

Globalization, Regionalization and Recent Trade Agreements: Impact on Arab Economies

" Rapid Exogenous Change - Slow Endogenous Response!"

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Introduction

This paper makes the case that for the Arab countries to benefit in this highly competitive global environment, they must adopt combined and coordinated internal and outward development strategies. Any outward-oriented reform (OOR) or export-oriented industrialization strategy (EOI) must be part of an internal-oriented sustainable reform (IOSR). The latter should include as its fundamental elements the following: (a) development of human resources; (b) equality of opportunities; (c) transparency in governance; (d) strong local demand; and (d) sustainable environment. Lack of progress in IOSR, relative to that of OOR/EOI, could be a call for social unrest and costly economic losses.

IOSR is neither automatic nor instantaneous, however. It does not happen, as sometimes advocated, as a by-product of opening the economy and the social system to international trade, finance and information. It requires deliberate policies and long-term commitment. Furthermore, IOSR is context-specific. Each country should adopt and specify the time path of its own and specific IOSR. The benefit from OOR/EOI policies and strategies in enhancing a country's competitiveness and sustainable growth depends on the progress in IOSR. Given the institutional and political structures of the Arab countries, many of the reform elements in IOSR are long-term. An IOSR strategy should define the boundaries and the time path for OOR/EOI reforms so the country does not go beyond its ability to interact effectively with the global environment, so to speak. Nevertheless, IOSR should not be used as a tool by interest groups to delay the implementation of OOR/EOI reforms.

The Context

Critical Issues

The transitional nature of the world's economic and political environment combined with unprecedented change in communication technology and financial institutions, raise some important questions requiring reflections.

- Is globalization an established system with defined rules and certain consequences?

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- Is the European Union with its forthcoming Euro currency that is certain to erode the socio-economic policy power of the individual states of the union, a predictable economic and political force?
- Is the potential economic gain from integration in the world economy limited by the extent of internal development? Could this be accomplished without an active state?
- What role can the state perform effectively in social and economic management as globalization takes hold?
- What is the effect of the decline in the economic and political power of oil on the developmental strategies of oil and non-oil producing Arab countries?
- What effects does the impasse in the peace process have on the development of the Palestine State and the Arab region in general and its fair integration into the world economy?
- And last but not the least, what are the lessons to be learned from the Southeast Asian countries – their relative ability and adaptive capacity to survive the recent severe economic, financial and unemployment crises that plague the region, and for some Asian countries, cause costly political and social unrest, e.g., Indonesia?

While the questions above are difficult to answer, they serve, nevertheless, as a guide to the discussion in this paper.

The Arab Region Dilemma

The above questions and issues, although difficult, are not new. A large body of literature has evolved recently to examine the effects of globalization, regionalism and trade agreements on the development potential of the Arab countries.¹ They vary in scope, diagnosis and prescriptions. On the one extreme of sweeping generalizations and pessimistic outlook, the situation is described as follows (ESCWA Secretariat 1996: 99):

“The region’s economic performance in the 1980s is symptomatic of an “Arab Disease” that is more fundamentally damaging than the “Dutch Disease” that afflicted Holland in the 1940s following the discovery and commercialization of natural gas. ESCWA member countries have weak manufacturing structures, high illiteracy rates, limited industrial skills, poor saving ratios, low level of manufacturing exports, inadequate R&D, high indebtedness, small companies with limited international experience, limited regional cooperation and trade, heavy dependence on government, inefficient bureaucracies, limited private sector participation, and above all a very unfavorable and hostile international economic environment. The region’s competitive fundamentals are weak and deficient. However, negative economic trends can be reversed; the required effort is massive and the conditions are unfavorable, but it can be done.”

According to this diagnosis, the lack of development is deeply rooted in weak socio-economic structures and institutions of the Arab countries. Gains from integration into the world or regional economies depend heavily on IOSR, based on sound policies and long-term commitment.

Other literature reach similar conclusions. Handoussa (1996: 345-360), starts with guarded optimism:

¹ The following volumes were published during the past four years: ERF 1995, ESCWA 1996, Handoussa (Ed.) 1997, Shafik (Ed.) 1998a, and Shafik (Ed.) 1998b. They are based on conference proceedings, include extensive bibliography and focus on the Arab countries, Iran or Turkey.

“For the Arab region, the challenge is to *redeploy its significant industrial base* so that it takes advantage of its installed capacity, restructure its weaker segments and turns from its inward orientation to become a dynamic competitor in the world market.” (Emphasis added).

Handoussa’s recommendations however, are basically structural and long term (*ibid.* 359). Focusing on the GCC countries, observations were not optimistic about development prospects:

“Future prospects for these (GCC) countries will be bleak unless appropriate policies are put in place before oil resources are exhausted. Institutions and policies that enhance the business climate should be embraced and distorting economic policies should be eliminated. Government spending should be cut and indiscriminate subsidies should be reduced and abandoned. Other helpful policies include privatization of state enterprises, reduction of public sector employment, deregulation of markets (including the labor market), and establishment of a competitive exchange rate.”

These are rather difficult, if not impossible recommendations to implement since, given the structure and organization of its resource endowment, the socio-economic roles of GCC governments should be substantial. As Sirageldin and Al-Ebraheem (1997) indicate in their analysis of the GCC economies, what is required is a long-term strategy in which the government plays a key role that is significantly different from its present one.

Focusing on one country, Handoussa and Kheir-El-Din (1998: 53-77) have a vision for Egypt. To enter the 21st century on a competitive basis, the authors present an ambitious program of economic and social progress of the next 17 years that encompasses a formidable task for the public sector. It calls for:

“... a consistent menu of public investment in infrastructure, the environment, science and technology, human resource development, and social safety nets, while forecasting growth in private investment across the production sectors.”

These illustrative examples indicate the dilemma facing the Arab countries. Basic structural and institutional reforms are required for the Arab countries to become competitive in the global environment. But the required reforms cannot be done without extensive government involvement and support. Governance, however is one of the key institutions that require extensive reform in the Arab world! However, as Nabli (1997) illustrates in the case of reforming State-Owned-Enterprise (SOE), the supply for such reforms depends on the political process that presents pressures for and against reform. In such political environment, sequencing of reform is essential. From a political economy perspective: “the design of a reform package should aim at giving priority to reforms that have the most impact and with the least resistance” (*ibid.*: 26). Nabli’s contribution is important. However, sequencing should take into consideration the synergetic nature and time lags inherent in structural and institutional reforms.

Recent Socio-economic Trends

In the 1980s, per capita income of the countries of the Middle East and North Africa declined. The decline was much greater than that experienced by any other region in the world including Sub-Sahara Africa (Riordan *et. al* 1998: 16-17):

“During the 1980s, growth in the Middle East and North Africa averaged 0.4 percent a year and real per capita gross domestic product (GDP) fell by 2.7 percent per year – the largest such decline in any developing region outside the transition economies.

