F&D

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Christina Romer Profiled

U.S. Oil and Gas Output Surges

Mexico's Trade Comeback

The Middle East
Focus on the Future

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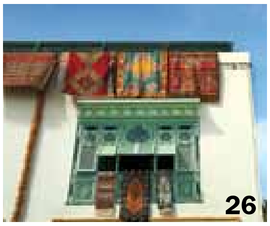
FEATURES

MIDDLE EAST: LOOKING AHEAD



ALSO IN THIS ISSUE

Full Speed Ahead

WHEN this magazine last looked at the Middle East and North Africa it saw a region on the threshold of change. Two years ago, citizens in the Arab world—fired by their ideals and visions of a better life—burst across that line, igniting a social movement that inspired people around the globe.

In Egypt, Jordan, Libya, Morocco, Tunisia, and Yemen—the so-called Arab countries in transition—people embraced change, ushering in a new era. These countries are now rushing at full speed into the future.

While these countries succeeded in breaking with the past, finding a way forward hasn't been easy. The transition countries face the difficult task of stabilizing their economic and political systems and meeting the expectations and hopes of their citizens. There are competing visions over where to go and how to get there, and instability lingers: as this magazine went to press, a surge of street protests in Egypt were marred by violence and armed conflict continued to roil Syria. The economies of the region were struggling to stay on their feet.

For a quarterly magazine, putting together a special feature on a region in the throes of fast-moving change is a challenge. This issue of *F&D* looks at the difficulties of this transition, focusing on deep-rooted and long-standing forces that shape the region's economy and offering options for moving ahead to achieve strong, inclusive growth.

Masood Ahmed, Director of the IMF's Middle East and Central Asia Department, maps out an agenda for modernizing and diversifying the region's economies. Marwan Muasher addresses the intersection of economic progress and political change, and Vali Nasr, in a Point of View column, underscores the vital role small and medium-sized enterprises play in a successful democratic transition. In our Straight Talk column, IMF First Deputy Managing Director David Lipton argues that only by opening up will the transition countries achieve the broad-based growth their societies so desperately need.

Elsewhere in this issue, we look at the surge in oil and gas production in the United States and at how that could shake up global energy markets and profile Christina Romer, former chair of the U.S. Council of Economic Advisers and an architect of the U.S. stimulus package.

With this issue, I take over from Jeremy Clift, who has been Editor-in-Chief since 2008 and is moving on to serve as Publisher of the IMF. Jeremy's drive and vision pushed *F&D* in a new direction, including onto Facebook, where we now have a community of 75,000 following the debate over global economics.

I look forward to continuing *F&D*'s tradition of excellence and to working with the talented people on the masthead here to bring you a thoughtful and provocative lineup of articles on the global economy.

Jeffrey Hayden
Editor-in-Chief

DEPARTMENTS

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Waste not, want not

Simple actions by consumers and food retailers can dramatically cut the 1.3 billion tons of food lost or wasted each year, says a new global campaign to cut food waste launched in January 2013 by the United Nations' Food and Agriculture Organization (FAO), the United Nations Environment Program (UNEP), and partners.

Worldwide, about one-third of all food produced, worth about $1 trillion, is lost or wasted in food production and consumption systems, according to data released by the FAO. Food loss occurs mostly at the production stages—harvesting, processing, and distribution—whereas food waste typically takes place at the retail and consumer end of the food-supply chain.

The "Think, Act, Save: Reduce Your Foodprint" campaign aims to coordinate action and provide a global vision for the smaller initiatives of this type around the world. The new campaign specifically targets food wasted by consumers, retailers, and the hospitality industry.

"In a world of 7 billion people, set to grow to 9 billion by 2050, wasting food makes no sense—economically, environmentally, or ethically," said UN Under-Secretary-General and UNEP Executive Director Achim Steiner.

The global food system has profound implications for the environment, and producing more food than is consumed only exacerbates the pressure. The report notes the following:

- More than 20 percent of all cultivated land, 30 percent of forests, and 10 percent of grasslands are undergoing degradation.
- Agriculture and land use changes, such as deforestation, contribute to more than 30 percent of total global greenhouse gas emissions.
- Some 30 percent of marine fish stocks are now considered overexploited.

Devastation from the March 2011 tsunami and earthquake in Japan.

Managing disaster risk

Disaster losses in Asia and the Pacific have risen faster than the region's economy has expanded, says a new report from the Asian Development Bank (ADB).

Investing in Resilience—Ensuring a Disaster-Resistant Future recommends that regional governments offer disaster risk financing instruments such as calamity funds, tax credits, and catastrophe bonds to strengthen disaster resilience.

"Asia's economic gain is being eroded by disasters, often hitting the poorest hardest," said Bindu Lohani, the ADB's Vice President for Knowledge Management and Sustainable Development.

Significant investments to strengthen disaster resilience can reverse this trend, says the report, but it notes that a range of obstacles underlie the rising disaster losses, such as inadequate risk data, weak and misaligned incentives, poor legislative and regulatory frameworks, limited funding, and power disparities.

Disaster risk financing instruments are particularly crucial for Asia and the Pacific, which lags other regions in the development of innovative financial solutions for disaster resilience. Less than 5 percent of disaster losses in developing Asia are insured, compared with 40 percent in developed economies.

Disaster losses are expanding at a faster pace in Asia because of environmental degradation, climate change, demographic pressures, and widespread failure to consider disaster risk when designing and locating many important development investment projects.

Paying dearly to send money home

Reducing the average cost of sending remittances to 5 percent from the current 12.4 percent would put $4 billion more in the pockets of Africa's migrants and their families who rely on remittances for survival.

Africa's overseas workers, who sent nearly $60 billion in remittances in 2012, pay more to send money home than any other migrant group. According to the World Bank's Send Money Africa database, sub-Saharan Africa is the most expensive destination for remittances. The average cost of sending money to Africa is higher than the global average of 8.96 percent and almost double the cost of sending money to south Asia, which has the world's lowest price tag for moving money (6.54 percent).

Receiving remittances is often a person's first exposure to financial services and makes the recipient more likely to use other financial services, such as bank accounts. Lowering the cost of remittances can thus advance financial inclusion on the continent. (See "Inclusive Africa," in this issue of *F&D*.)

Remittance prices are even higher between African nations. South Africa, Tanzania, and Ghana are the most expensive sending countries in Africa, with prices averaging 20.7 percent, 19.7 percent, and 19.0 percent, respectively, partly because of limited competition.

Events in 2013

March 14–17, Panama City, Panama
Inter-American Development Bank Annual Meeting

April 19–21, Washington, D.C.
Spring Meetings of the World Bank and the IMF

May 2–5, New Delhi, India
Asian Development Bank Annual Meeting

May 10–11, Istanbul, Turkey
European Bank for Reconstruction and Development Annual Meeting

May 30–31, Marrakech, Morocco
African Development Bank Annual Meeting

June 17–18, Fermanagh, United Kingdom
Group of Eight Summit

October 11–13, Washington, D.C.
Annual Meetings of the World Bank and the IMF

Dropout crisis

The Inter-American Development Bank (IADB) is launching an initiative that seeks to raise public awareness of the high school dropout crisis in Latin America and generate solutions to keep more young people in school. Through social media, film, and interactive online forums, GRADUATE XXI aims to involve Latin Americans from all walks of life in efforts to improve education systems and increase the number of high school graduates.

In recent years, access to education has improved significantly in Latin America. Primary education is virtually universal throughout the region. However, nearly half of the students in Latin America do not finish secondary school. Gaps in access to education persist among socioeconomic and ethnic groups, as well as between urban and rural communities.

The IADB has found that

- over half of young people in rural areas do not complete nine years of school;
- more than 40 percent of indigenous youths between the ages of 12 and 17 are not in school; and
- only 20 percent to 30 percent of all children and youth with disabilities in the region attend school; most of them never finish.

Student in Peru: gaps in access to education persist in Latin America.

Waterfront in Fushun, China, a city set to experience rapid growth.

Building sustainable cities

Rapid urbanization holds long-term economic, social, and environmental promise for developing economies if current investments in infrastructure, housing, and public services are efficient and sustainable, the World Bank says in a new report, *Planning, Connecting, and Financing Cities Now: Priorities for City Leaders*.

"With many urban centers in the developing world still taking shape, we face an historic but narrow opportunity to build smart cities that encourage inclusive green growth and improve people's lives," said Zoubida Allaoua, Director of Urban and Disaster Risk Management at the World Bank.

In the next two decades, cities are expected to expand by another 2 billion residents, as people move in unprecedented numbers from rural areas to pursue their aspirations in cities. More than 90 percent of this urban population growth is expected to occur in the developing world, where many cities are already struggling to provide basic needs such as water, electricity, transportation, health services, and education.

Launched at the Global Energy Basel Conference in January, the report provides a policy guide that local officials can use to create the jobs, housing, and infrastructure needed to turn their cities into hubs of prosperity for current and future residents.

The report notes that most new urban growth will not take place in megacities such as Rio de Janeiro, Jakarta, and New Delhi but in less commonly recognized "secondary" cities— places like Huambo in Angola, Fushun in China, and Surat in India.

The $787 Billion Question

Maureen Burke profiles **Christina Romer**, *former chair of the U.S. Council of Economic Advisers*

WHEN Christina Romer received an e-mail out of the blue in November 2008 from someone wanting to talk to her about the transition team of the newly elected U.S. president, her first instinct was to ignore it. Probably a job seeker who believed she had some connection to Barack Obama's campaign, she thought.

But her husband—and fellow economist—David did an Internet search on the e-mail's sender, Michael Froman. "You might want to call him back," he advised his wife, "He's the head of economic personnel for the transition" between the George W. Bush administration and the new Obama government.

Romer and her husband, both professors at the University of California, Berkeley, were staunch Obama supporters. But Christina (known to her friends as "Christy") had little involvement with the campaign, apart from a few briefing memos she had prepared for Austan Goolsbee, Obama's top economic advisor. So when she was invited to meet with the president-elect in Chicago to discuss being chair of his Council of Economic Advisers (CEA), the experience was "surreal, and a bit terrifying," she says.

The interview took place against the backdrop of growing financial instability that had spread from the U.S. mortgage market to a near global panic. Two months earlier, the giant investment bank Lehman Brothers had collapsed in the largest corporate bankruptcy in U.S. history. A few weeks later, the New York Stock Exchange suffered its steepest single-day drop in decades. Credit markets were frozen. Then the Bureau of Labor Statistics reported that the U.S. economy had lost 240,000 jobs in October, a sign that the financial crisis was spreading to the real economy.

Obama began the meeting by saying that monetary policy had done all it could to solve the crisis, so using fiscal—taxing and spending—policy was the only option. Though Romer agreed that fiscal stimulus was needed, the academic in her couldn't help disagreeing with the premise of the President's statement. "The Fed really isn't out of bullets. There is still more it can do," even with interest rates approaching zero, she told him. Drawing on her research about how monetary expansion had helped bring the country out of the Great Depression of the 1930s, the two discussed what tools the government had at its disposal and what U.S. President Franklin Roosevelt had done right 75 years earlier. "I was amazed at how much he knew about the 1930s and how incredibly intellectual the discussion was," Romer recalls.

Obama offered her the job on the spot and she accepted. Only three and a half weeks after the election, she left for

Washington on November 30. The next month was a whirlwind as the couple uprooted their family and found employment for David, a school for their youngest child, 12-year-old Matthew, and a house to rent.

Romer later asked Rahm Emanuel, then Obama's chief of staff, why she was approached for the post. Emanuel, now the mayor of Chicago, told her, "That's easy. You were an expert on the Great Depression, and we thought we might need one."

Turning gold into lead

Like Ben Bernanke, the U.S. Federal Reserve Board chair, Romer has devoted much time to studying the causes of and policy responses to the Great Depression. Although mainly focused on monetary policy, this work has led her to believe that the government has a role in stabilizing the economy. So it's no surprise that, chairing the CEA during the country's worst economic crisis since the Great Depression, Romer advocated swift government action that took the form of the massive 2009 stimulus package.

Romer's interest in recessions was shaped, in part, by personal experience. She was born in the St. Louis suburb of Alton, Illinois, to a chemical engineer and a schoolteacher, and later moved with her family to the manufacturing town of Canton, Ohio, in the U.S. industrial heartland. Attending high school there in the 1970s, she witnessed the region's decline—along with the oil price surges that began in 1973 and the recession and inflation that followed. "Economic issues inherently struck me as important because of what I saw around me," she says, prompting her to pursue the subject as her major at the College of William and Mary in Virginia.

In the spring of 1983, when Romer was in her second year of a Ph.D. program at the Massachusetts Institute of Technology (MIT), she got a personal lesson on how recessions affect ordinary people. Her father lost his job, and, not long after, her mother learned that her teaching position for the following year might be canceled. Although funding for Romer's education was secure, thanks to a prestigious National Science Foundation fellowship, she worried about how this would affect her wedding to fellow Ph.D. student David Romer, set for that August. Her parents reassured her that there was money set aside—and with her mother and aunts pitching in to cook food and arrange the flowers, the event went on as planned. Still, she says, this was a "formative experience."

Romer met her husband-to-be in a course taught by MIT economic historian Peter Temin. As a research assistant for Temin, Romer became fascinated by historical data. The then-prevailing view among macroeconomists was that the U.S. economy was much more stable following World War II than it had been in the decades prior to the war, leading many to conclude that policymakers had finally mastered the art of using monetary and fiscal tools to stabilize the economy. But the modern techniques of collecting and calculating indicators of macroeconomic performance such as real GDP and unemployment began only after World War II. The prewar series being used in those comparisons were derived by piecing together the available scraps of data using numerous assumptions. As a result, it was hard to tell if business cycles had genuinely changed, or if only the data construction had changed.

So, in a stroke of counterintuitive brilliance, Romer used what Temin dubbed "reverse alchemy"—applying the prewar methods of calculating unemployment and output to the postwar period. Rather than turning lead into gold, she turned gold (the good postwar data) into lead (a postwar series created in the same way as the prewar series). The study, which formed the basis for her doctoral dissertation, revealed that the decades that followed World War II were almost as volatile as the decades (excluding the years of the Great Depression) that preceded it—a marked departure from the conventional wisdom.

"That easy picture of what macro policy had accomplished was simply a figment of the data," Romer says.

Laurence Ball, an MIT classmate who now teaches economics at Johns Hopkins University, says that her dissertation received a lot of attention at the time. "It was threatening to some people for seeming to undermine the evidence that government involvement was a good thing," he recalls. "This is a bit ironic, since she's now an advocate of stimulus and activist policy."

In subsequent papers, Romer has argued that the lack of stabilization was not a sign that monetary and fiscal policy didn't matter. Rather, the problem was that those tools weren't used well. Overly expansionary policy led to inflation, which led to tight monetary policy to bring inflation down. "A lot of learning went on in that early postwar period," Romer says.

Both the times and the people made it exciting to be at MIT, she says. The country was in the middle of a severe recession following the Federal Reserve's tight money policies designed to eliminate the high inflation of the late 1970s. "We were seeing firsthand what happens when a macroeconomy is very sick," Romer recalls. And the view was shared by such faculty luminaries as Stanley Fischer and the late Rudiger Dornbusch (with Temin, coadviser on her dissertation) and a coterie of fellow students that included Ball and N. Gregory Mankiw, now a Harvard University professor, who preceded Romer as chair of the CEA in the George W. Bush administration.

After obtaining their doctorates from MIT in 1985, the Romers found jobs as assistant professors at Princeton University. Three years later, they moved to Berkeley.

Narrative approach

Romer's research, much of which she does with her husband, reflects her early passion for economic history. A defining characteristic of their work is its use of the "narrative approach"—that is, drawing not just on statistical evidence but also on evidence derived from the historical record. This approach was pioneered by Milton Friedman and Anna Schwartz in their classic 1963 study, *A Monetary History of the United States, 1867–1960.*

Considering the whole picture

Estimating the effects of fiscal policy is difficult, says Romer, because fiscal actions are often taken in response to other things happening in the economy. Separating the impact of those other factors from the impact of tax changes or spending decisions requires sophisticated techniques, along with creativity and hard work, Romer told students at Hamilton College in 2011.

Take the Bush administration's tax cut of February 2008, implemented as a result of the recession's onset two months earlier. Most of it came in the form of tax rebate checks mailed between April and July 2008.

Household income took a noticeable step up when the rebate checks came, Romer said. And yet consumption did not rise at all. In fact, it fell a tiny bit. At first blush, it appears the tax rebate had no effect.

But Congress didn't approve the tax rebate for no reason—it did so at the height of the subprime mortgage crisis, and house prices were plummeting. Most people's main asset is their home, and when house prices fall, people tend to cut back on spending, Romer explained.

"Against that background, the fact that consumption held steady around the time of the tax rebate may be a sign of just how well it was working," Romer asserted. "It kept consumption up for a while, despite the strong downdraft of falling house prices."

The essential lesson, Romer said, is that you can't deduce the effect of a tax rebate or some other policy by just looking at outcomes. You have to consider where the economy was heading in the absence of policy.

"Economists have a name for this problem: omitted variable bias," Romer said. "Anytime one is looking at the relationship between two variables, like consumer spending and the tax rebate, you need to worry that a third variable, like the fall in wealth, is influencing both of them."

Omitted variable bias is the central problem in most empirical research in economics, she noted.

In a seminal 1989 paper, "Does Monetary Policy Matter? A New Test in the Spirit of Friedman and Schwartz," the Romers used the narrative approach to identify seven episodes in the postwar era when, because of concern about inflation, the U.S. Federal Reserve, the nation's central bank, attempted to bring down inflation using monetary policy to slow economic growth. In each instance, they found that the Fed's policy actions caused output to be far below what one would predict based on developments before the policy change, providing "decisive evidence" that changes in monetary policy matter to the real economy.

What made this study unique was that, in identifying and analyzing the seven episodes, the Romers pored over forty years' worth of minutes of Federal Open Market Committee meetings and other records to discern the Fed's intentions and understand the rationale behind its policy decisions.

Though it can be tricky to use, the narrative approach holds a distinct advantage over a purely statistical approach, write the Romers (who are codirectors of the monetary economics program of the National Bureau of Economic Research), because it brings in "additional information that can solve the problem of identifying the direction of causation between monetary factors and real economic developments."

More recently, the Romers have used this method to gauge the impact of fiscal policy on economic activity. A key lesson that cuts across all their work is that the effect of a policy can't be deduced just by looking at the outcomes—one has to consider what else is going on in the economy and the reasons for the policy actions (see box).

How much is too much?

At Berkeley's commencement in 2011, Romer told graduates that "working in the White House was simply the hardest thing" she had ever done. But those two years were also the "most important and meaningful of my life," she said. This period was difficult, in part, because her husband was no longer a colleague—he had arranged to work as a visiting scholar at the International Monetary Fund. At separate organizations, not only did they cease collaborating on a daily basis, but government confidentiality rules often prevented them from even discussing her work. She missed hashing things out with the person whose judgment she'd trusted most for nearly three decades.

With its 14-hour workdays, the job was also unbelievably intense. On their arrival in Washington, Romer and the other members of Obama's economic transition team had immediate work to do. One of her first tasks in December 2008 was to assemble forecasts as a starting point for a policy response from a range of sources—including the Federal Reserve and a number of private sector analysts. But almost all these forecasts underestimated the severity of the economic problems that the new administration would face.

"We were just watching the forecasts deteriorate in front of our eyes," she recalls. "As more data came in, there was this gradual dawning of just how wretched the recession would be."

It was in this rapidly changing environment that Obama's incoming economics team—the designated heads of the National Economic Council (Lawrence Summers), Treasury (Timothy Geithner), Office of Management and Budget (Peter Orszag), and Romer—began planning a policy response just after the Thanksgiving holiday, in late November. The economy needed a stimulus package, all agreed, but there was debate about the appropriate size.

As recounted in Noam Scheiber's book *The Escape Artists: How Obama's Team Fumbled the Recovery*, Romer estimated that a $1.8 trillion stimulus package (a combination of spending, taxes, and transfers to states and localities) was needed to fully eliminate the gap between what the economy was producing and what it was capable of producing. Those calculations helped to push the size of the recommended package upward, but only four options ranging from $550 billion to $890 billion made it into the economics team's memo to Obama.

On February 13, 2009, the U.S. Congress passed the American Recovery and Reinvestment Act—a $787 billion fiscal stimulus bill. Though this was the largest fiscal stimulus in U.S. history, it was only about half as large as Romer's $1.8 trillion figure.

Romer admits now that, because the magnitude of the crisis was revealing itself only gradually, a lesser stimulus was probably the only politically viable option. However, in hindsight, it is clear that "even bigger [than $787 billion] would certainly have been better. Part of the pain that we've been living through is because we didn't have enough at that time."

In the hot seat

What Romer most regrets about her tenure as CEA chair is a report she issued in January 2009 with Jared Bernstein, an economic advisor to vice president-elect Joseph Biden. The Romer-Bernstein report laid out a case for fiscal stimulus, with the goal of convincing both Congress and the public that aggressive stimulus was necessary. A proposed roughly $800 billion stimulus would prevent unemployment from rising above 8 percent, Romer and Bernstein wrote—whereas without it, unemployment would hit 9.1 percent. When unemployment ended up topping 10 percent, many conservatives seized on Romer-Bernstein as evidence that the stimulus had not worked. (Of course, unemployment likely would have climbed much higher without the stimulus, many economists now argue. Romer and Bernstein's real error was in having a baseline forecast that was much too optimistic.)

"Inexperience played a big role in the way we built the case," Romer says. "I like the idea of providing information and trying to convey why we were suggesting a particular policy action. But I should have been more politically astute about how we did it."

Romer left her post in September 2010, after almost two years of grueling service—roughly the typical tenure for a CEA chair. There has been speculation that frustration with what some view as the Obama administration's premature shift away from stimulus toward a focus on deficit reduction played a role in her decision to leave. Or, that a conflict with Summers—whom she has known since grad school when he was on the faculty at MIT—was responsible for her departure. But Romer says that's nonsense—she resigned so the family could return to California, where her youngest son would start high school.

"There was a rumor I was leaving because I couldn't stand dealing with Larry Summers. So I spent the whole day that my departure was announced saying, 'No, I really love Larry Summers; it's not that.' Finally Tim Geithner called and said, 'Listen, if you don't say something nice about me, they're going to think I drove you away,'" she recounts with a chuckle.

The "cool factor"

Romer is happy to be back at Berkeley, where her second child, Paul, is now starting a Ph.D. program in chemistry after graduating from MIT. (Katherine, her oldest, is in a Ph.D. program in biology at MIT, and Matthew is now a high school junior.)

Looking back at her time in Washington, Romer marvels at the difficulty of juggling work at the White House and family life. "There was just no way to balance things," she says. After that first month of being on the transition team, Romer recalls coming home two days before Christmas, exhausted and empty-handed.

"Our two older kids had come home, put up a tree, baked the cookies, and I had no presents. I was just, like, 'I am so sorry,' " Romer remembers. "They said, 'Mom, it's okay. You have so upped our cool factor.' I guess there was something about working for Barack Obama that made up for a lot."

Romer is keeping her hand in the public sphere through the "Economic View" column in the Sunday *New York Times*, which she alternates writing with five other prominent economists. It's just the right amount of public exposure for now, she says. "I still care a lot about policy issues, and it's a forum where you can make a careful argument and talk about the evidence."

In hindsight, it is clear that "even bigger [than $787 billion] would certainly have been better."

An issue that continues to trouble Romer deeply is the U.S. unemployment rate (7.9 percent in January 2013). In a recent column, she discussed how the Federal Reserve could be much more aggressive in pursuing policies that would spur growth. The current jobs crisis requires a bold solution, she says—such as targeting a path for nominal GDP (the total dollar value of the economy). This essentially means the Fed would pledge to do whatever it takes to return nominal GDP to its precrisis trajectory in order to improve expectations of future growth, even if it means abandoning its current cautious course. "If Christy were running the Fed, she would be doing something very decisive," says Ball. "She's been outspoken—and appropriately so—about the terrible situation with high unemployment."

Romer feels it's important to educate the public on economic issues. "The truth is, whether we're talking about monetary policy or fiscal policy, it's complicated." Part of the problem is that politicians tend to oversimplify.

"They say, 'All we need to do is cut taxes and that will deal with the budget deficit.' Well, no it won't. Likewise, the Democrats say, 'We can keep all our entitlement programs as long as we raise taxes on the wealthy.' Not going to work—there's just not enough money even among the wealthy to pay for what's coming down the line on Social Security and Medicare," she says.

Romer uses speaking engagements, the newspaper column, and her teaching post to impart her views on the country's complex economic challenges. "If you're willing to take the time and speak in a way that nonexperts understand, I think you can eventually get through."

Ever the teacher, Romer seems to be right back where she belongs. ■

Maureen Burke is on the staff of Finance & Development.

Toward Prosperity for All

Masood Ahmed

Arab countries in transition need a guiding vision for the future

Mediterranean coast, Alexandria, Egypt.

You can tell whether a man is clever by his answers. You can tell whether a man is wise by his questions.

— Egyptian Nobel Prize–winning author Naguib Mahfouz

THE change that swept through the Arab world in spring 2011 unleashed a new optimism in the region, but many are now asking where the transition is headed.

The transformation in the Middle East presents a historic opportunity for the Arab countries in transition as they rethink not only their political but also their economic systems. Some of these countries have witnessed regime change (Egypt, Libya, Tunisia, Yemen) while others are undertaking political reforms from within (Jordan, Morocco). All of them can benefit from broad reforms to create more dynamic and inclusive economies that provide economic opportunity to all segments of society.

Toward a guiding vision

The year 2013 will be another difficult one for the Arab countries in transition. Only moderate economic recovery is in the cards—not enough to generate the jobs needed to meaningfully tackle the region's substantial unemployment. And the tragic conflict in Syria is leading to a serious humanitarian crisis that is having spillover effects on neighboring countries too, especially Jordan and Lebanon.

