Economic Development in the Middle East

Rodney Wilson

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ECONOMIC DEVELOPMENT IN THE MIDDLE EAST

Is there a conflict between Islamic values and economic development?

Despite its oil resources, the Middle East is falling behind other regions of the developing world, notably the countries of South East Asia. Here, Rodney Wilson examines the economic indicators for the region. The book considers:

- the economic consequences of rapid population growth, including the implications for education and employment;
- low savings levels, the absence of significant private capital inflows and foreign investment;
- fragmentation in the banking system and insignificant bond markets;
- basic infrastructure and excessive military expenditure;
- trade, falling oil prices and budget deficits.

The author considers alternative economic directions for the region and looks particularly at the positive aspects of the Iranian experience. He stresses that both the goals of development and the methods used to promote development have to be reassessed for a region where an Islamic value system prevails. Ultimately, development solutions which respect Muslim values may have more chance of success than those simply imported from the West.

Rodney Wilson is Reader in the Economics of the Middle East at the University of Durham. He has published widely and has extensive research experience of the area.

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London and New York

First published 1995
by Routledge
11 New Fetter Lane, London EC4P 4EE

Simultaneously published in the USA and Canada
by Routledge
29 West 35th Street, New York, NY 10001

Routledge is an imprint of the Taylor & Francis Group

This edition published in the Taylor & Francis e-Library, 2002.

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British Library Cataloguing in Publication Data

A catalogue record for this book is available from the British Library

Library of Congress Cataloguing in Publication Data

A catalogue record for this book has been requested

ISBN 0–415–12553–7 (Print Edition)
ISBN 0–203–01286–0 Master e-book ISBN
ISBN 0–203–20432–8 (Glassbook Format)

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1

INTRODUCTION

THE CONTEXT

The Middle East receives more media coverage than any other area of the Third World. As a result of its deep-seated conflicts the region is a major focus of attention for specialists in international relations and political scientists. Academics involved in development studies, and consequently their students, have much less knowledge of the Middle East. Indeed western economists and sociologists have been much more active in African and Latin American studies and most case study material used in development courses relates to these areas.

This relative neglect of the Middle East from the perspective of development studies is partly a result of the limited range of books and articles on the region written by British or American economists and sociologists. There are a number of books in English by Arab writers, but most adopt a country or sub-regional perspective, and do not treat the Middle East as an entity. Furthermore most of these authors are little known in development studies circles apart from notable exceptions such as Samir Amin.[1] Even he, however, has comparatively little to say on the Middle East, being regarded as more of an African specialist.

APPROACH

The intention has been to write a subject-orientated book rather than a country-by-country study. The intention is to be analytical rather than descriptive, with the analytical tools drawn from the theories of economic development. The book aims to complement established texts in development economics such as Gillis *et al.*,[2] Nafziger,[3] Thirwall[4] and Coleman and Nixon.[5] The first two are leading American texts, while the last two are aimed at the British market. These mainstream texts use the tools of conventional economic theory, and demonstrate how economists such as W. Arthur Lewis have constructed models from these premises which can be applied specifically to developing countries.[6] Such

approaches are categorised by economists as neo-classical, and are often described as technocratic by political scientists and international relations specialists.

There are many alternative approaches to development, and this book is also designed to appeal to those who have followed these traditions. One of the most popular texts on development worldwide is that by Michael Todaro. His work draws on a wide range of economic concepts and theories at an introductory and intermediate level. It is specifically targeted at economics students in developing countries, and draws on economic theories and concepts which are felt to be useful to explaining development problems.[7] Despite the difference in approach, the overall contents do not differ much from the text by Gillis and his co-authors mentioned above. Todaro places more stress on comparative economic systems, and there is a fuller discussion of the merits of the command versus the market economy.

A more fundamentally different approach is that of Wilber and Jameson, whose readings are designed for students of development studies generally and not only economists.[8] The readings are written from a political economy perspective, and the contributors include committed Marxists such as Paul Baran. Overall the text is well balanced, however, and it has been a popular recommendation for courses in development offered by sociology departments. The chapter by Howard Wiarda on non-ethnocentric theories of development is especially relevant for this study, as it considers Third World views on economic objectives. There is a highly critical contribution on privatisation by John Waterbury, who has considerable Middle Eastern experience.

The objective of this present study is to provide an account of the recent experience of development in the Middle East that will enhance the reader's understanding of how the development process works or fails in an important region of the world with several unique characteristics. This should encourage the reader to question the universality of the neo-classical approach to development. Are western economic concepts and values applicable in societies whose priorities may be very different, reflecting not only their stage of development, but differences in religion and culture? All too often economists neglect such issues.

In most courses on economic development the standard classical and neo-classical approaches are employed, so that students become acquainted with the conventional models, concepts and issues which are central to the subject. The meaning and measurement of development is the starting point, with the historical context emphasised. Growth and structural change are discussed in terms of one-sector and two-sector models. Concepts of dual economies are introduced as well as unbalanced growth and the notion of leading sectors.

One aim of this book is to reinforce the student's understanding of these basic concepts, by drawing on the experience of one specific geographical region. The Middle East economies are taken as case studies to illustrate

and explore further the usefulness of the material the students have learnt. Through this exposure to a region with a distinctive culture, religion and value system, readers are challenged to rethink their assumptions about development, and indeed the premises of much of modern economic history.

Attitudes towards development may be different in the Middle East to those prevailing in Europe or North America. Is development merely the improvement of personal or family material well-being? Can economic history be viewed as the story of continuous long-term progress, with minor setbacks at times of recession, and temporary downturns during economic slumps?

This, perhaps naïvely optimistic, view has prevailed in the Christian and lapsed Christian West for most of the twentieth century. The Islamic East has more recently entered its fourteenth century, but a common perception is that the last hundred years compare unfavourably with the early centuries of Islamic civilisation. Yet not many envy the West. In the opinion of at least some in the Middle East any economic gains the West has achieved have been outweighed by the social costs. One perception is that material advance has undermined human values, and even religion itself has been under threat in the West, leaving the populations in a state of spiritual confusion. If this view is taken, the western path of development, far from being a role model, is to be avoided if at all possible.

More fundamentally, the question must be asked whether the traditional economists' tools for measuring and evaluating development are relevant for a region where many do not share western aspirations. If judged by yardsticks such as per capita gross domestic product rises or the development of modern manufacturing, the economies of the Middle East may be seen as failures. But are they? Is it the methods and measures of evaluation which have failed rather than the economies themselves? Is neo-classical economics only applicable to North American or European area studies programmes because of its western ethnocentricity? Are development economists, western governments and international agencies trying to promote a style of living that many in the region simply do not want?

GEOGRAPHICAL COVERAGE

Geographically the Middle East will be defined to include all the Arab states including those of the Magreb. The core area is taken as Egypt, the countries of the fertile crescent and the Gulf states. Reference will also be made to the experiences of Sudan and Libya where appropriate. From the point of view of geography

Tunisia, Algeria and Morocco may not be part of the Middle East, but they are part of the Arab world. In terms of culture and religion they have much in common with the core states of the Middle East, and arguably this is also the case in the economic sphere. The non-Arab states covered include Iran and Turkey, as there are many parallels between the development of these countries and those of the Arab region. There are, for example, important lessons for Egypt from the Turkish experience of economic liberalisation and structural adjustment in the 1980s.[9]

Israel has economic and political structures which are different in many ways from the other states of the region. Nevertheless, despite its unique beginnings as an outcome of basically European wars, it should not be considered a nation apart from the region in which it is located. Israel is in essence a theocratic state, with religion enshrined in the constitution. In legal terms it already is what many of its neighbours would wish their nations to be. Those Israelis who live in hostile surroundings in West Bank settlements are not materially motivated. Their aspirations are spiritual, like those of their Muslim neighbours whom they rarely meet. In any study of Middle Eastern economies the Israeli experience is of positive interest in the context of water resource management, and perhaps of more negative interest in relation to developments affecting the Palestinians.

In a global economy which is increasingly made up of economic blocks, a regional perspective seems both relevant and appropriate. The Middle East does not constitute an economic entity, however, as there are no pan-regional structures similar to the European Union, the Association of South East Asian Nations (ASEAN) or the North America Free Trade Area. The Arab League has an economic directorate, but it has no clear mission, and members of the league are not subject to any binding commitments which are economically significant. Any there have been in the past have been of a negative nature rather than trade-promoting, the Damascus boycott of trade with Israel being the best known.

At the sub-regional level there have been several attempts at economic groupings, the most notable of which, the Arab Common Market, was created out of the ruins of the United Arab Republic when Egypt and Syria split in 1961. Like the earlier union, Nasser's common market venture never became an economic force, though both Jordan and Iraq did reap some benefits. The Gulf Co-operation Council has arguably been more successful as an economic if not as a military alliance, and it is interesting to ask why. Is it because the states have common economic interests, is structural similarity the key factor, or is it simply the openness of these oil economies?

In a region such as the Middle East there are enormous economic differences and disparities between the states. On one shore of the

Red Sea lies Sudan, one of the poorest countries in the world, while on the other side is Saudi Arabia, the world's largest oil-exporting nation. Clearly, any regional study of economic development must recognise these differences. At the same time one of the merits of treating the Middle East as an entity is the richness of the development experience that results from the diversity. Common cultural, linguistic and ethnic roots do not breed economic similarity as the enormous contrasts in the English-speaking world demonstrate.

A sub-regional classification of the Middle Eastern economies gives some indication of their diversity. A three-way split can be made, based on development characteristics. The oil-rich states with limited populations represent one obvious category; this group includes the Arabian Peninsula states plus Libya. All these states remain dependent on primary extractive activity as the main pillar of economic support, despite the tremendous efforts made to diversify. Another group could be the larger and more populous states of the region where significant market size has offered some scope for nationally centred development and import substitution. Egypt, Iran and Turkey clearly fall into this category. The factor endowments of these states are not dissimilar to those of newly industrialising countries in East Asia and Latin America which have successfully established modern manufacturing activity.

A third, and perhaps more controversial, grouping might include those states whose economies have been severely distorted by conflict and wars. Obvious candidates include Israel, Lebanon, Iraq and perhaps Jordan and Syria. In the case of the latter two economies it has been more the risk and anticipation of conflict, together with spill-over effects from neighbouring states, which has caused much of the damage rather than the actual hostilities. The economic literature on expectations and concepts such as external diseconomies may have particular relevance to these states, together with other analytical tools used by economists when examining countries involved in conflict.

THE PERIOD UNDER REVIEW

Historically the period examined starts from the 1950s, the time of the young officers' coup in Egypt and the revolutions in Syria and Iraq. These resulted in major changes in economic policy, and a reorientation in development for these states. For the Gulf the 1950s marked the beginning of the rapid rise in oil revenues, with dramatic consequences for development and an ultimate transformation of economic activity.

The study is not an economic history any more than it is an economic geography. Development theories and approaches are best tested by

considering the historical experience. This may involve the evaluation of qualitative information as well as computation using hard data. Statistics for Middle Eastern economies must be treated with caution. This applies especially to the period prior to 1970 when data-collection techniques were much less reliable than they have since become. Nevertheless, there are advantages in taking the 1950s as a starting point and a forty-year time span. By evaluating a relatively long period the increased number of observations improves the statistical significance of any econometric analysis. Such analysis is not attempted in this study, but for the more technically minded reader, some of the articles referred to in the bibliography contain this type of work. The evaluation of qualitative information also becomes more reliable, as, for example, it is easier to assess the impact of Turkey's more market-orientated policies in the 1980s if the outcomes of the more interventionist approaches of the three previous decades are understood.

There are a number of excellent texts on the economic history of the Middle East, the books by Roger Owen[10] and Charles Issawi[11] deserving particular mention. The former covers the 1800–1914 period on a chronological basis, and is essentially concerned with the impact of the European powers. Issawi's work covers the period up to 1980, but the latter period is inevitably dealt with rather thinly given the scope of the book. Like the present volume, Issawi adopts a subject-orientated approach, the major theme being the impact of the West through trade and finance and the Middle Eastern response through agricultural expansion, de-industrialisation and re-industrialisation.

Books in economic history do not date, but since the early 1980s there have been no new substantive volumes on the Middle East. The book edited by George Sabagh is worth noting, however, especially the chapters on labour mobility by Roger Owen, oil and economic development by Homa Katouzian, and educational change by Carter Findley.[12] An earlier edited volume which contains some interesting contributions on Egypt, Iran and Turkey is the work by Elie Kedourie.[13] Labour issues figure prominently, and the chapter by Marius Deeb on 'Bank Misr and the Emergence of the Local Bourgeoisie in Egypt' is undoubtedly a classic in its field.

ISSUES AND THEMES

It is an ambitious task to write a book examining the development experience of an entire region such as the Middle East. There is nevertheless much merit in treating the region as a single entity despite its diversity of experience. Islam is the dominant religion throughout the region, and Muslim beliefs have important implications for the economic value systems which can win popular acceptance. Oil is another matter of regional

significance, not only for the oil-exporting states, but also for those dependent on Gulf aid and remittances.

Although the coverage is wide ranging, there is selectivity in the topics chosen, with the concentration being on those development issues which are especially relevant for the Middle East. Area studies specialists are clearly most interested in development concepts which are applicable in their region of interest. Looked at from the point of view of development studies, the focus is on those topics where the Middle Eastern experience is deemed to be particularly illuminating in highlighting both constraints and possibilities.

Apart from the issues of Islamic economic values and oil resources, there are other development subjects where the Middle Eastern experience is important. Conflict and war is clearly one such topic, even though this is neglected in traditional development texts. The recent moves towards a more generalised peace between Arabs and Israelis could be of profound significance for the region's development, especially if resources and human energies can be redirected to civilian purposes and away from the past priority of the military.

Emphasis is placed on the role of markets in the development process. Efficiency may be hindered by poor information flows and high transactions costs. In the Peter Bauer tradition there is a focus on traders and their role as development agents.[14] Popular development texts such as Gillis *et al.* now stress the importance of market signals.[15] The role of development planning is downgraded, as the evidence suggests it has never worked adequately in the Middle East. Do markets determine resource allocation better than the state? Should the role of governments in the Middle East be to facilitate instead of direct? The rich and diverse experience of the countries under review should shed some light on these matters.

Even less attention is paid by development economists to the workings of *bazaar* or *souk* economies, but this is obviously a topic of importance in the Middle East context. How efficient are such markets and how do they evolve with change and development? This area of investigation has often been left to social anthropologists, but the operation of such markets must be of interest to anyone with an economics training. Interesting questions include whether bargaining constitutes competition, the transactions costs with heterogeneous products, and the economics of search in an informal sector context.

The economies of the Middle East always have been and remain trading-based.[16] Nationalistic and socialist government policies may have inhibited trade, but the economy of the *bazaar* and *souk* have survived, and indeed have enjoyed a revival in the last decade. In some economies such as Lebanon and Syria the informal sector has taken over from the formal as

the most vibrant. State economic enterprises stagnate or decline while the black market flourishes.

Islamic economists view trading as a desirable and productive activity, and in the Koran the virtues of trade are stressed:

> Rejoice in the bargain which you have concluded: that is the achievement supreme.[17]

Trade must be conducted honestly, and in the Koran there are several passages warning those who would try to take advantage of others through sharp practices, one of the most quoted being:

> Woe to those that deal in fraud. Those who, when they have to receive by measure from men, exact full measure, but when they have to give by measure or weight to men, give less than due. Do they not think that they will be called to account?[18]

The influence of Koranic economic strictures has been considerable on all Muslim societies, and in recent years there has been a revival of interest in Islamic economics. For many the challenge is to apply the teachings and concepts to modern economies, and it is evident that considerable progress has been made in developing the ideas. Islamic ideology may be as incompatible with capitalism[19] as it was with communism, but it does provide an economic system of its own. This recognises private property, but redistribution can occur, at least within families, through the *shariah* religious laws on inheritance. It recognises the value of markets and exchange, but avoids being capitalistic through the prohibition of *riba* or interest. There is even a well-thought-out critique of the western literature on economic development which may interest readers of this volume.[20]

As elsewhere in the developing world, privatisation has become a major issue in the Middle East.[21] The policies of the state for financing and managing import substitution industries are now rather discredited, and the emphasis has switched to economic liberalisation.[22] Nationalised industries are being sold and controls over economic activity are being reduced. Prices are already playing a larger role in resource allocation, with private business activity permitted, and even actively encouraged. The implications of these developments may, however, be different in the Middle East than in other parts of the Third World. An attempt is made to show how business attitudes have been shaped by the social and cultural environment.[23] Labour conditions are quite different to those in the western world, and entrepreneurs survive and react within a business climate which in many respects is unique.

One major theme of this work is that the economic progress of the Middle East has been unsatisfactory. It is not only outside observers who have this

perception, but more importantly the majority of economists in the region itself. There has admittedly been enormous economic change, amounting in many cases to a structural transformation. Rapid urbanisation has been accompanied by relative agricultural decline. The share of services in gross national product has grown. Primary extractive industry, namely oil, has dominated economic activity, but its peak of the early 1980s is already long gone. The benefits and costs of oil have been much debated.[24] In the oil boom years economic growth rates were, of course, impressive, but how productive an inheritance has it left? Much less was achieved than the crude figures suggested. There is a deep sense of frustration that the region is more dependent on the outside world, and the West in particular, than ever before.

The evidence on trends in international trade and capital flows points to a growing global interdependence, which has affected the Middle East as much as other areas. Many countries in South East Asia and even Latin America have, however, achieved international competitiveness with their exports of manufactured goods. Unfortunately this is not the case for the Middle Eastern countries despite the efforts to industrialise. The region remains very dependent on primary products, and for the non-oil producers, and even some of the OPEC states, balance of payments deficits are increasing. Many developing countries argue for trade, not aid, but from the Middle East the call for aid gets ever louder, as the countries have so little to offer in trade. This external trading weakness may seem paradoxical in a region where cities and towns have historically thrived and developed through their trade.

What has gone wrong with the region's development? Why has so little been achieved despite the enormous efforts and sacrifices? Is the West to blame, or are the causes of failure internal? Clearly, there are no simple answers, but the author will argue that there are several factors distorting the development pattern and inhibiting healthy growth.

Oil revenue may have provided development finance, but it has also encouraged consumption rather than non-oil production. Rentier economies have been created, whose growth is entirely dependent on oil and overseas financial assets.[25] Oil wealth has been translated into current income, but there has been little alternative domestic wealth creation.

Regional conflicts have also severely distorted the pattern of development, and been much more than distractions. More is spent on armaments by Middle Eastern nations than the rest of the Third World combined. Yet the countries import most of their weapons, and with the exception of Israel, local military equipment manufacture has failed to develop. Iraq's much-discussed armaments facilities were usually so-called turn-key plants, with foreign technology and even foreign personnel. Technologically the gap is widening between the Middle East and the West,

despite the huge numbers going through the region's school systems and the enormous enthusiasm for education.

Overall the aim has been to write a book with themes which will be familiar to all those involved in contemporary development studies. This should be instructive for Middle Eastern specialists, who may not perceive their region to be of interest in such terms. At the same time the uniqueness of the Middle East will be emphasised, as often development theorists believe their theories have universal applicability, but the Middle Eastern experience shows this is not necessarily the case. Selectivity and adaptation are certainly required, and this is undoubtedly the central theme of the study.

STYLE AND READERSHIP

The intention has been to produce a lucid, tightly structured, but nevertheless very readable book. The language is essentially non-technical, so that the material can be understood by a wide readership, and not only by trained economists. Mathematical presentation is avoided, as is econometric analysis. Instead economic trends are illustrated by line and bar charts, and comparisons between the countries of the region are made using *XY* scatter plots, with the linear regression line computed to illustrate whether the relationship between the *X* and *Y* variables is negative or positive. Such graphical presentations should help the reader to appreciate the type of relationships found between economic variables in the Middle East, while not purporting to convey statistical significance, given the limited data sets, or even to show the causality of the relationships.[26]

The book has been written for a worldwide readership, the aim being to increase Middle Eastern economic awareness in the developed industrialised countries. The reader within the Middle East may also learn much from the study. Often those in the area have more extra-regional than intra-regional knowledge, the information gap between the Arab countries and Iran and Turkey being especially large.

The readership for the book should include development specialists, with the topics covered of interest to economists, political scientists, international relations experts, sociologists and even social anthropologists. Those involved in area studies should be the other major group, particularly those with a Middle Eastern interest. These are the most obvious readership segments, though many of these will of course be social scientists.

As far as readership level is concerned, the market is broadly based. The work should appeal to established academics, who may read it for their own interest. The study was also designed to be used for Middle Eastern options and electives in economics, politics and international relations. Many such courses are offered by universities and other higher education institutions at the undergraduate and taught master's level.

REGIONAL VERSUS COUNTRY PERSPECTIVES

In any volume covering a whole region it is impossible to go into depth and detail about the economies of particular countries. This is not the objective of the present work. The aim is not to describe particular economies or even to analyse their peculiarities. Rather, the intent has been to identify regional themes and issues, and to draw on the Middle Eastern experience for illustrative purposes.

There are a number of useful country studies to which the interested reader should refer. The book by Amuzegar was the first in English to examine in detail economic developments in Iran since the Islamic revolution.[27] The study by Massoud Karshenas on Iran covers a longer period, with a particular focus on oil and industrialisation.[28] For the Turkish economy Z.Y. Hershlag's book provides a useful introduction, with an interesting contrast between the state interventionist policies of the 1970s and the more liberal market-orientated approach of the 1980s.[29] The volume edited by Tevfik Nas and Mehmet Odekon provides some important insights into the background against which Turkish economic liberalisation has occurred.[30] Perhaps surprisingly in view of its population size and economic significance, Egypt has been relatively neglected in recent years by economists and economic historians. Interested readers can refer to the volume edited by Roberto Aliboni on its economic potential.[31] An earlier World Bank study was much more comprehensive in scope and coverage, but it is now rather dated.[32] A more recent World Bank study by Hansen, which contrasts Egypt and Turkey, is also worth mentioning.[33]

There are numerous economic studies on the Gulf states, but the quality is very uneven. Among the better books is that by Ali Johany and associates on the economy of Saudi Arabia[34] and the work by Khouja and Sadler on Kuwait.[35] Other notable studies on oil economies include the volume edited by Khader and El-Wifati on Libya.[36] Khader also edited a book on Jordan,[37] but my own edited volume on that country is more up to date.[38] There are numerous studies on Israel, but few on Arab economic activity within the country. One interesting book at the sub-national level is that by Raja Khalidi.[39]

Volumes dealing with the region as a whole are much rarer, my own earlier book, *The Economies of the Middle East,* being a good example.[40] This study adopted a country-by-country approach, rather than each chapter being subject-based, as is the case with this book. The main competing volume is the text by Alan Richards and John Waterbury, *A. Political Economy of the Middle East: State, Class and Economic Development.*[41] The work is a good study, but in many ways better suited for political science students than economists. The coverage of the Gulf is perhaps the weakest part of it, and has to some extent already been

overtaken by events. One disadvantage of the Richards and Waterbury volume is its length: it is almost five hundred pages long, which is rather off-putting for the undergraduate reader or for those interested in comparative development experiences rather than the Middle East alone. This study is only half that length, and therefore represents a more compact and manageable review of the state of economic development in the Middle East, and the problems of the past, as well as present and future challenges.

2

MODELS OF MIDDLE EAST ECONOMIC DEVELOPMENT

THREE THEORETICAL EXPLANATIONS OF UNDERDEVELOPMENT

Which development theories are applicable to the Middle East? In this chapter three main types of theories are considered: those which assume an historical progression, those that attribute underdevelopment to non-economic behaviour, and political economy theories that concentrate on the role of the state as a facilitator or an impediment to development. Arguably all these approaches have at least some relevance to the Middle East, which is why they are considered here. Ultimately the question of what theories are most relevant can only be settled empirically. This can involve qualitative evaluation, taking the experiences of particular countries as examples. This is the approach taken in this chapter. Quantitative measures of development are considered in the next chapter, where the actual measures of gross national product growth and changes in economic structure in the Middle East are cited.

Before examining the three approaches to Middle East development in detail, it is useful to provide a brief overview of some of the issues raised with each of them. This gives a perspective on the extent to which the approaches are complementary, or whether they are best regarded as non-reconcilable substitutes.

Some economists claim their theories are universal, in that they are relevant for all countries for all time. Such theories can be historically based, identifying a series of stages of development through which countries pass. Marxist theories and Rostow's stages of economic growth theories were of this type, classifying economies as subsistence-based, feudal, and capitalist.[1] Human behaviour changes at each stage, according to Rostow, with enterprising entrepreneurs emerging to facilitate the take-off into self-sustained growth, ideas that draw on those of Schumpeter.[2] For Marxists human behaviour differs according to social class, capitalists attempting to maximise their own gains through the exploitation of their employees if necessary, while workers have more altruistic attitudes that shape the relations in a socialist society.

Are the economies of the Middle East at different stages of development, and are the more backward following a path already taken by the more developed? How can the differences in economic performance be explained both within the region and when comparing the region to other parts of the developing world? Is human behaviour the key, with those in the less-advanced countries simply not being materialistic enough in their motivation? If development is seen in purely material terms, this however becomes tautological, in the sense that people get what they aspire to. Neo-classical economists have a particular concept of economic man looking after his self-interest in market dealings. Indeed this type of maximising behaviour may well be necessary if markets are to function efficiently, which neo-classical economists see as a precondition of development. Do markets in the Middle East function efficiently, and if not, can this be explained by individual non-maximising behaviour and cultural conditioning?

Political economists are especially concerned with the role of the state, a subject with a huge development literature. How is the state to be viewed in the Middle East where politics and economics are especially entwined? Is the state protective, productive, dirigiste, predatory, rent-seeking, authoritarian or totalitarian, or some combination of some or all of these attributes? Is economic development possible without some measure of citizen empowerment, an especially relevant question for the Middle East where there is arguably less democracy than anywhere else in the Third World?[3]

THE STAGES OF ECONOMIC GROWTH IN THE MIDDLE EAST

The economies of the Middle East are perhaps the most difficult to categorise in terms of the stage of development they have reached. Most have progressed beyond the subsistence stage and have economic relations characterised by the exchange of goods and services based on monetary transactions. In economies such as Yemen, the Sudan and upper Egypt barter is still prevalent, but only in very remote rural areas where farmers largely grow crops and keep animals for their own subsistence needs. Many of the cities and towns of the ancient Middle East were important trading centres long before commerce developed in Europe, so it would be misleading to regard such developments as a relatively recent phenomenon.

Marxists would certainly classify the economic relations in much of the region as feudalistic, or at least pre-capitalist in many respects. The means of production in agriculture are often still controlled by large landowners who provide a type of paternalistic protection for their tenants, many of whom remain sharecroppers. The land reforms of the 1950s and

1960s in Egypt, Syria, Iraq and Iran reduced the traditional feudalistic land tenure arrangement in agriculture, but apart from in Egypt where over 15 per cent of agricultural land was redistributed, their scope was limited.[4] Under the Shah's so called 'White Revolution' in Iran, for example, landlords were restricted to owning one village, but this still meant they controlled thousands of acres. In Egypt the ceilings on land ownership were progressively reduced, but many landlords got round this by nominating other members of their family as owners. In Syria and Iraq where much of the land expropriated remained under nominal state control, the government officials controlling the land started to act in a similar way to the former landlords, with no real checks on their activities, as long as they maintained their allegiance to the state.[5]

The failure of indigenous capitalism to develop in most Middle Eastern states can be attributed to the strength of the traditional feudal structures. A strong attachment to the land prevails in much of the Middle East, and even where there has been considerable migration into towns and cities, traditional loyalties to rural kinship and tribal groupings remain. Investment in land and property is valued more than putting funds into productive enterprises, as there is a physical acquisition that can be used for the benefit of the immediate family and more distant relations. More uncertain investment in industry not only means personal risk, but is potentially irresponsible, as it is regarded as gambling with the assets of the wider family and kinship group. There is also a reluctance to go outside the family group for business finance, as the external providers of capital, whether a bank or equity investors, could potentially wrest control from the owner. For this reason, most businesses in the Middle East are family-owned and run, and rely on internal sources of finance. Large-scale private enterprises have failed to develop in most of the economies of the region, and there are few indigenous multinational companies.

THE THEORY OF DEPENDENCY AND THE 'FLYING GEESE' METAPHOR

Dependency theory may have particular relevance in the Middle East as a consequence of the failure of local capitalism to develop. From the nineteenth century European capitalism became dominant in the Middle East as British and French companies increasingly penetrated the region. Trade became directed to Europe, with the Middle East serving as a supplier of raw materials in exchange for British and to a lesser extent French manufactured goods. Economic historians such as Alexander Gerschenkron have pointed out the disadvantage faced by countries which are late developers, largely with reference to the Eastern European experience.[6] His theories may also be applicable in the Middle East where capital

markets were slow to develop, giving those in London and the West that had a lead a marked advantage. By the time capital became available in the Middle East with the oil revenue boom, it was too late for the financial infrastructure to catch up, and as a result the dependency on western markets continued.

Gerschenkron stressed that as modern industrialisation needed a huge amount of investment, companies based in developed capital markets were in a privileged position. It could be argued that it was this that placed Middle East companies in a disadvantaged position, and it is the supply of capital rather than the demand for capital which matters. Modern capital markets have to some extent been internationalised, but this does not imply that economic geography is irrelevant. Middle Eastern companies and even governments have to pay a country risk premium for funds raised in international markets, which western multinationals can avoid.

The theories of the dependency school have become less fashionable in recent years, partly because of the collapse of communism, but also due to the lack of evidence to support the notion of capitalist exploitation through imperialism. It is over three decades since the final withdrawal of the European colonial powers from the region, Aden and Algeria being the last to be freed. Although some assert that British and French colonialism has been replaced by American neo-colonialism, the facts seem to contradict this. The United States may be strong militarily, with considerable political influence in the region, but in economic terms the European Union and Japan are of more significance for the Middle East.

To explain the development rankings of East and South East Asia there is a so-called 'flying geese' metaphor, with Japan in the lead, Singapore and Hong Kong just behind, then Taiwan and Korea, followed by Malaysia and Thailand, with the Philippines, Indonesia and China, bringing up the rear.[7] The use of such a metaphor is based on growing regional interdependence in ASEAN and beyond to Japan and China, and the notion that development of the economies is linked, so that it is not a matter of one country moving forward at the expense of the others. Could such a metaphor be applied to the economies of the Middle East? What is the development ranking within the region, and are the economies moving forward together? It is not even so straightforward in the Middle East to identify a lead country in a similar position to that of Japan in relation to East and South East Asian countries.

Israel could potentially be seen in this role, but although it is the most developed country within the region on most criteria, its economy is small. Its supply capacity is very limited in relation to Japan, and it lacks the purchasing power to transmit substantial multiplier effects to other Middle Eastern countries that would help their exports.[8] Such effects could possibly occur with respect to the autonomous Palestinian entity,

and possibly to Jordan, but it is hard to see how it could have much impact on the larger regional economies such as Egypt, Syria, Turkey or even Iran. All this assumes, of course, a normalisation of trading relations between Israel and its neighbours. The Damascus boycott of trade with Israel as a result of conflict with the Arabs prevented this in the past. Peace could change the situation, but there is still a tendency in many Arab countries to view development as a zero-sum game, with one country developing at the expense of its neighbours, rather than complementing their economic progress.

Turkey, because of its size and the extent of its industrialisation, could also be seen as a leader of any 'flying geese' in the Middle East, but in its case the metaphor may also be unrealistic.[9] Its main regional trading partner in the 1970s and 1980s was Iraq, from whom it imported oil in exchange for manufactured goods and construction supplies. The Gulf War brought an abrupt end to this trade, and although economic links between Saudi Arabia and Turkey have subsequently increased, they have no common frontier. Since the collapse of the former Soviet Union, Turkey has concentrated on developing its economic relations with the Muslim Turkish-speaking countries of central Asia, and there has also been an increase in trans-Black Sea trade. This new northern orientation for Turkey, and the continuing strong economic links with the European Union, has to some extent marginalised its economic position in the Middle East.

PRE-CONDITIONS FOR SELF-SUSTAINING DEVELOPMENT

To advance from feudalism to a modern capitalist economy, it may be necessary for a type of 'take-off' to occur, an idea put forward by the economic historian W.W. Rostow.[10] This concept will be discussed in the next chapter in the section on industrialisation, but it is also relevant here as it is take-off which enables countries to break out of external dependency into self-sustaining growth. Such internal generation is achieved only when several pre-conditions are met, although economists, as always, disagree about what these are.

One pre-condition on which there is agreement is that the workforce should have a reasonable standard of education, at least up to secondary level. This is the case in most Middle Eastern states, with the exception of Yemen and the Sudan, although it could be argued that it only applies to the younger generation. Just what qualities the education imparts to assist development is more controversial. Critical thinking is especially valued in western education, but arguably less so in the Far East, where there is more emphasis on the absorption of knowledge. Yet most

countries in the Far East have taken off and outperformed the West for the last three decades. In some respects the education systems in the Middle East are more like those of the Far East, yet economic performance is notably weaker and take-off seems far away. Education encourages team effort in the Far East: perhaps this is the missing ingredient in the Middle East.

What determines the timing of any take-off into self-sustained growth? Is it influenced by external or internal shocks or do countries simply evolve into a take-off position? In the Middle East development has been far from a smooth, continuous process as there have been the politically determined shocks associated with war and revolution which have had far-reaching economic implications, not only for the region, but also for the rest of the world. The 1973 oil price shock was an example of this, a direct outcome of the October War between Israel and its Arab neighbours. The subsequent embargo on oil supplies to the United States caused the oil price to rise from under $3 per barrel to over $11 per barrel, bringing a substantial increase in revenue to the oil-exporting states of the Middle East which could be used to finance development. Similarly in 1979, the Iranian revolution not only had profound implications for the development of that country, but resulted in a further doubling of oil prices which brought windfall gains for the other oil-exporting states.

The oil price rises propelled the oil-exporting states forward in terms of the growth of their gross domestic product, and enabled them to build very modern infrastructures to facilitate industrialisation and commercial development. In some respects the Gulf states attained the development pre-conditions that they had hitherto lacked, at least in physical if not in human terms, given the long lead times necessary for investment in education and training to have much effect. The economic balance between the Gulf states and their northern Arab neighbours was transformed overnight, with the latter becoming more dependent on the former for finance, although the dependence was not entirely one way, as the Gulf states needed labour from Egypt, Jordan, Syria and Lebanon.[11] Nevertheless, the ranking of states in the development hierarchy changed abruptly. Some of the 'flying geese' surged ahead, while others fell back. Take-off into self-sustaining development has however remained elusive. Arguably all the physical and human pre-conditions were fulfilled in none of the states of the region. The 'geese' relied even less on each other, and more on the outside world.

To see why this was the case, it is perhaps pertinent to examine the structures of how markets operate in the Middle East, and the behaviour of economic agents in a market context. This is considered in the next section. The role of government may also be crucial. Theories on this, and their relevance to the Middle East, will be considered in the penultimate part of this chapter.

MIDDLE EAST MARKETS AS *BAZAAR* ECONOMIES

Markets are crucial for economic activity as within them the forces of demand and supply interact and prices are determined. The literature on economic development has increasingly focused on the role of market efficiency in facilitating development, and competition as a force encouraging that efficiency in transactions.[12] How efficient are markets in the Middle East, and how does the nature of transactions correspond with that depicted in the standard economic models? The traditional markets of the Middle East, the *souks* of the Arab world and the *bazaars* of Turkey and Iran, are renowned for their bargaining, but bargaining is not the same as competition. Clifford Geertz considered how far a *bazaar* economy is efficient in a study of Morocco, and concluded that in its own terms that it was,[13] but other more aggregated studies of distribution and pricing in the Middle East lead to rather different conclusions.[14] Mark-ups on imported goods are often high, the system of exclusive agents reduces competition and choice, bribery is prevalent to circumvent import controls; all of which means that countries get relatively poor value from their development budgets.[15]

If Middle Eastern markets function differently to those of the West, as Geertz suggests, it is worth examining some of their characteristics, and the behaviour of those involved in transactions, to ascertain the implications for development. Does the *bazaar* mentality have to be replaced before development can occur? The economics of information and search clearly has relevance for *bazaar* economies, where prices are seldom marked, and normally if a seller is asked to quote a price, the quotation will depend on his view of the buyer's cash position, his perceived interest in actually purchasing the good, and if he is expected to wish to bargain or not. The parties are in asymmetrical positions. The seller for his part will have an advantage in terms of both knowledge and skills over the buyer. When bargaining commences he will have been in the situation hundreds, perhaps thousands, of times before, with an experience of buyer psychology acquired over many years in what is perhaps one of the best 'schools of commerce', the *bazaar*.

In these circumstances search can be a daunting and potentially unproductive task. It may be advisable to concentrate on dealing with a particular seller, and try to obtain the best deal through bargaining rather than to seek alternative quotes. Sellers are of course aware of this and may aim to ensure that enduring customer relations are established. Geertz described the process of building up goodwill with regular customers as 'clientelization'. Loyalty to particular suppliers reduces the time buyers spend shopping around for their purchasers, or in other words, the search time. This can be considerable in *bazaar* economies where the products on offer are heterogeneous rather than homogeneous

and where the buyer has therefore to take quality into account as well as price. Decision-making with two variables, one of which is non-quantitative and judgemental, becomes a much more complex affair than merely deciding on the basis of the lowest price.

In the *bazaar* the goods on offer tend to be imperfect substitutes, and it is this that makes search important. Particular foodstuffs are differentiated with regard to characteristics such as place of origin, size, taste and maturity. Infinite variety is possible with no two items on offer exactly the same. Textiles and clothing sold in the *bazaar* are often the product of cottage industries or may even be manufactured in small workshops within the *bazaar* itself. Each garment is unique, indeed it is often tailored to the requirements of particular customers. Clients are prepared to spend time selecting particular cloths, being measured for fittings and then returning to the tailor several times while adjustments are made to a garment. It could be said that they are actually involved in the manufacturing process directly, rather than being mere final consumers.

In some *bazaars* there may be a clustering of establishments according to religious affiliation, as with the Jewish merchants in Isfahan in Iran and Fez and Rabat in Morocco. This, however, is the exception rather than the usual situation in the Middle East. Normally establishments are grouped according to the kind of trade which they are involved in or the type of activity performed. Establishments selling herbs and spices, for example, may be all located in one area of the *bazaar,* while those selling gold and jewellery will be found in a different location. In the case of the latter the location may be adjacent to the establishments offering money-changing and money-lending facilities which will also be clustered together.[16]

The *bazaars* of the Middle East seem much more enduring than the traditional retailers in the western world. Street markets in the West exhibit some of the characteristics of the oriental *bazaar* but they account for only a small share of retail transactions. Will economic development result in the *bazaar* becoming less important in the Middle East? This is of course the reverse of the question already posed, whether the *bazaar* mentality and methods of transacting are conducive to economic development? Are *bazaars* efficient or would their replacement result in lower prices and better service? In neo-classical economics competition is usually seen as a prerequisite for market efficiency, the notion being that monopolies create distortions and result in overpricing. *Bazaar* activity is better analysed formally with the tools of modern game theory, however, as the simple assumptions of perfect competition have little relevance in a market with complex interactions.

Social preferences are shaped by value systems and cultures. Although governments are concerned to promote development in the Middle East as elsewhere, and ordinary people have material aspirations, there is little

support for the 'westernisation' of commerce and business methods. The family business remains the backbone of the private sector rather than large publicly quoted corporations, and the emphasis is on personal dealing. The *bazaar* mentality permeates business culture, with trading regarded as a productive and honourable activity. Competition implies bankruptcy for the unsuccessful, and monopolistic competition a significant amount of take-over and merger activity. Such practices would be out of keeping with the ethos of *bazaar* society, as it involves threatening the positions of entire families.

THEORIES OF THE ROLE OF THE STATE

If markets do not function efficiently in the Middle East because of the transactions costs associated with *bazaar* economies, this could be one justification for direct government intervention in resource allocation. The literature on economic development in the 1950s and 1960s was largely biased towards state intervention, but disillusionment with how the governments of many developing countries actually managed their economies resulted in a swing of the pendulum towards less state interference in the 1980s and 1990s.[17] How effective are Middle Eastern governments in economic management? Can state action overcome market failure or does it merely result in a different type of failure? To answer these questions it is important to identify what government economic objectives actually are. The new theories of political economy can help in this, and it is certainly worth considering their relevance to the Middle East.

The role of the state in developing economies can be classified as protective, productive, dirigiste, authoritarian or totalitarian.[18] There is obviously a diversity in forms of government in the Middle East, and most do not fit neatly into one particular category. Governments in the region are mostly authoritarian, however, in the sense that power is vested in a dynasty, the military or some other ruling elite. The development objectives of the state then tend to be identified with those of the ruling group. This is not simply a matter of the material enrichment of the elite, although this may be important, but it is also a question of the self-aggrandisement of the ruling group by increasing the country's economic power. Hence more general societal objectives may be involved, going well beyond the material satisfaction of the ruling group.

Few, indeed perhaps none, of the governments of the Middle East could be described as totalitarian. This applies where a single party dominates all political institutions and controls absolutely all the instruments of economic power for its own ends. Syria and Iraq under the Baathists come closest to this model, as opposition parties and groups are ruthlessly

suppressed, but the control of governments in both states is far from being absolute. Black economies flourish in these two countries beyond state control,[19] opposition groups continue their activities underground, and disputes within the ruling groups themselves seem never-ending. The apparatus of government was arguably not effective enough for totalitarianism to prevail. There has never been a Stalin or a Hitler in the Middle East, nor is the emergence of such a ruler likely, given the social checks and balances. Allegiance to the state has become more significant as nationalism has grown, but there are many other loyalties to family, kinship group, and even the wider Arab nation or Muslim community. It can of course be argued that external interests are likely to prevent the emergence of powerful totalitarian regimes in the Middle East in any case, especially given the West's interest in the region's resources.

A protective state exists where there is minimal government intervention but the state is concerned with national security, internal law and order and the protection of property rights. The Ottoman Empire could be characterised in this way despite the authoritarian nature of its governments. The state only interfered in economic transactions by imposing taxes to keep itself-functioning, but the citizens were largely free to pursue their business activities, the major limitations being the need to adhere to social norms rather than any constraints imposed by government.[20]

It would be possible to classify the Ottoman state as a rentier rather than a productive state, and regard the so-called oil rentier economies of the last two decades as inheriting this outlook; but the term rentier is used in a different sense in the new theories of political economy compared to its use by some economists from the 1970s onwards with respect to the Gulf states. It is not seen as 'unproductive' but rather as an interest group approach to politics, seeking to redistribute excessive returns over opportunity costs.[21] This new definition is perhaps more applicable to the Middle East than the rather simplistic 'unproductive' notion. To elaborate on this it is necessary first to consider the characteristics of productive states to see if these are present in any of the economies in the Middle East. The issue of rent-seeking is a separate one, not the opposite extreme.

Modern political economy draws on neo-classical welfare analysis to define the productive state. The aim of government is to maximise social welfare, as the state represents the whole citizenry. Governments may intervene, both to increase efficiency where market failure occurs and to redistribute income, not simply to promote equity, but because welfare is increased when money is redistributed from the richer members of society who get less utility or satisfaction from their marginal income than do their poorer neighbours. The government recognises diminishing marginal utility, and acts as a beneficial agent for the good of society as a whole. Given this definition of the productive state, it is hard to see its relevance

to the Middle East, where governments usually represent interest groups rather than the whole citizenry. Redistribution can occur, as with the land reforms in Egypt, Syria and Iraq, but this was motivated by a political objective: the desire to break the economic power base of the landed class, and not to increase the income of the powerless peasants.

Governments in the Middle East may not be productive but they have assumed some of the role of the dirigiste state. This is sometimes regarded as one step beyond the productive state, but the categories are not a progression so much as alternatives which can exist simultaneously. The dirigiste state draws on structuralist theory, and assumes that there is a group of agents committed to maximising the national interest. This is not necessarily the same as the interests of all the citizens, but can be defined in terms of national power, military might, regional and even international prestige and other nationalistic objectives. In order to play this dirigiste role, the state must often assume the levers of economic power, so that there are no internal challenges to weaken its position. This may involve nationalisation of the commanding heights of the economy, allocating resources through the public sector and regulating private economic activity. Middle Eastern governments have taken all these actions in pursuit of the national and their own interests.

Supporters of the dirigiste state point to the stability it brings in conditions where a more *laissez-faire* approach would only result in uncertainty in economic decision-making, and hazardous outcomes.[22] The governments in the Middle East often last for two decades or longer, in contrast to the situations in western democracies where governments seldom hold power for more than two electoral terms, with some notable exceptions. Changes in government do not bring economic disruption where there is a considerable amount of policy consensus among the different political parties or groupings, but this is rarely the case in the Middle East. There a change of government often brings revolutionary economic as well as political change, as with the young officers' coup in Egypt in 1952, the Iraqi revolution of 1958, the return of Khomeni to Iran in 1979, and the Turkish military coup of 1980. Even the death of a leader and the accession of a colleague can bring major economic change, as when Sadat succeeded Nasser and launched his 'open door' policy to the West.[23] In these circumstances it can be argued that the less frequently there are changes in government the better. On the other hand it can be asserted that under strong dirigiste leadership pressures for change build up, and it is this that brings revolutionary discontinuities. If more responsive democratic institutions were in place, then the adjustment could be more evolutionary. This has been the experience in Jordan, for example, where a degree of parliamentary democracy has provided an outlet for economic frustrations, and helped ensure a continuous and healthy review of development policy.[24]

Dirigiste governments in the Middle East have often been predatory, in the sense of maximising their own self-interest at the expense of the public interest, resulting in an erosion of constitutional constraints on state action. Power in the region has often corrupted the rulers, and been corrosive for both economic and political institutions. Checks and balances have seldom been maintained, and it is far from clear that the highly centralised and concentrated decision-making has been for the public good. Arguably it would have been better for business decisions to be taken by those actually involved in production and trade rather than by the political and military elites. In an unregulated market there are many economic agents taking decisions, so the consequences of bad decision-taking are less far-reaching, and the law of large numbers usually ensures that overall outcomes are satisfactory. When power is concentrated and bad economic decisions are made, the results can be wasteful and potentially disastrous. The Algerian experience illustrates this, with most of the country's substantial oil and gas revenue spent on ill-conceived industrial projects.[25]

As we have already mentioned, the economies of the Middle East have often been described as rentier states, and there is a considerable amount of literature that refers to the oil-exporting states in this way from the 1970s onward. Definitions of what exactly was meant by the term rentier seemed to vary, one theme being that it implied living on the income of a non-renewable resource, from which a rent could be earned because of its scarcity value. After the oil price rises of 1973 and later 1979, the price of Middle Eastern oil seemed to bear little relation to its cost of production. The issue was then to whom should the rent accrue, the oil company, the government of the producing country or the government of the consuming country? These issues will be explored further in the chapter on oil revenue and development, but here it is worth noting its relation to the theory of the dirigiste state, and even the notion of predatory behaviour by government.

It could be argued that oil revenue increased the power of the dirigiste state, and gave it the resources to reinforce its role. Accountability became less important, as there was less reliance on the citizens of the state for tax income. There is the slogan, 'no taxation without representation'. Jordan, where the government has to impose high levels of personal taxes to cover its expenditures, enjoys a considerable measure of parliamentary democracy. In contrast, in the Gulf states, where revenue largely accrues from oil, there are some consultative processes, but no real popular accountability for expenditure by government. The link between democratic institutions and development is, of course, both complex and a source of considerable controversy. Whether democracy is a pre-condition for development or an outcome of it has been much debated by political economists. If development implies empowering the individual, democracy may be even regarded as an integral part of the process. The Middle East is possibly the least

democratic region of the developing world, but the extent to which this can be explained by the nature of the region's income and wealth must remain a debatable point.

THEORISING ON MIDDLE EASTERN DEVELOPMENT

All three approaches discussed in this chapter yield some interesting insights into the development failures in the Middle East. Examination of the historical stages of economic growth approach might lead to the conclusion that despite the many economic changes in the region, none of the economies had reached the take-off stage for self-sustaining growth to occur. External dependency continues, and the 'flying geese' metaphor which has been applied to the successful economies of South East Asia would not appear to be especially relevant to the Middle East, given the absence of a lead economy and weak regional linkages, especially in relation to trade. The deficiencies in the internal generation of development could be attributed to market failures. There is certainly evidence that markets function inefficiently in the Middle East, with high transactions costs. Government failure may be as serious a problem as market failure, however, with autocratic governments making poor decisions, and an emphasis on short-term rent-seeking and the politics of patronage. There is almost a reluctance to permit the emergence of new sources of economic power in case it threatens the state monopoly. These issues will arise again in later chapters of this book. We shall now turn to quantifying the exact state of Middle East development, to ascertain the extent of any shortcomings and the scale of the task ahead: this is the subject of Chapter 3.

3

GROWTH AND STRUCTURAL CHANGE

THE ECONOMIC INHERITANCE

The Middle East has a rich economic inheritance and was one of the first regions of the world to have a developed civilisation. Both the physical and human achievements were considerable, and mankind as a whole owes a great debt to the pioneering efforts of the Egyptians in agriculture and irrigation, the Persians in crafts and the Phoenicians in trading. The spread of Islam was to result in a resurgence of scientific discovery in the region that was only later followed by Europe at the time of the Renaissance. In the sixteenth century the city of Isfahan had more artisans than Paris, Europe's leading metropolis, while Shiraz was a major centre for scholarship and learning.[1] By the late nineteenth century Cairo had a sophisticated financial infrastructure, including a stock exchange, while Alexandria was one of the leading ports of the Mediterranean, its prosperity based on cotton exports, with Egypt being the leading world supplier.[2]

It is against this background that the economic performance of the region during the second half of the twentieth century must be judged. Much has been achieved, and the last fifty years have witnessed greater changes than the last five centuries. The population of the Middle East has increased to over 250 million, and continues to grow by seven million each year. Egypt, Turkey and Iran will all have populations exceeding 60 million by the turn of the century.[3] The urban-rural balance has changed drastically, and most Middle Eastern societies now have over half of their population concentrated in cities and large towns. The population of Cairo exceeds 12 million, while Tehran has over 6 million inhabitants.

In the Malthusian view such a rapid increase in population can only bring misery and hardship. The additional population is regarded as a liability rather than an asset. It adds to consumption pressures without contributing to production. Yet social indicators for Middle Eastern states do not support such a gloomy view. Life expectancy rose from around

55 years on average in 1970 to over 66 years by 1992, reflecting better diet and improved health care. This compares very favourably with sub-Saharan Africa and south Asia, although life expectancy is much higher in China and most Latin American countries. Daily calorie intake is more than adequate throughout the region, apart from Sudan. School enrolments have increased from only half of the population aged from 7 to 17 to over 85 per cent.[4] Two-thirds of the region's population can now read and write, with illiteracy largely confined to the older generation. Literacy levels are much higher than those in south Asia, although below those of China and most of Latin America. There has been a particularly dramatic increase in the number of girls in schooling, indicating that Islam has not been detrimental to female educational advancement.

The substantial investment in human capital has not been matched by a corresponding investment in physical capital in the poorer countries of the region, and this mismatch may be one factor to account for their relatively poor development performance. In countries such as Egypt, Sudan and Iran there has been major economic change, but these changes have often not been for the better; material living standards for the majority of people remain low, and in many cases are actually deteriorating. The measurement of development is a huge and controversial subject in itself. A useful first step is to review the major conventional indicators.

GROSS NATIONAL AND GROSS DOMESTIC PRODUCT

Figures for gross national product can give a very misleading impression in the Middle East, especially for the major oil-exporting states, but it would be incorrect to dismiss them as useless indicators. They represent real purchasing power internationally, and for small open economies this is highly significant. Alternative measures of development, including structural indicators, cannot be ignored but gross national product is a good starting point. It highlights the huge differences within the Middle East in terms of economic muscle and also demonstrates just how weak the position of the region is in relation to other parts of the world.

It is important to distinguish between gross domestic product and gross national product when making comparisons over time and between countries. Both measures are available for Middle Eastern economies. Gross national product includes net property income from abroad, which has been and remains highly significant for the OPEC states of the region with substantial overseas asset holdings. These movements tend to be erratic, reflecting changes in conditions in international financial markets rather than economic developments within the region. Inflows can also

result from changes in fiscal policy, but these may be distorting. Government spending in excess of tax revenues can be financed by the sale of overseas assets, which adds to gross national product. This, however, is a sign of economic weakness rather than strength.

The economic weakness of the region can be illustrated by international gross national product comparisons. Egypt's gross national product was around $34.5 billion in 1992, just over one-sixth the level of Belgium, and under half that of Portugal, the poorest country in the European Union. The disparity between the Middle East and the more dynamic areas of the developing world is becoming more marked, even including comparisons with other Muslim countries. Egypt's GNP was almost 50 per cent higher than that of Malaysia in 1970, but by 1992 the position had been reversed. Iran's GNP was over 13 per cent higher than that of Indonesia in 1970, but by 1992 it was Indonesia whose GNP was 20 per cent higher than that of Iran. The relative change in the global position of the Middle East is more encouraging, however, as growth in the advanced industrialised countries slows. As a region the Middle East accounted for 1.8 per cent of world GNP in 1970, but by 1992 this proportion had risen to 2.5 per cent.

Per capita gross national product is the most widely used indicator for measuring changes in living standards both within countries over time and for international comparisons.[5] For the Middle Eastern economies it illustrates just how poor living standards are for over 90 per cent of the region's inhabitants, and how standards in recent years have been falling rather than rising. In Iran for example GNP per capita contracted at an annual rate of 1.4 per cent over the 1985 to 1992 period. In Jordan the annual rate of decrease was 7.0 per cent over the same period and in Syria GNP per capita was stagnant. In some oil-exporting countries such as Qatar the figures are also bad, with an average annual GNP per capita contraction of 6.9 per cent between 1985 and 1992. Saudi Arabia fared better, however, with a 1.3 per cent annual increase in per capita GNP, partly a consequence of the oil production rises following the Gulf War.

