United Nations

E/2007/20

Economic and Social Council

Distr.: General
19 April 2007

Original: English

Substantive session of 2007
Geneva, 2-27 July 2007
Item 10 of the provisional agenda*
Regional cooperation

Summary of the survey of economic and social developments in the Economic and Social Commission for Western Asia region, 2006-2007

Summary

For the Economic and Social Commission for Western Asia (ESCWA) region, 2006-2007 marked another period of robust economic expansion in the region, with the exception of Iraq, Lebanon and Palestine, where regional conflicts and political instabilities reduced significantly the economic potential of those ESCWA members. The recent favourable external economic condition, represented by high oil prices, continued to buoy the region. While a deceleration of the gross domestic product (GDP) growth rate was observed, the level of growth was still high in most ESCWA member countries in 2006. Average GDP growth for the ESCWA region was an estimated 5.6 per cent for 2006, down from 6.9 per cent in 2005, which is forecast to decrease to 5.1 per cent in 2007.

In the two decades between the first and the current oil boom, the region exhibited negative average real per capita growth rates, rising unemployment rates and a growing gap in income distribution within and across the countries of the region. With lower oil rents, the rate of funding to the social infrastructure retreated, causing, in one instance, the quality of education to decline. Additionally, investment rates fell to a low 16 per cent in 2002, and productivity per worker was on average somewhere between steady and declining, while intraregional trade remained low, between 7 and 8 per cent. On the whole, however, the ESCWA region experienced excess savings, with extra funds continuously channelled abroad for reasons of low absorptive capacity or for regional security considerations. While this second oil boom represents a welcome occurrence to entrench the welfare gains of high growth,

* E/2007/100.

07-31237 (E) 140507

it comes with rising regional tensions. That translates into a pervasive threat of conflict that could add to the stresses of national institutions, which represent the very institutions that are charged with the process of development. There is a pressing need to enable the national agencies for development to avert the long- and short-term effects of the "resource curse", whereby the abundance of natural resources undermines overall economic performance and the competitiveness of the tradable sector, and the effects of "Dutch disease".

The theme of the Survey this year is to draw lessons from the previous oil boom and to search for policy alternatives capable of retaining financial and human resources in order to meet the requisites of development as a human right and to achieve the Millennium Development Goals.

Contents

I. Recent economic trends and developments in the Economic and Social Commission for Western Asia region

A. The global context

1. The world economy continued its expansionary track in 2006, albeit at a decelerating rate of growth towards the end of the year. Current growth was broad-based and seen as being positive for both developed and developing economies, though its linkage to employment creation has still been weak. Robust demand growth continued to enhance the stable growth in the world flows of goods, services and capital. Moreover, institutional reforms in developing countries have helped to support the level of world demand.

2. The growth of global liquidity, which had peaked in early 2004, bounced back in early 2006. Despite the monetary tightening trend by central banks in developed countries, a continuous rise in world commodity prices created an ample cushion in the world expansion of credit. The narrowed spread between policy interest rates and long-term bonds was observed in most developed countries and some developing countries. The global imbalance, represented by the expanding current account deficit of the United States of America, has continued to be supported by strong demand for the financial assets of that country. The demand for United States treasury bonds grew in China and in the oil-exporting countries.

3. More signs of inflationary pressure emerged in 2006. For some countries, it was comparatively benign, with the first-round effects of higher commodity prices, particularly of oil products. However, the general hike in commodity prices caused a moderate increase in the price of basic food stuffs. Moreover, some developing countries saw a rapid expansion of domestic demand, with home-grown inflation stemming from the rapid rise in housing prices and corresponding rents.

4. In that global context, the ESCWA region marked another year of robust economic expansion, with the exception of Iraq, Lebanon and Palestine, where regional conflicts and political instabilities reduced significantly the economic potential of those ESCWA members.* The recent favourable external economic condition, represented by ample global monetary liquidity and high oil prices, continued to have an effect on the region. Specifically, this set of external factors, together with various efforts of intraregional cooperation, helped to minimize adverse effects and consequences of conflicts and political instabilities that would otherwise have been more devastating to the region, increasing its vulnerability.