Important as it is now to focus on maintaining economic stability, it is vital not to lose sight of the more fundamental medium-term challenge of modernizing and diversifying the region's economies, creating more jobs, and providing fair and equitable opportunities for all. Restless populations' growing impatience for quick results—in the form of new jobs and better incomes and social conditions—is an incentive for policymakers to proactively introduce changes to the existing economic systems (see "Freedom and Bread Go Together," in this issue of *F&D*).

A comprehensive reform program needs to provide clear goals for the economic transition. Unlike the transformation of Eastern Europe more than 20 years ago, during which many countries turned toward the European Union (EU) and its economic model, today's Arab countries in transition lack a clear role model for their final economic destination. But like oarsmen racing a rowboat, only if people act jointly, driven by a common goal, can they excel.

Comprehensive economic reforms are needed to change these economies from following a "rent-seeking" model—in which firms aim to prosper from special government privileges or monopoly rights—to one whose guiding principle is the creation of economic value and jobs. But while such transformations produce winners, they also create losers, many of them politically well connected. Such vested interests will fight reform. But during the political upheaval that accompanies the creation of a new order the influence of such interests could be reduced—opening a window to reform.

National policymakers are clearly responsible for defining their reform agendas, but the international community can help by offering financing, policy advice, and better market access for the region's exports. The international community has already provided substantial financial assistance. Apart from sizable contributions from bilateral donors, especially the countries of the Gulf Cooperation Council, international financial institutions have committed $18.5 billion since the beginning of the transition, not counting the IMF's commitment of more than $8 billion to support homegrown economic programs in Jordan, Morocco, and Yemen. The IMF is also engaged in discussions on financial support for Egypt and Tunisia. More financing is clearly needed, and beyond financing, better trade access and technical policy advice will also be crucial. The economic challenges in the Arab countries in transition extend well beyond the IMF's expertise. Development agencies such as the World Bank and other international and regional financial institutions, as well as bilateral partners, are also contributing and must continue to do so in the period ahead.

Structural challenges

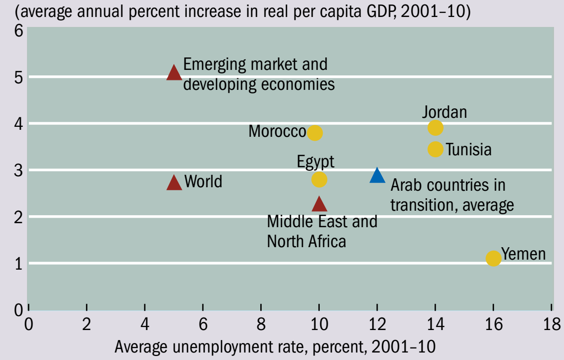
The Arab countries in transition have long suffered from a lack of dynamism, with high unemployment and—despite reform efforts—an inability to generate per capita growth on par with other emerging market and developing economies (see Chart 1). The region's labor force participation is low,

Chart 1

Tough job

Arab countries in transition suffer from higher unemployment and lower per capita GDP growth than other emerging market and developing economies.

(average annual percent increase in real per capita GDP, 2001–10)



Sources: IMF, World Economic Outlook database; World Bank, World Development Indicators database; and International Labour Organization, LABORSTA database.

and the responsiveness of employment to growth has been among the most sluggish in the world.

While many of these countries had moved over time to private sector–led systems, government jobs remain much more important than in other regions. The economic vitality that helped lead the transformation in emerging market and developing economies in other regions has been absent in many Arab countries.

To unlock the region's vast potential, many factors come into play, and the recipe for reform will naturally vary across countries. But there are some common priorities (see IMF, 2012).

Greater trade integration, both within the region and in the world economy, will be essential not only to boost growth but also as a catalyst for other important reforms. Business regulation and governance reforms are needed to ensure simple, transparent, and evenhanded treatment for companies, and ultimately greater transparency and accountability of public institutions. Labor market and education reforms will ensure adequate skill building and protection of workers. Improving access to finance will help catalyze entrepreneurship and private investment. And public finance reform will help free up resources for high-priority expenditures and reduce vulnerability, which will also spur growth.

Boosting trade

In recent decades, trade has not been a significant engine of growth for Arab countries in transition (see "Picture This," in this issue of *F&D*). The region's exports are both proportionally smaller than in other economies and mainly to Europe. This has prevented the region from benefiting from the high growth of many emerging markets, particularly in Asia. And progress toward exporting more higher-value-added products remains limited.

Deeper trade integration could significantly boost the region's economies, creating growth and jobs and helping maintain the momentum for broader reform. Such integration into the global economy would also help provide discipline and incentives to enact other reforms aimed at strengthening competitiveness.

Deeper trade integration could significantly boost the region's economies, creating growth and jobs.

For the Arab countries in transition, trade integration will first and foremost require better access to advanced economy markets. For instance, high tariffs, quota restrictions, and farm subsidies remain a significant impediment to agricultural exports to the EU, and current agreements with the EU do not provide for liberalization in trade in services.

To fully reap the benefits of integrating into global trade, the Arab countries in transition should also further liberalize their own tariffs and nontariff barriers and diversify trade toward fast-growing emerging markets. Increased regional integration, by addressing nontariff barriers and harmonizing policies, would also help the Arab countries in transition integrate into the global supply chain.

Business made simpler

These Arab countries face a legacy of complex and burdensome business regulations (see "Business, Not as Usual," in this issue of *F&D*). Egypt, for example, has 36,000 often overlapping regulations that affect the private sector. As a result, it is often a lengthy, expensive, and complicated proposition to start and run a business.

Most countries in the region fare poorly on global governance rankings, and increasingly so over the past decade (see Chart 2). Corruption is a major problem: more than half the firms in the Middle East and North Africa region report that they have been asked for bribes—a much higher share than in any other region in the world (World Bank Enterprise Surveys).

Although many countries have already taken action, it will take continued and intensified efforts

Woman casting election ballot in Tripoli, Libya.

to improve business regulation and governance. Lasting success calls for a system of checks and balances to insulate key national and regional institutions from excessive government discretion and nontransparent intervention. The experience of east Asia, for example, shows that countries that are effective in creating accountable, rules-based institutions generate significantly more economic growth than those whose institutions remain subject to arbitrary intervention by political leaders and public officials (World Bank, 2009).

Although countries differ in their reform needs, strategies to reform business regulation should focus on removing the barriers to starting or closing a business. Entry requirements—such as sector-ministry approval, which gives officials substantial discretion over which investors to favor or exclude—should be reviewed and based on clear and transparent rules. Similarly, high minimum capital requirements and restrictions on foreign ownership should be relaxed, unless they reflect a particular regulatory concern. Reform efforts should also focus on removing exit difficulties and introduce modern bankruptcy codes that decriminalize business failure.

Jobs and school

Labor markets in the Arab countries in transition face substantial problems. High unemployment is compounded by significant demographic pressure as more of the young population enters the labor market. Youth unemployment is high, ranging from 18 percent to 30 percent in Egypt, Jordan, Morocco, and Tunisia, and women face particular problems in securing employment (see "Only Fair," in this issue of *F&D)*.

Although the roots of the problem vary across countries, there are some common factors. Labor regulations discourage firms from hiring and divert job seekers into the informal sector, where workers do not enjoy the same level of protection as in the formal economy (see Chart 3). The (implicit and explicit) employment guarantees in government hiring—and mismatched salary expectations resulting from comparatively generous civil service compensation—have led to market segmentation and excess demand for public sector jobs. The education system's strong focus on formal qualifications for entry into the civil service means that labor market entrants often do not have the right mix of skills for today's job market.

Solutions to these employment problems will vary among countries, but should generally address five areas: reviewing labor market regulation to reduce disincentives for hiring while maintaining adequate worker protection; revisiting public sector hiring practices and compensation policies to reduce the public sector's labor market dominance and bias; reforming the education system, aligning it better with the needs of private employers; pursuing active labor market policies to make quicker inroads into lowering unemployment; and emphasizing policies that promote youth and female employment.

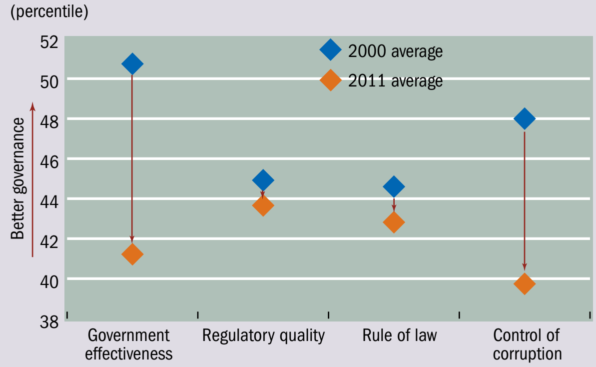
Where's the money?

Access to finance is a major constraint in the Arab countries in transition (see "As a Matter of Finance," in this issue of *F&D*). Private credit disproportionately benefits large, established companies, and, in some cases, private sector credit has been crowded out by the financing of government budget deficits. Only 10 percent of firms finance investment in the MENA region through banks—by far the lowest share among the world's regions—and 36 percent of firms in the region identify access to finance as a major constraint, surpassed only in sub-Saharan Africa (World

Chart 2

Clean house

Governance and corruption are increasingly serious obstacles for Arab countries in transition.

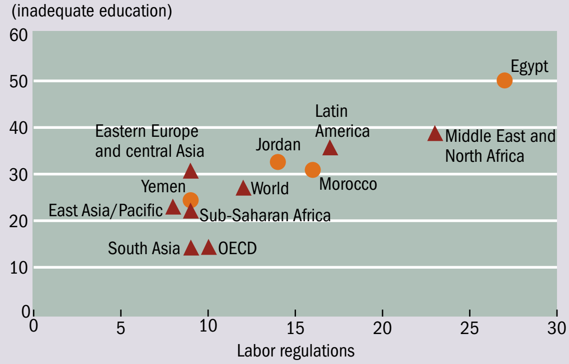


Source: World Bank, *Worldwide Governance Indicators*.

Chart 3

Matchmaker, matchmaker, bend me a rule

Arab countries in transition suffer from excessive labor regulations and education mismatches, which are major constraints on firms' activity.



Source: World Bank Enterprise Surveys, 2006–11.

Note: Chart shows percent of firms identifying each item—inadequate education and excessive labor regulations—as a major constraint. OECD = Organization for Economic Cooperation and Development member countries.

Bank Enterprise Surveys). Smaller firms in particular, deprived of bank credit, must rely on whatever limited alternatives they can find to carry out their investment plans.

The cost of lost opportunities from limited access to finance is large. Empirical estimates show that raising access to finance in the MENA region to the world average could boost per capita GDP growth by 0.3 to 0.9 percentage point.

Expanding access to finance is thus a priority for policymakers seeking higher growth and employment. Strategies for improving access to finance will differ among the Arab countries in transition given their different starting points, but must center on developing or strengthening alternatives to bank financing, improving the financial infrastructure, and strengthening competition in the financial sector.

Taxing times

Since 2011, government expenditure in the Arab countries in transition has been driven by the wage bill and subsidies, both of which were raised substantially in response to social pressures and higher international prices for imports. This spending has come in part at the expense of capital expenditures, which does not augur well for these countries' medium-term growth potential. Higher government expenditures have also increased deficits and debt, both of which make countries vulnerable (see Chart 4).

IMF estimates indicate that untargeted subsidies now cost the MENA region's budgets almost 8 percent of GDP. Generalized subsidies are an inefficient means of social protection: only about 20 to 35 percent of spending on subsidies reaches the lowest 40 percent of the income distribution. By contrast, in well-designed means-tested cash transfer systems, typically 50 to 75 percent of spending reaches the bottom 40 percent. If such transfer systems prove hard to implement, better targeting of price subsidies is the next best approach.

Reforms on the revenue side will differ according to countries' starting positions and preferences. Several countries, including Egypt, Jordan, and Yemen, have the capacity to raise additional revenue from direct taxes such as those on income, profit, and capital gains, which are now below the emerging market and developing economy average. Many countries could increase their income

Students celebrating the end of exams by dancing in the street in front of their school in Tunis, Tunisia.

from a value-added tax by exempting only necessities and improving compliance. And in some cases—Egypt, for example—standard rates could be raised closer to international averages. Regardless of the choice of instrument, the objective should be a broad-based tax system that generates the necessary fiscal resources fairly and without discouraging economic activity.

Protecting the poor

Reforms on both the expenditure and revenue side will raise money that can be spent on priorities such as infrastructure investment and health and education, which will increase growth and make it more inclusive. Some of the fiscal savings should also translate into lower fiscal deficits, which would reduce high debt—a key macroeconomic vulnerability in the region—and spur growth.

While generalized price subsidies are prevalent in the region, targeted safety nets to protect the poor and vulnerable are much less developed. Now that budgetary pressures make it all the more urgent to reform generalized subsidies, it has become equally urgent to develop better and more robust safety nets that target the needy. In some instances this will require a period of preparatory technical work, but in other areas immediate improvements can be had by leveraging existing nascent programs.

Getting the politics right

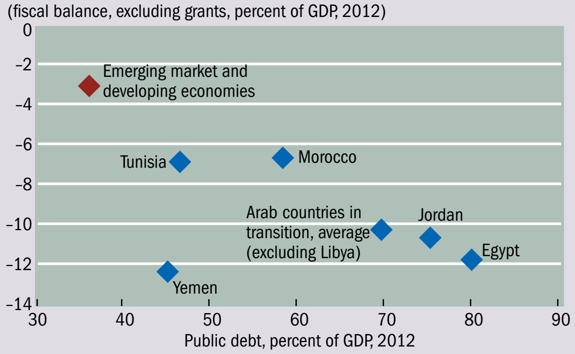
No doubt, implementing a comprehensive economic reform agenda will be tough, and getting the political economy right will be critical. More than ever, policymakers' success will depend on listening to all stakeholders' views when formulating policy agendas—including those whose voices were not heard under previous regimes.

Chart 4

Owing and growing

Arab countries in transition suffer from higher fiscal imbalance and public debt than most emerging market and developing economies.

(fiscal balance, excluding grants, percent of GDP, 2012)



Source: IMF, World Economic Outlook database, October 2012.

An element of success is knowing who stands to lose as a result of reform—whether in certain regions or economic sectors or along demographic or income groups. Such knowledge can help predict opposition to proposed plans. In

It has become urgent to develop better and more robust safety nets that target the needy.

a second-best world, it may be necessary to move ahead with reforms that garner sufficient support and postpone others: some progress is better than none at all.

Reform plans need to be anchored in clear and measurable performance goals. Otherwise, governments risk talking about reform without implementing it.

Effective communication is key to successful change and—particularly in the era of electronic communication and social networking—needs to be an integral part of the planning process. People must understand the reasoning behind difficult decisions if they are to support tough changes. For example, when reforming subsidies, policymakers should explain how expensive and inefficient existing subsidies are and the costs they impose on other parts of the budget. And in any reform involving revenue increases or expenditure cuts, it is important to demonstrate that the proceeds are being used to good effect.

Give change a chance

Each country's policymakers must articulate an agenda for economic transformation, drawing on the perspectives of various national stakeholders, the lessons of international experience, and the expertise of international agencies. The specifics will vary, but there are key common elements that respond to shared concerns. All must embark on this process with urgency, to build a shared national vision of how the economic framework will evolve and reassure hesitant investors on the future rules of engagement, thus accelerating the delivery of results that will sustain popular support for economic and social progress. ■

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Youth attend seminar at Ain Shams University, Cairo, Egypt.

Freedom and Bread GO TOGETHER

Marwan Muasher

Economic reforms in the Arab world must be implemented in parallel with political change

As Arab countries face dire economic challenges, it is easy to forget that not long ago many of them were in a similar—or worse—position. If the region is to successfully tackle unemployment, encourage foreign investment, and foster economic growth, leaders must take lessons from the recent past.

These lessons offer five rules for success. Economic reforms cannot succeed in isolation, but must go hand in hand with political transitions. They must benefit all segments of society and have buy-in from everyone. They should be quantifiable based on a clear goal. Finally, plans for economic reform must be communicated effectively.

Nothing new under the sun

This is not the first major economic test for Arab countries in transition, nor the first appearance of crucial economic reforms.

Egypt and Jordan, for example, dealt with similar economic crises 20 years ago that were worse in certain respects than those they face today. In the late 1980s, the budget deficit in Egypt was almost 20 percent of GDP and the inflation rate was also 20 percent—both twice what they are today.

Egypt's debt-to-GDP ratio was 76.5 percent, almost identical to today's 76.4 percent. And Jordan had a staggering debt ratio of 133 percent, compared with an estimated 65 percent today. Both countries' foreign reserves dropped dramatically in 2011 and 2012, but Jordan's almost disappeared in 1988.

Over the past two decades, Egypt and Jordan have undertaken serious economic reform efforts. Agreements with the IMF were signed, and many state industries were privatized. Egypt joined the World Trade Organization (WTO) in 1995. Jordan became a WTO member in 1999 and signed a free trade agreement with the United States in 2000. Both countries signed partnership agreements with the European Union.

As a result, both Egypt and Jordan were able to achieve healthy growth over a sustained period from 2000 until the global financial crisis in 2008. Despite these achievements, average citizens in both countries remained frustrated with a process whose lack of checks and balances left them little control—and with growth they couldn't see in their everyday lives. What went wrong?

Bread before freedom

Until the uprisings began in 2011, Arab leaders argued that economic reform must precede political reform—the so-called bread before freedom approach. They argued that it was premature and even dangerous to introduce political reform before supplying citizens' basic needs. Only when those needs had been met could people make responsible political decisions. But that strategy, even when conducted in good faith, did not work as planned.

The approach did preserve macroeconomic stability—which helps the poor, who are the first to suffer in an inflationary, low-growth environment—but failed to yield inclusive growth or address corruption, which multiplied in the absence of parallel political reform.

Economic liberalization—which included not only privatization and freer trade but also more liberal investment laws and stronger integration with the world economy—more often than not failed to achieve either political or economic reform. Because necessary economic measures were not accompanied by development of a political system of checks and balances, abuses by key economic actors went unchecked, and impunity was the rule.

As a result, many economic reform programs benefited only a small elite rather than the general population. The consolidation of benefits in favor of a small group further hamstrung the economic impact of the reform effort. In the absence of strong parliaments able to exercise proper oversight, the privatization of many state industries often took place without complete transparency and led to a perception, often justified, of corruption.

It is difficult to encourage foreign investment if there is no independent judicial system to properly address grievances. And it is hard to curtail corruption, which devours productivity, without an independent press or a strong parliamentary system. According to Transparency International's Corruption Perceptions Index, Jordan fell from number 37 (of 178 countries) to number 58 (of 176 countries) between 2003 and 2012. Between 2003 and 2010—just before the revolution—Egypt's rank fell from 70 to 98.

Although protestors' demands differed widely within and across countries of the Middle East, all sought to combat corruption. In addition to punishment for corrupt individuals, the uprisings called for institutional change to extinguish corruption at its very roots. The protestors believed proper oversight could be achieved by political reform that removed power from a dominant executive and redistributed it among the legislative and judicial branches.

Economic reforms must go hand in hand with political transitions. They must benefit all segments of society and have buy-in from everyone.

Most of the elite in Egypt and Jordan, and across the Arab world, believed that strong, representative parliaments do not understand economic reform and considered them an obstacle—not a partner—to economic development. Electoral laws in Egypt, Jordan, and elsewhere were designed to produce structurally weak parliaments dependent on and subservient to executive authority and unable to challenge executive branch policies—including the economic policies and practices of the past two decades.

Average citizens were accustomed to relying on government for some of their basic needs. There was no strong legislature to debate a government's decision to sell state assets, lift subsidies, or maintain liberal trade policies that some considered harmful to local industry. Genuine debate could have demonstrated the transparency and accountability of such decisions and assured average citizens that they stood to benefit.

But clearly the economic reforms of the past—however well constructed or critical—failed because they took place in isolation, without parallel political reforms. Governments often deemed such reforms not only unnecessary but detrimental to economic liberalization, which they feared might stall under a strong parliament.

Market-based economic policy prescriptions that focus on growth but ignore political reform and fail to improve the lot of the less privileged cannot solve the economic problems of the Arab world. The gap between the rich and poor widened in the region over the past two decades, exacerbated by the past few years' rising food and energy prices and the global financial crisis. This widening income gap is most pronounced in countries of the Middle East and North Africa that import commodities (including food and energy).

The failure in the Middle East of the so-called Washington Consensus of market-based reforms is one of omission. The old policies were not necessarily wrong, but rather insufficient. They ignored the interdependence of political and economic development. If the old policies cannot be applied to today's new realities, how should countries proceed?

Page from the rule book

Arab countries' future economic reforms must abide by a new set of rules.

Rule number 1: Economic reform will not work without parallel political reform

Purely economic solutions to economic challenges are not enough.

When Jordan faced a severe economic crisis in 1988 that led to an almost overnight 50 percent devaluation of its currency against the U.S. dollar, the late King Hussein was faced with large government deficits and meager foreign reserves. His solution was largely political: he called for inclusive elections that gave the country its first representative parliament in more than three decades. And it worked.

Jordan not only survived its economic crisis, but the new parliament, even with very strong Islamic opposition, approved an IMF-supported program and several liberalization efforts that led to higher growth rates in the early 1990s. The First Gulf War hit the country hard when all Arab and U.S. aid ended after Jordan opposed the introduction of foreign forces in the region, but there were no protests on the street: people felt their voice had been heard through the parliament. They had a stake in the process.

That lesson was quickly forgotten by countries of the region, including Jordan, whose peace treaty with Israel a few years later contributed to a decision to delay political reform. The past two decades have witnessed a stalling of political reform, with obvious disastrous results. As countries face similar economic crises now—exacerbated by rising energy and food prices, as well as the lingering global financial crisis—they cannot solve their problems simply by taking tough economic measures such as eliminating or redirecting subsidies. People are no longer willing to put up with a dominant executive branch making unilateral decisions that further aggravate their own dire living conditions.

Arab voters now expect economic policy that includes consultation with the people it affects and that is closely monitored by strong, elected, and accountable parliaments.

In Egypt, neither of the two transitional governments that followed the toppling of President Hosni Mubarak was able to sign an agreement with the IMF to get a badly needed loan, precisely because they were unelected and feared public reaction. By contrast, the government formed after the election of Muslim Brotherhood candidate Mohamed Morsi is now negotiating a financial arrangement with the IMF, which has historically been suspect in that country.

The IMF itself has learned from past mistakes. IMF financial arrangements with countries of the region since the Arab Awakening emphasize homegrown programs with significant input from the region's newly elected governments. The arrangements also advocate better-targeted subsidies and subsidy reform and highlight the importance of robust social safety nets, job creation, more equitable income distribution, and improved governance.

All elected governments have a fundamental stake in successfully addressing their country's economic problems and proving to their electorate that they can deliver greater prosperity. This means that fear of Islam cannot be used as an excuse by the ruling establishment or political elite to block the political progress needed to support economic reforms. There is nothing to fear from Islamists on the economic front. Despite a lack of experience, the Freedom and Justice Party (FJP) in Egypt, for example, introduced an economic program that should in no way alarm non-Islamists or the international community. The FJP program recognizes the importance of private property and the role of the private sector, a market economy that emphasizes social justice under the framework of Islamic law, and the need for domestic and foreign investment. Economic challenges facing the Middle East may catalyze political reform as they highlight the need for elected governments to make difficult economic decisions.

Rule number 2: Growth policies must be more inclusive

New leaders must be on guard against growth that benefits only a small elite, and economic reforms that speak only to some segments of society. Public demand for immediate improvement—job creation, better wages, and social justice—after the revolutions in Egypt, Libya, Tunisia, and elsewhere call for a new approach to economic development in the region.

Past economic reforms in the region have led to growth that did not trickle down to the average person. Rather than narrowing the gap between rich and poor, the changes often widened it. Future reforms must have a strong social component that allows the less privileged to improve their lives. Subsidies must be targeted to those who need them most. And governments should make critical investments in better health and education services for the majority of their citizens.

Rule number 3: Economic reform plans must be prepared with society's input

In the past, reform processes in the Arab world were mostly nominal and written by the regime—often without consultation—and then implemented without question by the government or bureaucracy. More often than not, these regime-led reform processes were insufficient, ad hoc, and poorly communicated. Without buy-in from the general public, not even the best intentions will translate into real change.

These top-down reform projects sometimes resulted in dramatic economic changes and impressive economic growth, including in Tunisia and Egypt. But they did not alter the authoritarian character of the regimes. They also lacked clear strategies for more inclusive growth, so the resulting economic benefits went largely to the business elite surrounding the regime. This did not go unnoticed by the broader public, and hostility and suspicion toward such policies run deep in most countries in the region.

Other projects were the result of social unrest and encompassed limited political reforms. The National Action Charter of Bahrain is one example. Developed in response to public demands for change, the charter was written and implemented as a royal initiative without consultation with diverse social and political actors. The reforms, enacted in 2001, included the creation of two parliamentary houses (one appointed and one elected) and the gradual transformation of the country into a hereditary constitutional monarchy. Despite these programs' lofty goals, they failed to deliver—the elected house does not exercise true legislative power, and the kingdom is not a true constitutional monarchy. The Bahraini public remains disillusioned by the government and continues to demand change.

Reform projects developed and implemented by the very leadership that needs reforming illustrate the need for programs that adequately represent and empower all the major forces in society. Reform that fails to incorporate the point of view of those affected will neither succeed nor be seen as substantive or credible. When the military leaders in Egypt attempted to set the rules of the political game by diktat after Mubarak's fall, they were immediately rejected by the public. In the new Middle East, Arab citizens of all political persuasions have been awakened and are focused on changing the game. While proper political institutions are being built, citizens have discovered that their voice can be heard on the street.

All elected governments have a fundamental stake in successfully addressing their country's economic problems and proving to their electorate that they can deliver greater prosperity.

Rule Number 4: Economic reform plans must be measurable and point to a final goal

In the past, the reform process has too often been heavy on promises and short on implementation. A clear set of transparent and measurable performance goals will ensure that governments actually undertake reforms and do not fall back on meaningless rhetoric.