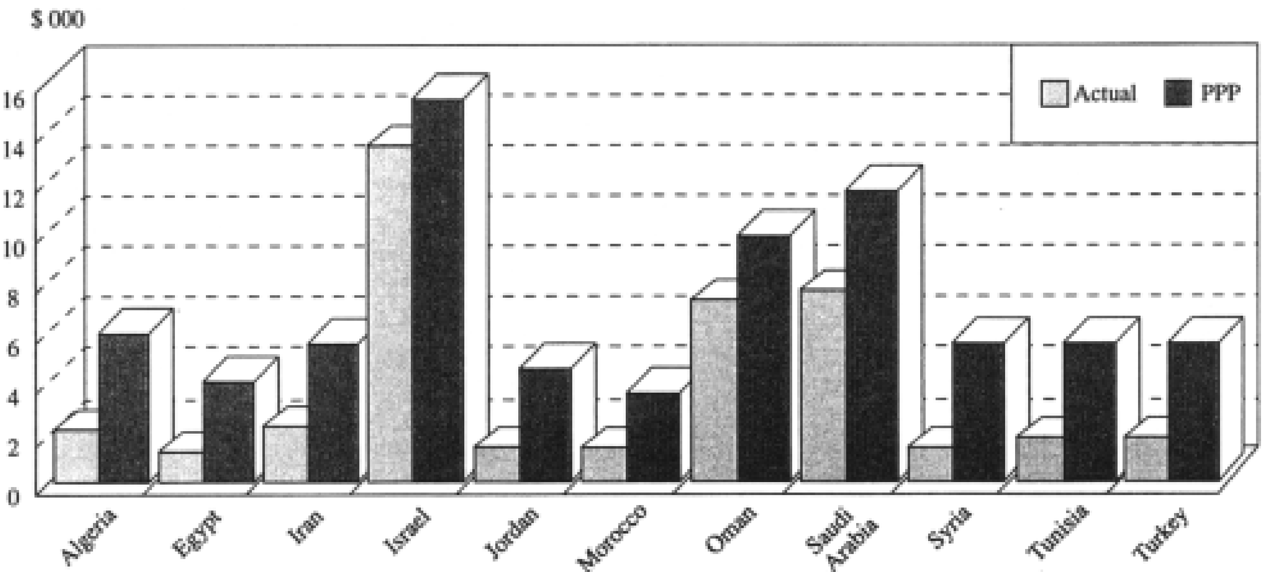
Oil production distorts gross national product figures, and for the Arabian Peninsula states in particular much of the change reflects oil price decreases and production swings.[6] It is often asserted that for OPEC countries per capita income is a totally misleading indicator of the level of economic development as the high figures merely reflect oil production, not successful advance through economic diversification. What constitutes successful development is a matter for value judgement, and there are no objective criteria. The very high levels of per capita income for the less-populous countries do give an indication of the ability to consume imported goods and services, which has implications for individual and social welfare. It is not the measure which is wrong, but the interpretation.

Another criticism of gross national product per capita comparisons is that a common unit of measure has to be used, most frequently the United States dollar. A dollar standard was appropriate when the United States currency underpinned the international monetary system but the dollar's role has diminished considerably in recent years and its exchange rate has been volatile in relation to the yen and Deutschmark. As a consequence the dollar is no longer a very attractive store of value or medium of exchange, but in a multicurrency trading system there is no single satisfactory alternative.

In any case, for the countries of the Middle East the United States dollar arguably remains a better yardstick than other currencies, not least because the price of oil is denominated in dollars. External aid inflows and soft loans to the poorer states are also dollar-denominated, which means that the dollar is certainly an appropriate standard for balance of payments receipts. It is on the import side, however, that the dollar is less relevant, because apart from the field of defence equipment, the United States is an insignificant supplier. Most civilian imports come from either Japan and the Far East or from the countries of the European Union. This applies as much in the case of capital equipment as of consumer goods, with Far Eastern contractors winning most infrastructure tenders.

The problem for the Middle Eastern states is that with balance of payments receipts largely dollar-denominated but expenditure obligations Deutschmark-and yen-denominated, exchange rate fluctuations between the United States, European and Japanese currencies affect the Middle Eastern countries as third parties. An appreciation of the dollar helps the states of the region; depreciation results in economic damage. For most of the 1980s fluctuations and depreciations in the dollar harmed the Middle Eastern economies, undermining the region's international purchasing power.

Figure 3.1 shows both actual and purchasing power parity (PPP) per capita GNP comparisons for eleven leading Middle Eastern economies. The actual figures are converted at current exchange rates, while the PPP figures reflect the real value of per capita income, taking account of variations in the cost of living which are not reflected in the exchange rates. For all the countries of the region the PPP per capita GNP figures are much higher than the actual figures, indicating that the countries may not be as poor as crude comparisons using current exchange rates might suggest. Egypt, for example, has a PPP per capita GNP figure of $3,670 compared to an actual figure of $640. For Syria the PPP figure is $5,220 compared to an actual figure of $1,160. If PPP figures are used, none of the countries cited fall into the World Bank's and United Nations' low-income category for developing countries. Most are in the middle-income bracket, apart from Israel and Saudi Arabia, which have per capita



Algeria	Egypt	Iran	Israel	Jordan	Morocco	Oman	Saudi Arabia	Syria	Tunisia	Turkey
1.84	0.64	2.2	13.22	1.12	1.03	6.48	7.51	1.16	1.72	1.98
5.74	3.67	5.28	14.6	4.22	3.27	9.63	11.17	5.22	5.13	5.17

Actual figures above; PPP figure below $ 000

Figure 3.1 Per capita GNP comparisons
Source: World Bank, *World Development Report,* 1994

gross national product figures comparable to developed industrial countries. If PPP comparisons are taken, the remarks made above about the relative poverty of the Middle East in relation to the industrialised world may need considerable qualification.

NOMINAL AND REAL INCOME

When examining changes over time in gross national product it is necessary to allow for the effect of price changes. Nominal rises mean little if economies are subject to substantial inflationary pressures, as has often been the case in the Middle East. All countries in the region compile price indices, but the coverage of these is often restricted, making their usefulness as gross national product deflators open to question. The most inflation-prone economies, Turkey and Iran, construct fairly sophisticated retail and wholesale price indices. Israel, which had high rates of inflation until the late 1980s, used its indices for wage indexing, though there were some moves to reduce the inflationary bias by moving away from this.[7] Turkey's inflation has fluctuated considerably, the rate rising from 38.8 per cent in 1987 to 75.4 per cent the following year before falling back to 63.8 per cent in 1990.[8] Its average inflation rate over the 1985–92 period was 54.7 per cent, compared to just over 20 per cent for Israel and Iran, and 17 per cent in the case of Egypt.

The difficulty with such high and volatile rates of inflation is that different commodities can be affected in markedly dissimilar ways over even quite short periods of time. Prices of imported goods may increase with a lag following depreciation, for example, but depreciation may be far from a smooth, continuous process. Domestically produced goods may rise in price after wage settlements, but these are usually annual or biannual rather than monthly or quarterly, even in high-inflation countries such as Turkey. Given inflation differentials between commodities, one problem which arises is which weights to assign to each component of the GNP deflator and when to weight. There are two standard methods: either the use of a base-weighted index, the Laspeyre approach, or a current-weighted index, the Paasche approach. The problem with the former is that the weights become outdated and irrelevant. In the latter case reindexing is necessary for each new period, but the problem is then consistency over time. In the Middle East it is the Laspeyre approach which is most commonly used so the appropriateness of the weighting must be open to question.

There are also distribution issues that arise when deflating GNP. Price indices in the Middle East are based on urban rather than rural prices. As a result the impact of inflation on agriculture and the countryside may be over- or underestimated. In practice the value of urban and industrial

production is usually exaggerated by a higher average rate of inflation in cities and major towns. Even the decline in the share of agriculture in GNP may be partly attributed to a pricing miscalculation.

THE WEALTH OF NATIONS

Per capita GNP only measures current income but reveals little about the underlying wealth of nations. The literature on national accounting stresses the importance of the wealth stock as well as the income flows. Countries such as Japan have a high gross national product per capita, but the accumulated wealth in the private housing stock does not compare with England, a country with a lower level of income but a much richer capital endowment for its citizens to enjoy. In mature industrial nations the problem is to generate sufficient income to maintain the existing capital stock. Any additions are a welcome bonus.

How do the Middle Eastern countries compare in international income and wealth relatively? Natural calamities such as earthquakes are a problem in some countries of the region, notably Turkey and Iran, but even the worst quake has not destroyed more than 1 per cent of the capital stock of any single country. It is common practice to provide steel frames for buildings and to reinforce concrete with metal rods, but this is not a major expense. The climate, despite the extremes of temperature, is kind as far as buildings and infrastructure are concerned, and storm or flood damage is less of a problem than in many parts of the world. There is no country in the region which faces problems like those of Bangladesh, where capital accumulation seems futile, given the annual problems of typhoons, tidal waves and monsoon-induced flooding.

The Middle East has a rich cultural and architectural inheritance which is reflected in the magnificence of some of the mosques and other public buildings. These represent only a minute proportion of the building stock, however, and the more modern buildings financed by government are at best nondescript, and at worst vertical slums. The peak public building period in Egypt, Syria and Iraq was the secularist era of Arab socialism of the 1950s and 1960s when the inspiration was the tower blocks of Eastern Europe. The contribution to the wealth stock of these high-rise buildings is extremely debatable. Indeed, many in the Middle East regard such blocks as liabilities rather than assets. They were never suitable for Arab lifestyles, given the desire for family privacy and space for male and female separation within the household. Additional space was also needed to accommodate several generations together, given the preference for extended family structures.

There is considerable variation in the quality of both the housing stock and the infrastructure in the Middle East. Maintenance has often been

poor and conservation neglected. The mud brick houses of the Nile valley and delta may not have contributed much to the value of Egypt's capital stock, but they are cheap to maintain and rebuild. The more expensive high-rise buildings constructed during the previous three decades require much more maintenance and are likely to prove a greater drain on current income. There are some architectural master-pieces in the oil-rich states of the Gulf, but these buildings are the exception rather than the rule. Most are as shoddy and mediocre in the Gulf as in the poorer states of the region, and unfortunately the generation of the oil boom has bequeathed a dismal inheritance to its children.

The wealth stock has implications for national income accounting. Replacement investment is needed as machinery and equipment come to the end of their productive lives, and even buildings and plant have to be replaced eventually. An allowance for depreciation has to be built into investment calculations. At the national income level net national product refers to the value of a nation's annual output less the capital consumption experienced in producing that output. In other words, net national product equals gross national product minus depreciation.[9]

In the Middle East, given the poor quality of much of the capital stock and inexperience in the maintenance of modern plant, depreciation can be extremely rapid. GNP figures may therefore give a more favourable impression than is justified. Much investment is replacement investment rather than new investment. Arguably, comparisons should be made using net rather than gross national product figures, but this is not done because there are no international standards governing depreciation. In the Middle East such calculations are invariably rough and ready.

INVESTMENT IN TRANSPORT AND INFRASTRUCTURE

The communications infrastructure is good in the Middle East by Third World standards, and this is perhaps the most positive lasting development which was facilitated by the oil boom of the 1970s. With some notable exceptions, such as Tehran, airports compare with the best internationally. For intra-regional passenger travel, air is the preferred, and indeed usually the most common, option. Airline fleets are of variable age, and most of the airlines which have modernised have purchased or leased the cheaper twin-engine aircraft, even for long-haul flights. The weakest link is the outmoded computerised booking systems which make reconfirmation an inconvenient necessity. Many national carriers would not be viable without government subsidies, but spending state money on this rather than on ground transport raises equity issues. Cross-border airline mergers could bring savings in the Middle East and produce a

world-class airline. At present the tendency is rather towards fragmentation, with the emergence of Emirates, for example, as a separate Dubai-based airline, undermining the position of Gulf Air as a transnational carrier.

Road transport has become the primary means of national communication in the Middle East as in most other parts of the world. Dependence on the internal combustion engine is perhaps quite appropriate in a major oil-exporting region, with a large proportion of global reserves. Most freight is carried by road, and the haulage business is one of the most buoyant private-sector activities. Roads have been much improved during the previous three decades, and the network of dual carriageways is particularly impressive in the Gulf states.

Communications have been planned on a purely national basis in the Middle East and there is no inter-state road system similar to that found in North America or the European Union. There is relatively little intra-regional trade and commerce in the Middle East, though the explanation for this is related more to economic structure than to transport infrastructure. It is always debatable how far the lack of inter-state highways merely reflects the low level of intra-regional trade or is itself a cause of the restricted volume. Given the willingness in the Middle East to exploit to the full even limited facilities, the latter direction of causation would appear unlikely.

Overland transport links were distorted and impeded following the creation of the state of Israel.[10] The area which constituted Palestine was at the heart of intra-regional communications, and Israel acted as a wedge between the Arab countries of North Africa and western Asia. Jordan was cut off from the Mediterranean, its only access to the sea being via Aqaba. As most Jordanian trade had been with Britain, and even today is with the European Union, this route was inconvenient and added to transport costs, with shipping having to pass through the Suez Canal. Jordan is likely to benefit considerably from the normalisation of relations with Israel, because although direct bilateral trade possibilities are limited, there should be significant benefits for transit trade and tourism.

Road communications may be more appropriate than railway links in a large, unevenly populated region such as the Middle East. There is no high-speed inter-city rail network either within countries or regionally, and the cost of such investment would be enormous. The comparatively short distance between Cairo and Alexandria has a good connection, but the quality of track between Cairo and Aswan is poor, with priority given to rolling stock. There is a modern upgraded track from Riyadh to Damman, but elsewhere investment in railways has been minimal. The Cairo metro system represented a substantial investment, but whether this was a justifiable priority for Egypt as a whole must be debatable, although it did help to speed up urban transit times in the capital.

THE STATE OF LAND AND AGRICULTURE

Historically the Middle East was not only self-sufficient in most foodstuffs, but there was a substantial grain surplus for export. The region contained some of the oldest areas of settled agriculture in the world. The highlands of Yemen had elaborate terracing for its agriculture, and the Nile and Tigris-Euphrates valleys had complex irrigation systems dating back to the fourth millennium BC. Crop rotation to prevent soil exhaustion was pioneered in the region. North Africa was the granary for much of the Roman Empire, and the Mediterranean littoral of the region was one of the first areas in the world to support fruit and vegetable production on a significant scale. The order established by the Ottomans enabled agriculture to flourish, and the security of tenure which land registration brought encouraged landowners to invest in farm improvement.

Over the last three decades the Middle East has become a substantial net importer of food, partly because of population growth and the consequent increase in demand. There have been significant rises in agricultural output, with both increased yields per acre and an expansion in the cultivated area, but the additional supply has been insufficient to overcome shortfalls. Egypt's population continues to increase by over a million every nine months, and may exceed 60 million by the turn of the century. In Iran the population has risen from 38 million before the Islamic revolution to almost 60 million in under two decades. In these circumstances it is hardly surprising that both countries need to import a large proportion of their foodstuffs, despite the efforts to encourage higher levels of domestic agricultural production.

It is evident that agricultural self-sufficiency is not a realistic prospect for most economies in the Middle East. Such a goal is questionable in any case. Self-sufficiency can be virtually guaranteed at a price, but given the land-resource base of the Middle East the opportunity cost may be considerable. Funds spent on land improvement reduce the budget for industrial infrastructure. Water used in agriculture could be used by manufacturing establishments. There may also be pricing distortions internally. Saudi Arabia has been able to produce a substantial grain surplus for export, but only by pricing domestically produced grain at five times the world level.[11]

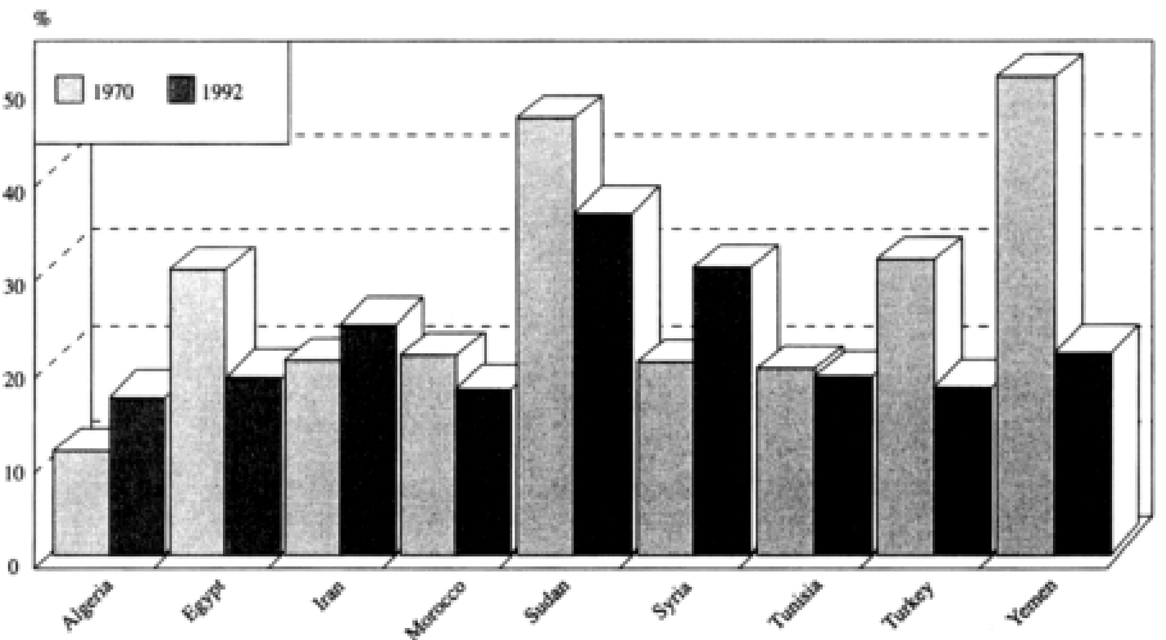
For shares of sectors in national income within countries the World Bank uses gross domestic rather than gross national product, as the concern is with production within countries. A falling share of agriculture in GDP is often viewed as a sign of development.[12] It represents part of the structural adjustment process rather than being economically detrimental. If a stages-of-growth approach to development is taken, then in the early stages primary productive activities such as agriculture are

the dominant form of economic production. With economic growth comes the development of processing and manufacturing activity, which may result in the establishment of a significant industrial base. The role of agriculture may therefore decline as an outcome of the growth process itself, even if this is relative rather than absolute.

In the Middle East the share of agriculture in GDP has declined in countries such as Egypt and Turkey, as might be expected, with an 11 and 15 per cent fall respectively over the 1970–92 period as figure 3.2 shows. In Egypt agriculture accounts for only 18 per cent of GDP, while in Turkey the share amounts to 15 per cent. These figures are of course well above the 5 per cent and less that is typical of many industrialised countries, but the gap has clearly narrowed. Even in Yemen, one of the least-developed countries of the region, the share of agriculture has fallen to 21 per cent, and it is only in the Sudan where agriculture's share of GDP exceeds one-third.

In the case of some states in the Middle East declines in the share of agriculture have not meant a declining dependence on primary production, but merely an increase in the share of oil. It must be debatable if the substitution of extractive primary activity for the exploitation of a renewable resource, namely agricultural land, really constitutes development. This substitution of oil for farm produce has occurred not only in the largely arid Arabian Peninsula states but also in more populous countries with historically important agricultural sectors. Though Egypt is not an OPEC state and its reserves of oil are limited, petroleum has become its major export and largest single contributor to GDP. It is this that accounts for much of the relative decline in the share of its agricultural sector, not the rise of manufacturing or even the growth of services.

The Middle East is one of the few areas of the developing world where the share of agriculture in GDP has actually risen in some states in recent years. In Iran, for example, agriculture's share rose from 20 to 23 per cent over the 1970–92 period, as figure 3.2 shows, the rise being most marked after the Islamic revolution in 1979. More stress was placed on encouraging increased agricultural production by the freeing of food prices, rather than by subsidising the urban industrial sector as the Shah had done. In Saudi Arabia the share of agriculture in GDP rose from 6 to 7 per cent over the 1970–92 period despite the growing significance of oil GDP in the 1970s, partly reflecting high agricultural prices, especially for grains, but also substantial farm subsidies financed from oil revenue. This demonstrates that it is misleading to believe there is a trade-off between extractive and renewable primary activity. Proceeds from the former can help the latter. Algeria also had a rising share of agriculture in GDP, a result of considerable efforts to reverse the declines of the 1960s following the departure of the French colonists.



	Algeria	Egypt	Iran	Morocco	Sudan	Syria	Tunisia	Turkey	Yemen
1970	11	29	20	20	43	20	20	30	48
1992	15	18	23	15	34	30	18	15	21

Data Source: World Development Report, 1994

Figure 3.2 Agriculture's share of GDP
Source: World Bank, *World Development Report,* 1994

For some countries great care has to be taken in interpreting figures for the value of agricultural output, as not all production may be recorded.[13] Often only marketed output is accounted for in official statistics, and in some cases merely produce sold through government agencies rather than private merchants. The latter often constitute part of the informal sector where economic activity is not enumerated, rather than the so-called formal modern sector. Subsistence agricultural production is also invariably excluded from the official figures for farm output. In the Middle East many rural families grew a significant proportion of the food they consumed themselves, a practice that continues even today. When cash-crop production is substituted for subsistence output the contribution of the agricultural sector could be interpreted as rising, when this may not in fact be the case. In Syria the share of agriculture in GDP rose from 20 to 30 per cent over the 1970–92 period, which appears at first sight as a remarkable achievement. In fact, much of this increase represents the substitution of cotton for subsistence crops and a tighten-ing up of lamb marketing with official involvement and enumeration.

INDUSTRIALISATION AND DEVELOPMENT

Since the reign of Muhammad Ali in the first half of the nineteenth century in Egypt, there has been interest in the Middle East in establishing modern industries. Muhammad Ali was very conscious of the successful experience in northern Europe, and Britain in particular, with industrialisation, and wanted his country to follow the same path. Egypt was an increasingly important producer of cotton, but most of the raw produce was sent to Lancashire in England for manufacture into textiles rather than processed locally. It seemed ironic that cotton textiles were actually imported into Egypt from a country which could not itself-grow cotton. Muhammad Ali thought a modest step forward would be to establish textile factories in Egypt to produce substitutes for these imports, but it was realised that the 'infant industry' would need tariff protection until it became properly established.[14]

Many development economists see industrialisation as the key to development, as manufacturing can act as a leading sector and serve as a stimulus to growth through linkages to other parts of an economy.[15] Development may involve structural transformation as the share of primary extractive and agricultural activity declines in relation to gross domestic product and the share of secondary manufacturing rises. At the same time industrialisation not only involves physical investment, but perhaps more importantly, human capital formation. The acquisition of industrial skills can be a crucial learning process, which may be a

prerequisite for development. Often the Japanese experience is cited as proof of just how significant the human skill element can be.

The motivation for the establishment of modern factories in Egypt by Muhammad Ali was not primarily related to development objectives as they are understood in the West today. Indeed, this could not have been possible, because the notion of developed and underdeveloped countries only emerged in the twentieth century, largely as a result of the relatively long periods of growth enjoyed by some industrialising countries. Muhammad Ali wanted to industrialise to make Egypt more independent, and to increase his freedom of manoeuvre. The objective was basically nationalistic, a desire not so much to emulate Britain and the West, but rather to detach Egypt from the imperial powers.

Military strength appeared to come from industrial success, and it was this that attracted Muhammad Ali and later Middle Eastern political leaders. The question of raising living standards for ordinary Egyptian families was of much less, if any, concern. What mattered was national economic power and the consequent political prestige, not the welfare of individuals. Saddam Hussein of Iraq, although a very different type of figure to Muhammad Ali, is very much in this tradition, with his vision of a strong ruler leading a mighty army and nation.

Given such objectives it is hardly surprising that nationalism and industrialisation became linked in the Middle East, with the state rather than the private sector taking the lead. This was the case in Atatürk's Turkey, Nasser's Egypt and even Iran under the Shah. It explains, however, why industrialisation has been pursued with a disregard for financial objectives, because profit has not been a major or even a significant motivation. It also explains why the populations of Middle Eastern states have often been much less enthusiastic about industrialisation than has the political leadership.

The industrialisation programmes of the early reformists may seem old-fashioned and inappropriate when viewed with the benefit of hind-sight, but they have to be judged in relation to the norms of their times. The stress was on the establishment of basic heavy industries such as steel-making, following to varying degrees the Soviet model of industrial development. In Turkey under Atatürk in the 1920s the state played the leading role in the establishment of such plants, which were seen as development imperatives irrespective of the country's factor endowment of available resources.[16] In fact, Turkey had both coal and iron ore, so domestic circumstances were not unfavourable for industries such as steel-making, and there was clearly a market for reinforcing steel rods in particular, given the requirements of the construction industry in an earthquake-prone country.

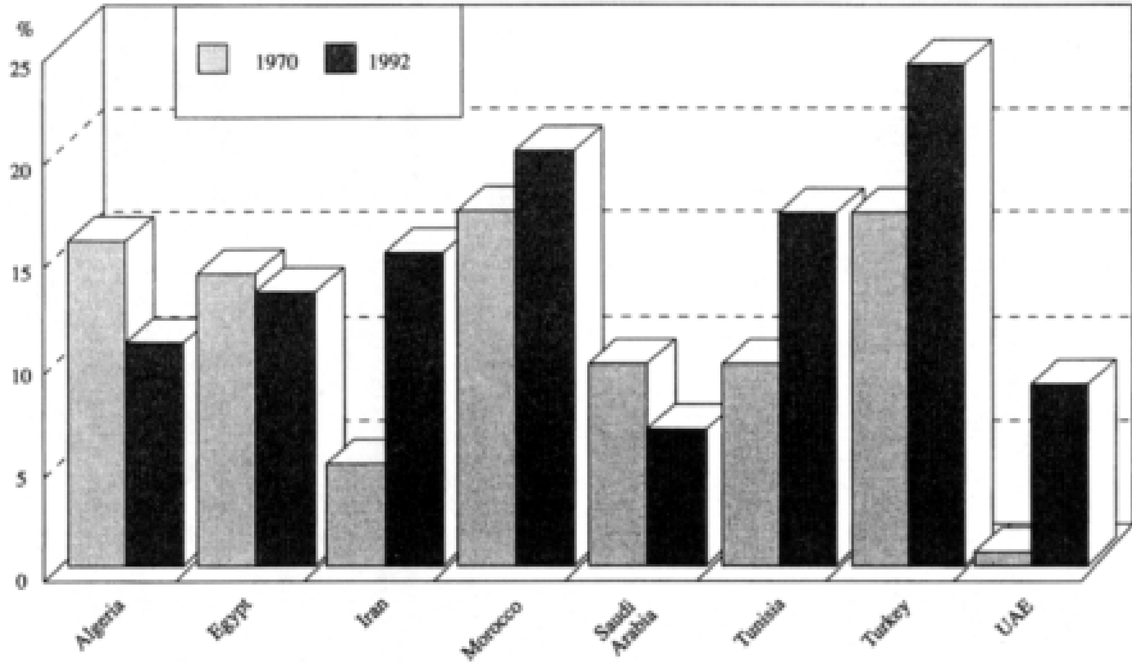
In the case of Egypt, conditions were much less favourable for the heavy industry established under Nasser in the 1950s and 1960s. The Helwan

steel plant was dependent on coking coal from Poland and imported iron ore, and used dated Soviet technology that was environmentally disastrous.[17] It is this type of plant which is being closed down in Eastern Germany, but in Egypt such a closure with its resultant lay-offs would be politically unacceptable. The country is therefore burdened with a lame-duck industry that will require both protection from international competition by quotas and continuing financial subsidies. The aluminium smelter was more up to date, but the rationale for such a plant in a country with only limited oil and gas supplies was never very clear. The main advantage for such plants in the Gulf is the cheap and abundant feed stock, but in Egypt the opportunity cost of providing cheap energy is arguably much higher.

The comparative advantage of the more populous Middle Eastern states might be expected to be in labour-intensive activities such as textiles. There was a more obvious rationale for what Muhammad Ali was trying to achieve than for Nasser's industrialisation efforts. The textile mills could at least use local cotton and employ relatively low-cost indigenous labour.[18] This was also the thinking in Iran in the 1930s when the first modern textile mills were set up in Isfahan, though in its case the international advantage would continue to be in traditional craft activities such as the manufacture of hand-knotted carpets. These were of unique design and the weaving was a highly skilled operation, though admittedly the main skills were managerial. It was those who oversaw the intricate production who were the creative or artistic force; the weaving itself was a very repetitive task often undertaken by women and children who merely followed detailed instructions.

Now that the heavy industrialisation efforts can be viewed from an historical perspective, in some cases more than half a century on, it is clear that the plants have for the most part not been a success, either in financial or economic terms. The financial costs might have been justified had there been spin-offs and linkages to other industries. In practice there was no 'big push' into self-sustaining growth; instead they appear to be dead-end industries. The plants have survived because of political sensitivities and their monopolistic position, but there can be no real future. In contrast, traditional industries are enjoying a revival. Their market advantage derives from the differentiated nature of the products, reflecting their unique designs and the skills of the production managers. They do not need artificial protection like the import-substituting heavy industries. Their profits come partly from a natural rent reflecting a real scarcity in management skills, not a monopoly rent resulting from government protection and the exclusion of competitors.

Figure 3.3 shows the changes in the share of manufacturing in GDP over the 1970–92 period for those Middle Eastern states which have made the greatest efforts to industrialise. Primary extractive industry is excluded,



	Algeria	Egypt	Iran	Morocco	Saudi Arabia	Tunisia	Turkey	UAE
1970	15	13	5	16	10	10	17	1
1992	10	12	14	19	7	17	23	9

Figure 3.3 Manufacturing's share of GDP
Source: World Bank, *World Development Report,* 1994

as this would severely distort the picture for major oil-exporting states such as Saudi Arabia. Turkey has clearly a much more substantial manufacturing base than the other states of the region, but figure 3.3 demonstrates just how far the Magreb states have progressed. Tunisia and Morocco have many small garment-manufacturing establishments, usually undertaking sub-contracting work for French companies. In the United Arab Emirates much of the industrial capacity is situated at Jebel Ali, the largest duty-free area in the Middle East, located outside Dubai. Industries include petrochemicals, ship repairs and even textiles. Petrochemicals dominates the manufacturing scene in Saudi Arabia, but there are also a number of smaller import-substitution ventures.

TRADE'S CONTRIBUTION TO THE ECONOMY

The stages-of-economic-growth approach to development, as outlined in the previous chapter, suggests that the share of services in GDP tends to grow in post-industrial societies. As economies mature there is a move away from basic heavy industry towards more specialised manufacturing, and much of the ancillary support gets hived off to other businesses, especially service companies. Demand- as well as supply-side theories also support an increasing role for services. With rising income the demand for services tends to increase while the demand for foodstuffs and basic manufactured products stagnates. In other words, the income elasticity of demand for services is higher, as fewer services fall into the category of inferior goods. Spending on education, health, travel and leisure can be virtually limitless, but there are often self-imposed limits on trading up in clothing, footwear, housing and even consumer durables.

In the Middle East the share of services in GDP has been rising in all countries, in some extremely rapidly. Throughout the region the services sector accounts for the largest single proportion of GDP, and in some countries such as Egypt and Syria around half of the total. Many find the dominance of services surprising in Egypt, given the size of its population, its rich land resource in the Nile Valley and the long-established industrial base. In the case of smaller economies such as Jordan and Lebanon, where services account for over two-thirds of GDP, the position is perhaps less surprising, because Jordan was a significant transit route for Iraq,[19] and Lebanon, before its disastrous civil war, a financial centre for the whole region.[20]

In the OPEC states of the Middle East services account for a slightly lower proportion of GDP, the share being 43 per cent in Kuwait and the United Arab Emirates, 45 per cent in Libya and 41 per cent in Saudi Arabia. To a large extent this reflects the dominance of oil in GDP. The national accounting ratios can in fact be misleading. Services are likely on economic

grounds to be more rather than less dominant in oil-exporting states, given their rentier nature. Such economies can finance high levels of both current expenditure from oil revenues by government and consumer expenditure. Consumer goods tend to be imported, but most services demanded fall into the non-tradable category. These include government-provided services, such as education and health, the income elasticity of demand for which can be very high. There may also be a buoyant demand for private-sector services, especially in transportation and distribution, with positive multiplier effects on the domestic non-tradable sector.

Trading activity was of course of paramount importance in the OPEC oil-exporting states of the Middle East long before the oil boom of the 1970s. The Arabian Peninsula states were to a large extent merchant economies, and the cities of the region developed as trading centres. Oil production increasingly dominated GDP from the 1940s onward, but the role of the traders was enhanced rather than reduced. Oil acted as a stimulus and presented new opportunities. The migrant workers attracted by the oil boom became clients of the merchants, and the increased ability to finance imports encouraged buoyant trading conditions. As only the value of imports rather than the retail prices was recorded, there tended to be an underestimation of the value added by the trading sector, and hence its contribution to GDP.

The oil boom passed over a decade ago, and the economies have since suffered the effects of falling asset values, particularly real estate, which has dampened consumer spending. Not surprisingly, this has adversely affected services, especially trading. Actual conflicts and threats to regional security have resulted in increased military expenditure, causing a squeeze on government current spending on education and health. Hence services have experienced a double blow. Nevertheless, the sector as a whole has proved remarkably resilient, perhaps reflecting its deep-seated economic strengths and historical experience. The natural caution of the merchants has helped their position. Most stock is self-financed rather than acquired through bank borrowing. Premises are usually owned rather than rented. Employees are often family members, and are willing to accept lower remuneration in hard times. In such circumstances cash flow becomes less critical, and low sales and turnover can be more easily accommodated. There is a flexibility to business cycles that traders in the West might well envy.

ECONOMIC STRUCTURE AND DEVELOPMENT

With development the share of agriculture in gross domestic product is expected to fall and that of industry to rise. That at least has been the experience of most of today's industrialised countries and many developing

countries. The position of services is more ambiguous. Traditional services such as domestic servants have tended to decline, but modern services such as finance, insurance, consultancy and the media have all grown. There appears to be an ever-increasing role for services in so called 'post-industrial' societies, although there is often a classification problem between industry and services. White-collar workers in industrial enterprises contribute to industrial GDP. If their jobs are contracted-out to management consultants, external accountants or computer software firms, this output is then recorded under services. Rises in the share of services and observed declines in manufacturing may reflect such practices, but this is merely a consequence of the method of measurement. Appearances may be deceptive.

In the Middle East the position is even more confused. There is of course the effect of the oil sector on GDP accounting already discussed in the previous section. Even allowing for this, however, it is not clear whether the economies are jumping a stage, from agriculture and other primary activity to services, leaving out the intermediate manufacturing stage. Can economies move to the post-industrial phase without ever establishing a substantial manufacturing base? Is an emphasis on industrialisation merely old-fashioned, given the negative image of much heavy industry, and the poor record of much of what has been established in the Middle East? Should governments and populations be aspiring to an alternative to industrialisation in the Middle East, and what form should that alternative take?

The stages-of-development approach advanced by the economic historian Walt Rostow includes the notion of 'take-off', a concept which implies that economies reach a certain stage where self-sustaining growth occurs.[21] Countries then proceed automatically along a growth path which leads to the establishment of a modern industrial state. There is much doubt about the validity of these assertions, and evidence from many parts of the world suggests that often there is no definitive transition to growth as a continuous process. Indeed, the early stages of industrialisation appear to be fraught with difficulties, and growth is often fragile.

The Latin American experience demonstrates just how fragile growth can be, with significant reversals rather than mere recessions in Mexico, Brazil and Argentina in the 1980s. Admittedly the problems of these economies were exacerbated by the debt crisis. Other experiences lend more support to the Rostow thesis. In East and South East Asia, economies such as South Korea, Taiwan, Hong Kong and Singapore, the so called 'gang of four', appear to have taken off into self-sustaining economic growth as discussed in the previous chapter. Malaysia and Thailand seem to be following in the same direction, and even very large and populous states such as China and Indonesia show signs of heading in a similar direction.

Compared to these states the economies of the Middle East must be regarded as poor performers if Rostow's criteria are used. Only Turkey could be regarded as an economy which has taken off, the turning point being the early 1980s. There were arguably very special circumstances which permitted Turkey's rapid advance during that decade, and many continue to express doubts about how self-sustaining its growth will be in the long run. There was significant under-utilisation of industrial capacity in Turkey during the chaotic 1970s, but greater demand stability in the 1980s meant this capacity could be brought into production. The country arguably benefited from the Iraq-Iran war in the short term, by being a significant exporter and re-exporter to both states. The oil for consumer-goods barter with Iraq was especially advantageous. At the same time earnings from tourism increased enormously, underpinning the balance of payments position.

For the Gulf states it could be argued that 1974 represented the year of take-off, as the quadrupling of oil prices enabled them to embark on large infrastructure expenditures which created the basic facilities needed for modern industries. The Riyadh government directly financed petrochemical diversification through the Saudi Basic Industries Corporation, while generous assistance was made available through the Saudi Industrial Development Fund to support the electricity industry and import-substitution ventures.

Whether all these efforts and the huge funding have really placed the Gulf economies on a path of self-sustaining growth must be open to question. Dependence on crude oil export earnings remains, and much of the diversification has been in petroleum-related fields. The new industries are largely manned by expatriate workers rather than by local citizens, and although the level of education and skills amongst Gulf nationals has improved remarkably, it will inevitably be a long time before these countries have a capable indigenous industrial workforce. Indeed, it is doubtful whether these states will be able to emulate the rapidly industrialising states of South East Asia, even if they want to do so. The culture in West Asia is quite different to that in East Asia, and this is reflected in employee attitudes to work. Social commitments affect work patterns in the Middle East, and work for material reward may not be the highest priority. The region will certainly develop along different lines to other parts of the world, but the challenge is to identify what the patterns are and to predict how they will evolve.

LEADING SECTORS AND UNBALANCED GROWTH

There has been considerable debate amongst development economists about the relative merits of balanced and unbalanced growth. Writers such

as Ragnar Nurkse[22] and Paul Rosenstein-Rodan[23] who advocate a 'big push' approach argue that countries must develop a wide range of industries simultaneously if they are to succeed in achieving sustainable growth. This prevents bottlenecks occurring, as one industry can supply another. An integrated industrial base can be established, with strong input-output relationships between the firms involved. Favourable externalities result, the revenues generated by one expanding business feeding through to others. Domestic multiplier effects are maximised, with minimal leakages abroad through imports of supplies and capital equipment.

Other development economists such as Albert Hirschman argue that balanced growth is unrealistic, and that countries need to concentrate their efforts on particular sectors or even just a few industries.[24] Once the leading sector gets established, then backward and forward linkages may build up with other industries and stimulate their development. Backward linkages will encourage the emergence of local suppliers and sub-contractors. Forward linkages will stimulate distributors and encourage more final processing. Both will result in increasing domestic value added. Uneven development must come first, however, only then can the benefits of growth be spread out more widely.

The Middle Eastern economies seem to be excellent examples of unbalanced development. Have the linkages which Hirschman identifies started to appear? Would more even development along the lines suggested by Nurkse and Rosenstein-Rodan be preferable? Government advisers in the Middle East were certainly aware of these differing approaches to development. The basic industries such as iron- and steel-making were established in order to provide building blocks for further industrialisation. The Helwan steel plant in Egypt, an example which has already been referred to, manufactured girders and reinforcing rods for the construction industry, and in addition provided sheet steel for the country's car assembly plant. The plant was designed with linkages in mind, the aim being to set up an integrated industrial complex in the greater Cairo area.

This strategy of integrated industrial development worked as long as the government was prepared to finance on very favourable terms the initial capital investment, subsidise the plants concerned once they started production and keep out competing foreign goods through tariffs, quotas and other measures. The downstream companies were obliged to purchase domestically produced steel products, but in order to prevent monopolistic overcharging, prices were set by government. Industry managers argued these were too low to cover costs, hence justifying the call for state subsidies.

The consequences of the policy were distorted prices, ever-increasing government spending and little discretion and choice for state sector management. Similar rigidities led to the collapse of socialist planning in Eastern Europe. Linkages were created, but these were forced by

government, and in many respects were highly artificial. They did not arise as a natural outcome of market forces; rather, such forces were repressed. In the Middle East, Turkey, Egypt, Iran and even Syria have all moved away from such policies towards a re-emphasis on markets, although the commitment to market reform can be questioned. Powerful lobbies have been created as a result of state-sponsored industrialisation, and there are many in government who seek to protect the interests of state-sector managers.[25]

The establishment of an integrated industrial base should not be confused with even development. Hirschman was correct in stressing that such policies were more likely to be associated with unbalanced growth. The whole modern industrial sector represented an enclave economy, with substantial intra-sectoral but few inter-sectoral linkages. Commerce and trade with the traditional economy was minimal. Indeed, the latter suffered as government finances were directed to the enclave sector, but it was the traditional sector that was the main source of government revenue, both directly through taxes and indirectly as marketing was directed through state-controlled channels. The prices paid to cotton producers in Egypt and Sudan, for example, were well below the prices at which the crop was sold in international markets by the state marketing monopolies.[26]

The OPEC economies of the Middle East also exhibit the characteristics of unbalanced growth. The oil sector exists in an enclave of its own, with few productive linkages to the rest of the economy. It is of course a source of revenue for the government, and through government spending the major stimulus of economic activity. The links with other sectors are at the macro rather than the micro level, financial rather than involving the real economy. Only a small proportion of the workforce is actually employed in the oil industry, and in the Arabian Peninsula states most of these are expatriates. Most oil industry output is exported, and its inputs are imported. The linkages are worldwide rather than local.

Efforts have been made to build up integrated industrial activity around the oil industry, diversifying out of crude oil and increasing domestic value added. Initially these involved refining, but later there was diversification into petrochemicals. Other notable efforts have included the utilisation of hitherto flared-off gas for liquefaction and export and as an input into energy-intensive industries such as aluminium smelting. As with the steel industry in Egypt and Turkey, a considerable number of intra-industry linkages have been established in OPEC states such as Saudi Arabia, but within a very narrow sector of the economy.[27] The enclave remains. It has merely become more diversified within itself and expanded marginally. At least market prices have not been distorted as much as in the countries with earlier-established industrial bases. There are only minimal opportunity costs in the low-fee stock prices paid by the petrochemical industry, because where oil is the feed stock, it could not have been sold

off in any case, due to OPEC quotas. In the case of gas, where the alternative is flaring, the opportunity cost is zero; indeed there is an environmental benefit, a positive externality.

MODERNISATION AND STRUCTURAL TRANSFORMATION

Development is often seen in terms of the modernisation of economic activity.[28] Subsistence agriculture is replaced by cash cropping, with prices determining production and sales and marketing geared to a national or even international market. In manufacturing small handicraft activities are replaced by large mechanised and automated plants, textiles, clothing and household furnishings being amongst the first activities to be modernised. Even labour-intensive services can be updated; modern commercial banks replace traditional moneylenders and moneychangers, and supermarkets are substituted for small *bazaar* or *souk* trading establishments.

In the Middle East modernisation has occurred, but traditional economic activity continues to exist alongside the new industries. It is by no means clear that the modern sector will replace traditional activities entirely, even in the long term. Subsistence agriculture, handicrafts and informal financial intermediation have existed for millennia in the Middle East and are one of the region's economic strengths. There has been a relative decline in the proportion of GDP accounted for by traditional activities, even allowing for measurement underestimation. In absolute terms, however, traditional economic activities continue to expand, and in some cases are proving more resilient than the modern industries established at such huge expense.

It is interesting to speculate whether the growth of the modern sector has damaged traditional economic activities, or whether it has actually been beneficial. In a stronger form the question is whether the modern sector is a substitute for traditional activity, or if the two sectors complement each other.[29] Both clearly compete for resources, and this involves factors of production and inputs. As the labour market is fragmented in the Middle East, with only limited inter-sectoral mobility, competition for workers is limited. Nevertheless, in Iran under the Shah a shortage of labour arose in the *bazaar* sector because young people stayed in education and then entered modern industries. It was the modern sector which offered higher wages and salaries, though these were not justified by the sector's productivity, which remained low.

These new manufacturing facilities were protected from international competition and received generous state funding. Foreign exchange was freely available to much of the modern sector, while imports for the *bazaar* merchants were subject to stringent controls. Yet it was the traditional sector which accounted for most of Iran's non-oil exports, while the modern industries struggled to produce goods which were barely acceptable in the

domestic market. The Shah's technocrats were expensive to support and in the end contributed little to the viability of the Iranian economy. It was however the *bazaar* sector which paid the price for modern development, with quality craft goods such as traditional hand-woven carpets going into significant decline. The full opportunity cost of modern industry was never apparent under the Shah; it was only after the Islamic revolution that the extent of previous economic mismanagement became highly visible.[30]

On the other side of the Gulf in Saudi Arabia and the smaller Arab states the oil boom years were the best-ever period for the traditional sector. Government expenditure financed from petroleum revenue helped to stimulate traditional trading, indeed many of the merchant families became extremely wealthy. Imports flowed in, but these represented new goods to distribute and sell; they were not a substitute for domestically produced supplies, as in the case of Iran. Modern industries were created, but in non-traditional areas such as petrochemicals which did not threaten the traditional economy. Of course, there was relatively little traditional manufacturing to replace, unlike in the more populous and historically more developed countries of the region. Nevertheless the fact that much of the modern sector was export- rather than domestically-orientated meant that inter-sectoral conflict between the old and the new was avoided.

The fundamental question must remain whether modernisation has really improved the economic situation of the Middle East. It can be argued that second-rate modernisation does not bring an improvement if menial production-line jobs are created to replace traditional crafts and skills. A region such as the Middle East may move into areas where it lacks any comparative advantage, and consequently it may for the foreseeable future always lag behind the advanced industrialised world. Modernisation may cause frustration, loss of respect, and even a sense of failure if the process remains incomplete and the new activities are poorly organised and executed. Rather than making craft goods which rank amongst the best in the world, the modern output may be shoddy and defective. Is this where development is leading the economies of the Middle East? The chapters which follow should shed further light on this issue, and we start in the next chapter with the human dimension of development.

4

POPULATION GROWTH AND EMPLOYMENT

The relationship between population growth and economic development has been subject to much debate in both the western world and the Middle East, but as with so much else in economics, no generally accepted conclusions have been reached. There is not even agreement on the fundamental issues of what determines population growth and whether there are universal trends. Many development economists believe that the rate of population growth reflects the stage of economic development a country has reached, with a tendency for the rate to decline as an outcome of the development process.[1] Others assert that population growth reflects family preferences, and is determined by cultural and social factors.[2] The trends in the western world towards falling rates of growth may therefore not be followed in a region such as the Middle East where Islamic values prevail.

THE DEMOGRAPHIC TRANSITION

Figures for population increase represent the difference between birth rates and death rates. High rates of population growth may occur as a 'once-off' result of a demographic transition when death rates decline, in particular infant mortality rates, but there is a lag before birth rates fall. Several arguments are advanced for this assertion. One is that when infant mortality rates are high, couples have more children so that there is at least a chance that some will survive. Such arguments are based on expectations, probabilities and risk. The demographic transition is a period when expectations are adapted or adjusted, but this takes time.[3]

There are real economic as well as human benefits associated with lower infant mortality. Family lands can be passed on to children when the parents become old. They then assume economic responsibility for their aged parents. There are diminishing returns to labour in relation to fixed family land holdings, however, and excessive numbers of offspring only add to the consumption burden without contributing much

to production. It is this type of constraint that may encourage couples to limit family size.

How relevant are these arguments in the Middle East? Infant mortality rates declined rapidly in most countries of the region between 1970 and 1992, although the rates remain high in comparison with western figures of ten per thousand births and less. In Egypt the fall was from 144 per thousand to 57, in Iran from 131 to 65, and in Turkey from 147 to 56. In some of the Gulf states such as Kuwait the infant mortality rate had fallen to below 14 by 1992, almost on a par with the West.[4]

The evidence on fertility rates is more mixed, however, and even where rates have fallen they remain two or three times those of Europe, the United States and Japan, and well above the rate for the population to sustain itself. In Egypt for example the fertility rate declined from 5.9 per thousand female population to 3.8 over the 1970–92 period, and in Turkey from 4.9 to 3.3. In Iran however the rate only changed from 6.7 to 5.5, and it actually rose after the Islamic revolution from 6.1 in 1979 to a peak of 6.4 in 1986 and 1987. On the other side of the Gulf in Saudi Arabia the fertility rate was 7.3 throughout the 1970s, but had fallen marginally to 6.4 by 1992. Even in Jordan with its highly educated female population the rate remains at 5.2, although this is below the figures for neighbouring Syria and Iraq, which remain at 6.2 and 5.7 respectively.

The demographic transition in the Middle East is going to take a long time. Figure 4.1 shows the situation in Egypt and Iran, two of the most populous countries in the region, with very different recent demographic trends. In Egypt births have fallen even faster than infant mortality, but in Iran there appears to be little relationship for much of the period. Indeed, the fertility figures for countries such as Iran in the early and mid-1980s raised doubts about whether the demographic transition would actually occur, although since then the rate has fallen. There were both state and social pressures for Iranian women to have large families after the revolution and during the war with Iraq. This has since changed, due to concerns about schooling and employment, with an altered emphasis in domestic political debate in Iran ranging from national security to the need for reconstruction.

The cross-sectional data for the region in figure 4.2 shows that lower infant mortality is related to lower fertility, but overall fertility rates remain high. Does this reflect a preference for children rather than material commodities? Is the tendency for married women to remain within the home the major factor? Is the low age of marriage an explanation? Is it ignorance of or an aversion to birth control? All of these factors may provide some clues. Social factors generally are significant. It is easier to bring up children when several generations live under one roof and grandparents can help to look after the offspring.

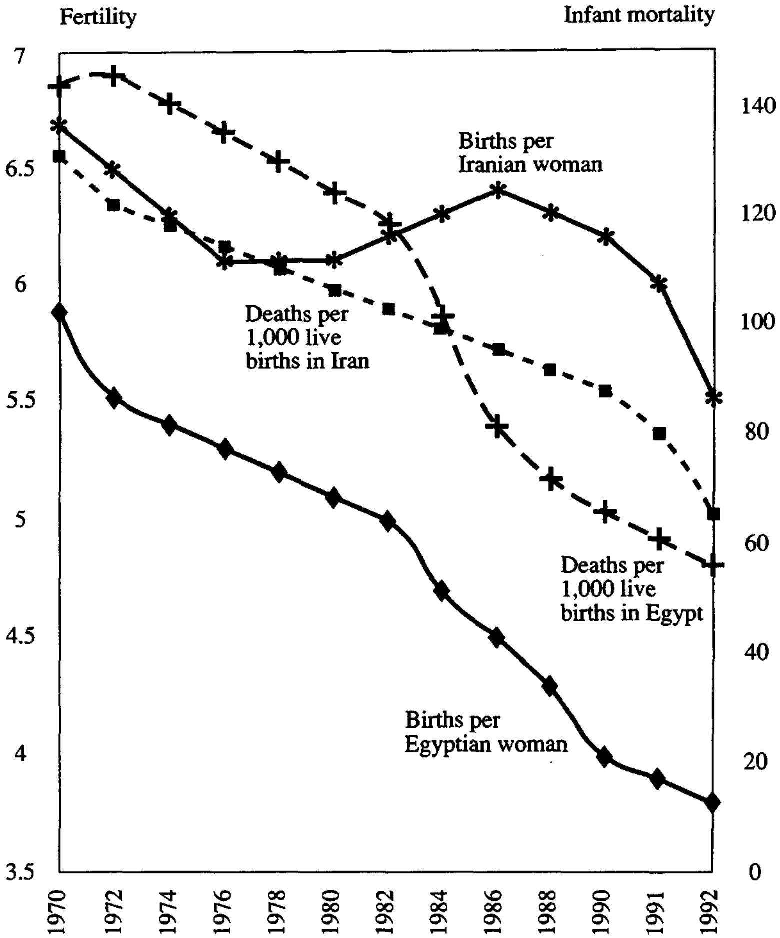


Figure 4.1 Demographic trends in Egypt and Iran
Source: World Bank, *World Tables,* 1994

The sexual segregation in Muslim society encourages family-minded women to influence each other. Given the desire for at least one son, many women continue to have children until that goal is achieved.[5]

Government policy may also encourage large families. The provision of free schooling means that education is not a financial burden. Subsidies on housing and low rentals also result in the costs of families accruing to the state, or in other words being a public rather than a private cost. Controlled food prices and subsidies to agriculture reduce the cost of feeding additional family members. In societies where family meals are

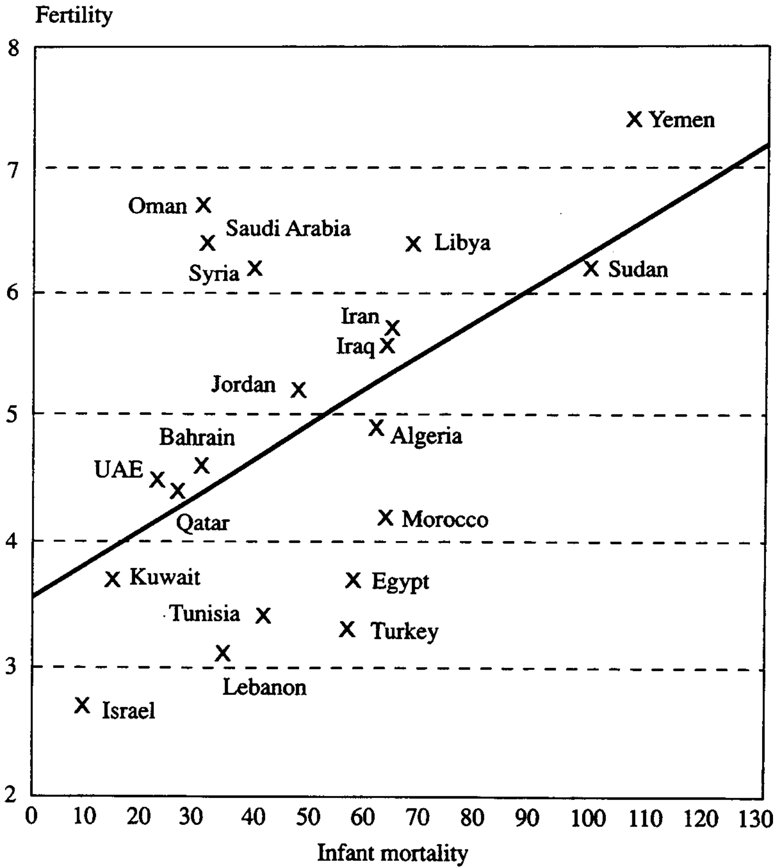


Figure 4.2 Fertility and infant mortality
Source: World Bank Atlas, 1994

cooked using fresh produce, rather than merely being assembled from pre-prepared ingredients, the cost of feeding additional mouths is minimal. There are economies of scale in cooking for an extended family, whereas the packaged foodstuffs or take-away meals consumed by many in western societies have a constant marginal cost.

