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Economic Reform in Arab Countries: A Review of Structural Issues for the Remainder of the 1990s

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Abstract

The paper reviews the main structural reform issues facing Arab countries in the remainder of the 1990s. While the nature, extent, and implications of the policy challenges differ among individual countries in the Arab region, several aspects are common to a large number of them. Accordingly, the paper identifies a framework consisting of a core of key reforms that would address these countries' structural weaknesses and assist them in exploiting their considerable economic potential.

JEL Classification
E60, O11, O53

1/ An earlier version of the paper was presented to the seminar on "Prospects of Arab Economic Development in the Nineties", organized by the Arab Fund for Economic and Social Development and the Arab Monetary Fund in Bahrain on February 1-3, 1993. The paper will be published in the proceedings of the seminar. The authors are grateful for comments received from Jack Boorman, Paul Chabrier, Manal Fouad, Gerry Johnson, Manmohan Kumar, Melhem Melhem, Chris Yandle, and seminar participants. Data used in the paper were compiled by Ulrich Thiessen and Ilsa Marie Fayad. The authors are soley responsible for any remaining errors.

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Summary

Arab countries' economic and financial performance in the 1980s was mixed relative to that of developing countries as a whole. Although economic growth lagged behind that in developing countries, inflation performance was more favorable and the group's current account position improved despite the impact of lower international petroleum prices. Macroeconomic aggregates for Arab countries as a group, however, conceal important differences among individual countries, especially when developments in oil and non-oil economies are compared.

Notwithstanding the diversity in economic and financial conditions, many of the countries in the Arab region face similar policy challenges, particularly in the structural reform area. It is in this context that the paper identifies a "core" set of required structural reforms. These include rationalizing the activities of a large public sector with a view to limiting them to areas warranted by market failure; strengthening the structure of government budgets and increasing their developmental impact; improving the mobilization and allocation of loanable funds from domestic and external sources; enhancing the institutional framework to encourage private investment and production; and rationalizing the external trade and payments system. The paper also discusses, as part of a comprehensive poverty alleviation policy, the importance of measures to protect the most vulnerable groups of the population during the process of adjustment and reform. To be fully effective, the structural reform efforts need to be supported by prudent demand management, an open international trading system, and, for some countries, appropriate external financial assistance.

There is a growing recognition among Arab countries of the need to strengthen their economic performance in the 1990s in a sustainable manner. Indeed, some countries have already embarked on programs aimed at correcting structural weaknesses. The analysis of experience to date under these programs provides an important input into the paper's specification of an overall framework for policy reform.

I. Introduction

Despite adverse exogenous factors, Arab countries have achieved important economic gains in recent years. Nevertheless, many of them remain subject to internal and external constraints that frustrate the full realization of their considerable economic potential. The foregone welfare gains are of particular relevance in the current environment characterized, inter alia, by rapid population growth in some countries in the region, concerns about the adequate availability of natural resources, uncertain oil price prospects, and a move outside the Middle East toward regional economic blocks combined with slow progress in multilateral trade liberalization efforts.

There is growing recognition among Arab countries as to the need to strengthen their economic performance in a sustainable manner. This involves the implementation of comprehensive measures to enhance the mobilization, and increase the efficient use, of productive resources. Indeed, several Arab countries have taken structural reform and adjustment measures aimed at improving the supply responsiveness of their economies and containing excessive aggregate demand pressures.

Given the considerable economic and financial diversity of the Arab world, there is no single approach to identifying in a concise and comprehensive manner the challenges facing individual countries in the region and their policy implications. At the same time, however, several of these countries share similar policy issues, particularly in the structural reform area. Accordingly, by reviewing the broad economic issues and the policies taken to date within the region, the paper specifies an overall framework which may be applied to individual country cases, taking account of their specific circumstances. Indeed, such a framework serves not only to identify the key areas in which policy formulation is required consistent with individual country conditions (or those of a homogenous group of countries), but also to assess the impact of such policy implementation on countries' economic performance as well as some of the conditions for effective Arab economic integration.

The paper is organized as follows. Section II reviews briefly economic and financial developments in Arab countries in the 1980s, using the experience of developing countries as a whole as a basis for comparison. This provides the background for Section III's discussion of a "core" set of structural policy challenges facing Arab countries in the 1990s. Following a brief analysis of these challenges, the paper reviews specific reform measures drawing on the experience of countries in the region. The paper concludes with a summary of the main findings.

II. Developments in the 1980s

The decade of the 1980s was a relatively disappointing one for developing countries as a group. As compared to the 1970s, it was characterized by weaker macroeconomic performance (Chart 1). Specifically: (i) real GDP growth was lower in the decade of the 1980s compared to that of the 1970s; (ii) the consumer price index increased significantly faster in the 1980s; and (iii) the accumulation of external debt was higher in the 1980s despite the sharp curtailment in the availability of spontaneous financing. These country averages conceal important differences among regional groupings, with relatively weak performance on the part of African and Latin American countries, particularly relative to Asian economies. Underlying the macroeconomic developments were adverse exogenous developments (including unfavorable terms of trade) and domestic policy weaknesses (including large financial imbalances associated with over-expansionary fiscal and monetary policies).

Arab countries' performance was mixed relative to the developing country average. 1/ Real GDP expanded at an average annual rate of some 2 percent in the 1980s (Chart 2). With a relatively high population growth, per capita incomes declined at an average annual rate of around 1 percent. 2/ Inflation performance in Arab countries was considerably better than that for developing countries as a whole, notwithstanding the acceleration in the rate of inflation in the latter part of the decade (Chart 3). Finally, the group's current account position improved after 1984, despite the lower level of international petroleum prices.

As is the case for the developing country grouping, macroeconomic aggregates for Arab countries as a whole conceal important differences among individual countries--countries which differ (substantially in some cases) in their natural resource base, labor endowments, and financial resources. This is most apparent when comparing oil and non-oil countries' growth performance--and despite strong interrelationships among the two groups (including those due to remittance and aid flows, both of which have been