Among the major oil exporters per capita GDP fell by more than 2 percent a year, while GDP for the more diversified exporters rose by about 3.5 percent a year. Real per capita export earnings for the region dropped by more than 4 percent a year between 1980 and 1993, however, and the import purchasing power of per capita revenue fell by more than 7 percent a year. The sharp decline and recent stagnation in the region's oil revenues have affected foreign exchange earnings both directly and through a multiplier effect on other sources of foreign exchange earnings. Indeed, of the region's important sources of revenue, only tourism and worker remittances advanced in real terms over the past decade, and gains in both areas are modest. Non-oil merchandise exports have suffered."

Gains through the mid-1990s did not raise real per capita incomes to their pre-1980s levels. The region is still catching up with weak past performance. One reason for the weak economic performance is the decline in the real price of oil. The effect of the decline of oil prices is magnified because of the high concentration pattern of exports in the region. Using concentration and diversification indices that indicate the degree to which a particular country is relatively more concentrated in its export structure or the degree to which a particular country's commodity shares have deviated from the world structure, Safadi (1996) illustrates a high export concentration in the region. This is understandable in the case of the oil exporting countries (GCC) where the share of oil and petroleum products in total exports exceeds 80% of total exports. However, the share of oil and petroleum products in Egypt and Syria's exports is relatively high, 40 and 59 % respectively (*ibid*).

Other reasons for the weak economic performance have to do with instability in the region that reduces the attractiveness of foreign investment and tourism. The impasse in the Israeli-Palestine peace process and the failure to reach peaceful agreements between Israel and its Arab neighbors Lebanon and Syria, have been costly to the development of these Arab States. Foreign investments have been negligible in the case of the Palestine State. In terms of foreign investment and export of manufacturing goods, Israel seems to be the main beneficiary of the stalled peace process.

Internal unrest in the region is yet another reason for the lack of progress. The case of internal strife in Algeria and Sudan, and the lack of normalization of Iraq, are but a few examples of unsettled conflict and unrest in the Arab region. Furthermore, recent terrorist incidences in Egypt have adversely affected the important tourist industry in that country. The causes of violence and unrest are complex and deep-rooted. They are beyond the scope of the present inquiry. For details, see Abdel-Fadil (1996) for the anticipated outcomes of the peace settlement between Israel and Palestine. For the case of Islam and government, see Sirageldin (1996), Mazrui (1997) and Waterbury (1998). Not all countries in the region continued to have weak performance in the 1990s. Tunis, Morocco, Jordan and Egypt have illustrated signs of dynamism in recent years. It is not evident, however, how deep-rooted these signs are (Shafik 1998a, 1998b).

Impacts of Openness

In an attempt to measure the impact of the Uruguay Round agreement on trade between ESCWA member countries and the OECD, Safadi (1996) uses a simulation model to estimate the net gain.² He concludes that the region is expected to have a net

gain of \$178 million in ESCWA member countries manufactured exports to the main OECD markets. This is a relatively small gain. Safadi argues however, that the estimated gain is an underestimate since liberalization should provide for wider advantages through enhanced efficiency, a result of increased international competitiveness. There are, however, necessary conditions for these additional advantages to be realized. These conditions are not automatic. They depend on significant internal reform. On the other hand, most of the gains estimated by Safadi are a result of net increase in oil-related exports (the GCC countries' share was 63% of the estimated \$178 million total net gain, mainly from oil related products). Safadi is careful to point out the implication of oil dominance on the development of the Arab region:

“The small share of ESCWA member countries' manufactured exports in their total exports to the OECD countries and to the world is directly related to the predominance of oil and oil products in the region: mineral fuels are by far the largest product group, accounting for approximately 74% of the region's total exports. This figure is roughly three times higher than the share of energy products in the exports of all developing countries combined. (Such) a concentration limits the region's opportunities to reap larger benefit from the Uruguay Round agreements; equally important, it substantially reduces the scope for developing mutually beneficial intra-regional trade.” (Safadi 1996: 131)

Other attempts to simulate the impact of implementing the Uruguay Round on the Arab economies are not positive. Using a multi-region, multi-sector general equilibrium model of world production and trade, Diwan *et al.* (1998) conclude that the Middle East and North Africa, following the implementation of the Uruguay Round, will experience a welfare loss: a decline in the region's GDP, terms of trade, and real wages.³ Furthermore, Diwan's team adds (*ibid*: 65-66):

“These static losses will be higher if a free trade area is established between the European Union and Eastern Europe and the former Soviet Union, and the Middle East and North Africa are left outside the association. (The) loss of preferred access to the EU markets in favor of the middle- income and medium-skilled economies of Eastern Europe and the former Soviet Union would leave the Middle East and North Africa further behind these countries. (*The globalization of world trade leaves the Middle East with little choice but to accelerate economic reforms.*)” (Emphasis added)

With these losses in the background, the authors recommend that to benefit from global trade, the countries of the region should “dismantle their protective walls” and restructure their economies “to be flexible and adept enough to gain sufficient markets abroad.” These prescriptions, although in line with the current conventional wisdom, do not follow necessarily from the authors' simulation exercise. To “dismantle the protective walls” is a necessary condition for a successful OOR or EOI policy, while “restructuring the economy” should be at the heart of a comprehensive IOSR policy. The relations between the two sets of policy reforms require careful articulation. Indeed, according to the

² The model includes two separate reduced form equations to calculate trade creation and trade diversion respectively for each market at the most detailed tariff-line level. For details and limitations, see Safadi (1996, 151-154).

³ Other modeling exercises indicate the same general results, at least in the short term. See for example, Harrison *et al.* (1995).

authors, some of the conditions necessary for the success of the required reforms, depend on forces outside the region's policy control: peace and increased aid.

Most of these impacts are not general enough to infer conclusions that are applicable to all the Arab economies. The impact of integration into the world or regional economic groupings is most probably context-, sector- or population group-specific. Galal (1996), by focusing on three Egyptian industries is able to identify institutional constraints that hamper firm productivity and growth. Galal's findings, based on a random sample of Egyptian firms, indicate that policy uncertainty and tax administration, both internal factors, are the two major constraints facing managers of the sampled firms. The findings also indicate that the severity of the constraints varies among industries, which suggests that attention should be given to industry-specific problems. It is evident from Galal's analysis that the constraints hampering industrial development in the Arab region are context-specific. They, therefore, vary from one Arab country to another.

Furthermore, the impact of globalization on population groups varies significantly. As discussed below, the growth rates of population and labor force in the Arab region are some of the highest in the world. The region is also characterized by low quality education especially at the basic level, and with low levels of technical training and R&D in the critical fields of information and communication technologies (UNESCO 1995a, UNESCO 1995b). The result of high growth rates of population and labor combined with low quality education and technical training is not only low productivity average and lack of competitiveness in the global markets, but also the emergence of serious inter- and intra-generation inequality. In such circumstances, women (Karshenas 1997), unskilled workers and graduates with low technical background (World Bank 1995) are at a disadvantage in the short- and medium-terms.

