MEI Insight No. 52
9 February 2012

Middle East Insights
Middle East Institute, National University of Singapore

After the Arab Spring: Creating Economic Commons

By Adeel Malik and Bassem Awadallah

If the latest Arab awakening was about jobs and justice, then political reforms, unless accompanied by a leveling of the economic playing field, are unlikely to be sufficient on their own. The latent demographic pressures across the Arab world and the resulting youth unemployment have created an employment challenge that is both real and urgent. During the next decade an estimated 100 million jobs need to be created in the Middle East. The public sector, already bloated and inefficient, is unprepared to meet this employment challenge. Sooner or later, Arab policymakers will have to return to addressing a longstanding development challenge facing the region: economic diversification. In fact, the challenges of demography and diversification are intertwined. Without developing a robust private sector and without reducing the region's dependence on natural resources, the gains that the Arab world has made in literacy and health cannot be translated into lasting economic prosperity.

The need for diversification has been long realized in the Middle East, at least in official speeches and policy documents. But, apart from partial success stories in Oman and Bahrain, diversification has remained merely a paper aspiration. Now, it has acquired a new urgency in the backdrop of the latest political upheavals. The crucial question is: what has prevented the emergence of a strong private sector and why has diversification been so difficult to achieve? In this brief commentary, we identify one crucial barrier to private sector development: the persistent economic fragmentation of the Arab world into isolated geographic units that are, at best, weakly connected to each other.

Despite its rich trading past and common cultural heritage, the Arab world is one of the most divided regions in the world today in terms of linkages in production and trade. In a region of 350 million people, regional markets are

often cut off from each other. Mutual trade between Arab economies remains minimal, hovering around merely ten percent of total merchandise trade. And, even as the region's trade with the rest of the world, notably South Asia and Turkey, has expanded considerably, the share of intra-Arab trade has remained virtually stagnant since the 1960s. This is a colossal economic failure and has wider repercussions for the region than is commonly understood. To begin with, the absence of a large connected market denies Arab firms economies of scale, which is the fuel for growth and diversification. The inability to produce for a larger market caps the potential for growth, reinforces the dependence of firms on state patronage, and denies the private sector an opportunity to become an independent constituency for socioeconomic change.

The costs of fragmentation are deeper, however, than a simple absence of scale economies. Thin markets are often more protected, preserve the monopoly power of insiders, and increase the returns to predatory behavior. Fragmented markets also mean that the market for secondhand capital goods is smaller, which can turn new investments particularly risky, as businessmen face the risk of being stuck with bad investments. This can end up creating an adverse business environment and reinforcing existing inequalities. Another cost—largely ignored in the literature—is the wasteful duplication of defense expenditures. As a region, the Middle East and North Africa (MENA) is the largest spender on defense (as a share of GDP). During the last decade, the region spent twice as much on defense as South Asia. Even by global comparisons the ratio of defense spending to GDP is particularly high in Gulf states, especially Oman, Saudi Arabia, and the UAE. Another cost of fragmentation is that regional public goods are underprovided. An infrastructure that connects regional economies is one such public good. Since the benefits of a connective infrastructure are likely to accrue to everyone in the region, individual countries are discouraged from investing in it. This generates a massive coordination failure.

The Arab world's economic fragmentation is puzzling given its favorable geography. The MENA region lies at the intersection of major trading routes, with easy access to markets in Africa, Asia, and Europe. Compared to Africa where nearly 40 percent of the population lives in landlocked countries, there is not even a single landlocked country in the Arab world. North Africa provides a particularly dramatic illustration. Stretching from Egypt to Morocco, the region is blessed with thousands of kilometers of coastlines. Its proximity to Europe and Africa makes it one of the choicest locations for

other emerging markets. Everywhere in the world, access to sea translates into lower transport costs and better prospects for manufacturing. However, the Middle East defies the economic laws of gravity: it has coastal access without market access. Algeria epitomizes this lost potential for development. With its nearly thousand kilometers of coastline, moderate climate, and large size, Algeria had the potential to be a major production hub of the Mediterranean—a South Africa of the Middle East. Yet, excessive dependence on natural resources and decades of mismanagement has turned the country into a barren economic landscape. Its borders with Morocco are virtually closed to any productive economic exchange.