With the possible exception of Egypt, the Middle Eastern countries are by East Asian or European standards not highly populated, and though food imports are increasing, it would be incorrect to suggest that population pressure is resulting in a real squeeae on resources. There are those doomsday pundits in Europe who worry about the population on the southern shore of the Mediterranean exceeding that on the northern shore, but apart from their own bigotry or Euro-ethnocentric

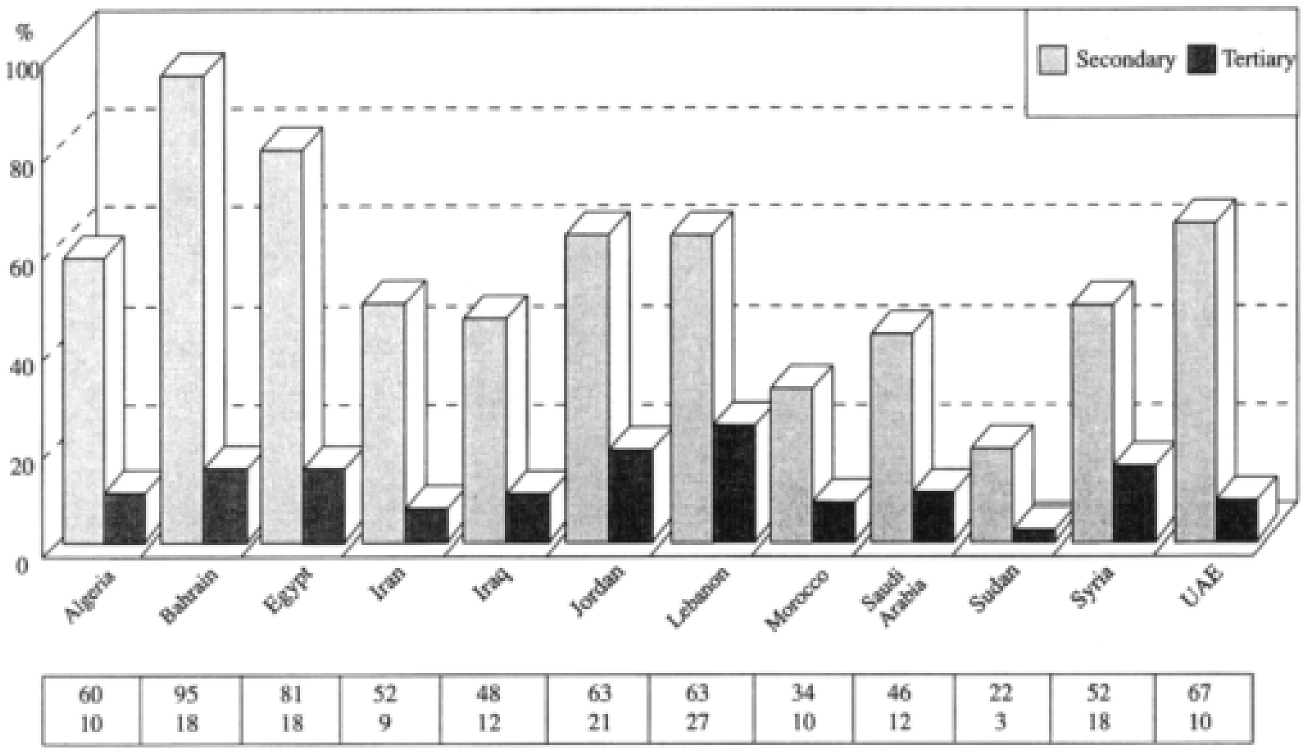
view of the world, it is not clear why this should be a concern. In Islamic writing there is no generally agreed position on birth control, some Muslim scholars arguing that it is permitted and others that it is not. There are few who would actively encourage such a policy, however, the general feeling being that it is a private matter for the individual.[6]

What are the economic implications of a delayed or indefinitely postponed demographic transition? Will development be aided or retarded? Do enlarged populations open up new production possibilities, or are they a severe drain on scarce resources? There are many different aspects to the economics of population growth. One is the quantity versus quality issue, or in other words, whether there is a trade-off between having a larger human capital stock, or improving its quality through education and training. It is this issue which is addressed next, as this has a crucial bearing on employment possibilities and ultimately how productive any population will be.

EDUCATION AND HUMAN CAPITAL FORMATION

There have been remarkable changes in the level of educational attainment in the Middle East over the last fifty years. As early as 1970 the majority of the population of primary school age were in school, with the notable exceptions of Oman, Sudan and Yemen. Now there are very high rates of literacy and numeracy amongst the young, and Oman has caught up with the other Gulf states. The major expansion in recent years has been in secondary and higher education. Enrolment ratios in relation to the relevant age groups at secondary level exceed 80 per cent in Egypt, Israel, Jordan and the states of the Upper Gulf. Elsewhere in Iran, Turkey and Saudi Arabia the proportion exceeds 50 per cent. Figure 4.3 illustrates some of the differences across the region, with a marked contrast between Algeria, where the secondary enrolment rate represents 60 per cent of the relevant age group, and Morocco, where the proportion is just one-third.

At university level there are more graduates from Egyptian universities than from those in Britain. Some countries in the Middle East have some of the highest enrolment rates for tertiary education in the developing world, notably Lebanon, where the university population represents over one-quarter of the age group, as figure 4.3 shows, and Jordan, where the proportion exceeds one-fifth. Israel, which is not included in the United Nations statistics for developing countries because of its level of development, has the highest number in the world of doctoral degrees per thousand population. It can be argued that in some countries in the Middle East an excessive proportion of the education budget has been allocated to universities, and an insufficient amount to primary and secondary education. This is certainly the case in Syria, where the university population represents



60	95	81	52	48	63	63	34	46	22	52	67
10	18	18	9	12	21	27	10	12	3	18	10

Secondary figures above; Tertiary figures below

Figure 4.3 Secondary and tertiary enrolments
Source: United Nations, *Human Development Report*, 1994

almost one-fifth of the age group, but the secondary school enrolment just over one-half.

Education is of course an end in itself as well as a means to human advance and development. Economists regard it as both a consumption and an investment good. Evaluating the contribution of education to development in the Middle East is far from straightforward. It is not clear whether education is a fruit of development or a prerequisite for economic growth. Traditionally education was associated with the religious establishment, the *ulama,* rather than the state, the main emphasis being on learning to read and recite the Koran.[7] The aim was to please Allah by understanding his teaching, not to use educational skills to promote material advance. This was considered unimportant in comparison to spiritual matters.

The modern education system in the Middle East has been heavily influenced by the western model, and covers a much wider breadth of knowledge than traditional religious education. It exists in parallel with traditional religious education, but in practice for most school children in the region, the latter has been virtually superseded. Even in Iran, the Islamic revolution did not bring a return to traditional education. The modern, essentially secular, approach to education remained, but with major changes to the curriculum in subjects such as history. Nevertheless, it would be incorrect to view education provision in the Middle East as a mere western clone. The cultural characteristics that define Arabic and the other languages of the region have an impact, as the means of instruction inevitably determine the output.

Undoubtedly the major development inheritance from the Nasser period in Egyptian history has been the system of universal education. This has affected the imparting of knowledge and skills not only in Egypt, but throughout the Arab world, as Egyptian teachers have taken up positions in many neighbouring countries. From Libya to the Gulf it is Egyptian teachers who dominate the educational establishment, and Egyptian television programmes and films that provide entertainment for the Arab masses.[8] Not surprisingly, it is also Egyptian attitudes and values which have been a major influence for much of the region. There is respect for the old and experienced, suspicion of impatient youth, scepticism about government and politicians and perhaps an over-obsession with form rather than substance. Of course it is always dangerous to generalise, and casual observation can be no substitute for solid anthropological enquiry. It is important that economists interested in development are aware of the wider social context, however, and not merely the quantitative indicators.

Under Nasser great efforts were made to educate girls as well as boys, as universal female literacy was seen as a highly desirable social and development objective. The traditional Koranic schools were restricted to males, but many felt that female education was essential for modern

societies and economies. The proportion of girls of primary school age who were in education was already 57 per cent by 1970 in Egypt, and the percentage rose to 93 by 1991. In the Gulf there have been very striking advances in female education. Saudi Arabia had only 29 per cent of its female population of primary school age in education in 1970, but by 1991 the proportion had risen to 72 per cent. Female school children and students are educated separately from males throughout the Gulf, which some educationalists argue is an advantage as the girls are not crowded out by more aggressive boys. Interestingly the examination results appear to be better for girls up to university level in the Gulf. A much higher proportion of young men attend overseas universities, however, especially at master's degree level and beyond. The good results for young women within the Middle East at this level may reflect the fact that the more able, who could enter foreign universities, are obliged to stay at universities near their homes.

Perhaps surprisingly, it has been in Iran since the Islamic revolution that female education has made its greatest advance. Despite the lip-service which the Shah's regime paid to the education of girls and the stress on the elimination of illiteracy, only half of the female population of primary school age were in education in 1970. By the 1990s there was universal primary education for girls, and an increasing number, even from the poorest homes, were proceeding to secondary school and university. As in Japan there is a recognition that even where women remain at home and leave formal employment after marriage, they have a crucial role in the informal education of their children. Education takes place not only in the classroom, but at home. Schooling for the mothers of tomorrow may be the best way of ensuring the spread of skills and knowledge in Muslim societies where the family is the key social unit.

The type of educational provision and the standard attained may have implications for development. Rapid expansion of education has meant large classes at all levels, with little possibility of individual attention.[9] Shortages of books and teaching materials mean that student-centred learning is impracticable, with reliance on teaching methods largely involving instruction to whole classes rather than small group and team learning. Even in universities tutorials and seminars are rare, most undergraduate teaching consisting of lecturing to large groups, with the emphasis on dictation and taking good notes to avoid the expense of purchasing text books. There is a liberal arts bias, though in Egypt subjects such as engineering and agronomy are highly respected, but there are poor facilities for experimental and practical work. Management education is in its infancy, but there are large schools of administrative studies in most countries of the region.

Standards of education are often criticised by academics from the West, but in a situation of scarce resources the choice has been between providing

high-quality individually tailored education to a few and more basic education for many. If an important part of development is seen as the widening of opportunities for the masses, then the policy pursued in the Middle East has been remarkably successful. If, however, a highly educated elite playing a leadership role is seen as essential for development, then the region has failed, but so arguably has the West where intellectuals seldom occupy key positions. There is always the risk of a brain drain from a region such as the Middle East. Many of Iran's intelligentsia left the country in the years following the Islamic revolution. Some of the world's leading medical scientists are Egyptian, but most of them practise in the West. Israel has been unable to provide suitable employment for its highly educated population, and the absorption of well-qualified Russian Jewish immigrants has proved a major headache.

Science education is often felt to be more relevant to development needs than a liberal arts education, although these issues arouse fierce controversy amongst educationalists. Figure 4.4 shows the proportion of those in higher education studying science in a number of Middle Eastern countries. Care has to be taken in making such comparisons, as like may not always be compared with like. Nevertheless, the relatively low proportion of those studying science in the Gulf states, Sudan and Egypt is evident, perhaps reflecting the liberal arts bias already mentioned. In Iran and some of the Magreb states the proportion is very high, even by western standards, perhaps indicating that these states can more easily cope with transferred technology. However, the transfer can be two-way. Those with science knowledge and skills can more easily find employment abroad than can law or arts graduates, who have more national or culture-specific educational attainments.

The merit of having a high proportion of students studying abroad can also be questioned. It may mean that students from developing countries have access to the often better education systems and facilities of the western countries. As figure 4.4 shows, it is not only oil-exporting states such as the UAE which have a high proportion of students abroad, but some of the poorest countries in the Middle East, including Sudan and Yemen. A large proportion of these students stay abroad if they have the opportunity, however, given the limited opportunities at home and much more attractive pay rates in the West. This also applies in Jordan, where educational aspirations and attainment are high, but domestic employment opportunities limited. Many of the Jordanians at university in the United States and other western countries never return, apart from visits to their relatives.

Education spending figures which are comparable are compiled by the United Nations for a number of Middle Eastern countries. These are shown in figure 4.5. It is apparent that spending has increased significantly as a proportion of GDP for all the countries covered,

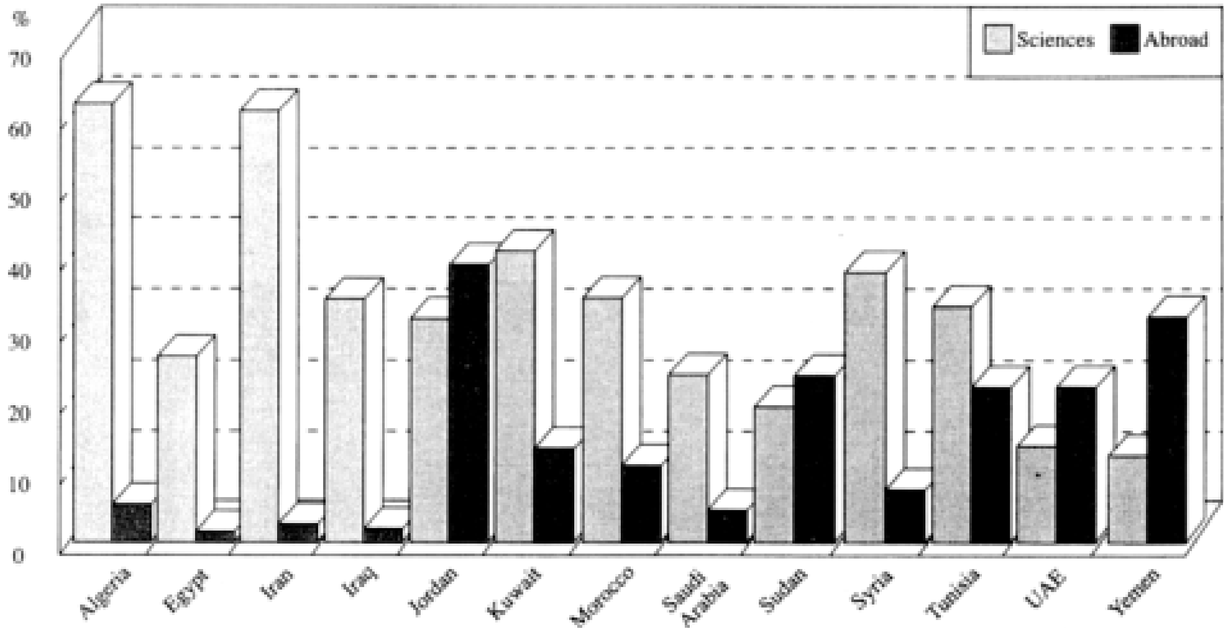
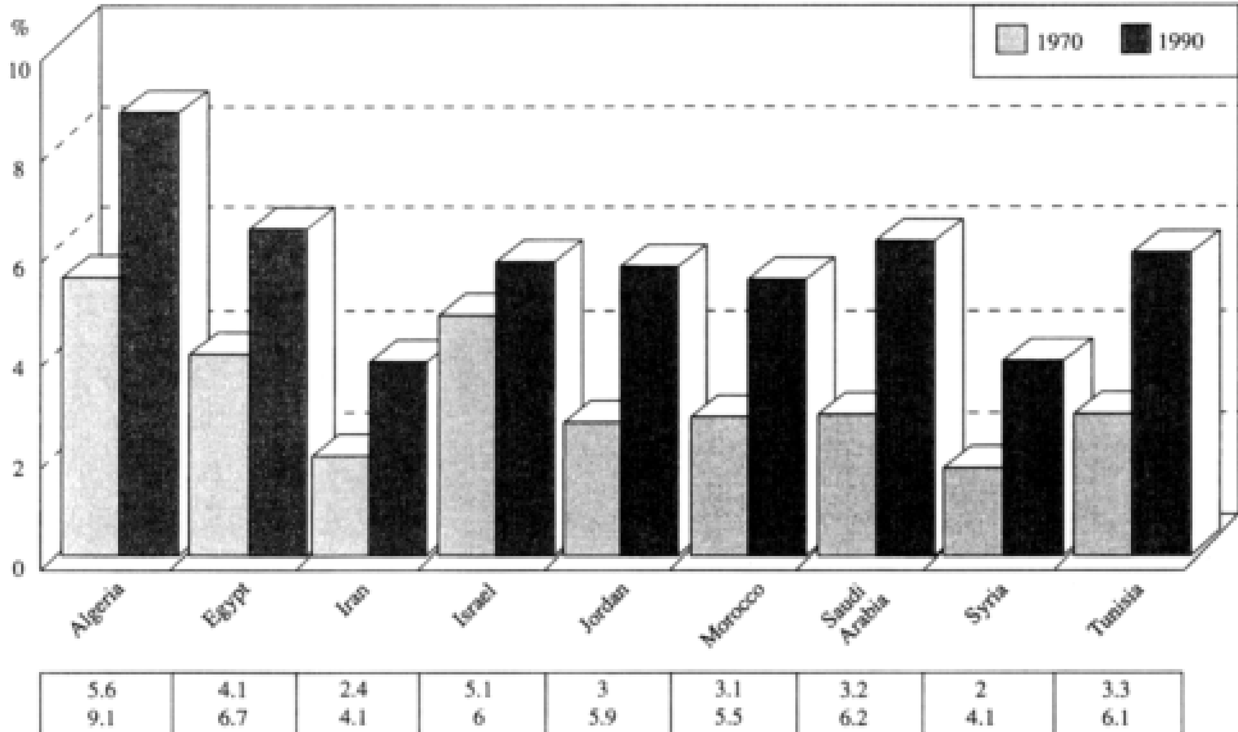


Figure 4.4 Tertiary education indicators
Source: United Nations, *Human Development Report,* 1994



Algeria	Egypt	Iran	Israel	Jordan	Morocco	Saudi Arabia	Syria	Tunisia
5.6	4.1	2.4	5.1	3	3.1	3.2	2	3.3
9.1	6.7	4.1	6	5.9	5.5	6.2	4.1	6.1

1970 figures above; 1990 figures below

Figure 4.5 Education spending as a proportion of GDP
Source: United Nations, *Human Development Report*, 1994

reflecting the spread of secondary education and the growth of universities in the Middle East. In Syria the proportion has doubled, and in Jordan and Tunisia it has almost doubled. The variations amongst the countries cited are nevertheless striking. Algeria, for example, spends a higher proportion of its GDP on education than any other country in the region; indeed the proportion is higher than that for the majority of countries in the developing world. In contrast, in Syria and Iran the proportion remains low, even in comparison to Egypt. In so far as this expenditure is on higher education, this is surprising, as it has already been noted that universities in Egypt have a liberal arts bias and those in Syria and Iran a science bias, the latter being supposedly more expensive. This raises the issue of whether science education in Syria and Iran is adequately funded, and perhaps throws into question the quality of what is provided.

MANPOWER PLANNING AND CAREER CHOICE

It can be argued that much of the huge public funding which has gone into education in the Middle East has been wasted if the newly qualified cannot find jobs. In the past the case has been made for manpower planning that attempts to tailor education provision to the type of jobs on offer.[10] Manpower planning has met with little success in those countries in the Middle East such as Egypt, Syria and Iraq where it has been attempted, admittedly only to a limited extent.[11] The basic problem is that students are educated for a working life that can extend beyond forty years, but it is impossible to predict what the employment pattern will be that far into the future. The horizon for development planning seldom exceeds five years, and many argue that even this is too long.

A more fundamental issue is whether the use of manpower planning in determining education priorities is desirable in any case, if choices are taken away from students and their parents. It is presumptuous to assume that unelected planners can make optimal decisions on behalf of those whose interests they purport to represent. A contrary argument is that planners have better access to information, and possess the necessary tools and knowledge to make good use of that information. Nevertheless, those who are making decisions for themselves and their offspring are more highly motivated to make the best choices to suit their individual circumstances. Planners lack knowledge at this level, and even if their decisions are socially motivated, the outcomes may conflict with the individual wishes of those being educated and of their parents.

Manpower planning is essentially quantitative, but qualitative factors are of course vital in education, in other words the question of standards. The quality of the inputs—those who do the teaching, will determine the productivity and effectiveness of the outputs—those who have been

educated. In the Middle East teacher training could be much improved, and arguably resources devoted to this would ultimately yield high returns. Such issues have been ignored by manpower planners in the region.

Another neglected issue is that of educational deepening, which could be deemed a major factor in economic advance. By this is meant people with more schooling taking over jobs that were previously carried out by those with fewer qualifications and less formal training and knowledge. Accountancy and banking in many western countries have become careers for university graduates, for example, rather than for school leavers. In the Middle East similar trends are occurring, with the civil service increasingly filled with graduates, potential company managers recruited from universities and even many of those in industries such as tourism increasingly well educated, with language degrees or hotel and catering qualifications.

The question of private versus social choice which arises in manpower planning is related to who pays for education. In the Middle East it is the state that pays the major part, as tuition at schools and universities is usually free. Arguably government should have some say in provision if it is the taxpayers as a whole who are meeting the bill. In practice, much government spending in the Middle East, including that on education, is financed from oil revenues. This makes governments less accountable to their own citizens and means that there is little lobbying over value for money in education. The major debate has been over how Islamic the curriculum should be.

There is nevertheless a large private subsidy by families for education. There is no system of student grants apart from at post-graduate level in the Middle East, and no formalised government loan schemes. Families have to support their offspring in education, the expectation being that the beneficiaries will pay for the upkeep of younger brothers and sisters or even cousins when they are fortunate enough to find employment. The extended family system has important financial implications for education in a region such as the Middle East. This should be taken into account in any calculations involving private and social costs and benefits in education.

LABOUR SURPLUS MODELS

The modern literature on employment in developing countries often takes as its starting point the Lewis model of labour surplus economies, even though many question the assumptions of the model.[12] Lewis assumes that the marginal productivity of labour in agriculture is zero, and therefore that transferring labour from the traditional agricultural sector to the modern industrial sector will not result in a loss of food output. At the

same time the surplus of labour limits wage payments in industry, and means the value of output exceeds the cost of the labour inputs. Hence when labour is redeployed from the traditional sector to the more productive modern sector, a surplus or profit results, which can be used to finance investment.

Growth becomes self-sustaining as long as rural labour is mobile and the surplus labour remains, keeping down wage rates in the modern sector. This neo-Ricardian two-sector model is consistent with the notion that labour-abundant developing countries should concentrate on the development of labour-intensive activities. It is in these that their comparative advantage lies, reflecting low marginal wage costs. This will be pursued further in chapter 8, where the role of the Middle East in international trade is examined.

How applicable is the Lewis labour surplus model to the Middle East? In the case of the Gulf states, at least in the 1970s, it appeared irrelevant, as local labour was comparatively scarce and expensive, and a substantial proportion of the workforce consisted of expatriate migrant labour. With population increases and oil price reductions, the situation in the Gulf has changed in the 1980s and 1990s, but the Lewis model assumes that industrialisation requires large amounts of labour, which has clearly not been the pattern in the Gulf.

For the more populous states of the region with substantial agricultural labour forces such as Egypt, Iran and Turkey, the Lewis model arguably has more validity. However, empirical studies of Egypt and other states in the region indicate that the marginal productivity of labour in agriculture is positive, and that rural urban migration is a much more complicated affair than Lewis suggests.[13] There is an opportunity cost involved in searching for employment because wages are forgone. In rural areas employment is often seasonal, but so are the vacancies. Job search is necessary but employment seekers may have to spend time on this during periods when alternative work is available rather than when they are seasonally unemployed.

The expectation of finding a job may influence the decision to leave employment in the countryside. The Harris and Todaro model may well have relevance in the Middle East, as it includes employment probability as a factor explaining migration.[14] Domestic labour markets are imperfect and segmented, but information about potential vacancies circulates through informal family networks, and if opportunities arise potential applicants can usually be found. There is often only a limited response to wage differentials, but this does not indicate that markets are not working. Rather, it shows that wage offers on recruitment are only one factor interesting job-seekers. In the Middle East workers often take a longer-term view than those in the West. What concerns them is job security and employment prospects. Employer attitudes also matter. Those who help

their employees in time of need by settling debts or making interest-free loans are more likely to win the loyalty of their employees in Muslim societies.

There is some evidence to suggest that improved education has increased occupational mobility in the Middle East and reduced social stratification.[15] This has arguably increased the efficiency of labour markets, though not necessarily their competitiveness. Loyalty by both employers and employees is highly valued in the Middle East. Employers will not simply dismiss their workers and hire others prepared to work for lower wages. The employer assumes a social commitment to the employee and his family, and will not attempt to bargain down wages merely because there is a reserve army of unemployed. For his part the labourer will also stay loyal, and will not desert his post for better-paid employment during periods when labour may be scarce. In the *bazaar* economy there is a tradition of lifetime employment. This may be less true for unskilled agricultural labour, and at the other end of the spectrum, amongst the well-educated professional classes. Nevertheless, there is a tendency for these groups not to shift about from job to job, but rather to seek stability of employment.

In agriculture work is often a family endeavour. Men carry out heavy irrigation work and planting, but women and children do much of the harvesting. Remuneration for the latter two groups is lower, and during harvest time wages fall. Men however seldom undertake these tasks, and wage differentials in rural areas often relate to different groups of workers for particular seasons.[16] The unemployed will not be taken on if the families of those employed on a regular basis are looking for work. Family preferences and nepotism are accepted at all levels. Indeed, it is regarded as more socially acceptable to employ a family member than a stranger. Perhaps it is also more efficient if some of the family members are accustomed to working as a team.

UNEMPLOYMENT AND UNDEREMPLOYMENT

The continuing rapid rates of population growth in the Middle East pose a real challenge for employment generation. Every year in Egypt, Turkey and Iran over half a million new entrants come on to each country's job market. Can these economies generate sufficient employment to clear the market? Are job-seekers prepared to accept lower salaries than those paid to people in employment? How flexible are the young in taking what is on offer, rather than waiting for employment for which they believe they are qualified? What role, if any, can government usefully play in employment creation?

There is a major employment problem across the Middle East, even in

the oil-exporting states of the Gulf. Jobs are scarce, not only for primary and secondary school leavers, but also for university graduates. Indeed, the more highly qualified the job-seeker, the more difficult it is to secure employment. Much of the unemployment is disguised, the costs not borne by the state but by the job-seeker's family. There is no system of unemployment insurance or state benefits for the unemployed in the Middle East, and in these circumstances there is no point in registering as unemployed. Any unemployment statistics which are published in the region are meaningless, even those reported to the International Labour Organisation. Increasingly it is the difficulty of finding a job which induces the young to stay on in education. Their families would have to support them in any case and tuition, as already indicated, is mostly free.

The ability of governments to generate employment has reached its limits in most of the Middle East. Under Nasser there was the guarantee of a job for every Egyptian graduate as public-sector industries and the civil service were obliged to increase the number of employees on their payrolls each year, with the government setting the target in relation to the anticipated supply of graduates.[17] Industries would indicate their employment requirements and the planners would take these into account, as well as the size of the existing workforce in the firm or plant. Usually the allocation was made as a percentage of the existing workforce, the numbers exceeding those requested by the industries. The results were poor individual supervision on graduate training programmes and increasing underemployment at the white-collar level throughout the state sector. Underemployment occurs where employees are engaged on a full-time basis, but in practice have only enough work to keep themselves usefully occupied for fewer than twenty hours per week.

Nasser's guarantee of a job for every Egyptian graduate was politically popular with the middle classes and the urban elite, but was not sustainable in the long run economically and financially. The policy had to be abandoned by Sadat, and under Mubarak considerable efforts have been made to curtail public-sector spending, partly by limiting employment expansion in the civil service and state industries. Public-sector pay has been frozen for long periods, making government employment much less attractive than the private sector.

Underemployment remains, but in practice employees receive what amounts to part-time pay for part-time work, though that is not the official job description. Many public servants work for the government from 8 a.m. till 2 p.m., the official working day, but then have a second informal job in the evening. Typical 'moonlighting' occupations include taxi driving and retailing, with the *souk* offering numerous opportunities for part-time, occasional and always flexible employment.

In recent years the public sector in Turkey and Iran has been subject to similar strains to those in Egypt. In the past it was the less-educated who were subject to the rigours of the labour market while university graduates enjoyed the protection of government. Now, however, all job-seekers are in the same uncertain position, so at least there is an equality of insecurity. In the Gulf, where there was much less financial strain, the creation of employment in the bureaucracy was much easier in the 1970s and early 1980s. Since then even these governments have had to exercise considerable spending constraint. This is particularly frustrating for many graduates and school leavers, as they are usually better qualified than those who hold the type of employment which they seek. Most current public-sector employees in the Gulf were recruited when labour market conditions were much tighter and qualified local nationals were unavailable.

URBANISATION AND POPULATION DISTRIBUTION

Throughout the developing world the population is becoming more urbanised and this trend is apparent in all the economies of the Middle East. Cities and towns have always been important as trading centres, and the deserts of the region have never been able to support large populations. In most of the Arabian Peninsula the urban centres were more economically significant than their hinterlands, and even before the oil boom and the rise of the modern city state in the Gulf, the sheikhdoms and emirates could be described as town states with economies based on fishing and pearling. The region contains some of the world's oldest centres of settled agriculture such as the Nile and the Tigris-Euphrates valleys, but even in these areas the populations were housed in large or small settlements, rather than in isolated farms and homesteads on the European and North American pattern.

The move to urban living is perhaps less traumatic for those who have always lived in communities rather than in detached surroundings because the change is a question of scale rather than of reorganisation and reorientation. Cairo may have become a city of over 12 million, but socially it is structured like a series of contiguous villages. Most inhabitants identify with their own neighbourhood in the first instance rather than the wider metropolis. This makes living in Africa's largest city less intimidating, especially as the strong social fabric of Middle Eastern societies means that serious crime is comparatively rare. The cities of the region may appear chaotic, but their inhabitants do not suffer the same risk of random crime as those in the urban jungles of the West.

Egypt, Syria and the Magreb states have around half of their populations living in major urban centres with the number of inhabitants

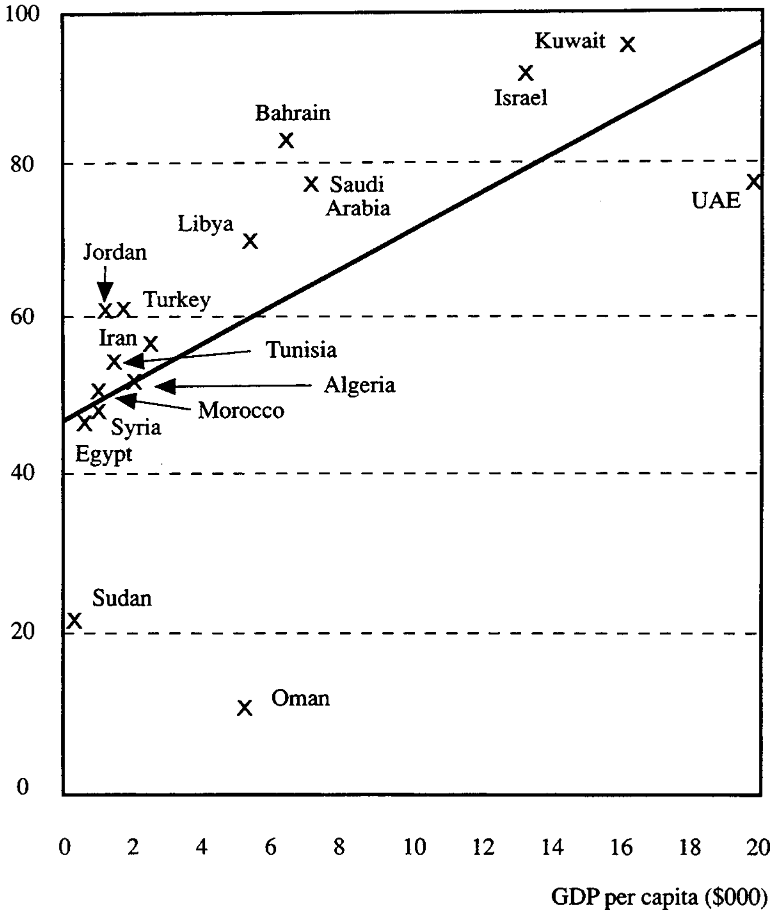


Figure 4.6 Urbanisation and GDP per capita
Source: World Bank, *World Development Report,* 1994

exceeding 100,000. In Iran the proportion is just below 60 per cent, and in Turkey and Jordan the urban percentage is just above this figure. Israel, despite the agricultural orientation of its early settlers, has over 90 per cent of its population living in urban areas, making it almost comparable with Kuwait and Bahrain. It is only in Sudan and Yemen that less than one-quarter of the population is urbanised, though there has been a significant rise in urbanisation in the latter in recent years.[18]

The relationship between urbanisation and gross domestic product per capita in the Middle East is illustrated in figure 4.6. Those countries with

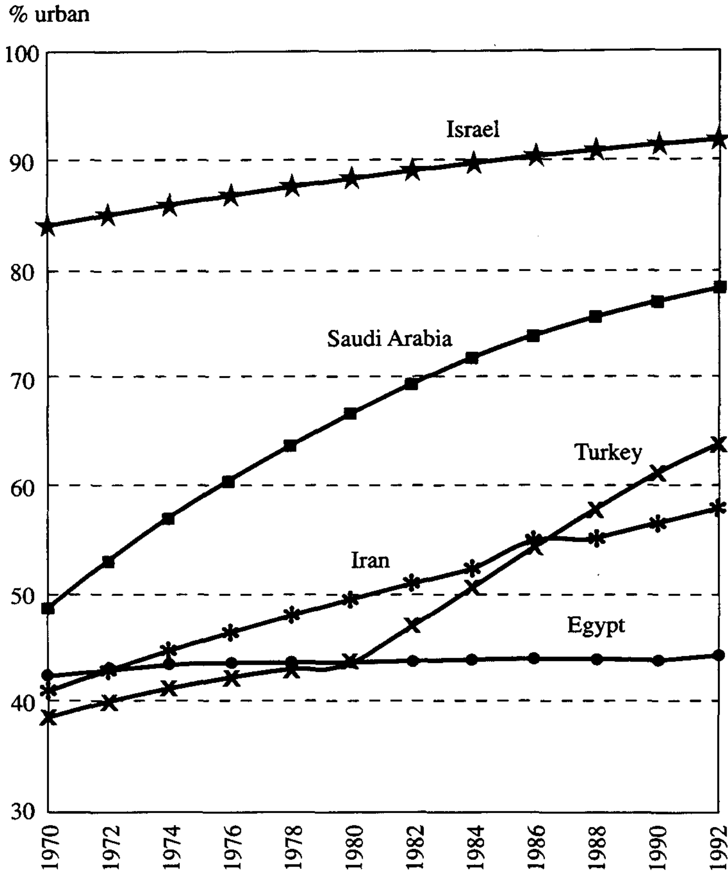


Figure 4.7 Urbanisation trends
Source: World Bank, *World Tables,* 1994

higher levels of per capita income appear to be more urbanised, as might be expected, but, with the exception of Israel, all the states in the high-income category owe much of their prosperity to oil. Agriculture is of only limited significance in these higher-income countries, but interestingly the relationship between industrialisation and urbanisation is also weak in the Middle East. Services are, however, better developed in the more urbanised countries. The standard literature on economic development tends to stress the advantages of agglomeration to industry in urban areas and the presence of external economies through inter-industry linkages.[19] Much less attention is paid to services, though in the Middle East the primary activity in urban centres has always been trading, not manufacturing.

The trend towards increasing urbanisation in some major countries in the Middle East is shown in figure 4.7. If these trends continue, will there be diseconomies due to congestion, and will overcrowding reduce the quality of city life? Israel and Saudi Arabia have less to fear in these respects than, for example, Turkey, where shanty dwellings house an increasing proportion of the urban population. Transportation in Istanbul and Ankara is severely congested in spite of substantial expenditure on urban highways. In Cairo a partially underground metro railway system has been built at enormous cost to help relieve traffic congestion. Arguably this money could have been spent much more usefully in the countryside, where the same sums devoted to irrigation improvements could have drastically reduced the country's food import bill. The opportunity costs associated with urban infrastructure programmes may be considerable.

EMIGRATION AND MIGRATION

Historically there has always been considerable movements of population in the Middle East, the deserts serving as routes for trade and commerce rather than representing barriers to economic exchange. The nomadic tradition encouraged travel, and the *bazaars* and *souks* often had merchants from many parts of the region. Nationality or ethnic group was not a bar to migration, as peoples could move comparatively freely throughout the Ottoman Empire. In the past the main barriers to movement were economic rather than administrative. It was the cost of travel, and the opportunity cost of remuneration forgone, that kept people near their home base. Since political independence and the rise of the nation state in the region it has been immigration laws, passport controls and work and residence permits that have hindered the mobility of workers and their dependants.

Many countries in the region have become more ethnically and religiously homogeneous since the rise of the modern Middle Eastern nation state. Turkey, for example, is predominately Moslem, most of the Armenian and Greek Christians having left Asia Minor following the early years of independence. In Egypt the substantial Greek Orthodox community left Alexandria, although the Christian Copts remain, an indigenous minority numbering at least 5 million. Israel, being a Jewish state, may have preferred religious homogeneity, but the Arab Moslems and Christians within its borders have risen in both absolute and relative numbers in recent years. If the populations of the occupied territories are included, less than 60 per cent of the total inhabitants are Jewish.

The permanent ethnic and religious mixing within the Ottoman Empire has been replaced by a more temporary migration of workers. There have

been two major destinations for migrants: the OPEC states of the Gulf and Libya, which have attracted workers from the poorer Arab states; and the European Union, which has imported labour from Turkey and the Magreb. In addition, since the Israeli occupation of the West Bank and Gaza in 1967, there has been daily and weekly commuting from the territories into Israel to work. This involves both Palestinian Arab workers and Jewish settlers in the territories.

A considerable amount has been written on the labour migrations of the 1970s and 1980s in the Middle East, most notably the studies by Birks and Sinclair which are listed in the notes to this chapter. In some respects the area has displayed more of the characteristics of a common market than a free trade area, as the mobility of factors of production such as labour and capital has been much more economically significant than the movement of traded goods. Whether from the historical perspective the labour migration has any lasting impact compared to the population movements of the early centuries of Islam or the Ottoman period must be more debatable.

The migration to the Gulf and Libya of Egyptians and Palestinians appears to be even more transitory than that of Turks to Germany or Magreb nationals to France. Non-nationals in the Gulf are only given work permits of fixed duration and they are not allowed to acquire property in these OPEC states. In contrast, many Turkish migrants have taken their families to Germany, and after going through the German school system, most prefer to remain and seek employment.[20] Despite the considerable ethnic, religious and cultural differences between Turkey and central and western Europe, the migrants increasingly identify with their country of residence. In contrast, in Libya and the Gulf the migrants may be Arabs in Arab and Islamic countries, but they seldom see a long-term future for themselves as expatriates, and in most cases there is no desire to be absorbed with local nationals.

There has been a decline in the number of Arab migrant workers in the Gulf and Libya since the peak of the early 1980s, when there were almost 2 million Arab migrants in Saudi Arabia, 1 million in Kuwait and 200,000 in Libya.[21] The decline is due to three factors. First, the fall in oil prices during the mid-1980s resulted in a squeeze on government spending and economic activity generally. Second, there was an increasing tendency to employ workers from the Indian sub-continent, who accepted lower wages, and workers from the Far East, who were recruited directly by companies from their own countries which won contracts in the OPEC states. Third, there was social and political resistance to employing Arabs from outside the Gulf. The expulsion of Palestinians from Kuwait following its liberation from Iraqi occupation was the most striking instance of this. Many paid a heavy price for staying at their place of employment during the occupation and for the actions of the few who collaborated with the Iraqi authorities.

THE ECONOMIC EFFECTS OF INTERNATIONAL LABOUR MOBILITY

The effects of labour migration can be evaluated from the points of view of the sending and the recipient countries, and from a private and social perspective. The scale of migration in the Middle East in the 1970s and 1980s demonstrates that wage differentials between states are important, and that workers are more than willing to move in response to these price signals. Controls through work permits and visa administration prevent labour mobility reducing wage differentials to the point where there would be a regional equilibrium, with no national oversupply or excess demand. To illustrate some of the economic implications, it is useful to construct a simple labour market model.

Figure 4.8 represents the demand and supply conditions in the labour markets of Egypt and Saudi Arabia.[22] Without migration the equilibrium wage rate is *We* in Egypt and *Wa* in Saudi Arabia. A number of work permits, *p,* are issued to Egyptian migrants by the Saudi Arabian government. This will not raise wage rates in Egypt where the supply of labour is infinitely elastic, *Se,* but reduces rates significantly in Saudi Arabia, where the supply of indigenous labour is price inelastic, *Sa*. The wage reduction is from *Wa* to *W(a + p)*. Clearly, there may be strong pressures from Saudi Arabian employers for an open policy regarding work permits, but perhaps resistance from Saudi employees whose earnings are threatened.

If the demand for labour rises in Saudi Arabia, perhaps following an increase in oil prices, market forces might bid wages up to level *W(a + p)**. In such circumstances there may be pressures from employers to increase the supply of work permits in line with the increased demand for labour so that wages remain at level *W(a + p)*. This increase is shown by the horizontal labour supply schedule *S(a + p)**. Underlying this is the assumption that an infinitely elastic supply of labour is prepared to migrate from Egypt in response to the wage differential *W(a + p) – We*. Such an inflow of labour is, however, unlikely to be politically acceptable, and will mean pressures from Saudi Arabian employees for work permit restrictions.

The private benefits of labour migration are simply the additional wages that the worker can earn in Saudi Arabia compared with those in Egypt or Jordan. Migrants may be permitted to purchase consumer goods, including cars, in their country of work and import these goods on preferential terms into their countries of origin. There is also the value of the job training which they receive in countries where there is more modern and sophisticated equipment and plant. This applies to some extent in the Gulf, but is certainly the case with Turkish workers in Germany. Private costs include the immeasurable anxiety associated with leaving friends and family and the costs of visits home, though these will often be covered by the employer in the host country.

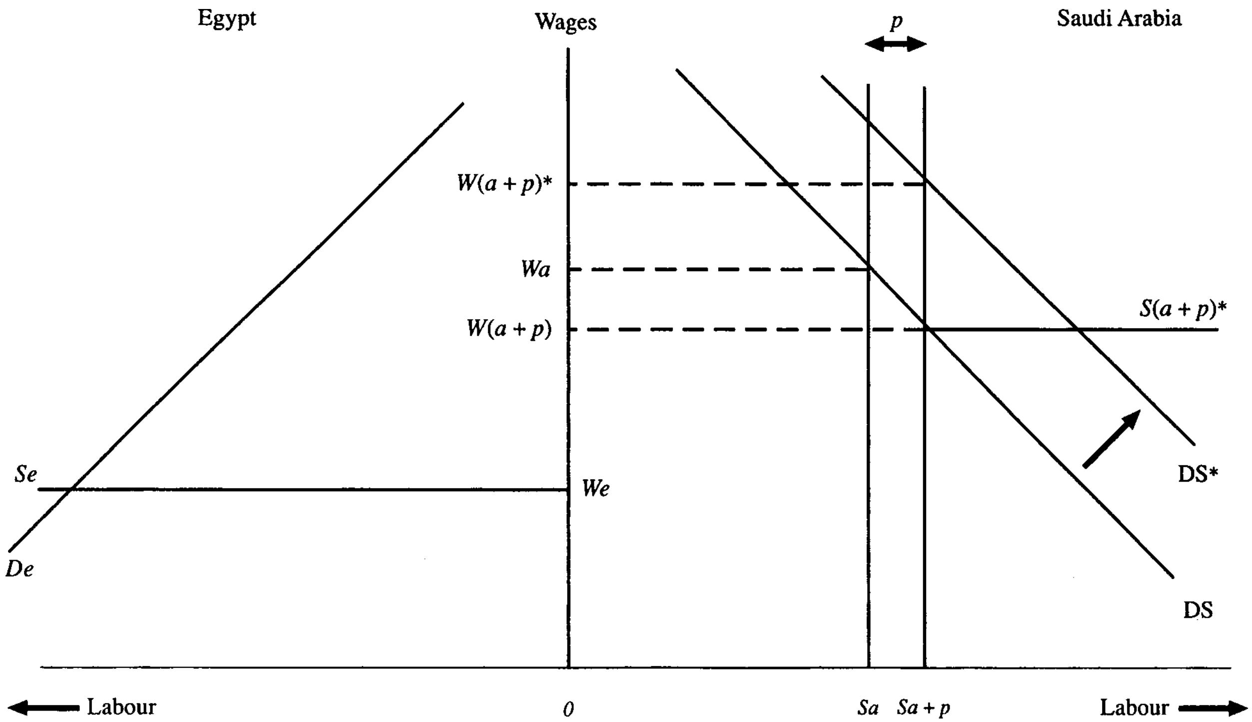


Figure 4.8 Intra-regional labour migration
Key: W = wages; D = labour demand; S = labour supply; e = Egypt;
a = Saudi Arabia; p = work permits

Social costs and benefits are even more difficult to evaluate.[23] The balance of payments of the sending country is helped by the inflow of remittances. Such transfers made a major contribution to small economies such as that of Jordan in the 1970s and 1980s,[24] and even for larger economies such as Egypt the benefit from the remittances was considerable.[25] Repatriated earnings were used to fund housing improvements, health care for ageing relatives and private education and overseas tuition for the young. As well as bringing private benefits, there are social spin-offs from such expenditure by reducing the burden of families on the state. Remittances used for house-building help to create local employment in the construction sectors, with positive multiplier effects as building workers in turn spend their wages. High-cost education funded through remittances can bring positive social externalities if the beneficiaries use their newly acquired skills and knowledge to good effect by being more competent managers or expert users of high technology.

There will be less benefit for the labour-supplying country if the remittances are merely used to purchase imported consumer durables such as household appliances. The local distributors of imported electrical goods will nevertheless gain their margin from the remittances being spent, and the government may directly benefit from import duties. On the negative side, in so far as the government has borne the cost of educating the emigrant, there is a national loss as the skills and knowledge acquired are not used in the sending country. There is a brain drain if those with higher education, who have been subsidised the most by their countries of origin, become migrant workers or perhaps more permanent emigrants.[26] The Coptic Christians from Egypt who have emigrated to Australia and North America often fall into the latter category, as do the thousands of technocrats who left Iran following the Islamic revolution.

As migrants, unlike emigrants, return to their home countries, it can be argued that the work experience and training they receive abroad can be put to good use in their countries of origin. In practice, in the Middle East there are few instances of such benefits. The Turkish workers in Germany, who have been increasingly displaced by immigrants from Eastern Europe, find the high-technology skills they have acquired are of little use when they come home. Many former car workers drive taxis or set up their own small retail establishments. There appears to be a preference for self-employment, and a reluctance to work in Turkish manufacturing, given the low level of wages in relation to those in Germany. Pride and self-regard appear to be as crucial to the work decisions of former migrants as economic and financial considerations.

In the Magreb countries, Jordan and Egypt, similar considerations apply. Egyptians who taught in schools and universities in the Gulf are reluctant to take up employment in the local educational system. Medical

doctors have preferred to move on from the Gulf to North America or Europe rather than return to Egypt and Jordan. Often migrants who do return retire prematurely, with no ambition to continue a career beyond the age of fifty. They live on their past savings or on the rental income from property they have acquired with their remittances. Whole apartment buildings in Cairo have been acquired by Egyptians resident in the Gulf.

Those who have supported younger family members often feel that it is their turn to be helped financially. As a consequence, there are large social groups who are consumers rather than producers, and increasingly economies such as Jordan or the West Bank and Gaza can be depicted as rentier economies. The term was often used with reference to the Gulf oil states, but in the 1990s it is perhaps more applicable to those states which have become dependent on remittances and other financial transfers rather than on the export of commodities or visible goods.

SOCIAL COSTS AND BENEFITS OF MIGRATION FOR THE HOST COUNTRY

From the point of view of the host countries the benefits of labour migration should be more clear cut, as presumably the foreign workers would not be hired if they were not needed. Conflicts of interest may arise within the host country, however, as the model of Egyptian migration to Saudi Arabia suggested. There is clearly a private benefit to the employers because the imported labour is employed productively. The foreign workers often have skills which local labour lacks and they may be prepared to work for lower wages. This may prove controversial if it reduces local wage levels, as the model used earlier demonstrated.

There are of course gains to the host country if it is able to benefit from the knowledge and skills of the migrant workers while it has not incurred the cost of their education. When the highly educated and skilled leave Egypt and Jordan for the Gulf or Libya there is a hidden subsidy from the poorer states to the richer countries of the region. The cost of this publicly funded education subsidy is arguably greater than the aid transfers from the OPEC countries to their fellow Arab and Muslim states. This may also apply in the case of Turkish and German financial relations and those between France and the Magreb.

On the negative side, the disadvantage of host-country dependence on imported labour may be both economic and social. The learning experience may be ultimately the most important benefit from an industrialisation programme such as that instigated by SABIC, the Saudi Basic Industries Corporation. These wider economic gains may justify the investment even when the financial returns are disappointing. It is, in other words, the externalities that are important, but these will be reduced from the national

point of view if the workforce is foreign and if expatriates hold all the key technical positions. Socially relations between the foreign workforce and local labour may be strained. At the workplace this may inhibit skill transfers and hinder on-the-job training for local nationals. In the wider society it can produce political tensions, especially if the immigrants are from more radical states and are less willing to accept the conservative social norms of the Gulf states.

Such factors have resulted in a reduction in the work permits issued to Arabs in the Gulf states, and the substitution of South Asian and South East Asian labour for Egyptians and Palestinians. There were concerns that at least some of the latter might subvert the local population with their ideas. There was also a worry that the migrants might wish to become permanent residents. In the case of non-Arab labour in the Gulf this is unlikely, as most only come for the money and wish to return to their home states as soon as possible once their work is finished.[27] They have no desire to establish roots in the Gulf, and are not interested in the domestic political scene. The workers from South Asia speak little Arabic and those from South East Asia usually speak none, so communication with the local population is limited. Most live with other migrants in special accommodation which is separate from local residential districts. Social mixing is rare, and even in the workplace there is the bare minimum of contact.

The prospects for future labour mobility both within and from the Middle East are poor. To some extent the opportunity of migration to the Gulf served as a safety valve for Palestinians from Jordan and the occupied territories in the 1970s and early 1980s. It provided welcome opportunities for educated Egyptians who could not be absorbed into lucrative employment at home. Germany was an attractive employment destination for both skilled and unskilled Turkish workers, and France played the same role in relation to the Magreb countries, especially for the non-Arab Berbers of Algeria who faced an uncertain future following the departure of the French colonists in the early 1960s.[28]

If labour is likely to be more tied within national boundaries in the Middle East in the years ahead there will be stronger pressures to create suitable employment opportunities locally. With rapidly increasing populations this is likely to prove extremely difficult. Substantial investment will clearly be needed, but this raises the question of finance. It is these issues which are addressed in the next chapter on capital markets and savings.

5

CAPITAL MARKETS, SAVINGS AND INVESTMENT

Finance is regarded as a major constraint on development in most regions of the Third World. There is often insufficient money available to finance worthwhile projects and the price of loanable funds is usually high, reflecting the shortage of savings. In low-income economies it is not surprising that savings rates are low, because most disposable income has to be used to purchase the necessities for everyday living, and many families simply cannot afford to make financial provision for the future, even though this leaves them insecure and vulnerable.[1]

The Middle East is different from other developing areas because, although there are shortages of financial capital in individual countries, for the region as a whole the revenue generated from oil exports produced a healthy surplus during the 1970s and for much of the 1980s. Although the situation changed with falling oil prices, the financial injection did provide a unique opportunity to undertake expensive capital projects. This surplus benefited not only the major oil-exporting countries, but through government-to-government transfers and remittances, it also aided the poorer countries of the region. Although by the 1990s the surpluses were much reduced, the oil price rises of 1973–4 and 1979 brought the greatest-ever boost to capital formation throughout the region, and resulted in the beneficial infrastructure improvements described in chapter 3. In comparison to most other areas of the Third World, the Middle East can therefore be considered well endowed with both financial and physical capital.

Favourable financial circumstances are not sufficient in themselves to ensure that economic development occurs. Much depends on the efficiency of the capital market and the effectiveness of the commercial banks and other financial institutions as intermediaries.[2] In the Middle East the position is complicated by the fact that oil revenues accrue to governments, and part of the role of financial intermediaries is to ensure that this revenue gets distributed to those sectors of the economy where it can be harnessed most effectively. State financial institutions play a key part in this process, but there is still a significant role for commercial banks as government

spending finds its way into private businesses and the pockets of individual families, and from there into bank accounts.

As well as the market for loanable funds, which involves the commercial banks, there is also the issue of risk capital and the need for equity markets. These are underdeveloped in the Middle East, but the question which must be asked is whether this really matters. Would development have been more rapid if the state had played less of a role in the financial system of the Middle East, with private equity and loan finance dominant as in most Western economies? Market efficiency depends on prices acting as an allocative mechanism and market participants being able to read the pricing signals. Have interest rates been allowed to bring the demand and supply of loanable funds into equilibrium in the Middle East? Is there evidence of financial repression, with interest rates being held below equilibrium levels and the state determining how credit is rationed?[3] These issues will be addressed in this chapter, and an attempt made to find answers in the light of the evidence from the region.

DOMESTIC SAVINGS RATIOS

The national account figures detailing consumption and savings as a proportion of gross domestic product are a useful starting point when considering the economic growth potential of any group of countries. High levels of savings might be expected in oil countries where income suddenly rises but consumption takes time to adjust. The evidence from the Middle East would appear to strongly support this proposition, the savings ratio in Saudi Arabia for example rising from an already high 62 per cent in 1972 to over 80 per cent by 1974, and later from 54 per cent in 1978 to 60 per cent by 1981. By 1990 the savings rate in Saudi Arabia had declined to 29 per cent as spending by both private consumers and government had inexorably risen. This level is nevertheless enormous when compared to that of the Kingdom's Red Sea neighbour, Sudan, where by 1990 the ratio was less than 2 per cent.