At a summit in Tunis in 2004, Arab leaders agreed on a reform document that reiterates their commitment to, among other things, "expanding participation and decision making in the political and public spheres; upholding justice and equality among all citizens; respecting human rights and the freedom of expression; ensuring the independence of the judiciary; pursuing the advancement of women in Arab society; acknowledging the role of civil society; and modernizing the education system."

Years later, these promises remain largely unfulfilled. That is not surprising, given the absence of evaluation mechanisms to monitor and track progress toward these objectives. The National Agenda effort in Jordan outlined not only final targets, but also milestones, performance indicators, and time frames, but was never implemented, and there has been no comparable effort in the region. Reform rhetoric without results is no longer convincing.

Economic reform plans should also spell out goals—for example, a balanced budget in 10 years or national health insurance for all. Citizens are more ready to accept short-term sacrifices if it's clear what they are for. Most people in the Middle East feel that governments operate only in crisis mode: they ask their citizens to pay endlessly for administrative excesses, with no payoff in sight. For example, the Jordanian public recently demonstrated against the elimination of fuel subsidies in the face of rising international fuel prices. People must be given a real stake in the process. Even if change takes a long time, policies should be structured to yield some benefits in the early years and to engage citizens at every stage on the way to an explicit national goal.

Rule Number 5: Communication must be a key policy tool

Effective modern communication must never be an afterthought; it must be part and parcel of the planning process, including for Arab economic reform policies.

Communication of reform programs cannot be started after a program is agreed to within the government. Reforms must be prepared in consultation with parliaments and civil society, and their objectives must be clearly communicated by leaders every step of the way. Keeping these programs secret, as has often been the practice in the Middle East, only adds to long-standing skepticism by the public and often leads to outright hostility toward them. As difficult as it might be, communication must be a key policy tool—employed at a very early stage—if there is any hope of achieving buy-in by the general public.

Got to change

Economic reform processes will work in the Middle East, but not if they follow the models of the past two decades. For economic programs to succeed they must also encompass political elements. The programs must be measurable, broad based, and inclusive—and presented as part of a public plan with the engagement of civil society. Reform initiatives cannot be dictated from the top; they must be agreed to by elected governments. Finally, they must build on an understanding of the links between all aspects of a program. This is the only way to develop and implement a comprehensive approach that addresses the multifaceted political and economic elements simultaneously, with clear and achievable objectives.

The Arab Awakening spurred citizens to expect more from their government. Political change will stall without greater prosperity for more people in the region. At the same time, economic change will not succeed without empowering the key institutions necessary to enable and support the development of more efficient and transparent economic processes. Political and economic elements must work hand in hand to move the region forward. ■

Marwan Muasher is Vice President for Studies in the Middle East Program of the Carnegie Endowment for International Peace.

Day laborers pouring concrete in Sulaymaniyah, Iraq.

Only Fair

Social justice must be at the foundation of Arab economic reforms

Nada al-Nashif and Zafiris Tzannatos

RAHMA REFAAT, an Egyptian trade unionist from Cairo, has fought for social justice for decades.

"The first time I was arrested was in 1977 while protesting the bread price increase under President Anwar Sadat," she says. "I was detained for six months."

Refaat has been arrested countless times since, most recently during the January 25, 2011, protests that ushered in Egypt's first democratically elected government. "We went to Tahrir to reject the humiliation of unemployment and oppression," she says.

One outcome of the mass protests was the formation of the Egyptian Federation of Independent Trade Unions, breaking a six-decade state monopoly on the trade union movement. Scores more independent trade unions have since emerged.

But the revolution is still not over for Refaat and other activists: not until workers, employers, and civil society are involved in the policymaking process.

"Restrictions on unions must be lifted and social dialogue seriously pursued if we are to make Egypt a place for all Egyptians," she says. "Politics and economics must go together—that's unavoidable."

Ordinary people

The Arab Spring came with little warning. The consensus had been that Arab governments were on the right track economically, if not politically—focusing on "economic reforms now, political ones later." They were driving through long-awaited pro-market reforms—spearheaded by Tunisia and Egypt—and economies were growing relatively quickly. Some even spoke of an "Arab renaissance."

But this description failed to capture what really mattered to most people: decent work, fair access to education and health care, support in old age, accountable government, and a say in how the country is run. It glossed over two decades of skewed economic policies, a widening social protection deficit, and the absence of institutionalized social dialogue between governments, workers, employers, and other segments of society. Instead, it focused on a narrow set of pro-market indicators such as the rate of privatization, trade openness, debt and inflation reduction, and foreign direct investment.

And when policymakers did look at the right indicators, they often misinterpreted them. For example, the focus on high youth unemployment missed the point that adult unemployment in the region was the highest in the world. Large numbers of young workers in fact constitute a window of demographic opportunity that, if properly used, can add bonus points to the economic growth rate. The quality of education in the region has indeed been low, but more relevant is the unsophisticated nature of production, which continued to demand only low levels of education and skill.

Amid declining social protection and in the absence of social dialogue, the living standards improved for some, but most Arab citizens could not reap the rewards of economic liberalization. Development failed to help the vast majority of the population and could not meet the aspirations of the rising number of increasingly educated Arabs. Arab citizens—young and old—suffered from a heightened sense of alienation and insecurity.

Not that fast

Arab governments emerged from the region's "lost decade" of the 1980s—which witnessed a regional slowdown due to tumbling oil prices—with a slew of reforms to tackle stagnant, or even declining, per capita GDP, rising fiscal burdens, slow productivity growth, and low competitiveness. But these measures threatened the prevailing social contract that bound Arab rulers to their citizens: an unspoken trade-off in which citizens forfeited political freedom for public sector jobs, public services, and state handouts.

Governments across the region introduced economic reforms at various times and differing intensities beginning in the early 1990s. They achieved some objectives, such as reducing debt and inflation. Arab economies began to grow more quickly after the turn of the century, averaging 5 percent between 2000 and 2010. These growth rates, though unprecedented, were still lower than those of any other region except Latin America.

Even more disconcerting, the Arab region combined the lowest per capita income growth with the lowest rates of voice and accountability (see Chart 1). This meant that citizens had no say in policymaking. Governments remained oblivious to the social impact of economic reforms and ignored demands for accountable systems of governance.

Private sector woes

Increasing the role of the private sector was the centerpiece of economic reforms pursued by Arab states in the 1990s. Privatization, or more precisely denationalization, went hand in hand with opening up capital accounts and fiscal consolidation through expenditure cuts. The success of trade policies was measured in terms of "openness" instead of by how well they supported sustainable and inclusive growth. Contrary to expectations, the revitalized private sector didn't produce sufficient gains to trickle down to middle-class and poor people.

Governments cut back on public investment on the assumption that it crowded out private investment. But total investment remained low in the Arab region. Moreover, it was directed to sectors that offered quick returns only to a few, such as finance, trade, and real estate. Foreign direct investment did increase but not as much as in other regions. In a globalizing world, what matters is not so much how fast one moves but how fast relative to others.

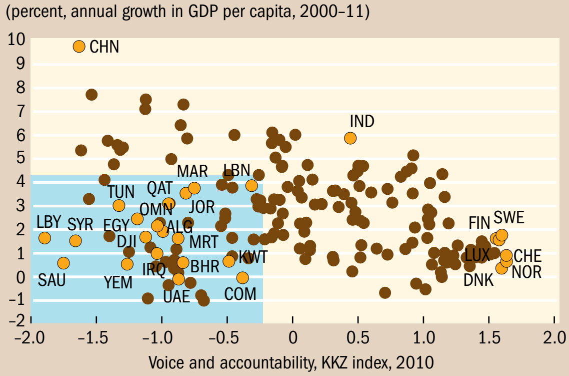
Successful privatization requires sound trade, financial, and foreign investment policies as well as transparency and sufficiently developed capital markets and accompanying institutional reforms. These have been largely absent in the Arab region. The rollback of the state was conducted without regard for the impact on the social sector of handing over public services to private operators.

Chart 1

Sotto voce

Per capita income growth and voice and accountability have been low in the Arab states.

(percent, annual growth in GDP per capita, 2000–11)



Sources: World Bank, Worldwide Governance Indicators database; and IMF, World Economic Outlook database.

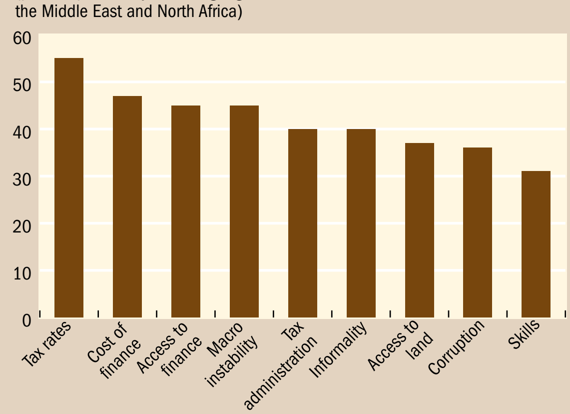
Note: ALG = Algeria, CHE = Switzerland, CHN = China, COM = Comoros, DJI = Djibouti, DNK = Denmark, EGY = Egypt, FIN = Finland, IND = India, IRQ = Iraq, JOR = Jordan, KWT = Kuwait, LBN = Lebanon, LBY = Libya, LUX = Luxembourg, MAR = Morocco, MRT = Mauritania, NOR = Norway, OMN = Oman, QAT = Qatar, SAU = Saudi Arabia, SWE = Sweden, SYR = Syria, TUN = Tunisia, UAE = United Arab Emirates, and YEM = Yemen. KKZ = Kaufmann, Kraay, and Zoido-Lobaton index in *Worldwide Governance Indicators*.

Chart 2

High hurdles

Constraints on investment in the Middle East are severe and wide ranging.

(percent probability of finding a given constraint to investment in countries of the Middle East and North Africa)



Source: World Bank, *Investment Climate Assessment* reports.

The private sector remained significantly constrained. Competition was subdued, and the region had the fewest—after Africa—competitors in local industry and the oldest median age of manufacturing firms (except in the high-income economies). It was not a low-skilled population that tied the hands of investors but taxes, corruption, and lack of access to finance and land (see Chart 2). Productivity in the region increased only slightly and remained below the world average.

Quantity versus quality

Arab unemployment has declined, especially among young people, since the 1990s thanks to job creation but also due to changing demographics. As the number of working-age people in the region stopped growing more than a decade ago, growth of the labor force began to decline, even though more women joined the labor force.

But jobs remained concentrated in low-productivity sectors such as agriculture and services and in the informal economy. As a result the Arab region was the only one where the reallocation of labor across sectors contributed negatively to productivity growth. The share of working poor declined over time but more slowly than in other regions, and the ratio of women's share in low-quality jobs to men's remained the highest in the world. What's more, the share of wages in GDP declined faster than in the rest of the world (see Chart 3), suggesting that workers were getting an increasingly smaller slice of a growing pie.

The ratio of youths to adults has declined over time, a trend that began in North Africa in the 1980s and the Middle East in the mid-1990s. In the Gulf Cooperation Council countries—Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates—the youth-to-adult population ratio is already below the world average.

Rising school enrollment has helped reduce the share of young people in the labor force while increasing their employability. In fact, youth unemployment fell more than that of adult workers, in both the Middle East and North Africa. So the general explanation that the Arab Spring was the result of "too many unemployed youths" is not the full story. In fact, in the 1990s there were more young people and more of them were unemployed compared with adults than at the outset of the Arab Spring. Still, the high Arab unemployment rate is largely the result of very high unemployment among women, especially those who are young and educated.

While joblessness normally declines as household income increases, in the Arab region unemployment affects households from all income groups more or less uniformly. Educated job seekers have high unemployment rates and, when they are employed, the extra pay they receive for their education—known as the wage premium—is low. This can be partly attributed to the low quality of education or a mismatch between skills and the demands of the labor market. However, a more likely reason is the excess supply of adequately (in terms of local production requirements) educated job seekers following the impressive increase in education enrollment in the region, especially for women, since the 1960s. Finally, the region has one of the highest skilled emigration rates. Arab job seekers seem to be able to meet employment requirements in more sophisticated economies abroad but can find no decent work at home.

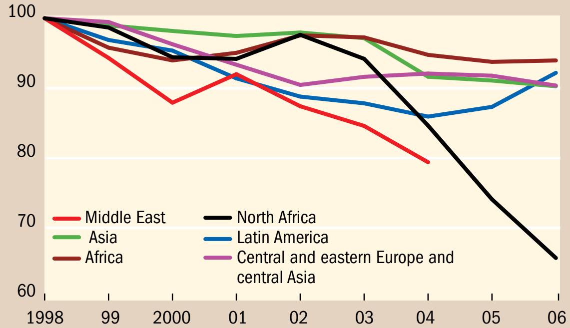
Skills constraints are among the least concerns of Arab employers (Chart 2). And the percentage of Arab firms offering training is the lowest in the world. This supports the view that the private sector is not competing through measures that would increase productivity but through extractive political methods.

Chart 3

Shrinking piece of pie

The share of wages in GDP declined faster in the Arab region than elsewhere.

(index of wage shares as percent of GDP, 1998 = 100)



Source: International Institute of Labour Studies (2011).

Less help for the poor

By most measures, Arab poverty has not increased since the 1990s, and in some cases has declined, albeit more slowly than in the rest of the world. But the drop of the wage share in GDP (by 21 percent in the Middle East and 34 percent in North Africa; Chart 3) and perceptions of rising wealth inequality have reinforced a sense of exclusion created by elite privatization.

Social protection used to be administered through benefits linked to public sector employment, various subsidies, and access to expanding education and health services, albeit of low quality. This stretched public budgets, prompting economic reforms that reduced public services and the ability of the state to serve as employer of last resort.

Many of the reforms made sense. For example, universal subsidies for food or energy did not benefit the poor much, and benefits were earned predominantly through employment in the formal sector, especially the public sector. But expenditure cuts were too blunt—and were not cushioned by effective and sustainable social protection measures. The private sector stepped in selectively, and clubby business practices soon prevailed.

Pension reform was viewed less as a way to provide old-age security and more as a way to bolster capital markets. (Before 2008, the ills of unregulated financial markets had yet to be acknowledged). Formal sector employers continued to bear maternity benefit costs, which made hiring women less desirable. This ran contrary to the worldwide trend toward funding maternity benefits via social security so that all women are covered. And unemployment insurance was almost nonexistent before 2010—lowest in the world save in sub-Saharan Africa.

Toward a new social contract

In 2010, Arabs were more pessimistic about their prospects than at the start of the millennium. (See Figure 3.10 in ILO and UNDP, 2013) Despite the decline in unemployment, they harbored low expectations. Positive market indicators meant little to those struggling to make ends meet in low-quality, unrewarding jobs with little social protection and no access to social dialogue.

It was not the numbers of young people, their attitudes, or their education that prevented better labor market outcomes and faster output growth. Nor was it the increasing number of women in the labor force. Rather, skewed economic reforms failed to create a level playing field for the private sector, stymied productivity gains, cut access to social protection, and deprived most citizens of access to the benefits of growth. Though economic growth was not jobless, employment was unrewarding for many workers, which, coupled with a lack of social dialogue, prevented the collaborative development of inclusive growth and made citizens increasingly insecure and alienated.

In sum, pro-market reforms delivered some positive benefits and showed the potential of the private sector. But they failed to deliver the rates of economic growth and wealth creation that other regions have enjoyed in recent decades.

In the wake of the Arab Spring, Arab states must deliver more with less to assuage popular discontent and maintain social stability. This is why they need better targeted and more coherent policies developed in consultation with employers, workers, and civil society. We have seen the limitations of top-down politics.

In coming years, economic growth in the Arab region is expected to remain among the lowest worldwide, below even pre-2010 rates and too low to reduce unemployment. Future policies must avoid the mistakes of the past: applying untested theories, ignoring implementation constraints, and having social protection programs that lack clear economic and social criteria, with, for example, uncritical government spending cuts and failure to focus on the most needy.

What to do

Arabs need a new development model that is grounded in social justice: one that creates prosperity through equal opportunities, productivity gains, and decent work; expands social protection; and promotes social dialogue. Pro-market reforms are not synonymous with unregulated markets, and their social impact must be considered when deciding which reforms to implement and how. The role of governments in this respect is paramount. According to a World Bank report (Silva, Levin, and Morgandi, 2012), "at least eight in 10 adults in Egypt, Jordan, Lebanon, and Tunisia say their respective governments should bear the primary responsibility for helping the poor in their countries."

Economic growth must be balanced and able to generate enough jobs and social services that allow men and women and their families to live in security and dignity. Employers and the self-employed need a level playing field to pursue legitimate profit-seeking activities, from micro and small-scale undertakings to full-scale investments, and move away from the kinds of investment with quick financial returns that benefited the establishment elite but excluded the majority of citizens. Future economic reforms should take full advantage of the private sector's vast potential.

Arab states must deliver more with less to assuage popular discontent and maintain social stability.

Economics first, politics later just won't do for the Arab world anymore: politics and economics go hand in hand. Policymakers should ensure that the benefits of economic growth are shared fairly, by expanding social protection and making it more effective. Macroeconomic policies should be supported by well-designed active labor market programs and increased access to quality education and training for all income groups. And the region also urgently needs up-to-date and reliable information systems, better statistics tracking, and effective monitoring and evaluation of policies and programs.

Arab states must decisively cast off the remnants of an unraveling social and economic order to move toward inclusive economic growth. They must define a new social contract in a participatory way to meet the aspirations of millions of men and women—including Rahma Refaat—who refuse to settle for less. ■

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As a Matter of FINANCE

Man withdraws money from ATM in Beirut, Lebanon.

Adolfo Barajas and Ralph Chami

THE Arab Spring ushered in a dawn of change across many countries in the Arab world. Discontent drove the demonstrations, and later the discourse. Now a new world has begun to develop in a number of countries still in varying states of transition.

Though it is still too early to reach definitive conclusions as to what drove the awakening across the Arab world, it is quite clear that the pace and quality of economic growth in the Middle East and North Africa (MENA) for several decades lagged far behind that of other developing economies (see Chart 1) and failed to deal with socioeconomic inequalities that fueled social tensions.

Although it has picked up since 2000, economic growth in the region is still lackluster and therefore of significant concern to policymakers. Several studies have uncovered a number of contributing factors, including subpar institutional quality, the difficulty of doing business, high rates of government spending, and lack of trade openness.

More recently, the limited effectiveness of the financial sector has been identified as an additional factor holding back long-term growth. By taking stock of the current state of finance following the Great Recession and reviewing its role in promoting growth, a picture begins to emerge of the challenges facing MENA countries when it comes to the promotion of financial development.

Emerging from boom and bust

Like much of the world, MENA countries experienced a marked acceleration in bank lending beginning in the mid-2000s. Until 2008, banking systems in most of these countries expanded credit to the private sector at a very rapid pace, often far above the rate of growth of the real economy. Recent analytical work found that eight countries in the MENA region were in the midst of a credit boom at some point around 2008, in the sense that the ratio of credit to GDP had surpassed the historical trend by an extraordinary margin (Barajas and others, 2011). At the same time, the region as a whole, along with sub-Saharan Africa and central and eastern Europe, was experiencing a generalized credit boom.

But with the global chain of events unleashed by the Lehman Brothers failure in September 2008, the ensuing drying up of funds—both domestic and foreign—contributed to equally spectacular declines in the growth of credit. For example, after peaking at over 26 percent in mid-2008, credit growth in Bahrain slowed to just over 4 percent by the first quarter of 2010. In Jordan, credit growth plunged: it grew faster than 14 percent in 2008 but contracted by 2 percent in the first quarter of 2010. This general pattern was observed in most of the region, more markedly among oil exporters and in the high-income Gulf Cooperation Council (GCC) countries in particular.

More recently, although credit growth has certainly been picking up from its postcrisis lows, the recovery from the boom-bust cycle is still incomplete. Based on the typical behavior observed during previous boom-bust cycles in the region over the past two and a half decades, the above-mentioned study suggests that it would take at least three years to return to "normal" growth rates, in the range of 5 percent a year. Indeed, as of 2011 and early 2012, which is when the latest observations are available for various countries, average postcrisis credit growth in the region had declined by some 10 percentage points compared with the four-year period before 2008, and the latest observed 12-month growth rate is approaching 4 percent on average (see Chart 2). Partly owing to heightened uncertainty and disruptions in economic activity resulting from the political transitions of the Arab Spring of 2011, credit is more subdued in the non-GCC countries, growing by less than 3 percent annually.

Stable systems

A notable positive aspect of banking systems in the MENA region is their lower propensity for widespread instability when compared with other regions. This applies not only to the recent boom-bust cycle, but over a longer period as well. A study by Laeven and Valencia (2012) identifies systemic banking crises throughout the world as events during which widespread bank runs, bank losses, or liquidations combine with large-scale crisis intervention measures. Their analysis reveals a strikingly low frequency of these events in MENA countries throughout the past four decades.

Between 1970 and 2010, the region experienced systemic banking crises about 13 percent of the time, compared with 22 to 23 percent of the time for the world and for emerging market and developing economies as a whole, respectively (see Chart 3). What's more, during 2000–10, crises erupted to an unprecedented degree in member countries of the Organization for Economic Cooperation and Development—more than 60 percent of these countries were in crisis at some point during this period—but the MENA region as a whole managed to avoid such crises entirely. Note that emerging market and developing economies in general were not immune to crisis in this recent period: they experienced such episodes about 8 percent of the time.

Although credit growth has certainly been picking up from its postcrisis lows, the recovery from the boom-bust cycle is still incomplete.

More than meets the eye

Notwithstanding the boom-bust cycle described above, the MENA countries have experienced several decades of steady, if unspectacular, financial deepening—that is, increasing importance of the financial sector in the economy. As a result, as of 2009 the region comes out rather favorably compared with other regions of the world, albeit with some caveats that are not immediately evident from the aggregate figures (Barajas, Chami, and Yousefi, 2011). Using standard measures of depth in banking (ratio of private sector credit to GDP) and stock markets (market turnover or ratio of value traded to GDP), it appears that financial development is quite adequate in the MENA region, amply surpassing the averages in other emerging market and developing economies (see Chart 4).

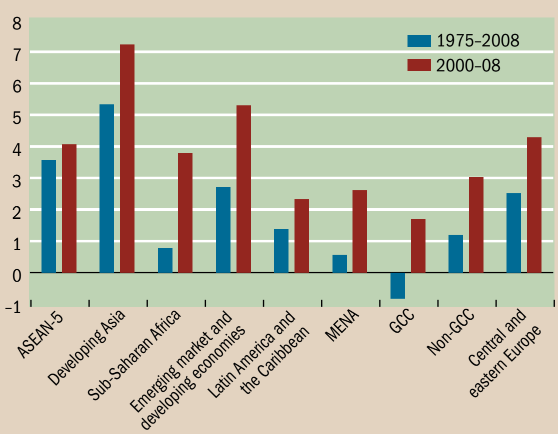
The first caveat, however, is that beneath the aggregate figures lies considerable variability across countries within the region. For example, in 2009 private sector credit amounted

Chart 1

Lagging behind

Economic growth in the MENA countries lagged far behind that in other developing economies.

(average real per capita growth, by region, percent)



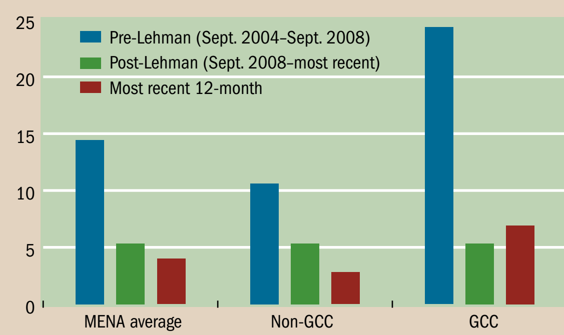
Sources: IMF, *World Economic Outlook*; and authors' calculations.
Note: ASEAN-5 = Association of Southeast Asian Nations, including Indonesia, Malaysia, Philippines, Singapore, and Thailand; MENA = Middle East and North Africa, including Algeria, Bahrain, Djibouti, Egypt, Iran, Iraq, Jordan, Kuwait, Lebanon, Libya, Oman, Mauritania, Morocco, Qatar, Saudi Arabia, Sudan, Syria, Tunisia, the United Arab Emirates, and Yemen; GCC = Gulf Cooperation Council, including Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

Chart 2

Credit cliff

Credit growth across the region fell off sharply following the Lehman Brothers bankruptcy.

(average annual growth rates of real credit)



Sources: IMF, *International Financial Statistics*; and authors' calculations.
Note: In order to incorporate the most recent data available for as many countries as possible, the post-Lehman period takes averages across somewhat different periods. For about half of the countries, the most recent observations are from June 2012 or later. For the remaining countries, the latest observations are from the first and second quarters of 2011 or from early 2012. GCC = Gulf Cooperation Council (see Chart 1).

to 78 percent of GDP in Jordan, almost eight times the level observed in Libya. Similarly, stock market turnover in Saudi Arabia, at 199 percent, was about 11 times that of Lebanon.

The second qualification is that, while the capacity of MENA economies to generate deposits has been quite substantial, the intermediation of those funds by banks into private sector credit has not been as impressive. MENA banking systems are more likely to send funds abroad or invest in domestic securities—government bonds, for example—than increase credit one-for-one with additional deposits received.

By expanding on these underlying issues and comparing financial depth, not only with that of other regions, but also in relation to structural characteristics of the economy, we can draw more meaningful conclusions. Recognizing that a country's financial development may be partly explained by structural factors such as its income, population size and density, age distribution, and whether it is an oil exporter or offshore financial market, the World Bank has produced financial depth benchmarks against which a country's level of financial development may be compared at different points in time (Al-Hussainy and others, 2011). Simply put, the benchmark indicates the degree of depth that would be expected from a country with given structural characteristics.

