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Overview of Context, Issues and Summary

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ABSTRACT

Despite being blessed with immense oil resources, Arab countries have neither achieved economic prosperity nor became developed countries. This chapter provides a brief overview of issues related to understanding the origins and symptoms of the resource curse and the challenges triggered by oil dependency in the Arab World including the traditional issues related to economic diversification, Dutch Disease etc. Among the novel issues explored are the interactions between oil windfalls and weak institutions (including fiscal institutions and optimal exchange rate regimes) as well as the role of political economy factors of the impact of resource rents on the strategies of the ruling elites to fend-off potential revolts that might remove them from power.

Keywords: Oil Curse, rentier–state, institutions, Arab World, GCC

The Arab region is blessed with large hydrocarbon endowments, with resource discoveries taking place since the first half of the twentieth century. Currently, 11 of the 22 members of the League of Arab States are natural resource exporters and 7 are members of the Organization of the Petroleum Exporting Countries (OPEC). The region holds close to half of global oil reserves and a quarter of natural gas reserves. It controls close to a third of oil production and 14% of natural gas production. The hydrocarbon sector dominates most of these economies, accounting for 50% of GDP on average. Fuel exports represent around three-quarters of merchandise exports. Moreover, these countries derive at least two-thirds of their fiscal revenues from hydrocarbons. Furthermore, resource dependency casts a much longer shadow through its indirect impact on the non-resource, labor-importing Arab economies. For example, large financial surpluses in the Gulf Cooperation Council (GCC) countries, accumulated from oil booms, were channeled into non-resource economies in the form of remittances and capital inflows. Most resource-poor Arab countries are relatively more dependent on remittances than on FDI inflows as a source of external financing.

Despite this blessing, resource-rich Arab countries have neither achieved economic prosperity nor become developed countries. And even though the per capita income of some such countries is high, their growth performance has been extremely volatile and raises the question of whether their current income levels could be sustained in the future.

One of the explanations put forward to explain why economic development in resource-rich countries of the region proved elusive is that of the "resource curse".[1] The early literature considered natural resource abundance as a source of economic development because of its ability to generate income, savings and investment, and, therefore, growth, thus enabling governments to provide public goods (Nurkse 1953). Unfortunately, the received literature suggests that avoiding the curse is, in fact, the exception rather than the rule in the development experiences of oil-rich countries. This is because for the case of non-renewable depletable resources, such as oil, the underlying income is temporary and is also unreliable because of its high price volatility. Therefore, consequences of failure to properly manage the volatility of oil income, or to effectively use it to accumulate large and sufficiently diverse stocks of tangible (e.g., infrastructure) and intangible (e.g., human and knowledge capital and good institutions) types of capital, are likely to be extremely dire. Country experiences have, by and large, lent support to this pessimistic view, in that resource abundance is associated with poor development outcomes and slower economic growth when compared to resource-poor countries (Gelb 1988).

The early strand of the cross-country empirical literature, pioneered by the seminal work of Sachs and Warner (1995), emphasized the failures of economic policy in explaining why resource-abundant countries have slower growth than resource-poor countries. They find that lack of openness and real exchange rate appreciation are the main culprits. Others focused on the role of volatility. For example, Hausmann and Rigobon (2003), who estimate that a one standard deviation shock to the price of oil (of 30%–35%) can generate an income shock as high as 6% of GDP in an economy where oil accounts for 20% of GDP, argue that such extreme

[1] The name resource curse is attributed to Auty (1993).