A brief review of the context of the Arab region indicates that many of the policy parameters of the 1970s and the 1980s have changed significantly. At present, there are basic internal socio-economic structural difficulties and unfavorable and hostile international economic and political environment requiring individual and collective attention by the countries of the region.

Globalization and Regionalism: A Viable Mix?⁴

Globalization as a Process

Globalization is best viewed as a process rather than as an abrupt phenomenon that emerged in the last decade or even in the past century. It has been a complex and cumulative process. In the present era, the post-industrial revolution in information technology made capital and technology, rather than labor, the main mobile factors of production. The process is being institutionalized and assisted by an international policy of openness and enforced by international agreements on trade and capital movement. Mankind is currently witnessing the dissolution of boundaries and national authorities in innumerable aspects of everyday life (Drucker 1997).

⁴ This section builds upon Sirageldin (1997).

Indeed, the counter-intuitive observation that the role of national governments increases as economies become more open to international trade and finance (Rodrik 1996), may be interpreted as a weakness rather than a strength in this apparent evolution of governments' roles- a reactive process rather than a purposeful and active role. Not only does globalization reduce governments' traditional roles in managing their states, but it also seems to challenge the *raison d'être* of regionalism. However, the term globalization and interdependence are often used interchangeably – leading to confusion in understanding their individual and combined socio-economic and political impacts (Reinicke 1997).

Globalization and Interdependence

Globalization is more than interdependence. Interdependence results from continuous increase in financial and economic activities between sovereign states leading to closer macroeconomic cooperation. The International Monetary Fund (IMF) and the General Agreement on Tariffs and Trade (GATT) are examples of international regulatory institutions attempting to set rules for orderly cooperation as interdependence increases among sovereign states. Government sovereignty, especially internal, is not challenged by these regulations which are taken mainly as safeguards.⁵ However, the rules of greater interdependence lead to reduced governments' external sovereignty. They set limits on levels of tariffs and exchange rates manipulation. In that respect, interdependence has been a forerunner to globalization. It sets the stage, so to speak.

However, globalization has a more fundamental qualitative dimension, especially in the micro frame that threatens government ability to exercise internal sovereignty and accordingly, threatens democracy. Persistent weakness in internal sovereignty will undermine democratic institutions. Reinicke (1997:130) presents the process as follows:

“Global corporate networks challenge a state’s internal sovereignty by altering the relationship between the private and public sectors. By inducing corporations to fuse national markets, globalization creates an economic geography that subsumes multiple geography. A government no longer has a monopoly of the legitimate power over the territory within which corporations operate, as the rising incidence of regulatory and arbitrage attests. By no means does this imply private sector actors are always deliberately undermining internal sovereignty. Rather they follow a different organizational logic than states, whose legitimacy derives from their ability to maintain boundaries. Markets, however, do not depend on the presence of boundaries. *While globalization integrates markets, it fragments politics.*” (Emphasis added).

The threat of globalization to democratic institutions through the erosion of the internal sovereignty of sovereign states is not being compensated, however, by the creation of a global democratic government. The United Nations in its present form, is far from being a world democratic government. It lacks both the consistency of a democratic constitution and the enforcement power of a true government – witness the veto power of few powerful nations. The Congress of the United States of America, although elected by US citizens to represent their own state interests, acts as if it

⁵ Sovereignty has two dimensions, internal and external. The internal dimension is the relationship between the state and civil society. The external dimension refers to relationships among states in the international system (Reinicke 1997).

represents the world – it imposes and enforces selective sanctions and rewards on sovereign states independently of the United Nations.⁶

Bertrand Russell (Sirageldin 1996b) describes this fundamental weakness of the United Nations as follows: “Over the history of civilizations, people invented two institutions that are ‘necessary conditions’ for the working of democracy – government and the law. But the law cannot be enforced without a government.” Without enforcement power, the United Nations cannot act as a true world government, and with veto power, the UN loses a fundamental characteristic of democratic institutions – consistency in enforcing the law or what Hayek (1955) called the ideal of *isonomy*.

There are other consequences to the process of globalization. Globalization implies openness of the socio-economic system and the intensification of linkages and interchange with other socio-economic systems. Openness is another avenue that leads to governments’ loss over internal sovereignty. It reduces governments’ degrees of freedom and control in the management of national policies. In the present environment of the world’s political economy characterized by an unequal power structure, enhancing labor market efficiency or reducing income instability are challenging and difficult tasks even for well-intentioned and well-informed governments of developing economies. There is a fundamental change, not only in the perceived role of the state but also in its practical ability to conduct economic and social affairs. Previously endogenous policy parameters are becoming exogenous to policy makers in the new *global paradigm*.

The loss of government authority as globalization takes hold, may be illustrated by an example borrowed from recent advances in *Quantum Computing with Molecules*.⁷ Two phenomena characterize the behavior of computing with molecules: (a) unlike classical bits, quantum bits (qubits) can be in more than one state simultaneously; and (b) the ability to disentangle the entanglement of two qubits instantaneously regardless of distance, by acting on only one of them ‘at a distance’. The increasing synergetic nature of globalization and lightning electronic speed, makes it possible and feasible for a dominant player, e.g., the Federal Reserve Bank of the United States or a global conglomerate, to influence the fortune of others ‘at a distance.’ Putting emphasis on ‘mechanisms’ alone (World Bank 1997) may not be sufficient to elucidate how states function in the new globalization era, and how these functions may be improved.⁸

‘Influence at distance’ needs to be taken seriously, especially if the objective functions of governments differ. In the present globalization era, the advanced economies seem to have adopted a new economic policy paradigm in which price stability is given higher social priority than are attempts to modulate income and wealth inequality. Thus, although the latter have been increasing significantly in the USA during the past decade

⁶ In his recent visit to China (June 1998), President Clinton of the United States of America informed Chinese leaders about the importance of the rule of law and democratic freedom. As he spoke, however, scores of Palestinian homes were demolished in Jerusalem and their residents evacuated by force in spite of United Nations’ and the world’s condemnation. The ideal of *isonomy* in the rule of law is evidently missing in the emerging *global governance*.

⁷ See Gershenfeld and Chuang (1998).

⁸ For a review of the changing role of government in nine Arab countries, in the case of privatization, see Ayubi (1997). However, the views of Reinicke (1997) on the system of globalization as it affects the sovereignty of the state should be kept in mind.

(Gottschalk and Smeeding 1997), the role of government is relegated more towards the arrangement of income stabilization measures. In this respect, Wolman and Colamasca (1997) describe this globalization process as the “Judas economy: the triumph of capital and the betrayal of labor.”

This task is assisted by the mechanism of the New World order: “... once you could count on the wage-price spiral to bust every boom. But today’s global economy is helping to keep inflation in check” (Dornbusch 1997). Greenspan, Chairman of the US Federal Reserve Board calls it the *X-factor* that separates the worrisome inflation predictions of the traditional wage-price model from today’s low-inflation reality. This X-factor could be anything from globalization to worker insecurity to better productivity growth. Whatever it is, the result is more room for the economy to grow without generating inflation (Business Week, May 25, 1998: 29). The relevant question to those on the other side of the fence is whether the X-factor could be ‘managed from a distance’ and what the effects are on their domestic economies.

