Globalization and Economic Adjustment in the Middle East

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Abstract: *Since the 1980s, economic adjustment has emerged as one of the key determinants of Middle Eastern economic development and a way to address challenges of economic globalization. It has produced positive effects in many countries in the region on their growth and industrialization but is facing challenge of social cost.*
Key Words: *Globalization; Industrialization; Middle East; Economic Adjustment*

Since the 1980s, the global economy and political environment have experienced significant changes in succession, with economic globalization accelerating its pace and the world's dual polar pattern collapsing. In the new international economic and political context, some countries have sped up their economic growth and narrowed the economic gap with the developed world by implementing reform and opening-up policies, harnessing advantages while avoiding disadvantages. Some other countries failed to adapt themselves to the new development environment and lagged behind in the economic development process. In the Middle East, economic adjustment has also emerged as one of the key determinants of economic development. This is especially true for the non-major oil exporting countries.

In the 1980s, economic growth in the Middle Eastern region nearly deadlocked, with its GDP showing an annual growth of merely 0.4% on the average. This made the region one of the slowest growth economies worldwide.[1] During this period its GDP per capita declined by 2 percent yearly on average.[2] In the 1990s, the yearly growth rate of GDP bounced back to a 3 percent growth; however, the GDP per capita only averaged 0.7% annually.[3] Compared to that of the rest of the areas in the world, the above two indicators only surpassed the Sub-Saharan Africa and Central Asia. In 2001, petroleum-exporting countries in the Middle East saw generally lower per capita national incomes than the 1980 level, and non-petroleum exporting

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[1] The World Bank, *World Development Report 1998-1999* (Beijing: China Financial and Economic Publishing House, 1999), p. 211.

[2] The World Bank, *Claiming the Future: Choosing Prosperity in the Middle East and North Africa* (Washington DC: the World Bank, 1995), p.15.

[3] United Nations Development Program (UNDP), *Human Development Report 2003* (Beijing: China Financial and Economic Publishing House, 2003), p.285.

countries merely fulfilled a slightly higher level of per capita GDP over the two previous decades. Compared with either the developed countries or Asian or Latin American countries with relatively rapid economic growth, Middle Eastern countries were suffering from an increasingly wider gap in their economic progress.

Amid the economic globalization wave that occurred in the last two decades of the 20th century, the fact that the Middle Eastern economy tended to verge upon depression was primarily due to the slump and longstanding weakness of international oil prices, together with the resultant sharp decrease in petroleum export incomes for those major oil exporting countries of the Gulf region. However, with regard to those gifted for more diversified resources and industrial structure, it basically resulted from the fact that the previous economic development strategies failed to meet the conditions of economic globalization. A number of these countries were more or less influenced by the centrally planning economic model after winning national independence and adopted an inward-oriented and import-substitution industrialization strategy. Such a strategy usually aiming at "disconnection" with global markets and the establishment of a self-sufficient economic system, ultimately rejected the rationalization to develop comparative advantages and essentially played against the economic globalization rule that stresses integration into the world economy. In terms of the market mechanism, this strategy is reflected in many aspects such as the over intervention of resource allocation by the governments, which weakens and in some cases even eliminates the functions of the market forces in resources allocation. Nationalization of economic agents ignores and even excludes private sectors and foreign direct investment (FDI). These inward-oriented trade policies focus on the support and protection of import-substitution industries at the expenses of the exporting industries based on comparative advantages. The blind macro-economic regulation spares no effort to address the funding need by means of massive foreign debts or expansionist fiscal and monetary policies, neglecting the importance of macro-economic stability. Since the 1980s, this development strategy has been confronted with grave challenges as changes occurred in global economic and political patterns, with the financial basis of such a strategy being seriously affected.