Deficiencies between savings and investment can of course be met by inflows of capital from abroad to bridge the gap. Where there is foreign aid, international borrowing, investment flows and remittances, the level of investment can exceed savings. In figure 5.1, savings and investment levels are shown for a number of Middle Eastern countries with investment exceeding saving in all cases. Jordan is the only country with dissaving or negative saving. This was made possible by the high level of remittances to finance domestic consumption. Its savings are largely generated from the earnings of its own citizens working in the Gulf, and this factor has enabled the country to enjoy a living standard which is

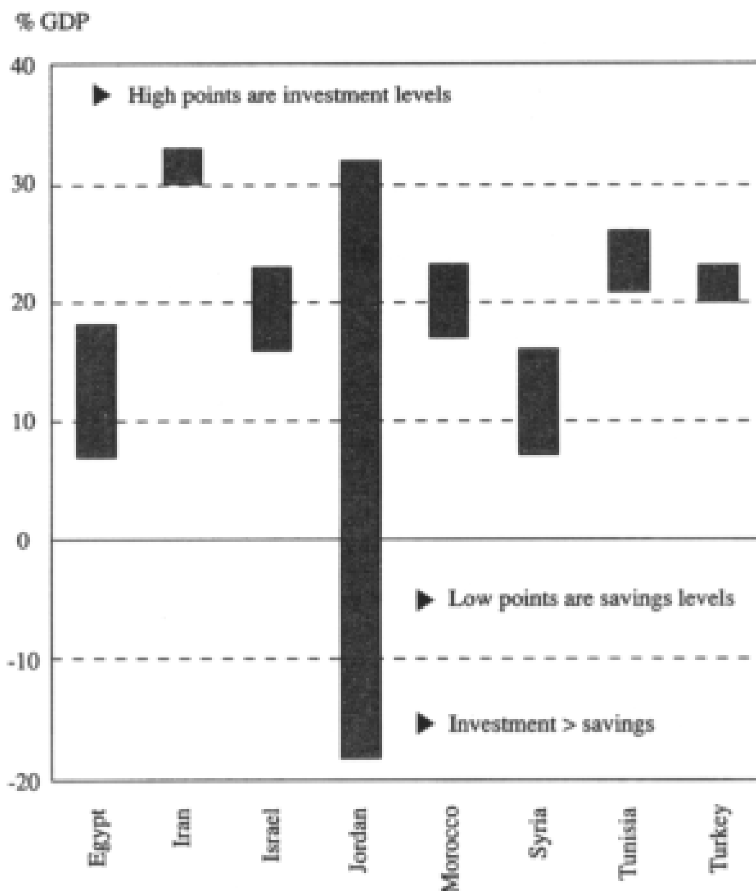


Figure 5.1 The investment savings gap
Source: World Bank, *World Development Report,* 1994

well beyond what the capacity of the domestic economy could support.[4] Egypt is in a similar position despite its much lower level of per capita income. United States government financial support and remittances help to sustain investment levels, but there is at least positive savings, although the level is low, even by Third World standards.

In contrast, in Iran the level of investment and savings is in much closer balance, reflecting in the case of the former the desire for the Islamic Republic to be economically independent of the outside world because of its experiences under the Shah. Iran accumulated short-term trade debts in the aftermath of its war with Iraq, but it has little long-term debt and its domestic savings rate remains encouragingly high. Morocco and Tunisia

can sustain investment levels above that of savings because of remittances, but both countries maintain moderate savings rates of 17 and 21 per cent respectively.

In Israel the savings level is relatively low in comparison to northern Mediterranean countries, but again, thanks to aid from the United States, the country manages to combine a high level of consumption with a reasonable level of investment. One issue in its case is whether the assistance from the United States reduces the will to save domestically, with foreign capital inflows crowding out potential finance from domestic sources. This is also an issue for countries such as Syria, which has an even lower savings ratio compensated in the past by aid from other Arab states. Although this has now fallen off, domestic saving has failed to rise.

FINANCIAL INTERMEDIATION AND DEVELOPMENT

There has been much debate amongst development economists about whether financial intermediation is a prerequisite for economic development, or if the development of banks and other financial institutions is a mere outcome of the development process.[5] Light can be shed on the issue by making cross-sectional comparisons between countries. One approach is to compare the ratio of savings to gross domestic product from the national income accounts to savings in the banking system. If a country has a developed banking system with a widespread branch network, it might be expected that the national savings ratio would be higher than in states which are under-banked. An alternative to the cross-sectional approach is to look at banking development over time, concentrating on institutional economic history. The issue here is whether banking expansion is associated with periods of economic growth, and what happens when growth slows or contraction sets in. Both approaches will be used here, but the expansion of banking will be dealt with later in the chapter.

Figure 5.2 shows that for eleven major Middle Eastern economies there appears to be a negative relationship between the ratio of savings deposits with commercial banks to GDP on the one hand and the national savings ratio on the other. This could be taken to indicate just how insignificant banks are for harnessing savings in the Middle East, and by implication how unimportant they are for the region's development. Commercial banks are important for higher-income families and medium-sized businesses, yet they are arguably much less important than state economic institutions. Private importance does not necessarily imply social or developmental significance in economies where the state plays a major role and governments still own most large industries. Furthermore, because of the importance of labour migration for earnings flows in the Middle East, there is also the question of workers becoming economically detached from their

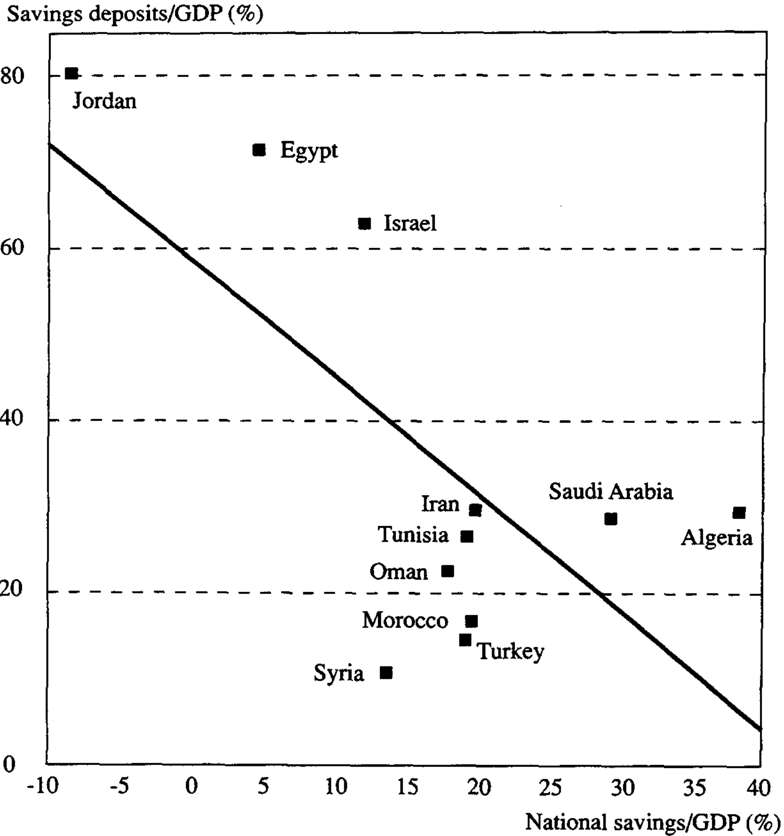


Figure 5.2 National and bank savings
Source: World Bank, *World Tables,* 1994

countries of origin and citizenship, so that national savings are less likely to be related to private savings.

The case of Jordan illustrates this disparity. It is at one extreme in figure 5.2, with a very high ratio of commercial bank savings deposits to GDP as a result of remittances placed in its banking system, but a negative national savings ratio indicating dissaving. Jordan is in many ways a consumer society, with remittances and other inflows from abroad fuelling both private spending and personal saving. The Jordanian banking system is highly developed, indeed the kingdom is if anything over-banked, but the commercial banks finance largely imports of consumer goods, not local productive investment. Egypt is a less-extreme case, but the high bank savings deposit ratio there also reflects private remittances. Israel appears to have a high level of savings

deposits, a reflection partly of its developed banking system, but also a result of financial inflows from Jewish communities worldwide to relatives in the country and to Israeli institutions.

The other countries included in the data from which figure 5.2 was compiled could be regarded as more typical of the Third World countries in terms of bank deposits in relation to national savings. Those above the trend line, Saudi Arabia and Algeria, could arguably be regarded as overbanked.[6] Some of those below the line, especially Syria, are certainly underbanked. In the case of the latter, there is a monopoly state-owned bank which alone has the right to offer retail commercial banking services.[7] As a consequence, in the absence of competition, there is little incentive to offer attractive rates to savers. Many savers prefer simply to hoard commodities or to put all their funds into property, so the banking system is deprived of funds which it otherwise might attract, and informal financial intermediaries such as moneylenders and private investment companies have taken over much of the financial business.

INVESTMENT AND THE DEVELOPMENT PROCESS

Arguably both the level and the inefficient nature of at least some of the investment in the Middle Eastern economies has impaired economic development. Investment levels are low in comparison to those in the newly industrialising economies of East and South East Asia. The proportion of GDP accounted for by investment in 1992 was 16 per cent in Syria, 18 per cent in Egypt, and 23 per cent in Morocco, Turkey and Israel. Those countries with higher levels included Tunisia where investment accounted for 26 per cent of GDP, Jordan where the level was 32 per cent, and Iran with a rate of 33 per cent, although there must be some doubts about the reliability of the last figure. In Malaysia the rate was 34 per cent, that for Indonesia was 35 per cent, while Thailand had a level of 40 per cent and Singapore 41 per cent.

Simply measuring the ratio of investment to GDP gives no indication of its efficiency of investment. The crucial issue is how much additional output results from the investment of the Middle East. With overall growth rates of output affected by fluctuations in oil production, it is perhaps most meaningful to consider the performance of particular sectors. Growth rates for industrial output compare unfavourably the economies of the Middle East with those of East and South East Asia. Chinese industrial output expanded by over 11 per cent per annum over the 1980–92 period, and the annual increase in Thailand was over 10 per cent. In Indonesia manufacturing production grew by 12 per cent annually over the same period. In contrast, the rate of growth of industrial output in Egypt averaged under 4 per cent, there was actually an average contraction of almost 2

per cent per annum in Algeria, and it was only in Turkey, which has the most successful manufacturing sector in the Middle East, where the rate averaged 6.7 per cent. The Iranian figure was 5.8 per cent, but this was from an extremely depressed base in 1980 because of the dislocation associated with the revolution.

The limited role of financial intermediaries as discussed in the previous section and the inefficiency of some of the banks themselves may explain the poor performance of the Middle East in relation to East and South East Asia. Misdirected effort by government may also be part of the problem. Development planning may be out of fashion worldwide, but in the Middle East it never stood much chance of being effective due to short-term political pressures on governments to direct investment spending in particular directions. Despite the absence of democracy in many countries of the region, political lobbying for economic and financial favours has often been successful. This may reflect a tradition of government that puts great stress on the role of patronage.

CURRENCY STANDARDS AND EXCHANGE

As markets develop and widen, currency is needed to facilitate transactions, as barter is really only appropriate for simple economies based on bilateral exchange. The Middle East was the first region of the world in which coins were used to facilitate trade; from the time of the ancient Babylonians in Iraq, the Pharaohs of Egypt, and the early recorded history of the biblical lands, there is evidence of currency being issued. Coins made of both gold and silver were used in the days of the Prophet Mohammed and there was much discussion of appropriate rates of exchange between the two mediums, as the price of silver, then as now, seldom moved in line with the price of gold.

Bimetallism continued up until Ottoman times, with the silver *akche* circulating alongside gold, though eventually a paper currency was issued, the *kurush,* which was backed by treasury bills *(kaimeh),* as well as both metals.[8] It was only in 1880 that the Ottoman Empire adopted the gold standard, but silver coins continued to circulate internally and their price varied in terms of the gold-backed currency issue. As the economies of the Middle East became increasingly dominated by the European powers in the nineteenth century, European currencies were substituted for local money. In Egypt sterling became the main medium of exchange from the 1880s onward, and the French franc was legal tender in Algeria from 1851 onwards and in Tunisia from 1891.

With increasing economic independence the economies of the Middle East issued their own paper currencies, but those states tied to a particular European power could not freely convert their currency, except into that

of the colonial country. The Egyptian pound was tied to sterling, for example, which facilitated trade with the British Empire but not with third parties. The same applied to the Magreb states and Syria, which were part of the French franc currency area. With political independence the links with the former colonial currencies were broken, but most Middle Eastern currencies were then completely inconvertible. This enabled governments to insulate their economies more fully from the outside world. In economic terms it meant that the currency issue merely facilitated internal exchange and the operation of the domestic market. Wider international exchange reverted to being conducted on a barter basis because, with inconvertibility, there was no medium of exchange to facilitate external transactions. Increasingly the United States dollar was used to fill this gap, but this in fact meant a return to a dual currency standard, with the high transaction costs which that implies.

The Gulf states have fully convertible currencies, unlike the other economies of the Middle East, though some such as Turkey have made important moves in that direction with the encouragement of the International Monetary Fund.[9] It is oil earnings and the substantial holdings of foreign assets which have enabled the Gulf states to maintain convertibility, not only for payments for traded goods, but also for capital flows. This has encouraged outward and inward investment by both Gulf nationals and foreigners, and reduced the transaction costs with international trade. Choice of imported goods has been maintained, unlike in those countries where inconvertibility has necessitated barter, often referred to as countertrade, primarily where elaborate deals involving three or more parties are involved.

Historically the Gulf states have always been trading economies and currency inconvertibility would be politically unacceptable, especially to the powerful merchant classes. There was resistance to the introduction of paper currency into Saudi Arabia by the king himself back in the 1940s, as the silver *riyal* was preferred, but pilgrim receipts were eventually to form the basis of the new paper currency.[10] Suspicion about money whose value can be affected by government economic policy remains, however, and there is concern that tampering with a currency standard may conflict with the ideals of Islam.

Inflation is a very sensitive issue, as price rises have consequences for income distribution and justice in trading. Those in debt may benefit from inflation if the service charge on debt does not rise with inflation, but those providing credit may lose through no fault of their own. If debt-servicing charges or interest rates rise with inflation, this results in worries over *riba* or usury, which is prohibited under the *shariah* Islamic laws. In Saudi Arabia Islamic concerns over monetary management have resulted in resistance to the establishment of a fully fledged central bank. The kingdom still has only a monetary agency to oversee its financial

system, and monetary instruments such as interest rates have never been used in pursuance of economic policy. Inflation is held as low as possible, and there was considerable concern after the oil price rises of 1973–4 when inflation rose to double-digit levels. Swift cuts in government expenditure were implemented; they reduced economic growth, but this was felt to be the lesser evil.

MONEY AND INVESTMENT

In modern economies notes and coins represent only a small proportion of the money supply, bank deposits being the main source of liquidity to meet transaction needs. Large business transactions in the Middle East usually involve the use of banking facilities, but the use of notes and coins predominates for many small business dealings and most personal transactions. The majority of employees continue to be paid in cash, and in the *bazaars* and *souks* of the region cash transactions are the norm. Some countries such as Yemen and the Sudan are under-banked, but in others such as the Gulf states and Jordan, as already mentioned, the banking habit is well developed.

With bank deposits it is always difficult to determine what should be included in transaction balances. Traditionally only current accounts on which cheques could be written were included, but in the West few customers keep significant balances in unprofitable current accounts. Transaction balances are also held in more profitable non-chequing accounts, with funds easily transferred into chequing accounts, usually on demand and often by a simple telephone call. In the Middle East chequing never developed to the same extent as in Northern Europe or the United States, and therefore it is perhaps better to take total bank deposits, a measure of broad money, as the most meaningful monetary indicator.

In figure 5.3 the ratio of broad money to GDP is plotted against the investment to GDP ratio, using a scatter diagram. As in figure 5.2, data are included for eleven Middle Eastern countries. The analysis attempts to determine if there is any relationship between the monetisation of economic activity, including the spread of the banking habit, and investment, on which future growth ultimately depends. For the economies included, there appears to be a weak positive relationship, as the trend line shows, but clearly not too much should be read into this. The high ratios of broad money to GDP in Jordan and Egypt reflect the depositing of remittances in the banking system, as already indicated. This, however, does not appear to get translated into high levels of investment.

Algeria has a much higher investment to GDP ratio, but this is financed from its oil and gas revenue, and reflects the continuing expense of maintaining the state-sector heavy industries. Arguably its high level of

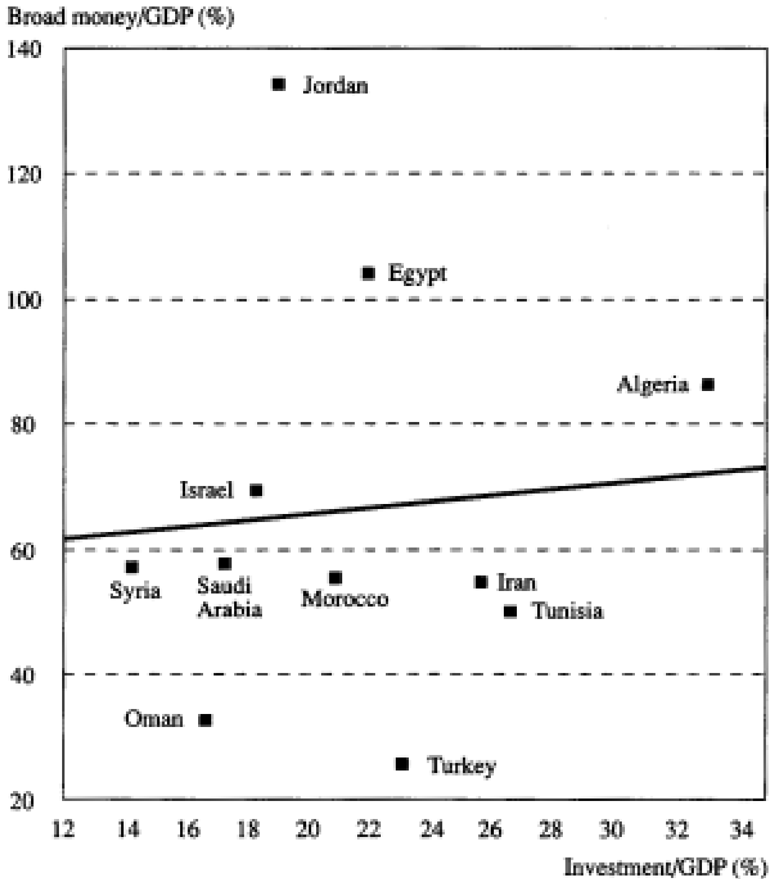


Figure 5.3 Money and investment
Source: World Bank, *World Tables*, 1994

investment has been less successful in promoting self-sustaining growth due to the mismanagement of these heavy industries, and perhaps because state bureaucrats rather than bankers are the key decision-makers in project selection. At the other extreme, Oman with its only recently partly monetised economy, and Syria with its state monopolised commercial banking system, both appear to have low investment ratios, as might be expected. Saudi Arabia's is also low, but this reflects the size of its oil GDP. Both the absolute level of investment and the ratio of investment relative to non-oil GDP are in fact quite high. In Turkey's case the relatively favourable level of investment in spite of the low ratio of broad money to GDP reflects the substantial contribution of foreign direct investment to

its growing industrial and tourist sectors. In this respect it is unique in the Middle East.

THE ECONOMIC IMPACT OF BANKING DEVELOPMENT

The development of financial intermediation has a qualitative as well as a quantitative impact on economic activity. It is the judgemental skills of the economic historian which are needed to make this assessment and not merely the computational skills of the applied economist. In the Middle East the pattern of banking development in the nineteenth century followed the standard colonial model, but during the twentieth century there has been a wealth of different experiences, which makes the region of particular interest to the financial historian. Developments in banking reflect the ideology and circumstances of particular Middle Eastern countries, but the causality is two-way, as the systems of banking have certainly had some impact on economic outcomes.

All the early banks active in the region were European-owned, the most widely represented, the Ottoman Bank, being a joint Anglo-French company quoted on both the London stock market and the Paris *Bourse*. Both the National Bank of Egypt and the Imperial Bank of Iran were British-owned in spite of their names. These institutions were largely involved in trade finance, arranging letters of credit and issuing bills of exchange, usually on behalf of European companies which were active in the Middle East.[11] Their commercial banking activity had a minimal impact on local merchants, because they continued to use the services of moneylenders and moneychangers whom they knew and understood rather than institutions run by foreigners mostly on behalf of foreigners.

Given their access to and knowledge of European financial markets, these new banks were well placed to raise funds externally on behalf of Middle Eastern governments. As the Ottoman, Egyptian and Iranian authorities were constantly in need of funds, it was only natural that they should come to rely on the new institutions for assistance. The arrangement of sovereign loans and the management of bond issues for Middle Eastern governments became a major activity,[12] and despite their commercial nature, the banks played a double role by performing some of the functions of central banks. This role continued until central banks were established in the 1920s in Turkey and Iran, and until the early 1950s in the case of Egypt. Central banks were set up for nationalistic reasons, as state dependence on foreign-owned banks was regarded as politically unacceptable.

In practice the new central banks lacked experience of international capital markets and also had few external banking contacts. As just another arm of the state bureaucracy they were not able to play much of a role in raising international funding on behalf of their governments. This would

have mattered less had there been indigenous capital markets for government stock. The absence of adequate markets severely constrains the fiscal stance of Middle Eastern governments because, though treasury bills can be off-loaded on to the commercial banks to a limited degree, they lack the ability to fund longer-term debt through bond issues. There are very small domestic markets in Turkish, Iranian, Egyptian and, more recently, Saudi Arabian government paper, but these lack both width and depth, the major participants being the commercial banks of each country. On any given day it is often quite difficult to sell government bills and bonds, which means that the liquidity of the assets must be questioned.

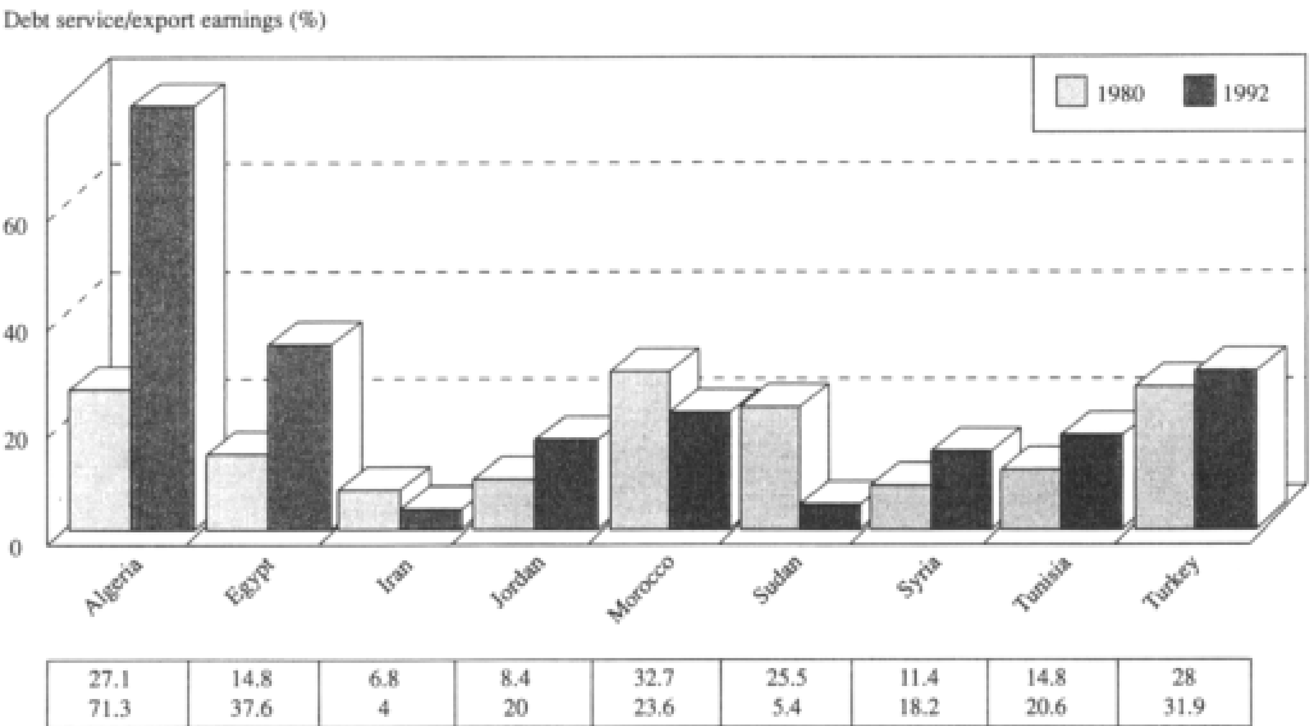
INTERNATIONAL BORROWING AND GOVERNMENT DEBT

As a result of the underdeveloped nature of local capital markets, Middle Eastern governments whose expenditure exceeds tax and other receipts are forced to borrow internationally. This imposes burdens which do not arise in the case of internal debt. The borrowing is usually dollar-denominated, which increases the cost of debt servicing and repayments in local currency terms with devaluation and depreciation. If the interest rates on the debt are variable and related to Euro-dollar rates over which Middle East governments have no control, this introduces an additional element of uncertainty and potential vulnerability.

Of greatest concern in the Middle East have been the political costs of borrowing. The governments of the region have in fact relatively little indebtedness to the commercial Euro-dollar markets. Much of their borrowing has been from western governments, the World Bank and the International Monetary Fund.[13] The latter have imposed structural adjustment programmes as part of their lending conditionality which many politically active groups on both the secular left and the Islamic right have opposed. These policies have included the phasing out of subsidies to reduce government deficits, liberalisation of imports and regulations on foreign capital, privatisation and exchange rate devaluation which has caused inflationary pressures.

The burden of debt increased for most Middle Eastern countries during the 1980s, as figure 5.4 shows. Algeria, for example, was able to borrow considerable amounts from the Euro-markets because of its ability to use its oil and gas resources as indirect collateral. The cost of servicing its $28.8 billion debt has risen to over three-quarters of its export earnings in terms of interest charges and loan repayments.

Egypt has a higher level of indebtedness, the outstanding amount being over $36.4 billion in 1992. Debt levels and the debt burden are, however, not necessarily closely related. Most of Egypt's debt is to governments rather than to commercial banks. Almost one-third was written off by the United



Algeria	Egypt	Iran	Jordan	Morocco	Sudan	Syria	Tunisia	Turkey
27.1	14.8	6.8	8.4	32.7	25.5	11.4	14.8	28
71.3	37.6	4	20	23.6	5.4	18.2	20.6	31.9

1980 figures above; 1992 figures below

Figure 5.4 External debt ratios
Source: World Bank, *World Development Report*, 1994

States in 1991 following Egypt's contribution to the allied effort in the Gulf War, and this has significantly reduced the repayments burden. Morocco, the other large Magreb debtor nation, had outstanding borrowing of $20.5 billion in 1992, but its loans were acquired over a longer period than Algeria's, and the terms imposed were less demanding.

Turkey has the largest debts of any state in the region, amounting to over $43 billion by 1992 compared to only $10 billion a decade earlier. It has used its new favourable reputation as a restructured economy to tap the international markets for funding. With buoyant export receipts from manufactures and rising tourist revenue, the debt seems quite manageable and the servicing ratio was virtually unchanged over the 1980–90 period, as figure 5.4 shows. Tourist earnings have proved vulnerable to actions by Kurdish extremists, however, which poses a real challenge for the Turkish authorities.

Just as Turkey was opening up further to international financing, its neighbour, the Islamic Republic of Iran, was closing itself off. Its debt was $7 billion in 1980, but this was paid off because the Islamic government did not wish to deal with international financial institutions run by infidels on the basis of *riba* or usury. The Iranian government's resolve weakened after the end of the war with Iraq, however, as there were substantial needs for finance to aid reconstruction. There were hopes that the price of oil would rise to help this, and funds were borrowed on the strength of these expectations. As the price has not risen and revenues have stagnated, by 1992 the debt had grown to $11.5 billion, representing 12 per cent of GDP. Its debt position in figure 5.4 appears more favourable, as the figures there refer to long-term debt. Iranian debts are short-term commercial obligations, unlike those of most other Middle Eastern states. This debt is a growing problem, although it is much less serious than in the case of a country such as Algeria.

RETAIL BANKING GROWTH AND THE FINANCING GAP

In the literature on economic development much attention has been paid to the notion of a dual gap: the difference between investment and savings on the one hand, and between balance of payments receipts and outgoings on the other.[14] Financial inflows can fill the external gap, at least for a few years, until debt-servicing obligations build up. In the Middle East, however, inflows have also been required to cover a third gap: that between government expenditure and receipts. In so far as it is the state which is the major investor and most saving is of a compulsory nature through taxation, the government deficit may correspond to the internal gap between savings and investment.

Fewer foreign financial inflows would be needed if taxation receipts were higher or if government spending was lower. An alternative, which is much favoured by officials of the International Monetary Fund, is to have a slimmer government, with more investment undertaken by the private sector, financed by personal and corporate savings. This may not solve the gap problem, however, as investment goods may be largely imported and contribute to the foreign exchange gap. Nevertheless the economies of the Middle East are being nudged in the direction of leaner government and enhanced private financing, partly by international pressures, but also by internal dissent over the outcomes of past interventionist policies. Are the domestic banking and financial systems within Middle Eastern economies fit to cope with the demands of increasingly free enterprise economies? It is to this question that we must now turn.

Reference has already been made to the over-banked nature of some Middle Eastern economies, and the under-banked nature of others. What are the institutional arrangements associated with each of these conditions? Are there any general patterns that emerge or conclusions to draw? The Middle East provides some interesting contrasts, with indigenous banks replacing foreign banks in the early post-independence period and moves towards state ownership through bank nationalisation in some states but not in others. More recently there have been changes in direction with financial liberalisation and deregulation, a process which is ongoing, and which is still only in its early stages. Each of these developments will be reviewed here, but the specific regional issue of the Islamisation of banking will be left to chapter 6, as it is perhaps best considered in the context of more-fundamental Muslim economic issues.

THE SPREAD OF INDIGENOUS BANKS

The rise of locally owned banks dates from the 1920s in Turkey, Iran and Egypt, the late 1930s in Palestine and Saudi Arabia, and as late as the 1960s in some of the Gulf states.[15] In Turkey the first indigenous commercial banks included Turkiye Tutunculer Bankasi (1924), Turkiye is Bankasi (1925), Denizli Iktisat Bankasi (1927) and Turkiye Imar Bankasi (1928). These banks were established to challenge the monopoly of the Anglo-French-owned Ottoman Bank and to fill the gap left by the exodus of Greek and Armenian private bankers, moneylenders and moneychangers from Anatolia as a result of the inter-ethnic tensions which accompanied the founding of the modern Turkish state.

In Iran, Bank Melli was established in 1928 as a national institution to act as a central bank and to challenge the dominance of the British-owned Imperial Bank of Iran.[16] Bank Melli was owned by the government, which

gave it a significant amount of state financial business, largely at the expense of the Imperial Bank.

Unlike in Iran, the initiative in Egypt to establish an indigenous bank came from a group of local wealthy merchants and landowners. There, as in Iran, it was British-owned banks which dominated, particularly the National Bank of Egypt and Barclays, the latter financing much of the Alexandria cotton trade. Banque Misr, the first locally owned financial institution, was established as a bank to help Arab and Muslim traders specifically, and to finance the development of the textile industry. It was to be a very effective institution, playing a major role in the industrialisation of Egypt in the 1930s.[17]

It was not until 1930 that a locally owned bank was established in British-administered Palestine, the Arab Bank, which opened in Jerusalem. It was founded by a Palestinian business entrepreneur, Abdel Majid Shoman, who had emigrated to New York in 1920 and learnt at first hand how American banks operated by working as an accountant with a textile firm. He returned to Jerusalem with the ambition to found a bank, and won the backing of a group of Arab merchants in Jerusalem to realise this ambition. Following the foundation of the state of Israel in 1948 the bank moved its headquarters to Amman and became the largest bank in Jordan. To this day it remains the main bank serving the Palestinian community world-wide, with branches almost everywhere Palestinians live. It became the first truly international Arab bank, though this was largely by force of circumstances rather than by design.

In Saudi Arabia there was much resistance to the introduction of modern banking, partly from Islamic fundamentalists who regarded all dealings in *riba* or interest as unacceptable and associated banks with the infidel or unbelievers. Most of the local moneylenders and moneychangers wanted the king to exclude foreign banks from his kingdom: they argued that they could provide virtually the same services as banks, but using means which were Islamically acceptable. Eventually, however, two of the largest moneychangers of the Hijaz, Salim Bin Mahfouz and the Kaki brothers, lobbied the king for permission to establish a licensed bank. As the king knew these moneychangers were devout Moslems, the licence was granted, while at the same time Banque Misr was excluded and later Citibank of America was refused access. The National Commercial Bank, which the Bin Mahfouz and the Kaki families founded in 1938, was to enjoy a monopoly of banking in Saudi Arabia, which enabled it to become eventually the largest bank in the Middle East in terms of its assets.[18]

NATIONALISATION OF BANKING

The moves to nationalise banks were motivated by patriotism and a desire to take over the assets of the former imperial powers, rather than because

of any ideological commitment to state ownership or a desire to impose government control over the commanding heights of the economy. Mosadeq in Iran made the first moves in 1952 as part of a package of measures that accompanied the nationalisation of the Iranian oil industry. Then came the Suez Crisis of 1956, when Britain and France invaded Egypt to retake the Suez Canal which Nasser had nationalised. In the aftermath of this, Nasser retaliated by seizing British and French assets including the National Bank of Egypt, Barclays, which was renamed Bank of Alexandria, and Banque du Caire. Egypt ended up having just four state-owned banks, as Banque Misr was also nationalised to reduce the power of the landowners and merchants.

In Syria all the foreign-owned banks were merged and a new state-owned institution created, the Commercial Bank of Syria. Following the Iraqi revolution in 1958 the Baghdad government adopted a similar policy, and the Raifidain Bank was granted a monopoly of all domestic and foreign banking transactions.[19] Algeria, following the expulsion of the French, took the same position, with Banque Nationale d'Algérie taking over most commercial banking business in 1966, while another state-owned institution, Crédit Populaire d'Algérie, was founded to manage the business of the smaller credit banks.

Elsewhere in the Middle East governments were less keen to be involved in the ownership of commercial banking, except where private capital was not forthcoming. Even then there was more willingness to contemplate more-flexible arrangements such as partnership in ownership through joint ventures. In Kuwait, for example, there were strong pressures after independence from the merchant community to ensure that all banks were under local ownership. The merchants were more interested in investment opportunities for themselves, however, rather than state ownership. Hence a law was passed stating that all banks should be owned by local citizens. Those few shares in the National Bank of Kuwait owned by foreigners were sold to local investors. The Gulf, Al Ahli and Commercial Banks were established with purely local capital. In the case of the British Bank of the Middle East, however, the British-owned stake was sold to the Kuwait government, and local shareholders were brought in to take 51 per cent of the shares, giving them effective control. The Kuwait government was content to act as facilitator, maintaining a 49 per cent stake.

In Saudi Arabia the government only injected capital into the Riyadh Bank, the second largest bank in the kingdom, when it ran into difficulties. Because it was not founded until 1957, it always had problems competing with the National Commercial Bank, which had almost a twenty-year lead. Eventually, when lending difficulties in the 1960s resulted in liquidity problems, the Saudi Arabian Monetary Agency took a 38 per cent stake. The motive was to provide a much-needed capital injection to help the merchant sheikhs who continued to own most of the bank and maintained

control. In Saudi Arabia, as in Kuwait, there was pressure by the 1970s to curtail the foreign-owned banks which, as a result of United States government lobbying, had been allowed to gain a minor foothold in the kingdom in the 1950s and 1960s to serve the western partners in the Arabian American Oil Company, ARAMCO.

Citibank's Saudi operations were Saudised in 1979, resulting in the founding of the Saudi American Bank. This was 40 per cent owned by Citibank, but the other 60 per cent of the capital was sold to Saudi citizens. The idea was to combine Saudi Arabian private investment with American bank management expertise for the benefit of all parties. The Saudi British, Saudi French and Saudi Dutch Banks were created under similar arrangements, bringing real competition in banking services to the kingdom.

BANKING REGULATION

The ownership of commercial banks arguably matters less than their effective regulation. At least some of the shortcomings of the operation of financial intermediaries in the Middle East may be due to the ineffectiveness of the central banks in the region. No central bank in the Middle East enjoys independence from government, so there is no question of independent monetary policies being pursued, but all have the regulation of the banking sector within their remit. The problem is the extent to which even the regulation of the banking system is subject to political interference on the one hand, and lobbying from the commercial banks themselves on the other. There is little doubt that the freedom of manoeuvre of central banks in the Middle East is very limited, and it is only in Israel that the central bank could be said to have reasonable independence over regulatory matters and more-limited independence on monetary issues.

In Saudi Arabia and Bahrain there is not even a formally constituted central bank, both countries having monetary agencies with much weaker powers. The failure to regulate the Riyadh Bank in the 1950s almost led to its collapse, and more recently, in the late 1980s the debt problems facing the National Commercial Bank were allowed to mount, without proper provisions being made. These problems have now been sorted out with the recapitalisation of the bank, but there was a three-year period when there was a reluctance to act, not least because some leading Saudi Arabian merchants and members of the royal family were involved. In the 1980s there was the debate over whether the money-changers, Al Rajhi, should be given a banking licence. By 1986 they were granted the licence because of political pressures, but the regulatory regime differs from that applied to the other banks.

In Egypt the joint ventures between foreign banks and the nationalised Egyptian banks have been subject to lax regulation. These banks are mostly

involved in import finance for which they levy high charges, largely reflecting their privileged position in the banking system and the lack of competition. These banks do little to help with export finance, which arguably would aid the Egyptian economy more. The numerous investment companies in Egypt have been left to their own devices; some have solicited for deposits, marketing themselves as a more lucrative alternative to the state-owned banks. Yet when the largest investment company, Al Rayan, became bankrupt, many investors of very modest means lost their savings, and the Central Bank of Egypt did nothing to help.

The largely Abu Dhabi-owned Bank of Credit and Commerce International was regulated from Luxemburg rather than from the United Arab Emirates. Its collapse caused substantial damage to many Arab commercial banks because of cross-holdings, including the National Commercial Bank of Saudi Arabia, but no efforts were made to avert the eventual bankruptcy, even although it was evident to most bankers in the Emirates from 1985 onward that BCCI was a flawed and corrupt institution.

OFFSHORE BANKING

The action by revolutionary governments against individuals with substantial private wealth inevitably resulted in attempts at evasion. Capital transfers were made through unofficial black market transactions which, though illegal, were nevertheless substantial in Egypt, Syria and Iraq in the 1950s and 1960s. At the same time the restrictions on the operation of foreign banks and the outright bank nationalisations created a vacuum, as there were many businessmen and wealthy private individuals who were unhappy about dealing with state-owned or -controlled banks, as they did not wish to disclose to governments full details of all their financial dealings.

It was this market that Beirut's private bankers sought to exploit, because, unlike other Middle Eastern governments, the Lebanese authorities adopted a *laissez-faire* attitude to banking and openly welcomed foreign banks. In 1956 a bank secrecy law was passed modelled on the Swiss legislation which permits depositors to open numbered bank accounts to provide anonymity. As a result substantial amounts were deposited in the Lebanese banking system, mainly in hard currency and especially in United States dollars. By the mid-1960s Beirut had become the major financial centre for the region, providing highly personalised banking services on the Swiss model for wealthy Middle Eastern businessmen. Not only Lebanese banks were involved, but also major foreign banks, including Citibank of New York and leading French and British banks. Lebanese nationals were employed by these banks, however, so arguably the foreign banks brought prosperity to Beirut and the quality

names brought business that might not have come to local banks, which were inevitably regarded as less secure. Local Lebanese banks offered higher deposit rates, however, so clients had the classic choice between risks and returns.

The Lebanese civil war which started in 1975 effectively finished Beirut as a financial centre, as personal banking by its nature implies frequent client consultation. But the wealthy were reluctant to risk visiting Beirut, and once communications links were cut and with the periodic closure of the airport, the international banks started to pull out. Though by the early 1990s a degree of law and order was restored to Beirut, it is unlikely to regain its pre-eminent role in Middle Eastern finance. There are several reasons for this. First, with non-stop flights to Europe and North America from the Gulf there is no need to transit through Beirut. Second, clients from Saudi Arabia and other Gulf states have become used to travelling to London or to dealing through Bahrain to some extent, as outlined below, if they need personal contacts closer to home. Finally, the telecommunications revolution reduces the need for centres such as Beirut.

Beirut's demise left a gap that Bahrain was to fill from the late 1970s onward, following the enactment of offshore banking legislation in 1975. Like Lebanon and unlike neighbouring Saudi Arabia, Bahrain welcomed foreign banks, provided they confined their dealings to non-residents.[20] The Bahrain authorities saw that there was the opportunity to make their island the dominant financial centre in the Gulf, creating much-needed high-paid employment, which the country with its meagre oil reserves found highly appealing. This policy was to prove highly successful, and by the early 1980s over a hundred leading international banks maintained offshore banking units in Bahrain, largely aimed at attracting deposits from Saudi Arabian clients, usually in dollars but also in *riyals,* which earned higher interest than was paid onshore because of the Islamic concerns about *riba*.

As with Beirut, conflict and uncertainty were to contribute to Bahrain's demise, especially the Iraq-Iran and the Gulf Wars, although the decline in oil prices from the mid-1980s onwards was also a major factor. Increasingly, with modern telecommunications and computer links, bankers and wealthy private businessmen are able to deal directly with European financial markets, especially with London. At the same time the retail banks in Saudi Arabia have become more sophisticated, and themselves maintain a presence in Europe and the United States. The need for regional banking centres is less clear given these developments.

This is illustrated by the case of Cyprus, which passed offshore banking legislation in 1982. No major Gulf banks have established a presence in Limassol or Nicosia; the only regional banks represented are the Arab and Jordan National Bank.[21] Lebanese banks transferred operations to Cyprus when conditions were particularly difficult in Beirut in the 1980s,

but most of this business has now returned to Lebanon. The main offshore banks attracted to Cyprus in the 1990s have been from co-religionist Orthodox countries, especially Russia and Serbia, as the latter's foreign trade financing activities from Belgrade were curtailed by United Nations sanctions.

STOCK MARKET DEVELOPMENT AND EQUITY FINANCE

Modern business enterprises raise much of their funding requirements through equity markets rather than by bank borrowings. If risk capital can be utilised, this arguably reduces risks for the business enterprises themselves, as there are no debt-servicing and repayments commitments. The complete absence of any major public companies in the Middle East, and the fact that there are no multinational corporations with their headquarters in the region, reflects the underdeveloped nature of the area's equity markets.

Other parts of the Third World, such as South and South East Asia, are the bases for increasingly important multinational enterprises, yet the Middle East, despite its substantial oil wealth, remains dependent on multinationals based elsewhere, with little corporate loyalty to or affiliation with the region. Most large manufacturing companies in the Middle East are state-owned, but this means that they take a narrow nationalistic view which is constrained by the small economic size of the states in which they are based. Some may argue that this identification of corporate with state interests is desirable, but it has resulted in local manufacturing being subject to domestic political pressures and being at a disadvantage in relation to the much freer multinational companies based in the industrialised world.

The Cairo Stock Exchange predates many markets in Europe and East Asia, having been established in 1864; investment companies and transport undertakings are quoted and traded to varying degrees. The growth of the market was constrained by the limited size of the economy and the fact that most of the modern sector was foreign-owned and -financed. Commercial banks, for example, are usually amongst the first shares to be quoted on young stock exchanges, but the National Bank of Egypt, as we have already indicated, was British-owned. As there was no industrial base, following the collapse of Mohammed Ali's textile mills, there were no manufacturing companies seeking quotations. Most of the local trading concerns were family businesses. It was only the enterprises serving the cotton trade which were quoted companies, because these were more substantial in size. Even in the transport infrastructure sphere, the largest project of all, the Suez Canal, was an Anglo-French venture, financed from London and Paris.

This experience illustrates the point that without a demand for local equity finance there is unlikely to be a supply. It was less a case of foreign investment filling a domestic savings gap, than of the equity market being seen as a source of funding for left-over projects that were too small to merit international funding and for which local knowledge was crucial. Equity markets cannot in themselves promote development; instead, they are reactive, though the presence of an active market may encourage entrepreneurs to take risks with expansion secure in the knowledge that the risks can be shared. The Cairo market throughout its 130-year history has never been very active, its heyday being the 1930s and 1940s before the young officers' coup of 1952. In Egypt financiers had always been in the habit of looking abroad, and the main reaction to the events of 1952 and the Suez Crisis of 1956 was a flight of capital overseas, both legally and illegally. It was this that drove Nasser to look to the state to fund his industrialisation drive, because he despaired of Egypt's entrepreneurs. The nationalisation measures of the 1950s and 1960s were motivated by pragmatism rather than ideology.

Under Sadat there was increased interest in private finance, but the main reliance was on foreign capital through the 'Open Door Policy' introduced in 1974, not the revival of the Cairo stock exchange that had been virtually moribund during Nasser's period of nationalisations. By the late 1980s the stock market had revived, largely without government encouragement, and the number of companies quoted more than doubled to 582 by 1991, with a total market capitalisation of over $907 million.[22] This however is less than one-fortieth of the capitalisation of Singapore, and less than 0.1 per cent of that of the London Stock Exchange. Furthermore over 60 per cent of the equity values represent closed companies rather than joint stock companies which are open to the public. The attraction of closed companies is that the capital cannot be diluted by new share issues to the general public which might undermine equity prices. Rights issues to existing shareholders are permitted, but the limitation on wider issues forces companies to rely on debt finance to a greater extent.

This feature of the Cairo stock exchange is not found in other markets in the Middle East, though these remain equally underdeveloped. There has been a revival of dealings on the Tehran stock market since the ending of the Iraq-Iran war, a development encouraged by President Rafsanjani. Though foreign investment is permitted again, foreign companies are restricted to a 49 per cent non-controlling interest in Iranian companies. Local equity capital is seen as a better alternative for risk capital, though the need for foreign expertise in manufacturing is once again recognised. The stock market remains smaller than that of Cairo, however, as does the Istanbul exchange, which has developed modestly since the mid-1980s. The only other Middle Eastern countries with active markets are Israel, which has by far the largest market, Jordan, where the business sector is small,

Kuwait and Saudi Arabia. Both the Tel Aviv and Amman markets have been affected by developments in the Middle East peace process, which, if ultimately successful, could substantially increase confidence and boost stock prices.

In Saudi Arabia the actively traded stocks are shares in the so-called Saudi-ised banks, such as the Saudi American bank, and holdings in government enterprises which have been part-privatised, such as SABIC. Most private businesses, including the large trading companies with import franchises, remain in private hands. There is a reluctance to 'go public' and launch equity issues as this would result in the dilution or perhaps even the end of family control. Despite the size of the oil-rich Saudi economy, a small-business mentality predominates which limits the potential for equity market development.

Kuwait had a much larger equity market than Saudi Arabia prior to the Gulf War, but its exchange has had a chequered history.[23] The greatest boom period was the early 1980s, when dealings were buoyant not only on the official market but on the unofficial *souk al manakh*. Companies whose shares were traded on the latter did not produce audited accounts, and in some cases disclosed little information on their activities. The market was highly speculative and more like a casino, where fortunes were won and lost. In the end as in all such markets the bubble burst, leaving a mountain of debt, the effects of which were felt for most of the 1980s. Such markets are more likely to be detrimental than beneficial for development.

The Middle East appears to have largely lost out in the boom in emerging financial markets in the 1990s. Yet, as will be seen in the next chapter on an Islamic model for economic development, there is a strong potential role for equity finance on a profit-sharing basis rather than loan finance involving interest.

6

AN ISLAMIC MODEL FOR ECONOMIC DEVELOPMENT

The countries of the Middle East all have Muslim majority populations, many of whom are devout in their religious beliefs and all of whom have been affected to a greater or lesser extent by Islam. These beliefs have determined the prevailing value systems of the societies throughout the region, and any study of development has to take these into account. It should not be assumed that development objectives are universal; they may relate to the value systems of the groups involved.[1] How these objectives are achieved may also raise moral issues which Muslims cannot ignore if they are sincere in their beliefs.

For many, perhaps most, western-trained economists the objective of development is usually identified in terms of increasing material prosperity for individuals, and many economists are also concerned with how the increasing income is distributed. Although the latter may involve moral issues of equity and fairness, the concern is essentially materialistic. Furthermore, the emphasis is on outcomes, rather than on the moral legitimacy of the means through which the material results are delivered. The approach is supposedly 'positive', which means value-free, but what this actually means is debatable. Positive is interpreted as scientific in the sense that economic theories rest on logical deductions and the construction of models that can be empirically tested. It is possible to define utility functions to take account of preferences between work and leisure, as well as the consumption of material goods. In practice, however, most economists stress the link between commodities and services and utility, any other possible dimensions being ignored.

For devout Muslims, as with many other religious believers, personal and even social material considerations are secondary.[2] The consumption of goods and services is a means, not an end. The term Muslim refers to submission to the will of Allah. It is this submission which brings the real rewards, the satisfaction from being faithful and of living as Allah wishes. Believers do not have to be wealthy to obtain these rewards, indeed they are unrelated to personal income or a country's level of development.

Faith in Allah represents a spiritual rather than a material dimension, and western-trained secular economists, including those of Middle East origin, may feel uncomfortable with this. Yet the issue of belief should perhaps be faced by all students of Muslim economies, even non-believers. Recognition of the value systems of Middle Eastern Muslim societies means asking fundamental questions. What is the purpose of development? Will it bring believers closer to their goal of submission to Allah? Does increasing individual and social prosperity facilitate living according to the will of Allah, or is it morally corrupting?

Secular economists who regard themselves as 'modernisers' often view Islam, and to varying degrees other religions, as a negative influence on development. Rewards in the next life are seen as a distraction from the tribulations of earthly life, indeed as perhaps a factor which undermines material incentives. The teaching in the Koran, which dates back over 1,400 years to a pre-industrial society, is not thought to be relevant to developing economies. The cities of Mecca and Medina in the Hijaz at the time of the Prophet Mohammed, in what is now the western region of Saudi Arabia, are thought of as static economies with no means of or potential for growth. Islam, in other words, is seen as backward- rather than forward-looking, with little relevance for the present day. Indeed, some even attribute the low level of development in the Middle East to the population's adherence to Islamic beliefs.[3] Secularisation, if not westernisation, is seen as the key to development, and religion is viewed as an obstacle to be overcome, if not actively discouraged.

THE POSITION OF ISLAMIC ECONOMISTS

Needless to say, there are few in the Middle East who take this view, and any who do are an unrepresentative minority. Political demands are increasingly expressed in the language of Islam, and much of the political opposition now comes from the Islamists rather than from the secularist left. These developments have been reflected in the economic sphere by the growth of interest in Islamic economics.[4] Funding from Saudi Arabian sources has encouraged research in this field, but the growth of interest in Islamic economics has more to do with politics than simply finance. The Iranian revolution in 1979 was the most dramatic manifestation of the desire to bring Islam into the political and economic sphere, but there are continuing indications of popular support for Islamic policies throughout the region. In Algeria the Islamic parties won the first round of the 1992 elections, which prompted the secularist government to cancel the second round. In Egypt many of the poor and low-income earners look to local Muslim activists rather than the government, and the trend towards stricter religious adherence is apparent even amongst the highly

educated youth in the universities. Islamic parties are well represented in the Jordanian parliament, although they suffered a setback in the 1992 elections.

These political developments have been accompanied by a parallel growth of interest in Islamic writings by academic economists.[5] Much of the initial work and discussions were amongst economists in universities in Pakistan, most of whom had completed higher degrees in Britain. Pakistan was created as a specifically Muslim state in 1948, as it was the religious factor rather than ethnic or linguistic differences that distinguished the country from neighbouring India. In such circumstances the search for specifically Islamic economic policies could be viewed as part of the quest for a distinct national identity.

In the Middle East there was not the same co-incidence of religious and nationalistic forces, because national identity could be defined in ethnic and linguistic terms. This was as much the case for Nasser's Arab 'nation' as it was for Atatürk's Turkey. In such a context secularist economic policies were quite acceptable. There was, nevertheless, a desire for an alternative to the capitalist economic system, which was associated by many in the Middle East with colonialism and imperialism. For some in government and academic circles a socialist planned economy was viewed as the best alternative, although not necessarily a communist system, which outside Iraq and Yemen had few adherents in the Middle East. Even those who rejected western economics in the 1950s and 1960s were secularised themselves in their economic thinking. There was little awareness, and no desire, to try to rediscover Islamic economic ideas, at least amongst the intellegentsia and the ruling classes.

In most Middle East states the modern secularised education system existed side by side with traditional Koranic schools, but over time the latter were increasingly marginalised as resources were directed to state education. Even at university level religious education tended to be segregated from the new mainstream, with teachers at traditional religious universities such as Al Azhar in Cairo largely isolated and neglected. The Egyptian government tried to bring the latter under its control and influence, much to the dismay of many Islamists, the term which is sometimes used to describe those who support the application of Islamic teaching in the political and economic sphere. Teaching and research on Islamic commercial practice was left to lawyers, who had little interest in development, rather than to economists. Most academic economists in Egypt were found in institutions such as the private American University or the state-financed Cairo and Ain Shams Universities. Few of these had much knowledge of or interest in Islamic economics. Those who were devout Muslims tended to separate their professional interests from their religious beliefs, partly because they were given no encouragement to do otherwise.

It is only during the last two decades that Islamic economics has started to be treated as a discipline in its own right, with courses offered in some state institutions. Part of the revival has been aided through private funding from Gulf sources, as we have already mentioned, such as the assistance from the Al Baraka Islamic financial group for the Centre of Islamic Economics in the King Abdul Aziz University in Jeddah and the Islamic Foundation in Leicester, England. Both these centres promote research in Islamic economics and development. There has also been encouragement from the Islamic Development Bank in Jeddah, which has helped to bring together Pakistani and Arab economists interested in this area. Needless to say, in Iran since the Islamic revolution there has been a proliferation of courses in Islamic economics in universities throughout the country, although the research effort is arguably weaker.

THE METHODOLOGY OF WESTERN AND ISLAMIC ECONOMICS

It would be incorrect to believe that it is only Islamic economists who deal with broader ethical questions. Early western philosophers and economic thinkers were concerned with moral issues, notably Thomas Aquinas in the thirteenth century and Nicholas Oresme in the four-teenth.[6] Both writers criticised the accumulation of material goods for their own sake, and commercial and moneylending practices that compromised people's spiritual lives. Adam Smith regarded himself as a moral philosopher as much as an economist; indeed, he did not really distinguish between the two.

With Ricardo classical economics became a more specialised discipline, and the increasing technical complexity meant that students who wished to progress to the highest levels of the subject had to devote all their time to it. Discourse with other disciplines such as philosophy or theology became minimal, a trend that was reinforced still further by the marginal revolution in the nineteenth century and the advent of neo-classical economics. This process was perhaps inevitable as the methodology of economics became more refined, but it meant that the subject became increasingly abstract and cut off from its moral roots.