Competition from foreign labor reduces labor power and acts as a check on wage hikes in the advanced economies, while built-in high rates of labor growth keep wages in-line in the developing part of the global economy. If wages and productivity increase in the developing economies, financial and investment flight will guarantee the control of the inflation dragon through higher unemployment and unemployed capacity. This is not a novel perspective. In their system of capitalism, Adam Smith, David Ricardo and Malthus (Schumpeter 1961), although differing in their conclusions, used labor reproduction as the main mechanism to reach system equilibrium. Indeed it was not long ago when the supply of female labor provided a similar wage-price stabilization function in the United States. In the 1950s and 1960s, when working women were not the norm, female labor-force participation increased during the boom and declined in recession periods. However, the increased elasticity of the supply of labor through the globalization of the labor market does not seem to stop building inflationary pressures. As Greenspan, Chairman of the US Federal Reserve Board put it recently: “A re-emergence of inflation is without question a threat to American economic expansion with pressure coming from the tightening of the labor market” (Economist 1997: 96). Big players in the new global economy may pursue national protective policies that may go against the very logic of the global economic order.

But in developing societies, policy priorities may differ. Integration in the global system at a fast pace combined with weak economic structures and institutions, and especially with high growth rates of population and labor, could create undesirable social consequences. Policy makers concerned with social and political stability may give higher priority to contain high unemployment, extreme inequity leading to wasteful unrest and conflict, or the emergence of patterns of consumerism and social behavior that conflict with society’s values, over price stability. This is indeed a policy dilemma and calls for more attention to what is referred to as IOSR.

The policy dilemma is not limited to the case of developing economies. Many advanced economies with established institutions and modern infrastructures, face the same policy dilemma. France, for example, although agreeable in principle to a unified Euro monetary system, has reservations to this system’s potential restrictions on France’s pursuit of its national policy priorities. France disagrees with Germany in giving higher

priority to price stability over other social issues. The potential conflict between internal and external sovereignty is illustrated by Feldstein (1997:63) as follows:

“The French have been particularly vocal in calling for political control over monetary policy. In a televised speech just before the 1992 French referendum on the Maastricht Treaty, then President Mitterrand assured the French public that, contrary to the explicit language of the treaty, European monetary policy would not be under the direction of European central bankers but would be subject to political oversight that, by implication, would be less concerned with inflation and more concerned with unemployment.”

The Quantification Problem

Not all difficulties result from the loss of policy control by national authorities. There are equally difficult conceptual issues. The impact of globalization is hard to measure without a workable definition of the term. However, there are difficulties in defining and measuring the degree of globalization. To assess the effect of globalization, it is essential to measure the extent to which a country is part of the globalization process. As discussed earlier, the process of globalization is not the same as interdependence. Most empirical studies equate the two terms however. The degree of *openness* or *outward orientation* of a country is usually taken as a measure of that process. There are many indicators of openness. Unfortunately, none is completely satisfactory. (Pritchett, 1991). In a recent contribution, Rodrik (1996) uses the share of trade in GDP as the measure of openness. For many countries in the region, this indicator may not provide a sensitive measure of the effect of openness on human resource development or labor income vulnerability. For example, in the case of oil economies, a large share of export in GDP does not necessarily imply a large share in labor content. Oil and its immediate derivatives constitute the bulk of exports while the percentage of labor engaged in this production activity is very small. An increase in the share of exports may be primarily a result of a change in the price of oil rather than an increase in labor force participation in tradeable goods sector. The latter increase implies greater participation of labor in the world economy and accordingly, more exposure to external competition, a tendency towards enhanced efficiency and increased vulnerability in the job environment. Although that measure of openness may increase, the participation of labor in the tradeable goods sector may not increase, it may actually decline. Indeed, a change in the share of exports will affect labor demand in other sectors of the economy. But in countries with substantial expatriate labor content in tradeable goods, it is not immediately evident which is the more vulnerable.

Furthermore, openness as a measure does not include the cross-border movement of intangible capital such as finance, technology, and information that are essential ingredients of the globalization process. Care must be taken in interpreting results using a narrow measure of openness for countries with different structures.

Globalization and Regionalism: Are They Compatible?

The previous discussion suggests that there is tension between a system of globalization and a system of regionalization. Regional trade agreements and the multi-lateral trading system have generally been complementary. However, the increase in

regional integration arrangements could raise a challenge to the efficacy of the multilateral trading system. Much will depend, however, on the credibility of the World Trade Organization (WTO) and its ability to accommodate and discipline regional trading arrangements. General multilateral discipline on regional trading arrangements – mainly in the form of Article XXIV of the GATT – has helped insure that regional agreements *per se* do not lead, on balance to deterioration in the conditions of trade and market access for third countries. However, as Safadi (1997: 38) concludes:

“To say that regional trading arrangements and the multilateral trading system are not alternatives, but rather complementary approaches to problems of international commercial diplomacy, is not sufficient. The key issue is what policy choices and decisions could be made to insure that regional trading arrangements remain supportive of the multilateral trading system in a way that strengthens its credibility for third countries. The need and advisability of further expansion of the disciplines in Article XXIV (and the understanding on it) is debatable and *may not be a realistic option at this point.*” (Emphasis added).

Safadi’s guarded pessimism seems to overlook the dynamic nature of the globalization process that may make regional trade restrictions obsolete. Recent experience indicates, for example, that capital movement across regional borders of the European Monetary Union (EMU) or the North American Free Trade Agreement (NAFTA) has been large.

In 1995, unemployment was at high levels in Germany. However, net capital outflow was estimated to be \$22 billion – which was double that of 1994. More recently, Daimler of Germany acquired Chrysler in a historic merger creating a \$130 billion automotive colossus known as Daimler-Chrysler AG. Chrysler was known by its nationalistic ads: “Buy American.” Capital movement seems to be motivated by profitability considerations rather than national or regional affiliations. The argument for a *natural market*, as has been advocated for the creation of NAFTA may be outdated by the globalization process. The issue is whether third countries, especially the Arab developing ones, will have a significant economic net benefit in the coming decade!

In Europe, however, the effect of introducing the EMU on the development prospects of the 11 countries who agreed to membership, is yet to be seen. The EMU countries will be the second largest economy in the world. They already have robust economic growth, high saving and investment records. However, unemployment is relatively high: in the low teens (Spain close to 20%), and with high wages between \$12 per hour for Spain and \$32 for Germany compared to Mexico’s \$3 and Taiwan’s \$8. The real test is how the EMU would act in a downturn. Would the EMU countries diverge over monetary and fiscal policies to promote social spending, e.g. subsidize poorer regions or countries of the union? The answer to this question is affected more by the political dynamics as it unfolds within and outside the EMU, rather than pure economic calculus. Findings from models to estimate the economic impact of the EMU have been reported earlier in the paper. The impact is not large and could be negative in the shorter term. However, having said this, forecasting the impact at the present stage of the EMU formation could be uncertain.

