive. Governments are unlikely to be able to afford to provide services at below cost to urbanites if coverage is to be extended and health hazards are to be reduced.

The problem is both cause and effect of governance difficulties. At least in part, the problems stem from the weak tax base of most urban entities. Few cities have much independent tax authority, thanks to the fiscal centralization in most countries in the region. At the same time, macroeconomic austerity has deprived many municipalities of the funds needed to cope with urban problems. The problems of urbanization are fundamentally caused, of course, by rapid urbanization and urban population growth; they are significantly exacerbated, however, by governments' lack of revenues. Coping with urbanization is another force pressing governments to reform their policies.

Governments are very widely perceived as having defaulted on their responsibilities to their citizens. This situation provides radical opponents of existing regimes with excellent opportunities. Islamists, in particular, have been nimble in filling the niche vacated by fiscally retrenching governments. Islamists have created schools, clinics, day-care centers, and dozens of other NGO-style activities, to substitute for penurious and incompetent local government.The contrast of the incompetence of the Egyptian bureaucracy and the dedication of Islamist NGOs in caring for victims of the Cairo earthquake neatly illustrates the point. Islamic charities can draw on a vast reservoir of private wealth, particularly in the Gulf States.

Saving water

Coping with increasingly scarce water constitutes an inescapable challenge to government policy. Five facts about the water situation seem particularly relevant.

1) Water is becoming increasingly scarce. Renewable water resources per capita fell from 3,500 m^3 in 1960 to 1,500 m^3 in 1990 to 1,250 m^3 today. The World Bank projects that there will be only 650 m^3 per person by 2025 (compared with a world -wide average of 4,780 m^3 per person in that year). Ten countries' (and Gaza's) water use already exceeds 100% of renewable supplies.

2) Water quantity problems are exacerbated by water quality problems. These become increasingly serious as nations seek to solve the "water quantity" problem through reuse of water. Technologies exist to do this safely, but they require considerable funds and careful management. Neither are abundant.

3) From an economic perspective, the burden of adjustment to increasingly scarce water must fall on the agricultural sector, because the economic value of water in much lower in farming than for domestic or industrial use. Politically, however, such a shift is very difficult; past government programs to redistribute land, reclaim land, and increase domestic agricultural production to plug the food gap have created powerful interest groups who will oppose reallocation of scarce supplies away from their farms. And given the already serious pressures on urban infrastructure, no government wishes for a rapid acceleration of rural-urban migration--which is what large scale water transfers from farms to cities could imply.

4) Government water management systems suffer not only from lack of funds, and but also from managerial cultures which were geared to a situation of relatively abundant water.

5) Most water resources in the region are rivers and aquifers which cross international frontiers. There is a sharp clash between economic/engineering logic, which would favor managing a river basin as a unit, and political considerations, marked by fear and distrust of one's neighbors.

Some analysts fear that military conflict over water may erupt in the not-too-distant future. Although there are many reasons to doubt this, heightened tension over water is likely. For example, successful management of the water problem will require greater regional cooperation. If states were willing to risk this, then the engineering and economic obstacles are not large. However, many (probably most) states appear reluctant to take such (economically rational) steps. Domestically, the usual economic remedies for coping with water scarcity, greater reliance on markets, is very difficult to implement. Water markets are likely, at best, to play a relatively minor role in most countries. There are many solid economic reasons why this is so (Richards and Singh, 2001; Seckler, et. al., 1999). The political difficulties are even more severe, particularly when considering eliminating existing subsidies to farmers or trying to regulate over-draught of groundwater.

Obtaining Food

The Middle East is the least food-self-sufficient region in the world. During the 1980s, demand growth decelerated (thanks to declining incomes) and supply response accelerated. Regional agricultures used more land, more water, more fertilizer, more machines, and more labor--all just to keep up with population growth. In the 1990s the story was similar: the FAO (2000) reports that food production per capita in 1999 was some 4% above that of 1990. As usual, there is wide country variance. Although Egypt's food production per capita rose some 20% from 1990 to 1999, Jordan and Saudi Arabia experienced a fall (of 22% and 41%, respectively). (FAO data). There is also evidence of diminishing returns in agriculture: the rate of growth of agricultural value-added slowed from 5.5% in the 1980s, to 1.7% in 1990-97 (World Bank, 2000).

Unless there is a remarkable acceleration in the pace of technological change in farming, the water constraint dooms attempts at food self-sufficiency. The "food gap", or the difference between consumption and domestic production is projected to increase at roughly 3% annually during the coming decade. The region is already importing "virtual water" (water embodied in imported food) roughly equal to the annual flow of the Nile.

In short, increasingly ***the region must export in order to eat.*** This, however, poses deep dilemmas for policy makers. First, most analysts believe that the new world trading rules of the Uruguay Round and WTO will raise (slightly) world cereal prices. It will be more, not less, difficult to feed populations through imports should these projections become realities. Second, relying on food imports means that countries are increasingly dependent on the wider health of the global economy, something which they are nearly powerless to affect. Third, sustainable increases in food imports require sustainable increases in other exports--which is precisely what economic reform is intended to achieve. **The necessity to pay for imported food--hopefully with job-creating, labor-intensive exports--constitutes a key argument for the urgency of economic reform.**

Attracting Money for Investment

None of the above problems can be successfully managed without much higher levels of investment. Consider the employment problem. The total number of new jobs which the region will require by 2010 is roughly 47 million for "MENA". The investments required to employ them are estimated by the World Bank at about $31 billion in Iran, $30 billion in Morocco, $25 billion in Algeria, $14 billion in Egypt, and $12 billion in Tunisia.[9] Growth rates must reach levels of 7-10% to employ new job-seekers and to reduce the numbers of the unemployed. The challenge is huge.

Governments cannot provide such money; it can only come from private local citizens, and, to a lesser extent, from foreigners. So far, however, governments of the region have failed to attract the necessary funds. The low level of (and even more, the inefficiency of) investment, in turn, exacerbates governance problems via economic stagnation, rising unemployment and poverty, deteriorating cities, and increasingly scarce water.

A few facts should suffice to make the point. First, very large sums of money are held "off-shore" by citizens of Middle Eastern countries. Second, the region has captured a nugatory amount of the total world-wide flows of direct foreign investment. Apart from oil companies, most foreign investors shun the region. At the same time, the efficiency of national investment has been declining.

In addition, a number of countries in MENA now face a "debt crisis", the fruit of years of living beyond their means. Interest payments on debt as a percentage of GDP now rival those in chronically indebted sub-Saharan Africa, and are similar to those which plagued Latin America in the 1980s. Consider one critical debt ratio, the present value of debt as a percentage of exports. As a rule of thumb, any country with a ratio over 200% is said to suffer from "debt overhang": a level of indebtedness that deters private investors from risking their capital. Investors fear that the large size of the public debt[10] will force the government to raise taxes, either directly, or indirectly, via the inflation tax. In either case, a prospective investor will lose. Servicing an external debt requires an internal transfer (from private to public sectors) and an external one (from the indebted country's government to the foreign creditors). Domestic debts require an internal transfer. These transfers must come from local sources, creating fear among potential investors. On this criterion, Algeria, Morocco, Syria, Turkey, and Yemen have important debt overhang difficulties, while the problem in Sudan is entirely unmanageable.

Work habits, high efficiency wages, archaic infrastructures are some of the factors which inhibit investment and therefore growth. However, there is an emerging consensus that, in the Middle East as elsewhere, investment is impeded by defective governance. Key factors here include:

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[9] Nemat Shafik, personal communication, 8/17/95.
[10] The large majority of external debt in Middle Eastern countries is public debt.

- Public sectors dominate the non-farm economy. Their demands often "crowd out" private investors.

- Taxation is high and arbitrarily administered. Larger firm size is discouraged.

- Regulations are complex, opaque, and breeding grounds for governmental corruption.

- Legal systems are weak and/or overloaded, offering little practical redress.

The challenges facing regimes of the region are daunting. So far, the main policy prescription for coping with such problems is a shift toward a more private-sector driven, open and market oriented economy. Such policies, it is hoped, will generate jobs while simultaneously producing exports to buy the food to take pressure off of increasingly scarce water supplies. We turn now to a more detailed examination of the economic challenges and policy responses in five key countries in the region: Egypt, Jordan, Iran, Saudi Arabia, and Syria.

III. Country Experiences

A. Egypt

1. Overview

Egypt illustrates the reform challenges faced throughout the region. Egyptian economic reform began in 1991. During the past decade, some progress was made toward converting a grotesquely over-regulated, unbalanced socialist economy into a more modern economy with a greater role for the private sector. Growth rebounded during the 1990s, averaging 4.9% per year from 1991 to 2001. However, significant problems remain. Stabilization has been relatively successful, while structural adjustment has been weaker. There are signs that reform's pace has slackened recently.

Most importantly, reforms to date have failed either to reduce unemployment substantially or to halt the decline in real wages. At best, reforms have prevented unemployment from rising. The transition to growth led by labor-intensive exports has not happened. To the contrary: growth in the 1990s was mainly driven by domestic demand rather than by trade expansion; in 1999, merchandise exports were only 3% of GDP in 1999, and, worse still, exports today are less labor-intensive than they were a decade ago (World Bank, 2001). Living standards have, at best, shown very modest improvement.

At the same time, accusations of corruption in the privatization process abound, and many observers speak of the rise of "crony capitalism", similar to Suharto's Indonesia. Privatization seems to have resembled the Russian case, with a few insiders reaping most gains.

Newly wealthy Egyptians are flaunting their wealth in a conspicuous consumption binge that offends the poor and provides ready propaganda for radical Islamists. (Hirst, 1999) The government is widely perceived as a "geriatocracy", devoid of new ideas, while budgetary stringency has led the state to withdraw from some welfare functions (e.g., disaster relief, medical care, education), leaving a vacuum increasingly filled by Islamists. The medium-term political implications are disquieting.

2. The Background of Reform[11]

On the eve of the Gulf War, the Egyptian economy was in shambles. Growth turned negative in the late 1980s; by 1990 the country had amassed international debts of nearly $50 billion; its debt/GNP ratio of roughly 150% was arguably the highest in the world at the time. Real wages of unskilled workers had plummeted by 40% in four years, while civil servants earned only about half of their 1973 salaries. The level of open unemployment had doubled during the decade. The quality of government health, transportation, and educational services had plummeted from already dismal levels, a situation which was–and is--exploited by Islamist extremists.

At the core of Egypt's macroeconomic crisis were three *macroimbalances*: the gap between domestic savings and investment, imports and exports, and government revenues and spending. The collapse of oil revenues and mounting losses of public sector companies undermined public savings, while private savings were deterred by negative real interest rates on Egyptian pound deposits and by great uncertainty by private wealth holders as to the future direction and credibility of economic policy. Investment flowed into infrastructure, rather than into traded goods production; investment was increasingly inefficient and capital-intensive, creating few jobs.

Egypt, like so many middle-income countries, plugged the twin gaps by borrowing from abroad, largely from foreign governments. Egypt's foreign debt climbed from about $2 billion in 1970 to some $21 billion in 1980 to just under $50 billion in early 1990. This latter figure was roughly 150% of GNP; in 1990 debt service payments consumed over 25% of exports. The average government deficit for FY 1982-1990 was 21.2% of GDP. Revenue fell with oil receipts, while spending was inelastic downwards for the usual political reasons: blockages by vested interest groups who would lose sinecures and economic rents, and fears of popular wrath over subsidy cuts. Some 80% of government spending consisted of subsidies, public sector salaries, interest on the public debt, and the military. The last two were sacrosanct, forcing all adjustment on the spending side onto the first two.