volatility, coupled with financial-sector underdevelopment and real exchange rate appreciation, could lead to inefficient specialization and post-boom growth collapse. Also, Van der Ploeg and Poelhekke (2009) find that volatility of natural resource prices is a major determinant of growth performance and that the direct positive effect of resource dependence on growth is swamped by its adverse effect via increased volatility. However, exploiting more sophisticated panel data econometrics, more recent empirical literature provides more articulated evidence. It finds that the curse is real, but is conditional on bad governance. Moreover, conditional on bad governance, this literature suggests that the curse is transmitted through three channels: excessive domestic consumption, debt overhang and real exchange rate overvaluation (e.g., Collier and Goderis 2007 and Elbadawi and Soto in this volume). The empirical significance of these channels, and their being confined to badly managed economies, corroborates the recent political economy literature, which predicts that resource booms, when government accountability is lacking, allow politicians to expand public-sector employment or directly boost private consumption to enhance their popularity (e.g., Robinson and Torvik 2005 and Robinson et al. 2006). In the context of the Arab World, Galal and Selim (2013) argue that weak political institutions in the region seem to have predated the discovery of oil. In other words, the institutional set-up was initially weak and its effects have lingered over time.

Unfortunately, as stressed earlier, the received literature suggests that avoiding the oil curse is, in fact, the exception rather than the rule in the development experiences of oil-rich countries. For the Arab World, avoiding the oil curse is, therefore, not only critical for its development, but also extremely challenging for its public policy and institutions. However, it is important, at this juncture, to draw a sharp distinction between the GCC group [comprising Bahrain, Kuwait, Oman, Saudi Arabia, Qatar and the United Arab Emirates (UAE)], which is endowed with large natural resource rents resulting in high rent per capita, and the populous oil-rich Arab economies (like Algeria, Sudan, Syria and Yemen), which have lesser rents and larger populations, resulting in significantly lower rent per capita.

On the one hand, GCC growth seems more exposed to the ebbs and flows of the oil price cycle than the growth of the populous group. They tend to experience very high growth spells during booms, but their GDP growth is almost halved and non-hydrocarbon GDP growth is lowered by a third during busts. Nevertheless, oil booms have enabled them to achieve large savings and investment ratios as well as accumulate significantly higher reserves and external surpluses. In recent decades, the GCC states have been able to channel some of their oil wealth into massive investment programs, with priority given to basic infrastructure. On the other hand, the impact of oil price fluctuations on the domestic economies of the populous group seems to be somewhat mitigated, except for one aspect: these countries tend to engage in excessive borrowing during oil busts, with external debt stocks exceeding 100% of GNI. Moreover, unlike the GCC countries, they have so far failed to use their natural capital to develop the required physical capital to promote the much needed economic diversification of their economies. Nevertheless, all of the oil-dependent Arab economies are subject to the curse, despite the differences between the GCC and others in terms of the extent and manifestations of the phenomenon. As we will show in this volume, the GCC group, especially the relatively populous Saudi Arabia, has been subject to more subtle forms of the resource curse, such as the one associated with the labor market.

In this context, the Economic Research Forum (ERF) initiated, in 2011, a major research project on understanding and avoiding the oil curse in the Arab World. This research aimed at understanding the origins and symptoms of the curse, the challenges triggered by oil dependency, as well as suggesting the macroeconomic policies that might, hopefully, turn this curse into a blessing. To this effect, thematic papers not only examined the implications of large oil windfalls for long-term optimal investment-savings decisions, but also on growth, Dutch Disease and economic diversification. This research also made an attempt to account for the interactions between oil windfalls and institutions. In particular, it assessed the role of fiscal institutions in improving the management of oil revenue and investigated optimal exchange rate regimes for resource-rich economies. It also comprised a political economy analysis of the impact of resource rents on the strategies of the ruling elites to fend-off potential revolts that might remove them from power. Finally, the discoveries from within and outside this research were selectively deployed in writing some case studies of resource-dependent Arab countries, with the twin objectives of explaining the economic and political developments in these countries as well as proposing strategies for turning the resources into a boon for development in these countries.

This volume provides a critical mass of scholarly work in the field of natural resource economics, focusing on the unique context of the Arab World, which would complement recent academic books and several articles on the subject. For example, the recent book by Ross (2012) has mainly focused on issues of democracy and conflicts, though it also addresses other topics related to the oil curse and its consequences for growth. Also, Humphreys et al. (2007) have emphasized institutional and contractual issues related to oil extraction and management. Moreover, these books do not address Arab-specific issues, though their analysis is inherently relevant to the Arab region, which makes this volume among the very few in the field of natural resource economics in the context of the Arab region. One Arab-specific book (Elbadawi and Makdisi 2011) almost exclusively focuses on the role of oil dependency in explaining the Arab democracy deficit. Another recent report by Diop et al. (2012) has solely focused on diversification and structural transformation in countries in the Middle East and North Africa, choosing to focus on the role of macroeconomic factors and policies, including the real exchange rate and fiscal policy, in promoting (or hindering) diversification away from oil.