Trade Agreements: Its Effects on Arab Economies

There have been recent extensive surveys of the issue. These include UNCTAD (1996), Safadi (1996), El-Naggar (1996), and Hoekman (1998), among others. In this section, a brief summary is presented including conclusions based on these studies, especially Hoekman's (1998), as they relate to the Arab region. In general, the system of trade in the Arab region is complex. It has created an inefficient production system that is protected from international competition. Conclusions are conditional and guarded.

For ease of presentation, the Arab countries may be divided into two groups: countries with nil or negligible import tariffs but have sizable export subsidies, e.g., Saudi Arabia and some other GCC countries, and those with tariff and non-tariff restrictions. In an extensive review of the relation between the WTO, the EU and the Arab region, Hoekman (1998: 98) makes the following general conclusion:

“Elements of the trade regimes that inhibit the competitiveness of the Middle Eastern and North Africa firms include high average rates of effective protection, substantial dispersion of such protection across industries, and nontransparent implementation of trade policies. High tariffs and the red tape associated with them constitute a tax on export production, both directly by raising input costs and indirectly by putting pressure on the real exchange rate. High levels of effective protection also reduce firm's incentives to enter world markets, since profit rates are often higher in sheltered domestic markets. These distortions have resulted in a somewhat dualistic economic structure, with export-oriented firms having few links to the rest of the economy and most firms concentrate on the domestic market. Export production in such a highly protected environment would require well-functioning duty drawback and temporary admission mechanism, which are generally not available.”

Tariffs in the Arab countries, with the exception of the GCC, account for a sizeable share of government revenue, about 20% compared to less than 6% in Turkey, Indonesia, Republic of Korea, Malaysia or Mexico (*ibid*: 100). Furthermore, effective rates of protection exceed nominal rates by a large margin. This is a result of additional taxes, duties, and fees such as import licensing fee, taxes earmarked for universities, municipalities, custom services, and statistical tax, among others. Inefficiency and delay in custom clearance or red-tape procedures also add additional hidden tax burden on imports. Quantitative import restrictions also exist in the region, although these have been declining in some countries such as Morocco, Tunisia and Egypt.

In the case of exports, there are both obstacles and incentives. Port services for handling and storage, inflated insurance premiums, or quality control, among others, create disadvantages to exporters in various countries of the region. On the incentive side, the case of wheat in Saudi Arabia is a very obvious example. A combination of import restrictions and generous subsidies have raised wheat production from 3000 tons in the mid-1970s to more than 4 million tons in 1992, more than half of which is exported. However, direct subsidies for wheat alone exceeded \$2.5 billion a year, (Hoekman 1998).

These distortions have created a highly protected economic structure. Their presence discourages entrepreneurial development in the region – high productivity does not lead to parallel competitiveness! During the next decade, the Arab countries, if they do not undertake fundamental reform, will be at a disadvantage facing a more competitive world environment, even in markets they had some initial success with.

IOSR as a Base for OOR/EOI

The previous discussion and review of the Arab region economic competitive position is not optimistic. The critical question is not what the gains are from the globalization process. Gains are negligible, if any. The question is what needs to be done internally so the Arab region's prospect for long-term sustainable development could be based on solid foundation in the globalization environment.

Why IOSR First?

The Arab region should focus on the long term. The previous review indicates that a weak structure cannot compete or even hold its relative position in a dynamic and competitive environment. There are key elements that should have high priority in the IOSR reform agenda: development of human resources, financial institutions, transparency in government, and equal opportunity. These will be examined briefly.

Human Resource Development: The importance of human resource development in the Arab region cannot be underestimated. The development of human resources in East Asian countries is one of the vital ingredients responsible for their success. It is probably the one factor that will facilitate their recovery from the present crises:

‘The Asians’ success has been built not on their discover of a new form of capitalism but on a tried-and-true recipe. The vital ingredients include a hard-working, well-educated, and trained labor force, and a vigorous entrepreneurial class that invests in efficient plants and equipment. Each country spends more on human capital than do the vast majority of nations with comparable levels of per capita income. Most of these nations also encouraged entrepreneurial activities after they learned to appreciate the importance of a market economy.’ (Becker 1998: 22).

Three aspects of human resource development in the Arab region are reviewed below: The growth of population and the labor force, the formation of human capital through quality education and R&D activities, and labor mobility.

Fertility and Population Growth in a Global Environment. High rates of population growth are a major policy concern in the region. The built-in high rates of labor force growth and its implied pressure on the development of human resources in the region are discussed below. The persistence of high rates of population growth will extend that pressure further into the future. Most of the countries in the Arab region are aware of this issue and have established public population programs.

The process of globalization seems to change some of the basic parameters affecting reproductive behavior. These potential effects are best examined within two competing frameworks of fertility behavior: (a) the human capital; and (b) the social capital. In the human capital framework, children are viewed as part of the family asset management. Time allocated to reproductive behavior competes with time allocated to other activities contributing to family welfare within and across generations. The price of time, especially that of women becomes an important factor. As economic growth takes hold especially when fueled by information-based technology that requires heavy investment in human capital, families tend to invest more in child quality and less on

quantity. To the extent that globalization increases income and wealth inequality and employment vulnerability in the labor market, it should have a negative effect on fertility. Societies may experience a fertility transition that is independent of socio-economic development - a standstill scenario (Sirageldin 1991).

The social capital framework on the other hand, views children as a vehicle by which the family enhances its social contacts and status. The social capital framework attempts to provide an equilibrium solution for the persistent decline in fertility to below replacement levels in Western societies. This is a trend viewed by many observers as a serious threat to the very existence of these societies (Coleman 1988, Portes and Landolt 1996, and Schoen *et al.* 1997). What is missing in the social capital framework in its present form, is the lack of adequate understanding of what determines the demand for social capital. Without a clear understanding of the socio-economic structures responsible for generating the demand for this type of social capital, it is hard to explain fertility differentials and trends. Accordingly, the stability of the demographic system is not well established.

In developing countries, children provide roles that fill gaps in the provisions of the social system. These gaps include the lack of corporate security or inadequate police protection, labor market practice that, for example, equates trustworthiness with marital status and achieved fertility, or facilitate admission in social groups and gatherings (Sirageldin and United Nations Secretariat 1979). The demand for children is embedded in the social system. It implies a much longer and irreversible commitment than, for example, the demand for pets, although the latter may be viewed as one type of investment in social capital in some circumstances.

If relative status implied in the social capital framework, or the opportunity cost of time implied in the human capital framework, becomes globalized, then it will be harder to predict the time path of fertility change. Globalization brings uncertainty to the foundation of human existence: how does a global society reproduce itself?