As new foreign lending dried up in the latter half of the 1980s, the deficit was increasingly financed by monetary expansion. Inflation accordingly rose to roughly 25%, with

[11] This section draws on Richards (1991).

the usual baleful results: further distortion of price signals, sharply negative real interest rates which exacerbated the savings-investment gap, and (thanks to fixed nominal rates) a steadily increasing overvaluation of the exchange rate. Such under-pricing of increasingly scarce foreign exchange discouraged the production of traded goods, and favored imports over exports; in short, it greatly exacerbated the trade gap.

Microeconomic distortions reinforced macroimbalances. Egyptian price distortions of the 1970s and 1980s were internationally notorious. The divergences between private and social rates of return in industry were little short of astonishing. In the second half of the 1980s, price reforms began to be implemented in agriculture, but cotton remains underpriced even today. Prices in Egypt have borne little relation to social scarcities.

Price distortions interacted synergistically with the regulatory environment to create a producer's nightmare. Consider the increase in capital intensity. On the one hand, the relative price of labor to capital rose as labor emigration pushed up wages, while accelerating inflation and financial regulations created strongly negative real interest rates. Supervisory personnel, so crucial to successful labor intensive production techniques, were particularly scarce during the migration boom. Because laws made it almost impossible to fire workers, labor costs became overhead. Regulations were--and remain--voluminous, ubiquitous, opaque, and arbitrarily enforced.

The Gulf War created an entirely new situation. Indeed, it provided a strategic opportunity which the Egyptian government swiftly seized. The government adopted a reasonably conventional stabilization and structural adjustment package, endorsed by the IMF, in exchange for massive debt relief. Such a bargain was attractive both economically and politically. Economically, the reduction of up to $20 billion of debt cut yearly interest payments by $2 billion for the next ten years. Politically, the deal was easier to sell domestically, since the government could plausibly argue that its creditors were shouldering part of the burden of past mistakes. By "front-loading" the reforms, international donors hoped to change the payoffs facing the government: if they failed to reform, they would not enjoy subsequent tranches of debt relief.

3. The Promise

In May 1991 agreements with the Fund and the Bank were signed. The program contained six components:

1) The stabilization program contained the usual *macroeconomic measures*. In particular, the program mandated a banking reform, which made the Egyptian Pound a convertible currency, created new financial instruments (in effect, "Treasury Bills" issued by the Central Bank) and raised nominal interest rates. Macroeconomic targets which were monitored were net foreign assets, net domestic assets (government + state-owned enterprises + private sector) and

public sector borrowing (government + state-owned enterprises).

2) The Structural Adjustment Loan (SAL) provided for a *privatization program* covering sale of government assets and setting up legal and institutional mechanisms for a better management of the public share in corporations. The Central Bank's regulatory functions were also to be strengthened.

3) *Price liberalization* measures included raising the farm-gate price of cotton in steps to be equal to the world price in 1995, except for a small export tax on extra-long staple cotton, in which market Egypt has some market power. Cotton marketing and trade were to be liberalized, subsidies on fertilizers and pesticides, halved in FY 1991, were to be completely liberalized by FY 1993. Energy prices were to rise to international levels by 1995, rail tariffs are to be raised, and price guidelines for intercity bus transport were to be removed.

4) *Trade liberalization* was to be achieved by cutting import bans and licensing requirements, eliminating import deposits, lowering tariffs to between 10% and 80%, and reducing the variability of tariffs. Export restrictions were to be reduced and then eliminated, and the drawback system was to be extended to indirect exports.

5) *Investment licensing* were to be abolished by December, 1993. Trade in fertilizer and cement was to be privatized, and labor laws were to be reformed so that private companies could more easily lay-off or fire workers.

6) A *Social Fund*, with a capital of some $600 million largely provided by European donors, was to reinforce the social safety net by: a) providing labor-intensive public works to generate employment, b) offering loans to small and microenterprises, and c) retraining public sector workers.

4. The Performance

The first component of reform, macroeconomic stabilization, did relatively well for most of the 1990s. The U.S. forgave the roughly $7 billion of military debt up-front. Some 15% of the remaining debt was forgiven in May 1991 following the IMF's approval of an 18 month Stand-By Arrangement, which was extended another 6 months. A further 15% was forgiven in September 1993, when the IMF concluded that the first set of reforms had been successfully concluded, and agreement was reached on an Extended Fund Facility. The final tranche (about 20% of the original debt), was forgiven in 1996. Egyptian debt is now quite manageable, constituting $31 billion; its present value is estimated at 29% of GNP. (World Bank, 2001b).

Reform of banking laws and a firm government commitment to a fixed nominal exchange rate stimulated an influx of off-shore money. International reserves soared, rising from $2.68 billion in 1990 to $11.7 billion in 1993, and peaking at $26.7 billion in 1995. This money is largely short-term and highly liquid. However, because Egypt's capital account had not been fully liberalized, the country was spared the worst effects of the Asian financial crisis of 1997. Nevertheless, reserves have fallen, particularly since 1998, declining to $15 billion in 2000.

Fiscal reform was also initially very successful. Government deficits have fallen from over 20% of GDP before the Gulf War to 2.5% in FY 93/94. By 2000 deficits had risen to 3.6% of GDP. Fiscal discipline has combined with tight monetary policy to cut inflation from over 25% in 1990 to 11.2% in 1992/93 to 6% in 1994/95 and to 3% in 2000. Macroeconomic performance has been the strongest component of reform.

Until 1998, the government pursued tight fiscal and monetary policies. The balance of payments was stabilized, and the rate of economic growth picked up. However, there are two types of problems: 1) the current macroeconomic posture blocks export-led growth and 2) the sluggishness of microeconomic and structural reforms such as privatization and de-regulation impede a more vigorous private sector response. These problems have combined to retard achieving the ultimate goal, the acceleration of growth, job creation, and real wage increases.

The current macroeconomic posture implies high interest rates to continue to attract Egyptians' funds abroad. *Ceteris paribus*, however, such interest rates reduce investment and growth. Such rates are probably less significant as a growth impediment than remaining regulatory problems, but they do need to be addressed. However, so long as the GOE persists in its present policies of exchange rate management, the government cannot reduce interest rates. Here there are significant differences of views between many Egyptian government officials and many foreign observers, including the World Bank.

The GOE acknowledges that Egyptian inflation has exceeded that of its major trading partners during the past decade. Since the nominal exchange rate has been pegged since the devaluation of February, 1991, the real exchange rate has therefore become increasingly overvalued. By 1997, the World Bank estimates the overvaluation to be some 37% compared with the February, 1991 level, and 40% compared with the 1987 level (when foreign exchange controls were partially relaxed). The GOE argued, however, that Egyptian exports are inelastic with respect to the exchange rate, and that a fixed nominal exchange rate is essential for investor confidence in the entire economic reform package (the so-called "nominal anchor" argument). The government has pegged the credibility of its reform efforts to the nominal exchange rate. While oil exports are, of course, inelastic with respect to the exchange rate, this is much less obviously so for workers' remittances and, especially, for non-traditional manufactured goods and processed agricultural commodities. The over-valued exchange rate contributes to the relatively sluggish growth performance of the Egyptian economy by weakening such exports–the hoped for "engine of growth" for jobs and incomes.

A common rejoinder from Egyptian government officials and economists is to note that current (low) growth figures are for *measured* growth. Most Egyptian economists stress that much economic activity goes uncounted. They argue that the so-called "informal sector" is booming. It is certainly true that casual observation is not wholly consistent with a gloomy picture of economic stagnation. It is also true that the regulatory morass of Egyptian policy creates large incentives for unreported activity. De-regulation would benefits not only for growth by reducing dis-incentives for investment, but also would improve policy makers understanding of the economy by improving the quality of data. Improved data would help all participants in the current macroeconomic policy debate by increasing the consensus on what is actually happening in the Egyptian economy.

Even if the current growth figures are underestimates, and even if, therefore, the Egyptian economic performance has recently been more robust than existing data suggest, current exchange rate policy is quite risky. The problem may be labelled the "Mexican risk". The government's current interest rate policy is largely responsible both for the government's ability to maintain an overvalued real exchange rate and also for the existence of large foreign exchange reserves. However, it must be noted that most of the capital inflows have been in short-term government securities. Such a policy is reminiscent of the Mexican situation before the crash of the peso in December, 1994, when a political event triggered a run on the peso.[12] It is reasonable to ask how long the GOE can maintain its present posture.

The recent historical experience with such a "nominal anchor" policy is disquieting. Similar policies have been tried in Chile (1978-82), Mexico (1994-5), and Argentina (today). In each case, the "nominal anchor" was deemed (reasonably) necessary to bolster investor confidence. But in each case, the country was ultimately forced to undertake large, sudden devaluations when the credibility of the overvalued rate finally became unsustainable (often the result of some exogenous "shock to confidence" of a political nature). The resulting recessions were typically very sharp: in Chile, output fell by 14%, and over one-quarter of the labor force was unemployed. Mexico's experience was equally grim. There is no obvious reason why Egypt, which is following similar policies, should be spared a similar fate. Unfortunately, as elsewhere, shifting from a "nominal anchor" policy is a bit like dismounting from a tiger—getting off may be as dangerous as staying on.

Most crucially, however, the short-term liquid savings have yet to be translated into investment in the real economy. Only such investment can generate sustainable employment growth. There is consensus among observers that reforms of the real economy are proceeding sluggishly. In particular, progress on privatization has been slow. Privatization occurred mainly after 1996; about half of some 314 public enterprises have been privatized. However, the regulatory regime remains largely untouched, particularly at the level of implementation.[13] The "rules of the game" are still opaque, and investors maintain a "wait and see" attitude. The regulatory environment and the slow pace of privatization undermine one of the main goals of exchange rate management.

Since 1998, there are increasingly disturbing signs. First, the macroeconomic

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[12] The GOE's situation is somewhat less risky than that of Mexico, since, unlike Mexico, the deposits are not dollar denominated, a fact which placed all of the exchange rate risk on the Mexican government.

[13] Examples abound of middle and lower level officials continuing to enforce old rules, even when these have been officially changed by the Cabinet.

achievements seem to be in jeopardy, largely thanks to the government's insistence on maintaining *both* a fixed nominal exchange rate *and* pursuing its growth objectives. Egypt's exchange reserves have fallen, credit expansion has accelerated, government payment arrears have accumulated, and the level of dollarization has increased (World Bank, 2001). Continued high levels of protection discourage production for export. Meanwhile, new job seekers have unemployment rates over 15%, real hourly wages for men in 1998 were only 2/3 those of 1988. Urban poverty has increased from 20.3% in 1991 to 22.5% in 1995 (World Bank, 2001).[14] These are the most conservative estimates available; other sources find considerably higher levels of poverty, and show steeper levels of increase. To support the exchange rate and to finance continuing–although smaller–fiscal deficits, the GOE has borrowed heavily domestically. Debt service now consumes about a quarter of the budget. The analogy with Indonesia in the last days of Suharto is disturbing.

5. The Political Economy of "Creeping Cronyism"

Egyptian reform was delayed until 1991, moved cautiously since then, and has failed to solve the fundamental problems of the political economy. Three factors best explain this pattern of change:

- the structure of interest groups;
- the personality and priorities of the leadership, particularly President Mubarak.
- the presence of substantial international rents.

The principal losers from economic reform were precisely those upon whom the regime had traditionally relied for support, and whose ability to act collectively was institutionalized under Nasser: organized labor and managers in state-owned enterprises, government bureaucrats. bureaucrats, and holders of import-licenses and other rent-seekers. Egyptian reformers faced a powerful phalanx of vested interests which blocked the adoption (and still more, the implementation) of policy change. The government managed to reduce employment in public enterprises slated for privatization from 1.2 million in 1990 to 950,000 in 1996 by offering various "early retirement" schemes. However, redundancies remain substantial, but the government fears–understandably–the political consequences of mass-layoffs in a labor market which is already failing to absorb the yearly crop of 500,000 new job seekers.

