

# Executive Summary

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The *Arab World Competitiveness Report 2002–2003* (AWCR) represents the first systematic benchmarking exercise for the region, combining broad macroeconomic and political analyses with analyses of country competitiveness. Published under the umbrella of the World Economic Forum's Global Competitiveness Programme, this Report has been produced as a companion volume of the *Global Competitiveness Report* (GCR). As such, the underlying approach of the AWCR is largely consistent with the GCR, defining competitiveness as "the set of institutions and economic policies supportive of high rates of economic growth in the medium term." Unlike the GCR and other regional reports, however, the AWCR does not attempt to rank individual countries according to their international competitiveness, mainly because of important data limitations.<sup>1</sup> Nevertheless, some Arab countries, namely Jordan and Egypt, are also included in the GCR and thus serve as an anchor in the sense that they provide important hints as to where other countries, which are not ranked in the main report, broadly stand on an international scale.

The AWCR comes at a critical time. The global economy is wrestling to achieve a sustained recovery, and several countries in the Arab world have been hard-hit by the recent decline in economic activity. For several countries, namely those in the Gulf region, the main economic channel precipitating decline has remained the curtailment of oil production in line with falling demand. However, with economic integration, especially with the European Union (EU),

having gathered momentum in recent years, other economic channels, such as nonenergy trade and capital flows, have become increasingly important. Moreover, the security situation in the post-September 11, 2001 period continues to have an important bearing on economic activity in several countries, primarily through depressed receipts from tourism. The hardest-hit economies, of course, are the West Bank and Gaza, where the ongoing conflict has led to a sharp contraction of output and a massive increase in unemployment.

With recovery in the industrial countries expected to be delayed into the final quarter of 2002 and early next year, the World Bank forecasts real output in the Arab region to expand by less than 3 percent this year, significantly less than in the two preceding years.<sup>2</sup> A moderate recovery is expected for 2003, but this expectation is predicated on a number of critical assumptions, notably an increase in world demand, the normalization of tourism receipts, and an improvement in the terms of trade. World Bank forecasts are more or less in line with those of other institutions, although some institutions, including the International Monetary Fund, are even more cautious.

While the short-term outlook for the Arab world remains clouded with substantial uncertainties, this *Arab World Competitiveness Report* is primarily concerned with the region's ability to achieve sustained economic growth over the medium and long run. That this ability is severely impeded by a wide range of structural factors becomes immediately clear when one looks at the Arab world's growth performance over the last few decades relative to other regions. While the current slowdown has much to do with lower oil production and the deteriorating security situation, it is also consistent with the trend of decline in real incomes per capita in most Arab states over the last ten years. Economic activity in the Arab world boomed during the oil boom of the 1970s, and declined along with the sharp decline in oil prices that occurred first in 1981 and again in 1986. It would have been hard for the oil-exporting countries to avoid a dip in economic activity during the 1980s. However, the region continued to stagnate in the 1990s. The question is, why?

Between 1975 and 1999, economic growth averaged 3.3 percent per year, which was, basically, in line with the world average. Because population growth remained very strong, however, per capita incomes stagnated in the final quarter of the last century—underperforming all other regions, in fact, except for sub-Saharan Africa. In several countries, including

Iraq, Kuwait, Libya, and Saudi Arabia, GDP per capita actually fell during this period. It is estimated that around 12 million people, or 15 percent of the labor force, are currently unemployed, a number that could rise significantly over the next few years unless there is an upswing in economic growth that creates more jobs.

The current cyclical slowdown exposes the existing structural impediments even more. Several of these impediments have been highlighted in a recent United Nations Development Program report.<sup>3</sup> According to this Report, three major “deficits” prevent the Arab world from reaching its potential. Removing them requires, the report argues, rebuilding Arab societies based on the following:

- Full respect for human rights and human freedoms as the cornerstones of good governance, leading to human development.
- The complete empowerment of Arab women, taking advantage of all opportunities to build their capabilities and to enable them to exercise those capabilities to the full.
- The consolidation of knowledge acquisition and its effective utilization. As a key driver of progress, knowledge must be brought to bear efficiently and productively in all aspects of society, with the goal of enhancing human well being across the region.