Education and Human Capital Formation. One thing is certain in the Arab region: The supply of labor in all the Arab states will more than double in the next twenty-five years. It will continue to grow at high rates for some decades to come. Between 1995 and 2030, the total population of the Arab States is expected to double, from 254 million in 1995 to 514 million in 2030, while its population in the working ages, i.e. 15-64 years old, will more than double during the same period, from 138 million to 332 million. This increase is certain because of the built-in demographic momentum and is independent of the fertility decline already taking place in the region. Fertility decline implies an increase in labor force participation, especially for women. Female labor force participation rates will also increase as a result of increased female education. The growth rate of the labor force, but not necessarily the absorptive capacity of the labor market, is expected to exceed the growth of the working age population. The growth of the Arab labor force for the coming several decades is both certain and barring unreasonable policies, is exogenous to public policy.

Uncertain but critical dimensions of human resource development in the region are the quality of education outcomes, the level of competitive motivation and discipline, and the spatial and occupational mobility of the labor force. A recent review of the status of basic education quality and the structure of research and development in the Arab

countries is not very positive about development in the region (Sirageldin and Al-Khaled, 1996: 11):

“What is evident – is that the quality of basic education in the Arab World is not internationally competitive. The effect of low-quality education in the context of the demographic momentum discussed earlier should have serious consequences to future development, especially in the context of globalization where the main engine for job creation is based primarily on capital mobility seeking efficient and competitive labor forces around the globe.”

The conclusions about the status of R&D in the Arab region are similarly pessimistic:

“The picture painted for R&D activities in the Arab region may not seem very positive. In 1992, R&D activities in the Arab region were under-funded, under-staffed, not adequately focused on emerging scientific areas, e.g., informatics, lacked adequate linkages with the private sector, and may have inherited a rigid government bureaucracy with built-in institutional inefficiencies. If this is true, the R&D establishment in the Arab world, in the absence of fundamental reform and a long-term vision, may not be able to perform its pivotal role as a vehicle that links sectors development with technological advances, especially in a global environment characterized by complex and continuously changing technologies.” (*Ibid*: 16).

A systematic monitoring of the quality of basic education, the structure of higher education, and the R&D establishments in the region should be an integral element of human resource development policies in the region.

Labor Mobility. Labor migration within national boundaries, has been viewed as an investment in human capital, with micro and macro benefits. Labor moves as long as the expected benefit from the move exceeds the cost of moving. There is also net social benefit to society since voluntary labor mobility, whether occupational or geographic, implies more efficient allocation of resources. This net social benefit is not as obvious in the case of international migration. Sending countries may lose valuable investment in human capital if a sizable portion of its educated and skilled labor force opt to migrate. On the other hand, migration may relieve unemployment pressure and provide a flow of foreign exchange in terms of remittances. If migration is temporary, as it is mainly the case in the Arab region, its long-term socio-economic impact is not as obvious (see for example Sirageldin and Al-Khaled 1996). The socio-economic effects of migration on the labor receiving countries, mainly the oil economies of the region are also unclear. The high rates of migration flows and remittances are declining partly as a result of declining oil revenue and partly of development in local markets.

The effect of globalization on intra-regional labor mobility is mixed, however. In theory, it is reasonable to expect that a more mobile capital whose return is regarded as more secure by the international socio-political system would be a viable substitute for labor mobility. This, however, is not necessarily the case. International capital seeks the most skilled workers regardless of their origin, especially those with technical education. The unskilled and many of those without technical training may not be immediately tapped by the demand generated by direct foreign investment. This segment of the labor force will be in excess supply with high incidence of unemployment (World Bank 1995). The built-in growth of the labor supply combined with low level education standards, will make it more difficult for local labor markets to clear the excess supply. The result is that this group of workers will seek and accept employment abroad at lower wage rates. On

the other hand, globalization is bound to create a high demand, across the Arab countries and beyond, for highly skilled workers especially those in information technology and the so-called 'brain industry'. Evidently, there will be an excess supply of unskilled workers and an excess demand for the highly skilled segments of the labor force. Location of investment may generate migration flows for the latter segment.

Financial Institutions. Historically, financial capital plays a key role in the development of capitalism. As Greider (1997:228-9) puts it, in each long expansionary cycle of capitalism:

"It is finance capital that usually rules in the final stage, displacing the inventors and industrialists who launched the era, eclipsing the power of governments to manage the course of economic events. As capital owners and financial markets accumulate greater girth and a dominating influence, their search for higher returns becomes increasingly purified in purpose – detached from social concerns and abstracted from the practical realities of commerce. Across many centuries, this story of finance capital's capacity to become deranged in pursuit of higher returns, has played out again and again in different forms of manias and crashes. Eventually, as history informs us, the disorders may be corrected in a grim, violent manner – a great war or economic depression. Those events will destroy financial capital on a massive scale and thereby restore a balance between the demands of old wealth and the needs of new productive enterprise. *This sort of resolution produces vast human suffering and political upheavals, of course, but also clears the way for capitalism's next expansive era.* The present industrial revolution of *one world* has now reached this pathological stage. The divergence between *financial values* and *real economic activity* is visible and growing. . The symptoms of disorder can be glimpsed in the recurring dramas of financial market 'disturbances', in the spectacular debt failures and in the continuing gyrations of money values that regularly destabilize global commerce and national economies." (Emphasis added)

In the present phase of the development of capitalism, based on information technology and minimal global barriers, the role of international finance capital is becoming more pivotal and powerful. In the global economy, capital acquires political power of its own. It disciplines and oversees state governments and central banks policies and even challenges their authority. International financial corporations are growing in size and power. State governments or central banks no longer control the authority and behavior, sometimes destabilizing, of global capital. On the contrary, it is the authority of the governments and central banks, especially in their pursuit of domestic monetary policies and national development objectives, that is being inhibited by the private interest of global capital. The role of financial capital in national development is complex. Greider (1997) provides an excellent and detailed review with an institutional framework that contrasts with formal neoclassical analysis as that of Barrow (1997), for example. For a review, see Sirageldin (1998).

The following discussion focuses on the danger of open finance given the limited development of financial institutions in the Arab region. The large flow of temporary labor migration in the Arab region during the past twenty five years has unintended effects on the development of financial institutions in the region. An important consequence is the large flow of remittances out of the oil economies. This flow of remittances provides a valuable source of foreign exchange to most of the labor-surplus countries in the region. This has created formal and informal establishments trading in foreign exchange all over the Arab countries. Most governments of the region have

introduced various types of financial regulations, mainly to attract remittances and minimize capital flight. Financial reforms in the labor sending countries have been focused on this objective. These reforms are not intended as an overhaul of the financial system to be better equipped to attract foreign investment on a scale demanded by the globalization process. Deregulation and privatization of the financial and banking systems to some extent, have not been in line with the narrow requirements of maximizing the inflow of remittances and foreign exchange – as perceived by policy makers at the time. Although, at present, the rehabilitation of the financial system is a priority, there are necessary prerequisites requiring careful considerations (El-Erian and El-Gamal 1997, Darrat 1997, ERF 1995). Moreover, the pace of lifting all curbs on capital outflows needs careful consideration, especially in the context of the high volatility of private international capital flows.