This comparison reinforces our earlier discussion. As of 2009—the most recent year for which structural benchmarks have been estimated—MENA countries had an average credit-to-GDP ratio of 48 percent and a stock market turnover ratio of 45 percent, both about 10 percentage points above the average for emerging market and developing economies as a whole (see upper left and lower right panels of Chart 4).

For the world as a whole, the average level of a given indicator should be equal to the level predicted by the average structural characteristics. However, this does not necessarily hold for individual countries or regions, which may under- or outperform their benchmarks. Although banking systems in emerging market and developing economies, on average, had roughly the amount of private sector credit that would be expected from their structural characteristics—actual ratios of credit to GDP and credit to deposits being roughly equal to the respective benchmarks—MENA banking systems underperformed.

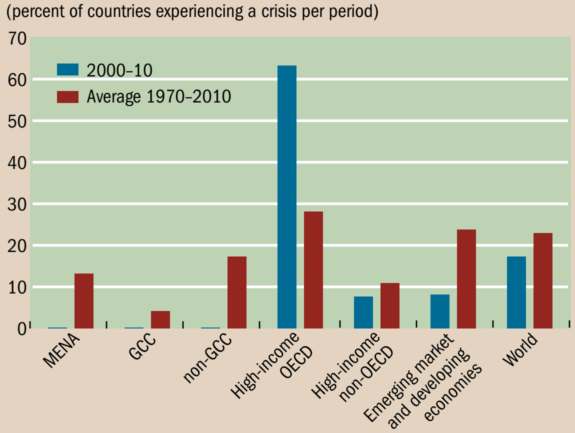
The underperformance was most notable in the non-GCC countries and with respect to the credit-deposit ratio, which indicates the inability to convert deposit funds into private sector loans. Indeed, the MENA credit-deposit ratio was 18 percentage points below its structural benchmark, and in the non-GCC countries it was 40 percentage points below (see Chart 4, upper and lower left panels). This is partly due to heavy public sector borrowing, particularly in certain non-GCC countries. For example, in Algeria, banks lend almost 50 percent *more* to the government than to the private sector, in Syria over 20 percent more, and in Egypt roughly the same amount as to the private sector. On average, MENA banking systems lend close to 13 percent of GDP to the government and to state-owned enterprises. Regarding stock market activity, turnover appears at first glance to be relatively robust in the MENA region, yet the high level observed in the GCC countries reaches only about half its structural benchmark.

Chart 3

Crises averted

Compared with other regions, MENA countries have experienced fewer systemic banking crises over the past four decades.

(percent of countries experiencing a crisis per period)



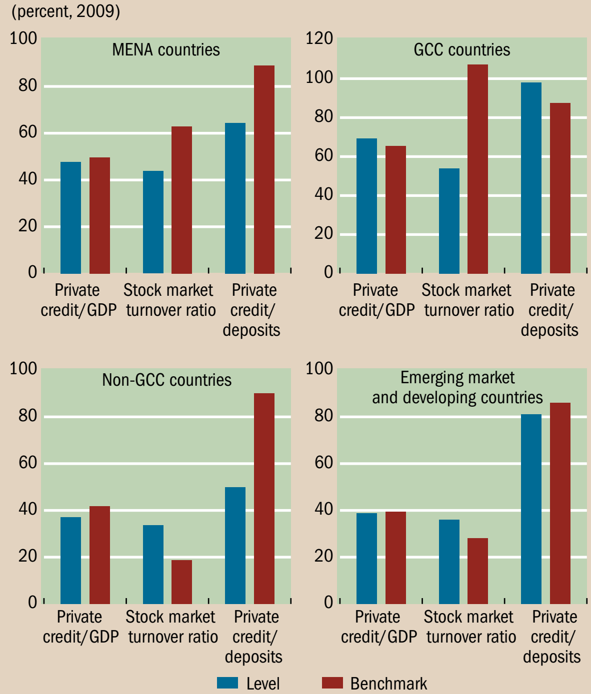
Sources: Laeven and Valencia (2012); and authors' calculations.
Note: OECD = Organization for Economic Cooperation and Development; GCC = Gulf Cooperation Council; MENA = Middle East and North Africa (see Chart 1).

Chart 4

Surface depth

The MENA region appears to have adequate financial depth on average, yet it underperforms relative to benchmarks for its structural characteristics.

(percent, 2009)



Source: World Bank, FinStats database.
Note: GCC = Gulf Cooperation Council (see Chart 1).

Improving access

A final caveat concerns the region's ability to generate access to finance commensurate with its financial deepening, a point emphasized in World Bank (2011). Despite the important strides made by MENA countries to reform their business environments and deepen their financial markets, the region still ranks lower than any region except sub-Saharan Africa in access to both deposits and bank loans. Moreover, available credit tends to be heavily concentrated, favoring a few large and well-established firms, while smaller and young businesses—those that create the majority of jobs—are left to rely on limited internal finance or informal channels to secure much-needed funds.

Furthermore, MENA countries fall short on access to credit not only relative to other regions but also relative to the depth of credit. For example, almost invariably, the population's use of bank loans falls below that in other countries with similar ratios of private sector credit to GDP (see Chart 5).

Previous IMF research found that a given level of banking depth in MENA countries is less effective than in other regions when it comes to generating economic growth over the long term—an indication of a quality gap in MENA banking systems. Although it is difficult to ascertain exactly why the same amount of bank credit in MENA countries pays a weaker growth dividend than in other regions, it is quite plausible that limited access to credit and to financial services in general is a key piece of the puzzle, and may in part explain the persistent underperformance of MENA countries in economic growth.

Depth is not enough

The MENA region is at a historic juncture. Beyond the challenges of political transition, the economic objectives are quite clear: raise the rate of economic growth, create more jobs, and ensure that economic growth is more inclusive. It is also clear that financial stability alone is not enough for the region to enjoy the benefits of economic growth and that there is a dire need for inclusive financial deepening. Achieving this objective depends on a comprehensive agenda covering sound economic policies as well as far-reaching structural and institutional reforms.

A successful reform agenda for the coming years will necessarily be a balancing act. Increasing depth—in countries that are still lagging—and enhancing access to the existing depth will require a combination of market-friendly policies that remove distortions, such as barriers to entry, interest and credit controls, and direct state ownership of banks, as well as substantial pressure to finance the government. In addition, broader policies aimed at improving the environment for financial intermediation should be pursued: macroeconomic stability must be maintained, legal protection of creditor and small shareholder rights must be strengthened, and credit information and collateral regimes must be enhanced. Naturally, as credit increases in size and breadth throughout these economies, and the borrower pool expands beyond the traditional large and well-connected firms, credit risk is likely to rise. Policymakers should ensure that market-harnessing policies, both at the micro- and macroprudential levels, are up to the task, so that the gains achieved by greater finance are not undone by excessive instability. ■

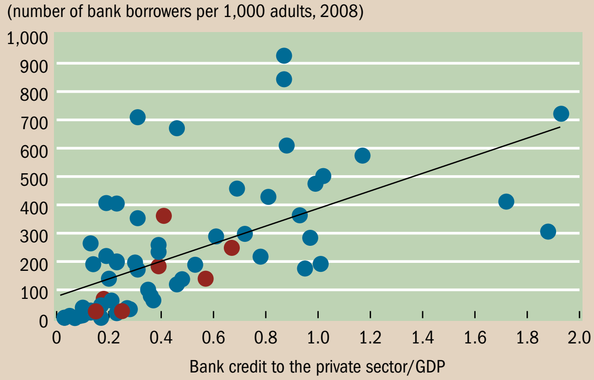
MENA countries fall short on access to credit not only relative to other regions but also relative to the depth of credit.

Chart 5

Borrowers' dilemma

Compared with other emerging market and developing economies, those in the MENA region provide less access to commercial banks and bank loans for the same amount of credit.

(number of bank borrowers per 1,000 adults, 2008)



Sources: IMF, *Financial Access Survey*; World Bank; and authors' calculations.
Note: MENA countries are in red.

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BUSINESS,

Kilim shop in Mahdia, Tunisia.

Private enterprise, driven by a nascent middle class, is the key to successful democratic transition in the Middle East

Vali Nasr

IT is no accident that the Arab Spring commenced in Tunisia instead of, say, Syria or Yemen.

It started there because of the promise of prosperity and growth. It started there because of the country's large, literate middle class. It started there because of that middle class's relatively liberal political outlook and thirst for the political freedoms that accompany economic prosperity.

In an environment of political stability and open economic activity, private enterprises flourish and economies grow, supporting the emergence of a middle class. It is that middle class, in turn, that pushes for further political change and bolsters democracy.

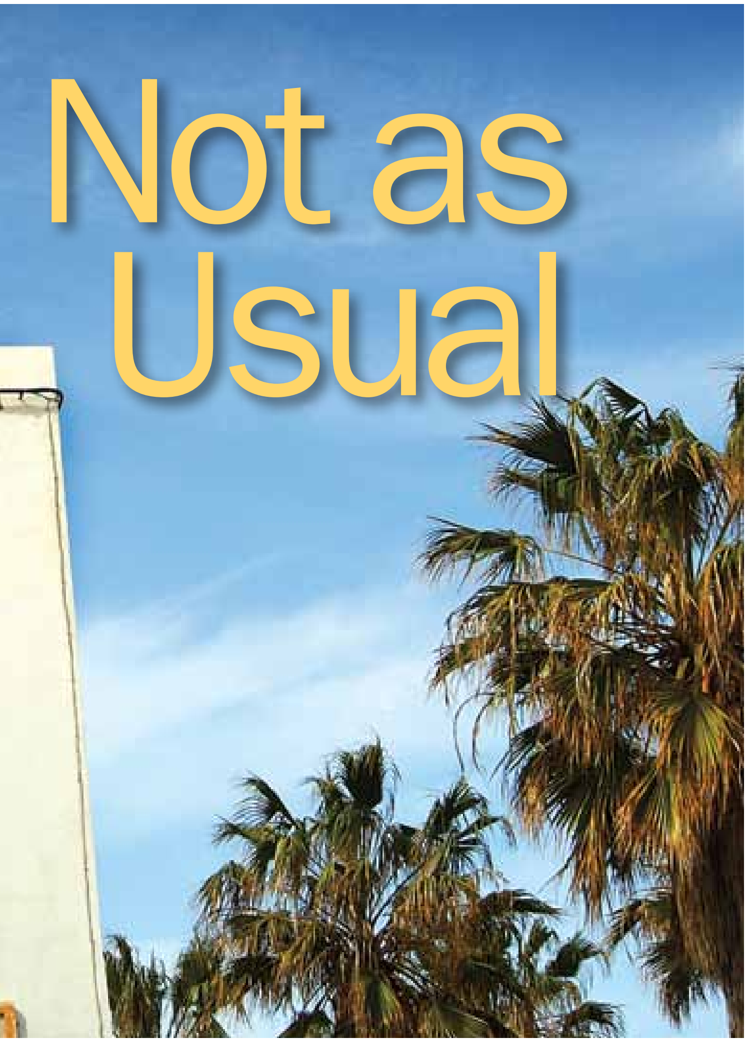
If the Middle East is to realize the democratic promise of the Arab Spring—and if the rest of the world is to enjoy the global benefits it would garner—countries in the region and abroad must foster private enterprise and the emergence of a strong and vocal middle class.

Fertile ground

When protests erupted across Tunisia in January 2011, the economy was open and vibrant. The population was educated and technologically adept—20 percent of the population used Facebook to communicate with family and friends at home and abroad.

During the decade leading up to the Arab Spring, Tunisia was enviously referred to as the "China of the Arab world." Although it was authoritarian and beset with corruption, it was also integrated into the global economy through manufacturing exports and tourism and was growing at a rate comparable to those

Not as Usual



of large emerging economies. This growth produced the middle class that ultimately pushed for political change.

For more than a generation, most of the Arab world has suffered from economic stagnation. State control of economies has produced bloated red-ink-generating public sectors that have crushed innovation and entrepreneurship while shielding inefficiencies behind government protection and high tariff barriers.

As a result, the Arab world has fallen behind other developing regions. It suffers from a sclerosis that has deepened poverty and frustration. And this is only aggravated by the demographic "youth bulge" in the region.

If this picture does not change—if the Arab world fails to follow in the footsteps of successful transition economies in eastern Europe, Latin America, and southeast Asia—the region will not only fail at democracy, but will also grow poorer and more unstable. And that will lead to myriad social and political problems that could threaten global security and economic prosperity around the world.

The most obvious risk is the familiar specter of extremism and terrorism, but fratricidal regional conflict, humanitarian crises, and large-scale labor migration to Europe are also worrisome threats.

Private sector–led growth

The Arab population today numbers 400 million, which will double to 800 million by 2050. Population growth makes aggressive economic growth an urgent imperative. Even to tread water and maintain current living standards, the Arab economies would need to grow at "tiger-economy" rates of 9 to 10 percent for a decade or more. That is a daunting task, one the public sector cannot accomplish alone. Growth must come from the private sector, and that requires reform of the economy: removing regulations, relaxing government control, promoting trade, and bolstering the rule of law.

The region clearly has the potential for private sector growth. In the past decade, the opening up of economies—most prominently in Tunisia, Egypt, and the United Arab Emirates, as well as in Jordan and Morocco—and the influx of new technologies and capital born of high oil prices nurtured the growth of small and medium-sized enterprises. These new enterprises both embraced traditional manufacturing and services and created new industries such as technology start-up ventures. Witness the purchase by Yahoo! of the Jordanian Internet start-up Maktoob for more than $120 million in August 2009.

Thanks to some of this small and medium-sized enterprise activity, we can look past today's gloomy picture and imagine real economic change in the region. Economic reform in Dubai, Malaysia, and Turkey and even the modest loosening of government control in places such as Egypt, Pakistan, and the West Bank have made room—if rarely enough—for local commerce and global trade. Local entrepreneurs and businesspeople have begun to take advantage of these changes.

A growing middle

The result of the escalation in private sector activity has been the birth of a small but growing middle class. In the 1960s, on average less than a third of the populations of large Muslim countries such as Iran, Pakistan, and Turkey lived in cities, and by most estimates, only about 5 percent were middle class. Today, about two-thirds of these countries' populations live in urban areas, with about 10 percent qualifying as middle class.

If the middle class is defined more broadly to include people with formal employment and a steady salary and benefits who can afford to devote a third of their income to discretionary spending, it now includes about 15 percent of Pakistan's population and 30 percent of Turkey's. The numbers are even higher if the definition is extended to include those who have adopted modern family values, such as the desire to have fewer children and to invest in their advancement. One estimate puts as many as 60 percent of Iranians in—or ready to enter—that group.

Signs of this emerging middle class and the capitalist surge it has been driving are found throughout the Middle

East, even in revolution-struck Cairo, war-weary Beirut, and sanctions-worn Tehran. While the overall picture in the Middle East looks grim, signs of promising economic activity in pockets across the region started to emerge in the past decade. That activity did not change the overall economic picture but produced a certain momentum and pointed to the possibility of change. Between 2002 and 2008, real GDP in the Middle East and North Africa grew by 3.7 percent, up from 3 percent in the previous decade.

Middle-class entrepreneurs represent the best hope for betterment of their countries—and the most potent weapon against extremism and for democracy. Until now the Arab world's tiny middle class has relied on state salaries and entitlements, with few ties to free markets. The growth of local entrepreneurship on the back of burgeoning capitalism—and integration with the world economy—could help change that.

These forces are already having an impact. The 2009 Iranian election controversy was a struggle by its rising middle class to protect its economic interests against President Mahmoud Ahmadinejad, who has sought to increase state domination of the economy. And as mentioned, the Arab Spring began as a push by the middle class for political change to match that group's cultural and economic aspirations. Just as Turkey relied on its middle class to transform itself into a successful Muslim democracy fully integrated into the global economy, so too can the Arab world grow with a newly created middle class combined with entrepreneurial zeal.

The promise of the new Arab middle class is compelling: by bringing stability to the Middle East it can boost the global economy too. The Middle East sits at the heart of a larger Muslim world also poised for change. As one and a half billion consumers move up the economic ladder, they will demand the material benefits of liberal capitalism. Some will seek distinctly Islamic goods: not just halal food and head scarves, but also Islamic banking services, education, entertainment, media, and consumer goods.

Boom in Islamic finance

Such consumer demand has already made waves in global markets, as illustrated by the boom in Islamic finance (financial services that abide by Islamic rules forbidding the collection and payment of interest). The growth of such services is integrating the Middle East more closely into the global economy. Although Islamic finance remains a niche market—the Islamic bond market, worth close to $100 billion, represents a mere 0.10 percent of the global bond market, and about 300 Islamic banks and investment firms in more than 75 countries oversee banking services in the hundreds of billions of dollars—some estimate the assets of this sector will grow to as much as $4 trillion by 2015.

Some members of this new middle class are the children of the old bureaucracy, but a far larger percentage come from the provinces and from lower social classes. These sons and daughters of the rural poor have made the jump to the middle class by embracing the regimen of modern economics. Many are devout, but their wealth and aspirations can put them squarely at odds with extremism. After all, with wealth can come conspicuous consumption, liberal social and political values, and a vested interest in engaging the world.

This does not mean there will be no middle-class Muslim terrorists. But much as in Latin America in the 1990s, terrorism will stop resonating with a truly integrated Muslim middle class. Those with a stake in commerce and trade will not subscribe to destructive ideas that endanger their future. The alienation and rage many Muslims now feel toward the West is a product of historical grievances but has been greatly aggravated by their isolation from the global economy. Were that to change, many Muslims would begin looking forward rather than backward. The rise of this "critical middle" is a trend every bit as powerful and important as extremism. And it holds the key to changing the hearts and minds of the Muslim world.

It is too soon to say whether businesspeople in Tunis or Cairo will lead a full-fledged revolution that anchors Arab politics in democracy—a historical transformation akin to the one spearheaded by Protestant burghers in Holland four centuries ago. But history does suggest that a robust embrace of capitalism by entrepreneurs is the way to truly modernize the Middle East.

Western interest

The world has a vested interest in the success of the Arab Spring. If the change does not put the Middle East on the path to prosperity and democracy, increased instability and extremism will wash onto Western shores.

Those who vanquish the Islamic extremism now on the rise across the Arab world will not be enlightened clerics or liberal reformers but entrepreneurs and business leaders. This has obvious implications for Western governments. Values gain currency when they serve the economic and social interests of the people, and when those who hold them gain power, those values shape states' behavior.

The triumph of democracy in Europe followed in the footsteps of capitalist development. Moderate capitalist values have not yet been fully embraced in the Middle East, not because of the fundamental nature of Islam, but because the commercial class leading the process is still too small. Helping that bourgeoisie to grow and dominate its societies is the best way to ensure that democratic values take root.

What can the United States and its allies do? The first solution is to step up trade with the region. The West has committed much in blood and treasure to protecting its interests in the greater Middle East, yet it does very little real business with the region (except with Turkey). Excluding oil and weapons sales, U.S. trade with the whole Arab world amounts to barely a fraction of its trade with Latin America, eastern Europe, or India. The United States now has free-trade deals with Jordan and Morocco, and Europe is considering an economic partnership with the Arab countries of the Mediterranean rim. These are positive steps, but there are still far too few Arab-made goods on Western shelves.

Western governments seem to understand the importance of entrepreneurship, commerce, and open markets to the future of the Arab world, but mechanisms to promote economic change are absent. Bureaucratic rules have prevented financial investments in small and medium-sized enterprises—American dollars have gone only to non-profit-generating ventures—and no concerted effort has pushed governments to embrace reform. Talk of economic change lags behind discussions of politics.

Small and medium-sized businesses remain the region's beacon of hope and the anchor of the international community's economic vision for the region, thanks in part to their

The promise of the new Arab middle class is compelling: by bringing stability to the Middle East it can boost the global economy too.

success over the past decade. But this vision is also based on the belief that there is still ample capital in the region—from local investors who are far more comfortable with political risk than Western investors—that could keep that dynamism alive. There is also hope that the new breed of leaders taking over will be business friendly. Egypt's President Mohamed Morsi fashioned himself "Egypt's Erdogan" (referring to the popular pro-business Turkish prime minister) during the country's recent presidential elections. And it is accepted wisdom that the Muslim Brotherhood's merchant base will encourage the party throughout the Arab world to favor business-led growth.

Stability and reform

There are things that small and medium-sized businesses can do to fulfill their promise—practices that worked in newly democratic countries in Asia and Latin America. But these are contingent on two fundamental factors: political stability and thoroughgoing economic reform.

It is difficult to envisage investors returning to Egypt until the country returns to the rule of law, street agitation ends, and government stability is palpable. But businesses also need assurance that labor strikes will end, that the government will impose and defend labor market rules, and that relations between the government and business will be stable and predictable.

Although there may be plenty of capital in the Arab world, it is less likely to go to businesses in countries where labor strikes disrupt operations, wage hikes cut into profits, and the continuous threat of instability clouds the prospects for business growth. Some political instability is to be expected after the monumental changes that have swept across the region. It will take time for the dust to settle and stability and rule of law return. But some of the political chaos is due to the miserable state of the economy.

Take Egypt. In the first year after President Hosni Mubarak stepped down, Egypt's economy contracted by 0.8 percent (on a calendar basis in 2011), with manufacturing falling by 5.3 percent. Unemployment rose to 12 percent (25 percent for young people). Private domestic investment fell by 10.5 percent, with foreign investment dropping off the table—from \$6.4 billion in 2010 to \$500 million in 2011. The plunge in domestic and foreign investment presented the government with a gaping hole of \$11 billion in its financing in the second half of 2011. International arrivals have decreased about 35 percent—a grave problem for a country whose tourism accounted for 11 percent of GDP. Not surprisingly, the government's budget shortfall ballooned, to \$11 billion (10 percent of GDP, the largest in the Arab world). Combined with capital flight, which continues unabated thanks to persistent political instability, foreign reserves fell sharply, from a high of \$43 billion to \$15 billion. Two out of every five Egyptians live on less than \$2 a day, so the human impact of such jolts has been profound.

No doubt, economic stabilization is needed to address this challenge. That was what Western powers promised at the 2011 meeting of the Group of Eight industrial countries (G8) at Deauville. But stabilization would provide only a short-run gain—not enough to reverse the trends that have dogged the region and precipitated the crisis of governance and economy in the first place.

Clear path ahead

Economic transformation and democratization need private sector growth and business dynamism. Small and medium-sized enterprises have to lead the way with enough growth to turn Arab countries into breakout emerging nations; only then will democracy stand a chance in the region. And that demands structural reforms.

Every recent case of successful democratization has gone hand in hand with economic restructuring. International financial institutions have joined hands with Western governments and private donors to pair thoroughgoing reform with the capital needed to fuel growth.

This partnership reached its apogee in the so-called Washington Consensus. The much-maligned strategy to foster growth and democracy did not always work—or work perfectly—but without it, most democratization efforts would have failed.

The Arab world needs a new Washington Consensus: a clear strategy for implementing reforms and providing needed funds to make them possible. That is the best way to create the right environment and sufficient capital for entrepreneurial growth. ■

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Defining Moment

Only by opening up will the Arab countries in transition achieve the broad-based growth their societies so desperately need

David Lipton is the IMF's First Deputy Managing Director.

THE Arab Awakening, which started with the self-immolation of a street vendor in a rural town in Tunisia in December 2010, continues to dominate events in the region. The following month, the call in Egypt for "bread, freedom, and social justice" echoed across much of the Arab world. The mandate for change is not just political—it extends deep into the economic sphere. People are calling for a say in how their countries are governed and for greater opportunities for human fulfillment.

Two years later, the future of the Middle East and North Africa is unclear. Policymakers face the immediate challenge of satisfying people's high expectations and carrying out tough reforms to bring public finances under control and bolster weakened financial systems. And progressing on economic reform is proving difficult in the face of political wrangling over constitutional and governance issues and a debate over the role of religion in public life.

Some are warning darkly that the revolution in the region is failing. Rather, I believe it could take any one of three paths. We could see

• a tendency toward economic chaos, if squabbling over political power prevents stabilization, let alone reform;

• stabilization achieved by a reassertion of vested business interests, which would offer a respite from eroding economic conditions but would condemn the region to a return to economic stagnation, or tepid growth at best; or

• emergence of a new economy, as newly mandated governments gradually end economic disruptions and undertake reforms to open the way to greater economic opportunity for their people.

Needless to say, the first two paths are undesirable, but the third will be hard to attain. The current state of the world economy is not making it easier to undertake substantial reform. A slowing global economy, ongoing uncertainties in Europe, higher food and fuel prices, and the conflict in Syria, with its deplorable loss of life, all risk undermining the fragile gains that have been made in the region these past two years.

For leaders trying to manage difficult political transitions, pursuing both stabilization and transformation is daunting. What are the prospects for success? And what, if anything, can the international community do to affect the outcome?

Region in transition

The Middle East and North Africa is a diverse region, encompassing 20 countries with a population of more than 400 million people and $3 trillion in GDP—about 6 percent of the global population and 4 percent of global GDP. Country circumstances vary widely. Some countries in the region possess vast oil and gas reserves, while others must import both energy and food. The most telling economic statistic about the region, however, is that non-oil exports of the region, the whole region, are $365 billion, about the same as the exports of Belgium, a country of 11, not 400, million people. This region suffers from a lack of integration into the world economy.

Long before people took to the streets, the Arab countries in transition—Egypt, Jordan, Libya, Morocco, Tunisia, and Yemen—faced the challenge of employing rapidly growing, young populations. Despite several rounds of reforms, their economies were unable to generate enough jobs. There were three related problems.

First, there was a lack of openness and access to key export markets. Second, in some countries, energy and other subsidies were repeatedly increased to placate restive populations, which left budgets overstretched without room to invest in education, health care, and infrastructure. And third, where meaningful structural reforms were attempted, there was a widely held perception that the control over investments in new sectors remained in the hands of a select elite.

The result was a lack of economic vitality and high and rising unemployment, especially among well-educated young people.