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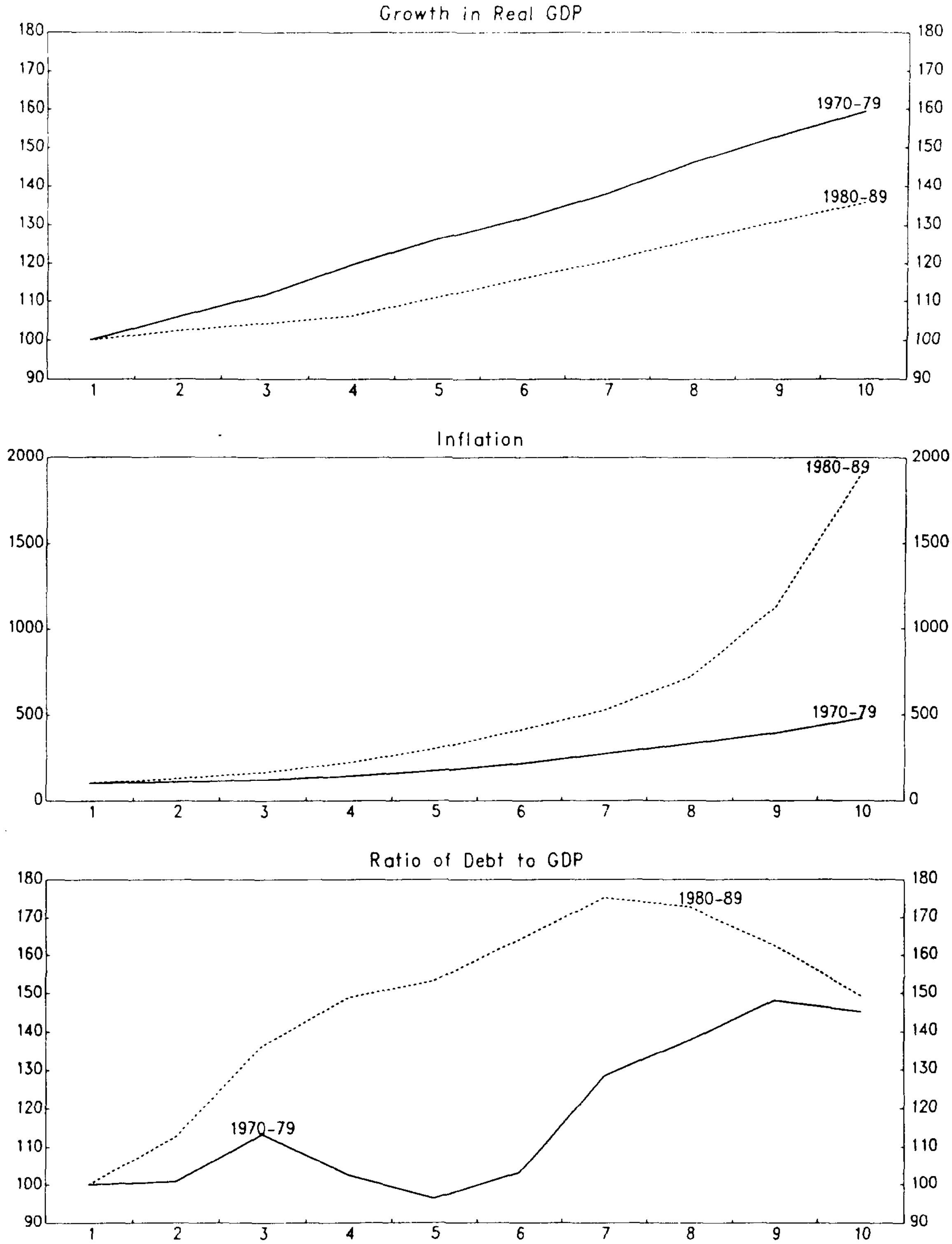
1/ Aggregates for Arab countries are compiled on the basis of computed GDP-weighted averages for individual members of the Arab League for which comprehensive data are currently available (i.e., Algeria, Bahrain, Djibouti, Egypt, Jordan, Kuwait, Lebanon, Libya, Mauritania, Morocco, Oman, Qatar, Saudi Arabia, Somalia, Sudan, Syria, Tunisia, United Arab Emirates, and Yemen).

2/ It should be noted that the comparisons with the developing country group are sensitive to the starting point for the comparison periods. Thus, the choice of 1980 as the base year biases downwards the comparison as the year was associated with an historically high oil price level. Indeed, nominal oil revenues of the Arab OPEC members increased from US$56 billion in 1975, to US$278 billion in 1980. Following the sharp fall in international prices, they declined to US$49 billion in 1986. Additional information is contained in El-Kuwaiz (1990).

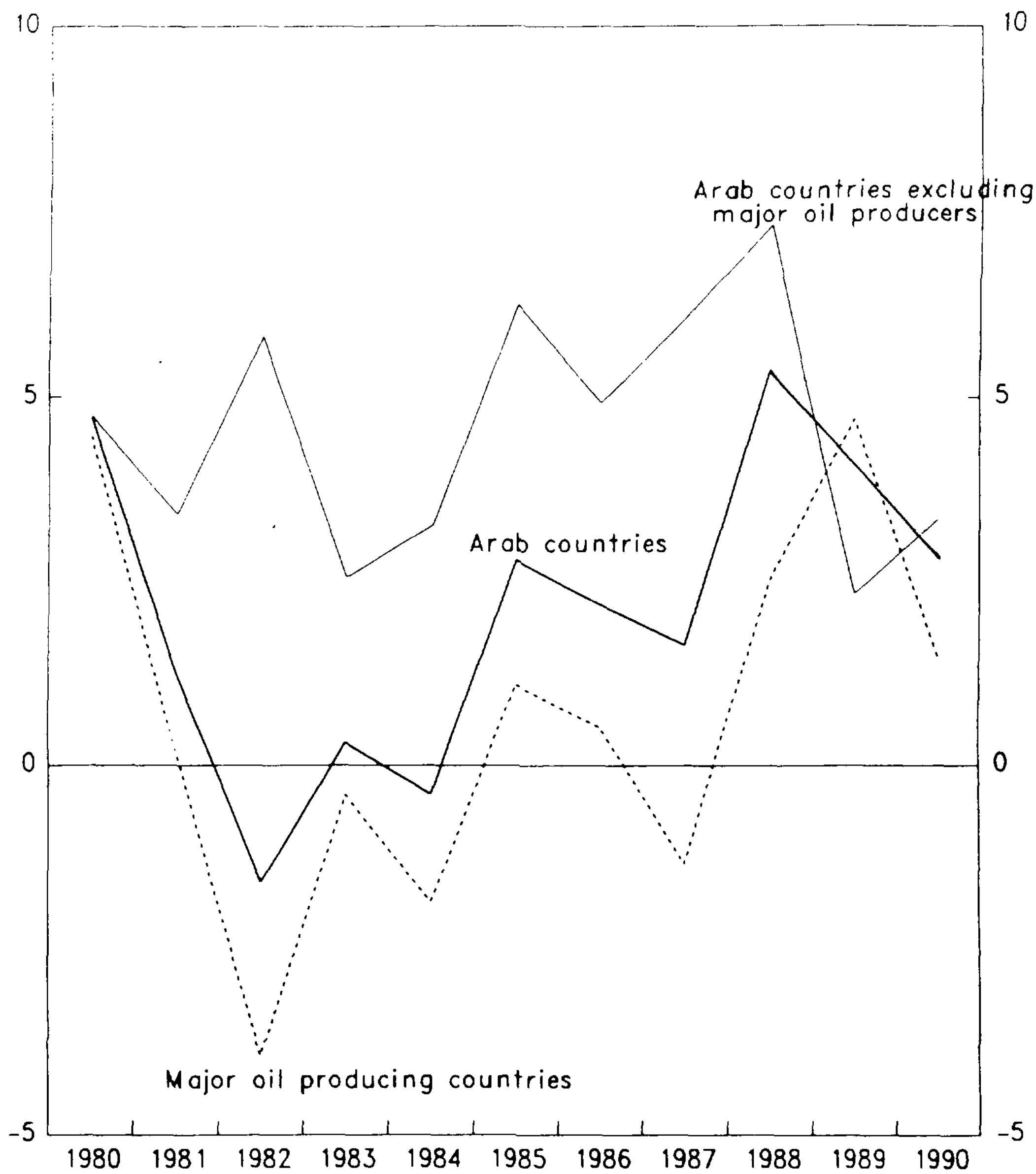
CHART 1
DEVELOPING COUNTRIES
SELECTECTED INDICATORS
(Index numbers)