Openness in financial flows such as allowing nationals to borrow directly from international money markets and foreigners to hold national assets without adequate monitoring system, could cause unpredictable capital flight and erratic fluctuations in the foreign exchange market that undermine the value of the country's currency. Serious instabilities in the financial market could be triggered by policy errors, over-borrowing by the private sector, or by destabilizing international speculations in the stock markets. In the global environment, wage differentials and the shifting of 'bottom line' of profitability across national economies are triggering capital flight more often. By the very nature of the globalization process and the requirements set by international regulatory institutions, state governments have little power over these activities – being 'influenced at distance' – although the local consequences could be devastating. Results of such destabilizing activities include the transfer of national assets and jobs outside the country leading to a vicious circle of flight. It is a contradiction of the present system that in times of crises, it is only financial capital that is being compensated for losses resulting from its own errors of speculation activities in the free financial market that they insist to construct. The cost of the bail out, however, is being borne by labor plight, and engineered by the intervention of national governments into that very market, finance capital and the international regulatory agencies strive to maintain perfectly competitive! The present global economic policy metaphor seems less about reducing government than about which gets to use it – capital or labor.

As the recent experience of Southeast Asia illustrates, the near collapse of the financial institutions in the countries of the region which is a result of large scale capital flight, has led to severe devaluation of their currencies, a steep rise in unemployment, disruption of exports, and costly unrest. For example, after months of civil unrest and riots, a result of rising unemployment and prices, the President of Indonesia had to resign in May 1998. Also, the Prime Minister of Malaysia acknowledged in an interview with Business Week (May 1998), that his country has been set back at least ten years as a result of the financial crises. There have been policy errors. But in retrospect, the case of Indonesia illustrates that the explosive outcome that emerged has been inevitable – a result of combination of government-suppressed wages and government-administered bribery. Since the early 1990s, protests of Indonesian labor against low wages and the suppression of labor and human rights by government authorities have been on the rise with signs of ethnic violence (Greider 1997). In a global market system, the financial integrity of the country cannot be maintained by state policies alone. The behavior of

finance capital is a powerful force with a short-term profitability vision purified from social concerns. It is instructive to sketch briefly the process that led to the financial crises in Southeast Asia.

Countries of Southeast Asia started their development path on a solid foundation: effective control of high rates of population growth, development of high quality labor force, high saving ratio, and strong institutional reform that encourages outward orientation and international competitiveness. As a result of relatively low wages, high productivity, and initially undervalued local currencies, the region became a haven attracting foreign investment and lending to the private sector on a large scale. However, success brought with it roots of difficulties. The large inflow of foreign investment and finance raised the value of local currencies to levels higher than their true market values. The private sector, in the absence of control, a requirement encouraged by the IMF, or of an adequate internal monitoring system, over-extended itself, especially in short-term borrowing. Furthermore, the initial relative advantage of cheap labor with minimum guarantees of labor rights started to erode. The result has been a shaky national financial system and insecure economic and political structures that could not withstand external shocks. When the crisis occurred, national governments had little effective policy options to implement. On the other hand, traditional safeguards of the present international regulatory institutions are not adequate to deal with large and uncontrolled borrowing by the private sector. Traditional structural adjustment policies dealt mainly with public debt and governments' over-spending – a more controlled environment. According to Bhagwati (1998: 40):

“Emerging markets have clearly benefited from liberalizing curbs on imports, services, and foreign investment in industry and equity markets. (The) IMF made an enormous error in pressuring developing countries to lift all curbs on capital outflows, thus enabling foreign lenders and fund managers to whoosh billions of dollars in and out of their economies.”

The debate over the proper pace of financial liberalization will surely go on for years. It will take several years for the developing countries to build regulatory agencies and financial systems to cope with today's volatile private capital flows. The emerging economies that already have opened their doors for capital outflows, will continue to be exposed to new shocks and experiences. Evidently, learning through experience in the present world system of global commerce and finance has high socio-economic and political cost. The rules governing international finance capital are yet to be developed and mastered.

Transparency in Government and Equal Opportunity. The role of governments in economic and social development is being revisited and examined critically at the present time. Regardless of past records of success or failure, the question at the center of current developmental debates is under what conditions states are able to adapt to the demands of a globalizing world economy. As illustrated above, the question has no easy answer. For some, the main function of the state in the present global environment is to assure that markets flourish. In this paradigm, governments should leave production activities to the private sector since public investments tend to produce heavily subsidized and inefficient state-owned enterprises in agriculture, manufacturing, energy, banking and financial services. More importantly, public investments tend to crowd out the private sector from profitable investment opportunities

and discourage international direct investment. On the other hand, public direct investment in production activities has been viewed as important for promoting economic growth and the generation of employment opportunities especially in countries characterized by the existence of monopolies, lack of developed capital markets and information. The optimal mix between public investment in activities that promote market efficiency and those that supplement private sector production is context-specific and is largely an empirical question.

There have been recent empirical attempts to test the crowding effect of public investment on private investment (see for example Ghali 1998 and references cited therein). However, most of these studies test for the effect of total public investment on the growth of private investment and not for the effect of its composition between public investment for direct production and public investment to enhance market efficiency. The attempt by Ghali (1998) is a case in point. Following Barth and Cordes (1980) and Ramirez (1994), Ghali introduces private and public capital stocks as separate inputs in a neoclassical production function. Using multivariate cointegration techniques, Ghali is able to investigate the effects of public investment on private capital formation and economic growth in the case of Tunisia over the period 1963-1993. The findings indicate that in Tunisia, public investment had a negative short-term impact on private investment and a negative long-term impact on both private investment and economic growth. The study concludes with a blanket policy recommendation: that ‘shrinking the public sector’ should benefit the long-term growth prospect of Tunisia. The study however, does not differentiate in its empirical specification, between the effect of public investments that are market friendly and those that crowd out private investment.

Evidently, there is a general consensus that public investment is important when confined to the provision of the goods and services and the rules and institutions that allow markets to flourish (World Bank 1997). It is agreed that an important role for the state is to assure the efficient functioning of markets. It has to be emphasized however, that government functions, regardless of their content, may not succeed in achieving their objectives of promoting private sector growth or economic growth in the absence of transparency and accountability. Furthermore, these government functions must be supported by an uncompromising ethical system of equal opportunities. In his address to the Oman 2020-Development Vision Conference in May 1995, the Secretary of Development of Singapore, Mr Daniel Selvaretnam, made the point that equal opportunity is a basic tenant of Singapore development – student’s or employee’s promotions or any other state affair is based on merits and merits alone. There are large civil penalties for lack of compliance to this system. What is more important is the high social penalty. The social system has endogenized this ethical principle according to Selvaretnam.