To achieve broad-based and sustainable growth, the countries of the Middle East must move away from state-dominated to private investment and from protected industries to export-led growth. In short, the private sector must become the main source of growth.

Key areas of reform

To achieve this goal, I see four main areas where reforms are needed.

1. Stronger emphasis on trade: The overarching strategy to deliver growth on a scale and timetable that would create enough jobs and prosperity for the rapidly growing populations in these countries is economic integration. More trade integration would not only create growth and jobs, it would provide discipline and incentives to help get the reform strategy right. A country that opens up to international competition will inevitably find a greater logic in the other reforms listed below because they will help it compete.

2. Improving the business environment and facilitating access to finance: Complex regulations hold back job creation and growth in the region. Take Egypt, where no less than 36,000 regulations currently affect the private sector. And Egypt is by no means the only country afflicted by burdensome legislation. Indeed, many new political parties are grounded in support from people running small businesses who see improvement of the business climate as a key priority. Another major constraint on economic growth in the Arab countries in transition is companies' lack of access to finance. Now, private credit mainly benefits large established companies, and only 10 percent of firms use banks to finance investment. This is the lowest share of bank financing in the world.

3. Enhancing the labor market and improving education: Youth unemployment ranges from 18 to 30 percent in Egypt, Jordan, Morocco, and Tunisia. In Egypt, 650,000 people enter the labor force each year. Women face particular problems in finding jobs—only about a quarter of the female population in Egypt, Jordan, Morocco, and Libya is employed. The public sector dominates the job market, and labor laws are rigid. Governments should reduce disincentives to hiring, while still protecting workers. The labor force is also inadequately educated and lacks technical skills in engineering and science. The education system must shift its focus from training young people for entry into the civil service to preparing them to work in the private sector.

4. Replacing untargeted subsidies with a modern social safety net: Price subsidies in the Middle East and North Africa cost around $210 billion in 2011, more than 7 percent of regional GDP. Besides being very costly, such subsidies do a bad job of supporting the poor. Safety nets targeting people who really need them are more efficient and effective. To build public support, reforms must be clearly explained, with credible commitments that subsidy savings will be spent on investment and that vulnerable people will be protected.

Role of the international community

When one considers the potential costs of the two undesirable paths I described earlier, and the benefits for the region as well as the global economy of the third path, it is clear that the international community should provide adequate financing, trade access, and policy advice to support positive change.

At the IMF, we are trying to rise to the challenge. Throughout this difficult period, we have been advising countries on how to maintain economic stability by managing the shocks they have experienced, how to ensure that vulnerable households are protected during the transition, and how to lay the basis for job-creating growth.

More trade integration would not only create growth and jobs, it would provide discipline and incentives to help get the reform strategy right.

Our involvement has shifted from mainly providing advice to helping with financing. In the past year alone, we have provided $8½ billion in loans to Jordan, Morocco, and Yemen. A support package with the government of Egypt has also been mapped out, and we hope to help Yemen with a follow-up arrangement to supplement the emergency assistance we provided last year. We also stand ready to provide financial assistance for Tunisia. In Libya, which needs capacity building, not financing, we have stepped up our support to help the country rebuild its institutions and economy after the end of the conflict in 2011.

While the IMF can help countries stabilize and reform their economies, the task is so great that the entire international community must do more.

The Deauville Partnership, launched by the Group of Eight (G8) in 2011, has provided a useful coordinating framework but cannot by itself deliver on all that is needed. It will be critical for the international community, including the G8 countries, regional partners such as the Gulf Cooperation Council countries, and international and regional financial institutions, to provide adequate financing and capacity building. The European Union and the United States must grant better trade access for products and services from the region. The invaluable expertise of the European Bank for Reconstruction and Development and other financial institutions can increase the pace of investment in the private sector—as happened in eastern and central Europe.

Each country in the Middle East and North Africa must carve out its own path for change. The process must be truly participatory. Broad buy-in will be essential, and reform plans, no matter how technically sound, cannot be imposed from above.

Failure to agree on a compelling, shared vision is not an option. The risk of returning to the old status quo is all too real. But the reward of meaningful reform can be substantial. If the Arab countries in transition achieve growth that is 2 percentage points higher than projected, they could cut unemployment in half over a five-year period. That would be a major achievement. ■

Trade, Growth, and Jobs

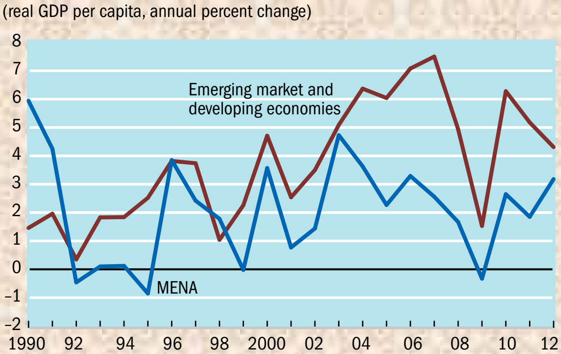
Closer trade integration would reward countries in the Middle East with increased growth and jobs

COUNTRIES in the Middle East and North Africa (MENA) have lagged behind emerging market and developing economies in both economic growth and trade over the past two decades, and trade has not been the significant engine of growth in these countries that it has been in others. Not surprisingly, lackluster economic growth in the MENA region has restrained employment growth, which has not kept pace with a rapidly expanding workforce.

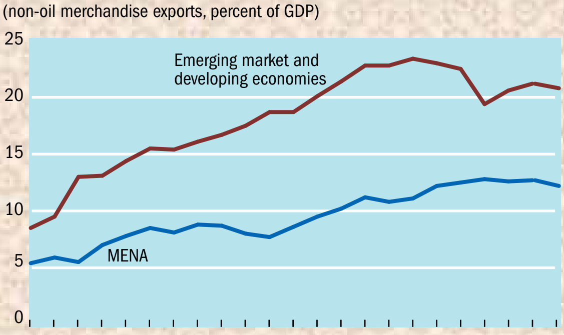
Worker collects barley in Algiers, Algeria.

GDP per capita and exports in the MENA region are significantly lower than the average for emerging market and developing economies.

(real GDP per capita, annual percent change)



(non-oil merchandise exports, percent of GDP)



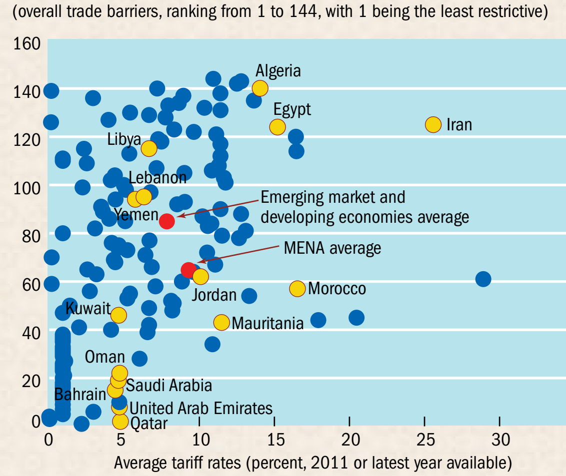
Source: IMF, World Economic Outlook database.

Market access

Trade restrictiveness is one important problem holding back the region. It remains high despite significant tariff reforms. Most MENA oil importers have streamlined and lowered tariffs over the past two decades, often via trade agreements with the European Union and the United States. But oil importers' tariffs—averaging about 10 percent in 2011—remain high.

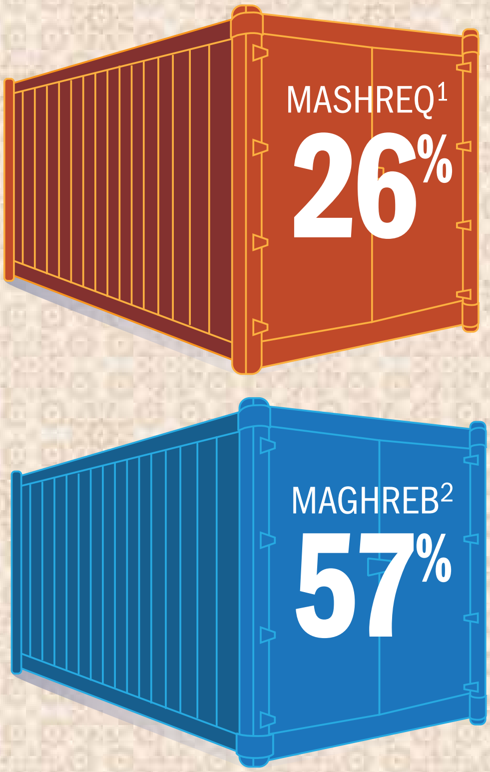
MENA countries have considerable trade restrictions among the 139 countries surveyed.

(overall trade barriers, ranking from 1 to 144, with 1 being the least restrictive)



Source: World Economic Forum, *The Global Competitiveness Report*, 2012–2013.

Europe is a key export destination for the MENA region.
(exports to the European Union, percent of total exports, 2011)



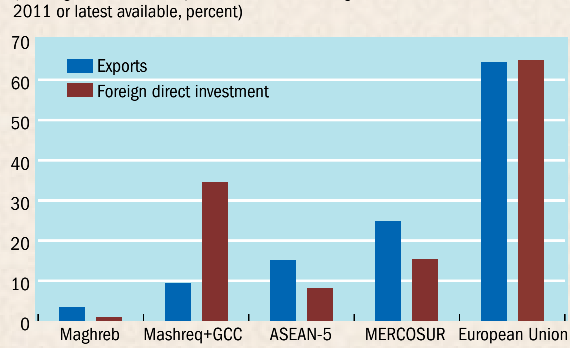
Source: IMF, Direction of Trade Statistics database.
[1]Egypt, Jordan, Lebanon, and Syria.
[2]Algeria, Libya, Mauritania, Morocco, and Tunisia.

Operations at Khalifa Bin Salman Port in Hidd, Bahrain.

Regional integration

Trade, particularly in the North African countries, remains oriented mainly toward Europe, and the region has thus benefited relatively little from the high growth of many emerging markets. Deeper trade integration with international markets could give the MENA region a substantial economic boost. Empirical evidence suggests that increasing the region's openness to equal that of emerging Asia could raise annual per capita GDP growth by almost a full percentage point. MENA oil importers also trade little with their immediate neighbors. Given their close proximity (distance is one of the most important determinants of trade), these countries could be exporting about 50 percent more than they currently are.

Trade within the MENA regional groups remains very low.
(intraregional share of exports and stock of foreign direct investment, 2011 or latest available, percent)



Sources: ASEAN; EUROSTAT; IsDB; UNCTAD; Arab Investment and Export Credit Guarantee Corporation; and national sources.
Note: Maghreb = Algeria, Libya, Mauritania, Morocco, and Tunisia; Mashreq + GCC = Egypt, Jordan, Lebanon, Syria, Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates; MERCOSUR = Argentina, Brazil, Paraguay, and Uruguay; and ASEAN-5 = Indonesia, Malaysia, Philippines, Thailand, and Vietnam.

Prepared by Amine Mati of the IMF's Middle East and Central Asia Department. Text and charts are based on the Regional Economic Outlook: Middle East and Central Asia *(various issues).*

On the Rise

Thomas Helbling

High prices and new technology have triggered a sudden surge in oil and gas production in the United States that could shake up global energy markets

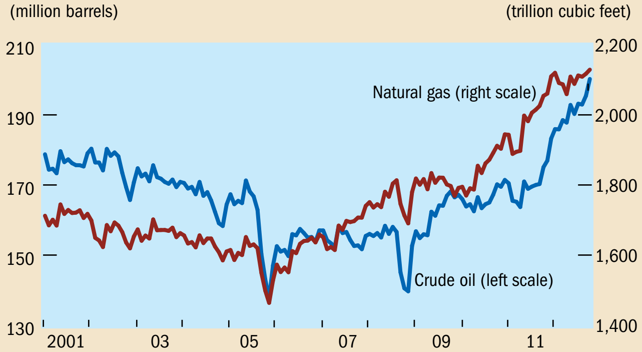
A STRONG rebound in gas and then oil production in the United States over the past few years has taken markets and policymakers by surprise (see Chart 1). As a result, natural gas prices in the United States are at a 20-year low after adjusting for inflation, while light sweet crude oil from the landlocked production areas in the U.S. Midwest is selling at an unusually large discount from international benchmark prices.

The surge in production is largely the result of the new ability of producers to extract oil and gas from unconventional geological formations—so-called shale rock and tight rock or sand formations. The revolution in production occurred first in natural gas and more recently in oil.

Chart 1

Big bounce

Natural gas, then oil, production has risen sharply in the United States over the past few years.



Source: U.S. Energy Information Administration.
Note: Three-month moving average.

It is already widely accepted that the availability of shale gas resources has fundamentally changed the outlook for natural gas as a source of energy. Prospects for unconventional shale and tight oil production are more uncertain though. Could its development foreshadow a long-term decline in oil prices, as happened during the mid- to late 1970s after the 1973 Middle East war triggered a surge in oil production? Conversely, are there risks that the revolution will not last? Moreover, how will it alter the macroeconomic effects of sharp changes in oil prices (so-called oil shocks) on the U.S. and other economies?

Triggered by high prices

The sudden takeoff in the production of oil and gas from unconventional sources in recent years is another case in which high prices and new technologies combined to turn a previously uneconomical resource into an economically viable one. The jump in oil prices in late 1973, for example, made the development of new oil resources in the Arctic (Alaska) and the North Sea economical and eventually contributed to declines in oil prices that persisted well into the 1980s. More generally, the development of new sources of supply is a normal response to a commodity price boom and has historically been one of the forces behind price declines after a boom. The technology and geology behind the revolution in the United States are the same for both fuels (see box).

The future of the unconventional revolution depends heavily on two issues: how much additional oil and gas will be economically extractable and the long-run effect on prices and markets. Whatever happens, the ride could be bumpy in the short run, as markets try to adjust.

Gauging supply potential

Production of crude oil from unconventional sources increased about fivefold in the United States between 2008 and 2012, reaching close to 1 million barrels a day by the end of 2012. On average, shale oil—or light tight oil as it is often called—was about 16 percent of total U.S. production in 2012 and accounted for almost three-fourths of the 1.3 million barrel rise in overall daily oil production in the United States over this period.

So far, much of the increase in oil production has reflected field development in the Bakken Shale, which spans the western states of North Dakota and Montana—although in 2012, production in the Eagle Ford Shale in the state of Texas also started expanding rapidly. Eagle Ford area production is expected to continue to expand, and new field development and extraction should start in other known shale rock formations. Expanding development to other formations is necessary if production is to increase further.

At this point, the ultimate oil extraction potential from shale rock and tight sand formations in the United States is uncertain. In a study commissioned by the U.S. Energy Information Administration (EIA), the total amount of technically recoverable but not yet developed shale and tight sand oil resources in the United States was estimated at 24 billion barrels, less than one year of annual global oil consumption in 2012 (U.S. EIA, 2011). But those estimates are based on 2009 data and such prognostications typically change over time. On the one hand, ultimate recovery usually is a fraction of what is technically recoverable because not all extraction is profitable—if the new supply is big enough to outstrip demand, prices could fall, further reducing the incentive to produce. On the other hand, estimates of the recoverable resources from a newly developed oil formation have often increased over time, as greater knowledge and experience permit better estimates of recovery. More recent estimates say that the amount of technically recoverable unconventional shale and tight oil resources is 33 billion barrels (U.S. EIA, 2012). Moreover, not only is the quality of the estimates a factor, so is the technology, which generally improves over time with the result that the ultimate recovery could be higher than initial estimates.

Recent medium- and long-term scenarios for U.S. oil production generally forecast that production from these new sources will increase by another 1½ to 2½ million barrels a day over the next two to three years before stabilizing at 2½ to 3½ million barrels a day. All else equal, this level of production from unconventional sources suggests that total U.S. crude oil production could reach some 8 million barrels a day—and some estimates are even more optimistic.

The unconventional oil and gas revolution

Oil and gas have long been produced from what are now called "conventional sources": wells are drilled into the earth's surface, and pressure that is naturally present in the field—possibly with help from pumps—is used to bring the fuel to the surface.

Other geological structures in the United States—shale rock and tight sand formations—have long been known to contain oil and gas. But the fuels are trapped in these formations and cannot be extracted in the same way as from conventional sources. Instead, producers use a combination of horizontal drilling and hydraulic fracturing, or "fracking," during which fluids are injected under high pressure to break up the formations and release trapped fossil fuels. Both technologies have been around for more than a half century, but until recently, using them cost more than the price of crude oil and natural gas.

This changed when prices began to rise sharply in recent years. Producers were able to profitably extract oil and gas from these formations. At the same time, improvements in horizontal drilling and fracking technologies reduced the cost of using them.

This shale revolution has been helped by factors specific to the United States. First, the rights to below-ground minerals are private and landowners can lease these rights, which made it easier for small, independent oil and gas companies willing to take the risk—and to push for improvements in the technologies. Second, a competitive natural gas market with access to distribution networks by all producers allowed shale gas producers to market their product. Larger oil and gas companies have long been more skeptical of the new resources and only recently began to invest in the technology.

How much the new sources of oil will affect prices depends on the shift in the global supply. Oil markets are sufficiently integrated that prices adjust based on global demand and supply. Over the past five years, the increase in U.S. crude oil production has been the most important source of new production outside the 12 members of the Organization of the Petroleum Exporting Countries (OPEC—see Chart 2). But the increase is still small. In terms of current production, oil extracted from unconventional sources in the United States on average amounted to slightly more than 1 percent of the global total of about 90 million barrels a day in 2012. Had there been no change in oil demand, prices would likely have declined by more. But in the end the increased U.S. oil output roughly matched the global growth in oil consumption. Because there was little production growth elsewhere, increased U.S. oil production in the end contributed to the relative stability of oil prices in 2012.

If recent scenarios of further global production growth are accurate, the new sources on their own are unlikely to change the global oil supply picture as fundamentally as supply developments in countries outside OPEC did in the 1970s. Indeed, many non-OPEC producing countries recorded strong cumulative production growth at the time (see Chart 3). That said, unconventional oil production in the United States should facilitate the expansion of the global oil supply in the near term. If the potential for rapid supply expansion elsewhere is also realized, notably in Iraq, oil market conditions could ease over the next few years. In the longer term, shale and tight oil could also be produced elsewhere because there are similar geological formations in other countries (British Petroleum, 2013), but significant exploration and development have not yet started.

Regardless of their impact on global supply and prices, the new resources are significant for the United States as an oil producer. The estimated technically recoverable resources are about 10 times current annual U.S. oil production. Even allowing for lower ultimate recovery, U.S. oil production is set to increase considerably. This is a fundamental change from the outlook not long ago, when U.S. oil production was projected to continue to decline.

More than crude oil

The global oil market implications of the unconventional oil and gas revolution in the United States go beyond the increases in crude oil production. As a result of unconventional oil and gas production, production of natural gas liquids (NGL) such as propane and butane increased about 30 percent during 2008–12. These by-products of natural gas are important, because what matters to end users is not crude oil, but usable petroleum liquids. The combined rise in crude oil and NGL production resulted in an increase in total liquids production from about 6.9 to 8.7 million barrels a day during 2008–12, a 26 percent increase.

Moreover, NGL production is likely to increase further. Current estimates suggest that the shale gas resource basis in the United States is sizable. The EIA-commissioned study also concluded that the technically recoverable amount of undeveloped shale gas resources is 750 trillion cubic feet, about 31 times total U.S. annual gas production. The ultimate recovery surely will be smaller, but largely thanks to shale gas, the estimated proved reserves of natural gas in the United States have risen rapidly in recent years, after declining in the 1970s and 1980s and stagnating in the 1990s.

U.S. natural gas markets are still adjusting to the surprise increase in shale gas production. Over the past few years, prices have fallen to levels not seen in decades, both in dollar terms and relative to other energy sources—mainly coal and crude oil.

So far, oil markets have been unaffected by the new abundance of natural gas in the United States. The main increased usage of gas has occurred in the U.S. power sector, where the share of electricity produced with natural gas has started to rise because many power plants can switch between gas and the now relatively more expensive (and dirtier) coal. But in the longer term, there is potential for other industries to switch to natural gas—even transportation, because natural gas can be used in internal combustion engines, which now rely mainly on refined petroleum products such as gasoline or diesel fuel.

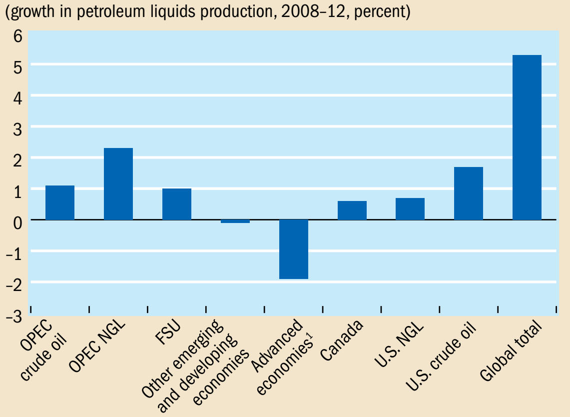
If there is widespread substitution of natural gas for petroleum products, global oil markets would be affected. The price incentives are there. On an energy-equivalent basis, natural gas prices are a fraction of gasoline or diesel prices in the United States. The price incentives are reinforced by the prospective abundance of natural gas. A switch to greater use of natural gas typically involves investment, which is attractive only if natural gas prices remain relatively lower over the life of a project. Natural gas abundance potentially extends even beyond the United States. A recent study by the U.S. Geological Survey concluded that significant shale gas resources might also be available in other countries, including China and Argentina. But as with unconventional oil production in other countries, it is too

Chart 2

Standout United States

Over the past five years, the increase in U.S. crude oil production has been the most important source of new production outside the members of the Organization of the Petroleum Exporting Countries (OPEC).

(growth in petroleum liquids production, 2008–12, percent)



Source: Author's calculations based on data from the International Energy Agency and the U.S. Energy Information Administration.

Note: NGL = natural gas liquids, such as propane, which are by-products of natural gas production; FSU = former Soviet Union.

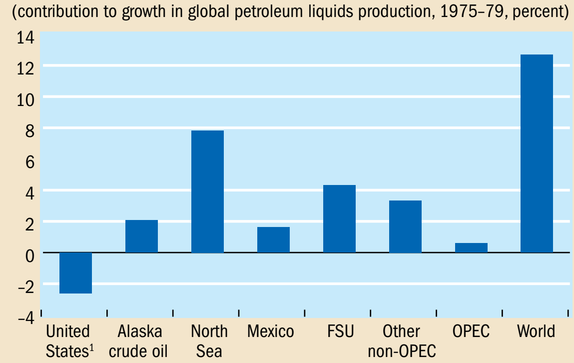
[1]Except United States and Canada.

Chart 3

Muscling up

In the 1970s, many countries outside the Organization of the Petroleum Exporting Countries (OPEC) sharply boosted oil production.

(contribution to growth in global petroleum liquids production, 1975–79, percent)



Source: Author's calculations based on data from British Petroleum and the U.S. Energy Information Administration.

Note: NGL = natural gas liquids, such as propane, which are by-products of natural gas production. United States includes the lower 48 states but not Alaska. FSU = former Soviet Union.

[1]Includes NGL.

early to assess whether the successes in U.S. shale gas production can be replicated elsewhere.

Could short-term market instability derail the unconventional oil revolution? In U.S. natural gas markets, recent price declines have raised the possibility that the shale gas revolution could be self-defeating if prices sink below levels needed to sustain its production. The situation likely is different in U.S. oil markets, which are part of what is in effect a global oil market. That said, integration has so far been hampered by temporary bottlenecks in the internal distribution infrastructure, which has not expanded enough to accommodate the sudden extraction of oil from the new sources. The inability to get their oil to the global market has forced producers of shale and tight oil to sell their product at prices above cost, but at steep discounts from international price benchmarks for similar grades of oil. The distribution infrastructure, however, is starting to be upgraded. Assuming that producers can overcome coordination problems and that regulatory barriers will adjust, an improved infrastructure will provide access to the seaborne international oil trade and eventually bring local prices closer to international prices. Another concern is potential environmental damage, which could hold back the expansion. So far, however, there is no conclusive evidence that the new technology leads to groundwater contamination, the main fear about the process.

Unconventional oil and the U.S. economy

The oil and gas sector will remain a significant source of investment and employment in the United States should production expand as expected. Employment in oil and gas extraction and in mining support activities almost doubled over the past decade after declining during the two previous decades. In 2012, some 570,000 employees worked in these two sectors, up from about 300,000 in early 2004. The resurgence in oil and gas will also stimulate the creation of jobs in other sectors.

Because of increased domestic production, net imports of natural gas, crude oil, and petroleum products have declined markedly from a peak of about 12.5 million barrels a day in 2005 to roughly 7.7 million in 2012. Besides higher domestic production, the decline in net imports reflects the impact of high oil prices on consumption. For natural gas, the decline in imports was relatively larger, from a peak of about 3.6 trillion cubic feet to about 1.6 trillion in 2012. In value terms, the decline in the petroleum trade deficit (which includes crude oil and petroleum products) was smaller because of the rise in world oil prices. The deficit peaked at about 2.7 percent of GDP in 2008 and is now below 2 percent. A smaller oil trade deficit should result in a lasting improvement in the overall trade and current account balances if, as expected, oil and gas production remain higher. The higher level of U.S. oil wealth could generate some pressure for an appreciation in the dollar.

The new resource base could also change the effects of oil price shocks on the U.S. economy, although how is still uncertain. It seems clear that the transfer effects of oil shocks will change. If oil prices spike, the wealth transfer from the United States to its foreign suppliers will be smaller than before because a larger share of the wealth from higher prices will accrue to domestic oil producers and U.S. residents. Conversely, though, the United States would benefit less from a price decline because domestic oil producers would take a bigger share of losses from the lower prices. The unconventional oil revolution could affect two other key factors that determine the impact of oil price shocks on economic growth and inflation—household and industrial use (Blanchard and Galí, 2009). Although households are unlikely to reduce oil consumption in the short

It is too early to assess whether the successes in U.S. shale gas production can be replicated elsewhere.

term, in the longer term, they might substitute gas for oil—which, all else equal, would lessen the effects of oil shocks. In contrast, the share of oil as an intermediate input in production could increase if oil- and gas-intensive industries, such as petrochemical producers, relocated to the United States.