B. Oil sector development

5. The world demand for crude oil continued to grow in 2006, albeit at a more moderate rate than in 2005. The rebound in the growth rate was largely expected from strong demand growth from North America and China at the beginning of the year. However, the projection of demand growth was successively cut as a result of sustained weaker demand from North America and developed countries throughout

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

the year. High oil prices encouraged those developed countries to switch their fuel sources to natural gas. Moreover, while strong demand growth was observed in China and other developing countries, overall demand growth in crude oil was moderate in 2006.

6. Despite the weaker than expected growth in demand, crude oil prices stayed historically high. The crude oil price of the Organization of Petroleum Exporting Countries (OPEC) reference basket averaged $61.08 per barrel in 2006, compared to $50.64 in 2005. The tight supply-demand condition in fuel products remained, as the bottleneck in refinery capability stayed unresolved. Moreover, owing to ample global monetary liquidity, speculation caused a rapid price hike until the summer, which was followed by a rapid plunge towards the end of 2006. The OPEC reference basket is projected to average $55 per barrel in 2007.

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

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

C. Output and demand

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

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

11. On average, GDP growth in the countries of the Gulf Cooperation Council was estimated at 5.9 per cent in 2006, after registering 7.3 per cent in 2005. While crude oil production and exports were the key factor for economic growth in the Gulf Cooperation Council, the development of non-oil sectors contributed to stabilizing overall economic performance. The development of non-oil sectors has been crucial for resilient growth in domestic demand in those countries during the present oil boom. The financial services and construction sectors led the growth in non-oil

production, thereby creating more linkages among supply-demand structures of the economy. The development of those linkages was observed in most countries of the Gulf Cooperation Council, which contributed to stabilizing GDP growth rate in that subregion.

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

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

Economies of the ESCWA region: rates of economic growth and inflation, 2003-2007

(Annual percentage change)

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

Country/area	Real GDP growth[g] 2003	2004	2005	2006[a]	2007[b]	Inflation rate[g] 2003	2004	2005	2006[e]	2007[f]
Conflict-affected economies[d]	-13.9	11.4	4.6	0.4	6.0	14.6	12.2	15.2	26.9	32.9
ESCWA region except conflict-affected economies	7.4	7.0	7.0	6.0	5.0	2.2	5.1	3.7	5.4	4.1

Source: Economic and Social Commission for Western Asia, based on computations of growth rates from real GDP figures at constant 2000 prices. The latter are taken from national sources and from official figures as provided in responses to questionnaires in *National Accounts Studies of the ESCWA Region*, No. 26.

[a] ESCWA estimates, February 2007.

[b] ESCWA projections, February 2007.

[c] Iraq rates are based on official sources except for 2005 and 2006, which are ESCWA estimates.

[d] The average of Iraq, Lebanon and Palestine.

[e] 2006 estimates are based on official preliminary figures.

[f] International Monetary Fund, *World Economic Outlook* database, September 2006.

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

D. Costs and prices

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

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

E. Labour markets

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

17. In Iraq, where the estimation of unemployment was exceptionally high, the acceleration of emigration and outflows of the skilled labour force became a major

concern. To a lesser degree, the same phenomenon was observed in Lebanon after the war in the summer in that country. Security pressure caused a reallocation of human capital and a potential for uneven development in the region.

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

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

F. External sector

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

21. In respect of the United States-Middle East Free Trade Area, the United States was active at various stages of trade negotiations in the ESCWA region. In January 2006, a free trade agreement was signed between Oman and the United States; a free trade agreement between Bahrain and the United States entered into effect in August of that year; and the United Arab Emirates was at the negotiation stage to establish a free trade agreement with the United States. In parallel to those developments and within the framework of the Euro-Mediterranean Partnership, the Agadir Agreement between Egypt, Jordan, Morocco and Tunisia came into effect in 2006, aimed at establishing a free trade agreement between the four Arab Mediterranean countries with benefits of preferential access to European Union markets. The Gulf Cooperation Council was actively engaged in trade negotiations with its important trading partners and held several rounds of negotiations with the European Union to establish a free trade agreement. The Gulf Cooperation Council also considered setting up such agreements with China, India and Singapore.