The pattern of reform has also reflected interest group alignments. The top layers of the army and bureaucracy–the power elite created by the Nasser regime–have, in a manner similar to their former Russian allies–responded with alacrity to the new opportunities offered by banking liberalization and privatization. A symbiosis between government regulators and speculative

[14] Rural poverty decreased considerably–from 28.6% to 23.3%. From a political perspective, however, the urban rate is much more important. The last national household survey was conducted in the mid-1990s. (World Bank, 2001). No further data are available, and estimates vary widely.

entrepreneurs has developed; “insider trading” is rampant, particularly in the construction sector, where public land may be sold very cheaply to a friend who then resells it at its market value. As one astute observer put it, “At first sight, it might seem that power has moved from the barracks to the boardroom. More to the point, the army has moved into business” (quoted in Hirst, 1999).

One can overemphasize the strength of interest groups in Egypt, however. Take the potential losers from reform: these face "free-rider" problems in opposing reform, and, given the highly centralized political system in Egypt, would probably fall to a determined effort by the President. (Waterbury, 1993). Similarly, determined action from the top could do much to contain corruption. The President, however, chooses to move as slowly as possible, and his two sons, Ala’a and Gamal, are major players in the “business-bureaucrat” symbiosis.

Leadership always matters for reform, but, arguably, in Egypt it matters even more. The Egyptian political system is extremely centralized, with most key decisions made by the President and his closest advisors. The men close to Mubarak are very much "men of the old order": there has been very little turn-over in the Cabinet, and hardly any in key portfolios. Mubarak, a military man, has surrounded himself with engineers--not a set of backgrounds which is conducive to whole-hearted embrace of market-friendly reform. Mubarak is no "technopol", or economist-turned-politician, like Turgut Ozal. His experience at the Sadat assassination is said to reinforce his caution. He is in his seventies, and has not appointed a successor. His caution is legendary, his compatriots aged, and his regime sclerotic.

Economic rent provides the third prop of dilatory reform. Until the mid-1980s, 1970s, oil rents, whether directly in the form of oil export revenues, or indirectly as workers' remittances from the Gulf and Iraq permitted the GOE to pursue business as usual. The collapse of oil rents in the early to the mid-1980s greatly increased the pressure for reform. Although there were important changes (particularly of the government budget), a consistent reform program was not even formulated until mid 1986, not implemented until May, 1987, and abandoned in November, 1987. Throughout the 1980s, the government procrastinated as problems mounted, long after oil rents had dwindled.

Currently, higher oil prices permit somewhat greater rent from this source. However, the key rent is strategic. Ever since Sadat’s turn to the U.S. in the late 1970s, the regime has successfully and skillfully exploited its unique position as the largest Arab nation, and the first (and until very recently, the only) Arab state to have signed a peace treaty with Israel to extract concessions from the United States, the EC, and through these, international agencies such as the IMF and the World Bank. The Mubarak government skillfully utilized "strategic rent" to delay reforms for half a decade after the oil price collapse of mid-1986.

But even strategic rent had its limits. On the eve of the Gulf War, pressure for change was mounting. The IMF, badly burned in 1987, was taking a harder line, while the US connection was endangered by Egypt's coming dangerously close to violating the Brooke

Amendment. After failing to meet the targets of the May, 1987 stand-by agreement with the fund by November, 1987, several years of complicated negotiations ensued. The GOE used its strategic importance to extract favors from the US, and to induce the US to lobby the IMF to exercise great restraint in dealing with Egypt. While this dance was performed, the problems mounted. The patience of all parties was running out, as Egyptian policy makers appeared to take an ever-shorter perspective on the problem.

But then, of course, Saddam Hussein dramatically restored Egypt's strategic rent. Mubarak's support of the Gulf War Coalition was partly repaid with exceptionally generous debt-forgiveness terms. Throughout the 1990s, the pace of reform has been frequently questioned and the regime repeatedly prodded by the U.S., the World Bank, and the I.M.F. But, at the end of the day, Egyptian caution always prevailed: strategic rent enabled–and enables–the government to move at its own slow, opaque, andunaccountable pace.

Although Egyptian reform is often held up as an example of progress (particularly by the World Bank) reality is rather different. The combination of interest-group structures, strategic rents, and the personality of the President have yielded a patch-work reform which has failed to accomplish its central goal: launch the economy on a path of employment-generating gro wth, led by manufactured exports. The largest Arab economy is failing to provide the necessary jobs for young men, which delegitimizes the regime in the eyes of its increasingly restless youth.

B. Jordan

1. The Fragility of the Jordanian Economy

Like Egypt, Jordan illustrates how a country's configuration of interest groups can hinder the reform process. Much more than Egypt, Jordan shows how external events can undermine even a relatively determined reform effort. Jordan has repeatedly overcome internal divisions, embraced reform, enjoyed modest success–only to be derailed by regional developments entirely beyond the Kingdom's control. Jordan is a small country with an inherently a weak domestic economic base. Its population is small (5 million), it has no oil, and it is surrounded by neighbors which are either richer and/or military stronger. Until ten years ago, the country relied heavily upon external grants and loans, transportation services to the Gulf, and the export of skilled labor. The Gulf War temporarily demolished all three sources of foreign exchange.

However, during the first half of the 1990s, growth was surprisingly strong, fueled by the repatriated capital of Jordanians expelled from the Gulf and sound macroeconomic management. From 1992 to 1995, the country enjoyed a boom, with GDP growth of 9%. However, the faltering peace process, the decline in oil prices, and reduced demand from Asian economies after 1997 dragged growth down to 1.5%, 1996-99. This led to the adoption of a new round of economic reform, in which Jordan joined the WTO and offers plans to accelerate privatization. It seems highly likely that the aftermath of the terrorist attack on the US on September 11, 2001 will once again illustrate the vulnerability of the Kingdom's economy to negative external shocks.

Elements of Jordan's vulnerability include its possession of few natural resources and a rapidly growing population. These structural features of the economy interacted with policy decisions to create additional difficulties:

- A relatively large public sector
- A small private sector with a small, but growing industrial component
- Chronic trade imbalances (currently averaging about $2 billion annually)
- A heavy foreign debt burden
  (currently about $8 billion, with a NPV of 110% of GDP).

To make matters worse, Jordan suffers from increasingly acute, chronic water shortages. This problem appears to be one of both supply and pricing. The largest consumer of water is agriculture (70 percent in l990), while household consumption accounted for 24 percent of consumption. Jordan has only 198 cubic meters per capita (1998) , and with a population growth rate exceeding 3% per year, pressure on water supplies is becoming increasingly acute. (As a "rule of thumb", less than 500 cubic meters per capita indicates severe water-stress). Existing ground-water resources are being radically overutilized; withdrawals are estimated at some 180% of recharge. (Chesnot, 2000) A system of water pricing that heavily subsidizes water use by wealthy, influential, and (often) Palestinian farmers in the Jordan Valley has exacerbated shortages elsewhere in the Kingdom.

The continuation of the Arab-Israeli conflict stymied regional arrangements for joint use of shared rivers such as the Jordan and the Yarmuk. Many observers hoped that the treaty with Israel would help to alleviate these problems. Water-sharing arrangements in the Jordan and Yarmuk rivers, combined with sharing of ground water were intended to increase the short-run water resources of Jordan by 100 million cubic meters. It was also hoped that technology transfer and regional cooperation would increase resources still further over the long term.

None of these benefits has yet materialized. The combination of severe drought in the late 1990s and increasingly difficult Jordanian-Israeli relations as the Israeli-Palestinian peace talks stalled, and then collapsed, have undermined–but have not eliminated–regional cooperation. Although Israel reconsidered its initial 1999 decision not to give Jordan the 50 million cubic meters which Jordan believed it had been promised by the Treaty, the incident dramatized the difficulties of cooperation in the current regional political environment. Despite various clauses in the Treaty which call for joint water infrastructure projects, none have begun. Water problems remain a central worry for the regime, with no simple solution in sight.

Jordan is not a mineral-rich country. Although the country has substantial deposits of phosphates and potash, these products are subject to greater price fluctuations than industrial exports. Unlike its neighbors, Jordan is not a major oil producer. Modest quantities of crude oil were discovered in l983, but Amoco and Hunt oil withdrew from prospecting in the country in l989. Oil imports have continued to be a major drain on the economy and on foreign currency.

Jordan's principal resource is its people. The government has made substantial investments in human capital formation. Health conditions in the country are among the best in the region; government figures place Jordan's primary (over 95%) and secondary (65%) enrollment rates (http://www.kinghussein.gov.jo/resources3.html) at among the highest in the Arab world. Adult literacy today is one of the highest in the region: about 94% for men and 80% for women. Over the past ten years school enrollment rates have grown by nearly 4% a year.

Unfortunately, population growth threatens to undermine these achievements. Jordan's population was estimated at 3,453,000 in l990, prior to the influx of 200,000-300,000 expatriates who returned from Kuwait in the wake of the Iraqi invasion. The strategy of "exporting human capital" temporarily collapsed. The current 3% birth rate represents a decline from 3.6% a decade ago. The average number of children per mother (TFR) has declined from 7.4 in l976 to 5.2 in l992 to 4.5% in 2000. The population in 2000 was over 5 million. Most alarmingly, the labor force is projected to grow by nearly 5% per year over the next ten years.

Quality problems in the educational system raise expectations without providing skills which are truly competitive in international comparative perspective. The problem appears to be especially acute at the university level, where a combination of rising enrollments and declining expenditures have seriously jeopardized educational quality. The result is increasing pressure on government educational budgets, high unemployment among graduates, and mounting frustration. This situation poses a serious challenge to political stability, and is a problem in all countries of the region.

The Jordanian labor market combines relatively high levels of unemployment with labor imports. Unemployment among the unskilled is concentrated among relatively elderly illiterates. This is presumably because of the premium which unskilled labor markets place on physical strength. The other, more politically relevant dimension of *unemployment is that of graduates, at least one-fourth of whom do not have a job*. Unemployment rates in Jordan are a monotonically rising function of education.

Jordan has also been a labor *importer*. Foreign laborers, largely from Egypt and South Asia, fill jobs in the construction, agricultural and domestic help sectors that Jordanians have traditionally eschewed for cultural and low wage level reasons. Despite graduate unemployment, family support allows graduates to avoid the social stigma of less- skilled labor.

Jordan would have faced unemployment problems much earlier had the country not been able to rely in the l970s upon the out-migration of some one-third of its labor force, largely to the Arab oil states of the Gulf region. In l987 some 325,000 Jordanians were working abroad, while the domestic work force stood at 550,000. At that point, unemployment was officially reported to be 10 percent, although the official statistics likely represent under-reporting. Although the Gulf War temporarily closed employment in the oil states, today perhaps 300,000 Jordanians are again working outside of the country.

One possible medium to long term solution to the employment problem is the expansion of light industry and services. At present, Jordan's manufacturing sector tends to be organized in small-scale operations with small workforces. The regulatory and financial regime impede business expansion. The industrial sector contributed 25 % of GDP in l998 (up from 11.6% in l985). Together with mining it accounted for 11.4% of the workforce in l998.

The Jordanian economy is overwhelmingly a service economy, which accounts for two-thirds of GDP. Any sensible strategy for development must include services development. Some potential areas include Arabic language computer soft-ware and tourism. High hopes were placed on the possible positive impacts of the peace agreement with Israel. Although tourism boomed briefly, it collapsed in the wake of the violence in Israel and Palestine since September, 2000.