This volume, we would argue, provides a new and complementary contribution to the existing literature by applying frontier research to issues that are directly relevant to the highly resource-dependent, but substantially under-researched, Arab region. Therefore, this volume should be an important reference for researchers and policy makers alike.

The three main questions addressed in this volume are: (i) Is there a resource curse in the Arab World and what are the symptoms? (ii) How do large oil windfalls interact with institutions and how can the latter help avoid the curse? (iii) What type of policies can help improve macroeconomic management in Arab resource-rich economies?

An attempt to answer these questions will be presented throughout the remaining twelve chapters of this volume. To the extent possible, the analysis tries to distinguish between two groups of countries: the six richer GCC countries versus the populous countries.

The book is divided into four main parts. Parts I and II of the book describe the symptoms of the curse in Arab resource-rich economies. Part I addresses questions related to business cycle linkages of Arab economies with the rest of the world and economic diversification. In Chapter 2, Cashin, Mohaddes and Raissi argue that while the international business cycle is very important for the Arab region's economic performance; macroeconomic and political developments in this region also have large consequences for the rest of the world, due to the abundance of natural resources. They are able to disentangle the speed and transmission of inward and outward macroeconomic shocks from and to the Arab region and to and from the rest of the world (China, the Euro Area and the United

States). Their results show that whereas the impact of a negative GDP shock from the Euro Area and the United States is modest, the impact of a shock to output in China is more substantial, reflecting the direction of evolving trade patterns, and China's growing role in the global economy and the world oil market.

Chapter 3 describes an important symptom of the curse. Indeed, Elbadawi and Kaltani provide new evidence about the impact of oil rents and real exchange rate undervaluation on various measures of exports. The results suggest that real exchange rate undervaluation can ameliorate the negative impact of oil rents on exports and can be particularly effective in countries with underdeveloped financial markets or low institutional development. In light of these findings, the chapter argues that a strategy of depreciating the real currency can be a viable, albeit second best, industrial policy choice in order to promote export diversification, technical upgrading and export sophistication in institutionally deficient oil and mineral-dependent economies. Moreover, this type of public policy can minimize the reliance on traditional vertical industrial policy, which usually requires high initial institutional capacity in order to succeed.

Finally, in Chapter 4, Diop and de Melo provide empirical evidence that natural resource rents in Arab countries are correlated with a declining share of services to GDP, in other words, that services sectors are a victim of a Dutch Disease phenomenon. On the basis that services can no longer be considered non-tradable because of recent revolutions in technology, transportability and tradability, they explain that rents from natural resources tend to inflate wages and non-tradable prices in resource-rich countries, thereby appreciating the real exchange rate and discouraging domestic production of tradable goods and services. This explains why Arab resource-rich countries have become large importers of tradable services and why only domestic production of non-tradable services (such as real estate, retail trade, hotels and restaurants) has really developed.

Part II addresses another symptom of the curse, related to the labor markets, where, more in the GCC than in the populous group, natural resources act as a mechanism for patronage through the provision of well remunerated public jobs to nationals. Indeed, in Chapter 5, Ali and Elbadawi argue, from a political economy perspective, that it is optimal for resource-rich authoritarian regimes that rule over small populations to offer public-sector jobs in an inflated bureaucracy to effectively remove incentives to revolt. Alternatively, when natural resource endowments are limited, it is optimal for governments to set up a repressive security apparatus and employ a smaller proportion of the population. Illustrating the case of Saudi Arabia in Chapter 6, Al-Sheikh and Erbas show how oil income enables the government to hire nationals in the civil service at very high wages and how this skews Saudi worker preferences for government-sector employment and increases their reservation wages for private-sector employment. This labor market segmentation crowds out private business, contributing to high unemployment.