Modern neo-classical economists pride themselves on being positive, meaning value-free. What they have to offer is a well-developed and tested box of tools to apply to any problem which is presented. Economists in their professional capacity do not make moral judgements. They may have private views, but these are best kept to themselves in case they interfere with professional advice. Economists can use their models to demonstrate outcomes under particular sets of circumstances, and show how these change when the assumptions are altered. Moral Judgements are left to decision-makers, who take into account not only their advice, but also that

of other specialists, including political advisers. The moral decisions are therefore avoided by economists, the buck is passed to a higher authority.

Islamic economists, because of their religious beliefs, cannot duck their moral responsibilities in this way. This is why the subject is viewed as normative rather than positive, because Islamic economists do not wish to attempt to give value-free advice. It is not merely the outcomes that matter, but the legitimacy of the means to reach desirable objectives. How such concerns are handled raises important methodological issues. One way is to adopt almost a polemic approach, urging policy-makers to follow a particular line because it is morally right, almost regardless of the economic arguments or indeed the economic costs. Economic theory is then adapted to fit the moral arguments, rather than making any moral compromises, as it is the morality which is of paramount importance. This approach is interdisciplinary in the sense that economics is regarded as part of moral philosophy, even if those involved are working in a particular specialised area.

An alternative methodological approach is to construct a completely Islamic economic paradigm from first principles, drawing on the writings of early Islamic economic thinkers such as Zaid bin Ali and Abu Yusuf in the eighth century, and later scholars such as Abu Ubaid, Ibn Khaldun and Jamaluddin al-Afghani.[7] Some followers of this approach ignore or even reject the conventional western neo-classical literature and instead build up models which tend to be historical and legalistic in nature, with some parallels in institutional economics.

Other modern Islamic economists, perhaps the majority, draw on the writings of earlier Muslim scholars, but at the same time recognise the value of the tools and methods of western economists. Their approach is more in the mainstream of modern economics, at least with regard to method and style, but is nevertheless distinct in that it starts from different axioms.[8] Some Islamic economists are even more mainstream in approach, accepting the basic premises of western theories, but modifying certain assumptions to make them acceptable to Muslims. For those who follow this approach, the task is to validate what is acceptable in classical and neo-classical theory, and weed out and suggest alternatives for what is not.

SOURCES OF ISLAMIC ECONOMIC PHILOSOPHY

In order to understand the principles of Islamic economics and their significance for development thinking, it is important to know something about the sources. Western neo-classical economics makes little or no reference to biblical teaching, but the ultimate source of inspiration for Islamic economics is the holy Koran. The Prophet Mohammed as a leader and ruler was specifically concerned with economic justice and rights, and

his experience as a trader meant he had practical knowledge of commerce and the procedures involved in economic transactions. Hence the Koran is very explicit in its economic teaching, as is the *Hadith,* the sayings and the deeds of the Prophet Mohammed as recorded in the *sunnah* holy writings. These represent another important source of authority for Muslims, especially for the majority *Sunni* sect, who dominate throughout the Middle East, with the exception of Iran.

There is much more space devoted to economic matters in the Koran than in the Bible. Over 1,400 of the 6,226 verses refer to economic issues, because the Koran provides a complete recipe for all aspects of life, material as well as spiritual. It is quite specific about the duties and obligations of believers, as well as their economic rights and entitlements. On inheritance, for example, it is stated:

> A male shall inherit a portion equal to that of two females…for parents one sixth to each if the deceased left children…in what ye [the man] leaves [his wife's] share is a fourth if they die childless but if ye leave children, [your wife] gets an eighth after payment of legacies and debts.[9]

Under this formula a married man who leaves a widow, a son and a daughter, but whose parents are dead, will have his estate divided in the following manner.

$$\begin{aligned} \text{Widow's share} &= \tfrac{1}{8} \\ \text{Son's share} &= (1 - \tfrac{1}{8}) \times \tfrac{2}{3} = \tfrac{7}{12} \\ \text{Daughter's share} &= (1 - \tfrac{1}{8}) \times \tfrac{1}{3} = \tfrac{7}{24} \end{aligned}$$

This contrasts with the usual situation in the West where, in the absence of specific instructions in the will of the deceased, a widow inherits all her husband's estate, which is then passed on to each of the children, in equal proportions regardless of sex, on her death.

The Muslim inheritance laws, as with much of the guidance which is provided by the Koran, are enacted in the *shariah,* the Islamic religious laws. These cover most aspects of economic activity and commercial life, as well as criminal justice and other matters. In states such as Saudi Arabia and Iran, the *shariah* law is the ultimate legal authority; but even in those states which have enacted western commercial codes, such as Egypt, Syria, Turkey and the Magreb countries, many believers still look to religious laws rather than the secular. These states have in fact incorporated Islamic inheritance laws into their legal systems, but not Muslim commercial codes. *Shariah* courts hear cases concerning commercial matters in the Gulf states and Iran, but even in the more secular countries in the Middle

East that have civil courts, many of the local businessmen may prefer to have the religious authorities arbitrate in disputes between Muslims. In those states where there is no formal parallel *shariah* court system, there is in practice an informal network which looks after most everyday commercial affairs.

The other source of authority for commercial transactions in Muslim states is the *fiqh,* which refers to Islamic jurisprudence. This is the science or philosophy of Muslim law, especially the knowledge necessary for its interpretation. The *fuqaha* are the jurists who give opinions on various legal issues in the light of the Koran and the *sunnah,* and these opinions are included in the *fiqh.* On most fundamental matters there is a consensus amongst Muslim jurists which is referred to as *ijma.* As this has been reached by general agreement it is much respected. For many commercial and economic matters, especially those reflecting modern developments, it is the *ijtihad* which is important, the effort to derive juristic opinions.

Those most qualified to give such opinions are the *ulama,* the religious scholars who are fully conversant with the Koran and the *sunnah.* In the past such scholars often tended to be removed from the everyday realities of the commercial world, and had great religious knowledge but little economic awareness. This is changing today as more widely educated and travelled Muslims are accepted into the *ulama,* although amongst the highest Islamic legal authorities there remains a stronger emphasis on scholarly work than on practical dealings.

ISLAMIC VIEWS ON TRADE AND COMMERCIAL ACTIVITY

Economic activities are classified as productive or unproductive by both western classical and Islamic economists. Adam Smith viewed manufacturing as productive, because it made a positive contribution to the wealth of nations, but trading and distribution were seen as unproductive because they did not add value. Islamic economists have always taken a rather different view: trading is held to be as important as manufacturing. Without distribution and sales, production would be worthless. This is more in line with modern western economic thinking, which draws no distinction between physical goods and services. What is classified as unproductive by Islamic economists is any task which requires no effort, yet is rewarded. It is those who work who will benefit:

> Those who patiently persevere will truly receive a reward without measure.[10]

Interest as a reward for deferring consumption is, for example, seen as unjust because the return comes from mere waiting, not from effort.

There are many passages where trading is singled out for praise in the Koran as a worthy occupation. Exchange is viewed as mutually beneficial and certainly preferable to keeping exclusive control over personal property:

> O ye who believe, eat not up your property among yourselves in vanities: but let there be amongst you traffic and trade by mutual goodwill.[11]

Another passage in the Koran speaks of the 'Hope for a commerce that will never fail'.[12] Buying and selling can corrupt, however, and as indicated in chapter 1, fraudulent and dishonest trading practices are condemned. Competition in the accumulation of material possessions is seen as especially harmful:

> The mutual rivalry for piling up the good things of this world diverts you from more serious things.[13]

In other words, material accumulation in order to show off to others or even to keep up with their consumption levels can be a harmful distraction from more important spiritual concerns. As in the Bible, in the Koran the coveting of a neighbour's goods is explicitly condemned:

> And in no wise covet those things in which God hath bestowed his gifts more freely on some of you than on others: to men is allocated what they earn and to women what they earn.[14]

The prophet Mohammed himself had first-hand experience of trading in camels following his marriage to Khadija. Later, as the ruler of Medina at the commercial heart of the Hijaz, he was frequently called upon to arbitrate in disputes between buyers and sellers. Disagreements over weights and measures were common, as were differences over exactly what bargain had been struck and the nature of the goods being covered. Honesty in trade is stressed in the Koran, and any attempt to deceive or cheat in transactions is condemned:

> Give full measure when ye measure, and weigh with a balance which is straight: that is the most fitting and the most advantageous in the final determination.[15]

With agricultural products freshness was often an issue in a region with a hot summer climate and no technology to preserve fresh produce. Mohammed was concerned that proper contracts should be drawn up for trade, and that there should be transparency in all transactions and

trading practices. People should not attempt to get involved in dealings in areas in which they have little knowledge:

> And pursue not that of which thou hast no knowledge; for every act of hearing or of seeing…will be enquired into [on the day of reckoning].[16]

Traders are respected as knowledgeable throughout the Middle East, and they are seen as playing a key role in the dissemination of knowledge. These attitudes owe much to traditional Islamic teaching and writings. Such attitudes can be helpful for development in modern societies, however, where the marketing matters as much as mere production.

The international advantage of Islamic economies arguably lies in efficient information transmission through a well-developed trading system. This may act to the advantage of the Middle East in coming decades, as links between smaller firms become more important and production is scaled down, with greater emphasis on flexibility and diversity. The obsession with large-scale production under both the capitalist and the communist systems and the downgrading of mercantilism was ill-suited to Islamic societies. If the next stage of development is the emergence of a new form of mercantilism, the Islamic world will be in a much better relative position.

JUST REWARDS IN AN ISLAMIC ECONOMY

Western economists and development theorists have always been deeply concerned with questions of income distribution both within and between nations, and modern welfare economics attempts to show how a redistribution of income and wealth can bring about an improvement in utility or satisfaction for society as a whole. Islamic economists are also concerned with these issues, but their interest is not merely with the outcomes, but how material rewards can be justified. Merchants and traders, for example, earn their rewards through conveying information and taking risks. This is a justifiable reason for remuneration because it implies effort. Rewards on such a basis are always legitimate, whereas windfall gains as a result of gambling or the exploitation of others are viewed as unjust.

There are nine passages in the Koran that specifically deal with rewards. Muslims get their rewards from Allah both in their worldly life and in the hereafter, the latter being more important. All believers have a right to a basic entitlement during their lives, because without this they would be unable to realise their human potential. The position is set out clearly in the Koran:

> It is God who has created you; further he has provided you with your sustenance.[17]

The amount of entitlement is not important: the emphasis is on needs rather than the situation of one Muslim relative to another:

> God may reward them according to the best of their deeds, and add even more for them out of his grace: for God doth provide for those whom he will without measure.[18]

There may be a minimum reward, but there is no maximum. In an economic-policy context this could be interpreted as support for the notion of a minimum wage, so that all Muslims can live with dignity, but not for a programme of compulsory redistribution of income and wealth that takes from the rich to give to the poor. Such policies create resentment, and redistribution under duress from the secular authorities is regarded as undesirable in contrast to the voluntary giving of alms, which is viewed as part of a believer's duty in serving God. Riches bring responsibilities, including the responsibility to give:

> Your riches and your children may be but a trial: but in the presence of God is the highest reward. So fear God as much as ye can; listen and obey; and spend in charity for the benefit of your own soul and those saved from the covetousness of their own souls …If you loan to God a beautiful loan, he will double it to your credit.[19]

The real reward of wealth is the ability to be generous. Wealth is only a means of serving God, not an end in itself.

Striving for material possessions may result in earthly rewards, but these are not important in the long run; indeed, materialism may bring ruin:

> If any do wish for the transitory things of this life we readily grant them—such things as we will to such persons as we will…[but] …in the end we have provided hell for them.[20]

In contrast, those who strive in the service of God for a place in the hereafter will be blessed. It is not the material possessions which are condemned, however; what matters is how they were acquired. People should not become obsessed with the amounts of goods others have: God's bounty is for all believers, but not necessarily equally. What is important is that everyone should have sufficient, not that all believers should have the same:

> God has bestowed his gifts of sustenance more freely on some of you than on others: those more favoured are not going to throw back their gifts to those whom their right hands possess, so as to be equal in that respect.[21]

In other words, income and wealth distribution in this world are not important issues, because believers are promised so much more in the hereafter. It is submission to Allah during life on earth that brings fulfilment, but the fruits of this are enjoyed in the afterlife. Given such beliefs, concern over worldly goods is inevitably secondary.

INCENTIVES AND ASPIRATIONS IN MUSLIM SOCIETY

Economists who emphasise constraints on the supply side as an impediment to development often stress the importance of incentives for the individual businessman, entrepreneur or capitalist as the key to faster growth. How important are such material incentives in Islamic societies? Can a value system which condemns the individual pursuit of material self-interest be conducive to economic development? Does the downgrading of economic differentiation as defined by living standards impede material advance?

For many in Iran it is the Ayatollahs, Mullahs and other members of the *Ulama,* the religious scholars, who are the most highly respected members of society. Business leaders, and even the government and lay members of the *majilis,* the Iranian parliament, do not command the same respect. The authority of the religious leadership comes from their knowledge of the Koran and the holy writings, and their ability to interpret the *shariah* religious laws. An Ayatollah is able to recite the entire Koran without referring to the written text, a remarkable feat of memory which few can achieve. Many regard those who can manage this task as inspired by Allah.

The religious leaders are respected for their piety, not their possessions, for they have little personal material wealth and no need or desire for worldly goods beyond what is necessary for sustenance so that they can perform their religious duties. Ayatollah Khomeini had little interest in economics, indeed he is credited with saying that economics is a donkey. The donkey is the servant of man, who is in turn the servant of God. This places economics in a very low position. Development for Khomeini was a tool, a means, but not an end. The objective of development was to strengthen the community of believers, the *ummah* the true Muslim nation. Only then could they confront the infidel, the unbelievers, including the great satan, the leaders of the United States who wallowed in their materialistic decadence, and repeatedly tried to corrupt the Muslim faithful.

Such views may sound extreme to many in the West, but in Iran where the CIA was credited with overthrowing the Musaddiq government in the 1950s and reinforcing the power of the corrupt governments under the Shah, the rhetoric still strikes a popular chord. Elsewhere in the Middle East, especially in the Arab world, similar sentiments bring popular approval, and explain why the mourning for President Sadat of Egypt, when he

was assassinated by extremists, was so muted. Mubarak is regarded by a significant element of the Muslim masses in Egypt as a tool of the United States and its agent, the much-despised International Monetary Fund, which has dictated so much of recent economic policy in Egypt as a result of the government's indebtedness.

The mix of religious conviction and the politics of populist rebellion has proved a powerful force in the Middle East, and has somewhat sidelined economic debate in recent years. Against this background reforms that try to reduce the role of the state through privatisation or the reduction of regulation are seen as peripheral. It is not that Islamists are opposed to such policies, but rather that they believe most Arab governments are incapable of carrying out any worthwhile policy because of their moral corruption. The United States and the western economies are not seen as role models which the Islamic economies should aspire to follow, in any case, and therefore any western economic policies which they pursue are at best inappropriate and perhaps *haram,* forbidden to the faithful.

Private ownership of property is respected in Islam; indeed, as already indicated, there are detailed rules governing its inheritance. The accumulation of property is not viewed as an end in itself or an incentive mechanism; rather, private ownership is regarded as the natural state of affairs. Aggressive take-over activity is frowned upon in the Islamic world, as is any attempt to monopolise a market by driving competitors out of business. Believers should not deal with their fellow believers in such a manner. God is realistic about the aggressive nature of man, however, and although human conflict may be inevitable, it is important that this should not result in injustice. In the Koran there are several passages dealing with the distribution of the spoils of war:

> And know that out of all the booty that ye may acquire in war a fifth share is assigned to God, —and to the Apostle, and to near relatives, orphans, the needy and the wayfarer.[22]

It can of course be debated whether this ruling should apply to price-cutting wars between businesses, but the implied business ethics make some sense. In the Koran and other Islamic holy writings, there is always balance. The writings may be concerned with spiritual matters, but that does not mean they are out of touch with everyday economic realities.

THE PROHIBITION OF *RIBA*

One of the best-known Koranic injunctions in the economics sphere is the prohibition of *riba* or interest. This has been much debated in writings by Muslim economists, including the question of what is meant by *riba,* the

alternatives to *riba*-based finance and the implications for the relationship between Islamic and western economies.

The definition of *riba* has itself been a contentious matter, complicated by the difficulty of the precise interpretation of meaning from classical Arabic, the language of the Koran, to English, the language of most western economic writing and international commerce. Even the interpretation of classical Arabic in terms of modern colloquial Arabic used by bankers and businessmen can present problems, hence it is hardly surprising that much confusion and misunderstanding has arisen. *Riba* can be interpreted as the addition to a principal sum advanced through a loan which accrues to the lender and is paid by the borrower. One *shariah* court in the United Arab Emirates interpreted the addition as being compound interest, with the prohibition of *riba* not applying to simple interest. Most Islamic scholars reject this view, however, and see simple interest as an additional levy.

There is general agreement that usury, meaning exploitative interest charged by a lender to a borrower, constitutes *riba*. Such exploitative practices are morally dubious, and the case for a prohibition on moral grounds appears convincing, especially if the lender is a wealthy individual or institution such as a bank, and the borrower is poor and in need of funds. In such circumstances interest charges represent a redistributive flow from the poor to the rich, which can be regarded as regressive, a move that worsens income and ultimately wealth inequalities. The Koran is explicit in condemning usury, which is compared unfavourably with rewards from desirable activities such as trade:

> They say that trade is like usury, but God hath permitted trade and forbidden usury.[23]

Debtors should be treated with leniency rather than be exploited:

> If the debtor is in a difficulty, grant him time till it is easy for him to repay. If ye remit it by way of charity, that is best for you if ye only knew.[24]

In other words, debt rescheduling is desirable, and debt forgiveness especially worthy.

In developing countries, including the economies of the Middle East, the charges levied by moneylenders are often regarded as usury. They advance funds to those who do not qualify for bank lending, either because they are perceived as too risky or because the amounts required are small, and the transaction costs in processing the loan are large in relation to the potential returns. These can only be recovered by charging high rates to the borrower, either through interest or some other means. Whether such charges are actually exploitative usury must be open to question, given that the borrower

has no other access to funds. Islamic economists recognise that such charges have to be recouped if lending is to continue, the issue then being how the charges are calculated and levied.

The question of whether all interest constitutes *riba* is further complicated by the distinctions between real and nominal interest. Should interest charges be allowed to compensate for inflation? This would imply zero real interest but a nominal interest rate equal to the rate of price increase. As inflation rates vary from month to month, this means frequent variations in savings and lending rates if real interest is to be avoided. Yet such variations could be unfair, as not all savers and borrowers will be affected equally by inflation. If, for example, inflation reflects rising food prices, this may hurt the poor more. Yet as price indices include many non-food items which may be less prone to inflation, they may not adequately reflect the burden of inflation for those on low incomes.

The seasonal variations in the prices of fresh foodstuffs introduce additional difficulties. Are lending and borrowing rates to vary according to whether it is harvest or planting time? If so, then rates would presumably fall at harvest time when food is plentiful but rise during planting when the last season's produce is running out. Yet in the rural communities of the Middle East it is during the planting season that farmers seek credit for seeds and fertilisers.

One of the injustices of interest transactions from the perspective of Islamic economics is the failure to distinguish between microeconomic and macroeconomic considerations. In western economies interest is used as an instrument of monetary policy to control the level of aggregate economic activity. Interest rates are raised to curtail borrowing by consumers and investors to reduce short-term inflationary pressures. Rates of interest may also be raised when government deficits are increasing, in order to encourage the commercial banks and the public to purchase government securities. Such interest rate rises penalise existing borrowers whose loans are subject to variable interest, including those who have taken out long-term mortgages to purchase housing. Existing bond-holders are also penalised, as the value of their securities falls reflecting its unattractiveness in comparison to the newer higher-yielding government issues.

These macroeconomic developments are the responsibility of government, and have nothing to do with borrowing by individuals and firms at the microeconomic level. The latter may suffer as a result of policies about which they were not consulted, and indeed often could not have anticipated when they entered into their agreements to borrow. Islamic economics is therefore concerned to separate the microeconomic from the macroeconomic, but this does not mean it deals only with the former. Indeed, in some respects the ideas of Keynesian macroeconomics are anticipated in the Koran. There is for example a realisation that

hoarding is undesirable, because it removes funds from circulation, reduces economic activity, and causes suffering and hardship:

> And there are those who bury gold and silver and spend it not in the way of God: announce unto them a most grievous penalty.[25]

As *riba* encourages abstinence from consumption and the removal of funds from circulation, it is seen as unjust and inappropriate.

CHARITY VERSUS LENDING

In western neo-classical economics interest is regarded as a reward for deferring consumption. Muslims, however, are not encouraged to hoard in a selfish fashion, but to spend and use the bounties which Allah has provided for the benefit of his followers:

> O ye who believe, spend out of the bounties we have provided for you.[26]

Believers are urged to be generous rather than miserly, and to share their earnings with the less fortunate:

> Give of the good things which ye have honourably earned, and of the fruits of the earth which we have produced…And whatever ye spend in charity or devotion, be sure God knows it all.[27]

The faithful who are discreet in their giving are especially praised:

> If ye disclose acts of charity, even so it is well, but if ye conceal them, and make them reach those really in need, that is best for you.[28]

Throughout the sections of the Koran dealing with *riba,* the contrast is made between the evil of seeking such rewards and the blessings which will be bestowed upon those who give freely. The prohibition of *riba* should not be viewed negatively: it is not just the lending for interest which will lead believers astray, but there is also the lost opportunity of alms-giving. It is this that represents the opportunity cost, because the generous rather than the miserly moneylenders reap the real rewards:

> The parable of those who spend their substance in the way of God is that of a grain of corn: it groweth seven ears, and each ear hath a hundred grains.[29]

Another verse contains a similar appealing message:

> And the likeness of those who spend their substance seeking to please God and to strengthen their souls is a garden high and fertile: heavy rain falls on it but makes it yield a double increase of harvest, and if it receives not heavy rain, light moisture sufficeth it. God seeth well whatever ye do.[30]

It is not the monetary value of the charity which matters, but the act of giving itself, and the spirit in which donations are made.

ISLAMIC PROFIT-SHARING

In western economies the rate of interest serves as a pricing mechanism to bring the demand for loanable funds into equilibrium with the supply of savings. If the demand exceeds the supply, interest rates rise, encouraging savings but deterring borrowers. For business borrowers, the returns on the projects for which they are seeking funding may be insufficient to justify the increased costs of borrowing. Some economists in the Islamic world believe that the prohibition of *riba* applies only to personal loans and not to business finance, where interest can continue to act as a rationing mechanism to determine how loanable funds are allocated. Most Muslim economists reject this thinking, asserting that it would be inconsistent to permit some transactions based on interest, but not others.[31]

The Islamic alternative to *riba* finance is based on the concept of profit-sharing between those who provide the funds and those using the finance. This is referred to as the principle of *mudarabah*.[32] The return for the financier is related to the income from the use of the funds after costs have been covered. This implies a variable return which cannot be fixed in advance.[33] The financier's return is justified by the risk taken, as there will always be uncertainty over future returns. If there are no profits then the financier will obtain no return. This contrasts with fixed-interest lending, where the borrower has to service the debt regardless of the level of profit or loss. When western businesses get into difficulty, it is often the banks who foreclose. Bankruptcy is less likely with Islamic financing, where loan servicing obligations are eliminated when there is no profit. Under some circumstances losses can even be shared, although the provider of the funds has discretion in this matter and there is no question of unlimited liability for either party.

With western *riba*-based finance there are of course risks, the major risk being that of default by the borrower. For this reason collateral or some form of guarantee from a third party is often required before funds are advanced. This reduces the lender's risk. There can also be uncertainty over the return if the loan is contracted at variable interest, but in such cases the

variability will depend on government monetary policy and macroeconomic conditions, not on the return from the project at the microeconomic level. Islamic finance is by nature participatory in the sense that the provider of the finance shares in the project risk with the businessman undertaking the venture. Indeed, it can be regarded almost as a type of venture capital financing, especially when small businesses are the recipients.

Within an Islamic financial system the role of banks is clearly different from that of conventional commercial banks because the banks tend to be more closely involved with both their depositors and those being funded. Nevertheless, Islamic banks aim to provide a similar range of services to western banks. Depositors are offered current accounts for their everyday transactions, and are issued with cheque books and cash cards for use in automatic telling machines. No interest is offered on such accounts, but clients are usually expected to open current accounts if they are to qualify for bank funding. Overdrafts are not usually permitted by Islamic banks, although if a client accidentally goes into the red, the bank may at its discretion honour the cheque. A charge will not normally be levied in such circumstances, but the bank will write to the client seeking an explanation. The automatic telling machines are programmed to issue funds only to clients with credit balances.

Savings facilities are offered by Islamic banks on a *mudarabah* profit-sharing basis in which depositors share in the bank's profits. Such deposits are often designated as investment accounts, and are regarded as long-term precautionary balances rather than funds required for immediate transactions. There are often minimum periods required for notice of withdrawals from investment accounts, varying from one month to a year.[34] The longer the minimum period, the larger the depositor's share in the bank's profit. Investment accounts are run in perpetuity and are therefore different from time deposits, which have to be renewed at regular intervals.

If a bank makes losses the depositors get no profit share, but the value of their deposits is guaranteed and they have first call on the bank's assets in the case of liquidation. This puts them in a different category to shareholders, who can make capital losses as well as gains and in the event of insolvency lose their investments. Shareholders are paid dividends based on the bank's profits, but these are discretionary rather than formula-based as with investment account holders.

For individuals with substantial funds to invest, Islamic banks can act as intermediaries between the investor and the fund user. In such cases the investor shares directly in the profit from the project being funded rather than in the bank's profit. This may, and usually does, involve a higher risk for the investor. The bank charges the investor an arrangement fee for setting up such financing and a management fee for looking after the ongoing distribution of the profits. The recipient is also charged fees on the same basis. As stock markets are poorly developed in the Middle East, as indicated in chapter 5, such funding can be a substitute for equity finance.

ISLAMIC FINANCING

Different types of financing are required according to the purpose for which funding is being sought and the period for which the finance is required; this applies whether the finance is provided by an Islamic or a conventional bank. For example, short-term trade finance may be required by a Middle Eastern merchant to cover stockholdings of imported consumer goods until they are sold. These financing terms will be quite different to those of a manufacturer investing on a long-term basis in new premises or equipment. Once-only lump-sum finance may be required or ongoing funding on a monthly, quarterly or irregular but frequent basis.

In practice in the Middle East, most longer-term business finance is from ploughed-back profits or borrowings from relatives rather than institutions. Governments fund large-scale investments by the large state-sector businesses. This leaves the commercial banks, including the Islamic banks, in the position of providing mainly short-term trade-related finance, often to cover import purchases. Islamic banks arrange this through an interest-free *murababah* arrangement rather than through commercial lending. *Murabahah* finance involves a bank purchasing a good on behalf of a client and reselling it to the client for an agreed mark-up. The bank assumes ownership of the good until it is resold, this risk justifying its reward. In practice the bank will not take physical possession of the good; it will be either in transit to the client, or in a warehouse, or even on premises owned and used by the client. The bank will, however, have legal title to the good, with all the obligations which that implies.

The calculation of the *murabahah* mark-up is quite different to interest, because it is related to the administrative costs of providing the finance with an additional allowance for profits, a portion of which will be shared with depositors with the financial institution. It is unrelated to interest rates as dictated by the requirements of monetary policy or the fiscal needs of government. It is also unrelated to market interest rates as determined by the demand and supply of loanable funds. In an Islamic financial system savings may be determined by current income, expected future income in relation to needs and present and past wealth, but it is not determined by interest or the price of money. Financing requirements may be determined by business needs and opportunities, including marketing considerations, but not by the price of borrowing at any particular time.

Longer-term finance for equipment and other major items of capital expenditure can be made available through *ijara* or leasing, a recognised method of Islamic finance which is becoming increasingly popular with Islamic banks and their clients.[35] Under *ijara* finance the bank maintains

ownership of the equipment and the client pays an agreed rental on a monthly, quarterly or annual basis over a period of years, usually at least three and often five. Rentals are fixed in advance and the bank will normally expect to more than recoup its investment in the equipment over the period of the rental. At the end of the contract, the bank may sell the equipment as secondhand, either to the client using it or to a third party. Under another variant, *ijara-wa-iktina,* the client has the automatic right to acquire the equipment at the end of the contract at a price agreed when the original arrangement is made. This represents a form of hire purchase rather than a leasing arrangement.

More directly participative Islamic finance can be provided through *mudarabah* trust financing, in which the bank takes a direct stake in the shareholding of the company. The Islamic bank then acts as the *mudarab,* the managing trustee, and is regarded as a partner with the beneficial owner, the *rab-al-maal.* The *mudarab* should be regarded as more than a sleeping partner, because the bank acting in this capacity will expect to be consulted about all matters of financial policy, but the day-to-day running of the business will be left to the *rab-al-maal.* The *mudarab* can be viewed as a non-voting shareholder, but unlike the holders of preference shares, the bank has a veto over financial dealings which it regards as imprudent or unwise. In the event of the business failing, the *rab-al-maal* may be required to dispose of the business assets so that the *mudarab* receives some compensation which it pays to those whose funds it is using as trustee.

If a business wishes to have Islamic finance without unlimited liability it may prefer a *musharakah* arrangement whereby a new venture is formed between the Islamic bank that provides the funding and the business that seeks funding. Under this arrangement both parties share in the ownership of the new venture. If it fails, both parties lose, but the assets of the original company are not liable to be used to compensate the bank. From the bank's point of view *musharakah* investments are a greater risk, but the returns are also potentially higher, as any profits from the new venture will not be diluted by the obligations and costs of the existing business. Hence keeping the accounts of new ventures unconsolidated has powerful attractions, and it may be easier for the bank to sell its share in an unencumbered venture than to disinvest from a *mudarabah* arrangement.

Islamic banks are of course commercial in nature and not charitable agencies. Like other banks they aim to make profits for their shareholders, but in their case profits are arguably even more important as this determines the returns to those with savings and investment accounts. There is, however, provision for loans to be extended without any return to the bank through the Islamic principle of *Qard hasan,* lending which is not subject to either interest charges or profit-sharing. Rather than

foreclose on borrowers and then make costly provision for bad debts in order to correct the financial position of the bank, Islamic banks try to help directly those in difficulty. *Qard hasan* loans are only available to bank customers, funds being made available to those who have already had finance but are in business difficulties due to unforeseen circumstances such as ill health. Such loans are not intended to reduce business risk, as this might encourage unnecessary risk-taking. *Qard hasan* loans are designed to help those who face unanticipated personal or family hardship due to circumstances beyond the control of those involved.

ISLAMIC BANKING DEVELOPMENT

Financial dealings in compliance with the *shariah* law date back to the early centuries of Islam, but they involved traditional moneylending and moneychanging rather than commercial banking as it is understood today. As indicated in chapter 5, modern commercial banking was introduced into the Middle East from Europe during the nineteenth century. The methods involved *riba* transactions, however, with no allowance made for Muslim susceptibilities.

It was only in the 1960s that serious consideration was given to how modern commercial banking could be adapted so that *riba* could be avoided. When Ahmed El Naggar, an Egyptian doctoral student, was at university in Germany, he was impressed by the operation of mutual savings and loan associations. He thought that local savings banks could be organised in Egypt in a similar fashion, with savings being pooled and distributed to members in need of funds. If a group of Muslim savers could follow this practice, there would be no need for interest. Ahmed El Naggar on his return to Egypt opened and managed a small savings bank in 1963 in the town of Mitr Ghams in the Nile delta. The venture was very successful in harnessing funds from landowners and small traders who had hitherto not used banks because they were devout Muslims who were concerned about any dealings involving *riba*. Within three years more than 60,000 Muslims had deposits with the bank.[36]

The Egyptian government was unhappy about the new Islamic bank, especially some of Nasser's more leftist ministers who were suspicious of all Islamic institutions. The senior staff of the major state-owned banks and the Central Bank of Egypt were also unhappy, especially the latter because they could not monitor the bank's activities. Rather than close down the bank, however, and risking widespread discontent, the decision was made to nationalise the bank. There was much delay and debate over this, but eventually in 1972 the Egyptian government injected £E1.4 million (more than $2 million at the exchange rate then existing) and effectively bought the bank. The institution was renamed the Nassar Social Bank,

which survives today. But it was not encouraged to become a major financial force in the countryside as Ahmed El Naggar had envisaged. He in fact left the bank as a result of these developments, eventually becoming the chairman of the Association of Islamic Banks.

The major move forward for Islamic banking came in the Gulf in the 1970s. In these countries there had always been support from the merchants for the principles of Islamic financing, and many businessmen refused to use conventional commercial banks. Until the 1973–4 quadrupling in oil prices these merchants lacked the resources to found any type of bank, but with the oil boom new opportunities opened up. The Dubai Islamic Bank was founded in 1975 by a group of merchants, followed by the Kuwait Finance House in 1977, the Bahrain Islamic Bank in 1979 and the Qatar Islamic Bank in 1982.[37] All these banks have proved very successful in attracting depositors and in harnessing funds from those who hitherto had not used banking services. The Kuwait Finance House accounted for almost 20 per cent of all bank deposits in the country by the late 1980s, and although the business was disrupted by the Iraqi invasion, it has since recovered remarkably. It has purchased business and commercial property on behalf of its clients, who have then entered Islamic leasing and hire-purchase contracts. It also offers transaction services to current account holders, including the use of cash dispensers.

The oil price rises also enabled Saudi Arabian businessmen to establish Islamic banking networks throughout the Muslim world. Amongst the most notable of these was Prince Mohammed bin Faisal, who established the Faisal Islamic Banks in Egypt and the Sudan, both in 1977.[38] He also established the Geneva-based Dar-al-Maal al-Islami to recycle Gulf funds Islamically into western markets, with a particular emphasis on mark-up financing involving exports to Muslim countries. The Al Baraka Investment Company, which is the Islamic banking affiliate of Sheikh Hassan Kamel's Dallah Group, a leading Saudi Arabian trading company, has pursued a similar strategy, with branches in London, Bahrain, Tunis, Istanbul and even the Central Asian states and China. It helped the initial financing of the Jordan Islamic Bank, although this is now independent. The Al Rajhi group, which started as a moneychanging business to serve pilgrims to Mecca, has now become an international Islamic investment company with offices in London and Zurich.

On the other side of the Gulf Islamic banking was to develop rather differently. Following the Islamic revolution in 1979, legislation was passed making it compulsory for all banks operating in Iran to conduct their business according to the *shariah* law.[39] This took effect in 1983, and since then all retail banking in Iran has been on an interest-free basis, although discount rates are used for transactions with the central bank, and in foreign deals with infidels or unbelievers interest is still permitted. Even before the Islamic revolution there were 'charity trusts' in Iran associated with the

mosques which carried out some banking functions, including the provision of interest-free loans. These provided essential financial services to ordinary people and small merchants who did not deal with banks, and in some respects were similar to the Mitr Ghams savings bank in Egypt.

ISLAMIC TAXATION

Islamic economics not only provides a framework for private financing through a banking system free from *riba,* it also sets out the rules for public finance through taxation. The most important Islamic tax is *zakat,* a tax based on wealth, which is paid annually at a rate of one-fortieth of the value of personal or business liquid assets.[40] Property and equipment are excluded, but cash holdings and financial assets, including shares in quoted companies, are subject to the tax at the standard rate of 2.5 per cent. The payment of the tax is viewed as a religious duty, and in such circumstances there is little evasion, as this would be regarded as immoral.

Governments are usually responsible for *zakat* collection, although in the case of Iran before the Islamic revolution it was the *mullahs* and others who worked for the mosques. When the state is involved, however, it cannot treat *zakat* as general fiscal revenue, as *zakat* is regarded as a form of alms-giving for worthy causes. This limits the government's discretion and means the tax cannot be used as an instrument of fiscal policy. It is often administered by a special Ministry of Religious Affairs, with revenue earmarked for transfer payments to the poor and needy. It is, for example, permissible to use *zakat* expenditure for health care or education for the poor, but not for military expenditure or even infrastructure work. It tends to be used for recurrent spending to meet immediate needs rather than for long-term investment.

In much of the Middle East the tax base is limited, partly reflecting low incomes, apart from in the Gulf states and Libya, but also as a result of difficulty in the collection of direct taxes. Petroleum revenues and import duties are the major source of government finance. There is no income tax in the Gulf states, where *zakat* represents the major form of personal taxation. In those non-oil states which do impose income tax, most is collected from the government's own employees. The value of *zakat* is that it widens the tax base, with even the less-well-off and those who are highly critical of governments willing to make voluntary contributions.

ISLAMIC INSURANCE

Entrepreneurial activity involves taking risks, and in developing countries, such as those of the Middle East, an aversion to risk is often cited as a reason for business stagnation. Commercial risks cannot be covered by insurance,

but risks associated with transport and distribution can, and this represents the major form of insurance business in the Middle East. Life and endowment insurance is not regarded as legitimate, because life is in the hands of Allah, and if a householding income-earner meets an untimely death, it is the duty of the *ummah,* the community of believers, to provide for the family. In closely knit societies there is less need for institutionalised help, given the strong tribal and kinship support mechanisms.

Islamic law stipulates that gambling *(qimar)* is forbidden, and all types of speculative activity are regarded as gambling.[41] Forward and futures dealing is prohibited in much of the Islamic world because although such markets can be used for risk avoidance, there is always the temptation to speculate; indeed, speculative funds to a large extent provide the liquidity for hedging activity. Risk-sharing is advocated by Islamic economists rather than risk-seeking, and *murabahah* and *musharakah* are regarded as appropriate instruments for this purpose. Mutual insurance is seen as preferable to insurance through publicly quoted companies who profit from the misfortunes of others.[42] Mutual insurance funds established by the *ummah* are referred to as *takafol* companies. Unlike conventional insurance companies, *takafol* undertakings are not involved in *riba* transactions, as they avoid holding long-term bonds but may hold equities. Dar-al-Maal al-Islami has a *takafol* insurance subsidiary, as do the Faisal Islamic Banks of Egypt and the Sudan.

AN ISLAMIC FUTURE?

Overall it is evident how Islamic economic teaching provides a comprehensive set of principles governing commerce, banking, public finance and even insurance. Many Muslims see an Islamic economic system as an alternative to capitalism, socialism and communism. It is undoubtedly too early to judge the economic success or failure of the Islamic Republic of Iran. A significant proportion of the younger generation in the Middle East are looking to it as a model for development. Just how it evolves in the coming years deserves to be studied carefully by development economists, but care is needed in the choice of criteria for evaluation. For this some knowledge of the fundamentals of Islamic economics would certainty seem indispensable.

7

OIL AND DEVELOPMENT

For the last sixty years oil has been of major significance for the economies of the Middle East. The region has almost one-half of the world's oil reserves and around one-quarter of global supplies of natural gas.[1] Middle East oil has been a periodic preoccupation for western governments and business, especially during the dramatic 1973–4 and 1979 oil price rises, as these had a major impact on the world economy. Within the region itself, oil production has accounted for a substantial proportion of national product and been the major source of government finance. The earnings generated from oil have not only contributed to development funding in the oil-exporting states but have also flowed into the non-oil economies through inter-government assistance, remittances and, to a lesser extent, private investment flows.

Oil and gas exports are likely to remain crucial for the economies of the Middle East for the foreseeable future, in spite of the price reductions since the mid-1980s. The price of oil has had a major impact on past development trends, and the region's economic prospects cannot be assessed without some predictions of future price changes. The determinants of oil prices are therefore of vital interest as far as Middle East development is concerned. Much of this chapter is concerned with this issue, and in particular the role of the Organisation of Petroleum-Exporting Countries (OPEC) in oil price determination. Oil, however, is more than a mere exportable commodity. It is also a resource on which an industrial strategy can be based. This issue is also addressed here, in particular the development of energy-intensive manufacturing using hitherto-flared gas, and the production of petrochemicals and other oil derivatives.

THE COSTS OF OIL EXTRACTION

The Gulf, Libya and Algeria are the lowest-cost areas of the world for oil extraction, at below $7 per barrel compared with twice that amount for oil from Alaska or the North Sea. Conditions for oil extraction are extremely favourable in the Middle East, with large fields, deposits easily exploited, a

climate conducive to year-round operations and oil of fair to high quality. When oil was first discovered it was near the surface and under pressure. As a result, when a bore hole was drilled the oil surged out in a geyser. For the oil companies the task was largely to harness the well-head supplies and arrange for transportation of the crude to their refineries in the oil-consuming countries.

As the most-accessible oil has been extracted, it has become necessary to invest more to harness the oil reserves. Extraction in recent years has involved increasing the oil pressure underground artificially to ensure that it flows up to the surface. The oil in the Gulf, Libya and Algeria is largely extracted by this means, the pressure being increased by the release and compression of associated gas underground, or by water injection, including the use of sea water on coastal and offshore fields. This of course adds to costs, but the technology is well-tried and tested and the operations are almost routine.

The calculation of what should be included in costs is far from straightforward in the oil industry. As a result, any estimation of price on the basis of cost of production plus mark-up for profits and royalties is more complex than at first appears. The initial investment costs are very high for oil development. Once, however, the fixed costs have been incurred, they can be virtually written off. This ignores the issue of the return on investment in plant and equipment. Nevertheless, where oil producers are price-takers and prices are too low to cover fixed costs, the choice may be between closing down production completely or maintaining output as long as variable costs are covered.

Economists are always concerned with marginal cost rather than total cost or average cost. What exactly is meant by marginal cost in the oil industry? Just what additional production to include is somewhat uncertain. The cost of oil extraction varies according to the level of production from a particular field, reflecting increasing variable costs as diminishing returns set in. The cost of production also varies from field to field, the smaller and deeper outlying fields usually being more expensive to exploit than large, shallow fields on or near which oil production operations are usually centred. Should the marginal cost refer to the cost of additional production from the central field or the marginal cost of oil output from the peripheral field? There is usually much cost overlap between fields, and a considerable array of choice about where to produce the marginal barrel.[2]

QUALITY, PRICE AND DEMAND

Light oil requires less refining than heavy oil and therefore usually commands a higher price. Most Middle Eastern oil is of light to medium quality, Libyan oil being especially light. This means it should and usually does command a price premium over rival produce. Transport costs distort the picture, however,

oil from North Africa destined for Europe being naturally cheaper than oil from the Gulf.[3] The latter has either to be shipped around the Cape of Good Hope in Southern Africa en route to Europe or sent through the Suez Canal or Sumed, the Suez Mediterranean pipeline, shipments through which are subject to transit fees levied by the Egyptian government. The quality advantage may therefore be offset by a transportation disadvantage, oil from the Gulf commanding a price premium because of its quality but a discount at the point of shipment in the Gulf, reflecting the cost of onward conveyance. In the early 1990s, for example, Arabian light oil from Dubai was selling at $3 to $4 per barrel cheaper than Forties and Brent oil from Britain's North Sea fields.

The demand for oil, as for any other commodity, depends on the price quoted. Oil is a normal good in the sense that at higher prices less is demanded and at lower prices demand increases. The final consumer, however, demands oil not for its own sake but as a fuel for transportation or as energy for heating or cooling. Hence the demand is derived from the demand for and use of other products, which are to a considerable degree oil-dependent. If the price of oil rises quite substantially, as in 1973–4, the need for transportation and heating does not suddenly diminish. The increased price of the oil simply gets passed on to the final consumer, and the demand for oil is maintained. In other words, in the short run the demand for oil is inelastic with respect to price, with little response even to large price rises.

In the longer term, if the price rises are maintained the demand response will be much more elastic, partly as a result of fuel and energy consumption savings, but also as a consequence of the substitution of other sources of energy for oil. As far as transportation is concerned the main savings have come through greater fuel efficiency, because there are no satisfactory substitutes for petrol- or diesel-powered vehicles, slow advances in battery technology limiting the potential of electric cars and vans. For aircraft there is no substitute for oil products, but modern jets have fewer yet more powerful and fuel-efficient engines, and consume less than half the fuel per passenger-mile than aircraft of twenty years ago.

For electric power generation there are several viable alternatives to oil; gas, coal and nuclear energy being the main contenders. Renewable energy sources are the most attractive alternative, but only hydroelectricity has been developed on a significant scale, the experimental projects with tide and wind power accounting for only a minute proportion of global electricity generation. Nuclear energy seems to have the most promising future, despite concerns about the environmental risks and the problems of disposing of spent fuels and decommissioning older facilities. France gets four-fifths of its electricity from nuclear stations, but the proportion of electricity from nuclear generation is minimal in most developing

countries, including the newly industrialising nations. A higher proportion of Middle Eastern oil and gas may go to these countries in the future, partly as a result of their industrialisation but also because at least some of the advanced industrialised countries will turn increasingly to nuclear energy.

The oil price rises of the 1970s resulted in a reappraisal of energy policy by the major oil-consuming countries. The increase in the demand for oil slowed down in the United States and Japan during the 1980s, and in Germany and France the demand for oil actually fell. This was partly a result of technological advances, but was also due to higher oil consumption taxes and the closure of oil-powered electricity-generation facilities. The question of how far tax policy was responsible for energy conservation was much debated, but it seems clear that least has been achieved in the United States, where fuel taxes remain low. In the early 1990s the United States still accounted for almost one-quarter of world oil consumption, compared to a 17.5 per cent share for the European Union and 7.9 per cent for Japan. The fastest increase in oil consumption in the 1980s was by China, with a rise of almost one-third as a result of its industrialisation drive. China is now the fourth largest oil-consuming nation in the world, and exports from the Middle East flow increasingly eastwards rather than westwards.

For the oil-exporting countries of the Middle East a major concern is whether the demand for oil will increase in the future with rising gross domestic product worldwide. In other words, what is the income elasticity of demand for oil? For countries such as France and Germany it is already negative, rising income being associated with falls in the demand for oil imports. For the United States and the United Kingdom the income elasticity is positive but less than one. Hence with rising gross domestic product, more oil is being consumed, but proportionately less over time.[4]

It is only in the newly industrialising countries such as China that the income elasticity of demand for oil is positive and greater than one. How long this will be sustained is far from certain as China moves into a different phase of its industrialisation, with lighter, less energy-using consumer-orientated production. In some of the more mature Asian 'tiger' countries such as Singapore oil imports are already starting to level out, though there is less sign of this in Taiwan and Korea, two of the more mature economies that are still classified as newly industrialising countries.

THE POLITICS OF OIL SUPPLY

Oil production in the Middle East has not merely been a matter of geology or exploiting the lowest-cost field. Where exploration is carried out and what fields are developed has been influenced as much by political as by economic factors. Until the late 1960s oil production and exports from the

region to a large extent reflected the major western oil companies' need to juggle the demands of the different governments in the Middle East, all of whom wanted to see more oil produced in their territories so that they could obtain more revenue. The oil companies were also concerned with the political stability of the regimes in the oil-exporting countries, the reliability of supply, the probability of the nationalisation of oil company facilities, demands over royalty levels and pressures to employ and train local nationals. Since then, what gets produced where and exported has depended on political and economic muscle within OPEC which effectively determines country quotas.

Iran was the first country in the Middle East in which oil was exploited with trial production starting in 1903 and a major discovery in 1908.[5] Under Reza Shah the country was politically stable, and the oil concession agreement which was signed with D'Arcy in 1901 on very favourable terms was to run until 1994.[6] The Anglo-Persian Oil Company, which later became British Petroleum, was founded in 1909. Oil was not discovered in Iraq until 1927, but by that time Persian production was well established, and a slow growth of demand, reflecting the fragile state of the international economy at the time, meant Iraqi oil exploitation was limited in these early years.

Which oil fields were developed also reflected rivalries in Middle Eastern interests between the major western powers. Britain, through the Anglo-Iranian Oil Company, had a virtual monopoly of exploration in Iran, so the United States had little choice but to look to Saudi Arabia on the other side of the Gulf, the one area that had not come under European imperial influences. In the 1930s the oil fields of the eastern province were opened up, and the Arabian American Oil Company (ARAMCO) was formed by a consortium of leading United States oil companies.[7] It was ARAMCO that developed the Ghawar and Safaniya fields in the Dhahran area which were to prove to be the largest and most productive in the entire world. ARAMCO continues to account for most Saudi Arabian oil production and exports, though it was nationalised in the 1970s and the role of the American associate companies is now confined to specialist support and marketing.

There was enormous resistance to attempts to take over the oil concessions awarded to western multinational oil companies. Conflicts between the oil companies and host-country governments over revenues date back to the 1920s and 1930s when oil started to be exploited in significant quantities, but it was the Iranian government which was the first to demand control of production. After Dr Musaddiq consolidated his power as prime minister in 1952 he set up the National Iran Oil Company, a state-owned entity, to take control of Iran's oil from the Anglo-Iranian Oil Company.[8] This provoked a two-year boycott of purchases of Iranian oil by the major western oil companies. Purchases were only started

again when Musaddiq was overthrown and terms were agreed which were satisfactory from the point of view of the oil companies.

Meanwhile the Anglo-Iranian Oil Company had changed its name to British Petroleum. It was to concentrate on developing the oil fields of the Emirates on the Arab side of the Gulf, where the rulers were much more co-operative. It was this new orientation and the co-operation with Shell, the Anglo-Dutch company, which were to result in the major developments in Kuwait, Qatar and Abu Dhabi, and eventually Oman. The increasing significance of the Arab Emirates as oil suppliers was not so much a reflection of the quality of their oil or relative cost factors, rather what mattered was the political environment and the security of oil supplies. Iran, and subsequently Iraq, had their exploration and production curtailed because of their political intransigence. The beneficiaries were the Arabian Peninsula states that had their oil fields developed and exploited to a greater extent than might otherwise have been the case on the basis of geological decisions alone.

OPEC CONTROL OVER SUPPLIES

It was the inability of the oil-exporting countries to control and manage their own resources that prompted the formation of OPEC. The events surrounding Musaddiq in Iran had highlighted the conflict of interests between the western oil companies and at least some of the oil-exporting countries of the Middle East over export volumes, prices and oil revenue. In these circumstances the more militant oil-exporting countries felt that some countervailing force was needed to take on the western oil companies and redress the balance in the oil market. When British Petroleum led a reduction in Middle East oil prices in 1959 and broke the link with United States prices, this prompted much adverse reaction from the governments of the region. It was to be the trigger for the establishment of OPEC, following a conference in Baghdad in 1960 hosted by the new revolutionary government of Iraq. The five founding members comprised Iran, Saudi Arabia, Kuwait, Iraq and the major non-Middle Eastern exporting nation in the developing world, Venezuela. Subsequently a further eight countries were to join, four Arab nations—Algeria, Libya, the UAE and Qatar—and four non-Arab countries—Indonesia, Nigeria, Gabon and Ecuador.[9]

OPEC enjoyed little success in raising oil prices during the 1960s, largely because the United States could still supply most of its own needs and the western oil companies were the dominant players in the international oil industry.[10] They had the exploration and production expertise and, as vertically integrated multinational companies, also controlled the transportation, refining, distribution and even ultimate retail sale of petroleum and oil products. The United States multinationals acquired most

Saudi Arabian output through their participation in ARAMCO, and Shell and British Petroleum accounted for much of the production in the increasingly important fields of the smaller Gulf states.

By the late 1960s, however, the balance of economic power was starting to change, and the western multinationals, the so-called 'seven sisters', Exxon, Mobil, Texaco, Socal, Gulf, Shell and BP, were starting to feel threatened. First was the fact that United States production was declining, and the country was moving from being the world's largest producer to its largest importer. Second, there was the increasing importance of independent European state oil companies such as Agip of Italy and Elf and Total of France. They wanted to break the oligopoly of the 'seven sisters' by purchasing supplies directly from state companies in the producing countries such as the National Iranian Oil Company.

Third, the knowledge of how to manage and maintain oil production facilities was becoming more widespread, and the technical advantage of the 'seven sisters' was steadily eroded. Technological transfers to the OPEC states had occurred, and countries such as Iran could increasingly handle all operations themselves. For highly specialised tasks they could hire in independent engineers and consultants, who were becoming less and less concerned about what the major oil companies thought of their involvement. Fourth, and perhaps most crucial at the time, was the revolution in Libya and the seizure of power by Muammar Qadhafi in 1969.[11] The new Libyan regime took a much more aggressive stance towards the oil companies, and indicated its willingness to use oil as a political weapon against the West in the context of the Arab-Israeli dispute.[12]

OPEC AS THE PRICE-MAKER

The zenith of OPEC's power was in the mid-1970s, when it appeared to be in a position to dictate world prices of petroleum. The events that brought this about are clear enough, but there is much disagreement over what the crucial factors were that enabled OPEC to make the running in the international oil market rather than the western oil companies, as had hitherto been the case. The Arab-Israeli War of October 1973 was the catalyst for change, as the Arab members of OPEC organised a boycott of oil supplies to the United States and the Netherlands in the aftermath of the conflict.[13] Oil was to be used for the first time as a political weapon to punish the West for its alleged support for Israel. The United States was singled out as the chief ally and backer of Israel, and the Netherlands was selected for its pro-Israel sympathies which had their origin in the revulsion against the Nazi persecution of Dutch Jews back in the 1940s.[14] The Netherlands was not itself a major market for oil, but of much greater

significance was its refining capacity. Rotterdam was the major refining centre for Europe, petroleum products being sent up the Rhine to the German industrial heartland.

The boycott was ineffective as the major oil companies simply switched supply and provided oil to both the United States and the Netherlands from non-Arab sources. The Gulf states wanted to distance themselves in any case from the hawks in the Arab League, and had already formed OAPEC, the Organisation of Arab Petroleum-Exporting Countries, in anticipation of such a confrontation with the West over Israel.[15] Interestingly OAPEC included not only Saudi Arabia and Kuwait, but also Libya. The non-Arab members of OPEC, including Iran, were less concerned about the issue of Israel; indeed, under the Shah, Iran was Israel's major oil supplier. The boycott, however, resulted in considerable panic amongst western buyers, and both spot and contract prices were driven up from under $3 to over $11 per barrel. Iran and Venezuela were keen to take advantage of the situation by raising the price of their oil rather than supplying extra to meet any shortfall. Therefore there was solidarity within OPEC over the new level of pricing, even though the non-Arab members did not participate in the boycott.

OPEC became very aware of the advantages of acting collectively as a result of the events of 1973–4. The actions of one member influenced the decisions of others, even when the regimes the oil ministers represented varied enormously in political complexion, from revolutionary republics such as Libya to conservative monarchies such as the Shah's Iran or Saudi Arabia. Thus when countries such as Libya and Algeria sought to get control of their own oil production through the nationalisation of foreign oil company assets, Saudi Arabia, Kuwait and Abu Dhabi were prompted to follow their example, even though there was no ideological basis for state ownership as far as the Gulf states were concerned.