Jordan has long suffered from chronic trade imbalances. The l988 devaluations of the Jordanian dinar cut the trade deficit somewhat. The gap between imports and exports was $1.7 billion in l988; $1 billion in l989; $1.5 billion million in l990, and $1.4 billion in l99l. Despite further reform after the Gulf War, the trade gap rose to $2.4 billion in 1993, and stood at $2 billion in 2000. In the late 1990s, the gap between imports and exports was nearly 20% of GDP. Part of the trade imbalance derived from an excessive consumerism and consumption of foreign goods, many of them luxury items. However, the trade deficit is largely structural, deriving from the small manufacturing base, the paucity of natural resources, and the large net food importing requirement.

The consequence of prolonged trade imbalances was the accumulation of international indebtedness. From l984 to 1988 the proportion of public and publicly guaranteed foreign debt to GNP rose from 59.3% to 95.1%. The debt service ratio increased from 13.8 percent to 29.8 percent during the same period. The repayment burden eventually became unsustainable and the IMF was called in spring, l989. Jordanian debt before the peace treaty with Israel was at least $7 billion; Jordanian officials assert that the total debt was closer to $8.8 billion.[15] Debt has, at least, stabilized since 1994; the most recent estimates place the debt at $8.4 billion. The PVD/XGS ratio remained over 250% throughout the decade (260% in 1991; 228% in 2000). In Jordan, as elsewhere, such “debt overhang” discourages private investors.

Jordan has long relied on foreign aid for investment in both military hardware and

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15 Remarks by Dr. Jawad Al-Anani, Minister of State for Prime Ministerial Affairs, at The Washington Institute for Near East Policy, Washington, D.C., July 28, 1994.

infrastructure. In the l980s, lower liquidity levels among Gulf oil states led to a significant drop in aid to Jordan. Still, in 1989, Official Development Assistance (ODA) was some 6.3% of GNP, the highest in the region. While the Gulf states did promise assistance in the wake of the l989 economic riots, transfers ceased upon Jordan's refusal to support the anti-Iraq coalition in the l991 Gulf war. Such aid has not been resumed: in 1998, ODA was only 5.7% of GNP. Unlike Mubarak, King Hussein was unable to translate friendship with the West and signing a peace treaty with Israel into large scale debt reduction. However, the US Senate's passage of the US-Jordan Free Trade Agreement following the terrorist attack on the US on September 11, 2001 shows that the Kingdom can still garner some important strategic rents.

2. Economic Reform in Jordan.

Policy makers recognized the need for economic reform by the mid-l980s, but real progress did not begin until the economic crisis of l988-89. The original agreement reached between the government and the IMF called for a reduction of the budget deficit; a reform of the tax system; a tighter credit policy; a more prudent debt management and borrowing policy; a decrease in the rate of inflation; an improvement in the current account to a balanced position in l993; the building up of foreign currency reserves to cover three months' worth of imports.

The government was clearly committed to meeting the conditions of the agreement with the IMF. And, despite extensive parlementarians' railing against the agreement, at no point did any MP or group of MPs come forward with an alternative plan. When it came time to pass the l990 budget, there was no attempt by parliament to advocate increased spending as a way out of such problems as unemployment. In effect, the parliament gave endorsed the IMF package. The case illustrates the point that, in a crisis, the old guard are often disorganized, without a program, and unable to resist determined leadership (Waterbury, 1993).

Despite the government's good faith in its implementation of IMF conditionality, the Gulf crisis destroyed the original timetable of reforms. Thousands of refugees flooded into Jordan. The Kingdom's political position on the crisis further exacerbated the situation, since coalition states were disinclined to alleviate Jordan's refugee problem. The embargo against Iraq deeply hurt Jordan's commercial, industrial, and overland transport sectors. The blockade of the port of Aqaba led shippers to avoid using it even for other purposes. Jordan also lost its Kuwaiti and Saudi markets as well as Gulf state aid because of the Kingdom's failure to join the anti-Iraq coalition. The regional instability also cut into Jordan's increasingly important tourist trade. Assessments of the economic impact of the crisis on Jordan range from $1.7 to $5 billion.

The Gulf crisis also caused the budget deficit to exceed projections in 1991 by JD 121.7 million, reaching JD 216.7 million. As a result of these economic dislocations, Jordan put a moratorium on the payment of its rescheduled debts, a situation about which the IMF was reportedly very understanding. An IMF team arrived in Jordan in mid-September l991 to prepare a new letter of intent and a new agreement was announced in October l99l. Jordan largely fulfilled the terms of this obligation, and achieved the promising results in the early 1990s noted above.

Jordan's Memorandum of Understanding with the IMF of July 4, 2000 lays out the intent for the next phase of economic reform, adopted as a response to the deceleration of growth in the late 1990s. The program emphasizes privatization, tariff reduction and other policy changes necessary to meet WTO membership requirements (Jordan joined WTO in January, 2000). Although there are domestic difficulties with implementing some aspects of these reforms, the key difficulty, as so often in Jordan's history, is the negative impact of exogenous events: the stagnation and then collapse of Israeli-Palestinian peace talks, the Al-Aqsa Intifada, and the threat of regional war after September, 2001 have all undermined confidence and deterred foreign investment.

3. Crafting Credible Reforms.

In comparative regional perspective, Jordan has been relatively successful in adopting economic reform policies. There are three keys to this relative success:

- Good leadership,
- Support by a critical constituency of businessmen;
- Extensive "use of others", like the I.M.F. and World Bank.

Barriers to reform include significant internal and external political risks. The external problems have already been discussed. Domestically, the main problem has not been the oft-cited one of fear of social unrest in the wake of subsidy cuts. The government did, of course, face riots in Ma'an and elsewhere in the late 1980s as it took the first reform steps. But such disturbances did not greatly slow the pace of reform.

Much more importantly, privatization faces a critical political difficulty: "downsizing" the state implies that the regime's core constituency, "Trans-Jordanians" (i.e., non-Palestinians), will disproportionately lose: the Trans-Jordanians are over-represented among state functionaries,while Palestinians dominate the private sector. Members of the key tribes, e.g., the Majali, Bani Hassan, Bani Sakhr, Bani Hameideh, and the Adwan, are threatened not only by possible "down-sizing" of the government, but also by the (presumed) competition from Israeli and, especially, West Bank entrepreneurs in the wake of the peace agreement. Former Prime Minister Rawabdeh stressed this point in his opposition to privatization (IISS, 2001). His replacement may, or may not, lead to an acceleration of privatization, which, in turn may, or may not, be politically destabilizing.

Leadership, as usual, matters greatly. Until his death in February, 1999, implementing reform provided yet another example of the legendary political agility of King Hussein. As a small, militarily weak country in a rough neighborhood, foreign policy dominates domestic policy. Indeed, in Jordan, foreign policy *is also* domestic policy. Unfortunately, if you use one instrument to aim at two targets, you are likely to miss often. The principal political barrier to sustainable growth in Jordan is regional instability. A weakness of his leadership from an economic point of view was the "churning" of top personnel; there is relatively low continuity at the relevant Cabinet positions, or at the Prime Minister's level. In contrast with Morocco, a stable "change-team" seems absent from the Jordanian scene. This practice has continued under Abdullah, who replaced his first appointed Prime Minister, Abdul Raouf al Rawabdeh, with Ali Abu al-Ragheb in June 2000.

The regime is strongly supported by the upper tier of merchants, industrialists, agribusinessmen, and wealthy farmers--the Jordanian bourgeoisie. These "King's men", drawn from both Palestinian and Transjordanian communities, have strong ties to the regime and to some extent have submerged their ethnic identity into a sense of being "Jordanians." Their views must be considered by top decision makers; they are critical allies of the King on issues ranging from the Islamists to the Peace Process. Any policy which threatens their interests would be difficult to sustain.

In addition to regional fears, (at least) three problems impede improving the climate for private business. First, there is the problem of debt overhang. Obtaining debt relief may be a necessary condition for the success of the new strategy. Although the govenment has lobbied strenuously for this, so far they have not had great success. Instead, part of the U.S. “payoff” for Jordan’s signing the 1994 treaty was the drafting of a Free Trade Agreement with Jordan. Second, private sector activity in Jordan has historically often relied on state contracts. The symbiosis of state and private business is extensive–unsurprisingly, given the small size of the country and its elite. The business elite also usually hold multiple assets and diversified asset portfolios. They are usually not unambiguous "winners" or "losers" from reform. Their support of reform typically comes from 1) their (often intense) loyalty to the King, who has protected them for decades, and 2) a general preference for markets rather than controls.

It may be that a combination of the need to placate this key constituency, plus the fact that many key businessmen benefit as rent-seekers from current arrangements explains the sluggish reform of the regulatory regime in Jordan. Despite the presence of free zones and industrial estates, Jordan has attracted very little FDI, while Jordanians hold over $6 billion off-shore.

Abdullah has done reasonably well managing the treacherous foreign and domestic politics of the Kingdom. But maintaining the fragile balance between East Bankers and Palestinians, Islamists and regime supporters, in such an unstable and lethal regional environment is inherently deeply problematic. That Jordan has done as well as it has, despite repeated negative external shocks, is a testament to the skill of its leadership and to the soundness of its policy mix. But the fact remains that youth unemployment, and its discontents, have not been substantially reduced after ten years of reform efforts: unemployment stands at 25 to 30%, and 30% of the population lives below the national poverty line. Jordan shows the limits of even strong reform efforts in the face of the "youth bulge" and the unstable regional political environment.

C. **Iran**

Iran has a state-centered, stagflationary economy. Per capita incomes declined precipitously during the 1980s, and more gradually from 1993 to 1997. Only during the past half decade has the rate of economic growth exceeded that of the population. The economy is plagued by wide-spread unemployment, chronic budgetary deficits and inflation, declining living standards, and widespread poverty.

Iranian economic decline was particularly marked during the 1980s. Income per capita in 1992 was estimated to be some 38% below what it was at the time of the revolution (1979). Two factors explain this miserable performance. First, the growth of output sharply decelerated, thanks to declining oil prices, the stress of the war with Iraq, and economic mismanagement. Second, the rate of population growth rose: the rate of natural increase d from 2.9% between 1966/67-1976/77 to 3.9%, 1976/77-1986/87. The total fertility rate soared to 6.2. Consequently, population grew from about 40 million in 1980 to perhaps 55 million in 1990.

Although economic growth failed to revive during the late 1980s/early 1990s, the rate of population growth plunged. Indeed, the fall in fertility in Iran may have been the fastest such decrease ever recorded (Bulatao and Richardson, 1994). Today the TFR in Iran is approximately at replacement level (2.0-CIA, 2001). The population growth rate has plummeted from 3.3% (1980-1990), to 1.6% (1990-99), to an estimated 0.72% in 2001.[16]

The important consequences of this demographic picture are: 1) the large majority of Iranians are young: 50% are younger than 18, and roughly 2/3 are younger than 30; 2) there is a "labor force bulge" of young people born in the 1980s who have begun entering the labor market, and 3) thanks to the rapid deceleration of population growth in the 1990s, labor force additions will not remain as high for as long as they will elsewhere in the region (although increasing female labor force participation could change this). However, today between 720,000 and 850,000 new workers enter the labor force every year.

Employment creation has not come close to keeping pace. Unemployment rose from 10% in the early 198os to 25% today[17]. Over 2/3 of all new jobs created since the revolution have been in the public sector. More than 80% of all college graduates in the country work for the

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[16]First two figures: World Bank; second figure: CIA.

[17]As usual, estimates of unemployment vary widely: from 14% to 25%.

state. Iran displays all the usual regional symptoms of high and rising unemployment of semi-educated young people. Some analysts believe that over half of the Iranian population live in poverty (CIA, 2001). A GDP growth rate of 6.7% per year is necessary to provide jobs to new labor-force entrants–that is, just to keep the already high level of unemployment from rising; the economy has not yet remotely approached such an achievement.