G. Economic policy developments

22. With the exception of the conflict-stricken economies of Iraq, Lebanon and Palestine, the high oil revenues in the GCC countries and the robust economic performance of the more diversified economies enabled the Governments in the region to form active fiscal expenditure policies for their fiscal year covering 2006. An increase in Government expenditure in the health and education sectors was observed to be a priority in most of the countries. Moreover, the priority attached to economic diversification efforts was also reflected in the initiation of urban development projects, particularly in the countries of the Gulf Cooperation Council. Despite the significant increase in Government expenditure, ESCWA member countries maintained their prudent fiscal policy stance. The oil price projections for revenue estimation were very conservative in the national budgets of the GCC countries. Egypt and Jordan successfully met their targets in reducing budget deficits and public debt. While development needs spurred Government expenditure in Yemen, it was executed on the basis of increased oil revenue and stable international assistance.

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

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

25. In order to alleviate an extremely high inflation rate, the Central Bank of Iraq revaluation of the national currency has occurred continuously since November 2006 so that import prices would decline in terms of national currency. In the two months prior to the end of 2006, the Iraqi dinar appreciated against the United States dollar by 12 per cent. The Central Bank of Kuwait raised the value of its national currency against the dollar by 1 per cent in order to quell inflation pressures that stemmed from the depreciation of the dollar against other major currencies. While other central banks of the Gulf Cooperation Council countries did not follow this move, policy discussions on the exchange rates of those countries, which are pegged to the dollar, intensified in 2006, particularly in the light of the imminent Gulf

Cooperation Council monetary union that planned for 2010. Moreover, Oman announced in December 2006 its decision not to join the Monetary Union by 2010, which stirred discussions over processes and schedules for the single currency of the Gulf Cooperation Council.

H. Prospects

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

27. A worrisome economic factor for the region is a worldwide credit crunch where the growth of global monetary liquidity stalls. With less inflows of capital, the more diversified economies may face foreign exchange ceilings on domestic demand growth, which could cause severe macroeconomic imbalances and possibly inflation. While the countries of the Gulf Cooperation Council are not expected to face foreign exchange ceilings even if those circumstances are present in the world economy, such ceilings could damage the strongly emerging financial sector of the subregion. Despite a low probability of such a worldwide credit crunch occurring in 2007, there is a need to recognize the potential vulnerability of the region.

28. Policy discussions on institutional developments and arrangements concerning regional economic cooperation will be intensified in 2007. The outcome of such discussions, particularly those concerning the Gulf Cooperation Council monetary union, will be crucial for the ESCWA region and for the international financial architecture. Moreover, labour market reforms will increasingly be on the agenda in relation to trade negotiations for free trade agreements with trading partners of developed countries. Such reforms influence national human resource development as well as the distribution of human capital within the ESCWA region.

II. Lessons from the previous oil boom

A. The issues

29. The current oil boom affects ESCWA members in very different ways. Given the persistence of relatively high oil prices, the region will continue to enjoy higher than average growth rates. However, falling oil prices and their impact on welfare are of major concern. The *Survey of Economic and Social Developments in the ESCWA Region, 2006-2007* examines the monetary and financial policy implications of the boom for countries or areas in different contexts, especially the Gulf Cooperation Council and more diversified economies. It also looks at how, when they are available, those resources can be deployed in order to foster the achievement of lasting pro-poor and rights-based goals. The specific focus of the *Survey* is the interaction between monetary, financial, fiscal and distributive policies in the ESCWA member countries and areas under conditions of oil boom. The work

aims to identify policy options for specific country groups within ESCWA and the institutional means to achieve the desired objectives under the concrete circumstances of the ESCWA members.

30. Managing the boom hinges on the outcome of Government policy decisions and on the adequacy of those policies. While the “resource curse” could plague natural resource-rich countries in the long run, the “Dutch disease” is believed to affect those countries in the short run, when export markets are exceptionally favourable. The inflow of foreign exchange resulting from the oil boom is thought to trigger a range of adverse economic outcomes, including inflation and deindustrialization. The latter partially occurred in the case of the nascent industries of the more diversified economies, while oil rents may have favoured industrial developments in the GCC countries. The ESCWA region has been subjected to elements from both types of negative externalities. However, none of those issues is inevitable or unavoidable given the right policy mix, and the possibility exists for making durable welfare gains.