In sum, the unexpected emergence of economically viable unconventional oil and gas resources in the United States and, potentially, elsewhere could have far-reaching effects on global energy markets. Natural gas in particular is likely to become a more important source of primary energy, and its share in total consumption will likely increase substantially. Moreover, the United States is unlikely to become the large net gas importer predicted a few years ago.

The impact of shale or tight oil seems unlikely to be as far reaching. On its own, given continued growth in oil consumption, this new source will ease but not remove the oil supply constraints that have emerged since the mid-2000s, and it is unlikely to exert strong downward pressure on prices. But the shale revolution highlights the reality that price incentives and technological change can trigger important supply responses in the oil and gas sector and that supply constraints can change over time. The full potential of the new resources at the global level is still unknown. Exploration and development outside the United States are only beginning. ■

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Held Back by Uncertainty

Nicholas Bloom, M. Ayhan Kose, and Marco E. Terrones

Recoveries are slowed when businesses and consumers are unsure of the future

SOME economists and politicians argue that the two years of harsh times visited on the United States and euro area during the Great Recession of 2008–09 should have been followed by rapid recoveries. Milton Friedman—the late Nobel Prize–winning economist—called this the "guitar string" theory of recessions. When you pull a guitar string down, then release it, the string bounces right back. And the farther you pull it down, the faster it returns.

However, the economic performance in many advanced economies since the Great Recession has not followed that script. Instead, the deep recessions in those economies were followed by recoveries that have been disappointingly weak and slow. It is as if the guitar string was pulled down so hard that it snapped.

These developments are something of a mystery: Why has the current recovery been so slow? Some argue that recoveries following financial crises tend to be slow because the legacy of the crisis—balance sheet repair, weak credit expansion, and lingering problems in housing markets—weighs on activity (for example, Claessens, Kose, and Terrones, 2012). This argument certainly has its merits, considering the historical record.

However, the ongoing recovery has been different at least in one important dimension from the earlier ones—whether associated with financial crises or not. It has experienced bouts of elevated uncertainty. This suggests a complementary explanation for the anemic recovery, one that emphasizes the roles played by macroeconomic and policy uncertainty in curtailing economic activity. Businesses have been uncertain about the fiscal and regulatory environment in the United States and Europe, and this fear of an unknowable future has probably been one of the factors leading them to postpone investment and hiring. This is clearly illustrated in a recent survey in the United States by the National Association for Business Economics

Measuring uncertainty

It is a challenge to quantify uncertainty because it is not an observable variable but rather one that is deduced from others. In the language of statistics, uncertainty is a latent variable.

But it is possible to gauge it indirectly in a number of ways, using measures that emphasize distinct aspects of uncertainty that an economy faces over time. Some of the measures focus on macroeconomic uncertainty—including the volatility of stock returns, dispersion in unemployment forecasts, and the prevalence of terms such as "economic uncertainty" in the media. Others consider uncertainty at the microeconomic level, which is often measured by various indicators that capture variation across sectoral output, firm sales, and stock returns and dispersion among forecasts by managers in manufacturing firms (Bloom, 2009; Baker, Bloom, and Davis, 2012).

Because we are concerned primarily with macroeconomic uncertainty, we concentrate on four measures based on the volatility of stock returns and economic policy. The first is the monthly standard deviation of daily stock returns in each advanced economy in our sample of 21 countries, which captures uncertainty associated with firm profits and is also shown to be a good proxy for aggregate uncertainty (see Chart 1). The second is the Chicago Board Options Exchange Volatility Index (VXO), which is an indicator of the implied volatility of equity prices calculated from S&P 100 options. The third refers to uncertainty surrounding economic policies in the United States and euro area and is a weighted average of three indicators: the frequency with which terms like "economic policy" and "uncertainty" appear together in the media; the number of tax provisions that will expire in coming years; and the dispersion of forecasts of future government outlays and inflation (see Chart 2). The fourth, which represents uncertainty at the global level, captures the common movement in the first measure using data for the six major advanced economies with the longest available series (Chart 1).

(*Economic Policy Survey*, 2012), which reported that the "vast majority" of a panel of 236 business economists "feels that uncertainty about fiscal policy is holding back the pace of economic recovery."

How important is uncertainty in driving economic activity? This article addresses that question by analyzing the main features of uncertainty and its impact on growth.

Here, there, and everywhere

Economic uncertainty refers to an environment in which little or nothing is known about the future state of the economy. There are many sources of economic uncertainty, including changes in economic and financial policies, different views about growth prospects, productivity movements, wars, acts of terrorism, and natural disasters. Although uncertainty is difficult to quantify, recent research has been able to develop a number of measures using a wide range of approaches (see box).

It does not matter which measure is used: it is clear that uncertainty has increased in recent times (see Chart 1). Uncertainty about economic policies in the United States and the euro area has surged since the 2008 recession, and remained stubbornly high ever since (see Chart 2). In the United States, uncertainty has recently been driven primarily by wrangling over fiscal policy, including taxes and government spending, and long-term structural issues, such as health care and regulatory policies and entitlement programs—such as the government-sponsored retirement plan Social Security and old-age health plan Medicare. Interestingly, monetary policy uncertainty does not appear to be one of the major factors behind the recent rise in policy uncertainty, possibly because of low and stable inflation and interest rates.

At the national level, uncertainty about the economy runs contrary to the business cycle. During expansions, macroeconomic uncertainty is, on average, much lower than during recessions, regardless of the measure we use (see Chart 3). Likewise, microeconomic uncertainty about specific industries or companies, measured by the volatility of movements in plant-level productivity in the United States, also behaves countercyclically and reached a post-1970 high during the Great Recession (Bloom and others, 2012).

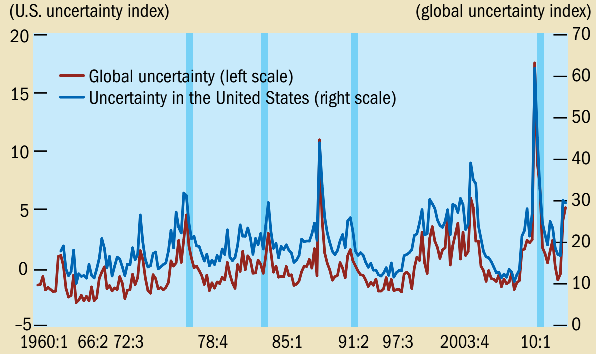
Uncertainty and economic activity

However, it is difficult to establish causality between uncertainty and the business cycle. Does uncertainty drive recessions or do recessions lead to uncertainty? Although it is hard to provide a conclusive answer to this question, economic theory does point to clear channels through which uncertainty can have a negative impact on economic activity.

Chart 1

Uncertainty rising

Uncertainty rises during recessions and did so dramatically during the Great Recession.



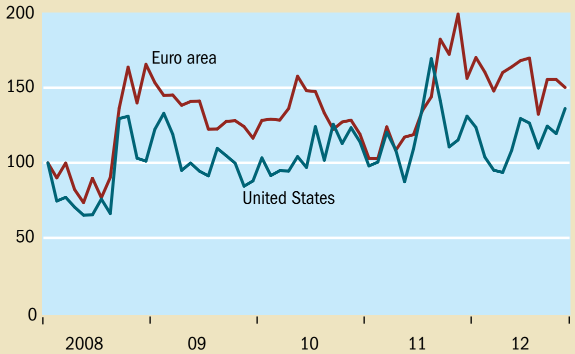
Sources: Kose, Loungani, and Terrones (2012); and authors' calculations.
Note: Shaded areas denote periods of global recession (1975, 1982, 1991, 2009). The U.S. index gauges macroeconomic uncertainty and measures stock market volatility. The global index focuses on common movements in stock market volatility for six major advanced economies—France, Germany, Italy, Japan, the United Kingdom, and the United States.

Chart 2

Stubbornly high

Policy uncertainty in the United States and the euro area has remained high since 2008.

(policy uncertainty index, January 2008 = 100)



Sources: Baker, Bloom, and Davis (2012); and www.policyuncertainty.com.

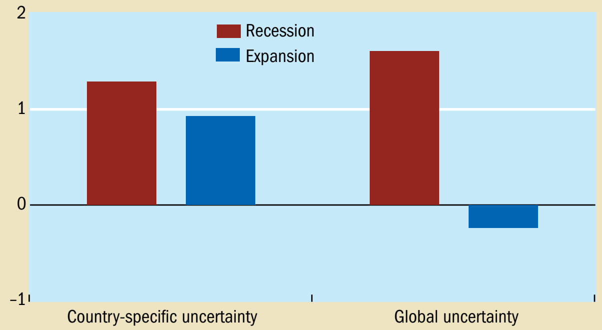
Note: Index gauges macroeconomic uncertainty and measures stock market volatility; media mentions of "economic policy" and "uncertainty"; the number of tax provisions expiring in coming years; and the dispersion of forecasts of future government outlays and inflation.

Chart 3

Cyclical variation

During recessions uncertainty is much higher than during expansions—whether about the prospects for a specific country or the global economy.

(uncertainty index)



Source: Kose and Terrones (2012).

Note: Country-specific uncertainty is the monthly deviation of daily stock returns in each of the advanced economies. Global uncertainty is the common factor of the country-specific uncertainty for six economies (France, Germany, Italy Japan, United Kingdom, United States). The data cover the period 1960–2011.

On the demand side, for example, when faced with high uncertainty, firms reduce investment demand and delay projects as they gather new information, because investment is often costly to reverse (Bernanke, 1983; Dixit and Pindyck, 1994). The response of households to high uncertainty is similar to that of firms: they reduce their consumption of durable goods as they wait for less uncertain times. On the supply side, firms' hiring plans are also negatively affected by higher uncertainty, reflecting costly adjustment of personnel.

It does not matter which measure is used: it is clear that uncertainty has increased in recent times.

Financial market problems, such as those we have witnessed since 2007, can amplify the negative impact of uncertainty on growth. For example, uncertainty leads to a decline in expected returns on projects financed with debt and makes it harder to assess the value of collateral. As a result, creditors charge higher interest rates and limit lending during uncertain times, which reduces firms' ability to borrow. The decline in borrowing causes investment to contract, especially for credit-constrained firms, and results in slower productivity growth because of reduced spending on research and development. These factors together can translate into a significant reduction in output growth.

Empirical evidence suggests that uncertainty tends to be detrimental to economic growth. The growth rate of output is negatively correlated with macroeconomic uncertainty. Moreover, a relatively small, 1 standard deviation, increase in uncertainty is associated with a decline in output growth of between 0.4 and 1.25 percentage points, depending on the measure of macroeconomic uncertainty (Kose and Terrones, 2012).

Policy-induced uncertainty is also negatively associated with growth, with policy uncertainty increasing to record levels since the Great Recession. Specifically, the sharp increase in policy uncertainty between 2006 and 2011 may have stymied growth in advanced economies (Bloom, 2009; Baker and Bloom, 2011; Bloom and others, 2012; Hirata and others, forthcoming). Empirical evidence indicates that such a large increase in policy uncertainty is associated with a highly persistent and significant decline in output (see Chart 4).

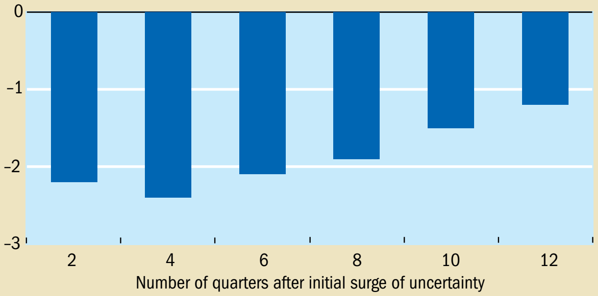
The degree of economic uncertainty also appears to be related to the depth of recessions and strength of recoveries. In particular, recessions accompanied by high uncertainty are often deeper than other recessions (see Chart 5). Similarly, recoveries coinciding with periods of elevated uncertainty are weaker than other recoveries. The unusually high levels of uncertainty the global economy experienced since the latest financial crisis and the associated episodes of deep recessions and weak recoveries play an important role in explaining these findings. Moreover,

Chart 4

Depressing effect

A large increase in policy uncertainty is associated with a highly persistent and significant decline in output.

(decline in GDP, percent)



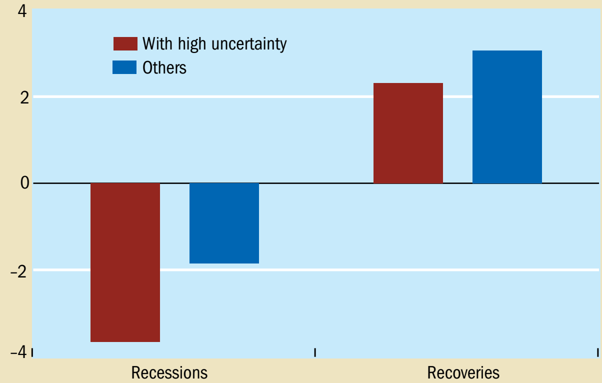
Sources: Baker, Bloom and Davis (2012); and www.policyuncertainty.com.
Note: This chart shows that GDP declines 2.2 percent in the second quarter in response to an increase in uncertainty in the first quarter, 2.4 percent in the fourth quarter, and so on. The increase in uncertainty is assumed to be equal to the change from 2006 (the year before the global financial crisis) until 2011. These results are based on an econometric model called vector autoregression (VAR). The VAR model is estimated using quarterly data from 1985 to 2011 and includes the following variables: the uncertainty index, GDP, the S&P 500 index, the federal funds rate, employment, investment, and consumption.

Chart 5

Uncertainty matters

Recessions accompanied by high uncertainty are often deeper than other recessions, and recovery is slower.

(amplitude of recessions and recoveries, percent)



Source: Kose and Terrones (2012).
Note: The amplitude of a recession is the percent decline in output from peak to trough. The amplitude of a recovery is the one-year change in output from the trough of the recession.

the ongoing recovery in advanced economies has coincided with lower cumulative growth in consumption and investment along with a sharp and sustained contraction in investment in structures as uncertainty has stayed elevated (Kose, Loungani, and Terrones, 2012).

Policymakers can help

High uncertainty historically coincides with periods of lower growth. The recent pickup in uncertainty increases the likelihood of another global recession. It is difficult for policymakers to overcome the intrinsic uncertainty economies typically face over the business cycle. However, uncertainty about economic policy is unusually high, and it appears to contribute significantly to macroeconomic uncertainty. By implementing bold and timely measures, policymakers on both sides of the Atlantic can reduce policy-induced uncertainty. This can in turn help kick-start economic growth in the euro area and strengthen the recovery in the United States. ■

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Degrees of DEVELOPMENT

New data suggest that the higher the educational attainment of civil servants the better a country's economic outcomes

Rabah Arezki and Marc Quintyn

EDUCATION of the population is generally viewed as a key ingredient for economic growth. Economists have emphasized three main channels through which education theoretically induces economic growth. Education increases labor force productivity, which raises the level of output. It enables technological innovation, which promotes economic growth through improved inputs, enhanced processes, and better products. And it facilitates the transmission of knowledge and the adoption of new technologies, which also enhance economic growth.

While that may seem to be a self-evident proposition, empirical research on the relationship between education and development is far from conclusive. That may be because education is not being measured properly. Research into the empirical relationship between education and economic outcomes has traditionally used measures based on the average number of years of schooling of the general population (see Box 1). But such measures have been criticized because they capture only the number of years of schooling without considering the quality of that education. When learning (as measured by cognitive skills) is examined, there is a much stronger association between education and economic growth (Hanushek and Woessmann, 2008).

In nearly all countries, the state plays a major role in decisions that affect economic growth. A state's ability to govern intelligently and honestly—its capacity, as economists say—is crucial to development. But analysis of the educational attainment of the general population—whether quantitative or qualitative—may not be useful in assessing education as a factor in the role of the state in economic develop-

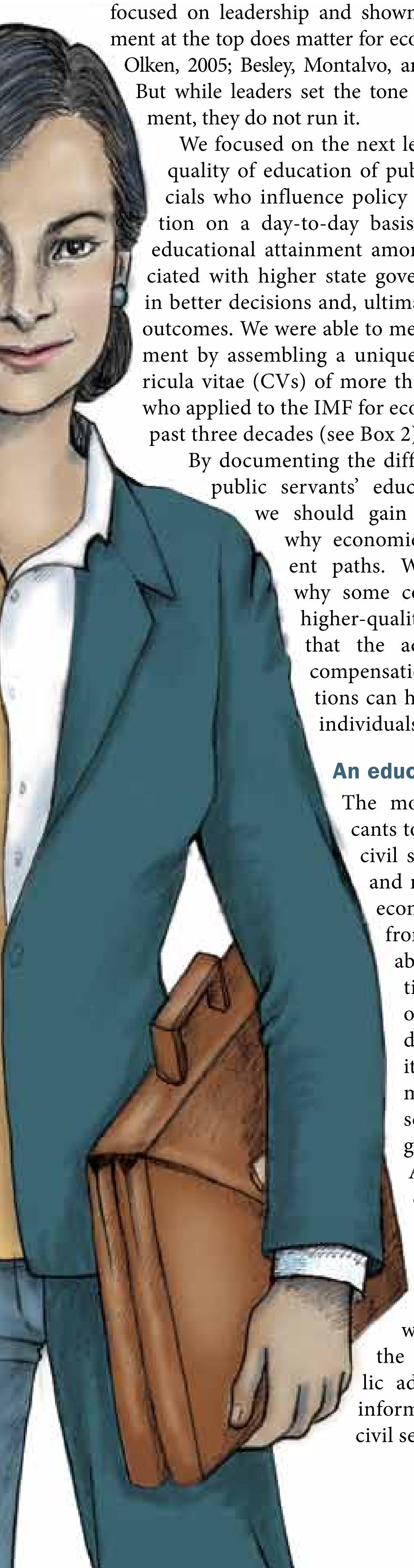
Box 1

Measuring education

Most of the research on education and economic development has focused on the overall educational attainment of a country's population. Barro and Lee (2010), for example, constructed measures of educational attainment of the adult population for 146 countries at five-year intervals from 1950 to 2010—broken down by sex and age group. They found large differences in educational attainment of the general population across countries and that the general population in rich countries had an average of 11 years of schooling, compared with about 7 years of schooling in poorer countries.

But other research has been far less conclusive on finding a link, which is why researchers are searching for better ways to measure education and its contribution to governance and development, such as using measures of cognitive skills.

ment. The educational attainment of civil servants may differ from that of the general population. Researchers have already focused on leadership and shown that educational attainment at the top does matter for economic growth (Jones and Olken, 2005; Besley, Montalvo, and Reynal-Querol, 2011). But while leaders set the tone and direction of government, they do not run it.



We focused on the next level down, looking at the quality of education of public servants—those officials who influence policy design and implementation on a day-to-day basis. We found that higher educational attainment among civil servants is associated with higher state governing capacity, resulting in better decisions and, ultimately, better development outcomes. We were able to measure educational attainment by assembling a unique database from the curricula vitae (CVs) of more than 100,000 civil servants who applied to the IMF for economics training over the past three decades (see Box 2).

By documenting the differences in the quality of public servants' education among countries, we should gain additional insight into why economies develop along different paths. We also further explore why some countries end up with a higher-quality civil service and argue that the adoption of merit-based compensation in public administrations can help attract well-educated individuals.

An educated civil service

The more than 100,000 applicants to the IMF were mid-level civil servants in central banks and ministries of finance and economy. Using the data from their CVs we were able to explore the association between the quality of education and various dimensions of state capacity—the ability of governments to deliver public services, spend on public goods, and collect taxes. Although data on educational attainment are available for the general population, they are not available for public administrations. In fact, we know so little about the characteristics of public administrations that even information on the number of civil servants is not consistently available across countries, let alone over time. This database attempts to fill the gap by building a novel data set on educational attainment in public administrations—albeit only those in the economic and financial sphere.

The data set is comprehensive in the sense that it covers a wide range of age groups and levels of seniority as well as both men and women. However, the degree to which individuals who work in central banks and ministries of finance and economy are representative of overall public administration is difficult to ascertain. Nonetheless, we believe we do make an important contribution by shedding light on an area for which so little systematic documentation is available. Using this data set, we discovered that educational achievement in public administrations across regions is quite different from that of the general population. The general population in Latin America and sub-Saharan Africa has, on average, a low level of educational attainment, but a high proportion of civil servants in those regions have college degrees.

We constructed a quality-adjusted measure of educational attainment by computing a weighted average of officials' years

Box 2

Database: applicants' CVs

The data set is a compilation of tabulated information from 131,877 CVs of civil servants from 178 countries who applied to the IMF for training between 1981 and 2011. The IMF Institute for Capacity Development's Participant and Applicant Tracking System, the repository for the CVs, includes country of residence, agency, age, gender, position, and detailed educational background (such as degree, graduating institution, and study abroad). The IMF capacity-building activities include all aspects of macroeconomic policy and national statistics and more specialized courses, such as finance. Those courses are offered either at a regional location or at IMF headquarters in Washington, D.C. Applicants may be nominated by their country or apply on their own.

Box 3

Ranking academic quality

Universitas, a global network of universities, ranks countries according to their universities' overall academic track record and includes such measures as publications by university professors and the market value of a higher-education degree (reflected in the unemployment rate for individuals with a higher-education degree). According to this overall ranking of 48 countries, the United States ranks first, the United Kingdom second, Canada third, and Indonesia 48th. Countries outside the Universitas ranking are arbitrarily assigned a score that is 25 percent of Indonesia's. Outside the advanced economies, those in east Asia and central and eastern Europe have the largest share of officials who studied in one of the top 48 countries. More generally, a significant portion of civil servants in developing economies studied abroad.

of education. We used as weights a countrywide academic ranking from Universitas, a global network of universities (see Box 3). According to this overall ranking of 48 countries, the United States ranks first, the United Kingdom second, Canada third, and so on—to Indonesia, which ranks 48th. When we consider where the civil servants obtained their degrees, we find that, outside advanced economies, east Asia and central and eastern Europe have the largest share of officials who studied in one of the top 48 countries ranked according to academic standards. Using our quality-adjusted measure of education, we found higher-quality civil services in countries with more economic growth (see Chart 1). This positive association also holds when we control for initial GDP per capita to capture the fact that it is easier for countries to grow fast when they are catching up.

Education and government effectiveness

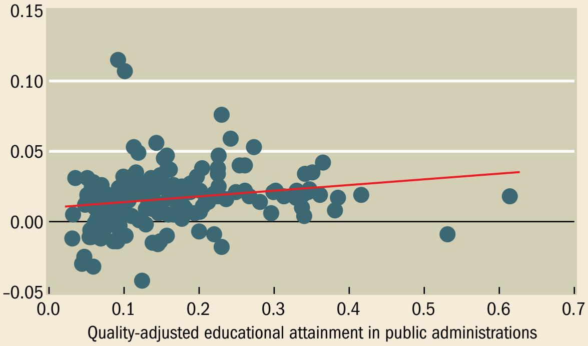
Government effectiveness is essential to economic development. After all, the prospect of economic development is remote in countries where governments fail to limit corruption, enforce laws, and foster an environment conducive to private sector development. The data reveal a positive association between quality-adjusted education among civil servants and various dimensions of government effectiveness—that is, when civil servants are better educated, there is less corruption, higher tax collection, better public finance management, and more support for private markets.

Chart 1

Educated growth

Better-educated civil servants go hand in hand with higher economic growth.

(GDP growth per capita, 1970–2009, percent)



Sources: Arezki and others (2013); and Heston and others (2009).
Note: Quality-adjusted education, relying on the Universitas rankings, ranges from zero, when all public servants have only a high school degree, to 1, when all have a doctoral degree from a U.S. university.

Higher educational attainment in public administrations is associated with less corruption in those administrations. Chart 2 shows the cross-correlation between our measure of educational attainment and an indicator of corruption based on data from the *International Country Risk Guide* (2012). Higher educational attainment in public administrations continues to be associated with less corruption. This finding suggests that a more educated public administration workforce can eventually lead to higher development by helping limit the misuse of public funds and shelter private companies from capture.

Moreover, we found that when civil servants are better educated, countries are able to collect more tax revenue. Revenue mobilization is one of the biggest challenges for developing economies, and higher revenue mobilization should be considered a sign of state capacity and state building for developing countries (Besley and Persson, 2009). The correlation between our measure of educational attainment and tax revenue collected as a percentage of GDP is positive and strong for a large cross section of countries. This finding suggests that better-educated civil servants are more effective at administrating taxes, ensuring compliance, and understanding and enabling private sector development.

A more educated public administration workforce helps raise the standards of the domestic financial sector.

Another dimension of government effectiveness is reflected in a state's ability to support the development, regulation, and supervision of private markets—such as the domestic financial sector, which in turn plays an important role in fostering growth. We found a positive and a statistically and economically significant relationship between our quality-adjusted measure of education in public administrations and a composite index that captures domestic financial sector standards, including regulation, supervision, and competition (Ostry, Prati, and Spilimbergo, 2009). This suggests that a more educated public administration workforce helps raise the standards of the domestic financial sector, in turn enhancing private sector development and economic growth.

Education versus institutions

One crucial issue is whether educational attainment of civil servants is the source of good governance or whether education is the result of robust institutions, such as checks and balances supported by an independent judiciary. If it is institutions that spur educational attainment, then public policies should focus on strengthening specific institutions to ensure that talented civil servants choose to join public administrations and that a country's educational system enhances cognitive skills.

Recent research emphasizes the role of institutions in shaping economic outcomes. For instance, Acemoglu, Johnson, and Robinson (2001) demonstrate a causal relationship between the quality of institutional arrangements—such as those that aim to limit investors' expropriation risk—and income per capita for a large cross section of countries. Arezki and Dupuy (2013) build on this approach with a theoretical model that shows an association between better-educated civil servants in the public sector and higher welfare for society as a whole. These findings suggest that decisions by talented civil servants enhance the quality of the delivery of public goods and in turn lead to economic growth.