The end of US-Soviet contention for hegemony induced smaller amounts of financial aid from the rest of the world to the Middle East on the one hand, and the slump in global oil prices reduced petroleum exporting incomes of the major oil exporting countries as well as their financial capacity of providing the non-oil exporting countries with financial assistance on the other hand. Therefore, with the sources of preferential funding significantly lessened, the financial capacity of the governments for its intervention in their economic development was seriously weakened. However, due to the institutional constraints, the original economic system could not be remedied by stimulating private investment, attracting FDI or boosting exports. On the contrary, it rendered outflow of private capital and more serious funding shortage in the countries.[4] In this context, the governments of many countries had to issue more currencies and expand foreign debt to survive and were ultimately trapped in a severe inflation and debt crisis. According to statistics provided by the International Monetary Fund's (IMF) *World Economic Outlook*, during the 1980s and 1990s, Turkey underwent two-digital inflation for a long time, with the rate twice exceeding 100%. Countries like Algeria, Egypt and Syria also suffered two-digital inflation rates respectively in different periods of time. Statistics in the *World Development Report 1985* by the World Bank show that in 1983, the debt service ratio in most Middle Eastern countries overtook or neared the safety level of 25 percent. In Egypt, Algeria, Morocco, Turkey and Tunisia, it was as high as 27.5%, 33.1%, 38.2%, 28.9% and 22.3% respectively. It was imperative therefore to carry out economic adjustment as the outdated economic development strategy was doomed to lose its rationality. For that reason, since the 1980s, economic adjustment has gradually become the key component in the economic evolution in the Middle Eastern region. In the first years of the 21st century it kept representing one of the major tendencies in the region.

I. Proceedings of Economic Adjustment

Since the 1980s, it can be observed that an increasing number of Middle Eastern countries have developed the market-economy-oriented adjustment. Basic elements in the adjustment can be roughly reduced to four facets, namely macro-economy stabilization, marketization of resource allocation, privatization of state-owned enterprises and liberalization of trade policies. It purposes to reduce the government's excessive intervention on the economy and achieve the economic growth revival by setting up the market economy system.

Macro-economic stabilization. Almost all countries embarked on the economic adjustment by dealing with inflation and foreign debt burden that represent the two major threats to the macro-economic stabilization. They usually chose to adopt tight fiscal and monetary policies, especially to reduce the financial burden of the government by reducing the amounts and coverage of government subsidies and shrinking the scale of governmental investment and credit, while tempering overheated investment and consumption by removing the long-standing negative interest rate and restricting currency supplies. Since the "economic stabilization" program was launched in Turkey in 1980, the tight fiscal and monetary policies have gradually become a long-term policy generally practiced in the Middle Eastern countries. Their shared approach to cope with the foreign debt issue is to conduct negotiations with creditors of the "Paris Club," "London Club," World Bank and

[4] Statistics in the World Bank's "*Middle East and North Africa*" Working Paper No. 9, 1993 show that foreign private assets of major oil exporting countries in the region totaled 80 billion USD in 1991. Takeo Kishimot, a Japanese scholar, published the "Developments of Petrodollar" on *World Economy Review* in March 1993, stating that the value of OPEC member states' foreign assets hiked to 670 bln USD from 473.2 bln USD during 1987-1990 period, including massive private assets.

IMF, signing agreements of debt rescheduling arrangements in different forms. This is the case, for example, in Turkey, Tunisia, Morocco, Algeria and Egypt. Syria was mainly indebted to Eastern European countries and Russia. Syria reopened debt-related talks with Russia, Poland, Czech, Slovakia and other creditors in 2004 and reached the agreement of debt rearrangement a year later. As world petroleum prices and oil export incomes have hiked since 2000, profitable oil exporting countries are accelerating the payback of foreign loans.