Another aspect of geography in which the Middle East is hugely favored but is failing to materialize its inherent advantages is urbanization. At least 50 percent of the total population in the MENA region (excluding Yemen) resides in urban areas. Latest measures of urban concentration place the region ahead of other developing countries, including those in Latin America, making it one of the most urbanized regions of the world. Recent evidence suggests that urbanization can deliver concrete benefits to firms: by locating them in urban centers, firms enjoy not only proximity to markets but also superior access to a range of mutually supportive activities (skills, machinery, suppliers, resources, and the like). These agglomeration economies are simply absent in the Middle East.

Even if Arab economies do not suffer from the kind of structural geographic barriers that hinder prosperity in Africa, the region has built pervasive man-made barriers to trade. Severe restrictions are placed on the movement of goods and labor across borders. Centralized control and arbitrary regulations mar the business climate and, although tariff barriers have been slashed, the more cumbersome and invisible behind-the-border barriers continue to be a source of trade frictions. The *license raj* has survived longer in the Middle East than elsewhere in the developing world. Dismantling these barriers is not easy, since they are an important source of rent for insiders who use them to manipulate the economic system to their advantage.

That is where the region's latest political revolts have created an opening for change. Dismantling regional trade barriers has been an economically desirable but a politically inexpedient step. Numerous regional trade initiatives have been floated in the past, but these have remained merely pious intentions. Internal rivalries, dependence on external powers, and the absence of a strong domestic constituency have frustrated past attempts at

integration of regional economies. It is true that part of this failure is rooted in production structures that look more similar than different, but an enabling policy response—through a regionally coordinated industrial policy, for instance—has also been lacking. Dependence on external windfalls from oil and aid has further insulated the region from pressures for economic cooperation. Now, the demographic and political shifts in the region call for a new logic of economic integration. The demographic challenge is common to all Arab countries; it also deserves a common response. Given the multiple costs of fragmentation outlined above, it is clear that the failure to develop a vigorous private sector is not simply a failure of national economic policies but a regional failure. The region's thick borders and thin markets have been a bane for the private sector. For a genuine private economic activity to take root, however, the region needs exactly the opposite: soft borders and thick markets.

In this milieu, we believe that fostering regional economic cooperation is arguably the most important collective action problem that the region has faced since the fall of the Ottoman Empire. Addressing the region's long-standing development challenges requires a regional approach. The starting point of this should be a connective infrastructure and greater economic access for small and medium enterprises. Here, the lessons from Turkey are particularly instructive. Turkey's recent economic success rests, among other things, on a development strategy that has mainstreamed trade and brought firms from the margins to the mainstream. So far, it has been easier to forge a consensus in the Arab world on matters of security. But concerns of economic security are likely to have more far-reaching implications in years to come, and deserve a similarly swift and unified response.

Some positive signals are already at hand. There has been a belated official realization to improve regional connectivity. The GCC is planning, for instance, to spend US$ 142 billion on regional infrastructure projects. This includes an outlay of US$ 79 billion on developing a rail network that aims to connect GCC economies. But there is a need to mainstream the agenda of regional economic cooperation beyond the exclusive confines of the GCC. Existing discourse in the region has centered on the necessity of political reforms. This is important. But the gains made in political freedoms cannot be consolidated without meaningful economic change. Ultimately, the Arab world will need not just political commons, but also regional economic commons that serve as incubators for entrepreneurship and growth.

Adeel Malik is the Islamic Centre lecturer in development economics at the University of Oxford and a fellow of St. Peter's College, Oxford. Bassem Awadallah is the Secretary General of the Islamic Chamber of Commerce and Industry and a former Finance and Planning Minister and Chief of Royal Court of the Hashemite Kingdom of Jordan.

This commentary was previously published on Al Jazeera English: http://www.aljazeera.com/indepth/opinion/2012/01/201211774316934390.html.