Source: International Monetary Fund, World Economic Outlook data base.

CHAPT 2
ARAB COUNTRIES
GROWTH OF REAL GDP

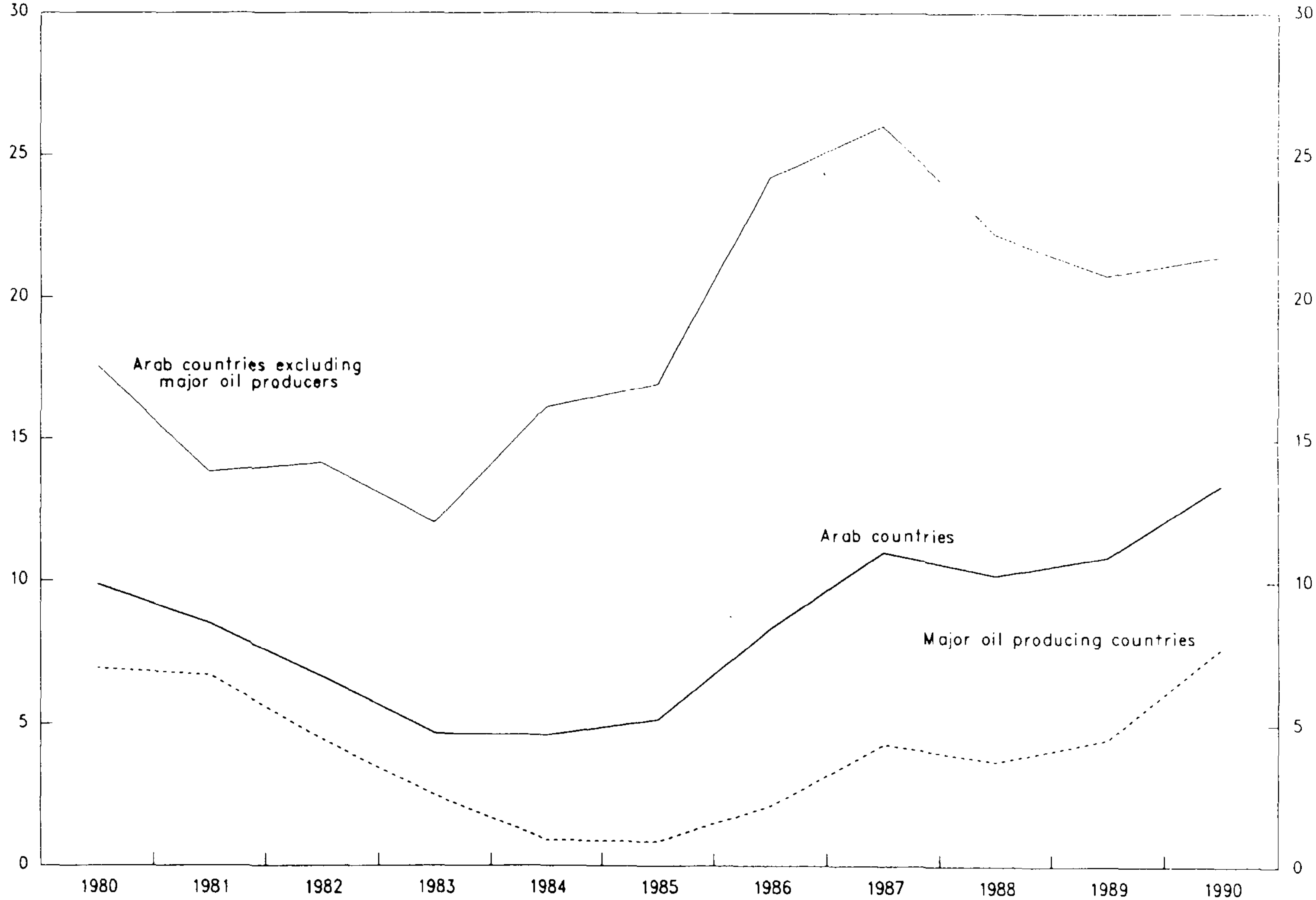
(Annual changes in percent)



Source: International Monetary Fund, Data Fund.

1/ Weighted geometric average.

CHART 3
ARAB COUNTRIES
CONSUMER PRICES 1/
(Annual changes in percent)



Source: International Monetary Fund, Data Fund.

1/ Weighted geometric average.

affected by changes in oil export receipts). 1/ As would be expected, the fall in oil prices, compounded by a reduction in production and exports, impacted more severely growth performance in the oil countries. 2/ Thus, while non-oil countries' per capita income gains exceeded those of developing countries as a group, the oil countries recorded negative per capita growth rates in several years during the 1980s. The non-oil countries' inflation performance was also better than that of developing countries as a whole but fell short of that of oil countries. This differentiated performance was consistent with monetary developments, with non-oil countries recording larger domestic liquidity growth throughout the period (Chart 4). This reflected primarily the financing requirements of fiscal deficits in the context, inter alia, of limited reserve funding.

III. Major Policy Issues for the Remainder of the 1990s and Reform Experiences to Date

Arab countries are facing important economic challenges and opportunities in the remainder of the 1990s. Of course, their exact nature and magnitude vary depending on the country being considered. In addition to differences in economic and financial conditions--including the degree to which they were impacted by the 1990-91 Middle East crisis--countries vary in the extent to which they have already embarked on comprehensive economic adjustment and reform programs. Thus, some countries have implemented some corrective measures but, as yet, do not appear to have reached the critical policy mass required to address, in a decisive manner, the economic and financial imbalances. In contrast, others have persevered with comprehensive adjustment and reform programs, placing them more firmly on the road to sustained medium-term economic growth and financial stability. In view of these factors--which are compounded by differences in the "reserve cushion" available to countries in the region and their vulnerability to exogenous shocks--the type of approach taken in this section will, by necessity, involve a certain degree of aggregation and generalization. Nevertheless, it provides a useful framework for subsequent application to individual country cases, taking account of their specific circumstances.