Tackling the three deficits will deepen and improve the Arab world’s social capital, which is determined by a wide range of factors including the level of education, workforce skills and attitudes, managerial talent, legal institutions and regulatory practices governing business, the level of trust, and the presence of networks. It will also accelerate the speed of technological progress, affecting the Arab world’s transition from an economy that largely competes with basic factor conditions to one where competitiveness is increasingly achieved by harnessing global technologies for local production. Therefore reducing, and eventually eliminating, the three deficits constitute a necessary condition for the Arab world to move to a steeper growth trajectory in the future.

Knowledge, innovation, and technology are also shown to play a central role in the present *Arab World Competitiveness Report 2002-2003*. As our previous research has shown, technological advancement represents a key driver of national competitiveness and economic growth.<sup>4</sup> In the current research, technological progress has been found to be a function of a complex set of variables, including the level of

education of a country’s population, the mix of public and private institutions that support innovation, the diffusion of ideas across sectors, the inflow of ideas from foreign economies into the domestic economy, the availability of venture capital, and tax laws favorable to new start-ups.

A business environment that is conducive to entrepreneurship and private risk-taking, thus supporting innovation, also requires macroeconomic stability, well-managed public institutions, and well-functioning goods and factor markets. Moreover, there is substantial evidence that the degree of a country’s openness and integration into the global economy represents an important driver of its competitiveness and economic growth prospects. A liberal trade regime expands trade and investment options, and allows countries to specialize in and export those products for which they have a comparative advantage, thus helping to improve the efficiency of resource allocation. Distortions may arise not only from trade restrictions, but also from exchange controls such as multiple exchange rates, bilateral payment arrangements, or surrender requirements. Restrictions on capital flows limit a country’s access to foreign savings and may therefore affect its growth potential. (However, it is important to note that dismantling such restrictions can also involve considerable risks.) Finally, the combined influences of distance, geography, and costs of trade affect the way countries compete internationally. Upgrading a country’s physical infrastructure, that is, the quality of roads, railroads, ports, air traffic, and so on, should be considered an important policy objective, because lack of improvement may lead to a plateau in productivity growth.

It is important, however, to distinguish between necessary conditions for growth and development, and true engines of development. Necessary conditions for development are, for example, basic infrastructure or low-to-moderate inflation. Without satisfying the minimum thresholds of these factors, development will never take place. Yet these factors alone are not sufficient for development. Engines of development, by contrast, are the true forces that propel an economy to higher levels of income. It is possible for an economy to be sound and stable, but to stagnate nevertheless, because the engines of growth are not working with sufficient power. In addition, to an extent we do not yet fully understand, it may be necessary to have several engines functioning simultaneously to complement one another.

Much of the current policy debate about the Arab world's competitiveness is about necessary conditions: resolving international conflicts and tensions, achieving macroeconomic stability, and creating better institutions. When considering longer-term development and competitiveness, growth engines should also be considered. The region has for too long pursued a one-dimensional growth strategy, making it far too reliant on capital accumulation as the single engine of growth.

Based on an approach that encompasses both necessary growth conditions and individual growth drivers, this Report identifies key impediments to economic development in individual countries. These impediments—and appropriate policies to remove them—are examined in individual chapters of this Report.

Jonathan Story (INSEAD), in the introductory chapter of the Report, provides the geopolitical background for our assessment of the region's competitiveness. As he discusses, the Arab world had been at the epicenter in the last three decades when the “tectonic plates supporting the structure of global politics started to grind”—precisely where the region is again today. Story argues that the Middle East has “never starred in the theatre of Francis Fukuyama's famous story about the end of history, and the ultimate victory of liberal democratic ideals.” In its recent *Human Development Report*, the UNDP stressed that one of the key challenges facing the Arab world was the failure of the growth of market democracy. According to Story, market expansion has failed mainly because of “universal tensions between world and local time”—with world time being analogous to fast travel, instant communications, and a networked economy, and local time the provincial reality of most people's experiences, such as mythologized pasts that include holy places, ruins, and legends.