It is evident that the Arab region, especially the GCC countries and other oil-exporting countries, cannot escape a significant role for the state.⁹ This role should include the reform of governance as a basic requirement. As mentioned earlier, the globalization process affects the internal authority of the state in various ways. Among

⁹ The case of government role in the GCC countries is examined in Sirageldin and Al-Ebraheem (1997). Missing from the present discussion of the role of government, is the relation between public policies, environment and conflict. For a recent analysis and references, see Sirageldin (1996).

others, these include labor relations, tax and subsidy systems, and environmental considerations. The interventions, however, could be selective and divert attention from the fundamental objective of IOSRs. Transparency in governance is a basic requirement to reduce undesirable external pressure. It should be clear that at the heart of this discussion, is the belief that there are non-trade factors essential for accelerating industrialization. It is not the intention of this paper to make a textbook case for free market as a means of achieving optimal resource allocation and welfare maximization. This case can hardly be disputed given some rather restrictive assumptions and preconditions to exist. But in reality, they never exist in their totality. In the absence of these conditions, there must be a role for public intervention. As Park (1996: 361) remarks in the context of the East Asia experience:

“(The) spectacular success stories of rapid industrialization in east Asia countries have shown that appropriate industrial policy, that is one incorporating the EOI strategy, can make a critical difference in the success or failure of industrialization efforts, and more importantly, that state policy interventions *do* matter, which directly challenges the validity of the neoclassical doctrine.”

Lessons from Southeast Asia¹⁰

The Southeast Asian experience has been documented extensively. Until 1997, many East Asian countries, dubbed the Asian Tigers, were widely regarded as economic miracles. The real per capita gross domestic product of Hong Kong, Singapore, South Korea, and Taiwan grew at 6% per year for 35 years from 1960 to 1995. Right behind were Indonesia, Malaysia, Thailand and China. However, the Asian reputation has suffered recently because of financial crises and recession. This section attempts to distill some lessons that are of relevance to the Arab countries.

It is generally acknowledged that the Asian experience, especially its aspect of state policy intervention, does not conform to neoclassical free market policy prescriptions. The neoclassical school attempts to explain the East Asia experience as composed of good and bad policies. Good policies which are responsible for success include non-functional market-friendly interventions such as capital formation, human resource development, technological upgrading and export promotion. Bad policies on the other hand, relate to selective policy intervention affecting inter-industry resource allocation in favor of government targeted industries (World Bank 1993). Caution is called for, however in making a distinction between functional and selective interventions (Park 1996: 362):

“First of all, any intervention that removes market failure, whether it is functional or selective, is market-friendly. Second, any market-friendly measure such as skill formation or export promotion can be formulated along functional lines or on a selective-industry basis. Finally, because of imperfections in capital and technology markets, strong selective policy interventions are needed for the acquisition, adoption, adaptation and indigenous development of new technologies.”

The experience and empirical evidence on the experience of East Asia and most of the Association of Southeast Asian Nations (ASEAN) indicate strong public interventions. Indeed, state interventions are not necessarily a panacea. There are many

¹⁰ This section benefited from Park (1996).

historical cases where interventions have created much more harm than good. But the opposite cases also exist. In the Arab region, where state intervention is required for basic structural transformations, the question should not be whether state intervention *per se* is good or bad. What matters is the quality of intervention, its content and timing – learning from previous and others errors. Parks’ concluding remarks in his review of the East Asian experience are to the point (1996: 380-381):

“(The) nature, extent and objectives of industrial policy and the consequent implications for State intervention in the economies of developing countries may change over time. Successive policy changes may be viewed as an evolution towards a completely functioning free market. This further implies that no single optimal industrial policy exists for all developing countries; rather, there are different optimal policies for different groups of developing countries at different stages of industrialization.”

There are other factors in the Southeast Asian experience. The intensification of inter-industry trade has generated a dynamic base for the transfer of technology and increased efficiency and competitiveness. Recent analysis indicates that there has been significant increase in productivity growth resulting from improvement in technology that raises the demand for physical capital (machines and buildings) and human capital (highly educated workers). Thus, although the region has suffered recently, probably as a result of some policy shortcomings such as unwise credit subsidies and deficient regulations of financial markets, the basic fundamentals are robust (Barrow 1998: 24).

Again, it is important to remember the necessary conditions. All the East Asian successful economies have had a strong and successful population program and high quality education especially at the basic level (Sirageldin and Al-Khaled 1996). In the present financial crises in the Southeast Asia region, the countries that have the most investment in their human resource development and a constitutional framework for equal opportunity and the ideal of *isonomy* will probably recover faster with lower socio-economic losses.¹¹ However, recovery will depend to a large extent on the ability of national governments and the international community to control the present behavior of international financial capital in which a common ground between the needs of labor and capital is found. Only time can tell however.

Summary and Conclusions

A review of recent studies that attempt to estimate the potential gain from the Arab region integration in the world economy, indicates initial losses or insignificant gains. This is not surprising since the fundamentals of the economic structures and institutions in the Arab world are not developed or equipped for a highly competitive global environment. For the Arab countries to benefit from the inevitable integration in the world economy, they must adopt combined and coordinated internal and outward development strategies. Any outward-oriented reforms (OOR) or export-oriented industrialization strategy (EOI) must be part of an internal-oriented sustainable reform (IOSR). The latter should include as its fundamental elements the following: the

¹¹ The ideal of *isonomy* refers to the certainty of being governed legally in accordance with known rules. See Hayek (1955) and Sirageldin (1996).

development of human resources, equality of opportunities, transparency in governance, strong local demand, and sustainable environment. Lack of progress in IOSR, relative to that of OOR/EOI, could be a call for social unrest and costly economic losses.

The delicate balance between IOSR and OOR is best illustrated by attempts to reform financial institutions. Lifting all curbs on capital flows without instituting a system to monitor private sector borrowing in the international money market and provide signals when the system overshoots or overheats, could lead to crises and economic setbacks as the case of Southeast Asia illustrates. The pace of financial liberalization should be closely linked to development in IOSR on the one hand, and to development in the international monetary regulatory institutions on the other hand.

IOSR is neither automatic nor instant. It requires deliberate policies and long-term commitment. Furthermore, IOSRs are context-specific. Each country should adopt and specify the time path of its own and specific IOSRs. Given the institutional and political structures of the Arab countries, many of the reform elements in IOSR are long-term and require a major role for the government. This situation indicates the dilemma facing the Arab countries. Basic structural and institutional reforms are required for the Arab countries to become competitive in the global environment. But the required reforms cannot be done without extensive government involvement and support. Governance is one of the key institutions that requires extensive reform in the Arab World.

Government reform and a careful delineation of its role in this transitional phase of Arab development are not an impossible task. The paper presents examples of Southeast Asia's successful experience where governments play important roles. However, transparency and accountability in governance, combined with the development of a first-rate quality of human capital and equality of opportunities are basic ingredients to pursue successful policies of OOR or EOI. The new international order presents opportunities that can only be captured with the right mix of policies, governance and long-term commitment.

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