1/ For this purpose, oil countries are defined as those deriving more than half of their domestic output from the extraction of crude oil. As in the case of the coverage used by the Arab Monetary Fund (1991), the grouping includes Algeria, Bahrain, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. As noted by El-Kuwaiz (1990), there are substantial differences even within this subgroup of Arab countries. Various attempts have been made to classify Arab countries on the basis of other criteria such as per capita income, population density, and debt burdens.

2/ Real GDP in oil producing countries is heavily influenced by fluctuations in oil production. For a discussion of related national accounting issues, refer to Ahmed, El Serafy and Lutz (1989).

There is widespread agreement that most countries in the region stand to benefit from sustained domestic policy efforts aimed at improving the efficiency of resource use. Indeed, some observers have noted that the real issue is not whether to implement adjustment and reform measures, but rather the nature of the required measures. 1/ This issue assumes added importance given some countries' rapid population growth and concern about water supplies and oil price prospects. Moreover, the international environment facing Arab countries includes movements toward regional trading blocks outside the region (e.g., in Europe, Asia, and the Americas) 2/ in the context of slow progress in multilateral trade liberalization efforts. 3/

This section seeks to identify, in a summary fashion, some of the major structural economic challenges facing countries in the Arab world. This is accompanied by a discussion of their policy implications and a review of selected Arab countries' experience in implementing appropriate reform measures. 4/

1. Reforming public enterprises

One of the important features of many countries in the Arab world is the dominant role played by the public sector. Thus, over the years, the public sector increasingly participated directly in a wide range of economic activities, many of which bore little relation to arguments of strategic importance, natural monopolies, public goods, and other market failures. In many countries, the growth of the public sector initially had its roots in considerations relating to the establishment of "essential industries" (such as steel, fertilizers, and chemicals)--i.e., industries deemed imperative for the development of the economy but considered beyond the capacity of the

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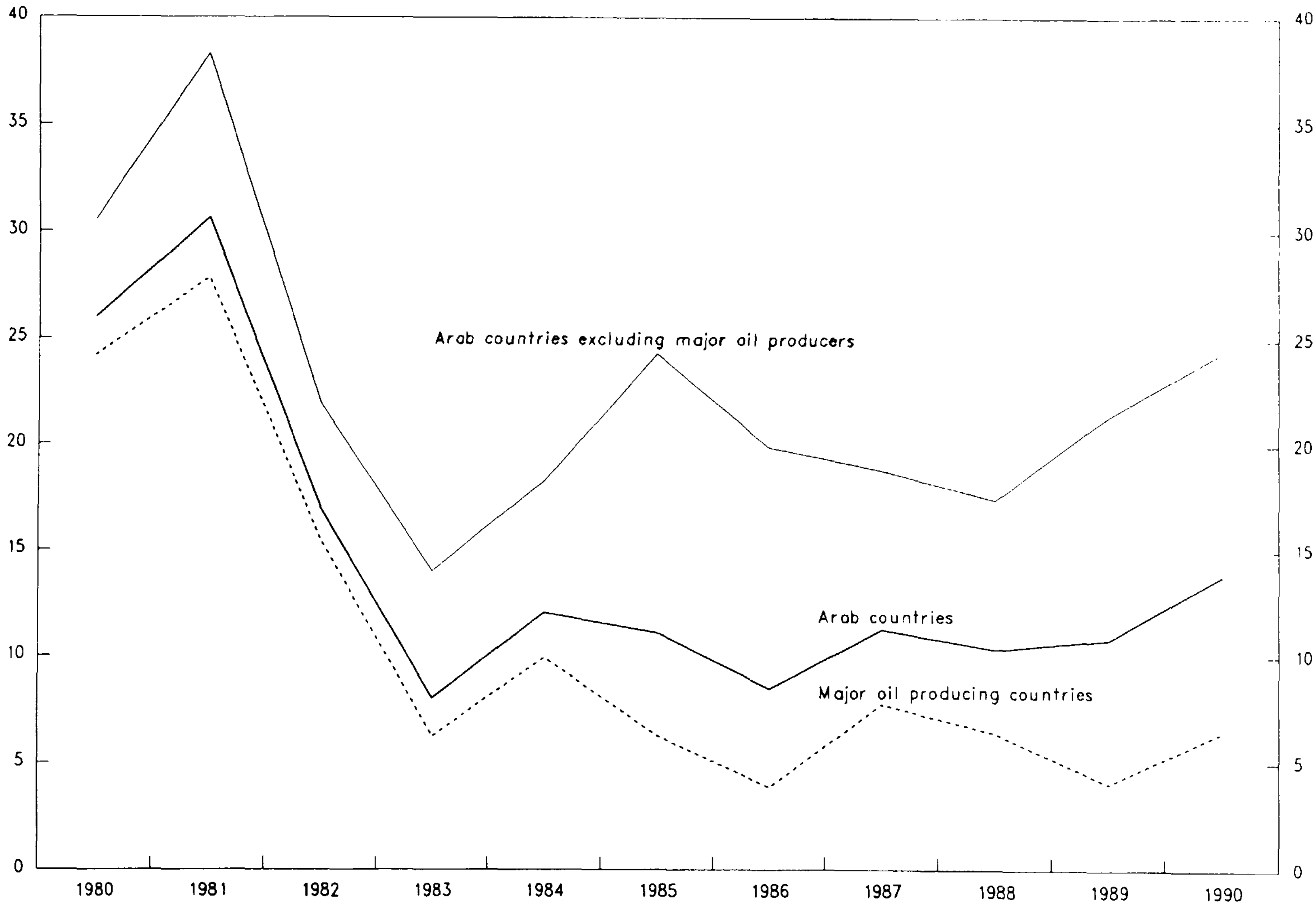
1/ For example, El-Naggar (1987).

2/ For an analysis of the potential impact of European integration on Arab countries, and the revision of "trade and aid privileges" associated with developments in Central and Eastern Europe, see Langhammer (1993).

3/ A related issue that is not addressed directly in this paper is the scope for efficient economic cooperation among Arab countries. For a discussion of Arab economic integration, see Shafik (1992). It may be noted, however, that progress among countries in the identified policy areas would be an important contribution to the process of "policy convergence" that would be essential to underpin effective Arab economic integration.

4/ It should be noted at the outset that, unless accompanied by appropriate fiscal, monetary, and exchange rate polices, the structural reform measures discussed below will not result in a sustainable improvement in economic and financial performance. At the same time, it is worth noting that several of the structural reforms discussed below can lead to an improvement in public sector finances, facilitating the reduction of macroeconomic disequilibria and more efficient resource allocation. For a discussion of the developing country experience in this regard, refer to IMF (1992). Selected aspects of demand management policies in Arab countries are discussed in Shaalan (1987).