The extent to which the change of ownership of oil resources was crucial for the oil price rises of 1973–4 has been much debated.[16] Ownership of course gave the producing countries control over supplies, as hitherto the oil companies could vary the amount they extracted from their concessions to suit market conditions. Their interest was in maintaining continuity of supplies and keeping prices stable and reasonably low. The western oil companies earned more from refining and distribution than from production, and therefore from their point of view low prices were good for business because they encouraged oil use and expanded the long-term market for oil. Variable prices could result in users questioning the security of supply, and higher prices would deter consumption in the long run, even allowing for the short-run price inelasticity of demand. The ownership of oil resources by the western companies meant output could be expanded when conditions were buoyant and be reduced in times of recession. As a result production variations served as automatic price stabilisers.

Once the producing countries owned their own resources, they could exploit market tightness to raise prices. Whether the same result would have occurred without the transfer of ownership is by no means clear. The objectives of the oil-exporting countries were, of course, different to those of the western oil companies. However, the exploration operations of the oil companies have always been regulated by concession agreements, and licensing could have been extended to cover production levels without a transfer in the asset ownership. The nationalisation, nevertheless, meant that production levels could be varied on a month-to-month, or even day-to-day basis, subject to the dictates of government. This strengthened the hands of individual oil ministers in their OPEC negotiations, and there was little doubt that it was this more than any other factor that prompted the transfer of the oil industry into state ownership in the otherwise conservative oil-exporting countries of the Arabian Peninsula.

OPEC AS A CARTEL

As the members of OPEC act collectively in announcing price and production targets the organisation is often described as a cartel. With a cartel arrangement individual producers maintain their ownership of resources, unlike a monopoly where ownership is pooled. There are different types of cartel, depending on the objectives of the members and their willingness to share their resources. An extreme case occurs where production is based on the lowest-cost supplier within the cartel in order to maximise revenue. The cartel members then share in the revenue, including the higher-cost suppliers who may not actually produce any oil during the period in question. Such a revenue-sharing cartel maximises the profits for its members over time, but it implies a high degree of trust between members.

Suppose, for example, that Kuwait was the lowest-cost producer in OPEC, and it exploited all its oil and shared the profits with other members of the cartel. When its oil reserves were exhausted, oil production would shift to higher-cost OPEC states such as Iraq or Iran, which would be expected in turn to share their earnings. The problem for Kuwait could be that when it came to its turn to receive oil revenues, the other countries might refuse to share. Kuwait, with its oil exhausted, would be in a highly vulnerable position. It is for this reason that OPEC has never been a profit-sharing cartel, despite the enormous potential benefits from exploiting the lowest-cost fields fully. Instead OPEC producers all contribute to the output of the cartel, even high-cost producers. The profit that members obtain is then derived from their own sales, with no revenue-sharing.

In the 1970s many viewed OPEC as a price-fixing cartel, with the differentials between the members set at levels which were expected to

guarantee sales of crude oil for each member of the cartel. This interpretation of OPEC's operation is, however, an extremely contentious point in the literature. If the price-fixing interpretation is accepted, the implication is that the Arabian Peninsula producers' prices were set sufficiently below Libyan levels to allow for the additional transportation costs and the extra refining of the somewhat heavier crude oil. There was no attempt to impose explicit production quotas for each member of OPEC or even the cartel as a whole. By setting price differentials implicit production targets were set both for OPEC and its members, but there was no obligation to keep production at particular levels. Every barrel of oil which was demanded could be sold at the stipulated price without restraint. The only obligation was to maintain the price at the agreed level, and for members not to act unilaterally and cut prices before the next OPEC meeting. All price changes were to be agreed multilaterally within OPEC, with no discounting permitted which might undermine the interests of the other members.

A market-sharing cartel is the main alternative to a price-fixing system. OPEC started a market-sharing arrangement in the 1980s with an overall production target agreed for the cartel, and shares explicitly apportioned amongst the members. The production target was set so that the overall supply of oil to the market could be restrained in order to maintain prices in a specified range. The obligation for each member was to adhere to its production quota, but it was free to obtain as high a price as it could for its oil. Such an arrangement implied the need to monitor oil flows by OPEC. This task proved far from easy, and in practice there was always the temptation for members to cheat. This was one of the factors that arguably brought about the dramatic oil price decline in 1985.

It can be argued that OPEC would not have worked had Saudi Arabia not been able to function as a swing producer. It was because it had the ability to vary its production level from 4 million barrels a day to over 12 million barrels a day that OPEC had the market power to influence prices.[17] Often it did not need to exercise its market power: the mere threat was enough to influence expectations amongst oil traders. When Sheikh Yamani was at the height of his influence as Saudi Arabia's oil minister in the 1970s, the press used eagerly to report his comments at OPEC meetings, and this news could influence prices. By the 1980s, however, Saudi Arabia needed to maintain its oil production at a higher level, two factors being the requirement to maintain output of associated gas and to provide feedstock for its petrochemical industry, although the extent of this physical constraint should not be exaggerated. Arguably of greater significance were the Kingdom's increasing current revenue needs, which grew even more substantially after the Gulf War and the resultant defence spending pressures.

By the late 1980s there were also strategic and political considerations. By maintaining oil output at a high level, prices were held in check. This curtailed Saddam Hussein's military spending as Iraq's ability to ship oil was limited, given its war with Iran, and the subsequent pressures within OPEC, especially from the Gulf states. At moderate prices Saudi Arabia still had plenty of revenues for its own defence spending, given a production level four times that of Iraq before the Gulf War. Since sanctions were imposed on Iraqi sales, the imbalance has increased, with Saudi Arabia and later liberated Kuwait more than making up the shortfall in supplies.

LIMIT PRICING WITH OPEC AS THE RESIDUAL SUPPLIER

The price that OPEC set as a price-fixing cartel or aimed to achieve as a market-sharing cartel was influenced by the behaviour of non-OPEC suppliers of oil. One result of the 1973–4 price rises was to encourage the development of oil fields well away from the Middle East. The resistance to the development of Alaska's oil on environmental grounds was less effective because United States strategic interests overrode such considerations. The higher oil prices made the development of offshore oil fields in difficult climatic conditions such as the North Sea viable. As a consequence the share of OPEC in world exports fell from over 87 per cent in 1973 to 62 per cent by 1983 after the second oil price shock. OPEC was increasingly forced to play the role of residual supplier, if not exactly marginalised.

The cartel would have been able to continue to play a more significant role if Mexico had joined: its oil production was becoming increasingly important in the late 1970s. There was strong pressures from the United States for Mexico not to join, and given the importance of its northern neighbour as an export market and source of investment funding, it was hardly surprising that these pressures succeeded. Mexico's status in OPEC remained that of an observer. Ecuador, the only Latin American member of OPEC apart from Venezuela, in fact left the organisation in 1993, the first member to quit.

In figure 7.1 simple demand and supply analysis is used to depict the position of OPEC as a residual supplier of oil. The left-hand diagram shows the global demand schedule for oil and non-OPEC supply. At price P_0 the entire world demand for oil can be satisfied by non-OPEC suppliers such as Mexico, Alaska, Russia and the United Kingdom. Below price P_0 there is a supply shortfall as at these prices the more costly non-OPEC fields will not be economically worthwhile to exploit. It is this gap that OPEC as a residual supplier can meet. This is depicted in the right-hand

diagram. The lower the price, the more it will supply, as shown by the amount *X* corresponding to price P_x compared to the larger amount *Y* at the lower price P_y. P_o represents the ultimate limit price for OPEC, because if the price is above this level it will sell no oil. Note that the demand schedule for OPEC oil is flatter than for non-OPEC oil. In other words below P_o, as the price of oil falls, there is a greater responsiveness in the demand for OPEC oil. The price elasticity of demand for OPEC oil is greater than for non-OPEC oil.

OPTIMAL DEPLETION AND TIME PREFERENCES

Oil, like other extractive resources, is not renewable. As oil is extracted it contributes to national income or gross domestic product, but there is a sense in which its depletion reduces national wealth. Oil production involves the transformation of a physical resource into either paper assets or manufactured products. The former may be squandered by politicians, the latter will be subject to depreciation, even when the oil revenues are used for long-term development purposes such as the building of infrastructure. Roads and bridges deteriorate over time, and the more infrastructure that is built, the more repair and replacement which will be needed.

Yet leaving the oil in the ground also has its problems. Resources may be conserved for future generations, but by then technical advance may result in better alternatives being used. In the long run there may be no demand for oil and reserves will be worthless. This has already happened in the case of coal. In the 1920s and 1930s there was much concern about what would happen when world coal reserves were exhausted. Yet sixty years later demand has steadily fallen, and there are enough reserves left to meet current production levels for the next 250 years. It seems that most of the world's reserves of coal will never be mined.

In the case of the Middle East oil-exporting countries, levels of reserves vary considerably. Saudi Arabia has sufficient oil for over eighty years of production at current levels, whereas Algeria has only twenty years of production remaining, and Egypt, which is not a member of OPEC, a mere thirteen years' supply. There are clearly different concerns over pricing and extraction given such differences in reserve levels. Saudi Arabia is not merely concerned with maximising revenue in the short term, but well into the next century. High prices may encourage energy saving, the development of oil substitutes and the opening up of non-OPEC fields. In the long run there may be no market for Saudi Arabian oil if OPEC pursues a high pricing strategy. This is one reason why Saudi Arabia tends to argue for price moderation in OPEC, and adopts a stance which suits the short-term interests of the consuming countries.

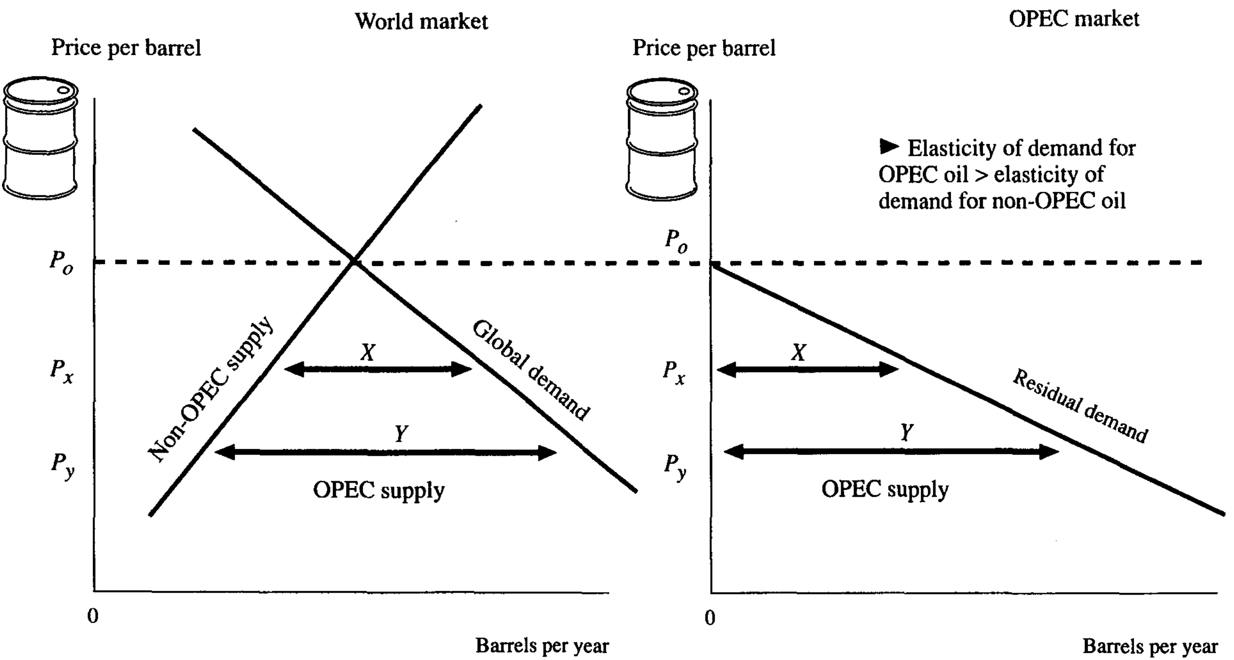


Figure 7.1 OPEC's role in the energy market

Considerations about how much oil to extract are of course influenced by revenue needs. The Arabian Peninsula countries with their relatively small populations and modern infrastructures have much more limited government spending and import needs than countries such as Iran and Iraq, with much larger populations and run-down infrastructure facilities which have been partly destroyed through wars. From their point of view the ideal scenario in OPEC would be for Saudi Arabia and the small Arab Gulf states to hold down production, both to boost prices and to allow them to export more to maximise immediate revenue. From the Saudi Arabian point of view this is unacceptable, as it would mean possible short-term revenue losses and certain long-term revenue reductions. The tension between Iraq and Kuwait over the amount of oil each country should produce and OPEC quotas was a contributory factor to the Gulf War.

Optimum depletion theory suggests that user costs should be added to marginal cost when calculating oil prices.[18] The concept of user cost was first defined by Harold Hotelling as the cost of using a resource today and forgoing tomorrow's profit. In other words, future profits may have to be discounted to calculate user cost, and this figure built into any current oil price calculation. The concept is that of a temporal opportunity cost, the sacrifice of the future for the sake of the present. How great the sacrifice is will clearly depend on the size of a country's reserves. In Saudi Arabia's case with plentiful reserves, oil depleted now will mean little sacrifice of future income.[19] For Algeria or Iran the future sacrifice may be much greater because their reserves are less.

It is the user cost that matters, however, and this depends not only on the relative size of the future income forgone, but the rate at which this is discounted. This in turn will reflect time preferences for current versus future income. Saudi Arabia may put a higher value on future oil income and a lower value on current income than may Iraq or Iran. This suggests that the rate of discount may be lower for Saudi Arabia than for Algeria or Iran. Hence the higher future sacrifice for the latter countries may not be worth much when discounted at a high rate into present user costs. For Saudi Arabia the lower future sacrifice may be partly offset by the lower discount rate. In other words, the calculation of user cost is far from unambiguous if differences in time preferences are also involved. Pricing to provide for optimal depletion is a much more complex matter than Hotelling suggested as far as the Middle East is concerned.

PREDICTED AND ACTUAL OIL PRICES

Past predictions of future oil prices have often proved remarkably inaccurate and this has made oil revenue projections virtually impossible in the Middle East. The oil price rises of 1973–4 and 1979 were not predicted, and are

usually described as exogenous shocks to the economic system. However, the oil price falls since the mid-1980s were widely predicted, perhaps giving some hope to the forecasters.[20] The Iraqi invasion of Kuwait was thought of as a possible catalyst for a third oil price shock but, perhaps thanks to operation 'Desert Storm', this proved not to be the case as far as the West was concerned.

Exhaustible resource models have now been abandoned by many energy economists, and the pricing of oil is increasingly treated just like any other commodity. The basic problem is that the predictions of exhaustible resource theory concerning steadily rising prices for scarce resources appears to be at variance with the realities of the 1980s and 1990s. As oil becomes depleted its price might be expected to rise, reflecting increasing scarcity, but for the last decade the price has fallen consistently in real terms and even in money terms the fall has been substantial. From a high of almost $36 a barrel in 1980 for Arabian light crude, the price has slipped back to under $17 a barrel. As figure 7.2 shows, the Iraqi invasion of Kuwait had only a very modest and short-lived effect. Oil specialists as ever are divided over where prices are heading, but most predict prices in the range of $15–$25 per barrel by the turn of the century.

Allowing for inflation, by the 1990s the oil-exporting countries of the Middle East were more or less back where they were before the oil price shocks of 1973–4. The dollar, in which oil prices are denominated, had itself depreciated against the German mark and the Japanese yen, the currencies in which a substantial part of the civilian imports into the Middle East are denominated. In terms of purchasing power, or the cost of obtaining manufactured goods, the economies of the Middle East which are oil-dependent appear to have experienced a continuous deterioration, with the two brief exceptions of the oil price shocks.

Two factors explain the failure of resource exhaustion theory to explain oil price trends. First is the simple fact that oil is not becoming exhausted. In 1973 there were thirty years of proven reserves worldwide. By 1992 there were over forty years of reserves. The increase in reserves partly reflected pricing developments, as the oil price rises of the 1970s encouraged oil exploration. It also reflected technical change, particularly in the exploitation of oil in inhospitable environments and the efficient utilisation of oil from small offshore fields. Second there was the levelling out in the demand for oil in the mature industrial economies already discussed. Increasing efficiency of energy use and the development of substitutes for oil raise questions about its long-term future as a fuel.

SPOT, FUTURE AND OPTIONS OIL PRICING

Oil is increasingly viewed as just another commodity whose price should be treated accordingly. The fact that it does not seem to be an especially scarce

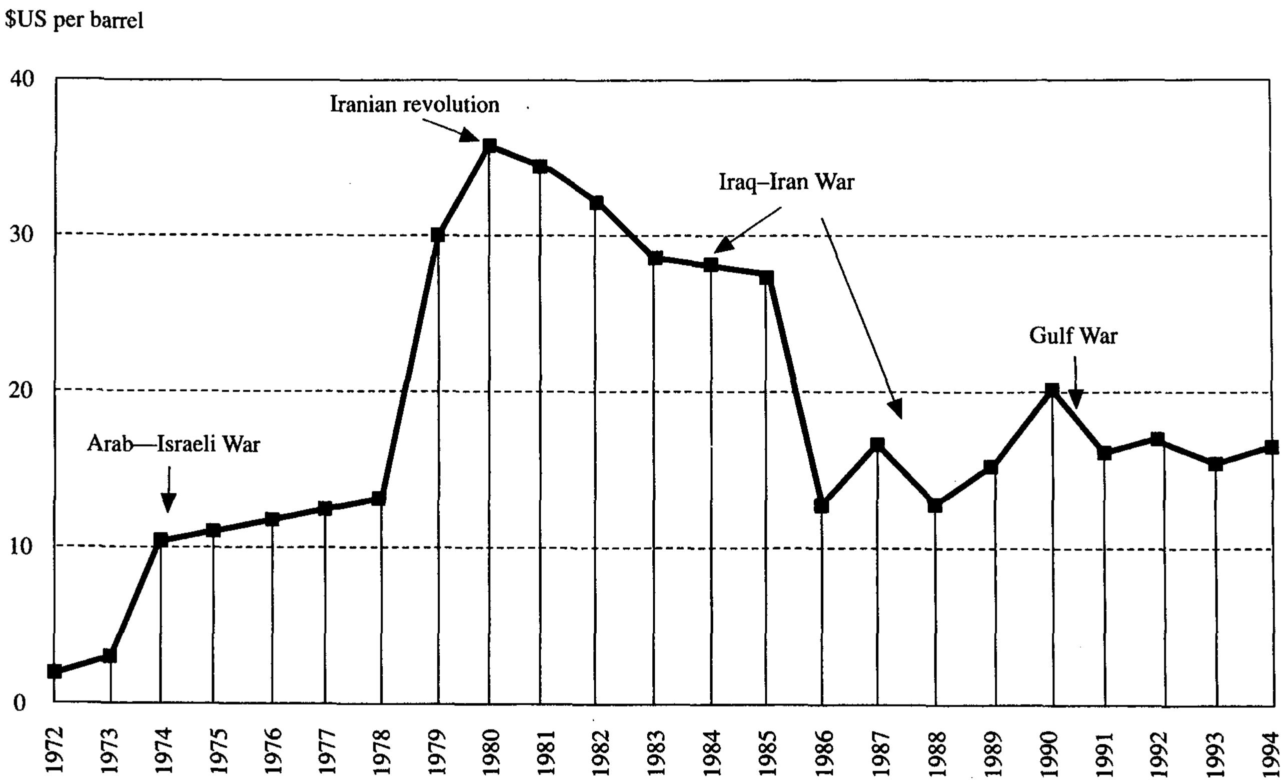


Figure 7.2 Spot oil prices (Arabian light *ex* Dubai)
Source: British Petroleum, *Statistical Review of World Energy*

or precious resource means that it has lost something of its mystique. Any notion of oil as 'liquid gold' seems to have disappeared. Oil substitutes may be slow to develop, especially in the field of transportation, but western consuming nations take an increasingly relaxed view of supplies. One consequence is that there is less concern over long-term contracts and security of supplies.[21] There has been a steady growth in the so-called Rotterdam spot market for oil, which is not physically sited in that Dutch city but is simply the term used for oil and product deals covering north-western Europe.

Long-term contracts, which were much favoured by the major refinery operators in the turbulent 1970s, are less necessary in the 1990s given the greater oil price stability. There has in any case been a growth in other hedging instruments, notably futures and options, which means that risk can be reduced without having to resort to the inflexibility of fixed contracts. As London is the major centre for financial derivatives in Europe it is not surprising that dealings in such futures and options contracts have been largely concentrated on the city's International Petroleum Exchange. There is similar trading on NYMEX in North America, but this is of less interest from the point of view of Middle East producers, as much of the American trading relates to oil from Alaska and Venezuela.

An oil future is simply an agreement to purchase or sell oil at a predetermined date in the future, often one or three months hence, at a price agreed now. It differs from an oil contract, which usually provides for regular deliveries over a period of time rather than a once-only future transaction. With either type of deal, the parties are tied into a fixed price or prices, which may be advantageous to the buyer in the case of a rise in prices for immediate delivery, referred to as spot prices, as mentioned above. If the spot price is falling, the oil purchaser may regret entering the contract deal or purchasing forward, because it is obligatory to pay the initial price agreed, even where this implies an opportunity cost. The loss can be regarded as an opportunity rather than an actual cost, as it refers to what might have been, or in other words, the value of what was given up in order to secure certainty. Both oil contracts and oil futures can be regarded as hedges against risk.

One way of maintaining greater flexibility in oil dealing is by using the options market. Options are a financial derivative that confer the right to buy or sell, but unlike contracts or futures, it is not obligatory to carry out the transaction. Oil contracts and futures can be sold on to third parties, and this releases the original purchaser or seller from the obligation, though in the end someone will have to take delivery of or supply the oil. To a large extent, of course, contract and futures prices will reflect expectations about how spot prices will change. If spot prices decline when they were expected to rise, or decline by more than

anticipated, then expectations will be revised. This may have a considerable impact on the value of futures.

Suppose, for example, a future for 1 December delivery was bought for $20 per barrel in October when the oil spot price was $21. By November the spot price has declined to $18 per barrel and it is expected to remain at this level until the end of the year. In these circumstances the holder of the $20 future will face the choice of either using it to purchase oil at an expected $2 per dollars above the December spot price, or of attempting to sell the future and use the cheaper spot market. The latter course of action is likely to be especially unattractive because, given expectations in the market, buyers for the future may be only willing to pay $17.

Oil options represent an attractive means of avoiding being trapped in such loss-making situations. Rather than being a potential victim of adverse market developments, the buyer or seller has a choice of whether to proceed or not to the final transaction. The essential difference with an option is that it does not have to be exercised, unlike a future which implies a pre-determined commitment. A right to buy at a fixed price is referred to as a ‘call’ option, and a right to sell a ‘put’ option. In practice in the oil market options are usually taken out with respect to future rather than spot transactions, largely because they are the type of specialised dealing product which appeals to those who are already familiar with financial derivatives.

To see how options on futures work, it is best to cite an actual example. Suppose it is 1 July and a refinery owner wants to purchase 400,000 barrels of crude oil for delivery on 1 October. The oil can either be purchased through a future contract, at a guaranteed price of $18 per barrel, or the refinery owner can wait until October and purchase in the spot market at an unknown price. The future brings certainty, but for an initial outlay of $7,200,000 ($18 × 400,000). Using the spot market is clearly risky, but some of the risk can be hedged by the use of options. This involves a much smaller initial outlay as the cost of a call option is only 50 cents per barrel. If the buyer decides to purchase ‘call’ options on 400,000 barrels of oil futures for delivery on 1 October the initial cost is only $200,000. (Note, this is an option to buy a future.)

By 15 September the price of the future for 1 October delivery has risen to $20, reflecting a rise in the spot oil price. The purchaser decides to exercise the call option and buy at $18. Simultaneously the purchaser sells the future for $20, a gain of $2 per barrel on 400,000 barrels, or $800,000. This can be offset against any higher cost of the spot acquisition on 1 October. If by then the spot oil price had risen to $19, the refiner would have to pay $7,600,000, which is $400,000 more than the cost of the future in July. The refiner could offset this however by his $800,000 gain on the option, minus the initial cost of the option, an overall positive

balance of \$200,000 (– \$400,000 + \$800,000 – \$200,000 = \$200,000). To purchase the future the refiner would have had to sacrifice bank deposit interest or incur lending costs, so the attraction of options is evident. Even if the spot oil price in October had risen to \$20, options may still have been preferable to futures when these interest rate considerations are taken into account.

The increase in dealing through futures and options has major implications for the market in Middle Eastern oil. Oil contracts have declined in relative significance, and attention has become increasingly focused on spot oil prices. With greater use of financial derivatives such as futures and options as hedges, the insurance premium which contracts once enjoyed has been competed away. As a result bilateral bargaining between individual OPEC suppliers and oil purchasers has become less important. The power of price determination is becoming more remote from Middle Eastern producers with spot prices of Arabian and Dubai light determined by demand and supply in the Rotterdam market rather than the Gulf. The volume of spot transactions exceeds that of future transactions and options, but these are catching up quickly. Spot oil prices still determine future and option prices, but the situation may well be reversed eventually, given the enormous potential for dealings in these derivatives.

OIL PRODUCTS AND REFINING

The growth of financial derivatives in oil such as futures and options has tended to have a stabilising effect on oil prices, even though the markets are used for speculation as well as hedging. This increased certainty is welcome to OPEC members, but it was to some extent the oil price shocks that gave OPEC its power. Oil prices reacted much less to the Iraqi invasion of Kuwait than they did to the Iranian revolution or the Arab-Israeli war of 1973. These developments, together with the poor outlook which crude oil has in common with other primary commodities, are encouraging Middle Eastern producers to move away from exporting crude oil into refined petroleum and further downstream products. This increases local value added for the oil-producing country, brings technology transfer, creates some employment and raises export earnings. It can be viewed as part of an economic diversification strategy, designed to reduce reliance on primary production and introduce manufacturing, even if it is still closely oil-related.

These potential benefits must be qualified, however, and there are several offsetting factors. One major difficulty for Middle Eastern suppliers is the increased logistical problems in the transportation of refined products which adds to costs and potentially reduces profitability. Oil refineries were situated historically near the markets for petroleum products rather than at the source of crude oil supply on grounds of cost. It is cheaper and easier

to ship crude oil than a variety of refined products all of which have to be handled separately. Crude oil can be pumped through pipelines over thousands of miles, but although this is technically feasible for refined products, it is not economically viable. Many refined products are more volatile and flammable than crude oil, and the safety measures involved in the transportation are both complex and costly.

The employment generated by investment in refineries is very limited, given the capital-intensive nature of the technology. With even further automation in the control systems in recent years, it is now possible for fewer than a hundred workers to run a refinery with a throughput of 250,000 barrels a day. In the Gulf the refineries are amongst the most modern and high-tech facilities in the world, requiring largely skilled staff.[22] Most day-to-day running is increasingly handled by local nationals, although migrant workers from the Indian sub-continent and other Arab countries still constitute a majority of the workforce in the Saudi Arabian refineries, but not in Kuwait or Bahrain. When major problems or the servicing of complicated equipment arise, expatriates are called in on a short-term basis. Most of these are employed in the companies which supply the equipment, and are not a permanent part of the host-country workforce.

Investment in complex refinery operations brings with it technology transfers, and there has been much skill acquisition by local nationals in the Gulf in the field of petroleum technology. Although technicians from the United States, Europe and Japan are still best at handling certain specialised operations, it is possible to foresee a time when a future oil trouble-shooter such as 'Red' Adair will be a Kuwaiti, Saudi Arabian or Iranian national. Personnel in the Kuwait Oil Company learnt much from the experience of putting out oil-well fires after the Iraqi retreat from their country. All this is positive, especially as it appears that even disastrous conflicts can have some favourable spin-offs.

On the negative side is the isolation of industries such as refining from the rest of the economies in Middle Eastern states. Virtually all equipment is imported, and even the consumables used in the production processes are supplied from abroad. Local multipliers are therefore minimal, and in foreign-exchange terms the cost of imported supplies has to be offset against any gains in terms of import savings with refined products or export earnings. Most refineries were geared largely to the local refined products market until the 1970s, and it is only since the 1980s that export refineries have been established in the region.

Saudi Arabia has the largest capacity in the Middle East of 1.8 million barrels a day, followed by Kuwait with a refined throughput of 820,000 barrels per day. With the merger of ARAMCO, the Arabian American Oil Company, and the Saudi Arabian refining company SAMAREC, ARAMCO has become the major international oil company, in the same league as Exxon and Shell.[23] The company is the world's number three refiner, and

can increasingly out-compete the major western oil companies. Iran would like to pursue a similar strategy, but its refining capacity is only 720,000 barrels a day, much of which serves the domestic market.

DOWNSTREAM DIVERSIFICATION INTO PETROCHEMICALS

The move by the Gulf states into petrochemical production, which started in the 1970s, was a much bolder step than mere refining. Products such as ethylene and methanol are building blocks on which whole downstream industries can be based, including all types of plastics from low-grade bags to high-quality materials for vehicle bumpers and similar consumer-durable items. Plastics have increasingly been substituted for traditional metal and wooden products, and the petrochemical and plastics industry has become of greater international significance than the steel industry in terms of the value of output. The other major petrochemical product in the Gulf states is urea which is used for fertiliser production. The South and South East Asian market can be easily served from the Gulf, and this is where most of the exports are sent.

The region's comparative advantage in petrochemicals derives from the readily available oil feedstock which minimises transportation costs, and the presence of cheap energy, both in the form of electricity produced by oil- and gas-fired stations and gas itself. As gas is produced as a by-product of oil production, it makes sound economic .sense to harness the associated gas which would otherwise be wastefully flared off as an energy source.

As petrochemical technology is highly complex the states in the Gulf decided to develop the industry through joint-venture arrangements with western and East Asian companies that had the necessary expertise, rather than attempt to go it alone.[24] This policy had many advantages, not least that foreign joint-venture partners had an interest in securing value for money from the stage when contracts for the construction of the facilities were being awarded. Their participation also ensured that the output was up to international standards in terms of quality, especially as the foreign joint-venture partners were to be purchasers of the output themselves, and had further responsibilities for marketing to third parties.

The Saudi Arabian Basic Industries Corporation has responsibility for petrochemical development in the Kingdom, with most of its facilities located at Jubail on the Gulf. It has separate joint ventures with Shell, Mobil and Exxon for ethane production, and ventures with Mitsubishi, Celanese and Texas Eastern for methane. Its urea venture is with the Taiwan Fertiliser Company. The Jubail site has become the largest single petrochemical complex in the world, and Saudi Arabia already accounts for 10 per cent of world petrochemical exports. In the course of the 1990s a $6 billion

expansion scheme is being undertaken to double capacity from 10 million tonnes a year.[25] Investment is going ahead in a plant to manufacture acrilonitrile, the nylon intermediate. This may result in further downstream diversification into artificial fibres for textiles.[26]

As a result of all these schemes, it is envisaged that the Gulf will move from being a major supplier of crude oil into high-value-added petrochemicals, and eventually further downstream into consumer goods inputs, if not the final products themselves. Although the strategy was not well thought out in the early years and costly mistakes were made, after more than two decades of effort it has started to take on a momentum of its own. In the 1970s there was little market research undertaken, but this has since become a priority for SABIC when considering any new venture. Other states are diversifying as well as Saudi Arabia, including Bahrain, which has a urea fertiliser plant, and Oman, which has a methanol plant. In the United Arab Emirates there is a small fertiliser plant outside Abu Dhabi. In the longer term Saudi Arabia's main rival in Gulf petrochemicals will be Iran. Though the war with Iraq severely disrupted its programme, production of methane and ethylene plants has recommenced, with an estimated annual output of 4.3 million tonnes and a further 1.2 million tonnes of chemical fertiliser.

OIL AND DEVELOPMENT

The role of oil in the economies of the Middle East has changed over time and it is possible to identify stages in its development. Initially the main benefit was financial because, although revenues were modest from the 1930s to the 1960s, these met most of the expenditure needs of the royal households in the Gulf and funded the major proportion of government current spending. As oil production expanded in the 1960s revenues grew, and the quadrupling of oil prices in 1973–4 resulted in a huge windfall. This could be interpreted as the second stage. Oil revenue was viewed primarily as a means of funding investment rather than merely current expenditures, though for some of the Gulf states the revenue was so great that it was possible to put some aside into 'funds for future generations'. As Middle East production stagnated and declined in many countries, the link between oil prices and development became of crucial importance. This was clear from the infrastructure boom resulting from the 1979 oil price rises, and the virtual halt to major investment projects following the price falls of the 1980s.

A third phase has now started in which the volume of exports and the price of crude oil is becoming of less significance for the economies of the region. Oil is less important as an output but more crucial as an input. It is the marketing of refined products and petrochemicals which matters

increasingly, not the sales of crude oil. In these circumstances pricing issues become more complex. Low domestic pricing of oil inputs can help the international competitiveness of the Middle Eastern refining and petrochemicals industry, especially during the entry, start-up and infant-industry phases. In the longer term Middle Eastern crude oil may not be internationally traded, instead it is oil products exports which will matter. In this situation OPEC's declining significance as a cartel is less damaging to the economies of the Middle East than might otherwise have been the case. Diversification into downstream production means that it matters much less that oil prices are behaving like those of other primary commodities, with cyclical volatility and a long-term tendency to decline. The economies of the Middle East may still be oil-dependent, but the nature of this dependence is changing from output to input dependence. This has the merit of being more controllable.

Some of the issues which were prominent in the literature on the oil and development link are arguably now less relevant in a period of lower oil prices. There was a long debate in the 1970s and 1980s about whether oil windfalls were a blessing or a curse. One argument for the latter view was the notion that oil-dependent economies tended to suffer from 'Dutch disease', so called because of the effect of gas exports from the Netherlands in driving up the guilder, making manufacturing exports uncompetitive and imports cheaper, with resultant adverse consequences for unemployment. Although this argument is at first sight persuasive, and there was certainty evidence in its support in the Netherlands and arguably in Britain, its relevance to the Middle East is open to question.

The countries of the Gulf had little local manufacturing capacity in the 1970s which could have been threatened, and the shortage of labour was more of an issue than unemployment. Oil exports were in any case denominated in dollars, as were most imports, so the level of the exchange rate was of relatively minor importance for trade. A strong exchange rate checked inflationary pressures, and any depreciation would only have resulted in imported inflation which would have added to that generated domestically through supply bottlenecks.

For countries such as Egypt, with manufacturing capacity and non-oil exports such as cotton and textiles, Dutch disease was more likely, especially as oil became increasingly the dominant export after the return of the Suez fields by Israel, and there was also the indirect effect of Gulf oil exports on the exchange rate through remittances. Investigation by economists, notably Bent Hansen (who was referred to in Chapter 1), revealed little empirical support for Dutch disease in Egypt. Cotton and textiles were mostly exported to Eastern Europe under bilateral trade deals that had administered rather than market prices. Imports were subject to tariffs, quotas, foreign exchange controls and other restrictions. The official exchange rate was itself-controlled, although admittedly at a high, and possibly overvalued,

level in the 1970s. It is doubtful, however, if a lower rate would have done much to boost exports, given the supply constraints in the Egyptian economy.

Oil revenues were probably of more consequence at the political economy level, as they reinforced the role of the state by increasing both its power of patronage and its ability to control economic activity. There was less need to collect other forms of tax revenues because of the significance of oil revenues, and also perhaps less government accountability. All countries in the Gulf adopted some form of development planning, simply in order to determine their expenditure priorities and ascertain how spending plans interacted. The consultation when planning the expenditure of oil revenues only extended to the government ministries, however, and not to the general public. Furthermore, governments frequently ignored their own development plans if circumstances changed, either through new defence and security concerns or because of the changing price of oil.

These issues will be considered further in the final chapter, on the role of the state. The other developmental problem, that of export earnings stability resulting from excessive oil dependence, will be considered in the next chapter, on trading issues.

8

INTERNATIONAL AND INTRA-REGIONAL TRADE

The Middle East has always been a cross-roads for international commerce due to its geographical position between the more populated regions of Europe, South Asia and East Asia. Rather than being a barrier to trade, the deserts of the region have been like oceans, crossed by important trade routes such as that across the Sahara to Nigeria, over the arid lands of central Asia to China or through the Persian Empire to the cities of the Indian sub-continent. The spread of Islam and the Arab conquests served to develop intra-regional trade, as did the spread of the Ottoman Empire in the sixteenth century. Initially the great European powers were to view the region as strategically important for transit trade with the East, a process that would result in the construction of the Suez Canal and its opening in 1869. By the twentieth century, with the discovery of oil the European countries saw the region as an important trading entity in its own right, whose resources were vital for modern industry and commerce.

It is possible to classify the trading history of the region into three distinct phases, which could well be repeated, as history often is. Each phase brought demographic and economic change. First, during periods when the region was economically insignificant the emphasis was on transit trade through re-exporting. Second, there were periods of strong intra-regional trade, which were associated not only with conquest but also the rise of sufficient economic power to serve the needs of the peoples of the region. Some view such phases as times of economic harmony and contentment, as in the early centuries of Islam and during the heyday of the Ottoman Empire. Third, there were periods of external colonisation, both direct and indirect, when the resources of the Middle East were seen as the property of the international community rather than belonging to those who inhabited the region itself. These resources could be exploited either by peaceful trading relationships or, if necessary, through force if regional resistance or obstructions arose.

The era of direct colonialism came to an end in the 1950s and early 1960s with the withdrawal of Britain and France from the region. Many, including Islamists as well as secularist socialists and Marxists, argue that

the era of neo-colonialism has been prolonged by the region's significance as a source of global oil reserves. This era is arguably now also coming to a close, partly due to the end of the Cold War and the reduction in the global commitment of the United States, but also because there is less dependence by the West on Middle East oil supplies. It remains to be seen, however, whether strong intra-regional trading links will again emerge to propel the economies of the Middle East forward, or whether the region will simply be bypassed by world trade between more dynamic neighbouring areas, a forgotten and neglected backwater, apart from some centres for transit trade.

TRADE AND DEVELOPMENT

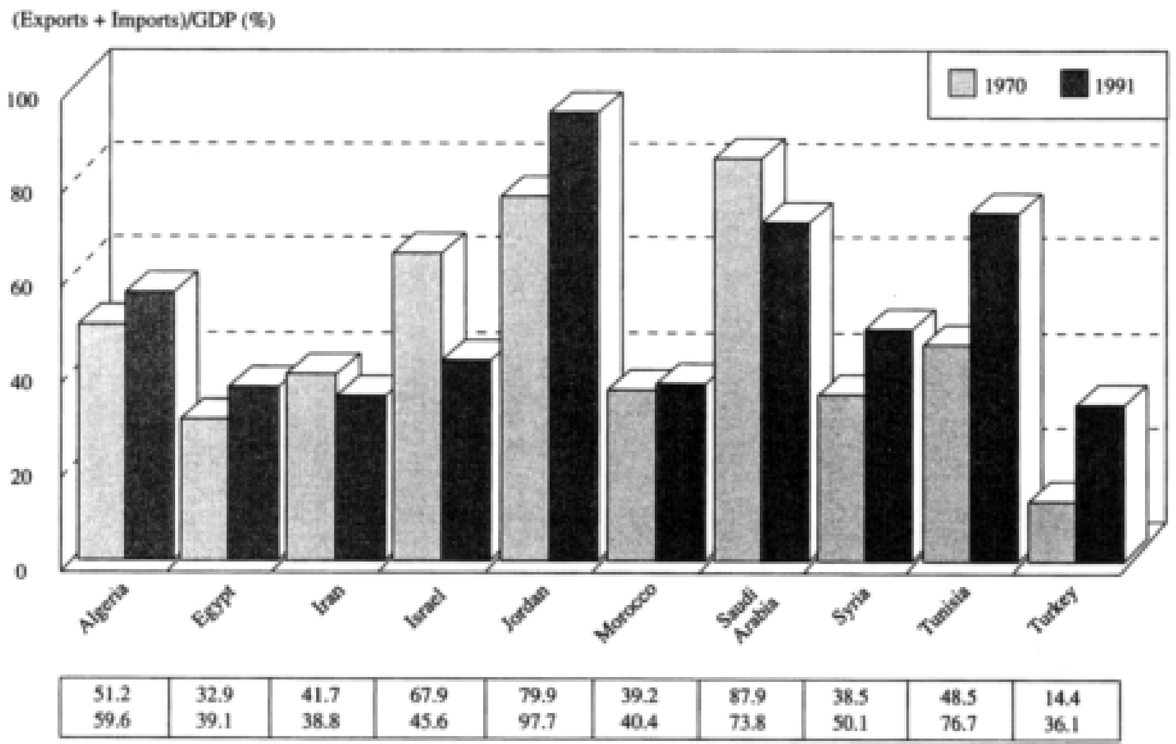
The relationship between the extent of international trade and economic advance has been discussed by western economists since the time of Adam Smith, and Islamic economists such as Ibn Khaldun were also well aware of the issues involved. The notion that specialisation within nations and exchange between nations can bring economic gains is the essence of the theory of absolute advantage, which is the starting point of most modern literature on international trade. David Ricardo's theory of comparative advantage is arguably more relevant to the Middle East than Smith's theory of absolute advantage. The former shows how countries with an absolute disadvantage in all lines of producticin in relation to other countries can still gain from specialising in producing and selling those items in which they themselves are most efficient. In other words, even if Middle Eastern production is less efficient generally than that of the Far East, there may be some items such as petrochemicals or even cotton yarn in which the region is relatively efficient. Far Eastern exporters of vehicles and electrical goods will not have a market in the Middle East unless they accept some goods in exchange. Oil and gas are the major items offered at present, but other commodities on which trade can be based will have to be identified in the longer term if commercial relations are to continue.

For trade in primary commodities such as oil and gas, the so-called 'vent for a surplus' theory may have more relevance than absolute or comparative advantage.[1] The rationale is that countries with surplus natural resources, in excess of present and future conceivable national needs, might as well exploit the resources and export the surplus. In exchange the primary producing countries can obtain useful goods which they do not produce themselves, such as high-technology manufactured items, including possibly even weapons to defend their resources. With 'vent for a surplus' theory there is no opportunity cost in exporting the primary commodity, as nothing is given up. In contrast, the theories of absolute and comparative advantage imply specialisation in one line of production means sacrificing another

line. In the Middle East oil industry the capital and technology are imported, and often even the workforce consists of migrant labour. There are no local factors of production redeployed from other activities. Indeed, the growth of oil production has helped finance non-oil development rather than hindered it, although it would be an exaggeration to say that there have been no sacrifices.

In developing economies trade growth theories have particular relevance, notably the model developed by Harry Johnson that distinguishes between pro-trade-biased and anti-trade-biased growth.[2] Pro-trade-biased growth implies that a country is opening up to the world, exporting to exploit its 'vent for a surplus', or specialising according to its absolute or comparative advantage. In such circumstances the growth of trade will exceed the growth of gross domestic product. Such growth occurred throughout the nineteenth century as the economies of the Middle East became increasingly open to trade with Europe, involving the exchange of primary commodities for manufactured goods. As oil production and exports rose, growth could also be described as pro-trade-biased. Anti-trade-biased growth occurs when countries pursue import-substitution policies, producing manufactured goods themselves even when they are more expensive than competing imports, as economic diversification and industrialisation are seen as desirable goals, the key to modernisation and economic advance. Such policies were followed in Turkey under Atatürk in the 1920s and 1930s, in Egypt under Nasser in the 1950s and 1960s and in Syria under Assad during the 1970s and for much of the 1980s.

One simple measure of openness to trade is to add the value of exports and imports and divide the total by gross domestic product. If the ratio is increasing, countries could be described as opening up, but if it is decreasing, then their development is anti-trade-biased. In figure 8.1 these ratios have been calculated for a number of leading Middle Eastern economies, with a comparison made for two years, 1970 and 1991. It is apparent that openness to trade is partly a function of country size, a small economy such as Jordan being much more trade dependent than larger economies such as Egypt or Turkey. Oil economies such as Algeria or Saudi Arabia tend to be more open, given the opportunities they have to take advantage of 'vent for a surplus', and exchange oil and gas for manufactured goods. In some economies government policy-makers may be adopting policies to reduce trade dependence. This is apparent in the case of Iran, where trade as a percentage of gross domestic product has fallen because since the Islamic revolution there has been more stress on self-reliance. In Saudi Arabia the share of trade has also fallen, but this reflects the growth of the non-oil sector over the period. One notable area of growth has been the local construction industry, which could be classified as a non-tradable activity.



Algeria	Egypt	Iran	Israel	Jordan	Morocco	Saudi Arabia	Syria	Tunisia	Turkey
51.2	32.9	41.7	67.9	79.9	39.2	87.9	38.5	48.5	14.4
59.6	39.1	38.8	45.6	97.7	40.4	73.8	50.1	76.7	36.1

1970 figures above; 1991 figures below

Figure 8.1 Openness of major Middle Eastern economies
Source: World Bank, *World Tables*, 1994

The most surprising figures are those for Israel, where the ratio of exports and imports to gross domestic product has fallen from two-thirds to well below one-half. Does this reflect healthy economic diversification and increasing self-reliance, or is it merely that gross domestic product is more dependent on capital inflows, and that the trading sector is becoming an increasingly peripheral activity? There may be some truth in the latter, with capital inflows from the United States crowding out and damaging the real productive base of the economy. Normally as countries become more affluent their propensity to trade increases, as consumers demand more choice which includes imported goods. This is arguably happening in Turkey, Syria and perhaps even Egypt, at least amongst the middle classes and those with access to remittances. The oil trade, of course, distorts the figures, but this is less of a problem when taking 1970 as a base, before the major oil price rises, and 1991 as the year for comparison, after the substantial price falls.

PRO-TRADE AND ANTI-TRADE GROWTH

Harry Johnson's trade growth model makes a distinction between production growth and consumption growth. This distinction can be quite revealing when examining some of the difficulties which the Middle Eastern economies have experienced in their international trading relationships. Figure 8.2 provides a graphical representation of a single-economy model, with importables depicted on the vertical axis and exportables on the horizontal axis. Exportables are those goods which a country enjoys a comparative advantage in producing because of its favourable cost structures. Such goods are not necessarily exported, they can also be supplied competitively to the home market. Importables can only be produced for a home market which is protected by tariffs or other measures which constrain lower-cost competing imports. Such comparative 'disadvantage' goods may be exported, but subsidies will be needed as a result of their lack of competitiveness.

The figure shows two production possibility curves, *p'p'*, the initial curve *and p'p'*, the curve after economic growth has expanded production possibilities. The figure also shows two consumer indifference curves, *ii* being the initial curve, and *i'i'* the consumer welfare level attainable after economic growth. The initial production point is at *P* where the relative price line for importables and exportables is tangential to the production possibility curve *pp,* and the initial consumption point is at *C* where the same relative price line is tangential to the indifference curve *ii.* It is international trade that enables a country's consumers to enjoy welfare levels above those attainable on the domestic production possibility curve, as exports *x* are traded for imports *m.* Without trade, consumers could

Figure 8.2 A trade growth model

Notes
1 Consumption growth is pro-trade biased.
2 Production growth is anti-trade biased.
Source: World Bank, *World Tables,* 1994

only purchase what was available domestically, or in other words the point *C* would correspond with *P*.

After growth occurs production rises to *P*' and consumption rises to *C*'. The line joining *P* to *P*' represents the production growth path, and that joining *C* to *C*' represents the consumption growth path. The slope of the path represents the trade or anti-trade bias, which is determined by the shapes of the production possibility curves. If the production line is sloped at 45 degrees from *P*, then production growth is neutral, with exportables and importables expanding proportionally. If the production line is greater than 45 degrees, as tends to be the case in those Middle Eastern states pursuing protectionist import-substitution policies, then production growth is anti-trade-biased. Consumption growth is pro-trade-biased if more importables

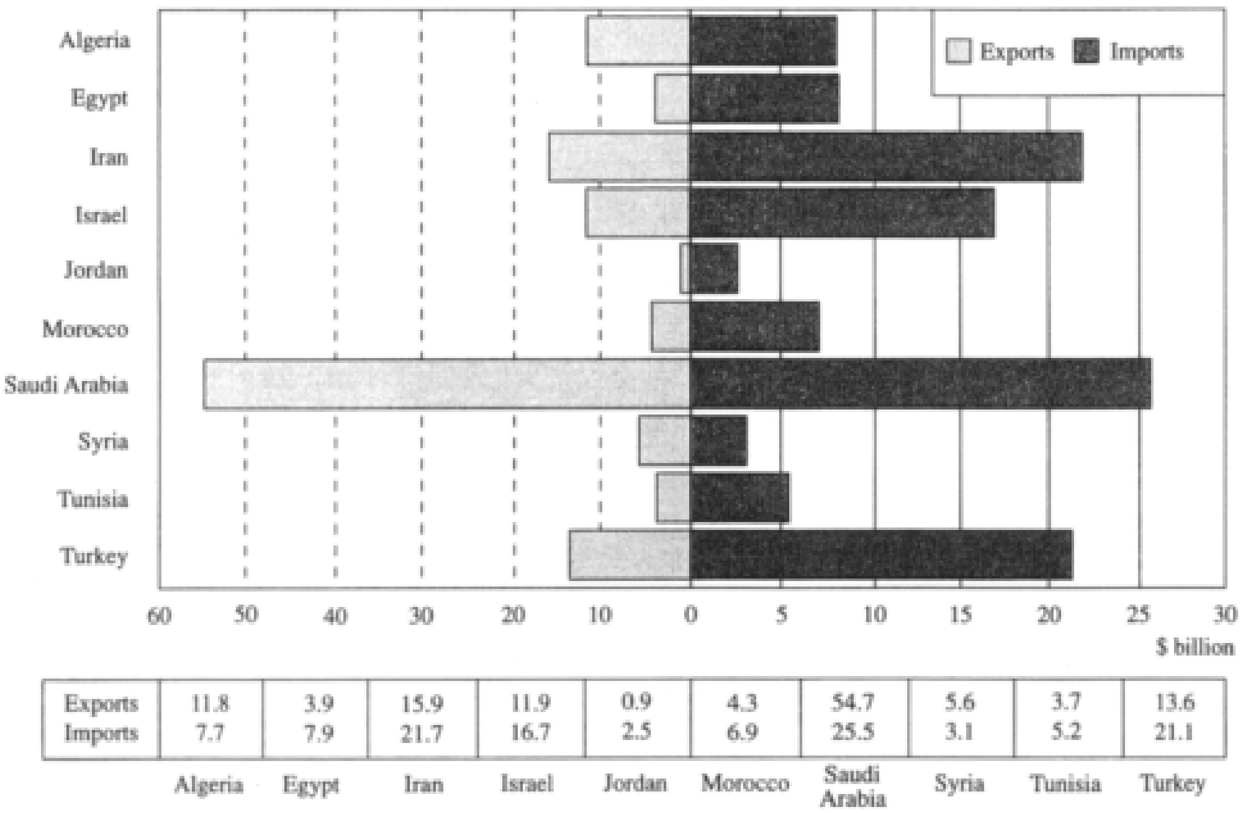
are consumed, the country's comparative disadvantage good. This is the case in the Middle East, with a preference for imports or import substitutes. It should be noted that the trade bias for consumption growth works in the opposite direction to the trade-bias for production growth. This means that the lines for the Middle East both slope in the same direction, though they are not necessarily parallel.

What are the implications of applying Johnson's trade-growth model to the Middle East? A bias towards importables seems plausible for both production and consumption growth. Imports, and the imported inputs to manufacture import substitutes, get sucked in, while exports are weak. The result is a poor and deteriorating trade balance, except in those states which are significant oil exporters. Although increasing economic openness is a feature of the majority of the economies, this is consumption- rather than production-led. This contrasts with the position in more economically successful regions of the world, such as East and South East Asia, where openness reflects export-led growth, and a pro-trade bias for production rather than consumption. More empirical evidence is needed to support these propositions, but Johnson's methodology is instructive in identifying what to look for.

TRADE DEFICIT PROBLEMS

The balance of trade constitutes only part of the balance of payments of a country, and capital inflows can often compensate for trade deficits. As financial inflows through aid and remittances have largely kept the non-oil economies in the Middle East afloat for over two decades, it is easy to be complacent about large and often mounting trade deficits. This has been the case, for example, with the Mubarak government in Egypt, where there is a widespread belief that the United States will come to the rescue, as it has in the past. Development assistance and past debt write-offs have a political price, however, which would not have to be paid if the trading accounts were in better shape. It seems unlikely in any case that such favourable external circumstances will continue to prevail in the future as remittances dry up and aid goes to the former communist countries rather than the Middle East. As a consequence more effort will have to be made to correct trade deficits, either by curtailing imports, which implies domestic hardship, or by export promotion, which will be a completely new experience for the states of the Middle East and a far from easy challenge.

Figure 8.3 shows the visible trade position for the major economies of the region in 1991. Saudi Arabia is by far the most important exporting state in the region, with its oil and petroleum product exports worth almost as much as those of all the other states combined. The scale on



	Algeria	Egypt	Iran	Israel	Jordan	Morocco	Saudi Arabia	Syria	Tunisia	Turkey
Exports	11.8	3.9	15.9	11.9	0.9	4.3	54.7	5.6	3.7	13.6
Imports	7.7	7.9	21.7	16.7	2.5	6.9	25.5	3.1	5.2	21.1

Figure 8.3 Visible trade of the major Middle Eastern economies
Source: World Bank, *World Development Report*, 1993

the left-hand side of the figure has been halved in relation to the right-hand side so that the differences between the other states are not dwarfed by Saudi Arabia's export earnings of $54.7 billion. Iran is the second most important exporting country in the Middle East, followed by Turkey and Israel, the latter two representing the major exporters of manufactured goods in the region. Only Saudi Arabia enjoys a substantial trade surplus, much of which has been wiped out in recent years by capital outflows, not least the payments to the western allies for their contributions to the Gulf War. Algeria also recorded a surplus, but this was required to service its huge debt of $26.5 billion. Egypt has a larger external debt of $37 billion, but its interest payments were a mere $580 million in 1991, with $1.2 billion of principal repaid. In contrast, strategically less-significant Algeria was forced to pay almost $2 billion in interest alone, with repayments of principal amounting to $7.7 billion.

Substantial trade deficits were recorded for Egypt, Iran, Israel, Jordan, Morocco, Tunisia and Turkey. In the case of Jordan, imports were almost three times greater than exports, and for Egypt imports were over twice as great as exports despite additional measures taken in 1988 and 1989 to curtail purchases of foreign goods. Egypt, however, is quite a small import market, especially in relation to its population size of almost 55 million. Israel imports over twice as much as Egypt, and Saudi Arabia, the largest Middle Eastern market, over three times the amount. In the years ahead Turkey seems likely to overtake Saudi Arabia as the major market, provided it can sustain its visible exports and its tourist industry is not damaged by Kurdish terrorist incidents.