Peter Cornelius (World Economic Forum) and Andrew Warner (Harvard University) present an analytical framework in their chapter, “Engines of Growth for the Arab World.” Their point of departure is that growth in the region has been highly disappointing. While in the 1980s the substantial slowdown could be attributed to a massive deterioration in the terms-of-trade in the oil-exporting countries, in the 1990s it became apparent that the poor growth performance largely mirrored the lack of restructuring. The chapter identifies preconditions for sustained growth in nine different areas, maintaining that these preconditions

must be met in order to launch the economies in the Arab world on a steeper growth trajectory. Such preconditions include developing an improved macroeconomic environment, well-functioning financial markets, openness to trade, quality of government, rule of law, accessible and relevant education, infrastructure, eliminating or reducing corruption, and ushering in the new economy. Meeting these preconditions is no guarantee, however, that economic growth will actually accelerate on a sustained basis. For this to happen, the growth engine needs to run smoothly, fostering innovation and technological transfer and ensuring that it is easy to start a business.

That the region has remained highly susceptible to factors such as changes in energy prices and geopolitical events is reflected not least in the substantial short-term fluctuations of economic activity. As Xavier Sala-i-Martin (Columbia University) and Elsa V. Artadi (Harvard University) in their chapter entitled, “Economic Growth and Investment in the Arab World” show, however, this volatility masks the fact that the growth rate in the Arab world has actually tended to decline since the 1960s. Examining the reasons for this trend, Sala-i-Martin and Artadi focus particularly on investment, which, interestingly, increased in the second half of the 1970s and early half of the 1980s and has remained fairly robust since then. The answer to the puzzle of high investment/low growth lies in the quality of investment, the authors argue, emphasizing that private investment in the Arab region is both insufficient and inefficient. The slowdown of the growth process has very important implications for human welfare; as Sala-i-Martin and Artadi show, the distribution of income in the last two decades has not improved much, and little progress has been made in poverty reduction.

While the Arab world represents only 5 percent of the global population, it is a region with one of the fastest population growth rates. Over the last few decades, the Arab world's population has become substantially younger. As the United Nations Population Fund's Country Technical Services Team for Arab States write in their chapter entitled, “The Arab Population,” it will take only about thirty years for the total population in the Arab region to double from its current level of around 290 million. With fertility rates and population growth rates expected to fall in the next few decades, it is forecast that in 2025 it will take around forty-three years for the population to double again. These figures are alarming and pose substantial challenges for the Arab world, especially when the limited capacity and

availability of land and the scarcity of water resources are taken into account.

In his chapter “Structural Reforms in the Middle East and North Africa,” John Page (World Bank) takes as his point of departure the “inward-looking, statist model of development” that had characterized most countries in the region until around the mid-1980s. Since then, many economies have embarked on a reform process designed to achieve the “Washington Consensus” of macroeconomic stability; that is, a higher degree of integration with the world economy and an expanded role for the private sector. In reviewing the reforms in detail, Page finds that although encouraging progress has been made in some areas, the list of unfinished economic policies remains long.

In his chapter entitled, “Fiscal Revenues in South Mediterranean Arab Countries: Vulnerabilities and Growth Potential,” Karim Nashashibi (International Monetary Fund) reviews the fiscal revenue performance in these economies. He finds that revenues have been declining considerably over the last decade, mainly because of a fall in mineral receipts and trade liberalization. Given that trade protection is still higher than in other regions and must be reduced further, Nashashibi argues that there is an important need for countries to reform their income-tax systems and petroleum-product pricing, and to maintain flexible exchange rate policies.

Rodney Wilson (University of Durham) discusses “Arab Banking and Capital Market Developments.” Financial systems, as numerous empirical studies have shown, help mobilize savings; allocate resources; facilitate the trading, hedging, diversifying, and pooling of risk; monitor managers and exert corporate control; and facilitate the exchange of goods and services. Examining the banking industry and bond and equity markets in the Arab world, he finds that many of these functions are not yet fulfilled. In several countries, financial markets have remained in their infancy, retarding economic growth. Wilson also examines Islamic finance, which may be a market segment where the Arab world has a competitive advantage; this has yet to be fully exploited, however.