CHART 4
ARAB COUNTRIES
BROAD MONEY AGGREGATES 1/
(Annual changes in percent)



Source: International Monetary Fund, Data Fund.

1/ Weighted geometric average.

private sector. In several cases, these factors were accompanied by sociopolitical considerations (e.g., Algeria, Egypt, Iraq, Sudan, Syria, and the former People's Democratic Republic of Yemen), including the wish to reduce the influence of external forces and certain segments of domestic society. 1/ In some countries, the importance to the government of securing control over the exploitation of a strategic natural endowment also played an important role. Thus, the private sector came to perform an increasingly residual role in a number of economic and financial sectors, with administrative allocation of resources replacing market signals. Moreover, in the 1970s, the increased dominance of the public sector in several oil countries reflected the structure of these economies, particularly the relatively limited role of the private sector in production activities in the context of large windfalls accruing to the public sector as a result of the oil price increase of 1973-74. Indeed, public finance policy was the primary determinant of domestic liquidity, aggregate demand, and non-oil GDP growth. 2/

Economic performance of public enterprises in Arab countries has been far from satisfactory in most cases. 3/ The enterprises' earnings have tended to fall short of their current financial obligations, let alone provide for an adequate return on capital. As in other developing countries, production efficiency has been undermined by insufficient commercial orientation and management accountability--including exogenously determined investment, pricing, and employment considerations. In addition to direct transfers from the budget to subsidize mounting losses, some of the public enterprises have been provided with subsidized inputs and credit--placing a heavy burden on already strained budgetary and monetary policies. In some cases, the banking systems' nonperforming claims on public enterprises have also weakened the integrity of the financial system. These problems have been compounded by rigid labor legislation in a number of countries--an issue that also has adversely affected private sector production and investment.

There is increasing recognition as to the need to rationalize the public sector's activities to those operations that it undertakes most efficiently and that are warranted by market failures. In some Arab countries, this recognition has been translated in enterprise reform efforts incorporating the provision of greater autonomy and accountability, financial restructuring, and privatization. However, as compared to other

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1/ See El-Naggar (1989b). El-Naggar notes that several other countries (e.g., Jordan, Morocco, Tunisia, and the former Yemen Arab Republic, as well as members of the Gulf Cooperation Council) may be viewed as belonging to the group of "pragmatic interventionism", where sociopolitical considerations tended to play a relatively less important role.

2/ The impact of fiscal policy on macroeconomic aggregates in these countries during the decade of the 1970s is discussed in Morgan (1979). Indicators of public sector activities for some other Arab countries are presented in Heller and Schiller (1989).

3/ For a more detailed discussion of this issue, see Wall (1990).

developing country regions, the scale of privatization in the Arab world has been limited. Thus, with one exception, no country in the region may be regarded as having implemented a comprehensive program of wholesale divestiture of public sector enterprises--in contrast to the experience, for example, in Asia, Central and Eastern Europe, and Latin America.

In Arab countries implementing public sector restructuring programs, the initial stages of the process included diagnostic studies to assess the financial viability of enterprises and the rationale for public ownership and control (e.g., Mauritania, Morocco, and Tunisia). 1/ There have also been decisions made regarding the best institutional setup to implement the restructuring program. Thus, in some countries, the process of granting greater autonomy to enterprises has involved the use of a holding company construct (e.g., Algeria and Egypt) which, while still under public ownership, was to be free from administrative interference. The holding companies were provided with the authority to approve business plans, restructure, merge, liquidate, or privatize the enterprises under their control. Progress, however, has been slower than anticipated--reflecting, inter alia, constraints inherent to the construct itself--and has resulted in further policy adaptations. Other, albeit less comprehensive, approaches have been implemented in the region. These include transfers to workers' cooperatives (e.g., Libya and Somalia); sales of some shares to the public (e.g., Oman, Qatar, and Saudi Arabia), to foreign minority partners (e.g., Qatar), and through joint ventures (GCC countries); employee buyouts (e.g., Morocco); use of management performance contracts (e.g., Algeria); and assumption by the central government of enterprise obligations to the banking system (e.g., Mauritania). 2/

In addition to institutional constraints (including the absence in some countries of sufficiently deep capital markets), the process of public enterprise reform has been delayed by concerns about the absorption of surplus labor and by difficulties in addressing the large financial obligations of the enterprises--obligations that not only involve direct and contingent budgetary liabilities, but also affect the soundness of the domestic banking system. Some countries have sought to "clean up" enterprises' balance sheets prior to their transfer to the private sector. This has included the setting up of a fund to cover accumulated losses (e.g., Algeria and Tunisia), cross-cancellation of bilateral obligations (e.g., Morocco), and a waiver of enterprises' arrears to the central government (e.g., Algeria and Tunisia). The issue of surplus labor

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1/ In the case of Tunisia, the privatization of the loss-making public enterprises identified in the study has been virtually completed. The authorities are now preparing to undertake the privatization of the other enterprises.

2/ Further country-specific information is contained in Candoy-Seske (1988) and Heller and Schiller (1989). More detailed analyses of privatization in Egypt, GCC countries, Jordan, and Tunisia are contained in, respectively, Abdel-Rahman and Sultan (1989), Khatrawi (1989), Anani and Khalaf (1989), and Bouaouaja (1989).

absorption has concerned primarily the extent of concomitant growth in private sector activities--which, as discussed below, has been closely related to policy actions to liberalize production and investment regulations.

More forcefully addressing the institutional and financial constraints constitutes a necessary but not sufficient condition for effective public sector enterprise reform in Arab countries. The process must be accompanied by modifications in the production environment. This includes: enhancing competitiveness and market discipline through domestic and external trade liberalization policies supported by appropriate regulatory and supervisory practices; rationalizing the system of credit subsidization through the banking system; modifying labor legislation; and limiting explicit and implicit guarantees for enterprises' domestic and external nonbank borrowings. While some important steps have been taken (as discussed later in the paper), progress to date remains limited in several countries in the region.

2. Other fiscal sector reforms

The dominant role of the public sector in Arab countries has also been reflected in the structure and size of the central government budget. For some countries--particularly the major oil exporters--the financing of budgetary expenditures did not pose a problem as long as international oil prices were at relatively high levels. However, sharp falls in oil prices and associated budgetary revenues, particularly in the mid-1980s, exposed the vulnerability of the fiscal accounts, requiring sharp cuts in expenditure and mobilization of budgetary financing from domestic and external sources. 1/ They also highlighted the importance for some countries of diversifying the revenue base by increasing the share of non-oil revenues. As noted earlier, non-oil Arab countries have faced more persistent budgetary problems which have contributed to inflationary and balance of payments pressures.