Resource allocation by markets. In an effort to enable the market to play a greater role in resource allocation, Middle Eastern countries gradually have eased their control on the price of production factors while strengthening the construction of their market mechanism for resource allocation. Loosening the government's domination of commodity prices, interest rates, exchange rates and salaries, and creating stock exchange markets are some of the typical measures. After the large-scale economic adjustment commenced in the 1980s, Turkey, which already had laid a certain foundation of mixed economy, has liberalized commodity price. Salary standards were determined by the employers and the labor unions through collective bargaining. State-owned enterprises (SOE) were generally endowed with decision-making autonomy regarding the product prices, employment, salary, bonus, investment and trade. The Turkish Lira is fully convertible thanks to loosened control on exchange rates and the correction of overestimated exchange rates. Commercial banks have the right to set interest rate subject to market changes, hence altering the actual long-standing negative interest rate. The Istanbul Stock Exchange witnesses robust share and stock trading of various types, playing a vital role in mobilizing and allocating domestic and foreign funds. Egypt inaugurated a wide range of economic transformation since the 1990s and has achieved remarkable results in the marketization of resource allocation. Particularly, the government has in part relieved the limits on subsidies for the prices of fuel, electricity and farm produce except cotton and sugar. A unified exchange rate came into being, replacing the very complicated six-layered exchange rate system. Foreign-funded banks are now allowed to operate in the Egyptian Pound business, while 16 holding companies have been founded to take over direct management of SOEs from the hands of the government. Both stock exchanges in Cairo and Alexander are playing an important role in business financing.

Privatization of market players. To develop the potential of private capital and FDI in the economic development, almost all countries have issued specific codes to encourage private investment and started various models of privatization. Most countries have striven to introduce foreign investments, not only by issuing preferential treatment policies, but also by building special economic zones with the intention to attract foreign investments and boost the growth of exporting industries. In addition to selling the shares of SOEs at the stock exchange markets, there are diversified forms of inviting FDI, which encompass mergers and acquisitions by foreign firms, partnering with foreign investors to set up joint ventures (this is the case especially in oil refining, petrochemical industries, manufacturing and banking sectors), production sharing and buyback (mostly seen in up stream sector of oil production), the building-operating-transfer mode (often adopted by infrastructure projects like transportation, telecom and electricity), transformation of imported designs or materials (mostly practiced in textile and garment industries and electrical appliance sectors). Some countries have utilized other methods, such as transforming the foreign debt into equity. Across the Middle Eastern region, the tendency is for private investments and FDI to expand their investments from the original processing and manufacturing industries into sectors such as finance, electricity, telecom and environmental protection where limitation upon the proportion of private and external investments tends to be reduced.

Liberalization of trade. To allow import and export trades to act as the propellant to economic development, the Middle Eastern countries have lowered import tariffs, reduced the application of licenses, hence lowering the import barriers; have taken measures to devaluate currencies, correcting the over-valued currency exchange rate and removing multi-exchange rate systems. Meanwhile, intra-regional economic cooperation has expanded to cross-regional economic integration, thus enhancing their market access to the world major trading blocs. During the 1990s, the Middle Eastern countries experienced a quite noticeable decline in import tariff. Comparing the two periods of 1991~1995 and 1996~1998, the average tariff level has fallen from around 37% to 27% or so.[5] Stepping into the 21st century, tariff reduction has been accelerated. During the 2000~2004 period, the average tariff across this region dropped from 22% to around 15%, registering a decrease rate of 30% and topped the average 19% import tariff decrease rate of developing countries as whole during the same period.[6] To stimulate export activities, all countries at large have unified their exchange rate and moderately implemented depreciation of currency, which replaced the long-standing multi-exchange rate and overvaluation policy, further realizing convertibility of currency to different degrees. Since the mid-1990s, the external economic relations of the Middle Eastern countries have witnessed a momentous positive trend. That is, while pursuing regional economic integration with countries in the region, they became more active in seeking to reinforce the cross-regional economic ties with Europe and the U.S. that show a more evident economic complementary nature for countries of the region. Since 1995, when the EU and South-Mediterranean countries held the Barcelona summit and made the decision to build a free trade zone, Tunisia, Morocco, Israel, Algeria, Egypt, Syria, Jordan and Lebanon have signed the new Mediterranean Association Agreement with the EU, with a commitment to establishing a free trade zone with the EU within 12 years. Turkey signed the customs union with EU in 1996. Entering the 21st century,

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[5] Dipak Dasguptal, *Making Trade Work for Jobs* (Cairo: Middle East and North Africa Working Paper Series No. 32, 2003), p.6.