These failures need to be weighed against the apparent increase in consumption per capita of various foodstuffs in urban areas, the apparent narrowing or rural-urban income gaps, increases in enrollment ratios, increases in male (and especially, female) literacy, the decline in fertility, and reductions in infant and child mortality. Several points are in order here. The only way to explain the combination of falling incomes per capita and increasing consumption of food is to posit an increase in the equality of income distribution, in which a higher share went to people with a higher marginal propensity to consume food. Consumption of food, water, and energy is very generously subsidized, consuming some 15-20% of GDP (Amouzegar, 1999). A plausible characterization of Iran under the mullahs is "shared poverty".

As Dr. Amouzegar and others point out, however, other evidence contradicts the picture of rising equality. (Amouzegar, 1993; Kanovsky, 1997) Perhaps the consumption figures have been doctored for political purposes, or perhaps national income accounts are faulty because much of Iranian national income is produced in the underground economy (some 40%; Amouzegar, 1999). During the past decade, income gaps have been widened, for three reasons: 1) the emergence of crony capitalism, thanks to the half-hearted and ill-conceived "reforms" under Rafsanjani, 2) a vast, hugely expensive subsidy system (some 15-20% of GDP), 87% of which accrue to the (relatively richer) cities, and 3) a system of multiple exchange rates, which offers great scope for corruption. (Amouzegar, 1999).

Both the revolution itself and the Iran-Iraq war greatly stimulated the centralization of economic decision making and led to the creation of statist, command-economy style allocation mechanisms. The government implemented price controls, rationing of consumer goods, a deliberately over-valued exchange rate, strict quantitative regulation of imports, and tight controls over banking. The government also constructed the familiar regulatory maze for private investors, who needed to obtain numerous permits. Nationalization was written into the Constitution, as were far-reaching subsidy/welfare measures.

Some 580 companies were nationalized in the wake of the revolution,. These were all medium to large scale enterprises. Like most developing countries, Iran displays marked industrial dualism, in which a large number of very small firms co-exist with a much smaller number of medium and large scale enterprises. This division also coincides with a "private-public" split. All large industries, and the large majority of medium-scale enterprises, are run by the public institutions–particularly the *bonyad*, of "foundations", which were set up during the revolution. These entities own some 20% of the country's assets, and contribute 10% of GDP (Khajehpour, 2000); they are strong-holds of the most conservative elements of the clergy. The largest of these, *Bonyad Mostazafan* (“Foundation of the Oppressed”), owns some 400 companies, distributed in most industries, and tolerates no competition. This entirely unaccountable institution owns perhaps 25% of the non-oil economy. The public industrial sector suffers from mismanagement and overstaffing; it incurrred losses in fiscal 1997 and 1998 of some $15.6 billion (Amouzegar, 1999).

Unsurprisingly, performance has been poor. Manufacturing output stagnated during the 1980s (actually declining at a rate of 0.1% per year). Some industries fared far worse than this: automobile production in 1992 was only 15% of the pre-1979 level. Growth revived during the 1989-92 period, when the manufacturing sector grew at double-digit rates. However, much of this growth was capital-intensive, and absorbed less than 10% of the new entrants to the labor force during this period. More recently, industrial growth has improved somewhat, and is estimated at 4.4% (CIA, 2001). The policy mix (labor laws, overvalued exchange rates, subsidized credit) increases industrial capital-intensity–and reduces the employment elasticity of growth.

This poor performance has two sources: the revolution itself and the usual problems of statist, inward oriented policies. The revolution and ensueing war may be blamed for political interference (particularly by the *komitehs*), labor strikes, exodus of managerial skills, and electrical power shortages. Inward-oriented policies such as tariffs and a grossly overvalued exchange rate insulated firms from competition, permitting inefficiency to flourish and creating a vested interest in the continuation of these policies. It is easy to understand why one of the corner-stones of both Rafsanjani's and Khatami’s reform policies has been privatization. As we shall see, however, progress here has been minimal, despite a decade of rhetoric.

Agriculture performed rather better. Agricultural output increased by 54% from 1980 to 1990. Growth in the early 1990s was also strong (4.9% 1991-95-FAO). However, most of this growth was the result of expansion in acreage, not increases in yields. Fertilizer consumption rose by 1/3, and the number of tractors roughly tripled: such a pattern of technological change is roughly compatible with increases in land areas dominating increases in crop yields as sources of growth.

For the past three years, Iranian agriculture and rural society have been devastated by the worst drought in a generation. More than half of the population have been affected, and rural to urban migration has accelerated. The Southeast of the country (Sistan-Baluchistan) is the hardest hit, but all 28 provinces have felt the effects of drought. The government estimates that 12.4 million acres of farmland have been ruined. In 1999 agricultural output fell by 6%. The drought’s impact on both rural and urban areas has been exacerbated by serious mismanagement of water resources. Drinking water is rationed in more than 30 cities, while no one, either in farms or cities, has any incentive to use water efficiently. Reform of water resources management poses yet another pressing challenge to Iranian policy makers.

Agricultural growth before the drought was partly due to the Pahlevi inheritance, especially in large multi-purpose dams and primary irrigation channels, and partly due to the government's own policies. The government offered very generous subsidies to cereal producers; wheat producers received subsidies equal to 80% of the cost of production; the government purchased 85% of the crop.

These policies had two goals: to pump oil money into rural areas, and to achieve food self-sufficiency. The first seems to have been achieved. Although larger farmers received the lion's share of the benefits (as in the U.S.), smaller farmers also benefitted. The second goal was not attained, however. Demand outstripped domestic supply, and imports continued to supply about 25% of consumption.

There have been the usual negative consequences of the distortions in relative prices which such self-sufficiency drives always entail. The creation of a government monopoly in grain trading reduced efficiency. Very heavily subsidized cereal prices encouraged the plowing up of marginal land which had been used for livestock grazing. This not only reduced livestock productivity, but also contributed to soil erosion, which, in turn, has accelerated the silting up of reservoirs and undermined some traditional farming systems for managing rangelands. The policy mix also encouraged over-pumping of ground water, damaging aquifers. The folly of neglecting agriculture under the Pahlevis has been replaced by the stupidities of unsustainable subsidization and relative price distortion under the mullahs. Meanwhile, the decline in public agricultural investment to one-third of its earlier level has created substantial backlogs for rehabilitation and maintenance of existing structures.

Part of the reason that the regime failed to achieve self-sufficiency was the gross mismanagement of the exchange rate. As the relative price of traded to non-traded goods, the exchange rate affects the relative price of every single good and service in the economy. The government’s management of the Rial was very poor until quite recently. Until 1989/90 the exchange regime was tightly controlled and very complex, with some 12 different exchange rates. Although reform in 1991 simplified the system (to three rates) and reduced controls, in 1993 the free market price of foreign exchange was *twenty times higher* than the official rate (in 1982 it was twice as high). This gap has since been reduced (as the Central Bank closely watched the illegal curb rate and tried to adjust its policy accordingly), particularly during 1999/2000. One of the rates was abolished, and the gap last year between the TSE (“Teheran Stock Exchange” rate) and the market rate fell from 40% to 2% (IMF, 2000). This favorable development was virtually entirely due to the impact of increased oil prices on the budget; structural weaknesses have remained largely untouched.

In general, the Islamists in Iran increased the centralization of the economy, redistributed income toward the poor and the rural areas, instituted unsustainable welfare and agricultural policies, and mismanaged the macroeconomy. Above all, they have failed to meet the challenge of job creation. Private investment has not been enticed into job-creating production of labor-intensive goods and services. Private economic agents continue to view the regime's commitment to a market economy with considerable, and well-justified, skepticism. Today, after over a decade of lip-service to reform, the economy remains sclerotic.

Several interlinked forces account for the stasis of Iranian economic policy. The Islamic Republic of Iran has always rested on a coalition of groups with disparate economic interests. The coalition included populist, un- or under-employed youth and students, urban *lumpens*, conservative *bazaaris*, *mullahs*, and segments of the professional middle class. At the time of the revolution, the opposition to the Shah seems to have been as widespread as Polish opposition to Communist rule. Like Solidarity, the initial coalition led by Khomeini was a very large tent, indeed. Over time, it seems to have narrowed, but the regime still rests on an uneasy alliance of two very different sets of interests: populist lower and lower middle classes, and prosperous mullahs and those with whom they do business.

More specifically, a leading student of the regime's political economy discerns two main groups of political actors: "Radicals", a grouping of "economically dependent radical *mullahs* (of mainly poor, provincial origin) and,...left-wing elements infiltrating the high ranks of the bureaucracy" on the one hand, and "conservatives", with "strong financial and blood ties to the *bazaar* (who) have tended to represent the interests of landlords and the urban bourgeoisie", on the other (Amouzegar, 1993, p. 32). Dr. Amouzegar discerns a third group, the "pragmatists", which arose after Khomeini's death, who "also have close affiliations with the wealthy, but...have mainly *managed* and handled national wealth rather than *owned* it" (p. 32). This last group is the core of support for "reform mongering".

The interests of each of the regime's two core supporters are institutionalized in the system of subsidies and welfare (for the popular classes) and in the *bonyad* (for the richer mullahs), who are often joined by are often joined by wealthy bazaaris, who enjoy monopoly power as holders of quotas and licenses. These two inter-linked, powerful groups are classic "rent-seekers", who obstruct change.

Change has also been impeded by the structure of political institutions. Article 44 of the Iranian constitution reads "The economy of the Islamic Republic of Iran is to consist of three sectors: state, co-operative and private, and is to be based systemactic and sound planning. The state sector is to include all large–scale and mother (sic) industries..." (Khajehpour, 2000). The weakness of both the President and the Majlis further impedes reform. In essence, any act of the Majlis or decree of the President can be overturned by the Supreme Guide, Ayatollah Khamenei. Further, the *bonyad* are explicitly excluded from the purview of the Majlis. Finally, the composition of the Majlis has impeded change. Consider this recent incident:

> the Guardian Council, which vets parliamentary legislation, rejected most privatizations under Khatami's five-year development plan as unconstitutional. Earlier, parliament had blocked key market-oriented elements in the plan on the grounds that the poor would suffer. Among the setbacks to the planned privatizations were votes to maintain government control on banks and

> insurance companies, allowing limited room for private activities in these sectors. The new moves also undermine government efforts to end the state's monopoly on airlines, the railways and other transport systems as well as telecommunications, water and power. (Reuters, March 6, 2000)

Khatami has not provided strong leadership on economic reform. This is partly because of his background and interests (he knows essentially nothing about economics), and partly because his main political program is social and political. Khatami seeks, above all, to strengthen Iranian civil society, to improve its relations with the outside world, to liberalize the political system, and to expand the scope of personal choice for ordinary Iranians. Given the strength of the vested interests which oppose this program–and his weak hand, thanks to the Constitutional power of the Supreme Guide–he has not focused strongly on economic policy. Further, his coalition for a freer and stronger Iranian civil society includes many who hold traditional socialist views on the economy.

On the other hand, two final considerations may be noted. First, Khatemi's program for enhanced rule of law is an essential prerequisite to a reform program which would produce a sustainable growth in living standards. Privatization of the *bonyad* in the current institutional environment would almost certainly simply change the specific form of the "crony capitalism", rather than stimulate any real gains in productivity. Unaccountable and corrupt private monopolies would simply replace the current unaccountable and corrupt monopolies of the semi-public *bonyad.* Second, the pressure to reform the economy is becoming steadily stronger (although increase in oil prices since 1999 has bought some time). The regime is acutely aware that the disaffection of the young continues to grow.