In order to assess the prospects of increasing foreign direct investment (FDI) in the Arab world, Florence Eid (American University of Beirut) and Fiona Paua (World Economic Forum) examine FDI patterns in the Arab world from 1985 to 2000 in their chapter “Foreign Direct Investment in the Arab World: The

Changing Investment Landscape.” They find that despite a deteriorating FDI trend for most Arab world countries, the prospects appear favorable in light of recent reforms being undertaken in a number of countries to improve the investment climate. Moreover, these prospects will be enhanced further if governments sustain the momentum of these reforms, and implement additional improvements in three critical areas: public institutions, physical infrastructure and human resource development.

Analyzing the trade performance of the individual Arab states, Friedrich von Kirchbach, Mondher Mimouni, Jean-Michel Pasteels (all from the International Trade Centre) and Fiona Paua (World Economic Forum) find that in most countries, export diversification has remained low. In the Gulf countries in particular, exports continue to be heavily concentrated on hydrocarbon products. Factor-based specialization continues to comprise the bulk of Arab world exports, and few companies have been able to gain competitive advantage by absorbing new technologies and producing increasingly sophisticated products. As a result, many countries remain highly susceptible to external shocks. As the authors emphasize, a key challenge lies in putting in place a business environment that is conducive to entrepreneurship and risk-taking.

Ahmed Farouk Ghoneim (Cairo University) and Jürgen von Hagen and Susanna Wolf (both from the University of Bonn) focus their chapter more specifically on “Trade Relations between the EU and North Africa.” Analyzing the economic implications of the Euro-Mediterranean Association Agreements, the authors discuss the main aspects governing these agreements, consider the competitiveness status and trends of the four Arab countries involved, and examine these countries’ potential for attracting foreign direct investment and for boosting exports. One of the key conclusions of the chapter is that the Association Agreements represent challenges for the North African countries rather than panaceas; however, as Ghoneim, von Hagen and Wolf argue, the Agreements may also represent an important opportunity if they are used to anchor otherwise tough reform decisions and overcome the many supply-side problems that have limited these countries’ integration into the world economy.

Paul Tempest (Windsor Energy Group and British Institute of Energy Economics) examines “The Hydrocarbon Sector” in the Arab states. As he discusses in his chapter, short-term prospects in the oil

market point towards a temporary decline in the Arab region market share and a dip in the price of oil. In the longer term, however, Arab countries will continue to dominate oil production, with 60 percent of the world's oil reserves and 25 percent of the gas reserves, and representing 45 percent of the international trade in oil. However, while Gulf countries are shifting more of their oil and gas exports to the Asia-Pacific region, North African producers are seeking closer long-term integration with oil and gas importers in Europe. As Tempest argues, this shift will have not only economic, but also important geopolitical, consequences.

Soumitra Dutta (INSEAD), and Charles El-Hage, Karim Sabbagh, and Paola Tarazi (all from Booz Allen Hamilton) present a discussion called the "Challenges for Information and Communication Technology Development in the Arab World." They identify three sets of issues that must be addressed to bridge the digital divide and to have new information and communications technologies (ICTs) serve as an enabler in future development processes. The authors stress that, first, the ICT environment must be upgraded by devising a clear and comprehensive development plan, incorporating ICT skills into the educational system, and enacting telecommunications laws and regulations that enhance competition. Second, Networked Readiness must be improved, and this can be achieved by improving ICT literacy, promoting access device penetration among citizens, and devising appropriate strategies to deliver e-government services and participate in e-commerce. Finally, Dutta, El-Hage, Sabbagh, and Tarazi offer counsel on ICT usage, suggesting that usage can be promoted by taking positive action among population groups less likely to use the Internet, promoting purposeful uptake of Internet technologies in the business community, and supporting online public services.

