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How does the Peace Process affect economic growth and regional integration?[1]

Ishac Diwan, The World Bank

Economic growth in the Middle East seems highly dependent on political developments. More than in any other part of the world, the growth process is not constrained by either a shortage of human resources, or capital. This is reflected in high rates of unemployment (from 10 to 30 percent), and large amounts of private capital placed abroad (estimated at several hundred billion of dollars). There is thus some basis for the hope that the peace process could unlock the region's potential and lead to large gains.

The potential economic benefits of the peace process can be classified in two broad categories: direct and indirect. Direct gains would stem from reductions in military expenditures and more external support. Indirect gains relate to the effects of a reduction in investment risk, a better external environment, and increased regional cooperation. With more resources and a more hospitable environment, a virtuous circle may come about with vigorous economic growth trickling down broadly in the region reinforcing regional stability further.

There are however important qualifications to this happy optimism.

First, political changes are likely to remain constrained by difficult trade-offs and the gradual nature of the process will dilute the extent of the gains in the short to medium term. For example, private investment has not risen in Gaza in the past

[1] Prepared for the Middle East Institute conference, October 21, 1994.

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year, and the promised aid has been slow in coming in.

Second, direct gains are likely to be small, and indirect gains tough to harvest. While peace will create an environment that is conducive to long-term benefits, only countries that are able to adjust their policies will reap substantial gains. In the short term however, the needed adjustment measures are likely to lead to social dislocations, and the benefits will come gradually. Concerns about domestic stability are likely to become the main constraint to reform-led-growth.

Third, for a sustainable regional economy to emerge, new types of regional relations are required, including inter-Arab relation. These will have to be based more on mutual economic benefits, and less on a strategic/security logic. The fear on this front is of dangerous hybrid regimes of interactions, with economic advantages secured by military might. Such gun-boat beggard-your-neighbour strategies would be counter-productive, securing their perpetrators short term gains by reducing the overall regional pie.

I will first review the sources of direct and indirect gains. I will then focuse on the issue of regional integration: should we be taking seriously all this talk about the new Middle eastern Market?

Direct gains

A more peaceful region would ultimately require reduced security needs. This would allow for a redirecting of resources away from the military and towards more productive sectors. The order of magnitude of arms expenditures has been exceptionally larg, suggestintg that this could be an important source of gains.

Between 1977 and 1987, the cumulative military expenditures of all the countries of the Middle-East were approximately $600 billion, on average, 17% of GNP per year. Imports are estimated at $175 billion over the same period, 15% of total imports and nearly 40% of all arms imports in the world. The largest importers have been Iraq, Saudi Arabia, Iran, Syria, Israel, and Egypt, in that order.

The potential benefits of cut-backs in the defense budget will accrue over time as resources move into more productive activities. It is not unrealistic to expect that, ultimately, Syria, Israel, and Jordan can redirect 5 percent of their GNP each year to more productive sectors, generating as much as 1 percent of extra GNP growth. But the p[rocess is likely to be slow. Where unemployment is large, as in Jordan and Syria, governments will be sensitive to the idea of releasing an large numbers of conscripts rapidly.

External Assistance

External assistance has been large in the past. During the past two decades, net inflows of capital, mainly from public sources, averaged 15 percent of GNP in the Mashreq and Israel, an international record. As such, these flows had a large effect on the evolution of these economies, especially the expansion of the public sector, but also, the accumulation of private savings abroad. But by 1990, capital inflows had shrunk by half, and the recent Gulf-war related rise is likely to be short-lived. The supply of official credits has become tighter over time, with shrinking aid budgets in the OECD and the Gulf, and increased competition by poorer countries and recently, by the reformist socialist economies. While the international community has pledged relatively large sums for the West Bank and Gaza ($2.5 billion over 5 years), this is unlikely to become a model of conflict resolution with much future in the region. It seems more probable that the coming of age of the peace process will mark the beginning of the end of the once fashionable "rentier-state" living style.

The legacies of the past offer both an exciting prospect and a difficult challenge. The prospect lies in the possibility of fueling a private sector-led strategy by attracting back some of the capital that had fled in the past. Indeed, this has already become the main policy tool in Egypt, Lebanon, and Jordan, where financial reforms are well ahead of other reforms. The challenge lies in the debt overhang. With government debt about equal to GNP in several countries, macro-economic stability is at best fragile. This situation will continue to scare away private investors -- both domestic and foreign -- and delay the return of past capital outflows, until the fiscal house in put in order.

Past strategies of external debt management in Egypt and Israel -- debt reduction for Egypt and increased reliance on grants for Israel -- have already ensured the creditworthiness of these two countries. In the case of Jordan, Syria, and Yemen, the required financing and the restoration of creditworthiness are likely to be compatible only if the stock of debt is reduced. External debt reduction will therefore have to be a key part of any market-oriented strategy. Jordan has recently made important gains in this respect. In the case of Syria, the situation is complicated by the large size of the debt due to the FSU, and the arrears to many international financial instiutions.

Indirect gains

It is hoped that a more peaceful environment, if coupled with domestic stability, could increase the dynamism of domestic entrepreneurs. But as the recent experience of Egypt has shown, macro-stability is not enough. A private sector-led-startegy also requires the adoption of reforms that create the economic space, free-up private incentives, and release mis-used factors of production.

Governments' incentives for change will be positively affected by three factors: (i) they will need to rely increasingly on domestic rather than external savings and on tax rather that aid revenues; (ii) because of reduced military tensions, they can "afford" more the short term negative effects of reforms from a security point of view; and, (iii) they could expect a stronger supply response to bold reforms than in the past.