Nevertheless, the configuration of interests, the institutional structure, and the nature of leadership suggest that reform will continue to be desultory. One consolation for American policy makers is that, by contrast with all of the other countries analyzed here, such failures will certainly not redound to the benefit of religious fanatics. Indeed, the failures will probably simply increase the already palpable contempt with which the mullahs are held by large numbers of youth (Rouleau, 2001).

D. Saudi Arabia

1. The Uniqueness of Saudi Arabia

The Kingdom of Saudi Arabia faces many of the same problems as other countries of the region. It has a large, bloated bureaucracy and public sector, a very high rate of population growth and a consequently young population, a high rate of youth unemployment, serious water shortages, and periodic budgetary difficulties. It has also embraced various aspects of "economic reform", such as macroeconomic austerity, subsidy cuts, and privatization plans. As a classic "mono-crop" exporter, the Kingdom also seeks to diversify its economy. In all of this, the Kingdom is very similar to many other developing countries.

At the same time, of course, Saudi Arabia is radically different from the other states considered in this paper. Any state is unique, but, to paraphrase George Orwell, some states are more unique than others. Two factors place the Kingdom in a "category of one": *the oil economy* and the *structures of governance*. The Kingdom has roughly one-fourth of the oil reserves on the planet. Not only is its production capacity of roughly 10.5 million barrels a day one of the highest in the world, but also it can vary its production from 10 to 3 million barrels a day. This high but variable production capacity gives Saudi Arabia great influence within OPEC and in the world oil market. Given the highly inelastic demand function for oil in the short-run, the Kingdom enjoys some market power over *short-run* oil prices. Saudi Arabia therefore has some ability to change the government's revenues—in the short run. Oil exports dominate the economy, accounting for 90-95% of Saudi export earnings, 75% of the budget, and about 35-40% of GDP (U.S. Embassy, Riyadh, 2001).

Several consequences follow from these simple facts of oil. The Kingdom's revenues depend upon the fortunes of the oil market, and although the government enjoys a degree of market power over these prices, such market power is limited by both demand and supply side forces. On the demand side, the Saudis learned to their cost the consequences of "overshooting" what for them would be a "desirable " oil price in the early 1980s, when high prices stimulated considerable conservation measures. The demand for oil is a derived demand; like any derived demand, final demand is therefore mediated by technology. (For any final demand for, say, transportation miles, the resulting demand for oil depends on the energy-efficiency of, say, automobiles). High prices also induce technological change on the supply side, particularly in exploration and extraction. Saudi oil market power, although real, is limited.

Further, long-run trends on both the demand and the supply sides imply a steady deterioration of both Saudi market power and of the reliability of oil revenues for the Kingdom over the long run. Very large gains in automobile engine efficiency by using fuel cells and other technologies are no longer pipe-dreams. Japanese firms are already marketing so-called hybrid cars, which get 48-60 miles per gallon. Many analysts expect that much greater advances will be seen within the decade. Similar savings from efficiency are expected in other areas. One need not agree with all of former Oil Minister Shaykh Zaki Yamani's forecast[18] to understand why the Kingdom of Saudi Arabia is concerned to diversify its economy.

Accomplishing such diversification is, of course, very difficult. It is impeded by the structure of the labor force, by work habits, and by the structures of governance. The forms of

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[18] "On the supply side it is easy to find oil and produce it. And on the demand side there are so many new technologies. The hybrid engines will cut gasoline consumption by something like 30 percent…Thirty years from now, there is no problem with oil. Oil will be left in the ground. The Stone Age came to an end not because we had a lack of stones, and the Oil Age will come to an end not because we have a lack of oil"
CBS News, June 25, 2000. http://cbsnews.com/now/story/0%2C1597%2C209367-412%2C00.shtml

governance are the second feature which sets the Kingdom apart from all other states. Although there are different perspectives on the Kingdom's political economy, one persuasive "optic" is that of "Islamic familialism"[19] The Kingdom is governed by the House of Saud, which has an estimated 6,000 to 10,000 princes. (Champion, 1999). The royal family is allied by marriage to virtually every significant familial (sometimes called "tribal") grouping in the country. The resulting webs of relations are complex and often opaque to outsiders. Fandy persuasively argues that such linkages imply that royal family is both inside of the state, and outside of it, located in the middle of a (familial-based) civil society. The dense network of personal and marriage ties are important for patronage and support, as well as for other, more symbolic modes of mutual influence.

Crucually, all of this is tied together by loyalty to Wahhabi Islam. Although, of course, there are significant numbers of Shi'a in the oil-rich Eastern Province, one of the fundamental structures of rule of the Kingdom is the alliance of the House of Saud with *'ulama'* of the Wahhabi school of Hanbali jurisprudence. The enormous prestige afforded by the Saudi role as "Protector of the Two Holy Places" (Mecca and Medina) is both used and defended by the ruling elite; it also forms the basis of challenges from opposition elements. The regime will go to great lengths to protect its reputation as an Islamic state. Any policy decision must be defensible in Wahhabi Islamic terms.

A second useful view of the Saudi political economy is provided by the "rentier state" perspective (e.g., Chaudhry, 1997; Krimly, 1993). Oil revenues are largely economic rent, and the production process is both state-owned and highly capital-intensive. Consequently, state revenues are largely independent of local people, whether as producers or tax-payers. Such rents free the state from some (but certainly not all) of the domestic pressures which confront less geologically fortunate states. The presence of rents thus allows the state to deflect pressures for more accountable governance. The logic continues that when rents decline, the state faces greater pressure to reform.

2. The Development of a State-Centered Political Economy

With some 65% of GDP in the hands of the state, the Saudi government dominates the formal economy. State economic prominence was an important consequence of the oil boom of the 1970s and early 1980s. The civil service grew from from 13,000 in 1962 to 232,000 in 1981, to whom we should add another 81,000 part-time or nonclassified employees (Ayoubi 1985). Saudi Arabia established a giant public-enterprise sector, with over forty corporations in housing, storage, agriculture and the Saudi Basic Industries Corporation (SABIC). In the plan period 1976--1980 alone, Saudi Arabia disbursed $290 billion, which went into infrastructure, port development, and new industrial cities at Jubail and Yanbu. The 1980--1985 development

[19] This concept is developed in detail, and used persuasively to analyze opposition movements in the Kingdom by Fandy (1999).

plan, although less spectacularly funded, was designed to put Saudi Arabia on an industrial footing. Then-Oil Minister, Ahmad Zaki Yamani, prophesied that Saudi Arabia would soon rank alongside Argentina, Brazil, and South Korea as a semi-industrialized country (*Middle East*, March 1984, pp. 25--27). The airline, the telecommunications system, and many other infrastructures are all managed and owned by the public sector.

The government also implemented sweeping welfare policies. As usual, these were designed to bolster regime legitimacy and to distribute the oil wealth among the various, complicated familial networks. Also as usual, such subsidies induced serious distortions in the economy, and created grave difficulties for future development. Consider farm subsidies. Saudi Arabia paid farmers from five to six times the international price of wheat during the early 1980s, while simultaneously subsidizing inputs; the effective rate of protection (the combined impact of protected output prices and subsidized inputs) may have reached 1500% in the late 1980s. (Wilson and Graham, 1994). Saudi government loans to farmers rose from under $5 million in 1971 to over $1 billion in 1983; from 1980 to 1985 the Saudi government spent some $20 billion on agriculture, mostly in the form of subsidies (*Economist*, April 6, 1985, pp. 80-83). The results were spectacular for the key food-security crop: at an estimated cost of $2.12 billion in subsidies, the Kingdom became the world's sixth largest wheat exporter. Production rose by over 700% from 1971 to 1983, entirely replacing imports and actually creating a small export surplus.

Critically, nearly 90% (13.3 of 15.3 cubic kilometers) of agricultural water was deep aquifer fossil water. At the 1990 rate of abstraction, usable reserves were estimated to last for a maximum of 25 to 30 years. Fortunately, budgetary concerns greatly reduced these subsidies during the "fiscal crunch" of the early 1990s. From 1992 to 1995 subsidies to wheat produces fell more than half ($850 million, down from $1.87 billion in 1993). However, with more than 45,000 private and nearly 5000 multi-use public wells, farmers seem to have simply shifted away from wheat into fruits and vegetables. Although the efficiency of water use has increased as a consequence, groundwater depletion, stimulated by "food security" fears, continues (FAO, 1997).

3. Pressures for Reform

Pressures for reform first emerged in the late 1980s, and have continued to be strong down to the present. Fundamentally, a rapidly growing population, a stagnant economy, and burgeoning public deficits have generated the impetus for policy change. At the peak of oil prices in the early 1980s, the population of the Kingdom was slightly over 10 million. Today it stands at nearly 23 million, and will rise to at least 30 million by the end of this decade. In 1986 per capital GNP stood at some $16,500. Today is about $6000. The sluggish growth of the economy, far below the rate of population growth (3.4%, 1990-99), has also been quite incapable of providing jobs for the rapidly growing numbers of Saudi youth. Some 100,000 young Saudis enter the labor market each year. Only half of them find jobs in either the public or private sectors (US Embassy, Riyadh, 2001). Unemployment is high (see Table 1). This problem will remain pressing for decades: thanks, perhaps, to cultural norms and to the relatively difficulty of women finding employment outside of the home (Saudi women constitute only 6% of the national labor force), the average Saudi woman will have between 6 and 7 children during her lifetime (TFR = 6.4). Over 50% of the population is under 18. The labor force will, therefore, continue to grow rapidly in the coming decades. Providing jobs for these young people provides an urgent spur to economic policy change.

During the oil boom, the government had provided most of the jobs. However, this has long since ceased to be possible, and for several years there has been a ban on new civil service jobs. Since 75% of government revenue comes from oil sales, the low prices of the past 15 years have tightly constrained government action. The government first began running deficits in 1984; two years later, they had reached 20% of GDP, a clearly unsustainable level. Austerity has since reduced deficits to more macroeconomically manageable levels, but deficits persist (See Table 2). Such deficits, in the face of the rising “youth bulge”, constitute another pressing goad for economic reform. It is widely understood throughout the Kingdom that only a thriving, rapidly growing private sector can provide the necessary jobs. The government hopes that policy changes will facilitate such a process.

Table 2: Budgetary Deficit as % of GDP:

1996	-3.7%
1997	–2.9%
1998	–9.5%
1999	–6.5%
2000	+7.5%
2001	0.0 (estimate)

Source: US Embassy, Riyadh.
http://usembassy.state.gov/riyadh/wwwhet01.html

The budgetary deficit has led to the accumulation of substantial government indebtedness. At the end of 1999, public sector debt exceeded 120% of GDP, central government debt was some 115% of GDP, and parastatal losses were about 5% of GDP.[20] Such debt is mainly financed by two large pension funds, funds which now have much cash, thanks to the low number of retirees relative to workers. However, growing interest payments on the debt are crowding out other expenditures. In common with most governments, austerity has hit capital budgets far harder than recurrent expenditures. In consequence, the construction industry has been depressed for years, and the aging infrastructure is not being up-dated and replaced.

[20] The government also has a foreign debt of some $26.3 billion; however, this is only about 33%of exports—unlike some of the other countries reviewed in this paper, the Kingdom has no “debt overhang” problem.

The government officially denies the existence of unemployment. The government argues that since there are some 5 million foreign workers in the Kingdom, and since Saudis could—allegedly—fill those places, unemployment does not exist. At best, this is a semantic quibble; more likely, it is simply wrong. Many, perhaps most, of the jobs now occupied by foreigners would not or could not be filled by Saudis—at least, not yet. At the low end of the job market, and as in advanced industrial countries, throughout the Gulf foreign workers do the hard, difficult, and dirty jobs which nationals disdain. Saudis are no more likely to sweep streets in Riyadh and Jeddah than native-born Californians are to do so in San Francisco or Los Angeles. This is highly unlikely to change. It is not necessary to posit a "mudir syndrome"[21], although such a phenomenon may well exist. It is simply that, as the MIT labor economist Michael J. Piore (1979) persuasively argued, jobs provide not only a wage and salary, but also an identity and a social status. At the higher end of the market, many Saudis continue to lack sufficient skills to replace foreigners. This may well change, indeed, it is now changing—but the process of transition will not be swift.