The model yields two important theoretical predictions, which are supported by the data.

• More public-spirited agents work in the public sector than in the private sector when institutions are strong, all else equal. The reason is that stronger institutions limit the availability of public wealth that can be stolen by corrupt civil servants, which drives corrupt employees out of the public sector. Educated agents are typically public spirited and are better at delivering public goods because they have superior skills but also because they are better at judging when it is appropriate to leave the private sector alone. This prediction is consistent with the positive association between less corruption and higher educational attainment shown in Chart 2. When talent is tilted toward more educated agents in the public sector, the result is more public goods and higher economic growth.

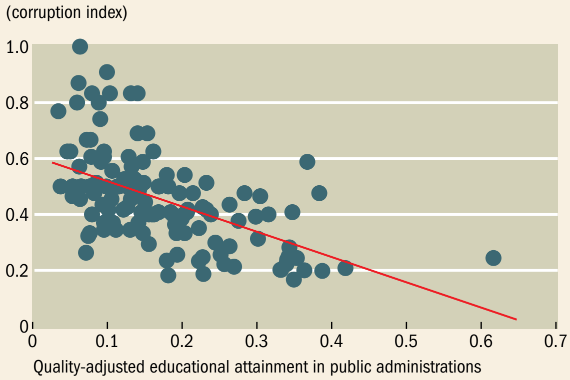
Compensation that rewards public-spirited agents raises the well-being of society as a whole, especially when institutions are weak. Such compensation programs make the public sector more attractive to public-spirited individuals and, as a result, improve the delivery of public goods and economic growth. This is consistent with some of our empirical findings that merit-based compensation is associated with better-educated public administrators.

• From a policy standpoint, our findings suggest that improving government effectiveness may be achieved, for instance, through strengthening the judiciary system. An effective judiciary that enforces the law with fairness is likely

Chart 2

Containing corruption

Higher educational attainment in public administrations is associated with less corruption.



Sources: Arezki and others (2013); and *International Country Risk Guide* (2012).
Note: Quality-adjusted education, relying on the Universitas rankings, ranges from zero, when all public servants have only a high school degree, to 1, when all have a doctoral degree from a U.S. university. The corruption score, based on a calculation by the *International Country Risk Guide*, ranges from 1, when a country is most corrupt, to 0.17 when it is least corrupt.

to dissuade civil servants from trying to manipulate rules and regulations to enrich themselves at public expense and discourage individuals disposed to corruption from entering public service.

Moving to merit-based compensation can also help attract well-educated individuals. The policy debate on issues of compensation has so far focused narrowly on chief operating officers' compensation in the private sector. Countries around the world, and especially developing economies, should focus on attracting educated people to their public administration to enhance the delivery of key public goods and boost economic development. Singapore, among other countries, has adopted merit-based pay, which has allowed the public sector to attract and retain quality staff and certainly played a key role in enhancing government effectiveness and eventually the country's good economic performance. ■

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What Are Structural Policies?

Monetary and fiscal policies deal with short-term economic fluctuations, but an economy's problems often go deeper

Khaled Abdel-Kader

ECONOMIES can get out of whack for a variety of reasons. Policymakers, in turn, have a number of ways to try to fix them, depending on what is wrong.

For example, when prices are rising too fast and consumers and businesses are buying at a rate that exceeds an economy's underlying ability to produce goods and services—that is, overall demand is growing too fast—policymakers can take steps to reduce demand. Similarly, during economic downturns, when businesses and consumers close their wallets—aggregate demand is shrinking—governments can take steps to encourage them to open their pocketbooks or substitute government spending for diminished private spending. Such government actions are called *demand management* or *stabilization policies.*

Sometimes an economy's problems are deeper and longer lasting than excessive or inadequate demand, usually as a result of government policies or private practices that impede efficient and fair production of goods and services—that is, supply. Fixing such problems can require changes to the fabric of the economy, called *structural policies*.

Stabilization policies are important in the *short run*, because it is easier to alter the various components of overall demand for a short time than it is to make a country's resources more productive. Stabilization policies include taxing and spending actions (see "What Is Fiscal Policy?" *F&D,* June 2009) and changes to interest rates and the money supply (see "What Is Monetary Policy?" *F&D,* September 2009).When longer-term, structural changes are required to improve aggregate supply, governments must address specific impediments. This may involve the core *structure* of the economy, such as how prices are set, how public finance is conducted, government-owned enterprises, financial sector regulation, labor market rules and regulations, the social safety net, and institutions.

The recent financial and sovereign debt crises triggered calls for bold structural policies in several euro area countries, while declining growth in many developed and developing countries pointed to a need for fiscal, financial, institutional, and regulatory reforms to enhance productivity and raise growth and employment. Structural policies not only help raise economic growth; they also set the stage for successful implementation of stabilization policies.

Dealing long term

Structural policies can zero in on a number of areas.

Price controls: Prices in free markets reflect the underlying cost of production. However, governments in some countries set the prices for certain goods and services—such as electricity, gas, and communication services—below production costs, particularly when the goods or services are produced by government-owned companies. These price controls lead to losses that the government must make up—which can cause budget and stabilization problems. Moreover, controls encourage higher consumption than would be the case if the prices of goods and services reflected the true cost of production. Underpricing leads to poor allocation of a society's resources. Were controls eliminated, prices would rise to cover costs, which would promote competition and efficiency.

Management of public finances: Although governments may briefly have to spend more than they take in during a recession—or collect more taxes than needed for a while to dampen spending in a boom—over the long term spending and taxing should be in synch. But complex tax laws and inefficient systems of tax administration, for example, can make it difficult to raise sufficient public revenue, which often leads to large budget deficits and accumulation of debt (a stabilization problem). That in turn can restrict a government's ability to finance development needs such as health care services, education, and infrastructure projects. Tax reforms can facilitate taxpayer compliance and raise revenue by removing exemptions, requiring advance payment of estimated tax liabilities, and simplifying the tax rate structure. Improved tax administration can also increase revenue. For example, better training and higher salaries for tax collectors could reduce corruption and help retain competent staff. Better management of public expenditures could result in more productive use of public funds.

Public sector enterprises: Government-owned enterprises make up a considerable share of the economy in some countries. Some operate efficiently and in the best interest of consumers. But often, because there is little if any competition, government-owned businesses deliver low-quality goods and services. Public businesses that compete with private firms often operate at a loss because of political influence or higher operating costs (as a result of unneeded workers, for example), and the government must make up the losses. Stabilization problems can arise if these government enterprises have to borrow from commercial banks to cover the losses. The loans are usually guaranteed by the government, which imposes contingent liabilities on the government budget because the government will have to pay if the enterprises don't. Countries with large state-owned enterprises could sell them to private individuals or firms. Or they could maintain public ownership in general, but take such steps as closing enterprises that are inefficient or have losses, changing their management, or reducing the labor force to align it with business needs—with an appropriate safety net to protect the laid-off staff.

Financial sector: The financial sector's role is to channel funds from savers to borrowers. A sound financial sector helps ensure that such funds are used in the most productive manner, which leads to higher economic growth and development. However, underdeveloped or poorly regulated financial systems in some developing countries could hamper economic growth and make it more difficult to conduct stabilization policies. For example, central banks generally carry out monetary policy by buying and selling on the open market securities that governments have sold to the public. But if there are no so-called secondary markets for government securities, or if they are poorly developed, central banks could be constrained in their attempts to carry out effective monetary policy and may have to resort to inefficient (or unfair) policy tools, such as credit rationing or interest rate controls. Inadequately regulated banks may engage in risky behavior that leads to banking crises—such as a "run," when worried depositors rush en masse to take out their funds, or a failure, which is generally the result of bad lending practices. But even sound banks can fail if they get caught up in a systemwide run that exhausts the cash they have to pay depositors. Banking crises can interrupt the flow of funds to borrowers, discourage saving, and lead to higher government deficits if the state guarantees deposits or recapitalizes banks. Policymakers can fix underdeveloped financial systems through the introduction of secondary markets, the development of stock markets, and the privatization of government-owned banks. To mitigate crises, policymakers must shore up the financial system through effective regulation and supervision.

Social safety nets: Governments often have programs designed to safeguard a minimum standard of living for the poor and other vulnerable groups. But in many developing countries some costly programs—like fuel and food subsidies—are poorly targeted and benefit the rich more than the poor. In developed countries, pay-as-you-go pension programs have huge unfunded liabilities because more people are retiring than entering the workforce. In addition, generous unemployment benefits often contribute to high unemployment because employers, who pay unemployment insurance premiums, are reluctant to hire new workers. Governments can change social safety nets to target the needy and achieve considerable savings. To focus on the needy, governments could give low-income households vouchers for basic food items or distribute food only in areas where the poor live. The government could also replace food and fuel subsidies with cash transfers. Pension programs can be changed so that benefits are aligned with projected revenues by raising the retirement age or fully funding pension systems.

Raising an economy's growth potential requires stabilization and structural policies that complement one another.

Labor market: Unemployment is prevalent in many countries for a variety of reasons and usually rises when the economy is not doing well. But sometimes the cause of unemployment is deeper than the effects of the business cycle. For example excessive social security contributions or a relatively high minimum wage may so boost the cost of hiring that demand for labor shrinks and unemployment rises. Demand for labor may also fall if workers lack the necessary skills because of inadequate training or education. Reforming education and improving on-the-job training programs can help restore demand for labor.

Public institutions: The performance of public institutions can significantly affect a country's economic environment. For example, low government salaries, say in tax administration, can encourage corruption. Also, inefficient legal systems and shortages of courts and judges make it hard for businesses to resolve disputes, which increases costs for businesses and deters investment, especially foreign direct investment—hurting economic growth. Governance and institutions can be improved by simplifying business regulations and licensing, enhancing the country's legal system, streamlining the system of tax administration, and raising salaries for government staff in charge of providing vital services while limiting employment in the public sector to business needs.

Hand in hand

Raising an economy's growth potential requires stabilization and structural policies that complement one another. Stabilization policies lay the foundation for economic growth by helping lower inflation, smooth out consumption and investment, and reduce government deficits. Successful implementation of structural policies is possible only after such macroeconomic imbalances have been resolved. Similarly, though, structural policies enhance the effectiveness of many stabilization measures: promoting competition (a structural policy), for example, can lead to lower prices and, hence, lower inflation (the goal of stabilization policies). ■

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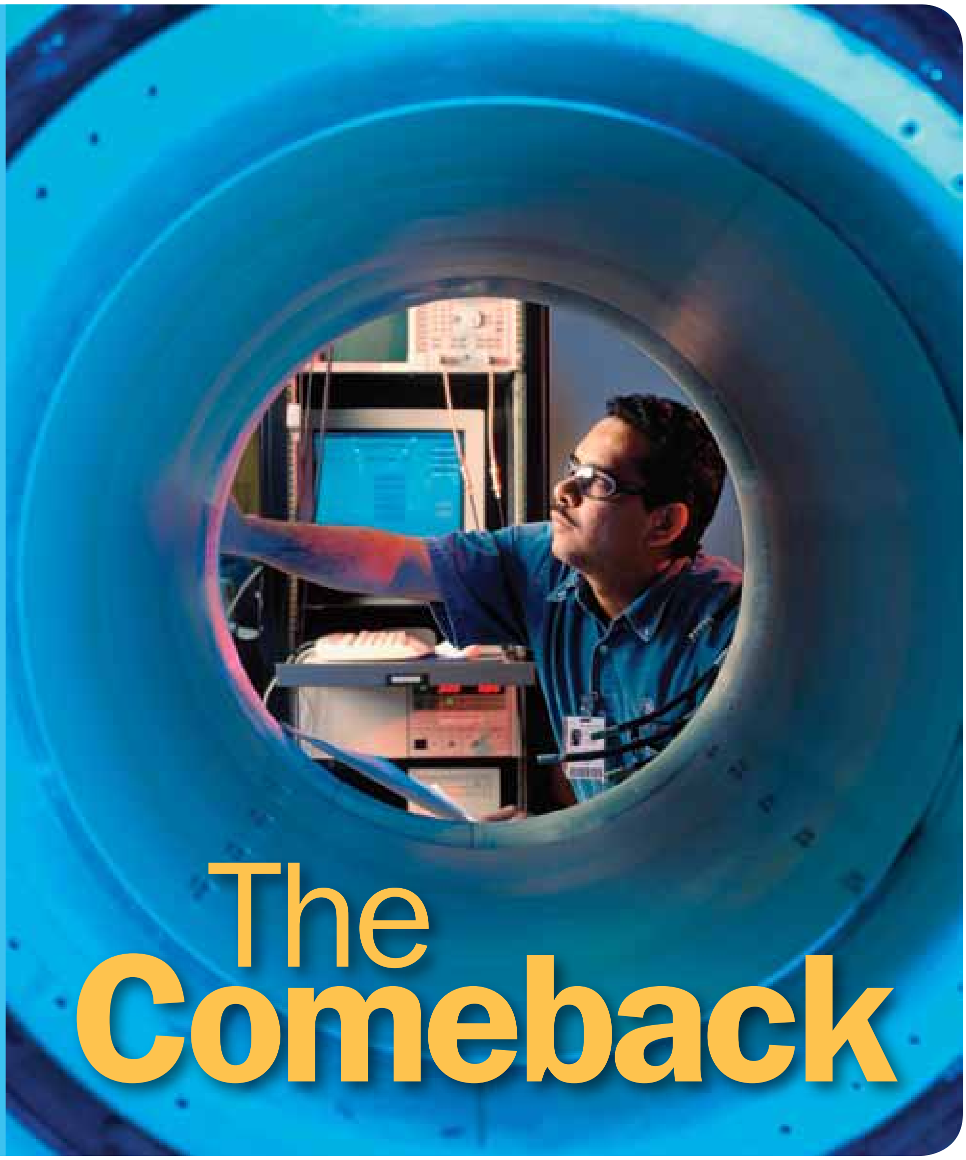
Mexico's newfound competitiveness helps it regain a share of the U.S. import market it had lost to China

The Comeback



Worker at medical equipment plant in Monterrey, Mexico.

Herman Kamil and Jeremy Zook

THE U.S. market has long been critical to Mexico—not only to its manufacturing sector, but to its overall economic strength. When Mexico signed the North American Free Trade Agreement (NAFTA) nearly two decades ago, the greater access it provided to the U.S. market was a boon to the country's manufacturing base, whose share of the country's GDP grew by almost 4 percentage points in the five years following the signing of the treaty. In turn, Mexico's share of the U.S. manufactured goods import market increased from slightly above 7 percent in 1994 to nearly 13 percent in 2001.

But Mexico's fortunes changed dramatically after China joined the World Trade Organization (WTO) in 2001. WTO membership reduced many barriers to Chinese exports. China's low-cost manufacturing base and ample production capacity enabled it to compete head-on and significantly undercut Mexico's export share in the U.S. market, despite the trade preferences Mexico received under NAFTA. Between 2001 and 2005, Chinese manufacturing exports to the United States expanded at an average annual rate of 24 percent, while Mexico's export growth decelerated sharply from about 20 percent a year to 3 percent on average each year over the same period. As a result, China's share of U.S. manufacturing imports almost doubled by 2005, eroding the previous gains in market share by Mexico (see Chart 1).

China was able to crowd out Mexican exports in the U.S. market because Mexico lost its advantage in several labor-intensive manufacturing sectors in which it specialized—including apparel, office machinery, furniture, and photographic and optical equipment. Looking for cheaper labor, many of these manufacturers, including those in the famed maquiladora industries (which assemble mostly imported parts into finished products for export to the United States), relocated their operations from Mexico to China.

But almost as quickly as it stumbled, Mexico regained its footing and began to claw its way back. Over the past seven years, Mexican manufacturing exports rose from about 11 percent of the U.S. import market to an all-time high of 14.4 percent—at first elbowing out such competitors as Japan and Canada, but in recent years gaining market share at the expense of China. Between 2005 and 2010, both Mexico and China gained market share in the United States. Since 2010, however, Mexico's gains in the U.S. import market coincided with a decline in China's market participation.

The return of Mexico

Mexico's rebound has been driven primarily by exports of electronics, telecommunications, and transportation equipment. Since 2005, Mexico's share of U.S. imports of transportation and communications products increased steadily to 18 percent, accounting for 76 percent of total Mexican manufacturing exports in the first half of 2012. But starting in 2009, most manufacturing sectors—20 of the 26 manufacturing import categories—showed gains, jointly accounting for 80 percent of total Mexican exports. Only a handful of industries lost market share, including electrical equipment (still a major sector, accounting for 14 percent of Mexican exports) and apparel.

The automotive sector has contributed the most to the increase in aggregate market share, explaining half of the rise between 2005 and 2012. Mexico's market share in U.S. imports of autos, auto parts, and accessories (excluding trucks) increased almost 9 percentage points over this period, particularly since 2009. Mexico accounts for a fifth of the total U.S. imports of autos and auto parts—the second-biggest foreign supplier of auto-related products to the United States, close behind Canada. The automotive sector accounts for one-quarter of all Mexican manufacturing exports to the United States. This large increase in production capacity and exports has been underpinned by a continued flow of foreign direct investment into the sector—mostly from the United States, but recently also from Japan and Germany.

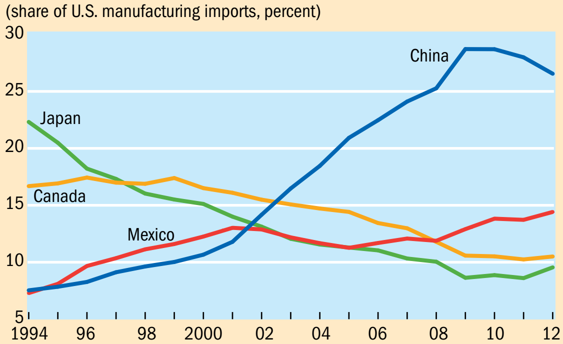
Chart 2 shows the changes in Mexico's market share of U.S. imports against those of China in each of the 26 manufacturing sectors, for the periods 2005–07 and 2010–12. We excluded 2008 and 2009 because the global economic crisis distorted trade worldwide. In each panel, the upper left quadrant (red bubbles) represents sectors in which China's market share increased while Mexico's fell; the lower right quadrant (green bubbles) plots sectors (if any) in which Mexico's share increased and China's fell. The other two quadrants depict sectors in which the shares for both countries either fell or increased simultaneously. The size of the bubbles is proportional to each sector's contribution to the overall change in market share in each period. During 2005–07 (top panel) there was no sector in which Mexico's share increased and China's simultaneously decreased. In fact, Mexico was los-

Chart 1

Shifting shares

Mexico's share of the U.S. import market for manufactured goods suffered after China joined the World Trade Organization, but has been climbing in recent years as China's has begun to fall.

(share of U.S. manufacturing imports, percent)

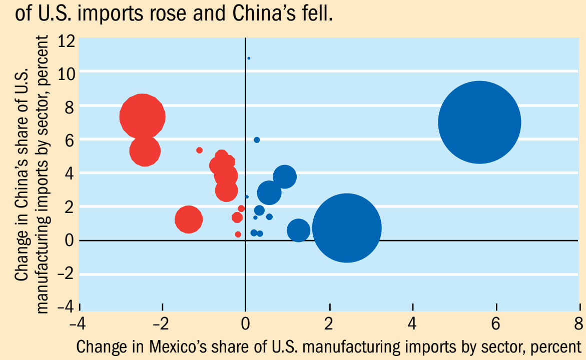


Sources: U.S. International Trade Commission; and U.N. Comtrade.

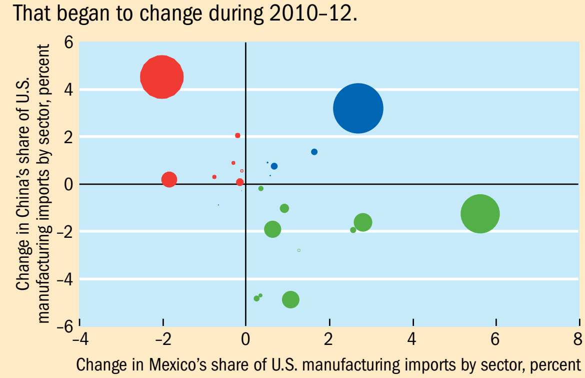
Chart 2

Changing fortunes

During 2005–07, there was no sector in which Mexico's share of U.S. imports rose and China's fell.



That began to change during 2010–12.



Source: IMF staff estimates based on U.S. International Trade Commission data for the 26 categories of manufactured goods.

Note: The upper left quadrant (red bubbles) portrays sectors in which Mexico's share of U.S. manufacturing imports fell and China's rose. The lower right quadrant (green bubbles) contains sectors in which Mexico's share of U.S. manufacturing imports rose and China's fell. The upper right quadrant (blue bubbles) represents sectors in which both China's and Mexico's share of U.S. manufacturing imports rose and the lower left quadrant sectors in which both countries' shares fell. The center of the bubble is the point of intersection of Mexico's and China's performance, while the size of the bubble is proportional to each sector's contribution to the overall change in market share in the period.

ing share in several sectors in which China was gaining participation. In contrast, during 2010–12 (bottom panel) there are several sectors in which Mexico's share increased while China's fell. In addition, the number and relative importance of sectors in which China's share went up and Mexico's declined in the most recent period.

We calculated the fraction of Mexico's increase in market share that can be associated with China's reduction, controlling for changes in the shares of the other competitors (based on a methodology developed by Jorge Chami Batista, 2008). During 2010–12, 40 percent of Mexico's dollar gains in the sectors in which it increased market share can be attributed to China's loss of share—some of which could reflect China's shift to exports of a different set of goods. Mexico's largest gains over China in market share were in a diverse range of goods—including electrical machinery and building materials. In contrast, during 2005–07, half of Mexico's increase in market share is explained by reductions by Canada and Japan and none by China.

Mexico's increased competitiveness

Mexico's comeback in the U.S. market reflects both its improved competitiveness and developments that are making Chinese exports relatively more expensive. Most important among these developments are a narrowing gap in labor costs between Mexico and China, increased productivity gains in Mexico, and rising transoceanic shipping costs. Mexico's protection of proprietary rights and commitment to free trade also play a role in encouraging manufacturers to locate there.

Wages in the manufacturing sector in China increased at an average annual rate of 14 percent in renminbi terms from 2003 to 2011, and close to 20 percent annually in dollar terms (which reflects both nominal wage growth and the appreciation of the Chinese currency). In contrast, average wages in the Mexican manufacturing sector have remained fairly constant in dollar terms, underpinned by moderate wage growth and a depreciation of the peso. In 2003, average dollar wages in Mexico were six times higher than those in China; in 2011 wages were only 40 percent higher (see Chart 3). This has reduced the competitive advantage that China had as a low-cost supplier of manufacturing goods to the United States in the early part of the 2000s. (Because reliable data on unit labor costs in the Chinese manufacturing sector are not available, we could not account for changes in productivity in manufacturing and how much they contributed to wage changes.)

We also found that during 2010–12, Mexico gained market share relative to China in sectors in which labor played a bigger role than capital, such as in the manufacture of furniture and of plumbing, heating, and lighting fixtures. This appears consistent with the notion that Mexico's recent gains in market share vis-à-vis China were driven in part by improved relative labor costs. In contrast, over the period 2005–07, there was no systematic relationship between changes in relative market share and the relative importance of labor in the production process.

In addition, strong productivity increases underpinned by significant investment in the manufacturing sector in Mexico have helped lower the cost of labor per unit of output and increase the competitiveness of manufacturing production (see Chart 4).

Locational luck

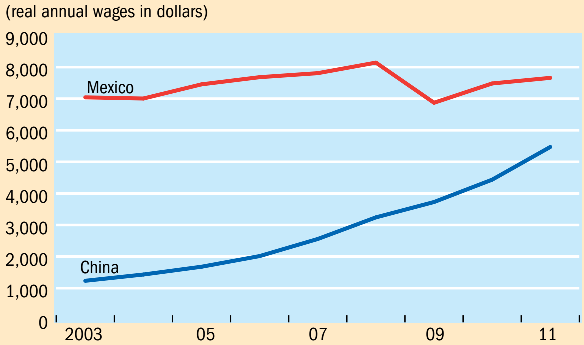
Mexico has also benefited mightily from being close to the United States. The price of oil increased from $25 a barrel in the early 2000s to more than $100 in February 2013, which substantially raised transoceanic freight costs. This proximity has given Mexico a competitive edge over China, particularly when it comes to trendy time-sensitive goods and heavy and bulky items.

For example, in 2009 Mexico became the world's leading exporter of flat-screen TVs, surpassing South Korea and China. According to the *Global Trade Atlas* (Global Trade Information Services), the country is also the leading manufacturer of two-door refrigerators. Proximity, as a proxy for

Chart 3

Coming closer

After adjusting for inflation and exchange rates, in Mexico annual real wages in U.S. dollars were six times higher than Chinese wages in 2003 but only 40 percent higher in 2011.

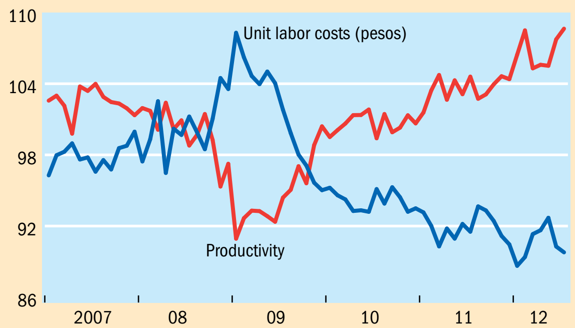


Sources: Barclays; and CEIC China database.

Chart 4

Efficient enterprises

Output per worker (productivity) is rising and labor costs per unit of output are falling in Mexico's manufacturing sector.