Telecommunications infrastructure plays a critical role in any ICT strategy, an issue discussed in detail by Scott Beardsley, Kito de Boer, Gassan al-Kibsi, and Luis Enriquez (all from McKinsey and Company) in their chapter entitled, "A Review of Telecommunications and Networked Readiness in the Arab World: Capturing the Opportunity." Three important findings emerge from their study. First, reform can be a powerful tool to improve the performance of the telecommunications sector and hence Networked Readiness. Second, telecommunications in the Arab world exhibits

an access gap compared to the rest of the world, particularly in penetration, in part due to the limited reform undertaken in the region. Finally, tailoring reform to each country and management of regulation at a detailed level will be critical to success.

Education must be a key element in the development strategy of the Arab states. Failing to expand access and improve the quality and equitable distribution of education resources could have serious consequences, as Thomas J. Cassidy Jr. (Harvard University) argues in his chapter entitled, "Education in the Arab States: Preparing to Compete in the Global Economy." Such consequences include possible regional isolation from global knowledge, information, and technology, the key drivers of prosperity and economic growth. The most critical challenge is to match educational output with labor-market and development needs, which requires sustained reform efforts in several areas. Redefining standards, redesigning curricula, rehab facilities, and installing computer networks in schools—all this is very important. But, as Cassidy argues, it might not be enough. Equally, if not more, important, is to change what people do and how they do it. Evidence from other countries suggests that educational reforms can be very taxing on the capacities of educational professionals, and it takes time, sustained effort, and a great deal of support to change people's behavior.

Finally, recognizing that standards of living are inextricably tied to the quality of the natural environment, Daniel C. Esty (Yale University), and Marc A. Levy and Andrew Winston (both from Columbia University's Center for International Earth Science Information Network, CIESIN), examine "Environmental Sustainability in the Arab World." Their analysis draws heavily on the Environmental Sustainability Index, a project initiated by the World Economic Forum Global Leaders for Tomorrow Environmental Task Force. Esty, Levy, and Winston find that, in general, Arab states lag behind in many important areas, and they foresee major problems with serious economic and social consequences unless corrective action is undertaken to address the challenges of environmental sustainability. As they stress, these challenges are not confined to the problem of water scarcity, but include alarming trends concerning air pollution, greenhouse gas emissions, population growth, and urbanization.

The chapters in this Report are largely data-driven and supported by an extensive appendix that provides key economic information on sixteen individual

member states of the Arab League. Specifically, the data appendix provides recent economic and social indicators, as well as a detailed analysis of the export structure of these countries. Finally, the Report contains the responses to the Executive Opinion Survey that the World Economic Forum, with the assistance of local partners, conducted in ten countries in the region. While the Survey should not be considered as representative of all countries in the Arab region, it provides anecdotal evidence that supplements publicly available information.

## Endnotes

1. A key limitation results from the lack of survey evidence. While the Survey was conducted in the first quarter of 2002, we were able to cover only ten countries, and in some of them the response rate remained relatively low. Although we decided not to use the results for a systematic ranking of countries, they may provide interesting anecdotal evidence, and the reader is encouraged to compare the Survey responses with those obtained by Aymo Brunetti, Gregory Kisunko, and Beatrice Weder and presented in, "Institutional Obstacles to doing Business: Region-by-Region Results from a Worldwide Survey of the Private Sector," World Bank Policy Research Working Paper no. 1759. Washington, D.C.: The World Bank, 1997. While their sample is even smaller (109 firms from the entire region), the results do suggest that governance is perceived to be rather poor, and to represent a substantial obstacle to business operations. See Nugent, Jeffrey B. "Dispute Resolution and Firms' Competitiveness in the MENA region." In *Globalization and Firm Competitiveness in the Middle East and North Africa Region*, Mediterranean Development Forum 3, edited by S. Fawzy. Washington, D.C.: The World Bank, 2002:76–118.
2. The World Bank. *Global Economic Prospects and the Developing Countries 2002*. Washington, D.C.: The World Bank, 2002.
3. United Nations Development Program. *Arab Human Development Report 2002. Creating Opportunities for Future Generations*. New York: United Nations Publications, 2002.
4. See John W. McArthur and Jeffrey D. Sachs. "The Growth Competitiveness Index: Measuring Technological Advancement and the Stages of Development." In *The Global Competitiveness Report 2001-2002*. Oxford: Oxford University Press, 2001:28–51.