31. The resource boom manifested itself initially through the improvement of the national balance of payments. That improvement enabled the regional and national economies to command additional resources in the world economy, including imports, investments abroad and remittances to other parts of the world, at no immediate or apparent cost to themselves. In such circumstances, additional spending in domestic currency becomes possible once a portion of the new foreign currency inflows has been internalized and exchanged for local currency. Through such diverse channels, the extraordinary currency inflows tend to induce a higher level of activity in the domestic economy, which in turn, and in some cases, can trigger the real appreciation of the currency. That appreciation can become a source of difficulty for the economy if it hinders export diversification or erodes the competitiveness of traditional areas of activity. It can also increase the structural fragility of the balance of payments or reduce the ability of the economy to cope with adverse shifts in resource inflows. In the ESCWA region, economic diversification has been sluggish.

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

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

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

B. Transmission mechanisms

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

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

that sense, Dutch disease is both avoidable and a policy outcome; it is the unintended consequence of Government policy choices and private sector behaviour.

C. Policy guidelines

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

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

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

40. Fiscal policy in the ESCWA region must have four objectives in order to avoid symptoms of Dutch disease, as follows: (a) to reduce the variability of growth (the short-term countercyclical function); (b) to raise the growth rate (the long-term supply function); (c) to affect the composition of growth by economic activity; and (d) to make growth more equitable. It is relevant in this context to re-emphasize, as suggested in the *Survey of Economic and Social Developments in the Economic and Social Commission for Western Asia Region, 2005-2006*, that presumptive taxes on income and short-term capital gains are preferable to a heavy reliance on indirect taxes. While indirect taxes are generally less income-elastic than direct ones in the ESCWA region, they do not represent a serious constraint on the accounting side. Moreover, the stabilizing function need not be carried out on the revenue side, particularly in oil-exporting countries. Creating an oil fund, for example, allows a Government to set aside petroleum revenues when international prices are high (and the economy is expanding), and to use that reserve when prices fall in order to offset recessionary conditions. However, the purpose of progressive taxation is not simply a matter of accounting; rather it is to introduce fiscal reforms that can also provide feedback into institutional reform, thereby encouraging development in all sections of society.

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

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

43. Public investment could be a central aspect of an active fiscal policy, which is particularly important for petroleum-exporting countries. Unless managed carefully and designed appropriately, public expenditure can be the major cause of Dutch

disease. The expenditure of large revenues from oil needs to be managed in line with the following two basic guidelines:

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

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

44. The objective here is to minimize the negative impact of short-term fluctuations resulting from abrupt capital flows and low oil-price shocks and to maximize the long-term contribution of technology and other knowledge-based factors to growth. The latter outcome alone is in itself a buffer against erratic capital or price movement. However, in the initial stages, this requires steady investments in research and development, human capital and the institutional framework that are independent of movements in capital flows and oil-price fluctuations. Such investment flows could create the sort of public/private partnership that can increase long-term private sector competitiveness and public sector efficiency. Moreover, there is empirical evidence to suggest that investments of that sort tend to exhibit much higher returns than purely physical investments. However, such a scenario also requires a higher level of regional integration and an investment and growth stabilizing fund. In short, a regional stabilization fund requires regional cooperation. Calls for integration in the past, which were based on the supposed benefits of integrating oil-producing countries with non-oil producing countries, have made little progress. Rather, it appears that as a result of increasing common geopolitical concerns and capital mobility, measures towards cooperation were undertaken not so much to reap the benefits of integration as to prevent the common woe of collapse resulting from geopolitical considerations. In fact, recent trends indicate that currency stabilization measures in the region were carried out on various bilateral levels in what amounts to de facto monetary cooperation. This needs to be taken one step further by expanding or instituting a de facto Arab monetary cooperation framework.

45. Much greater scope exists to use public investment to foster the non-oil tradable sectors. By definition, construction itself is a non-traded activity. However, the provision of infrastructure can be targeted to cost reduction for the tradable sectors. An obvious example is transport infrastructure that lowers costs for

exporters. Other examples are improvements in communications, including Internet services, and the creation of public or private sector institutions for research and development.

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

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