Source: INEGI (Mexico's National Institute of Statistics and Geography).

speed-to-market, has also gained importance because U.S. companies increasingly buy inputs (such as parts) rather than making them and, to hold down the costs of maintaining inventory, have adopted just-in-time manufacturing—which requires precise and timely delivery of those inputs. That is far easier for Mexican suppliers to achieve.

According to the 2011 *U.S. Manufacturing-Outsourcing Cost Index* (AlixPartners, 2011), goods produced in Mexico had the lowest landed costs (that is, their price at a California port) for U.S. importers in 2010 of all key low-cost outsourcing countries (see Chart 5). At the same time, U.S. producers have begun to "near-shore" their inputs—that is, buy them from a close, rather than distant, source, which enhances Mexico's advantage as a nearby manufacturing hub. Non-U.S. companies have also pulled up stakes in China and relocated their production to Mexico.

Mexico's strong commitment to the protection of proprietary technologies has also helped it attract foreign direct investment, with its beneficial impact on efficiency. Mexico has a strong reputation for protecting international intellectual property, patent, and trademark rights and is a party to several international treaties, including the World Intellectual Property Organization Copyright Treaty. This has helped minimize the risk of piracy, counterfeiting, and other intellectual property infringements, which is especially important in high-technology sectors and in manufacturing sectors whose technologies have military applications. In January 2012 Mexico joined the Wassenaar Arrangement on Export Controls for Conventional Arms and Dual-Use Goods and Technologies, which opened up new possibilities for U.S. and European firms to invest in high-tech sectors in Mexico, including those that involve semiconductors, software, aerospace, lasers, sensors, and chemicals.

Mexico's manufacturing base has also been buttressed by the economy's openness. Mexico's trade agreement network is one of the world's largest; it has free trade or preferential trade agreements with 44 countries and has shown a strong commitment to avoiding the use of trade restrictions and ensuring unrestricted access to markets and intermediate inputs to companies operating in Mexico. Moreover, Mexico has signed international standards and quality agreements that facilitate the participation of local manufacturing companies in global supply chains, particularly in the automotive and aerospace industries.

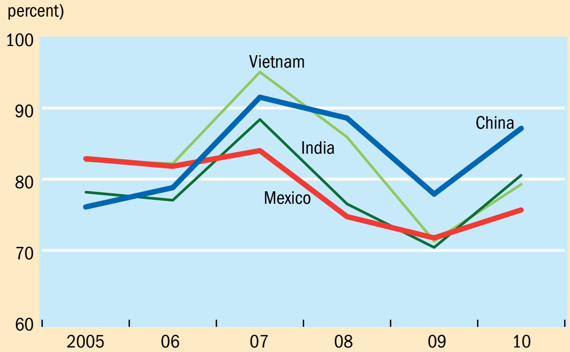
Mexico's strong commitment to the protection of proprietary technologies has also helped it attract foreign direct investment.

Chart 5

Cheapest of all

The cost of Mexican imports to U.S. customers is the lowest among all key low-cost outsourcing countries.

(landed costs in United States relative to total U.S. domestic manufacturing cost, percent)



Source: AlixPartners (2011).

A number of the factors that have contributed to Mexico's increased competitiveness and its recovery of U.S. market share are likely to be long lasting—or structural, as economists say. These include the locational advantage, improved unit labor costs from enhanced manufacturing productivity and increased labor participation, and trade openness that appear to have underpinned Mexico's improved competitiveness in the U.S. market in recent years. Nevertheless, China is expected to remain a low-cost manufacturing powerhouse for many goods the United States imports because of its mature manufacturing capability and the significant switching costs of moving production overseas (AlixPartners, 2011). For this reason, structural reform efforts in Mexico to further boost productivity and investment would help sustain the dynamism of manufacturing exports and boost potential GDP growth. These efforts should include such things as taking measures to increase competition and labor flexibility, improve education, and strengthen the rule of law.

Manufacturing in Mexico was hit hard by China's rise on the global stage at the beginning of the past decade; but today, as some of China's cost advantage has eroded, Mexico's manufacturing sector is among the best positioned to benefit from the changing global landscape. ■

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This article is based on Chapter 2 of the IMF's 2012 Selected Issues Paper for Mexico.

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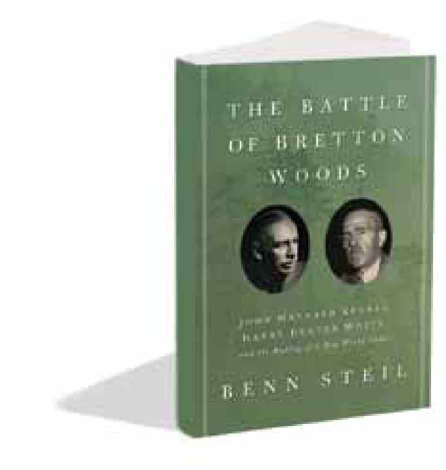
Whitewashing History



Benn Steil

The Battle of Bretton Woods

John Maynard Keynes, Harry Dexter White, and the Making of a New World Order

Princeton University Press, Princeton, New Jersey, 2013, 472 pp., $29.95 (cloth).

The landmark conference of 1944 at Bretton Woods, New Hampshire, in the United States, made the name of the resort town synonymous with institutions of international monetary cooperation. But even the principal authors of the Bretton Woods Agreements, which established the International Monetary Fund and the International Bank for Reconstruction and Development, did not regard them as a success.

The British negotiator and renowned economist John Maynard Keynes expressed dismay that Bretton Woods failed to create an IMF that could act like the "super-central bank" he envisioned. Instead, the IMF spent its first decades as a more modest agency, as conceived by U.S. Treasury official Harry Dexter White. In 1970, Edward Bernstein, a U.S. Treasury spokesman at Bretton Woods, reflected that "the international monetary system has not functioned as well as it should."

Clearly, a history of Bretton Woods should take account of such skepticism about the system and its effects. But Benn Steil (senior fellow and director of International Economics at the Council on Foreign Relations) advances a more radical interpretation. Dwelling on White's role as an alleged secret agent who not only communicated with the Soviets about American postwar policy, but also—as Steil tells it—worked on behalf of the Soviet Union to involve the United States in World War II, the author describes White as the architect of a Bretton Woods system guaranteed to produce, in his words, an "economic apocalypse."

There is enough reliable evidence from Soviet archives to suggest that White clandestinely gave information to Soviet intelligence, though it is impossible to know how much, or whether the Soviet Union put it to substantial use. Even most historians sympathetic to White acknowledge that he engaged in espionage. But Steil goes much further, suggesting that White, acting in the Soviets' interest, substantially wrote U.S. diplomatic notes in November 1941—notes that proposed terms so patently unacceptable that the Japanese had to break off negotiations and attack Pearl Harbor, bringing the United States into the war.

It is a dubious claim for many reasons. Neither White nor the Treasury was at the center of U.S.-Japanese negotiations. At the time of the supposedly critical note, the Japanese task force bound for Pearl Harbor was already at sea. The 2002 history Steil uses to support the case relies, itself, on documentation that historians John Earl Haynes and Harvey Klehr have determined to be fake.

White's espionage isn't the only area in which Steil makes far-reaching claims based on inadequate evidence. When discussing monetary policy, Steil writes favorably of "the pre-1914 gold standard, with its automatic mechanisms for regulating the price of credit and the cross-border flows of gold." This description, while consistent with economic models of how a gold standard could work, does not reflect historical scholarship on how it actually did work.

Even under the gold standard, paper was the principal circulating medium. Note-issuing central banks did not adjust the amount of circulating currency in a mechanical response to the flow of trade, automatically following rules. Rather, monetary authorities set interest rates—and therefore the amount of money in circulation—at a level they thought would generate a profit, at which their government could comfortably borrow, and that would allow them to keep enough gold on hand to ensure a credible commitment to convert paper into specie as necessary.

What Bretton Woods brought was not a perfect system, but a convention of international discussion.

Which is to say, the gold standard, like Bretton Woods, depended on policymakers' good judgment. Steil writes as if, in moving from the gold standard to Bretton Woods and onward into the modern era of floating exchange rates, the world moved from an era of automatic rules to one of discretionary policymaking, vulnerable to political influence. In fact all monetary systems respond to political influence; the differences among them come from political context, not from the institutions or the systems themselves. Bretton Woods and the modern system of floating exchange rates simply respond to more democratic influences than did the institutions of the gold standard era.

If, instead of saying Bretton Woods guaranteed an economic apocalypse, Steil had said that as implemented, the system could not continue forever, he would not have been wrong, and the book would have been better. The original system required that the United States—by the Marshall Plan, and by the North Atlantic Treaty

Organization—put dollars in the hands of the worlds' citizens and also maintain notional convertibility to gold at $35 an ounce, which it could not do forever. But this inevitable outcome was a sign of the system's success, not its failure: it aimed, after all, not only at currency convertibility but also at reconstruction and development. Once the world rebuilt and grew richer, the need for dollar centrality ended. What had been a U.S.-centric system became a multilateral system. With the creation of Special Drawing Rights—a genuine reserve asset—the IMF began to resemble Keynes's super-central bank. Even though the original Bretton Woods system ended in 1971, its goal of international monetary management in the interest of mutual prosperity remained, albeit more often in words than in practice.

In a comparative analysis of international economic performance under various monetary systems, the economic historian Michael Bordo found that Bretton Woods did better than others, including the gold standard. Under Bretton Woods, economies enjoyed stable, low inflation and high growth. Bordo remarks that the modern floating exchange rate system also does pretty well, while allowing even greater domestic policy discretion than Bretton Woods. What Bretton Woods brought was not a perfect system, but a convention of international discussion and occasional coordination. Surely this legacy should provide a starting point for pondering where the world's moneys, and the post–Bretton Woods IMF, might go in the future.

Eric Rauchway
Professor of History, University of California at Davis
Author, The Money-Makers: The Invention of Prosperity from Bullion to Bretton Woods *(forthcoming)*

Banks Stripped Bare

Anat Admati and Martin Hellwig

The Bankers' New Clothes

What's Wrong with Banking and What to Do about It

Princeton University Press, Princeton, New Jersey, 2013, 392 pp., $29.95 (cloth).

Financial regulation has become a hot topic in the wake of the recent crisis; many complex proposals have ensued, and a dizzying array of new acronyms and agencies has emerged. But in their new book, Admati and Hellwig make a forceful case for a classic and simple solution to excessive, unregulated lending: higher capital ratios for banks.

By "higher," Admati and Hellwig mean capital ratios of 20 to 30 percent, more than double—depending on how you count—the proposed levels in the recent Basel III agreement. Their arguments are an important contribution to the debate on capital regulation—with one important caveat, which I will get to.

The baseline argument for higher capital ratios—or the ratio of a bank's capital to its risk—is compelling: if bank failures impose externalities on the rest of us, we should look for ways to make those failures less likely and less costly. Higher capital ratios—sometimes also described as "lower leverage"—are a logical way to make banks safer. An analogy here would be highway speed limits, which can be justified because of the serious risk of injury to pedestrians and other drivers as a result of driver error at high speeds.

The authors take this reasoning further, arguing persuasively that government actions have exacerbated the problem of excessive bank risk in several ways. First, by providing a tax advantage for debt over equity, governments encourage higher leverage among banks. Second, by bailing out the creditors of failing banks, governments lower banks' ex ante costs of debt—compared with in a free market—and, finally, by reducing the ex post cost of bank failure for managers and bondholders, government policy encourages risk taking.

These arguments suggest that higher capital ratios would yield benefits, since better capitalized banks would have a lower probability of failure, with fewer externalities on the rest of us. But what of the costs? In our highway analogy, we could probably reduce the externalities of bad driving if we lowered the speed limit to a few miles per hour. But the cost would be that it would be impossible to get anywhere in a reasonable amount of time. The standard industry arguments against capital requirements usually have this kind of safety versus growth flavor. The main contribution of this book is to convincingly debunk these standard arguments.

One argument against increasing bank capital is that extra capital ceases to be available for investment, leading to lower growth. The authors are absolutely correct that this argument—which is remarkably common among people who really should know better—is based on a confusion between "capital" and "reserves." For banks, capital is simply the equity component on the right-hand side of the balance sheet and, in principle, should have absolutely nothing to do with how assets are invested on the left-hand side of the balance sheet. Reserves, on the other hand, represent cash that must sit idle. Capital and reserves are different and should not be conflated in this debate.

A second objection to costly bank capital argues that given the market's requirement for a higher return on equity than on debt, forcing banks to hold more equity will raise the overall cost of capital for banks, with that cost passed on to the whole economy. This reasoning is clearly inconsistent with the Modigliani-Miller theorem, which postulates that all else being equal, the value of an enterprise is unrelated to how it is financed. The authors do a good job of explaining the ideas behind this theorem to their intended (lay) audience, a task that is much harder than it seems. I have many failed attempts to my name—and am planning to use some of the book's explanations on my next try.

My only criticism of the book is that it focuses too narrowly on "traditional" banks, where our regulatory apparatus is well developed. Regulators can already enforce (or at least try to enforce) capital standards on banks. But the recent crisis began and accelerated in the so-called shadow banking sector, the much more lightly regulated world of securitization, repurchase agreements, and other short-term money markets. Indeed, if we were to increase capital requirements for traditional banks without doing anything about shadow banking, it could easily make the overall financial system less stable as more of the system moves into the shadows. Even small deviations from the Modigliani-Miller theorem—which certainly exist in practice—can induce significant regulatory arbitrage away from traditional banking. (Indeed, it is such regulatory arbitrage on the margin that is often blamed for the growth of shadow banking before the crisis.)

The authors do address this concern toward the end of the book, but they are too dismissive of the scale of the problem. If we lived in a world where all savings were forced into traditional banks, then we could focus exclusively on the safety of those banks. But in a world with multiple parallel highways, a speed limit on just one may only make the others more crowded in a crash.

Andrew Metrick
Michael H. Jordan Professor of Finance and Management, Yale School of Management

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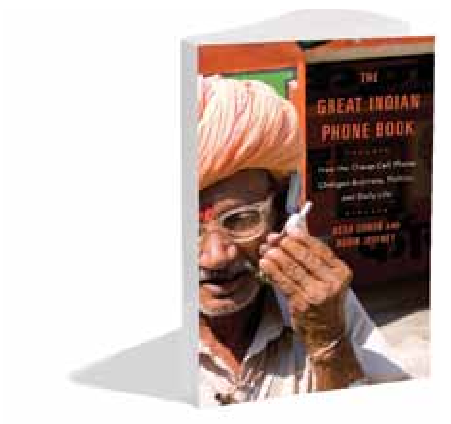
Ringing in the Changes



Robin Jeffrey and Assa Doron

The Great Indian Phone Book

Harvard University Press, Cambridge, Massachusetts, 2013, 336 pp., $29.95 (cloth).

The International Finance Corporation, part of the World Bank Group, has pronounced the mobile phone network "the biggest machine the world has ever seen," and in this book a historian and an anthropologist illustrate the titanic impact of the telecommunications industry on the largest democracy in the world.

This is an important book that can usefully be read by students, social scientists, and business managers—indeed, by anyone interested in change and its effects on developing and complex societies.

The authors demonstrate the futility of attempts by bureaucrats and political leaders to resist, impede, or control the change wrought by this telecommunications juggernaut.

This is well illustrated by Indian, U.S., and European authorities' attempts to auction the spectrum for 3G technologies for huge sums—a mistake that could impede and delay the introduction of, and investment in 4G and LTE, the next generation of wireless technology. Some argue that government has a duty to maximize revenues from these kinds of services. But if, in an attempt to maximize revenues in the short term, governments reduce operators' capacity to make speedy and timely capital investments in new technology, this will ultimately be to the detriment of their societies. Capital for investment is scarce, and extracting extravagant sums from operators impedes, delays, and ultimately raises the cost for consumers. An idea whose time has come cannot be resisted, and should not be delayed.

Jeffrey and Doron decided to focus on India—where there has been more dramatic growth in the spread of mobile phones than in any other region in the world—because its diversity and complexity make for a more satisfying and rewarding study. But the lessons from India are not restricted to this vast subcontinent. Some of the problems and challenges faced by a variety of operators in differing regional markets within India also confronted my own company, Digicel, in the very different markets of the Caribbean and South Pacific—places like Haiti and Papua New Guinea.

Papua New Guinea is a large market with amazing diversity—over 800 distinct dialects—villages only hundreds of yards apart, with large swathes of the population unable to understand one another. It has an inhospitable terrain with poor or nonexistent roads, presenting challenging conditions for tower construction. And in Papua New Guinea—as in India's Bharti Airtel, described in the book—we too, needed to get our marketing messages right and develop prepaid plans and appropriate distribution models for mobile phones and sim cards.

Like the successful operators in India, we did not confine our efforts to the more prosperous groups and areas in the countries in which we operate. Working closely with governments, we have swiftly penetrated even the most difficult parts of those countries—the Blue Mountains in Jamaica, the Highlands in Papua New

Guinea, and remote farming districts and deprived areas in Haiti.

And, as the authors point out, cheap mobile phones have given poor people an instrument that has vastly improved their quality of life and opportunities. But these improvements were unlikely to have happened so quickly, dramatically, and efficiently without the entrepreneurial zeal of the operating companies in India. Their marketing skills and technical abilities were released into a population that previously had no outlet for its latent abilities.

The operators identified telecommunications as the technology for the masses. By 2007 the Indian mobile phone industry employed 2.5 million people in the telecom services sector, and this number does not include the most entrepreneurial and innovative: those engaged in repairs and second-hand sales.

Advertising and marketing companies prospered, as did software developers, and a new world opened up for people who never had such opportunities, in areas such as radio plan design and building towers.

The last part of the book, covering consumption of telecommunications services, confirms our own experiences. We discovered that the fishermen in Samoa responded in similar fashion to their counterparts in Kerala, India, providing information to fellow workers at sea about the best ports to land their catches, information on weather conditions, calls for help in the event of an emergency, and the sharing of information on the best fishing grounds at any particular time. Small-scale producers, whether in India, Jamaica, or Haiti, have been empowered through their access to mobile phones, which has strengthened their contacts with markets and market prices.

The chapter on the impact of women's access to cheap mobile services is optimistic about the prospects for females in a country where the rate of change has, for cultural reasons, been slow. They describe the unique potency of a cheap mobile phone that puts an immensely disruptive device within reach of the poor. As the authors say, the trends are "unpredictable but worth watching and studying."

The authors add that each of the eight chapters in their tome is worth a book in itself. And they are right. In their stated aim of writing a book comprising "sound scholarship, engaging reading and intolerant of jargon" they have succeeded admirably.

Cheap mobile phones have given poor people an instrument that has vastly improved their quality of life and opportunities.

Denis O'Brien
Chairman, Digicel Group, and Chairman and Cofounder of Frontline, the International Foundation for the Protection of Human Rights Defenders

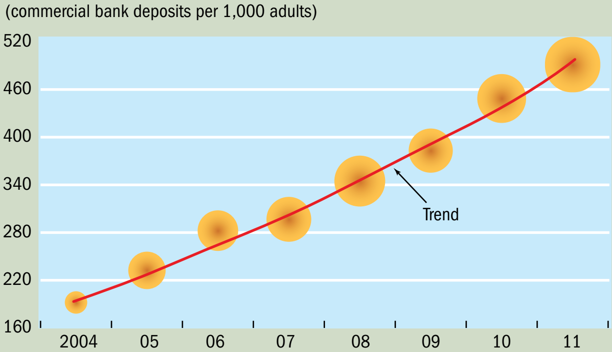
Inclusive Africa

The number of Africans with access to banking and other financial services is growing

AFRICA has been among the world's fastest growing regions during the past decade—the result of a prolonged commodities boom, favorable demographics, good economic policies, and generally improved political stability. Along with that economic growth came an increase in financial services to a growing number of Africans. Although major challenges to financial access remain, the relationship between the growth in per capita GDP and in access to depository services of commercial banks is striking.

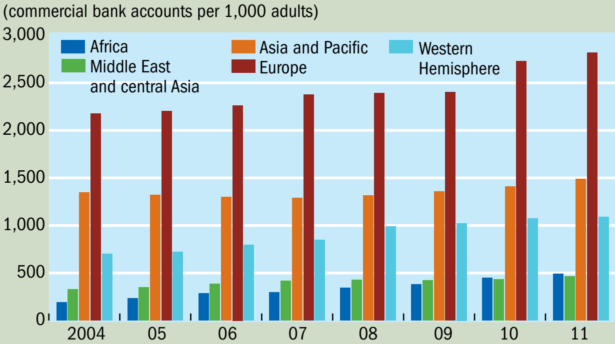
Admittedly this process of financial inclusion started from a low base—and there is a huge difference in development across countries. But among all the world's regions, from 2004 to 2011 Africa had the largest increase in access to depository services (as measured by the number of deposit accounts per 1,000 adults). Africa has caught up to the Middle East and central Asia in access to depository services, and the gap between Africa and the rest of the world is slowly narrowing.

As African GDP grew from 2004 to 2011, so did commercial deposits per capita.
(commercial bank deposits per 1,000 adults)



Note: Size of bubble indicates per capita growth of GDP; 2004 = 100.

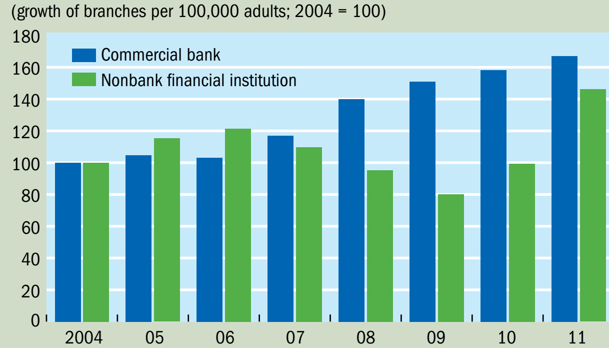
In terms of adults using commercial bank accounts, Africa is closing the gap with the rest of the world.
(commercial bank accounts per 1,000 adults)



The number of branches of other types of financial intermediaries (which gather funds from savers and lend them to borrowers) also grew in the region during 2004–11. Those intermediaries include credit unions, financial cooperatives, microfinance institutions, rural banks, savings banks, money market mutual funds, investment companies, finance companies, and leasing companies.

Overall, although there are differences not only across countries but also within countries between cities and rural areas, the number of branches of both bank and nonbank financial institutions grew between 2004 and 2011. Commercial bank branches grew 70 percent over the period, and nonbank financial institutions' branches expanded by close to 50 percent. There was a decline in nonbank branches during the 2007–09 global financial crisis, but growth rebounded in 2010.

Branches of both bank and nonbank financial institutions have been growing strongly in Africa.
(growth of branches per 100,000 adults; 2004 = 100)



Note: Countries in the sample account for roughly 80 percent of Africa's gross domestic product.

About the database

The IMF's Financial Access Survey database (*fas.imf.org*) contains annual data and metadata for 187 jurisdictions, from 2004 to 2011. It is available to the public free of charge through the IMF eLibrary (*www.elibrary.imf.org*). The 2012 survey was conducted in collaboration with the International Finance Corporation and the Consultative Group to Assist the Poor. It has more than 40,000 time series that include basic consumer financial access indicators covering credit unions, financial cooperatives, and microfinance institutions. It separately identifies small and medium enterprises, households, and life insurance and non–life insurance companies. The Netherlands Ministry of Foreign Affairs and the Australian Agency for International Development provided financial support.

Prepared by Luca Errico, Goran Amidzic, and Alexander Massara of the IMF's Statistics Department.

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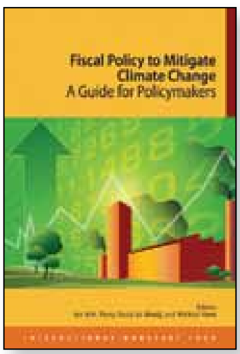
The Challenge of Public Pension Reform in Advanced and Emerging Economies

Pension reform is high on the policy agenda of many advanced and emerging market economies. In advanced economies the challenge is generally to contain future increases in public pension spending as the population ages. In emerging market economies, the challenges are often different. This book examines the outlook for public pension spending over the coming decades.



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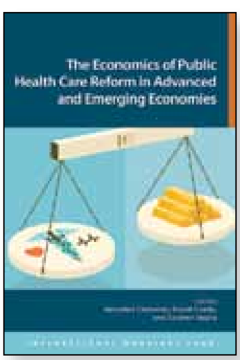

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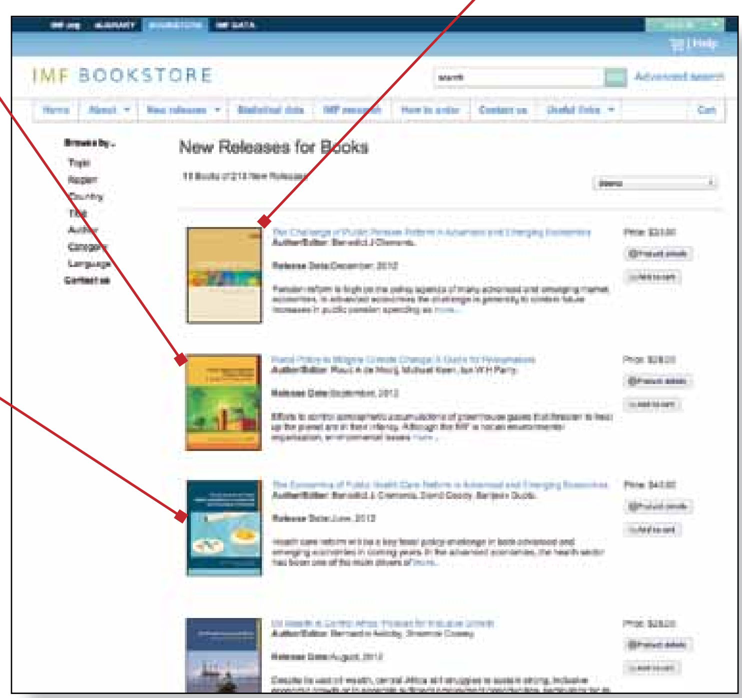

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