The trade deficits of the states of the region are recurrent rather than cyclical, and it is clear that fundamental economic restructuring will be needed if they are to be significantly reduced, if not eliminated. There has been dialogue about restructuring and economic reform between the International Monetary Fund and many governments in the region for almost two decades, and numerous measures have been undertaken, particularly with respect to exchange rate policy. There has been much tampering, but there is firm resistance to having outsiders set the agenda with respect to basic economic policy, especially in industry or agriculture. Currency devaluation and depreciation have not served to diminish the import bias of consumption growth, as purchasers of imported goods do not appear to be very price-sensitive.

Similarly, on the export side, the responsiveness of foreign buyers to exchange rate falls has been disappointing. The price elasticity of demand for Middle Eastern non-oil exports appears to be rather low. Most Middle Eastern exports are dollar-denominated, so export prices do not fall with domestic currency depreciation. The International Monetary Fund advisors are fully aware of this, but point out that with falling domestic exchange rates, dollar export proceeds are worth more but supply costs remain fixed.

This increases the profitability of exporting, which should induce production expansion. Unfortunately, in the Middle East exporting price signals often fail to work, either because of supply inflexibility by public-sector industries or short-term profit-taking by those in the private sector. The challenge is to have export profits ploughed back into investment to bring about further export growth.

THE TERMS OF TRADE

The economies of the Middle East, like other regions of the Third World, have experienced considerable terms-of-trade problems, with export prices falling in relation to import prices. Such deterioration in the terms of trade tends to occur with exports of primary commodities in exchange for imports of manufactured goods. World demand for primary commodities often remains static, at least in the short term. If the supply is increased in such circumstances, the price inevitably falls. This is apparent in the case of Middle Eastern oil exports, as already discussed in the previous chapter, but it also applies to the region's exports of agricultural produce and minerals. The basic problem is the low income elasticity of demand for primary commodities in relation to manufactured goods. This phenomenon was first noted by the Prussian statistician Engels in the nineteenth century. Bismarck's Prussia was an efficient producer of grains, but when output rose prices tended to fall in relation to the prices of imported manufactured goods from England where the industrial revolution was well advanced. Bismarck's solution was a policy to promote domestic manufacturing, with tariffs and other protectionist measures to safeguard the domestic market for the new infant industries.

Similar policies were tried in Egypt in the nineteenth century by Mohammed Ali, who established a mechanised textile industry.[3] Britain, however, did not permit Mohammed Ali to apply tariffs to textile imports from England. It was felt that a rival spinning and weaving industry in Egypt could be a long-term threat to the Lancashire cotton textile industry which used imported Egyptian raw cotton. It may have been impossible to thwart Bismarck, but Mohammed Ali was in a much weaker position as he relied on British support to preserve Egypt's semi-independence from the Ottoman Empire. Egypt was therefore forced to abandon its efforts to industrialise and had to rely instead on raw cotton exports for its earnings. It was not until much later in the twentieth century that Egypt could start again, long after all the European countries had emerged as successful industrial powers.

The major evidence of long-term declining primary commodity prices for developing countries was compiled by an Argentinian economist, Raul Prebisch, largely on the basis of prices for Bolivian tin, Brazilian coffee

and Central American rubber.[4] Long-run price data for the Middle East are more sketchy, but Roger Owen has compiled a long-run price series for Egypt's raw cotton exports which shows falling prices over most of the 1880–1900 period, and again from 1910 onwards.[5] Egypt's cotton production was expanded with British help following the American Civil War and the abolition of slavery in the Confederate states. With cotton from the southern states becoming more expensive, given the labour-intensive nature of the harvesting, Egypt was regarded as a cheap and reliable substitute supply source for the mills of Lancashire. The port of Alexandria was developed and the railway to Aswan constructed. This was seen as the first stage of a major project to connect all the possessions of the British Empire in Africa from the Cape of Good Hope to Cairo. This project was never completed, but the Aswan railway was of major commercial significance for cotton exports.

Raw cotton is still an important Egyptian export, but the development of mechanised cotton-picking in the United States in the 1960s undermined Egypt's labour cost advantage. The introduction of man-made fibres also hurt producers, although the 1980s saw a swing in fashion back to natural fibres, which brought some benefit to Egypt. This story of competition from other countries and substitute materials also applied to other Middle Eastern primary commodities. The silk production developed by the French around Mount Lebanon in the nineteenth century supplied the industry in Lyon with fine raw material. The Lebanese Christians in particular benefited from this development, but competition from cheaper Far Eastern silk, mostly from China, made production in the Middle East uneconomic. The same problems arose for Turkish tobacco, which catered for a niche market while the major growing regions of the United States and Southern Africa achieved commercial dominance in global supplies. A similar picture emerged for Yemeni coffee, which lost out to Latin American producers, who developed large commercial estates. As a result Yemeni coffee became a novel rarity, whose taste is known to few outside the Arabian Peninsula.

Even more dramatic was the fate of the Gulf pearling industry. During the first two decades of the twentieth century the pearling industry in the Gulf expanded rapidly, divers obtaining rich natural pearls from the oyster beds off the island of Bahrain and the peninsula of Qatar.[6] The pearls were shipped by *dhow,* the traditional sailing vessels of the Gulf, to Bombay, where they were sorted and graded. They were then re-exported to Europe and North America, to be sold as jewellery. During the 1920s, when long strings of pearls were regarded as highly fashionable, output and sales boomed. The Gulf enjoyed a measure of prosperity—at least the *dhow* owners if not the divers themselves. In the 1930s the Japanese developed the cultured pearl, which was a much cheaper substitute being more consistent in quality than natural pearls. Oyster farming was not

feasible in the Gulf, as conditions did not compare with Japan's inland sea. With the great slump, buyers, in so far as they purchased pearls, bought the cheaper Japanese variety. The Gulf industry was virtually wiped out by 1935, a precedent that many of the older generation see as a warning for oil.

Those Middle East economies that are still dependent on primary product exports continue to experience terms-of-trade difficulties, as figure 8.4 shows. Oil is the dominant primary commodity, and its price has affected the terms of trade of both OPEC states such as Saudi Arabia and lesser non-OPEC oil exporters such as Egypt. The deterioration in the terms of trade of both these countries since 1981 is apparent from the figure. Similar trends have affected countries not shown, such as Iran, Algeria, Kuwait and the United Arab Emirates. In contrast those states with a more diversified range of exports such as Turkey and Israel have experienced more favourable terms of trade trends in recent years. Both these countries have also enjoyed greater terms-of-trade stability from year to year. This means increased certainty in the economic environment, which facilitates investment and helps to ensure smoother economic growth. From figure 8.4 it is apparent that the problem for Saudi Arabia and Egypt has been terms-of-trade instability, and not just the longer-term trends. The two major Middle Eastern producers and exporters of phosphates, Jordan and Morocco, have experienced similar difficulties, the price sometimes doubling from one year to the next, only to halve again in the following year.

Harry Johnson's trade growth model can be used to illustrate the terms-of-trade problems facing primary product exporters, including those in the Middle East. In figure 8.5 a country's production possibilities expand outward with growth from *pp* to *p'p'*. The position is similar to that illustrated in figure 8.2, but in this case the production growth is export biased, with the *p'p'* skewed towards the horizontal axis. As increasing exports may reflect 'vent for a surplus' rather than comparative advantage, the horizontal axis refers simply to exports and not to comparative advantage goods that may be consumed domestically. If the terms of trade remained constant with growth, as in figure 8.2, production would rise to *P'* and consumption to *C'*, which represents a higher welfare level than *C*.

When countries are significant suppliers to the international market, as is certainly the case with Saudi Arabian oil production and probably the case with Moroccan phosphates, rising output may result in falling export prices relative to imports. If this is the experience, in figure 8.5 the flatter dotted line may represent the new terms of trade, with production at *P"* and consumption at *C"*. As *C"* lies on a lower indifference curve than *C*, consumers are worse off than before the production increase occurred. This phenomenon is referred to as immiserising export growth, because rising exports bring welfare losses rather than gains.

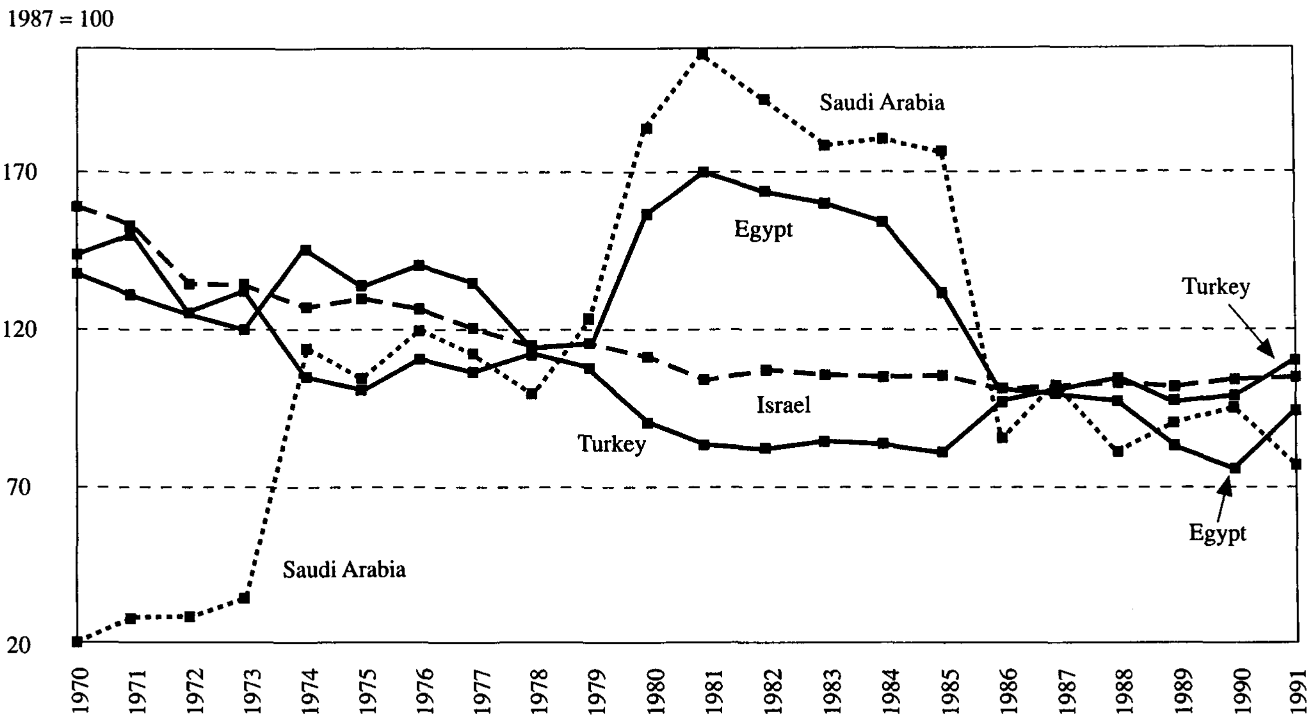


Figure 8.4 Terms of trade
Source: World Bank, *World Tables*, 1993

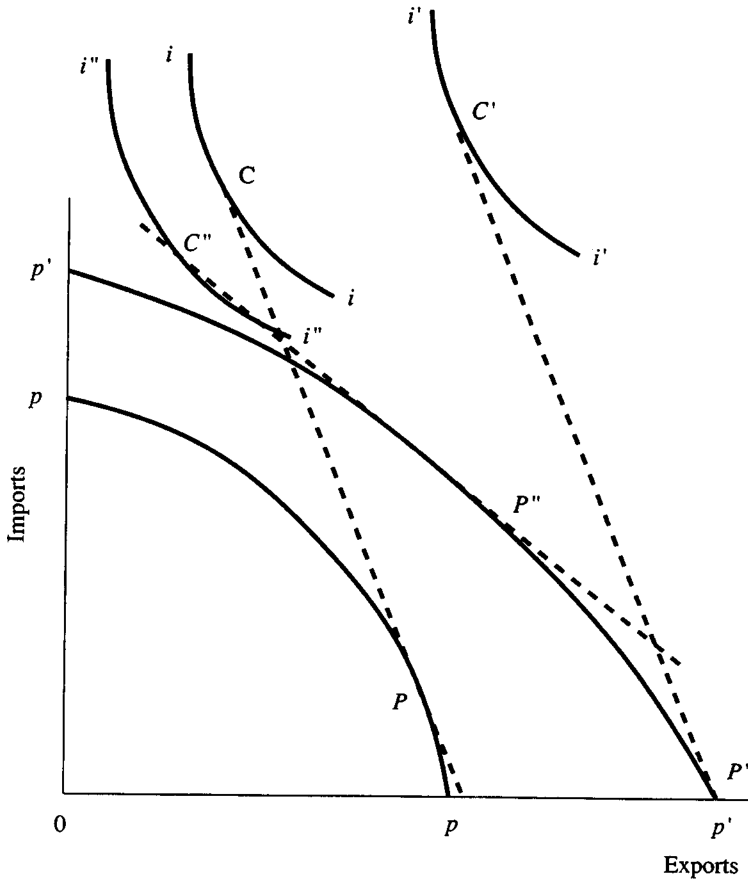


Figure 8.5 Immiserising growth

Notes

1 With unchanging terms of trade, growth shifts production to *P*'
2 Fall in export prices moves production to point *P*"
3 Despite growth, consumption falls to C" and welfare to *i*"

EXPORT DIVERSIFICATION

A reduction in dependence on primary product exports is the best way to avoid immiserising growth and the uncertainties of terms-of-trade instability. Governments throughout the Middle East have export diversification as a policy objective, and often the goals are set out in each country's development plan. Planning for diversification is much more difficult, however, than actually accomplishing the goal. Import substitution is an easier policy to follow, as governments can protect

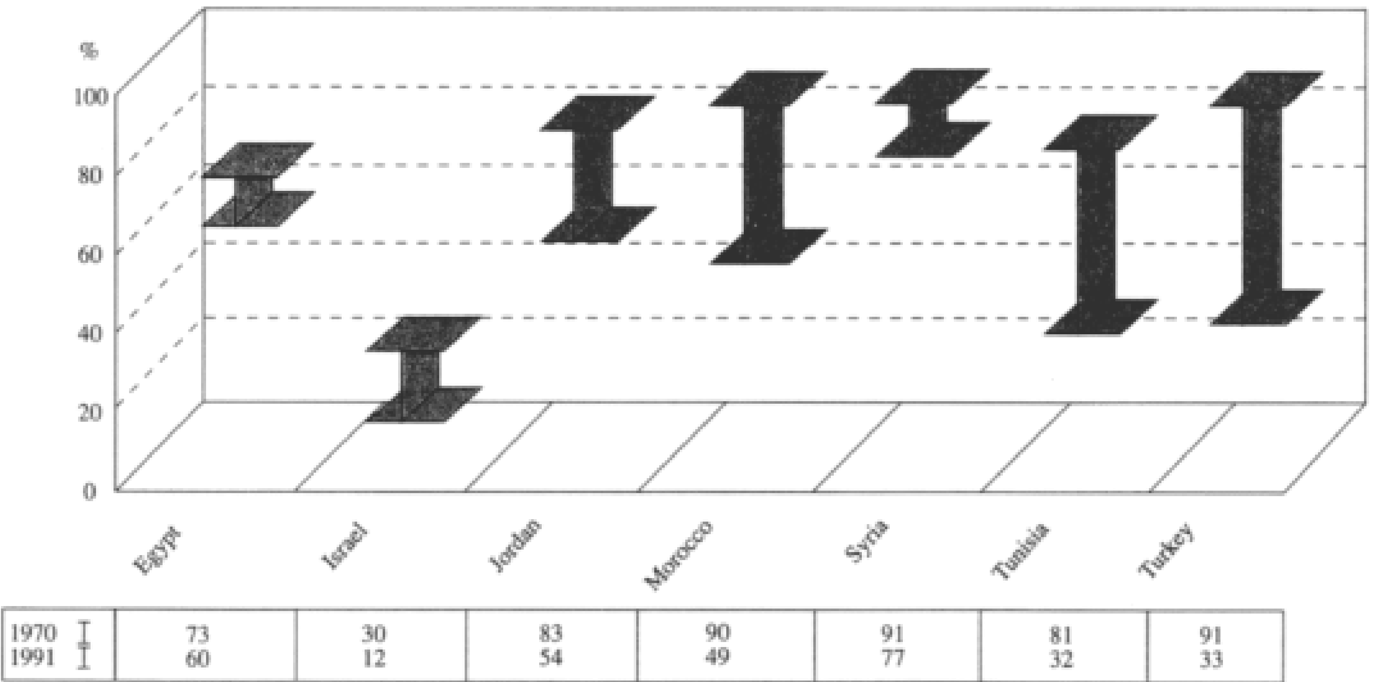
domestic producers through tariffs and quotas. Governments enjoy economic sovereignty over their own national markets, but small and even medium-sized countries have little influence over international markets. In the case of the Middle East only Saudi Arabia has some influence over the world oil market, but no other state in the region has any real policy influence over world markets in any primary commodity or manufactured good.

Subsidies can of course be paid to exporters, but governments cannot prevent other states adopting similar policies. Competitive devaluation between countries can also thwart export diversification plans. Only multilateral action can avoid trade wars, never unilateral action unless a country is in a strong negotiating position because of the sheer size of its domestic market in relation to the world market. The United States and the European Union enjoy considerable bargaining strength which they can exercise in negotiating forums such as the World Trade Organisation and its predecessor, the General Agreement on Tariffs and Trade which sets the framework for each round of multilateral trade talks. None of the countries of the Middle East acting on its own enjoys such muscle in trade negotiations, and even if they were able to act collectively, which seems an unlikely prospect, their global influence would be limited.

The economies of the Middle East remain more dependent on exports of primary products than most other regions of the Third World, apart from sub-Saharan Africa. There has not been a rapid diversification into exports of manufactured goods as in the major economies of South Asia, South East Asia and Latin America. Nevertheless, the share of primary product exports is falling in all the main states of the region, as figure 8.6 shows. A high-low chart is used, with 1970 being the higher figure for the share of primary products in all cases and 1991 being the low. The height of the vertical bar illustrates the extent of the decrease in the share of primary product exports in total exports.

Only Israel has become a diversified exporting state, where the share of exports accounted for by primary products corresponds to levels found in many developed industrial countries. In the cases of Tunisia and Turkey the move away from primary product exports has been dramatic over the 1970–91 period, with a mere one-third of the total being primary products by the 1990s. It is only in Syria that primary products still account for over two-thirds of total export proceeds, reflecting the failure of its state-run manufacturing sector. Even Egypt, which remains dependent on oil exports, has seen a significant fall, while in Jordan and Morocco dependence on phosphates and other primary product exports has been much reduced.

It is important to put the scale of each country's manufacturing exports in context, and not simply to look at shares. In figure 8.7 the major Middle Eastern exporters of manufactured goods are compared, with the value



	Egypt	Israel	Jordan	Morocco	Syria	Tunisia	Turkey
1970	73	30	83	90	91	81	91
1991	60	12	54	49	77	32	33

Figure 8.6 Share of primary product exports
Source: World Bank, *World Development Report*, 1993

of exports expressed in United States dollar terms. Israel is by far the largest exporter of manufactured goods, with its exports worth almost $16 billion in 1991. Turkey, in spite of all its efforts at diversification, still only accounts for half this amount. The value of manufacturing exports by the other states is quite small, only Morocco and Tunisia having a total of over $2 billion, while Egypt's total is under $800 million. The figure for Iran may be an underestimate, as many Iranians travelling abroad bring out carpets and other items which they sell for hard currency. This is a way of circumventing foreign exchange controls, as such personal exports are not recorded by any authority.

EURO-ARAB TRADING RELATIONS

The European Union's interest in the Middle East has always been primarily motivated by economic concerns. There are both positive and negative forces conditioning the relationship. On the positive side in trading terms, the region is of much greater significance for Europe than it is for the United States, because of its importance for Europe's oil imports. The Middle Eastern economies are also significant export markets for Europe, especially the Gulf states. On the negative side, trans-Mediterranean commerce has declined partly because of the European Union, which has resulted in France, Spain, Italy and Greece being more orientated to the north rather than the south. The ending of the Cold War and the lifting of the Iron Curtain means that the countries of the European Union are becoming more closely connected to their eastern neighbours. It is the former communist countries which are becoming the major focus of commercial and diplomatic efforts, to some extent at the expense of the Middle East.

After the Suez crisis in 1956 Britain and France, the main European powers with continuing interests in the Middle East, tended to turn away from the region, as we have already mentioned. In the case of France this was reinforced by the civil war in Algeria and the legacy of hostility this produced. Nevertheless, there was a desire to keep open trade links with the region, not least so that Europe could have export earnings to offset against its payments for oil imports. There was, however, a certain complacency towards the Middle East, a tendency to disregard the region and its problems as Europe looked inward to its own common market integration. The 1967 Arab-Israeli War, which demonstrated the weakness of the Arab countries, tended to reinforce European complacency.

It was in this context that the oil price rises as a result of the October 1973 Arab-Israeli War came as a severe shock to Europe. There was the issue of the security of oil imports, and the severe trade deficit problems which the quadrupling of oil prices brought. There was a feeling that

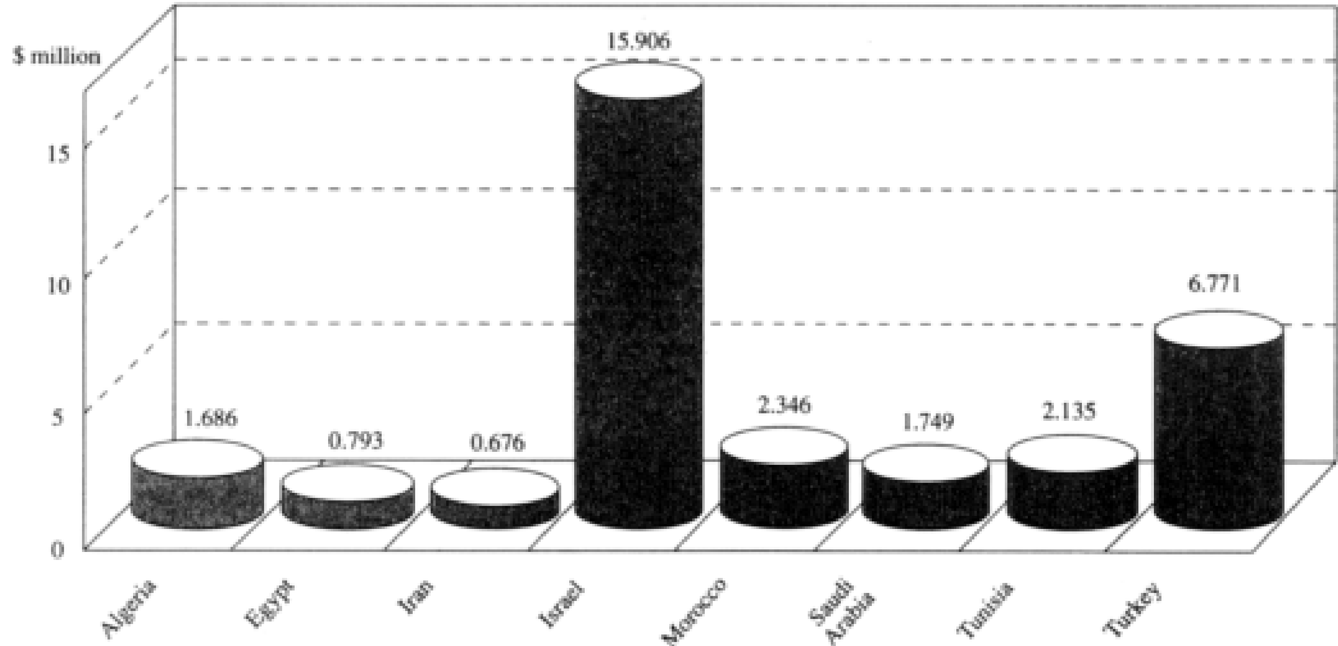


Figure 8.7 Value of manufactured exports
Source: World Bank, *World Development Report*, 1993

Europe should no longer ignore the region. The European Union (or European Economic Community as it then was) decided to pursue two initiatives, the co-operation treaties which represented an extension of the Mediterranean policy to the Arab countries, and the Euro-Arab dialogue. In both cases the European countries were primarily interested in economic objectives, especially in promoting exports to pay for their oil imports. For their part the Arabs were more interested in political dialogue, the aim being to separate Europe from American policy over Israel, and ultimately to weaken that policy.

The co-operation agreements were a rather cynical attempt to get the Arab Mediterranean states and Israel to extend trade preferences to the European Union in return for limited concessions on import tariffs and quotas. The arrangements were designed to regulate trade, and were arguably against at least the spirit, if not the letter, of GATT, which supports the principle of non-discrimination in trade. As the Arab states were not GATT signatories this did not present a problem. In the agreements the Arab countries are treated individually, rather than as a bloc, yet the European Union itself deals as a bloc. This puts Brussels trade negotiators in a powerful position, given the huge size of the European Union market compared to that of each Arab country.[7] Egypt, the largest Arab country in terms of population size, has a market for imports less than half the size of Portugal's, the poorest country in the European Union.

The co-operation agreements provide for an annual cycle of meetings between European Union and Arab trade officials from each of the countries in turn. Trade ministers are present at some meetings, but details of quotas and tariffs for particular items are usually dealt with at the civil servant level. The annual rounds have become almost a ritual since the late 1970s, with little of substance achieved; indeed, they have been unable to safeguard existing trade. It was clear, for example, that the enlargement of the European Union in 1986 to include Spain and Portugal would create problems for citrus exports from Morocco and Tunisia. Yet no action was taken, and once Spanish and Portuguese production rose in response to the favourable prices under the Common Agricultural Policy, imports from Morocco and Tunisia were duly curtailed. Similarly, the Common Market agreement between the European Union and the Republic of Cyprus had adverse implications for Egyptian exports of early potatoes which compete with those from Cyprus, yet the Co-operation Agreement with Cairo did nothing to safeguard its position.[8]

Egypt also lost out to Turkey over textiles, although exports from both countries to the European Union were restricted under the Multi-fibre Agreements. Turkey, however, as an aspiring member of the European Union, has an Association Agreement. This provides for more favourable treatment than a Co-operation Agreement. The only Arab country to

express interest in joining the European Union is Morocco, but by definition the Union is European, which Morocco is certainly not, and Turkey is arguably not, despite the fact that the area to the west of the Bosphorus is in Europe. Greece is of course hostile to Turkish membership, at least until the Cyprus issue is resolved, but there is also resistance from Germany and other member states because of the provision for free mobility of labour within the European Union. There is, however, a desire not to offend the Ankara government, as Turkey is a key military ally highly valued by the United States, and the country also represents for Europe the moderate and acceptable face of Islam.

EUROPE AND ARAB-ISRAELI DIFFERENCES

For the Arab states the main achievement of the Euro-Arab dialogue of the 1970s was seen as the Venice Declaration of 1980 by European leaders. This referred to the recognition of the legitimate rights of the Palestinian people. It went well beyond United Nations resolutions 242 and 338 in stating that:

> A just solution must finally be found to the Palestinian problem, which is not simply one of refugees. The Palestinian people, which is conscious of existing as such, must be placed in a position, by an appropriate process defined within the framework of the comprehensive peace settlement, to exercise fully its right to self-determination.[9]

This Declaration was music to the ears of all those Arab states which rejected the Camp David peace process and the United States' attempts to encourage bilateral talks between individual Arab states and Israel at that time. It appeared that the Europeans were prepared to go much further in their recognition of Palestinian grievances than either the Carter administration or the incoming Reagan leadership. It could, of course, be dismissed as empty rhetoric by those with little power to move events, but to Arab leaders at the time, apart from the Egyptians, it was warmly welcomed.

It was the Co-operation Agreement with Israel in 1974 that led to the later bilateral agreements with the Arab countries in 1975 and 1976. The agreement with Israel was partly a result of Britain's entry into the European Union in 1973, as the United Kingdom had been a significant market for Israeli citrus produce following on from the days of the Palestine mandate, and the Jerusalem trade officials wanted to protect this trade as far as possible. After the Co-operation Agreement was concluded it immediately became apparent that it would be very one-sided to include Israel in such

arrangements, but to exclude the Arab Mediterranean states. The issue arose in the course of deliberations in Brussels concerning the aftermath of the 1973 Arab-Israeli war and the resultant Arab boycott of oil sales to the Netherlands, which in Rotterdam (as already indicated) had the largest refining capacity in the European Union. Although the boycott was unrelated to the Co-operation Agreement issue, and was more a consequence of Dutch national policy, it became clear that some initiative should be undertaken with respect to the Arab Mediterranean states.

In fact the trade relations with the European Union were to prove difficult for Israel, not least because Europe had the agriculture of its own Mediterranean states to protect, and there was the constant concern to avoid offending the Arab states. With Israel obtaining most of its military hardware from the United States, there were not even the interests of the French and British armaments industries to consider, which, in different circumstances, might have been lobbying for offset trade agreements to enable Israel to pay for its arms imports. The European countries were largely restricted to supplying inputs to the Israeli consumer goods industries, automobiles and commercial vehicles. Nevertheless, Israel was and remains a valuable market for the European Union, with export sales worth $7.5 billion in 1990.[10] This compares with a figure of $9.3 billion for Turkey, the most important Middle Eastern market for European Union exports, and $7 billion for Saudi Arabia, which vies with Israel for second place. European Union exports to Egypt were only worth $2.9 billion in 1990, which puts the importance of Israel into perspective.

As Israel's exports to the European Union were valued at a mere $4.2 billion in 1990, the Union enjoyed a healthy trade surplus of $3.3 billion. Almost half of Israel's imports come from the European Union, yet only one-third of its exports get admitted. A significant proportion of the financial assistance from the United States to Israel simply leaks back to the European Union to cover Israel's deficit. There are economic parallels with Vietnam in the 1960s, with American assistance contributing to the trade surpluses of East Asian nations. The United States is of course a significant exporter to Israel, with sales worth $2.7 billion in 1990, but its share of the market is under 18 per cent, which is small in relation to the European Union, even allowing for arms sales. Much United States military equipment is supplied on non-commercial terms, at a cost to the American taxpayer and to the annoyance of European armaments' suppliers. The dumping of armaments is not covered by the rules of GATT, nor does it appear to be on the agenda for future discussion, despite the commercial significance of the arms trade.

One particularly contentious issue for Israel and the European Union has been the question of how to handle the trade of the Occupied Territories. Israel did not favour giving separate quotas to Gaza and the West Bank for their exports to the European Union as this might imply

some sort of *de facto* recognition of a separate Palestinian entity. On the other hand, there was a reluctance to include citrus exports from the Arab-run packaging stations in Gaza under the Israeli quota, as this would reduce sales and revenues for Israeli producers. For the European Union the amounts were modest, but the Israelis were pressed into a position by their own exporters to allow a separate quota for the Occupied Territories as an escape valve. For once in the Middle East, economic pragmatism won out over issues of principle.

OIL AND PETROCHEMICAL TRADE

The Middle East is of most importance to the European Union as a source of oil imports. Only the United Kingdom has significant oil supplies of its own, and even so, North Sea production is unlikely to be sustained for more than another decade. In contrast Saudi Arabia has sufficient reserves for 82 years of production at current levels, and Iran sufficient reserves for 74 years of production.[11] The European Union accounts for almost 18 per cent of total world oil consumption, but less than 1 per cent of world production. In contrast the countries of the Middle East account for over one-third of world oil production, and over two-thirds of reserves, but a mere 6 per cent of global consumption. Middle Eastern gas supplies are also of importance to Europe, especially those from Iran and Algeria, which have the second and fourth highest reserves in the world respectively, Russia and Saudi Arabia being the other major suppliers. There is more gas than oil in the North Sea, but reserves within the European Union's continental shelf only account for 3 per cent of the world total compared to one-third of the total for the Middle East.

These figures show how dependent the European Union is on Middle East energy supplies, and how vulnerable to any supply disruption. The events of 1973–4, and the further oil price rises in 1979 following the Iranian revolution highlighted this dependence and taught the countries of the European Union a lesson. Nevertheless, there is no coherent energy policy at the European level, apart from restrictions on national energy subsidies and the policies inherited from the European Coal and Steel Community which are being phased out. It is at the national level that policy shifts have occurred. Rather than shield consumers from the effects of rising oil prices in the 1970s and early 1980s, European governments raised their own taxes on oil and petroleum products. This encouraged the development of efficient engines and the replacement purchase of more modern vehicles by private motorists and road haulage companies. At the same time other fuels were substituted for oil for heating purposes, although gas, the preferred alternative, may increase long-term vulnerability to Russian and Middle Eastern suppliers as North Sea

reserves become exhausted. The French embarked on an ambitious nuclear energy programme, and by the mid-1980s obtained over two-thirds of their electricity from nuclear stations.

As a consequence oil consumption in the major countries of the European Union steadied or actually fell for most of the 1980s, and imports from the Middle East declined significantly in volume terms. Japan is a larger purchaser of Middle East oil than the European Union, and the newly industrialising countries of South and South East Asia have also become more important purchasers. With the fall in nominal oil prices from the peak of over $36 per barrel in 1980 to under $13 in 1986, and their subsequent fluctuation in the $16 to $20 range, the European Union has enjoyed a massive saving on its oil import bill. Allowing for inflation, oil prices are now back to levels below those prevailing before the 1973–4 oil shock. As a result the European Union enjoys a healthy trade surplus with Saudi Arabia of over $2.5 billion, while the United States has a deficit with the kingdom of over $3.4 billion annually. Libya is the only major oil-producing nation that still maintains a surplus in its trade with the European Union, amounting to $2.5 billion annually. It is difficult to redress this position because of the embargo on arms supplies to Tripoli, which precludes exports of European military equipment.

There are of course no European tariffs or quotas on oil or gas imports, but tariffs are levied on petrochemical products. This has caused considerable controversy in the Gulf, especially as Saudi Arabia has aimed at becoming a major exporter of petrochemicals in an attempt to increase local value added.[12] The major concern for the Gulf states was the 13.5 per cent tariff which the European Union levied on Saudi Arabian petrochemicals to protect the industry in Europe and allow time for adjustment. Many rounds of talks between European Community and Gulf Co-operation Council officials have failed to resolve the issues, but there has been some movement, with around 10 per cent of the exports supplied by the Saudi Basic Industries Corporation allowed in without tariff protection. On the Gulf side there is the recognition that tariffs are preferable to outright quotas, as at least there is no maximum placed on sales of petrochemicals. On the European side the allegation is still made that Saudi Arabia subsidises its methanol and ethylene production by pricing the gas inputs at below local market levels, and certainly below the world market prices paid by European oil and chemical companies.[13]

ARAB ECONOMIC INTEGRATION

Much of the Middle East was part of the Ottoman Empire; but long before the collapse of the Empire, penetration by the European powers had undermined local economic linkages. Trade as a consequence was

orientated towards Europe from the nineteenth century onward, and it was only after the retreat of Britain and France from the region that there was renewed interest in regional links. These were pan-Arab, however, and did not encompass Turkey or even Iran, though Iran has its own links with the Arab oil-exporting countries through OPEC, and both it and Turkey are represented in the Organisation of the Islamic Conference which created the Islamic Development Bank as an instrument to promote Muslim economic co-operation. Only Israel is excluded from regional forums, as an artificial state created by outside powers.

Attempts at Arab economic co-operation date from as early as 1950 when the Arab Joint Defence and Economic Co-operation Agreement was signed under the auspices of the Arab League.[14] Multilateral agreement was reached on the regulation of transit trade in 1953, but in practice this failed to amount to much, as overland links from the most populous Arab state, Egypt, would have to transit through the state of Israel. It was subject to a trade boycott by the Arab states, but this hurt all parties and not only Israel.

The most ambitious attempt at Arab economic co-operation was instigated by Nasser in 1958 with the founding of the United Arab Republic. With the two major participants, Syria and Egypt, separated geographically by Israel, it never stood much chance of success. Then there was the Arab Common Market agreement of 1964 between Jordan, Iraq, Syria and Egypt.[15] The agreement was politically motivated by the desire for pan-Arab co-operation, but the model adopted was inspired by the early success of the economic integration efforts of the original six members of the European Economic Community. This was ambitious on paper but never really took off, and again it was the Israeli factor that damaged the agreement, as Egypt was virtually suspended after the Camp David accords. Jordan did, however, benefit considerably from the arrangement, as Arab trade was significant for its economy, especially the small-business sector which served the Iraqi market as well as Jordan. There can be little doubt that Jordan, because of its small size, has much to gain from regional efforts for economic co-operation, especially if sanctions are removed from Iraq.

It is at the sub-regional level that economic links have been developed most fully, notably through the Gulf Co-operation Council. Although this failed as a defensive body to prevent the Gulf War, and there is little prospect of it acting as a coherent military counterweight to either Iraq or Iran, as an economic alliance it has achieved some success. Like the European Union the GCC states allow free labour mobility of their nationals between member states, which facilitated the exodus of Kuwaitis after the Iraqi invasion. Capital movements are unregulated, and Bahrain is allowed to function as an offshore financial centre for the Arabian Peninsula states which encourages its orientation to Saudi Arabia rather

than Iran. Dubai, with its highly successful duty-free zone at Jebel Ali, serves as a transit and warehouse centre for GCC trade, which means that its main re-exports are to the Arab side of the Gulf rather than to Iran. In the recent past, including the period after the Iranian revolution, Dubai served as a centre for illegal imports into the Islamic Republic. There have also been some more solidly based trade within the GCC, notably the export of oil pipes from Kuwait to neighbouring states and of construction materials from the factories on Saudi Arabia's Damman industrial estate in Eastern Province.

The impact of such trade is limited, however, compared to that between European Union countries, and is hardly likely to cement regional bonds or even build significant bridges. Nevertheless, attempts at regional economic co-operation continue and even the World Bank has identified this as a promising area for investigation in its initiative to encourage economic research in the Middle East and North Africa. The fact that its forum, the body set up in June 1993 in Cairo to encourage such research, had to be renamed the 'Forum for Economic Research in the Arab Countries, Iran and Turkey' says much about the aspirations for economic co-operation. The term 'Middle East' was dropped because this included Israel, which was not wanted as a participant. Many co-operation endeavours appear ill-fated. The Arab Common Market effort was revived in 1989 with the Arab Co-operation Council encompassing Egypt, Iraq, Jordan and North Yemen. This has a more limited agenda than Nasser's original project, as it only provided for joint industrial fairs in each of the capitals, a gradual reduction of some tariffs, and preferences for labour from the signatory states when work permits were issued.[16] The Gulf states refused to participate because of this, but the whole scheme was to fall apart in any case with the Iraqi invasion of Kuwait. Similarly, the Arab Magreb Union between Morocco, Algeria and Tunisia set up in the same year appears to have become moribund following the Algerian election fiasco and the virtual undeclared war between the Algerian security forces and Islamist opposition.

THE EXTENT OF REGIONAL TRADE

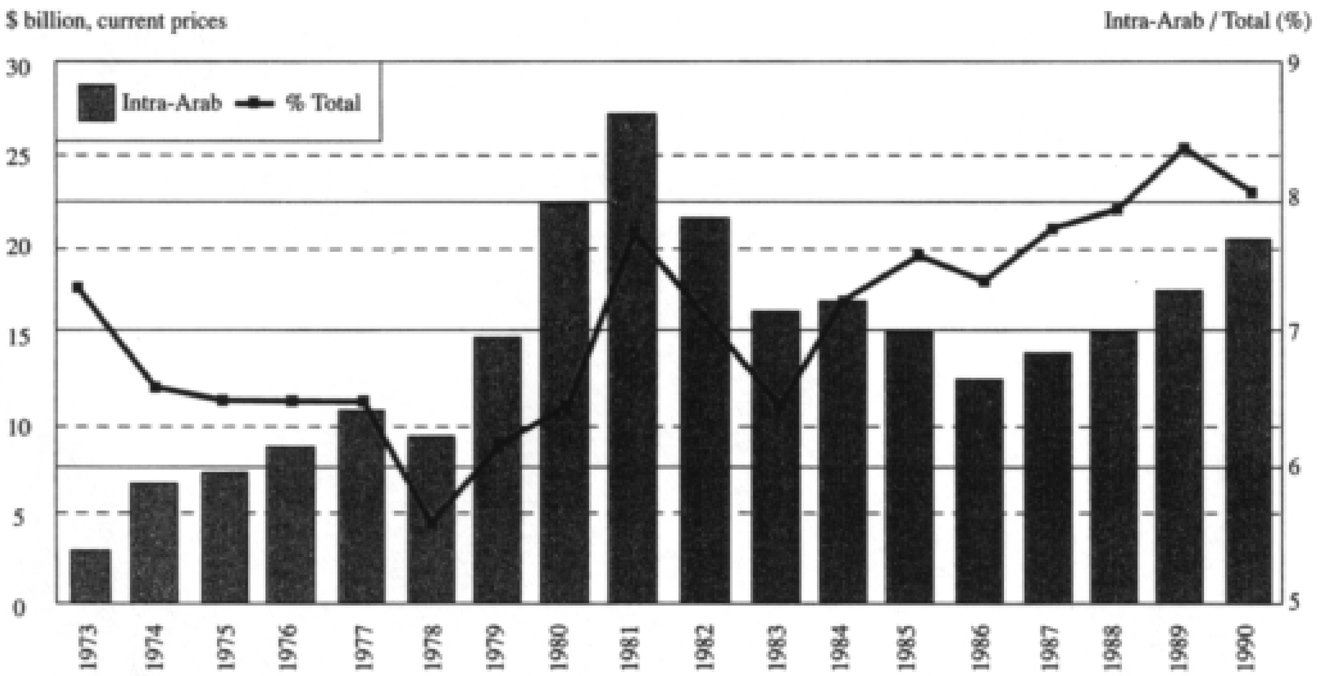
Figure 8.8 shows the extent of intra-Arab trade over the 1973–90 period, the values representing the sum of visible exports and imports. The value of regional trade increased substantially during the 1970s and early 1980s from a mere $3.1 billion in 1973 to $27.5 billion by 1981, but since then it has declined even in nominal current price terms, the low of $12.6 billion being reached in 1986. Although there was some revival in the late 1980s to $20.5 billion, this is less than half the 1981 figure if real values are taken, allowing for inflation. The figures show that there was, and to

some extent remains, a close relationship between oil revenues and the value of regional trade. It was the oil price rises of 1973–4 and 1979 that resulted in at least a doubling of the value of trade between the Arab countries.

Only a small portion of this was accounted for by the increased payments by the Arab oil-importing states, as countries such as Jordan obtained their oil at concessionary rates well below the international market price. Saudi Arabia and Kuwait became unwilling to supply oil to Jordan on such favourable terms in 1977 when evidence emerged that Jordanian petroleum dealers were reselling concessionary oil imports at near the full world market price to third parties. It was this that prompted Jordan to turn to Iraq for its main oil supplies, largely through countertrade deals under which oil was swapped for Jordanian consumer nondurables such as detergents, soaps and medical supplies. Services were also included in the arrangements, notably road haulage and the use of the port of Aqaba. These 'invisible earnings' are not included in the trade statistics, but they were to become an especially important lifeline for Iraq during its war with Iran.

A major factor promoting Arab trade was the financial transfers from the oil-exporting states to the poorer states. Remittances fuelled part of this, as did bilateral inter-governmental assistance. Palestinian and Jordanian migrant workers in the Gulf would continue to purchase some Jordanian goods even when they were resident in Saudi Arabia or Kuwait. The same applied to a lesser extent in the case of Egyptian and Lebanese migrants. There were also barter deals between Arab governments, such as those between Egypt, Iraq and Libya, under which Egyptian-assembled cars were swapped for oil for Egypt's refineries. Such deals were relatively small in scale by international standards, and it is important to see Arab trade in context. In figure 8.8 the solid line shows Arab trade as a proportion of the total international trade for the countries of the region. The proportion has fluctuated between 5.6 and 8.5 per cent over the 1973–90 period, the more encouraging figures of over 8 per cent occurring during the most recent four years. This proportion of intra-Arab trade is small, however, compared with the European Union, whose internal trade accounts for more than 60 per cent of the total.

The proportion of intra-Arab trade increased in the late 1980s partly as a result of the decline in the value of the oil trade of the region with the rest of the world. As well as this somewhat negative factor, there are more positive forces at work. In the past a major factor restraining Arab trade has been the severe foreign exchange restrictions and currency inconvertibility of the northern Arab states. No amount of institution-building could compensate for this basic fact of life. There was little point in paying lip-service to the concept of an Arab Common Market while at the same time not permitting the necessary payments for traded



Intra-Arab	3.1	6.9	7.3	8.9	10.7	9.5	14.9	22.5	27.5	21.7	16.5	17.1	15.2	12.6	14.1	15.2	17.6	20.5
% Total	7.3	6.6	6.5	6.5	6.5	5.6	6.2	6.5	7.8	7.1	6.5	7.3	7.6	7.4	8	8.1	8.5	8.1

Figure 8.8 Development of intra-Arab trade
Source: United Nations, *Direction of Trade Statistics*, 1992

goods to be made. The GCC was arguably more successful as a trading entity because all the currencies of the Gulf oil-exporting countries are freely convertible.

The moves towards payments liberalisation in Egypt, Syria and Jordan and the new emphasis on the market determining the exchange rates have arguably done more to promote Arab trade than all the over-ambitious institution-building by governments in the past. It is through liberalisation that the climate is created for Arab merchants to get on with their trading. Ultimately it is the businessmen who have to do the dealing; government's role is to provide an environment where transaction costs are reduced as far as possible with the minimum of bureaucratic impediments to the movement of goods.

Figure 8.9 shows the value of Arab trade as a proportion of the total international trade for twelve Arab economies in 1990. As in the European Union, the proportion of regional trade is highest for the smaller countries with more restricted industrial bases and only limited possibilities for import substitution because of domestic market size.[17] Bahrain, Jordan and Lebanon have the most highly integrated regional trading links. The figure for Lebanon is probably a substantial underestimate as official figures do not include the illicit smuggling into Syria, which is extensive. Also excluded are the trade flows between Israel and the 10 per cent of Lebanese territory it controlled in its security buffer zone. This zone was almost entirely supplied from Israel.

Egypt, Saudi Arabia and Libya appear to be the least regionally integrated countries. In the case of the latter two states, regional trade is insignificant in comparison with oil trade with the outside world. Libya also suffers from its geographical position, as it is neither in the Magreb or Mashreq. It could of course serve as a bridge between the western and eastern Arab world, but it is regarded by most other Arab governments as being on the fringes in every sense of the word rather than being a core state. Egypt's trade with other Arab states is also hindered by being cut off from its eastern neighbours by Israel, as has been already indicated, and the poor communications infrastructure linking it with Jordan and Saudi Arabia.[18] Its protected industries overlap those of other Arab countries rather than being complementary. Competition from other producers within the region would be unwelcome to the Egyptian authorities if it resulted in state-sector industries losing domestic market share and perhaps collapsing, with unfortunate consequences for employment.

CONCLUSIONS

Although commercial relations with Europe are declining in significance, there is little sign of any promising regional economic cohesion in the Middle East.

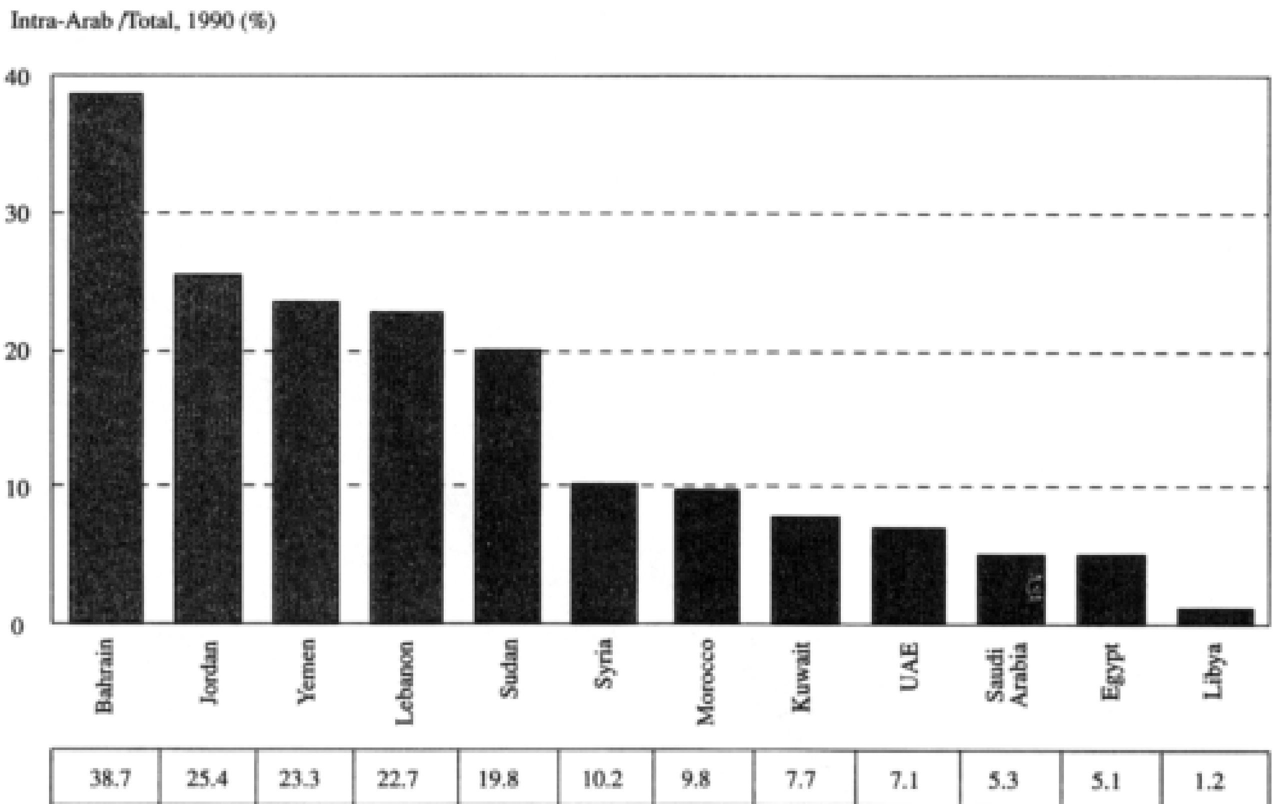


Figure 8.9 Intra-Arab trade, by country
Source: United Nations, *Direction of Trade Statistics*, 1992

Regional trade links remain weak, labour mobility is declining and governmental financial transfers have virtually ceased. Despite so-called open door policies, such as Egypt's *infitah,* it is by no means clear that the economies of the region are really opening up either internationally or even to their neighbours. The oil-exporting states of the Gulf are of course highly dependent on and integrated with the outside world, but they are becoming more isolated from their northern Arab neighbours. These countries may well turn in on themselves in the coming years, as Iran did following its Islamic revolution. Such an orientation may bring greater economic hardship, but some at least within the region may feel this is a price worth paying. Those smaller countries such as Jordan, which can never be even partially self-sufficient, are likely to be in an especially difficult position. It is these countries which have most to gain from regional integration; in its absence such economies will at best mark time.

9

THE ROLE OF THE STATE

In the Middle East the state is often portrayed as playing an all-powerful role, most of the discussion on the economy focusing on government policy rather than on businesses or entrepreneurs.[1] Theories on the role of the state were discussed in chapter 2, drawing on the economic development and political economy literature. The aim in this chapter is to focus on the Middle East experience, examining both those issues which are especially important in the region, such as the economic impact of military spending by the state, and issues where the region's experience parallels that of other developing countries, as in relation to the structural adjustment policies advocated by the International Monetary Fund, economic liberalisation and privatisation.

GOVERNMENTS AND ECONOMIC DECISION-TAKING

The notion of a strong, autocratic, centralised leadership prevails in the economic as well as the political sphere. There is a 'top man syndrome', with the emphasis on the personal ambitions of the ruler for the state. Economic policies are enacted through ministerial decrees rather than a consultative process involving parliamentarians. The spending budgets of government departments are largely determined through bilateral bargaining between the minister responsible and the president's or prime minister's office. Cabinet discussions are a formalised ritual where opposing views are seldom expressed, and parliamentary approval a mere rubber-stamping exercise. Decision-making is always at the level of the boss, rather than as part of a team exercise, and the views of individual economic agents, the ordinary citizens, are seldom, if ever, actively sought.

It would be misleading, however, to regard all regimes in the Middle East as dictatorial on economic matters and totally unresponsive to public opinion. Turkey is a parliamentary democracy where voters' opinions matter as much as in the West, and the Iranian and Egyptian parliaments at least question government economic policy, even if they

do not necessarily affect its outcome. For Israelis elections really matter, as indeed they do for the Palestinians in the Occupied Territories, even though they have had no opportunity to participate as yet. In Saudi Arabia there is a right to audiences with the ruler and ministers, although frank feelings are seldom expressed at these formalised gatherings. The basic difference between the Middle East and the West is not in the economic and political institutions, but in the social attitudes of the rulers and the ruled. It is not the legal detail and administrative framework which matter, but popular perceptions of government and what it can achieve in the spheres of economic policy and development.

One issue is why political power is sought in the first place, whether it is because of personal mission, an ambition to lead and direct, or simply as a way of ensuring that the ruling group obtains maximum economic benefit from the expropriation of the nation's resources. Economic patronage is an important means of reinforcing political power, indeed those who did not exercise such patronage would be regarded by many in the Middle East as too inept to rule. Where particular groups occupy powerful positions, such as the *Alawi* sect in Syria, which includes President Assad, or the *al-Takriti* clan in Iraq, which includes President Saddam Hussein, they expect a financial as well as a political pay-off. Governing parties worldwide represent particular interest groups, but in the Middle East those close to power are often small minorities whose membership is closed. Membership of the *Baathist* political party may be open to anyone in Syria and Iraq, but in the inner ruling circles it is family background and religious affiliation which really matter, even with regimes which are nominally socialist and secular.