There is increasing recognition among policy makers that the required effective and permanent reduction in fiscal imbalances necessitates the adoption of measures which also improve the structure of budgetary revenue and expenditure. In the absence of such structural improvements, a series of politically difficult fiscal adjustments would be required periodically to prevent the re-emergence of fiscal imbalances--adjustments that have already excessively constrained in several countries expenditures on social sectors (education, health, etc.) and infrastructure.

In many Arab countries, the tax system has been characterized by a myriad of taxes and rates, differentiated in scope by the type of income and sector of activity, with various levies and fees superimposed thereon, as well as ad hoc concession and exemption schemes. This has tended to weaken

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1/ The links between oil prices and fiscal policy developments in the Arab oil countries are discussed in El-Kuwaiz (1990) and Morgan (1979).

the elasticity and buoyancy of the tax system, give rise to production and equity distortions, and undermine tax administration. Accordingly, some Arab countries have undertaken comprehensive reforms of their domestic tax systems (e.g., Algeria, Morocco, Tunisia, and to a somewhat lesser extent, Egypt, Jordan, and Mauritania); while others are still at the policy design stage.

The key objectives of the tax reforms implemented in the Arab countries have included simplifying the tax system and rendering it more transparent; improving its buoyancy and elasticity; reducing antiproduction and antiexport biases; enhancing the redistributive features; and reducing the vulnerability of tax collection to adverse external terms of trade movements. The key challenge has been the reform of direct and indirect taxes, in the context of reduced reliance on international trade taxation. The most comprehensive reforms have provided for, inter alia, a broadening of the taxable income base; taxation of all individual income under the same tax schedule; elimination of multiple taxation of corporate profits; clarification of rules determining incomes and profits (including depreciation allowances); rationalization of exemptions (including a uniform minimum exemption floor); and introduction of current year payments of realized tax liabilities.

On the indirect taxation side, the challenge in most countries has been to rationalize a system characterized by a wide range of turnover levies and excises, with cascading features as a result of same-activity taxation at multiple levels and rates. The most direct reforms have included the replacement of various taxes and levies by a single value added tax (e.g., Algeria, Morocco, and Tunisia). Apart from the unification aspect, an important advantage of this measure has been the establishment of clear deduction rules governing taxes paid at earlier stages of production. The new value added tax has been accompanied by a reduction in the number of rates and a broadening of the coverage to previously excluded sectors. Equity considerations have been addressed through the exemption of basic consumption goods and activities deemed critical for social reasons. Other reforms of the indirect tax system have included the adoption of sales (e.g., Egypt) and consumption (e.g., Jordan) taxes, and shifting excises from a specific to an ad valorem basis (e.g., Mauritania).

Despite progress in tax reforms, the region as a whole continues to be heavily dependent on collections from international trade (including petroleum exports). Nevertheless, the strengthening of the domestic taxation base has provided increased scope in some countries for measures to lessen reliance on such taxes. In these countries, the reform of these taxes has been undertaken in the context of a broader trade liberalization effort (e.g., Algeria, Egypt, Jordan, Mauritania, Morocco, and Tunisia). Adjustment measures have aimed at rationalizing and liberalizing custom tariffs through a reduction in the average tariff rate and in the dispersion of rates. These measures also have provided for efficiency gains as a result of their impact on effective rates of protection.

Further progress in tax reform efforts would also need to take greater account of regional factors. Indeed, increased emphasis on tax harmonization among Arab countries constitutes an important contributing factor to larger and more efficient intra-Arab economic and financial relations.

As noted earlier, several oil countries (e.g., Libya and Saudi Arabia) took steps to reduce expenditures in the face of declining oil revenues. As was the case for other countries, the challenge was to curtail expenditure on limited efficiency activities, including lower priority infrastructural projects. Other Arab countries have complemented such efforts by imposing strict limits on public sector employment and wages (e.g., Jordan). Nevertheless, there is scope in several countries in the region for further cuts in unproductive expenditures and in rationalizing outlays on public sector wages and salaries. This would facilitate the provision of greater resources for education, health, other social services, and infrastructure--an issue that is of particular importance for several of the lower income countries in the region. 1/

3. Financial sector reforms

As in other developing countries, the reform challenges in the financial sectors of many Arab countries include three key elements: (i) rationalizing the rates of return structure supporting the mobilization and allocation of loanable funds; (ii) deepening money and capital markets in the formal sector of the economy; and (iii) strengthening prudential regulation and supervision.

The financial sector in many Arab countries has been characterized by strict controls over rates of return, supplemented by quantitative limits on the overall and sectoral allocation of credit. This system grew out of the desire, inter alia, to prevent usurious rates and to provide mechanisms for channelling credit to particular sectors deemed to constitute a national priority (e.g., heavy industrial and export-oriented sectors). In many cases, however, the system of strict controls over rates of return and quantitative credit allocations contributed to financial disintermediation, currency substitution, and credit rationing of productive activities--particularly in the context of an over-expansionary budgetary stance. In addition, the channeling of subsidized credit to certain sectors has resulted in investments in financially questionable projects, with recurrent funding requirements and a growing portfolio of impaired bank assets. Accordingly, several Arab countries have embarked on a process of financial liberalization as part of their financial sector reforms.

In some of the Arab countries, the first steps toward financial liberalization have included the implementation of greater rate flexibility through the use of prescribed ceiling and floors (e.g., Morocco), subject in some cases to timely changes in view of developments in international

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1/ This is discussed in Heyneman (1993).

financial markets (e.g., Qatar). In other countries, the initial phase focussed primarily on deposit rates. Eventually, however, most of these countries also have substantially liberalized their rate structures (e.g., Algeria, Bahrain, Egypt, Jordan, Morocco, Tunisia, and the United Arab Emirates) and taken steps to terminate preferential credit arrangements for public enterprises (e.g., Tunisia). In some countries where the banking system has been burdened by a large portfolio of nonperforming assets, the government has moved to strengthen the financial integrity of the banking system by exchanging a portion of these assets for government obligations (e.g., Kuwait) and recapitalization through direct budgetary transfers (e.g., Egypt).

The beneficial impact on financial intermediation of the liberalization of the rate structure also depends on a concurrent move away from quantitative credit restrictions and toward indirect monetary control instruments. Accordingly, steps have been implemented for increased reliance on reserve requirements (e.g., Morocco), elimination of prior central bank approval for bank credit (e.g., Tunisia), and modifications to the rediscount mechanism to render it more sensitive to market conditions (e.g., Egypt). Nevertheless, several countries remain encumbered by administrative credit allocation mechanisms that respond weakly to risk/return considerations.

Improving the financial intermediation process in Arab countries also requires a deepening of money and capital markets. This would provide for a wider range of domestic financial instruments--thereby allowing for a shift in portfolio incentives away from both acquiring physical assets (including for consumption purposes) and from holding foreign financial assets. At the same time, it would strengthen the institutional basis for indirect monetary control instruments--thereby also strengthening the allocation of loanable funds.