[6] The World Bank, *Middle East and North Africa Region: 2005 Economic Developments and Prospects* (Washington, DC: The World Bank, 2005), p.45.

for economic and political reasons, the US also proposed to set up a bilateral free trade zone with those countries. Jordan, Bahrain and Morocco have already signed the agreement of bilateral free trade with the US since then. Meanwhile, the Middle Eastern countries never have given up their endeavors for regional economic integration while they pursue free trade with the world's major economic aggregate countries. In 2003, member states of the Gulf Cooperation Council (GCC) established their customs union. Since the end of the 1990s, a great number of Middle Eastern countries signed on to the "Great Arab Free Trade Agreement" (GAFTA).

II. Achievements of Economic Adjustment

Many factors may produce effects on Middle Eastern economies and their importance to economic development varies according to the countries. Therefore, one needs to be very careful when evaluating the effects of market-oriented economic adjustment on economic performance. Regarding the major oil exporting countries in the Gulf for example, oil prices remain the single critical element for their economic health. The influence of economic adjustment, should it be carried out, would be difficult to identify. Besides, a number of countries in this region are plagued with warfare or sanctions. For these countries, the matter of imminent importance is rather to improve their political environment than to implement their economic adjustment. Therefore, we cannot obtain a clearer picture of the economic adjustment effects unless we choose sample countries that are strongly committed to economic adjustment, and enjoying a relatively peaceful political environment without the major impact of oil income. In this regard, it seems that countries like Turkey, Tunisia, Egypt, Algeria and Morocco better meet these conditions. These countries' achievements of economic adjustment could be summarized as follows:

First, their macro-economic stability has been resumed. Sticking to tight fiscal and monetary policies, many countries including Turkey, Tunisia, Algeria, Egypt and Syria have significantly reduced inflation rates and successfully maintained them at a one-digit level for many years. The IMF statistics[7] show that in 2005, the average inflation rate of the Middle easternern countries was 8.4%. Thanks to their export -promoting policy and the corresponding change of industrial structures, most Middle easternern countries have achieved rapid growth in export that has resulted in a reduced level of deficit or even a deficit-to-surplus turnaround for the current account of the balance of payments. From 2001 to 2005, the surplus of current accounts of balance of payments of the Middle easternern countries increased from $39.8 bln to $196 bln. Through negotiations with international creditors for debt rescheduling and rearrangement, the debt service ratio has been lowered to a one-digital level. In 2005, the average debt service ratio of the Middle eastern countries was 7%. Foreign debt issue is no longer a major obstacle to the economic

[7] IMF, *World Economic Outlook April 2006* (Washington, DC: IMF, 2006).

growth. Improvement and stability of macro-economic status are the most remarkable results of economic adjustment.

Second, more investments have been mobilized. The implementation of economic adjustment has enabled many countries to boost domestic private investment and FDI as the investment environment has been improved. During the period of 2001-2005, for example, the value of FDI inflow to the Middle East increased from $17.7 bln to $47.2 bln and its share in the total FDI inflow to the developing world increased from 4.9% to 8.7%.[8] Private investment and consumption gradually have turned into key sources of economic growth, with foreign funds functioning more vitally in economic development. According to the research report of the World Bank, private sectors contributed to 60%~80% of GDP in Egypt, Jordan, Lebanon, Morocco, Syria and Tunisia in the first years of the 21st century.[9] In Turkey, private economy has played a dominant role in the national economy since the 1990s, with private consumption usually making up two-thirds of GDP while private investment value often constituting 70~80% of total value of fixed capital investment. Private-owned enterprises have become the engines of economic growth in these countries. On the whole, although the share of FDI in the total investment is still limited, it is playing an important role in transferring technologies, job creating and export promoting in sectors such as petroleum, automobile, electrical appliance, textile and garment production. For example, some 20 automobile, commercial vehicle and tractor manufacturers with foreign participation operate in Turkey, using technologies from Europe and Japan and produce Renault, Toyota, Hyundai and Honda, posting a record output of 468,000 autos in 2000. Sixty percent of their products were exported through international sale network provided by foreign joint-stock partners.[10] Until July 2001, the number of business firms with participation of foreign capital in Tunisia totaled 2,243, among which 1,863 were in the manufacturing sector and most of them were producers for exportation. The firms with participation of foreign capital employed 207,000 workers, generating more than one-third of total export value.[11] Therefore private-owned sectors and FDI have played a significant role in those countries' economic growth. Compared with the over-dependence on state investment and state-owned enterprises before the economic adjustment, the development of private investment and FDI have provided the Middle Eastern countries with a much broader basis of economic growth.