The difficulties here may be seen in the performance of the Saudi government's "Saudi-ization" of the work force. The government has promulgated decrees enjoining private businesses to increase the percentage of Saudis on their payroll by 5% per year. This target has not been met, and has met considerable resistance from employers, both foreign and local, who object that they cannot find Saudis with suitable training. Privately, they also complain that few Saudis have the kind of work ethic which they wish to see in their employees. There is evidence that the pressure of unemployment has, over time, been a force for change. Saudis are now found in positions such as receptionists, kitchens, and hotel staff. But as one employer said, "Immigrants cost less, do as they are told, arive on time and are prepared to work six days a week". (Gresh, 2000). Social mores and habits may change, but they do so slowly. Such mores, then, constitute one barrier to successful reform.

4. Further obstacles to the reform process

Apart from relatively successful programs of macroeconomic stabilization, Saudi reform efforts to date have concentrated on four areas:

1) opening local capital markets to foreign participation,
2) revising laws affecting foreign investment,
3) privatization, and
4) Saudi accession to WTO.

[21] The phrase is due to Champion (1999). "Mudir" means "director" in Arabic; the idea is that Saudis want to be managers, brokers, or bosses, not workers.

Each faces a variety of difficulties and obstacles. Since the banking sector is widely considered the strongest element of the private sector, the first and second components of reform may have some promise. However, there are serious obstacles both to reform itself and to the impact which reforms in this area may have on the wider difficulties facing the political economy. The government has promulgated new rules which permit foreign ownership of mutual funds, a move which has improved banks' profitability. The government has yet to follow up such changes with permission for foreigners to invest in the Saudi stock exchange. The Saudi market, with a capitalization of some $60 billion, is the largest in the region. However, only 76 firms are traded, and the ratio of capitalization to GDP is lower than that in some other neighboring countries (e.g., Egypt). Although "Washington Consensus" advocates claim that further liberalization of the stock market will boost growth (e.g., U.S. Embassy, Riyadh, 2001), there is little reason to suppose that Saudi firms will discontinue their "German-style" of finance, getting most of their capital from re-invested profits and from banks to which they may be closely linked by familial ties.

In common with other countries of the region, there has been much rhetoric about privatization. As elsewhere, the gap between talk and action is wide. Large state monopolies (ARAMCO, SABIC, STC, SEC, etc.) dominate the economy. The American embassy reports that the privatization effort to date "has been largely limited to allowing private firms to take on certain service functions…which complement the work of still dominant state agencies" (2001). But so far, "there has not been a single sale of existing assets, with a transfer of management control, in any state corporation". Last year the Kingdom explored the idea of privatizing some shares of the Saudi Telephone Company. After much talk, and various missions, the government shelved the plan.

The government has been equally slow to change the rules governing foreign private investment, or to alter the rules of business behavior more generally. The usual maze of controls prevails, and the private sector is heavily dependent on the state for access, information, and capital. Estimates of off-shore funds held by Saudis range from $300 billion (Seznec, 2001) to $600-700 billion (US Embassy, Riyadh). Some of these funds are no doubt held abroad as part of a perfectly sensible diversification and risk-diffusion investment strategy by very wealthy agents. But some of it stays abroad because of the lack of profitable investment opportunities at home.

There may be sound political reasons why the government resists the urging of American and World Bank/IMF economists on privatization and deregulation. Fundamentally, such changes, unless carried out very carefully and gradually, could easily be politically destabilizing. There are echoes of each of the earlier case studies here. As in Egypt, the government does not want to launch any sudden changes which might add to existing unemployment. As in Jordan, the government has used the state sector as a political balancing mechanism. Some (e.g., Seznec) argue that King Fahd deliberately split the government between the royal family, which controls the ministries of interior and defense, and the non-royal civil service, which controls the ministries of finance and petroleum. Such a move, he argues, helps to restrict the power of the princes, whose behavior is often perceived to be un-Islamic, greedy, and, therefore, destabilizing. In this view, the civil service sees itself as defending non-royal Saudis. Open privatization would permit the many hugely wealthy princes to re-enter areas where they now have relatively little influence. In short, privatization could easily lead to a kind of "crony capitalism", in this case, led by wealthy princes. Given the under-current of Islamist opposition to the regime, it may be unsurprising that the government moves very slowly in this arena. And as in Iran, an entrenched phalanx of vested interests blocks reform. Not only would serious reform weaken the civil service; it would also require substantially reducing the vast subsidies and perquisites extended to the Princes.

Finally, Saudi accession to WTO carries peril as well as promise. Embracing globalization is, to say the least, politically tricky, given the political structure of Islamic familialism. The fundamental difficulty is simple: the rules of the WTO clash with the Wahhabi interpretation of *shari'ah* at many points. In Saudi Arabia, as elsewhere, regime opponents warn of a "cultural invasion". WTO accession is likely to strain the House of Saud-Wahhabi 'ulema' alliance. American trade negotiators too often provide handy propaganda for local Islamists. Demanding that Saudi Arabia open cinemas, for example, is a classic case of US domestic lobbies pushing their own interests, to the detriment of US national security. The US embassy asserts that accession to the WTO will "result in an open, transparent, and rules-based trade regime". This seems dubious; it seems far more likely that Saudi Arabia will continue to move very slowly and gradually, walking the razor's edge between economic stagnation and culturally and politically destabilizing reform. The House of Saud has done this with great skill for several generations. Whether it can continue to do so in the face of unprecedented pressures such as the youth bulge and globalization, remains to be seen.

E. Syria

1. A Classic Case of Dilatory Reform

Syria suffers from the many of the same economic difficulties as other states in the region. It has a burgeoning population, a very rapidly growing labor force, and a large external debt. The sprawling, sclerotic Soviet-style state-dominated economy fails to provide jobs and to attract investment. Exports are dominated by oil, whose price also affects the country via its impact on neighboring countries, which both employ Syrian expatriate workers and contribute substantial foreign aid to Syria. The country's agriculture remains heavily dependent upon highly-variable rainfall, which subjects the economy and society to periodic violent negative shocks by drought. Syria is plagued by the usual environmental problems: unsustainable extraction of ground-water, pollution of aquifers and rivers, increasingly severe urban water shortages, and desertification. In many ways, Syria's problems are typical of those of most countries in the region.

Syria's claim to uniqueness, however, is that it may have done the least to reform its economy of all the countries considered here. Syrian reforms have never involved any significant involvement from either the I.M.F. or the World Bank. Syrian reforms have been almost entirely "home grown"—and have been marginal, at best. The explanations for the absence of reform are far from unique, however. The *strength of entrenched interests* and the regime's power base have combined with the *presence of substantial rents* to retard the pace of reform. Syria provides a classic case of dilatory reform.

However, like many other countries in the region, the pressures for more substantial change remain strong, and may be gathering force. Although strong vested interests remain unchallenged, rents, particularly oil rents, have proved weaker during the late 1990s than in the first half of the decade. Some additional pressure for reform may therefore be expected, in much the same pattern as occurred during the late 1980s (see below). If oil prices remain steady, and if, as expected, they decline over the next decade, then Syria, whose reserves of oil are already dwindling, may face more serious pressure to reform.

Predicting oil prices is, of course, an extremely tricky business. This is much less true for predicting future job needs for the Syrian economy. Some 200,000 young Syrians enter the labor force every year. The labor force is growing by 4% per year—fully five times faster than the labor force of the US, and ten times faster than the labor force of the EU. This growth will not decelerate for at least a decade. It is estimated that the country will need $4 billion of investment to provide enough jobs over the coming decade; in 1999, however, the country received only $47 million in foreign investment (BBAC, 2000).

Some of the surprising (from a "Washington Consensus" perspective) strength of the economy may be traced to the country's relatively strong agricultural sector, which accounts for 29% of GDP and employs 40% of the labor force. It contributes 14% of exports, and provides inputs for the country's principal non-oil manufactures (textiles, tobacco, food processing, leather and beverages). Such industries provide perhaps 50% of total manufacturing employment. From 1986 to 1996, agricultural output increased by 30%--a very respectable performance, given that 80% of cropland is non-irrigated. Although the sector has been subjected to some of the same controls as the rest of the economy, farmers were never squeezed to the same extent in Syria as they were, for example, in pre-reform Egypt. Part of the explanation for the relatively better treatment of the farm sector is that the base of support of the Baathist regime lies, in part, with rural notables, particularly in minority areas, but also among the Sunni majority (Hinnebusch, 1989).

The Syrian leadership has shown considerable skill in using both economic and strategic rents to protect the fundamental structures of its economic rule. Syria's principal export is petroleum (65% of total value in 1998). The country has been able to attract substantial remittance flows from its workers abroad, and has managed to entice the return of some Syrian capital held abroad. Thanks to its skillful manipulation of regional politics, the country has managed to attract substantial foreign assistance from the Gulf states. Syria's participation in the Gulf War Coalition was rewarded throughout the 1990s by the Gulf states. Finally, Syria's de facto occupation of Lebanon has provided additional rents.

2. Riding the Roller-Coaster of Rents

Syrian economic policy has closely mirrored the trends in external rents. During the 1970s, when oil prices were high, the state greatly expanded its role, as Hafez al-Asad used state direction of the economy as one of several ways to consolidate his control of the country. As the inefficiencies and deficiencies of an inward-looking, state-directed economy became apparent, the regime did relatively little—until, by the late 1980s, external rents could no longer paper over these structural weaknesses. The government made many pronouncements, and promulgated a few reforms, which were largely aimed at generating non-oil exports. The partial success of these reforms, and the upsurge in strategic rents thanks to Syria's participation in the Gulf War Coalition, permitted the regime to avoid deeper, structural reforms throughout the 1990s.

During the oil boom years of the 1970s, Syria under Hafez al-Asad became a classic Arab Socialist economy. Between 1970 and 1982 employment in public-sector enterprises rose from 57,000 to 119,000, or, in the latter year, to half the entire industrial work force. In just two years the public-sector wage bill doubled, going from 3.5% to 6% of GDP. In 1979, Syria's total work force was about 2.1 million, of which about a third were engaged in agriculture. Combined public-sector and civil-service employment probably totaled 350,000. There may have been 230,000 Syrians in uniform and, although there is some overlap with the preceding categories, perhaps 200,000 members of the Ba'ath party (Drysdale 1982). Some 220,000 workers, in both the public and private sectors, were unionized and under Ba'athi supervision. Although the Syrian state's control of the economy was never as systematic as that of the Soviet Union, there were many parallels, from planning to the dominance of state-owned enterprise, to the ubiquitous secret police.

Such state dominance came at the expense of economic efficiency. The strategic sectors became used to their privileges and to low levels of performance. The state has hesitated to alienate them by asking more of them or paying them less. This was particularly true for the military: In 1981 Syrian defense outlays were 13% of GNP, placing it among ten nations worldwide to spend more than 10% of GNP on defense. Inflation and a growing external debt, which grew tenfold between 1970 and 1983 to $2.3 billion, plagued the economy, especially after the Syrian intervention in Lebanon in 1976.