Labels can be deceptive in the Middle East and the actual workings of particular regimes often do not correspond to supposed allegiances. There is a considerable amount of misinterpretation, especially in the West, regarding the economic policy orientation of Middle Eastern states. Iran is depicted as a backward, theocratic state, with economic policies that belong in the medieval era rather than in the modern world. Yet Ayatollah Khomeini was in many respects a reformer, propounding a reinterpretation of *Shi'ite* religious ideas, which helped to make religion more popular than ever amongst the ordinary people. Listening to or playing music had been regarded as sinful by many in the religious establishment, but Khomeini removed this prohibition. Literature and the arts generally had become fossilised under the old religious establishment associated with Ayatollah Shariit Madari which had collaborated with the Shah's regime. As a result western secular cultural influences had grown. What Khomeini recognised was the need for Islam to modernise, in order to ensure its successful revival and challenge secularist tendencies.

In the economic sphere Khomeini gave his blessing to a young, largely unknown economist, Abu'l Hasan Bani Sadr, who had spent many years working on a doctoral dissertation at the Sorbonne in Paris in the field of Islamic economics. Bani Sadr was elected President of the Islamic Republic in January 1980, and immediately started to remodel the economy along Islamic lines, instigating in particular the measures that were to culminate in the Islamic banking legislation of 1983.[2] Bani Sadr championed the rights of poor Muslims and set a radical economic agenda for income and wealth redistribution. As a politically inexperienced academic he was to be out-manoeuvred by Beheshti, Khamenei and Rafsanjani, especially because of his inept handling of the American hostage crisis when the embassy staff in Tehran were imprisoned for 444 days. It was Rafsanjani, the protector of the *bazzari* interests, and a former merchant himself, who was to accede to power, despite Khomeini's initial support for Bani Sadr's more radical economic programme.

ECONOMIC POWER AND APPROPRIATION

In the Middle East, as in many other regions of the world, those who exercise the levers of economic power invariably use it to the advantage of themselves and the interest groups they represent. Under the Ottomans, landowners throughout the empire paid taxes to the state and in return were given military protection.[3] Most paid willingly as the payment guaranteed their security of tenure and ensured that the land-holders could benefit from the investment they made in their land. Tenants and agricultural labourers did not pay taxes, which meant that the Ottoman administration was not accountable to them for its actions. At least there was an economic link, however, between a large number of Ottoman citizens, the landlords, and the rulers of the Empire. The agricultural surplus was appropriated, but the government provided some service in return and had a reasonably wide constituency to serve.

Oil has served to weaken the links between ruler and ruled in the Middle East, to an extent not found elsewhere. The revenue accrues to governments, who have the power to disburse it as they see fit. Until the 1950s no distinction was made between the personal finances of the ruling families in the Arabian Peninsula states and government finance. Oil revenues simply accrued to the ruling families, and there were no formal structures to govern its disbursement, and indeed no systems of accountability or even the reporting of financial balances. Formal government structures were gradually introduced, and the ministries expanded considerably in terms of numbers of civil servants, but the

ministers themselves remained members of the ruling family or closely associated with it. This situation still prevails, with some notable exceptions such as the Saudi Arabian oil ministers from the time of Sheikh Yamani onward. Such a crucial position required a person with considerable ability, not merely the right connections, a fact that was recognised at an early stage by the Saudi Arabian king.

In the Arabian Peninsula states the main constituency outside the ruling families are the merchants. There are, of course, merchant princes within the ruling families.[4] Most of the richer merchants have acquired their fortunes by having agencies and franchises to act as exclusive distributors of imports from the Far East and Europe. This makes them opposed to all but minimal import duties and against constraints on trade such as quotas, unless they are running import-substitution ventures themselves. The merchants favour a high level of government spending financed from oil revenue, as this keeps the wheels of domestic trade and commerce turning to their financial advantage. There is also a willingness to see government employment expand because this boosts demand. The merchants even favour a relatively liberal policy on work permits as immigrant workers are also customers, and their entry eases wages pressures in an otherwise tight labour market. This keeps the merchant's own business costs down.

Governments that are forced to rely on their own citizens for tax revenue are inevitably more accountable to them than those that do not. In the United States a political slogan in the eighteenth century was 'No taxation without representation'. Although such views have long been out of fashion in the West, especially amongst the thinkers of the left, they may help explain the lack of political accountability by some governments in the Middle East. In the oil-exporting states of the Gulf there is no income tax because oil provides for most fiscal revenue, and in these circumstances it is more difficult to make a case for representative government and public expenditure accountability. The oil revenue boom of the 1970s not only weakened the link between governments and peoples in the OPEC states of the Middle East, but also freed governments from accountability to their own people in some of the other states of the region. Syria, Jordan and Egypt all received substantial bilateral aid from Saudi Arabia and the other Gulf states, which reduced domestic fiscal pressures. In the case of Egypt the Camp David accords and the peace treaty with Israel resulted in the curtailment of such assistance, but then the United States stepped in with substantial help, arguably making the Sadat and Mubarak governments more accountable to Washington than to ordinary Egyptians.

Not only states were 'corrupted', but arguably groups such as the Palestinian leadership who could rely on backing from the Gulf states

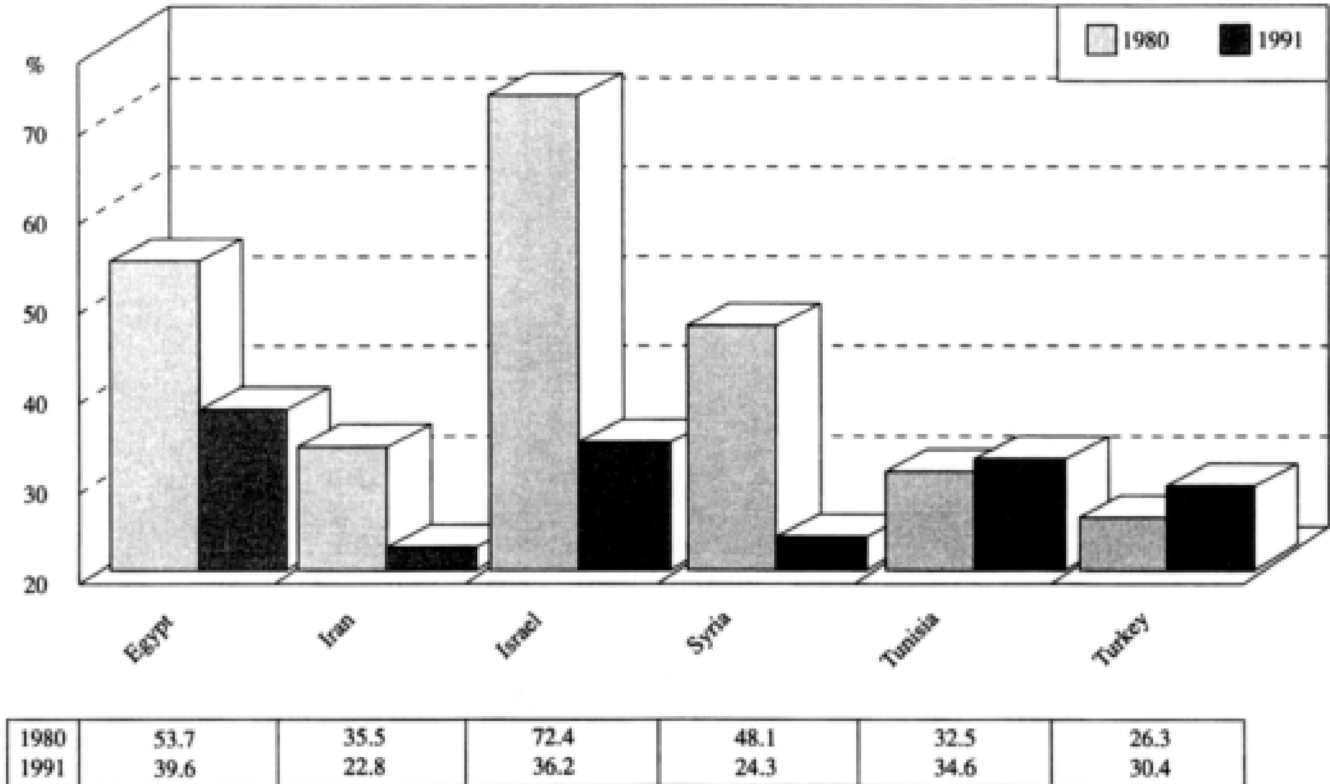
rather than contributions from their own people. Once these contributions stopped following the Gulf War, however, the leaders of the Palestine Liberation Organisation started to look around for alternative backing. The same applied to the various warring parties in Lebanon, whose reliance on different external financial backers tended to keep them in a state of mutual hostility, arguably prolonging the civil war. The collapse of the Lebanese currency following the conclusion of the war demonstrated just how significant these financial inflows had become, as the war itself had kept the financing going and sustained the economy.

THE FISCAL POSITION

A major economic responsibility of government is to manage its own finances, including the raising of funds to cover expenditure through taxation and borrowing. Clearly, spending cannot be fixed without reference to the taxation and borrowing capacity of governments, but in the Middle East, as with so much else, oil revenues and official inward flows have blurred the position. There has been more scope for government discretion over how much public spending to permit, and not merely the composition of the expenditure. For the oil-exporting states the issue in the 1970s and early 1980s was to determine how much to spend in any one year and how much to set aside for future years or even future generations. Since then the position has deteriorated significantly as oil revenues have fallen, but financial discipline is still not a virtue associated with Middle Eastern governments, even though there are at least some moves to determine expenditure priorities in a more coherent fashion.

Expenditure management remains a rather crude affair in the major oil-exporting states of the region, with the implementation of projects being slowed down or even halted in response to budgetary pressures. In some cases there have been simply delay and deferment of payments to foreign contractors for work already completed. As those tendering for contracts in the Middle East often build in uncertainty premiums to their offers, it is ultimately the governments of the region themselves who have to pay the price for such discretion and ability to manoeuvre.

Government expenditure as a proportion of gross national product is relatively low and falling for most of the states of the Middle East, as figure 9.1 shows, the most dramatic fall in Israel reflecting the years of Likud government which adopted a more cautious fiscal stance than the country’s Labour Party. The decline in Egypt arguably reflects IMF pressures on the government to reduce its role, and that in Iran and Syria may be a consequence of the relative decline in external revenues.



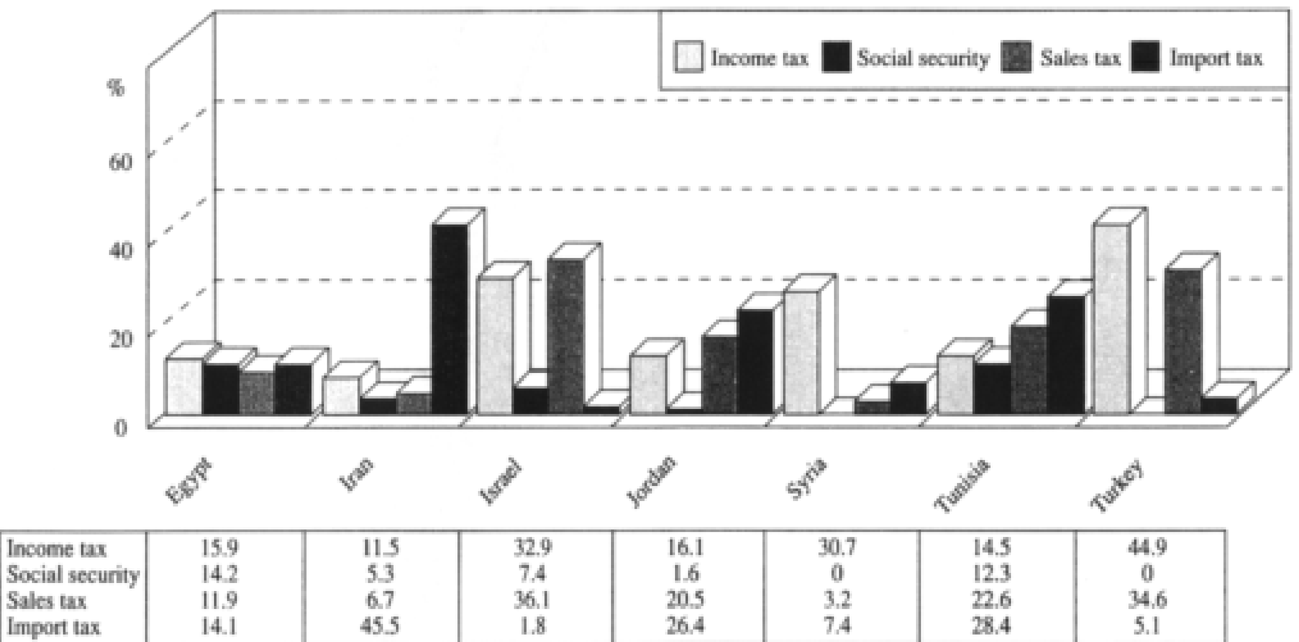
	Egypt	Iran	Israel	Syria	Tunisia	Turkey
1980	53.7	35.5	72.4	48.1	32.5	26.3
1991	39.6	22.8	36.2	24.3	34.6	30.4

Figure 9.1 Government expenditure as a proportion of GNP
Source: World Bank, *World Development Report,* 1993

It is only in Tunisia and Turkey that there have been modest rises, but the proportions are less than half those of most European countries, including those committed to a diminished role for government. Figure 9.1, which draws on World Bank data, excludes the major oil-exporting countries of the region in which a large proportion of GNP is accounted for by oil production, which distorts the picture and makes comparisons difficult. In the case of Saudi Arabia and the other Gulf states, defence spending is excluded from government expenditure figures because this information is regarded as sensitive from the point of view of security. This further complicates any potential comparisons.

Figure 9.2 provides a breakdown of the sources of government revenue for the six countries included in the previous comparison plus Jordan. Oil is a significant source of revenue in some of the countries, notably Egypt and Iran, but in these populous states revenue needs are considerable, necessitating reliance on traditional sources of taxation. Israel and Turkey have the most comprehensive and best-organised systems of income tax collection, which is reflected in the relatively high proportion of government revenue raised through these direct taxes. The proportion is also high in Syria, but this merely reflects the integration of social security contributions with income tax. The same applies in Turkey, but there the non-social security element of income tax probably corresponds to the Israeli proportion. There is little difference between the proportions in Syria and Egypt when the two figures are added together. In the Arab world income tax in practice is largely confined to government employees, as those in the private sector are reluctant to declare their income and enforcement procedures are lax. Government employees, however, receive their pay net of tax, so there is no scope for evasion.

In low-income countries the collection of income tax involves many practical difficulties. Assessing the incomes of those in the rural areas and many urban traders is difficult, because many receive income in kind through barter arrangements as well as cash payments. Social security contributions are a significant proportion of government receipts in Egypt and Tunisia but, as with income tax, these are largely confined to state employees, although this includes all those in nationalised industries. As those working for the state have guaranteed security of employment in all Middle Eastern countries, and cannot be made redundant, unemployment benefits do not have to be met from social security contributions. Apart from Israel, there is no unemployment benefit system for those made redundant in the private sector. As a consequence there is no economic incentive to remain unemployed, and unemployment statistics are meaningless, as we indicated in chapter 3. Most unemployment is disguised rather than open, especially in the state sector where there is much underemployment.



	Egypt	Iran	Israel	Jordan	Syria	Tunisia	Turkey
Income tax	15.9	11.5	32.9	16.1	30.7	14.5	44.9
Social security	14.2	5.3	7.4	1.6	0	12.3	0
Sales tax	11.9	6.7	36.1	20.5	3.2	22.6	34.6
Import tax	14.1	45.5	1.8	26.4	7.4	28.4	5.1

Figure 9.2 Sources of government revenue
Source: World Bank, *World Development Report*, 1993

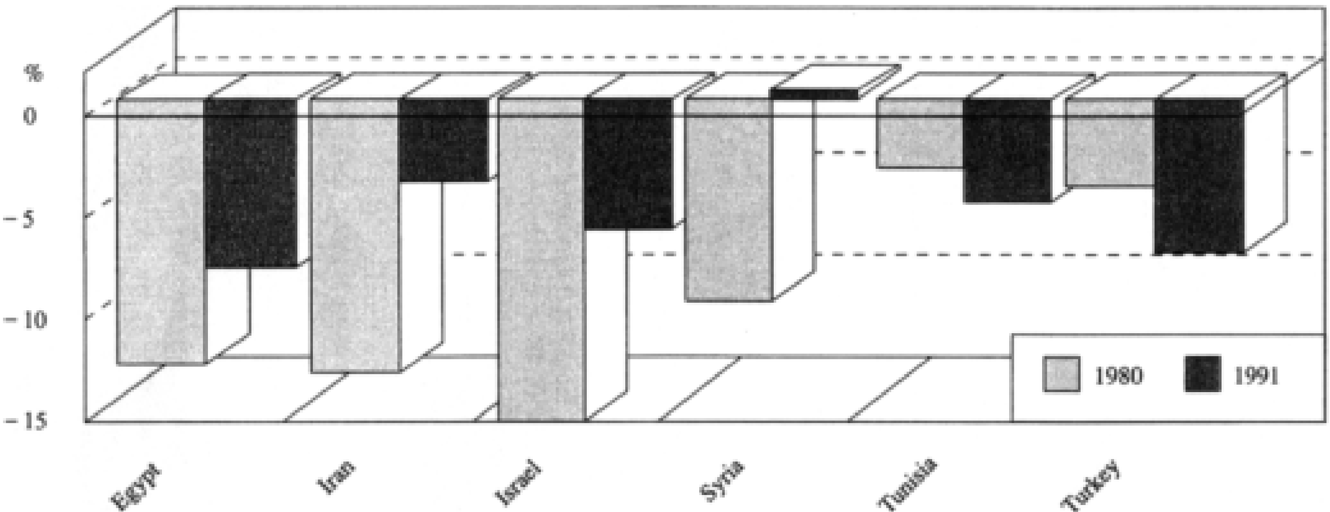
The main benefit from social security contributions in the Middle East is the retirement pension, which state employees receive from the age of 60, and for women maternity leave with full pay. As birth rates remain relatively high, even among women employed in the civil service and state agencies, the value of this benefit can be quite considerable. Most of the population do not receive such benefits, and are not eligible for pensions or maternity payments.

A large proportion of government revenue in the more populous and non-oil-exporting states in the Middle East comes from indirect taxes on consumption. Such taxes include those on sales and imports, the latter accounting for a major part of consumer goods in the more open economies of the region. Figure 9.2 shows that import taxes are especially important in Iran, Jordan and Tunisia. In Israel and Turkey, which have more significant domestic manufacturing bases, sales taxes appear to be more significant. Egypt and Tunisia are in an intermediate position, but the governments in both countries rely to a considerable extent on indirect taxation.

In the Middle East, as elsewhere, it has always been a struggle for governments to match expenditure with revenue, and deficits have been the usual outcome rather than balanced budgets for the more populous countries and the non-oil states. The major oil-exporting countries of the Arabian Peninsula and Libya have experienced problems due to fluctuating oil proceeds, and with much lower oil prices since the mid-1980s these problems have been compounded. By the early 1990s even Saudi Arabia was in fiscal deficit, a situation that seems likely to continue. For the economies of the Middle East fiscal deficits are a greater problem than for economies with developed capital markets. Middle Eastern governments are forced to borrow abroad, often in the Eurodollar markets, which means that the debt-servicing costs increase if the domestic currency depreciates against the dollar.

Figure 9.3 shows the fiscal deficit in relation to GDP for five of the major non-OPEC Middle Eastern states plus Iran, an OPEC member. Governments appear to have brought their deficits under greater control over the 1980–91 period thanks to restraint in government spending and success in harnessing additional sources of revenues. Government spending controls were most vigorously applied by the Likud governments in Israel, although the Labour government has shown less restraint.

Egypt has enjoyed a considerable measure of success in reducing its budget deficit, to the obvious satisfaction of the IMF. The Mubarak regime has been much more fortunate with its financial policies than with its efforts with regard to structural reform and the real economy. Subsidies on basic foodstuffs such as tea, fish and meat have been eliminated without popular discontent, and full market prices are



	Egypt	Iran	Israel	Syria	Tunisia	Turkey
1980	−12.5	−13.8	−16.1	−9.7	−2.9	−3.8
1991	−6.8	−2.8	−5.7	0.4	−4.3	−7.6

Figure 9.3 Fiscal deficits as a proportion of GNP
Source: World Bank, *World Development Report*, 1993

charged for electricity and most transport. Only the symbolic bread subsidies remain: an earlier attempt to remove these by Sadat in 1977 sparked widespread food riots in poor areas of Cairo. The projected Egyptian budget deficit was only 2.5 per cent of GNP in 1994, well below the levels of most European countries and the United States.[5] In Iran there have been great efforts to hold public spending under tight control, not as a result of any outside pressures, but rather because the Tehran government wanted to avoid any possibility of being dependent on international lenders. The long war with Iraq created enormous strains, and the price of reconstruction is potentially enormous. However, rather than rush to repair the shattered infrastructure, the government has proceeded cautiously, giving priority to the oil industry because of its importance for foreign exchange. The Rafsanjani government is all too aware of the mistakes of the Shah, who through lavish expenditure of oil revenues wanted to make Iran into a leading Asian industrial power within a decade. The present regime has no such materialistic ambitions. The aim is rather to safeguard the achievements of the Islamic revolution within the country, while at the same time rearming so that the Muslim masses can be defended from any threats from the secularist infidel. Iran's aim is spiritual leadership, not materialistic competition with what are regarded as corrupt and decadent countries.

There are, in any case, Islamic objections to deficit financing. Excessive government spending tends to exacerbate inflationary pressures, driving up nominal interest rates. This complicates the position in financial markets and means that *riba* or usury is more difficult to eliminate. Sound money policies and restraint on government borrowing are essential prerequisites for an Islamic financial system to work effectively. Fiscal stability is crucial, although this was impossible in Iran during the 1980s because of the war with Saddam Hussein. In these circumstances it is all the more remarkable that Iran has been able to reduce its fiscal deficit to a mere 2.8 per cent of GNP and virtually eliminate its long-term international debt, although short-term commercial debt has risen in recent years. The equally cautious Assad regime in Syria has even managed to achieve a budget surplus, though in its case it is not so much religious considerations that matter, but maintaining the maximum freedom of manoeuvre with the West.

As figure 9.3 shows, Turkey has an increasing fiscal deficit, but this has to be viewed in the context of its rapidly growing and diversifying economy. High rates of price increases have been a problem in Turkey for decades, and it is difficult to change the inflationary culture in societies used to price rises of up to 100 per cent per annum. Nevertheless, the economy is in a much stronger position in the 1990s than it was in the 1970s, and there is much reason for optimism, at least

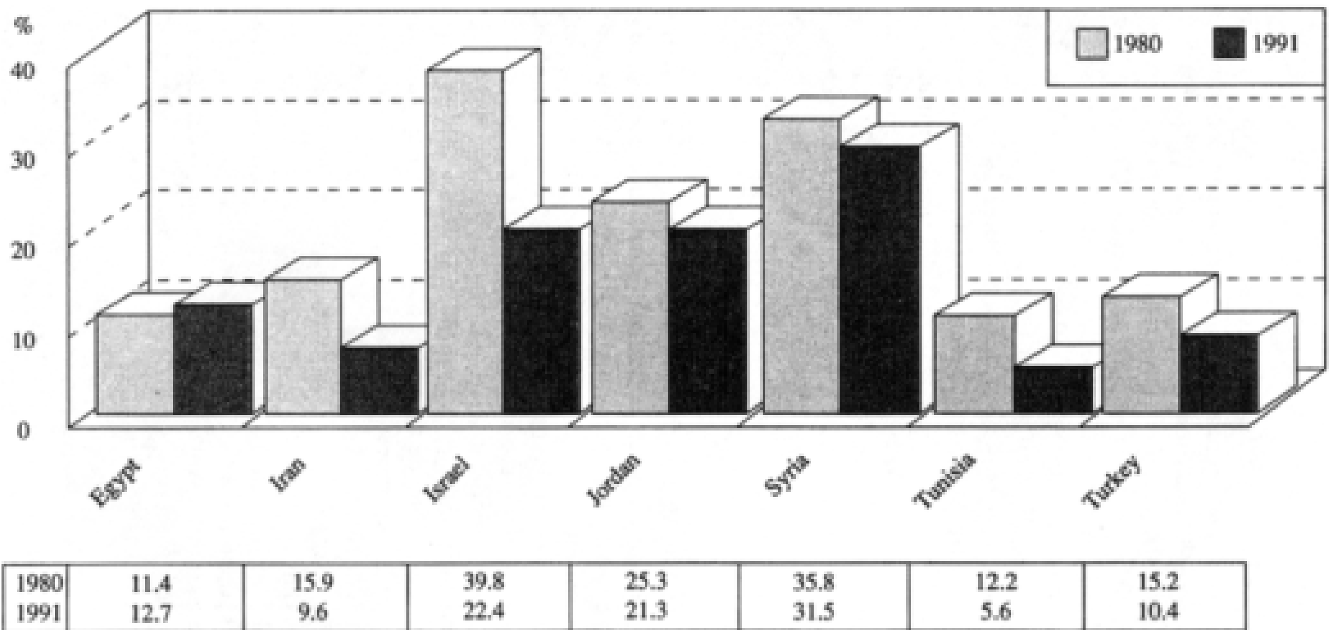
on the economic front, if perhaps less on the political, given the ethnic clashes in the east of the country involving the Kurds.

THE MILITARY EXPENDITURE PRIORITY

The Middle East has been a region of conflict throughout the last half-century. The Arab-Israeli conflict has inflicted heavy economic costs on the region since 1948, as although the 1948, 1956, 1967 and 1973 wars were short-lived, each distorted expenditure decisions for years before and years after. The *intifadah* or uprising in the Occupied Territories from 1988 onwards imposed large security costs on Israel, and severely disrupted economic activity in the West Bank and Gaza. The same applied in the case of the civil war in Lebanon from 1974 onwards, and the Israeli occupation of southern Lebanon after 1983. In addition to those conflicts directly involving Israel there have also been the Iraq-Iran War of the 1980s, the Gulf War in 1992, the continuing conflicts involving Libya and the West, the skirmishes between Morocco and Algeria, and the civil wars in Yemen and the Sudan. This list is by no means exhaustive: there have also been numerous minor incidents involving Bahrain and Qatar, Iran and the United Arab Emirates, and the Emirates and Saudi Arabia. The list of conflicts goes on and on, with new sources of differences arising as some of the old conflicts are resolved.

Apart from the human cost of the many conflicts, which are not really measurable, there are also the potentially quantifiable economic costs. Government spending on armaments has an opportunity cost for civilian development expenditure, which as a consequence is curtailed. Both investment spending on items such as infrastructure and industrial support suffers as well as recurrent expenditure on education and health care which can be so vital for human resource development. Figure 9.4 shows just how high military expenditure is for a number of Middle Eastern countries that include it in their national income statements. The comparable figure for Germany was 8.3 per cent in 1991, for the United Kingdom 11.1 per cent, and for the United States 21.6 per cent. With the ending of the Cold War military budgets are rapidly shrinking in the western countries and Russia, but in Egypt the budget grew over the 1980–91 period in spite of the peace treaty with Israel; elsewhere, notably in Syria, the figures are amongst the highest in the Third World.

If the Middle East moves into a more peaceful period of its history, it will be interesting to see if there is a real ‘peace dividend’ similar to that which has benefited the former belligerents in the Cold War. Given Egyptian defence spending trends since the signing of its peace treaty with Israel, the omens are not good, but a more generalised settlement



	Egypt	Iran	Israel	Jordan	Syria	Tunisia	Turkey
1980	11.4	15.9	39.8	25.3	35.8	12.2	15.2
1991	12.7	9.6	22.4	21.3	31.5	5.6	10.4

Figure 9.4 Military expenditure as proportion of total government spending
Source: World Bank, *World Development Report*, 1993

of the Arab-Israeli conflict may bring greater gains. The Israeli figure for defence expenditure in relation to total government spending is falling, but from a very high base. Yet these still-high figures are an underestimate of the full resource costs, because the wages bill of a largely conscripted army does not take account of the fact that the men involved, and in the case of Israel also the women, could be more productively employed elsewhere in the economy.

Even with low manpower costs in the armed services, most Middle Eastern states spend more on military salaries than on those for teachers or health personnel. In Jordan military expenditure is 28 per cent greater than the combined amount for education and health. In Iraq the comparable figure is over five times the education and health bill. In Iraq there are 6.3 members of the armed services for every teacher, and 105 for each doctor, with over 5.8 per cent of the total population employed by the military. In Syria the figure is lower, with 3.6 per cent of the total population engaged in the military, three times the total number of teachers and 47 times the number of doctors.[6]

Most military expenditure in the Middle East is on imported arms, as local defence industries, apart from that of Israel, have limited capabilities. Arms imports represent a huge foreign exchange burden and a serious leakage from the economies of the Middle East to defence equipment manufacturers in the West. Figure 9.5 shows the average annual amount spent by Middle Eastern states on arms imports over the 1987–91 period. No figures are available for Israel, but the figure includes data for both Iraq and Iran. Saudi Arabia and Iraq were by far the greatest spenders on arms imports over the period, with expenditure averaging over $2 billion a year. Turkey and Egypt each spend over $1 billion annually on arms imports, even though military supplies from the United States are often acquired at prices which do not reflect the full research and development costs of the equipment. Smaller, so-called front-line states in the conflict with Israel spend substantial amounts on arms imports, an annual average of $689 million for Syria and a surprisingly large $572 million in the case of Jordan.

Government spending on defence has created a local armaments industry in Israel which produces relatively sophisticated equipment, from missiles to fighter aircraft, usually adapted from the original American designs. Israel's defence and aerospace industry undertakes some sub-contracting work for American companies, and has been successful in exporting cut-price versions of United States equipment to Third World countries. Hence, in its case, there are certainly benefits from government spending on defence, with export penetration as well as local multiplier effects. Israel with its limited resources can never hope to be at the forefront of military technology, as brains are not a substitute for the money it takes to develop aircraft such as the Stealth fighter which is undetectable to enemy radar. In the event of a peace settlement, its military

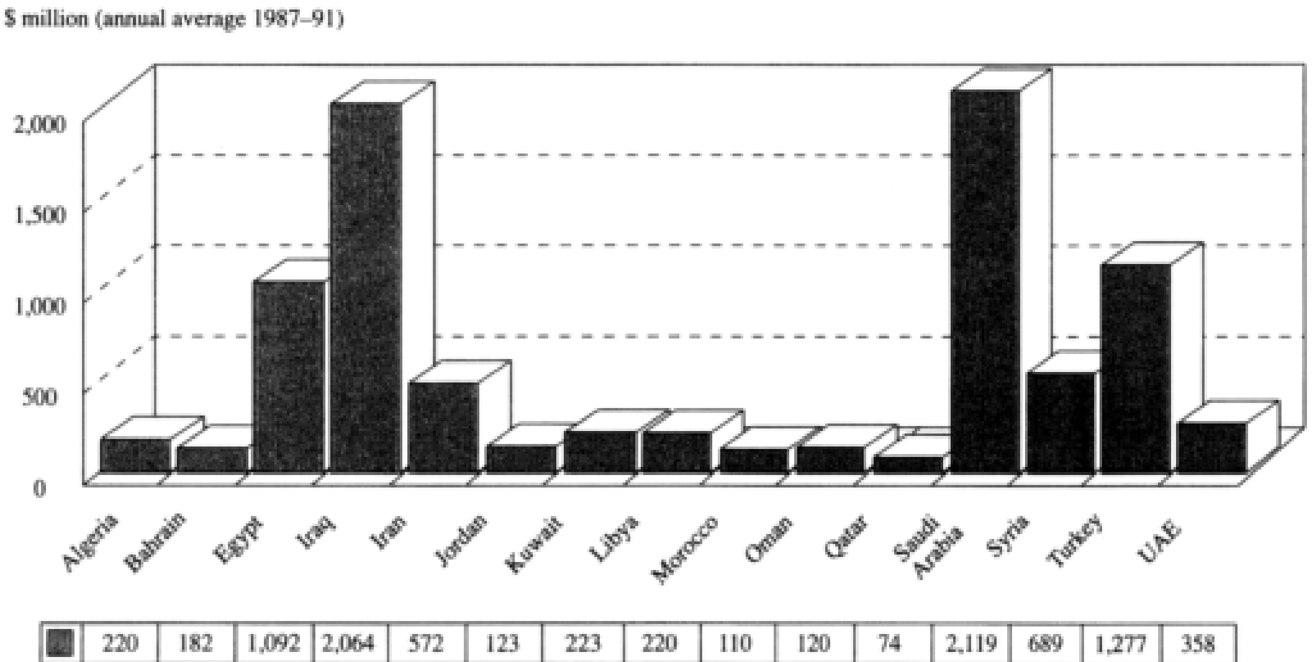


Figure 9.5 Arms imports
Source: United Nations Development Programme, *Human Development Report*, 1993

supplies industry could perhaps help to serve the regional market, but mutual suspicions between it and its neighbours would have to be much reduced for this to occur.

Elsewhere in the Middle East offset contracts have been negotiated with western arms suppliers, notably in the case of Saudi Arabia. The Tornado aircraft supplied by British Aerospace are maintained and serviced within Saudi Arabia rather than flown back to the United Kingdom. Similar accords have been reached between Egypt and the United States for tanks, trainer aircraft and helicopters, the western companies involved providing technical support. These deals are in the nature of import-substitution ventures, with a high price being paid to obtain the offset work. Whether this is economically or financially justifiable must be open to serious question.

The other major benefits from military spending have been skill acquisition and arguably the dynamic benefits that come from nation-building. In the case of a country such as the United Arab Emirates, the armed services bring together conscripts and professionals from different sheikhdoms who in the past have had divergent loyalties. Their cohesion into a fighting force to serve the whole country brings about a change of outlook and supplants the narrow allegiance of the tribal group. The same applies in such diverse and heterogeneous countries as Saudi Arabia and Iran, where being a conscript is an educational experience in itself. Service personnel also learn useful skills: the army cadet who learns to maintain and repair a tank today may be able to look after heavy goods vehicles tomorrow. Those who can manage computer-guided weapons can apply their software applications skills in the civilian sector at a later date. It can be argued that such skill acquisition through military service is expensive and often irrelevant, but in a region such as the Middle East, where a comparable level of civilian training may simply not be available, it may serve a useful purpose.

DEVELOPMENT PLANNING

Governments have asserted their control over Middle Eastern economies as much through development planning as through the annual fiscal rounds. Nevertheless, development planning has been as unsuccessful in the Middle East as in other parts of the Third World, and in recent years there has been much questioning of its usefulness, although planning bureaucracies continue to exist. In the case of the Middle East the exclusion of military expenditure from development planning may be one factor explaining the poor results, especially given the scale of defence budgets. Most governments in the region continue to draft five-year

development plans, however, although how seriously they are treated by the key decision-makers varies considerably from country to country.

The oil-exporting countries tended to view development plans as a shopping list. Each had a statement of government intentions for the coming five-year period and a listing of priorities. In so far as the compiling and publication of this information prompted public discussion of economic policy, it served a useful purpose, but unfortunately in the Middle East planning processes were unnecessarily secretive and there was little popular consultation. In the Far East governments listen to industrialists, entrepreneurs and bankers and then draw up economic policies to serve these interests. In the Middle East ministers and bureaucrats have tended to draw up the plans and then present them to the country as a *fait accompli.* The planning documents were seen as directives, to be enforced through administrative controls which owed their legitimacy to the plans themselves. Plans tended to be regarded as ends rather than means by those charged with their implementation, which encouraged inflexible attitudes rather than the flexibility that was arguably needed because resources varied with the state of the international oil market.

Most development plans in the Middle East are indicative, which means that they itemise state spending targets in broad categories, and set targets which it is hoped the private sector may attain. With more stress on private investment in recent years, the government's ability to meet targets is reduced, but increased reliance on the private sector reflects in part changing ideology but also, more importantly, constraints brought about by the reduction in oil revenues and financial inflows. The most ambitious comprehensive planning in the past was attempted by Syria and Algeria, both of which constructed elaborate input-output models for their economies, with estimates of inter- and intra-sectoral linkages. These models drew to some extent on Soviet planning methods, but also followed input-output methods pioneered by the development economist, Jan Tinbergen.[7] The reality, however, seldom matched the plans, and in practice the planners became very isolated from what was happening in the real economy. In Iraq there were also some attempts at comprehensive planning, but the requirements of civilian investment were always treated by the country's rulers as secondary to the needs of the military.[8]

The more modern planning techniques such as cost-benefit analysis have been largely neglected by governments in the region, although international agencies have applied such techniques to particular projects. It was the World Bank's cost-benefit appraisal of the Aswan high dam in Egypt in the 1950s that made it decide not to fund the scheme, opening the door to the Soviet Union to proceed instead.[9] The concern of the nationalist governments of the 1950s and 1960s in the region was with production rather than prices. Governments controlled prices for social

objectives, and tried to restrain market forces rather than harnessing them to promote development. Basic foodstuffs were subsidised to help the urban poor, and energy was subsidised to promote industrial development. Exchange rates were distorted by foreign exchange and import controls in the more populous states and non-oil-exporting countries, but the calculation of shadow prices was an exercise undertaken by academic economists, not those in government or the planning agencies.

In other words, prices as a means of achieving planning objectives were ignored in favour of the quantitative rationing of resources by the state. This has had the same unfortunate consequences for the Middle East as for the states of Eastern Europe. Planning has become out of fashion and somewhat discredited, although the ministries remain. Unfortunately, some of the beneficial features of planning, such as optimisation techniques and social accounting, have never really been tried in the region and seem likely to remain untested as governments move from one extreme position to another, following international fashion rather than addressing domestic realities.

ECONOMIC LIBERALISATION AND STRUCTURAL ADJUSTMENT

Egypt, Turkey, the Sudan and the Magreb states have to varying degrees implemented the classic type of economic liberalisation and structural adjustment policy much favoured by the International Monetary Fund. Often governments have been obliged to adopt such policies as a condition of receiving IMF balance-of-payment funding assistance. Multinational banks and western creditors have frequently stressed that IMF structural adjustment programmes should be in place, so that the countries can more easily meet their payments obligations and secure access to international commercial credits for trade finance on more favourable terms.

The IMF policies have often proved deeply unpopular, as governments have been obliged to exercise fiscal restraint, curtail subsidies on fuel and foodstuffs, and charge higher, and supposedly more economic, prices for basic services such as electricity and domestic water. The rationale behind such policies has been the belief that sound fiscal conditions are a necessary precondition for development, and that they will result in a more favourable economic climate in which the private sector should flourish. The aim is to remove the price distortions that inevitably arise with subsidies, so that markets can function more efficiently, and to reduce government intervention in economic activity in the long run, so that the private sector will not be 'crowded out' by the state.

There are two major sets of issues which arise from such policies. First, are they an infringement of economic sovereignty, and does it mean that governments such as those in Egypt and Turkey are mere captives of the IMF, at least in their economic policy-making? Second, does the economic 'medicine' actually work, and are the assumptions underlying such policies actually relevant to the economic conditions in the Middle East? One criticism of the IMF and to a lesser extent of the World Bank is that they have a standard set of policy prescriptions that reflect the fashion of some western economists for emphasising the need to overcome supply-side rigidities. Are supply-side rigidities a major problem in the Middle East, and has excessive government intervention actually crippled enterprise and the private sector more generally?

It has arguably been convenient for some Middle Eastern governments to blame the IMF for their economic predicament, as it deflects some of the popular criticism which inevitably arises with economic austerity measures. The IMF has in any case learnt from its early mistakes, and there is a desire not to undermine governments which it believes offer the best hope for reform in the long run, by forcing them to undertake unpopular short-run panic measures. The food riots in 1977 in Cairo were something of a turning-point not only for the Sadat government, but also for IMF officials, who saw the folly of trying to change too much too quickly. The governments under Mubarak have been much more cautious in their, approach to reform, but they have kept the support of the IMF throughout.

In Turkey the major reforms followed the 1980 coup, and it could be argued that the technocrats under Ozal could not have implemented the structural adjustment measures had it not been for the strong backing of the military and the suppression of any dissent from those on the left. As the 1980s advanced the austerity measures were relaxed, but the substantial improvement in the balance of trade and the rise in Turkish exports were seen as proof that the policy worked. It can be argued that it was not a powerful IMF, but rather a strong Turkish government, that brought about these favourable results. Indeed, it was only when the discipline was relaxed in the late 1980s that inflationary problems returned and the balance of trade went back into substantial deficit.

Iran has been attempting to introduce structural adjustment measures of its own during the 1990s, independently of the IMF but arguably much in line with what it recommends, demonstrating that there is not necessarily a conflict between the position of Islamists and the conventional economic wisdom of international institutions. The currency has been allowed to float down in response to market pressures, resulting in a rise of non-oil exports from $1 to $5 billion over the 1990–5 period. Imports have been allocated according to ability to pay, rather than by the planners, and the law on foreign investment has been changed to allow

multinational companies to have a majority shareholding in Iranian joint ventures.

The major criticism of structural adjustment programmes is that they can worsen income distribution and increase the difficulties of the very poor as the prices of basic commodities rise. In Egypt real earnings fell by 10 per cent over the 1987–90 period, and those of employees in the state sector decreased by a quarter as inflation rose towards 20 per cent. In Turkey real earnings fell by almost 40 per cent over the 1979–86 period, although since then they have risen as economic discipline has been relaxed. Critics of structural adjustment argue that greater international competitiveness is achieved at enormous social cost. In Egypt and Algeria one-quarter of the population continues to live in what the United Nations development programme defines as absolute poverty. The proportion in Tunisia, which the IMF often regards as an economic success, has risen to 17 per cent. Even in Turkey over 14 per cent continue to live in absolute poverty, with the absolute numbers rising by 5 per cent annually. The numbers in absolute poverty are also rising in Iran, with the proportion exceeding 30 per cent, to some extent a result of rapid population growth amongst the poor, but also reflecting recent economic policy changes which have taken the inflation rate to 21 per cent.

NATIONALISATION AND PRIVATISATION

The twentieth century has witnessed much debate over state ownership of productive resources, with socialists urging the state to take control of the commanding heights of the economy in order to protect the workers from exploitation by monopoly capitalism, while those on the political right urge governments to restrict their activities, to free business from damaging interference by incompetent, and sometimes even corrupt, bureaucrats. This debate has been echoed in the Middle East, with state ownership of economic resources increasing over the 1920–70 period and then retreating as nationalisation gave way to moves towards privatisation.

Arguments over the control of productive resources have a long history in the Middle East, and it would be a mistake to view governments in the region as merely copying policies pursued elsewhere. Economists in the region are of course aware of policy changes in Europe and North America, and international bodies such as the IMF and World Bank have in recent years favoured liberalisation and the encouragement of the private sector. Governments in the Middle East have always favoured the control of strategic resources, however, so that internal conflicts between private parties are avoided and the over-ambitious do not harm the interests of their neighbours. Although land ownership has usually been

private in the Middle East, water resources, which are arguably more vital, have always been controlled by the state. Historical records indicate that there was government management of water resources in ancient Egypt and Mesopotamia; indeed, the Pharaohs derived much of their economic power from their ability to ration water supplies to particular users.

Against this background it is scarcely surprising that Nasser wanted to nationalise the Suez Canal in 1956, taking control from the Anglo-French company which had hitherto collected and disbursed the revenues, mostly to its own shareholders in Europe. Nasser also took control of other foreign interests in the country, notably the banking system, which was also controlled by French and British capital. The textile mills, which were founded by local merchants and landlords in the 1920s and 1930s, were also nationalised under Nasser, because he distrusted the owners and was concerned that they were sending the profits abroad rather than reinvesting in Egypt. Some were doing this because of their lack of confidence in Nasser and their desire to have assets abroad as a safeguard in case their situation became difficult and they had to leave.

In Turkey and Iran from the 1920s, and in the Gulf from the 1970s, the state took the lead in heavy industrialisation largely because the private sector was both unable and unwilling to invest in such ventures. It was not a question of the state taking over existing assets, but rather the finance of new investment where domestic private capital markets were small or non-existent. The industries involved included steel production, oil refining, petrochemicals, vehicle assembly and the servicing of military supplies.

There is little doubt that most of the heavy industries in the Middle East would not have developed without state intervention, although just how beneficial these industries have been is open to debate. Where industries continue to need subsidised inputs for their survival they are possibly more of an economic burden than an asset. Much of the steel industry in the Middle East uses old technology which causes considerable pollution. In many respects it is in an even worse state than the plants in Eastern Europe which are threatened with closure, yet there would be considerable political opposition if there were similar threats in the Middle East, because these plants are still regarded by many as symbols of the region's industrial progress. It is only in the Gulf, where steel mills using modern gas-reduction techniques have been built, that the industry is really viable.

Commercial viability has become more of an issue in recent years with the moves towards economic liberalism and the privatisation of state-owned assets. Privatisation is proceeding very slowly in the Middle East, but liberalisation policies are much more advanced. The latter include the phasing out of state subsidies on foodstuffs, energy and industrial inputs, and the reduction and abolition of foreign exchange controls, including

multiple exchange rate arrangements. Egypt moved in this direction in 1989, and in 1993 Iran abolished its three-tier exchange rate system which discriminated in favour of imports of capital equipment and industrial inputs with a single floating rate determined by market forces.[10] Turkey had already followed this course a decade earlier. Despite payments liberalisation for traded goods, some controls still remain on capital transfers in all Middle Eastern states, apart from those in the Gulf. Foreign investment is actively encouraged, however, with free repatriation of profits. Even the former Marxist state, South Yemen, now unified with the North, was trying to encourage foreign direct investment in a new duty-free zone established at the port of Aden. It appears that the new economic liberalism was emerging in some of the most unlikely places, although this may have been the last ploy of a dying regime.

Western multinational companies remain cautious about Middle Eastern investment, and continue to be wary of political risk. As most regimes in the Middle East last considerably longer than those in the democratic West, it is by no means clear that such fears are justified. The concern, however, is that change will be violent, and that there could be abrupt policy reversals that could threaten and undermine businesses, especially those under foreign control. There has been less direct investment by multinationals in the Middle East than in any other region of the Third World apart from sub-Saharan Africa. The Japanese multinationals are especially notable by their absence, because although these firms are leading suppliers of exports to the region, they appear reluctant to commit themselves to any long-term manufacturing ventures. The only significant investments in recent years have been with SABIC (the Saudi Arabian Basic Industries Corporation), which has built petrochemical and fertiliser plants. Even in this case the foreign companies tried to keep their joint-venture stakes to the minimum required to stay in the projects.

If privatisation measures were broadly adopted and implemented, this would undoubtedly encourage foreign direct investment, but this still seems a distant prospect. Saudi Arabia has sold one-quarter of the state share in SABIC to private local investors but there is a reluctance to sell the remainder in view of the strategic importance of the company and its contribution to government revenue. Egypt has embarked on a very cautious privatisation programme involving medium-sized companies in fields such as food processing, textiles and construction supplies, as well as a few leading hotels.[11] Major state industries such as steel-making are excluded on strategic grounds, as is Egyptair, the Egyptian state airline, and the banks. In the case of the state manufacturing facilities it is doubtful if buyers could be found in any case, unless debts were written off and losses underpinned. The state airline could be a more promising possibility, as the Jordanian experience with selling off Alia, the Royal Jordanian Airline, shows.

None of the imaginative privatisation schemes attempted in Eastern Europe or the former Soviet Union have been tried in the Middle East. Privatisation may only result in industries being sold off to a few already wealthy speculative investors rather than through any mass subscription to share ownership. A voucher system whereby purchase certificates are distributed to the entire adult population, as in the Czech and Russian Republics, could be one answer. It would not bring any revenue to Middle Eastern governments, but it would establish the relative value of different enterprises, and it would give ordinary citizens the means to participate directly in financial markets and the commanding heights of the economy. Popular capitalism may deliver for the region the economic growth that eluded past socialist planners.

DEVELOPMENT AND DEMOCRACY

The link between development and democracy is a much-debated issue among political scientists and those concerned with international relations, but perhaps receives less attention from economists. Which comes first is far from clear, as in Russia, for example, political reform appears to have come before economic development, while in China the reverse seems to be the case. Has the lack of democracy in most of the Middle East and the autocratic style of government been an impediment to development or has it actually aided the process?[12]

There are disadvantages if decision-making is concentrated in just a few hands, with all directions coming from the top down. In Middle East politics, and indeed in business, power is concentrated at the top, and there is a lack of delegation of decision-making. This may mean that economic policy-makers and top businessmen have simply too many minor decisions to make, and progress is thwarted by delays because those with the power become overwhelmed. The absence of popular participation means that there are fewer economic agents to harness and the team spirit gets lost. On the other hand, there are fewer problems of co-ordination and delay in trying to reach agreement. Popular consultation can often result in inertia, as the planning processes over environmentally sensitive schemes in Europe illustrate. Such problems are seldom encountered in the Middle East.

In the Middle East, governments are often more concerned with power politics and international relations than with domestic economic concerns. The ordinary people are very interested in the basic economic developments that affect their own lives, but as politicians come from the wealthier classes they are somewhat removed from such mundane concerns. In Egypt it was the rise in the price of bread in 1977 which brought anti-government rioting to the streets of every major city in the

country, but there were no popular demonstrations against Sadat's peace treaty with Israel, a source of deep concern to many in the political class. Despite such events, government complacency over economic issues remains. The economy is regarded as safe, almost non-controversial, while the real heat of political debate is reserved for issues such as relations with the western powers, inter-Arab disputes, differences with Iran and how to deal with the Israelis.

There is little real economic democracy in the Middle East, which would imply widespread participation in and consultation on economic policy matters. Riots, such as those in Egypt in 1977, represent the ultimate public veto, but for people to express a negative view is less satisfactory than to indicate what they actually want. Much economic power in the Middle East is vested in the finance ministers and their senior civil servants, planning ministers and those involved in planning departments being usually less important. Central banks have no independence and are seldom consulted on economic policy matters, although the governor of the central bank may attend formal meetings as an observer. As government expenditure policy is the main means of controlling the economy, and monetary policy plays at best a minor role, this tends to reduce the influence of the central bank in any case.

Many economic policy changes are simply introduced by ministerial decree, which implies little or no parliamentary accountability. Indeed, it often seems that finance ministers are more accountable internationally to bodies such as the IMF than they are domestically to their own parliaments. Increasingly the ministers are technocrats, many of whom are trained economists, which means that at least they have a good grasp of the economic issues, if not always of the political constraints. Economists are often poor communicators, however, and as a result finance ministers often fail to get their message across to others in government and usually carry little political weight. Many feel most comfortable when dealing with their own civil servants, than when answering questions in parliament or even the queries of other ministers.

PEACE IN THE MIDDLE EAST AS A PRECONDITION FOR DEVELOPMENT

Perhaps the greatest hope for a change in the economic prospects of the Middle East comes from the moves towards peaceful coexistence within the region. Iran, despite its desire for military strength, does not want another war, following its heavy casualties in the long conflict with Iraq in the 1980s. Iraq has been severely weakened by its defeat in the Gulf War, and although its leadership is frustrated, the best it can hope for is to mark time. Turkey would have much to lose from any conflict, as good relations

with the European Union and the United States are of prime importance to its leadership, given its economic and military orientation. In any case, the Ankara government is increasingly looking north to its Black Sea neighbours and east to the Turkic republics of Central Asia, rather than south to the Arab world. The Arab states and Israel are conflict-weary, with the new chapter in Arab—Israeli relations which started with the Camp David accords between Israel and Egypt now being extended to settlements with Israel's more immediate neighbours, most importantly of all, the Palestinians.

Conflicts are far from over in the Middle East, but in the years ahead civil strife within countries is likely to be the major security concern rather than wars between countries. Civil strife can be highly damaging economically if it is on the scale of the Lebanese civil war which resulted in a collapse of government control and near-anarchy in some parts of the country, but this is unlikely in most Middle Eastern states. More probable are continuing terrorist incidents from groups such as the Kurds in Turkey, *Hamas* in the West Bank, Gaza and Israel, and Islamist opposition groups in Egypt and Algeria. Such incidents inflict economic costs, especially on soft targets such as the tourist industry, but they are unlikely to be serious impediments to development. Better-organised groups, such as ETA in Spain, the IRA in Britain, and various extremist organisations in India, have been able to inflict only marginal economic damage and have not had any significant impact on either industry or services. There is little reason to think that the experience in the Middle East will be any different, especially given the record to date.

Many Muslims in the Middle East are dissatisfied with the secularist governments in the region, but few, and even fewer of the truly devout, see terrorism against the state as the way forward. Most, being religious people, see provision of help for fellow Muslims as the best course of action: welfare systems for the poor whom the state fails to look after; religious education; and financial services such as Islamic banks and investment companies. The aim is to win the hearts and minds of the masses through peaceful social and economic actions, and to teach by example. Some armed incidents have only been a reaction to terror by the state, rather than actions instigated by Muslim groups themselves. Democratic societies should welcome such peaceful challenges which bring infusions of new ideas. It is those Middle Eastern states where there is a lack of democracy, such as Algeria, that see the Islamists as the greatest danger.

If peace does prevail between Israel and its neighbours, the economic situation in the Middle East heartland could be transformed. New infrastructure links could give Jordan direct access to the Mediterranean for its trade, Egypt could benefit from overland links with Syria, and Gaza could become a duty-free entrepôt centre. Regional complementarities

could be harnessed for the common good, with, for example, Israeli irrigation expertise combined with Gulf capital to introduce different types of crop production with more market appeal. The tourist potential of the Eliat and Aqaba area could be developed jointly, making the region much more attractive to the overseas visitor. Palestinians could develop their financial institutions, such as the Arab Bank, to become significant regional, and perhaps even international, enterprises.

All this could give more balanced development from a sounder base than the oil boom of the 1970s. It may be an exaggeration to speak of the effects of a 'peace boom' of the late 1990s surpassing those of the oil boom twenty years earlier, but there is little doubt that the region has enormous potential. By removing the restraints on trade which have existed ever since the state of Israel was created in the Middle Eastern heartland, and by shifting human energies in a more positive direction, there is much that can be achieved in the coming years and decades.

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The Economist produces quarterly country reports on each of the countries of the region and an annual review, with the smaller states of the region grouped geographically in single volumes. The weekly journal *Middle East Economic Digest,* also published in London, has useful coverage of current developments. There is a newsletter produced quarterly by the *Economic Research Forum for the Arab Countries, Iran and Turkey,* an organisation based in Cairo. Each issue is devoted to a particular theme, the December 1994 issue, for example, being concerned with regional trade liberalisation and the position of the Middle Eastern economies in relation to GATT, the General Agreement on Tariffs and Trade. The *Forum* also has a working paper series with useful contributions on the economics of population growth, regional labour markets, structural adjustment and stabilisation policy. The discussion paper series of the Middle East and North Africa division of the World Bank is also worth mentioning, with interesting papers on the tax systems of Egypt and Morocco, trade liberalisation, labour markets and demography, and poverty in Jordan.

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