Third, progress has been made in the process of industrialization. The economic adjustment has enabled Middle Eastern countries to accelerate development of the industries reflecting their comparative advantages and achieve the upgrading of industrial structure. Take Turkey for example, since the beginning of its economic

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[8] UNCTED, *World Investment Report 2006* (Switzerland：United Nations Publication，2007), pp.299-300.

[9] The World Bank, *Middle East and North Africa: 2005 Economic Developments and Prospects* (Washington, DC: World Bank, 2005), p.50.

[10] Economist Intelligence Unit, *Country Profile: Turkey* (London: Economic Intelligence Unit, 2003), p.9.

[11] Economist Intelligence Unit, *Country Profile: Tunisia* (London: Economic Intelligence Unit, 2004) , p.51.

adjustment in the 1980s, this country has made full use of low prices of energy and domestic labor force at that time, domestic market potential, as well as the strong demands for steel, automobile, home appliances and garments in neighboring countries, and encouraged domestic private-owned companies and foreign investors to develop industries such as small EAF steelmaking, automobile assembling, TV set assembling and textile and garment production, on the basis of using local raw materials and imported energy, cotton, auto and electrical appliance components as well as semi-finished products. These efforts resulted in a rapid growth and increased exportation of steel, automobile, television and textile industries. From the end of the 1970s to the end of the 1990s, manufacturing sector's share in the total national export value increased from 30% to 80%, making Turkey an exporting power of steel, automobile, television and textiles in the Middle East. Tunisia, that used to export three major primary products, namely crude oil, olive oil and phosphates in the 1980s, has witnessed radical changes in its industrial structure and export mix over the past twenty years, with its manufacturing, especially textile, food processing and electrical equipment sectors expanding quickly. Tunisia has taken full advantage of relatively low prices of local labor and vicinity to the EU market, calling on domestic private-own firms and joint ventures to robustly develop the textile industry by means of processing imported designs and materials. In this way the textile industry's actual production value was going up at an average pace of 8% yearly during the period 1990-2002. In 2004, it already had become a core industry that generated one-third of the national manufacturing production value, one half of the total labor forces employed in the manufacturing sector and 37.2% of the national total export value. As its 95% of the textile products are sold in the European market, Tunisia has become the fourth largest textile-exporting country for Europe.[12] Likewise, food processing, cable production, chemical and pharmaceutical industries also saw rapid development. From 1982 to 1999, the proportion of industrial finished products jumped to 77% from 33% in national export value. Economic adjustment and integration with the international market have enabled these countries to achieve radical changes of their backward economic structures relying heavily on primary product export and have made an important step forwards in the process of industrialization.

III. Problems to Address

Although economic adjustment has been making progress in the Middle East over the past 3 decades, it is still constrained by a number of internal and external factors. As the Middle Eastern economic adjustment lags behind that of other developing countries in many aspects, the Middle Eastern region, as a whole, remains in a disadvantaged position in the context of global competitions for trade

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[12] Economist Intelligence Unit, *Country Profile: Tunisia* (London: Economic Intelligence Unit, 2005), p.40.