In a manner typical of state-dominated, import-subsituting developing countries, Syria was increasingly unable to generate sufficient exports or to maintain adequate levels of investment. Like Egypt, it suffered from the "twin gaps" of rising deficits of both its foreign accounts and government budget. From 1980 to 1988 the current account was in persistent deficit and Syrian involvement in the Lebanese civil war strained the government's budget. The economy grew at 2.4% during the decade, well below the rate of population growth.

In this environment, the government promulgated some home-grown reform measures. It is notable that the government did this with essentially no participation from the IMF and the World Bank. Syria has accepted Bank and Fund missions, and has utilized their reports as an input into the policy process, but Syria has never entered into any formal "policy dialogue" with these institutions. Syria services just enough of its debt to the World Bank to avoid being declared insolvent, but otherwise largely ignores the Bank. Nor has it ever taken out any substantial "stand-by" loans from the I.M.F. International agencies, and Western governments, have had essentially no leverage over the Syrian state's economic policies. (Perthes, 1995). This is, of course, in marked contrast to Egypt and Jordan.

Three factors have permitted Syria to follow such a course. First, the government is sufficiently ruthless and efficient internally that dissent caused by economic hardship has little impact. Few Syrians have forgotten the events in Hama in 1982, when government troops killed an estimated 10,000 citizens to suppress an Islamist uprising. Second, the government has used its strategic position and its foreign policy decisions to acquire alternative sources of finance from Arab sources, and until 1985, from the East Block (the USSR and GDR). Third, Syria increased its oil exports from the mid-1980s until the present. All of these factors permitted the regime to avoid international loans, and the accompanying pressure to embrace the Washington Consensus.

From its inception, the Asad government cultivated wealthy, urban, largely Sunni mercantile interests. Even in the early and middle 1970s, measures such as the creation of several "free zones", liberalization of import restrictions, and encouraging private companies to act as intermediaries between foreign firms and state-owned enterprises helped to consolidate the "Alawite Soldier-Sunni Merchant" alliance. The government further strengthened this alliance as the regime sought to alleviate the serious foreign exchange crisis, which was created by the current account deficits of the 1980s. In 1983 the government allowed private manufacturers to keep 50% of their hard currency earnings from exports for their own imports; in 1987, the percentage was raised to 75%, and the classes of goods covered was broadened. The leading scholar of this process, Volker Perthes, notes how these reforms worked primarily by reducing the incentives for smuggling. (Perthes, 1995). Draconian legislation against currency smuggling (very lucrative, given the wide gap between market and official rates) merely served to concentrate operations in the hands of a few, very well-connected actors with close ties to the regime. (Perthes, 1995). Further liberalizations of currency dealings continued into the 1990s, and the government has consistently tried to move official exchange rates closer to market rates. The differences between "Arab Socialism" and "Mafya-Kapitalism", Russian-style, have blurred considerably in Syria.

The government also sought to improve the trade balance by introducing qualitatively similar "piece-meal" reforms in the vital agricultural sector. Beginning in the mid-1980s, the government permitted the entry of private agents into agricultural marketing of all except a few "strategic" goods (cotton, wheat, and sugar-beets). Private exporters of farm goods received favorable exchange rates, and ceilings on farm size were rescinded. Such measures contributed to the very strong performance of Syrian agriculture during the 1980s, when the country also enjoyed relatively good weather.

The results were encouraging. The private sector share of non-oil imports rose from 25% in the mid 1980s to over 63% in 1994; private nonoil exports rose from 46% to 78% (Rivlin, 2001). Home-grown reforms were aimed at the trade balance, and helped to reverse the deterioration of the 1980s. Such policy changes simulataneously strengthened the Soldier-Merchant alliance.

3. The Limits of Reform

The limits of reform may be seen most clearly with changes in investment rules and regulations. Investment Law No. 10 was promulgated in 1991 to attract investment by both Syrians and foreigners. Under this law, which covered investments of over 10 million LS ($240,000), investors could propose projects in any economic sector. Approved projects are given a 7 years' tax holiday, are largely exempt from customs duties and import restrictions, and are granted generous profit and foreign exchange repatriation. The government hoped that such a law would entice sorely needed investment.

It has not happened. As of 1997, exactly one foreign firm (Nestle) has invested in the manufacturing sector (MEED, 5/16/97). Private Syrians, meanwhile, are estimated to hold more than $25 billion overseas. The government has not seemed unduly concerned, perhaps because rents returned during the 1990s. First, the government collected a handsome dividend for nimbly joining the Gulf War Coalition. Unofficial estimates of the resulting aid are some $4-5 billion (Kanovsky, 1998). Second, oil production rose strongly as exploration brought new sources of oil on line. Output increased from 160,000 barrels per day in 1985 to 610,000 bbd ten years later. For the past seven years, oil has amounted to nearly 2/3 of Syrian exports. The strengthening of oil prices during the past several years has provided further rents. Third, the Syrian economy has reaped considerable "protection rents" from its de facto occupation of Lebanon. One million Syrians—perhaps one seventh of the labor force—work in Lebanon, and they send home between $1-$2 billion a year. Lebanese businessmen make substantial payments to the Syrian army, Syrian businessmen find many profitable opportunities in Lebanon, and Lebanon provides many of the consumer goods found in Syria, goods which ease the life of many a Syrian. Finally, although there is, of course, little reliable information, it is widely believed that some prominent Syrians profit from the narcotics business, based in the Beka'a valley in Lebanon.

Syria, like Iran and Saudi Arabia, has implemented relatively little of the Washington Consensus prescriptions. There has been liberalization of the trade sector and improved macroeconomic management, but very little relaxation of government control. Notions of a "level playing field" and "accountable governance" are quite ludicrous in the Syrian context. Syria remains a closely controlled dictatorship, with the levers of power firmly in the hands of the Alawite office corps. This classic "neo-Mamluk" regime (Bulliet, 1999) enjoys the support of a substantial segment of the Sunni merchant elite and of peasant notables, as well as the core support of the Alawite minority and military officer corps. Such support, combined with rents, have permitted the regime to fend off any pressures for deeper reforms.

Further reforms may emerge under Bashar Asad. As before, the driver will likely be any downturn rents. There are some reasons to expect such a change. As elsewhere, oil prices will be crucial. If they decline, then, of course, the government will, once again, be under considerable pressure. Further, whatever happens to oil prices, Syrian oil reserves are small, and production is expected to decline by the middle of the decade. Population and the labor force will continue to grow. The pressure on the regime is likely to increase. But it is much too early to rule out a continuation of "business as usual" in Syria. The regime's power base is strong, its ruthlessness unmatched. Syria has found ways in the past to collect strategic rents, and thereby avoid reform. It may find ways to continue to do so.

IV. Implications

"It is not fortresses but the wills of men that keep rulers in power."
Niccolo Machiavelli, *Discourses on Livy*, II.24

There is both good and bad news for governments in the basic picture presented above. On the positive side, the same economic development strategy which would successfully manage the growth/poverty/employment problem--increased reliance on private sector-led export growth--would simultaneously provide adequate food security at the national level. Countries which can plausibly reform their macroeconomies by balancing budgets, maintaining realistic exchange rates, dismantling excessive regulations, and promoting exports have at least a fighting chance of coping with these varied socio-economic challenges.

However, from an American policy perspective, the downsides are equally evident. It may be useful to present a "taxonomy of difficulties" facing those who would embrace the Washington Consensus by dividing the countries of the region into three groups:

A. The" NICs", or "newly industrializing countries", which have a relatively advanced level of industrial development, such as Algeria, Egypt, Jordan, Morocco, Syria, and Tunisia;

B. The low-income countries, like Afghanistan, Mauritania, Sudan, and Yemen.

C. The "oil-rich" states of the GCC.

A. *For the relatively advanced countries (or the "NICs"), like Egypt, Jordan, Syria, and Iran*

- the needed policy shifts may themselves be de-stabilizing, not only because the necessary changes involve austerity, but also because special interests which are major props of regime support--and who occupy important subsidized positions within the bureaucracy--face important challenges. Examples of the latter range from East Bank Jordanians to Egyptian workers in state-owned enterprises.

- over the longer haul, the needed changes are also likely to be destabilizing in another way: attracting the necessary volume of investment in the region will almost certainly require greater governmental accountability and more transparent rules of the economic game. This is not to say that democracy is needed for growth; it is merely to suggest that it is very unlikely that regimes will attract the necessary private capital from their own citizens or from foreigners if regimes persist in their arbitrary, authoritarian practices.

- the chances of success of implementing the "Washington Consensus" policies are reduced because these countries suffer from significant weaknesses in international export markets compared with major competitor countries from Eastern Europe, and South and Southeast Asia. In particular, they lack adequate infrastructure and skilled labor, particularly the "sergeants of industry" (e.g., foremen), which are necessary for modern industrial production.

B. *For low income countries like Yemen*

- exports are highly unlikely to provide adequate food security or sufficient numbers of jobs, while domestic productive capacity has been and is being damaged by population growth and property rights issues (e.g., for groundwater); natural resource degradation may have gone so far as to be very difficult to reverse.

- thanks to past population growth, the labor force is growing so rapidly that provision of sufficient jobs via the "private-sector led export model" is not credible: infrastructure is far too poor, and the labor force is overwhelmingly illiterate.

- the grim facts are that, at best, economic development in such countries is mainly a "holding action", designed to prevent further deterioration and the consequent complete breakdown of order. The danger is that of breakdown into the anarchy of a Somalia or Afghanistan, and the concomitant risks of the development of terrorist safe-havens.

C. *For the countries of the GCC*:

- Fiscal problems dominate the scene. The relief which the last several years have afforded seems unlikely to last: the "rent ceiling", given by alternative energy production costs, is perhaps about $25 per barrel. Even at this maximum (and relatively unlikely) price, revenue will be short.

- The imperatives of spending have (at least) three proximate causes: the perceived need to spend heavily on 1) maintaining defense postures , 2) consumer subsidies, and 3) provide jobs for the rapidly growing local labor force.

- GCC states (except for Bahrain) continue to spend large sums on military hardware. After the Gulf War, many locals (particularly in Saudi Arabia) question the utility of such spending.

- The GCC states have local populations which are thoroughly dependent upon, and expect to receive, a wide variety of consumer subsidies. Governments' ability to meet their side of the social contract is increasingly in doubt.

- *Most importantly, the large majority (e.g., in Kuwait, ~ 80%) of nationals are employed by the state.* Consequently, shortfalls in government revenue translate quickly into difficulties with employment creation.

- The need for job creation is particularly acute, given the weakness of a "demographic transition" in the GCC states: mortality rates have fallen sharply, but fertility rates have fallen only very moderately and remain very high by international standards. Past high rates of population growth fifteen to twenty years ago translate into very rapidly growing labor supplies today.

- The private sector cannot currently take up the slack in employment creation. The sector is a) too dependent on state largesse and b) relatively too small to do so.

- Most importantly, however, *the countries of the Gulf have limited comparative advantages in non-oil goods or services*. Wage rates, seriously inflated by past oil rents and current consumer subsidies, are far too high to compete in low wage activities, but skills are too low to compete in more sophisticated activities.

For all countries:

- Continued regional political instability deters private investment by nationals and foreigners alike;

- Managing water scarcity will necessitate closer regional cooperation, but national animosities have so far made such cooperation lag (to say the least) well behind the economic and environmental needs.

The countries of the Middle East face grave economic challenges in the coming decade(s). We know of only one plausible management strategy--that of private-sector led, export-oriented growth. However, the success of this *faut de mieux* strategy in most countries of the region is dubious. Consequently, mounting economic problems are likely to continue to pose challenges to governance. But, so long as regimes continue to have access to a) enough money for internal and external security, and b) support from at least some relatively united sub-section of the population, then they may continue to survive. But as the example of the Soviet Union shows, when a regime lacks the support of most of its people, contingent events and mistakes by the top leadership can lead to rapid disintegration and regime change.

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