Part III of the volume generally argues that institutions and sound macroeconomic management could contribute to avoiding the curse. In Chapter 7, Elbadawi and Soto argue that the oil curse is not predestined and that poor development outcomes depend on weak institutions and bad governance. They provide empirical evidence that resource-rich economies with a high degree of inclusiveness (a measure of democracy) and strong political checks and balances turn the resource curse into a blessing. In Chapter 8, Schmidt-Hebbel reviews recent international evidence on fiscal policies and outcomes in resource-rich economies at large, and Arab oil-exporting countries in particular. The chapter highlights the importance of developing counter-cyclical fiscal policies to stem excessive volatility and stabilize the non-resource economy. In comparing the decade-long experiences of Chile and Norway in setting up new fiscal institutions and rules to manage their resource rents, Schmidt-Hebbel recommends two institutional reforms: the adoption of fiscal rules and the creation of Sovereign Wealth Funds (SWF).

Chapter 9, by Paul Collier, discusses the principles and rules for optimal investment decisions in the Arab region. Collier shows that long-term sustainability is a major concern for the region. Despite some oil depletion since the 1970s, the GCC group still enjoys more resources than the populous group. Consequently, natural resources will deplete more rapidly in the latter group and so, despite being much poorer, they need higher saving rates of their resource revenues in order to convert their unsustainable resource incomes into sustainable consumption. To manage this process of high domestic investment successfully, their priority should be a phase of "investing-in-investing."

Finally, in Chapter 10, Al-Abri discusses alternative exchange rate regime arrangements for natural-resource-rich economies in the region. In his analysis, he evaluates the loss of flexibility or the gain in creditability with alternative assumptions about labor market flexibility. The analysis suggests that in countries with relatively more flexible labor markets, fixed exchange regimes are more desirable in responding to shocks, as their creditability gains might outweigh the loss of flexibility in monetary policy. However, with rigid labor markets, flexible exchange regimes are more desirable in responding to shocks.

The final part of the book includes a comparative chapter that contrasts the experience of oil countries in the region: the GCC versus populous economies, in addition to two case studies. In Chapter 11, Selim and Zaki argue that the resource curse in the Arab World is primarily an "institutional curse," even though it has several macroeconomic manifestations. In other words, while macroeconomic mismanagement and oil abundance are important determinants of performance, these factors are shaped primarily by the prevailing political institutions, which predate resource discovery. Over time, the interaction between these factors became intertwined, preventing these countries from embarking on a sustainable development path. While weak governance is responsible for the region's lack of development, the curse has operated in different ways in both groups. On the one hand, in the GCC, large rents per capita have been utilized to increase government legitimacy and foster regime stability. Indeed, the curse is expressed subtly through a clear segmentation of the labor markets, which act as an efficient mechanism of rent distribution in the form of well-remunerated public-sector jobs and other generous social welfare schemes to national citizens. In contrast, populous countries are much poorer *rentier* states and rents are not sufficient to provide a stipend to citizens. These countries have experienced conflict, violence and social unrest. Moreover, limited resources may have somewhat shielded the populous economies from extreme volatility, but seem to have led to more dire economic consequences. Resource busts tend to drive them to engage in excessive borrowing, while booms seem to have almost eliminated their manufacturing sectors. Most importantly, in a context of low rent per capita, excessive consumption resulted in massive deficiencies in infrastructure investments and an underdeveloped financial sector.

The last two chapters in this part provide two illustrations of the oil curse in the Arab World: the UAE (Chapter 12) and Sudan (Chapter 13). Soto and Haouas argue that while the UAE has not been immune to the oil curse, it has managed to make the benefits outweigh negative outcomes. Nevertheless, some symptoms of the curse remain in three areas: very low growth in labor productivity, absence of counter-cyclical policies and massive over-employment and declining productivity in the public sector. Furthermore, they show that Dubai was able to overcome the dependency on oil exports and diversify the economy. In Sudan, Suliman shows that the Dutch Disease and the fiscal linkages are the main mechanisms that transmitted the negative effects of oil booms. Moreover, the current distributive politics have tended to magnify the impact of shocks and it worsened the pro-cyclicality of fiscal policy and contributed to the excessive currency appreciation.