markets and foreign investment. Trade barriers in this region remain relatively high. In 2004 for example, only GCC countries, Lebanon and Egypt in this region, applied import tariff rates lower than 11 percent, an average level of the developing world. Even fast reformers like Tunisia and Morocco charged average tariffs as high as 25%~30%. Some countries have signed accords with the EU to establish free trade zones, yet their export potential can not be fully developed, as EU insists on excluding farm products from free trading while applying strict rules of origin to the industrial products imports. A research report of the World Bank even concludes: "agreements with the EU have not yet had a significant positive impact on the MENA partners."[13] Shortage of transportation, and related telecom and financial services also hinders the trade activities. Under those restrictions, the region's foreign trade fails to synchronize with the fast path of world trade development. The region accounted for 9.6% of the total trade value of the world in 1980, but the figure dropped to 2.6% in the year 2000.[14] Compared with many other regions of the world, the investment environment of a number of countries in this region remains restricted by many negative factors, such as frequent wars and conflict breakouts, complicated rules for industrial and commercial management, relatively high level of the minimum capital requirement for setting up business and long term capital financing difficulties. These factors weaken the region's competitiveness for FDI. According to the UK *Economist Intelligence Unit*'s rating on the investment environments in some Middle Eastern countries, risks in the sovereignty, politics, currency, banking sector and economic structure all ranked B in countries like Egypt, Algeria, Morocco and Tunisia.[15] As a result, the FDI inflow in this region lags far behind that of other areas worldwide. In terms of the ratio of FDI inflow value to GDP, the Middle East registered a ratio below 1% in 2003, a level similar to that of South Asia and corresponds only to one-third of the world's average, much lower than Africa, East Asia, Eastern Europe, Central Asia and Latin America or the Organization for Economic Cooperation and Development (OECD).[16]

With the deepening of economic adjustment, the contradiction between economic adjustment and social stability has emerged increasingly. Social costs have become more visible as the economic adjustment makes progress. Apart from late startup of economic adjustment and external political restrictions, the internal reasons why Middle Eastern economic adjustment proceeds slowly should not be ignored. With rapid demographic growth and slow economic growth in the 1980s and 1990s, the region accumulated extremely serious unemployment problems.

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[13] The World Bank, *Middle East and North Africa: 2005 Economic Developments and Prospects* (Washington DC: The World Bank, 2005), p.49.

[14] The World Bank, *World Development Report 1982* (Beijing: China Financial & Economic Publishing House, 1982) appendixes and *World Development Report 2003* (Beijing: China Financial & Economic Publishing House, 2003), appendixes.

[15] Economist Intelligence Unit, *Country Risk Service* (London: Economist Intelligence Unit relevant issues of 2006).

[16] The World Bank, *Middle East and North Africa: 2005 Economic Developments and Prospects* (Washington DC: The World Bank, 2005), p.44.

Algeria, Turkey, Iran and Egypt officially posted an unemployment rate of more than 10%, while independent research estimated an even higher rate. A wide social disparity of incomes also exists in those countries, with the Gini Index setting around 35 in Egypt and Algeria, and near or over 40 in countries such as Morocco, Turkey, Iran and Tunisia.[17] Under such a circumstance, economic adjustment measures like government subsidies reduction, business privatization and significant currency devaluation could only intensify unemployment and worsen the living conditions of poor people in a short term, although they may help resume economic growth and create employment in the long run. Except for a few countries in the Gulf region, most countries of the region suffer from an imperfect social security system that is typically characterized by low standards, limited coverage and incomplete items. The shortage of social security systems makes jobless people, poor people and other fragile groups even more disadvantaged in the economic adjustment process. In countries like Algeria, the powerful trade unions represent a strong and organized resistance to the privatization of state-owned enterprises. Iran adheres to an Islamic interest-free financing principle, making its banking sector difficult to integrate with the international financial system. All the above have forced decision-makers to take the social costs into consideration, hesitant to make a choice between facilitating economic adjustment and maintaining social and political stability.

In conclusion, the ongoing market-oriented economic adjustment in the Middle East is creating new hope for economic development there. In some countries, economic adjustment has achieved remarkable progress, enhancing their capabilities of coping with challenges aroused by economic globalization and realizing good performances in economic development. However, due to domestic and external restrictions, positive effects of economic adjustments in a number of countries are not as visible as in the other countries. Compared with many other developing countries, their economic adjustment is not fast enough, which has affected Middle Eastern countries' competitiveness for international capital and trade opportunities. Economic adjustment stands for a correct development path for the Middle Eastern countries in the context of economic globalization, but the extent to which they could seize opportunities of globalization and accelerate development will depend on whether they could accelerate the pace of economic adjustment, create a peaceful regional environment and properly address the social problems.

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[17] UNDP, *Human Development Report 2003* (Beijing: China Financial & Economic Publishing House, 2003), pp.287-288.