For most Arab countries an important challenge is the development and deepening of money and capital markets. In several cases, this involves renewed efforts at institution building. Some Arab countries have had money markets in operation for several years. Their effectiveness, however, has been constrained by, inter alia, the absence of interbank transactions (e.g., Algeria), limited central bank rate flexibility in intervention operations (e.g., Morocco), and restraints on financial sector participation (e.g. Algeria and Morocco). These constraints are being addressed, complemented by the introduction of new financial instruments and auctioning procedures for short-term government securities. Similarly, efforts are underway in certain countries to strengthen existing capital markets, including through improvements in trading, reporting, and accounting systems.

Financial liberalization may involve, under certain circumstances, increased risk for the soundness of the financial system; this also implies contingent liabilities for public finances, particularly in the context of explicit public sector safety net arrangements. Accordingly, steps to liberalize the financial system and deepen it must be accompanied by an appropriate strengthening of prudential regulatory and supervisory practices. The emphasis in Arab countries has been primarily on improving the regulation and supervision of commercial banks. Among steps taken recently are the introduction of minimum capital and/or net-worth requirements (e.g., Algeria, Egypt, Jordan, Morocco, and Oman) and minimum liquidity ratios (e.g., Qatar). Explicit guidelines have been issued for improved classification of loans according to risk and provisioning standards (e.g., Algeria, Bahrain, Egypt, Morocco, and Tunisia) and for portfolio concentration to individual single customers, and on account of foreign exchange transactions (e.g., Algeria, Egypt, Morocco, Qatar, and Tunisia). In most of the Arab countries, steps have been taken to strengthen on- and off-site surveillance, and improve and standardize accounting practices.

Despite these advances, there is recognition as to the need to continue improving the prudential regulatory and supervisory regimes, including its extension to nonbank financial institutions. This issue takes an added degree of importance in the context of efforts toward the international harmonization of prudential regulatory and supervisory practices, particularly in the context of the Basle Committee's guidelines. 1/ Indeed, regulatory strengthening is critical if Arab financial institutions are to compete on an equal and effective footing in what have become increasingly globally integrated and interdependent financial markets.

4. Other domestic liberalization measures 2/

Economic surveys of the Arab countries tended to emphasize the prevalence in several economies of rigid systems of administered prices. 3/ The resulting lack of price flexibility led to distorted market signals regarding the opportunity cost of goods and services, thereby contributing to production and consumption inefficiencies. In recent years, several of these countries (e.g., Egypt and Sudan) have taken steps to liberalize their domestic pricing system, including through adjustments in prices for major agricultural crops and for energy products. Moreover, steps have been taken to address the multiplicity of same-product prices associated with different consumer groups (e.g., Syria). Nevertheless, the process, while advancing, is far from complete in several economies. As a result, the objective of establishing a "level playing field"--both operationally and legally--for the private and public sectors is still some distance away. Moreover, continuing economic inefficiencies associated with

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1/ Information on these guidelines is contained in Leipold et al (1991).

2/ This section does not address the issue of industrial development policies in Arab countries. An ESCWA (1990) study considers this as one of the important policy challenges, arguing that "on the whole, Arab industrialization efforts remained fairly modest and confined to small enclaves, without ever reaching the level of an integrated and mature industrial structure."

3/ For example, Hasan (1987).

rigidities in the goods, labor, and credit markets are compounded by sociopolitical difficulties resulting from the population at large perceiving the government, rather than international conditions, as the main reason for upward adjustments in domestic prices of tradables.

Price liberalization has been accompanied by increased emphasis on strengthening private investment, within the framework of more appropriate macroeconomic and institutional policies. In addition to the adjustment and reform policies discussed elsewhere in this paper--policies that enhance the average return on private investment due to an improved operating environment 1/--some Arab countries have adopted a number of specific measures including tax holidays and free zones. While these may have some impact in attracting investment resources to a specific activity or area, experience in developing countries as a whole suggests that they generally do not constitute cost-effective instruments for net efficient additionality over the medium term. In this regard, it may be noted that some Arab countries have curtailed, rather than expanded, such incentives in the context of adjustment and reform programs. They have also taken steps to establish unified investment codes that avoid intersectoral biases, limit the duration of concessions, and provide for more efficient and transparent criteria for eligibility, approval, and monitoring (e.g., Morocco and Tunisia). 2/ Some countries that have retained investment licensing procedures have taken steps to shorten the time lag for approving projects (e.g., Mauritania).

5. External sector issues

The emphasis on public-sector led growth in several Arab countries was associated with an import-substitution industrialization strategy. As in many other developing countries, the strategy resulted in a weakening of the market discipline process emanating from international competition. This is particularly the case for most of the non-oil Arab countries, with the resulting inefficiencies in the tradable sector contributing to welfare losses in both production and consumption. By restraining export diversification, the process also has contributed to more pronounced vulnerability to unanticipated adverse developments in international price and demand conditions. Recognition of these tendencies has led most Arab countries to take steps, with varying degrees of success, to liberalize their external sectors. These steps have emphasized (i) relaxing trade restrictions; (ii) reforming the exchange and payments system; and (iii) enhancing foreign direct investment inflows.

1/ Indeed, a stable macroeconomic environment has been viewed as the single most important factor for investment promotion in Arab countries. See Shihata (1990). Handoussa (1990) contains an analysis of the Egyptian case.

2/ Prior to these reform measures, there were seven investment codes in Morocco and six in Tunisia.

With the exception of several oil countries, the trade regime in the Arab world has tended to be characterized by extensive quantitative restrictions, high nominal tariffs, and cumbersome administrative procedures. Some countries also have imposed export restrictions in an attempt to provide domestic consumers with a relatively cheap and steady supply of domestically produced tradables. The main thrust of trade reforms in such countries has been to evolve toward a more open system, with reduced reliance on quantitative restrictions. Accordingly, countries have taken steps to streamline administrative procedures and reduce the number of products subject to outright bans or prior authorization (e.g., Algeria, Egypt, Morocco, and Tunisia). As noted earlier, countries have also reduced the level and dispersion of tariffs (e.g, Egypt and Tunisia).

In several Arab countries, the maintenance of an overvalued "official" exchange rate led to the emergence of a parallel rate in the informal market. With continuing financial imbalances putting strains on the official rate and the balance of payments, several countries (e.g., Algeria, Egypt, Morocco, Sudan, Syria, and the former Arab Republic of Yemen) adopted multiple exchange rate regimes--effectively legalizing the more depreciated parallel rate. Initially, this sought to promote earnings from exports of specific goods, services, and factor transfers (viz., workers' remittances, and to a lesser extent, tourism receipts). 1/ The perceived attractiveness of such regimes to policy makers was closely correlated to the severity of the balance of payments pressures and the relative importance of sources of foreign exchange receipts not easily controllable by the authorities through the use of quantitative restrictions. The alternative of a comprehensive exchange rate adjustment was not pursued due to, inter alia, concern as to the resulting upward pressure on the prices of certain imports deemed sensitive from a sociopolitical viewpoint. In some countries, fiscal consideration also played a role. However, the provision to the budget and public sector enterprises of foreign exchange at a relatively inexpensive rate was offset by losses on the part of the central bank (implying an offsetting quasi-fiscal loss) and/or implicit taxes on private sector activities.