1.1 Lessons and Policy Implications

Natural resources in the Arab World have contributed to better standards of living and have most certainly widened the set of policy choices: countries did do better than they would have done without resource rents. Notwithstanding this improvement, the economic performance of Arab resource-rich countries has been disappointing, even in the absence of a counterfactual. For the Arab World, avoiding the Oil Curse is critical for its development. The main insight from this volume is that the interdependence between politics and resource management is the essence of the resource curse, where politics affects exploitation of resource wealth and in turn rents influence politics (Collier 2010). The main policy implication from this research is that for *Arab countries* to achieve sustained growth and prosperity, they *must adopt meaningful political reforms,* encompassing a strong system of political checks and balances. Though this remains a challenge, it is hoped that with adherence to the Extractive Industries Transparency Initiative (EITI) and the Natural Resource Charter (NRC) there is the potential of triggering some reforms on political accountability and of instituting more transparent and effective management of natural resources.

Assuming progress is made on this front, countries should first start by addressing *sustainability issues,* which means transforming their exhaustible natural resources into assets – human, domestic, private capital and foreign financial assets – that will generate future income and support sustained development. Addressing sustainability goes *hand in hand with reforming fiscal institutions.* Without sound fiscal frameworks, Arab countries will constantly be exposed to the risk of easily squandering their natural riches. It is hoped that the following reforms would contribute to higher savings and larger and more efficient investments, and put public finances on a sustainable track while increasing the ability of countries to adopt counter-cyclical fiscal policies.

Countries of the populous group are immediately confronted with shorter resource horizons and greater uncertainty about production volumes, with drastic implications on public spending sustainability once resources are depleted. Moreover, they have so far not been successful in effectively deploying their rents to build a broad-based domestic capital base. In addition, they have so far saved very little. Moreover, political instability in some countries and the violent conflicts that afflict some countries like Sudan and Yemen would tend to limit their access to international financial markets for borrowing purposes. To address this fundamental and pressing challenge, *countries of the populous group need both Sovereign Wealth Funds (SWF)* that would save or invest a small proportion of resource revenues in external financial assets abroad, in addition to a *Sovereign Development Fund (SDF)* that would invest the majority of their wealth in domestic infrastructure, either in the form of physical assets or in human capital through improving the health care and education of citizens (Collier, this volume). Moreover, these countries would need to closely monitor their public finances. They could benefit from *setting a target for the non-resource fiscal balance* (which is an indicator of the capacity of the economy to absorb resource revenues without causing inflation and a large current account deficit) at a level that can be maintained after resource revenues run out. This would avoid the need for abrupt breaks in government expenditures or tax increases after the natural resources have been depleted, given that the non-resource fiscal balance gradually converges to the overall balance as resource revenues decline (Daniel et al. 2013).

It is often argued that the use of SDFs to finance domestic infrastructure poses significant challenges. Administrative systems may lack the technical ability to scale-up expenditure rapidly (to identify, implement, budget as well as monitor and evaluate projects) and coordinate between government entities. In low-capacity and low-governance environments, like those present in the populous group, this may lead to, among other things, wasteful expenditure and budget fragmentation. In addition, even though the SDF also has the potential of acting as a means to improve the quality of public spending and even to crowd in private investors to strengthen investment discipline, it could become a vehicle for politically driven "investments" in a context of elite capture (Gelb et al. 2014). In order to bypass this problem and ensure that public spending is allocated towards high-quality public investment projects, *a more gradual increase in spending may be advisable for the populous group,* with an initial focus on investing resources to remove existing bottlenecks – a process sometimes called "investing in investing," as defined by Collier et al. (2010).

For countries with long resource horizons like the GCC, the main challenge should be to manage revenue price volatility. Collier (this volume) judges that *the creation of Sovereign Wealth Funds (SWF) is sufficient to ride out revenue volatility for the GCC,* which also have few