The prolonged use of multiple exchange rate regimes was accompanied in several cases by increased complexity in the structure of foreign exchange pricing. As was the case for multipricing of single goods, this had distortionary effects, with adverse implication for production and consumption efficiency. At the same time, the implicit subsidization through the exchange rate mechanism tended to obfuscate the underlying magnitude, nature, and implication of the overall subsidy program. Moreover, the implementation of multiple exchange rate regimes involved considerable administrative costs associated with attempts to separate the different exchange markets through monitoring and control of underlying

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1/ This may be contrasted to the experience in Latin America where the adoption of multiple exchange rate regimes was motivated by policy makers' desire to insulate the real economy from what were viewed as transitory shocks emanating from financial markets. See Kamin (1992).

transactions. It is in this context that steps to tinker with the multiple exchange rate regime have given way to more ambitious efforts at exchange rate unification at a market-related level (e.g., Algeria, Egypt, Morocco, Sudan, and Yemen Arab Republic). Success in such efforts have reflected, inter alia, the concurrent adoption of appropriate financial and structural reform policies.

Several Arab countries have also taken steps to reform the exchange system through liberalization of the external payments mechanisms. Progress in this area has tended to be slower reflecting hesitancy about fully allowing market forces to determine the allocation of foreign exchange. Thus, countries have allowed exporters to retain a portion of their foreign exchange earnings (e.g., Libya and Tunisia). Rules governing the use by residents of foreign currency accounts in domestic banks have also been liberalized (e.g., Morocco and Tunisia).

Steps have also been taken to enhance inflows of foreign direct investments. 1/ This reflects three main objectives: first, to increase the availability of nondebt creating external inflows (i.e., inflows whose "servicing" is linked to the performance of the underlying investment rather than subject to fixed contractual terms) 2/; second, to benefit from technology transfers, including upgrading the existing capital stock; and third, to facilitate the penetration of key export markets in industrial countries. In this regard, measures have been implemented to reduce limitations on sectors open to foreign investment and liberalize restrictions on the repatriation of capital, dividends, and profits (e.g., Algeria and Tunisia).

6. Protecting vulnerable segments of the population 3/

A sound macroeconomic framework is an essential ingredient of an effective poverty alleviation effort. Specifically, by facilitating improved investment and production performance, it provides the best environment for sustained improvements in employment and living standards. At the same time, there is growing recognition of potential short-term adverse effects of adjustment and reform policies on the economically most vulnerable segments of the population. Such effects are associated, in

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1/ Additional information on foreign direct investment flows is contained in Al-Sirour (1993) and El-Rifai (1993).

2/ The increased emphasis on nondebt creating flows has also reflected the fact that several Arab countries face heavy debt service burdens, with a number of them (e.g., Egypt, Jordan, Morocco, Somalia, and Sudan) resorting, at some stage, to nonpayment and/or formal debt restructuring arrangements.

3/ The paper does not address the important issue of family planning and related policies, including human resource development. Similarly, the paper does not deal with the equally important issue of the environmental impact of structural reforms in the context of "sustainable development". Discussions of these issues may be found in Heyneman (1993) and Tolba (1993), respectively.

part, with resource reallocations induced by the new relative price structures, in the context of limitations on full capital and labor mobility. Concerns are compounded in some countries by rapid population growth which places strains on an already stretched delivery mechanism for social services.

In view of the above, it is recognized that Arab countries need to supplement greater emphasis on intensifying poverty alleviation measures with steps to reduce the adverse short-term effects associated with certain reform policies. Indeed, reform efforts in Arab countries have increasingly included specific measures seeking to protect vulnerable segments of the population. 1/ These have included direct cash transfers (e.g., Algeria and Jordan), improved targeting of food subsidies (e.g., Jordan), and food-for-work programs (e.g., Mauritania). While such measures do not provide a substitute for a comprehensive poverty alleviation program, they are nevertheless important for offsetting some of the short-term costs of adjustment and reform. Some countries have also set up special funds which, with assistance from external creditors and donors, seek to finance projects designed to mitigate the adverse impact of adjustment and reform measures on dislocated segments of the labor force (e.g., the Social Fund in Egypt and the Employment and Development Fund in Jordan).

IV. Conclusion

Arab countries' economic and financial performance in the 1980s was mixed relative to that of developing countries as a whole, notwithstanding the impact of adverse exogenous factors. To improve their performance, and thereby sustain medium-term economic growth and domestic and external financial stability, Arab countries will need to confront more forcefully structural rigidities inherited from the past. Indeed, the need for sustained and comprehensive policy actions becomes more important in the context of some countries' rapidly growing populations, uncertainties about the prospects for the natural resource base, and the tendency in certain regions outside the Middle East toward regional integration.

While the nature, extent, and implications of the policy challenge differ among individual Arab economies, several aspects are common to a large number of countries in the region. It is in this context that the paper has attempted to identify a "core" group of required structural reforms. Broadly speaking, this includes the need to rationalize a large public enterprise sector so as to concentrate its efforts in those areas where it performs most effectively and that are warranted by market failures; strengthen the structure of government budgets to render them more

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1/ A recent analysis of Tunisia's adjustment program indicates that the country's relatively well-developed social safety net system was instrumental in protecting the more vulnerable segments of the population in the transitional stages of adjustment and reform. See Duran and Feler (1992).

elastic and increase their developmental impact; improve the mobilization and allocation of loanable funds from domestic and external sectors; enhance the institutional framework for private investment and production activities; and rationalize the external trade and payments system. To be successful, these policies will need to be supported by a prudent demand management stance, as well an open international trading system and, for some countries, the provision of timely external financial assistance. Moreover, given the relatively low-income status of some Arab countries and their rapid population growth, the paper has pointed to the importance of policies to protect the most vulnerable segments of the population during the adjustment and reform program as part of a more comprehensive approach to poverty alleviation and environmental sustainability.

While the adjustment and reform effort is yet to gain significant momentum in the region as a whole, there are several country experiences of policy implementation aimed at addressing the identified structural weaknesses. The key challenge for individual Arab countries is therefore twofold. First, to draw upon the experience of their neighbors in formulating and implementing appropriate policies; second, to ensure that these policies are implemented in the context of a comprehensive medium-term program, rather than in a piece-meal fashion. Successfully meeting these two challenges in a sustained manner is essential if the Arab world is to exploit its considerable economic potential in the remainder of the 1990s.

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