A crucial element of the happy scenario is the preservation of domestic stability. A liberalizing path entail however job destruction and social dislocations at a time where there is already a large deficit of labor demand. The challenge for policy-makers will be manage a smooth transition for those that will loose, especially the poor, and at the same time, elicit support from the domestic constituencies that stand to gain from a change in the economic incentive structures.

Policy will be important in insuring a desirable outcome. Several dimensions are worth stressing. First, the speed of the supply response will end up being the key; this is not helped by the gradualism imbedded in the peace process. Second, efficient social nets will be required -- the social fund in Egypt is a good example. Third, insuring that growth is broadly shared and that it trickles down to the poorest groups will be key.

Concerns about domestic stability may spill into new forms of regional instability, especially on the labor mobility front. In particular, because of the scarcity of jobs, there will be incentives to export unemployment, but also to restrict in-migration. The potential for conflicting relations should not be under-estimated: think of Syrian workers in Lebanon, Palestinians in Israel, Egyptians in Jordan, and even, Arabs in the Gulf.

Regional projects

Of all forms of regional cooperation, regional projects are the most promising in the short term, especially in the areas of water, environment, transportation, and energy. Thecase of water management is instructiuve of the possibilities opened up by the peace process. A sustainable water strategy would require large investments and possibly difficult social choices, but the long term benefits are tremendous given the stark alternatives. For usable water resources to increase, the development of regional and local projects (pipeline, water reclamation and desalination plants, better environmental protection) is crucial. But major sources of water encompass several countries. In the past, projects to enhance the available water and to increase its supply have not been undertaken because of risks of damage during wartime, heightened free-riding incentives which encourages decapitalization rather than investment in maintenance, conservation and reclamation, and the impossibility of undertaking projects encompassing countries at war with each other. Peace will encourage cooperation and reduce investment risk. In the absence of regional agreements, each country has had incentives to use as much water as possible without considerations for its alternative value in other countries. In the future, the incentives for rationing water more efficiently are likely to be enhanced. unsustainable, and the challenge that arises with peace is to redress the situation.

A New Middle East Regional Market?

Is a new Middle East Market around the corner? By international standards, the region is pretty well integrated, especially on the labor market front, but also on the trade front. Contrary to comon belief, regional trade flows -- 7 percent of total trade -- are not so small by international standards. After all, the region only has 4 percent of the world GDP, so if it traded equally with all partners, it should only have 4 percent of its trade within the region. Even this would be a good performance. After all, most of the world trade is either North/South or North/North, not South/South. And many countries of the region have a closed trade regime. Indeed, most regional trade is between relatively competitive economies (Jordan, Lebanon) and the Gulf. The real issue then is whether the peace process will affect in some way this logic. Seen from this angle, the answer may be different.

A priori, there are no reasons to expect higher levels of regional integration. One obvious possibility, that Israel would become develop strong trade relations with its partners is unlikely. With the exception of the West Bank and Gaza with whom it shares a customs union, trade is not expected to grow fast, or to reach large levels. Take the case of the more open economies first, Lebanon, Morocco, Tunisia, and the

Gulf. These countries can already import from the most competitive sources in the world; they will surely find a few products lines where Israel possesses some great strengh, but this is unlikely to be very large. After all, the advantage conferred by promximity has shrunk with the wolrd turning into a large village: transportation costs are nwo only 6 percent of world trade value. The case of Turkey, a relatively open economy, illustrate this well, its imports from Israel amount to less than 5 percent of its total import bill.

In the economies that are relatively closed, Jordan, Syria, and Egypt, the peace process is likely to create first new forces that would encourage faster integration to the world economy, rather than the regional one.

Israel is keen on using trade relations to cement peace treaties based on the notion that increased contact and the emergence of inter-dependencies based on mutual interests offer the best route to security. However, any opening to Israel that is not matched by a parallel opening to the rest of world would articifially favor Israeli goods over other imports. This advantage would then result in a relatively large share of imports originating in Israel, which is not likely to be desirable as long as the politics of peace process have not converged. What is more likely then is a process of simultaneous opening to the OECD countries and Israel.

This process would be enhanced if additional trade advantages are offered. Israel, the EU, the Gulf, Iraq, and possibly the US may want to follow such a strategy.

Being an important (strategic) beneficiary of increased trade with its neighbours, Israel is likely to enter in trade arrangements that are initially asymmetrical in nature.

Already, there are talks of opening up Israeli markets to Jordan well ahead of the time where Jordan will be asked to reciprocate. Indirectly, that also allows Jordanian goods a much larger access to the lucrative Palestinian market. This would also reduce dramatically Jordanian fears of capital and skills relocating in the West Bank in order to access the lucrative Israeli market. Given the size of its markets and its own trade reform agenda, Israel may also consider making similar offers to a other of its neighbours as well.

With such a scenario, a process of initial "encouragement" to international integration would converge over time to a trade regime that is as open with respect to Israel and the rest of the international economy. But is inter-Arab trade likely to rise as well? Ironically, it is possible that regional integration will ultimately be helped by international openess. There is a strong cultural bond uniting the countries of the region. As they get closer to the frontier of international competition, they could be expected to be increasingly in a position to develop their comparative advantage at supplying this differentiated market. Beirut, Amman, Bahrain, are clearly looking into this potential. In an increasingly global economy, competitivity requires openess. For example, the ability to import freely computers will boost a regional software industry. On the other hand, this industry will not take off as long as computers remain heavily taxed. Over time, international integration will encourage a finer regional division of labor, and it would not be possible to contemplate seriousely business deals involving for example Lebanese financiers and Syrian manufacturers, Jordanian exporters using Israeli technology, or Palestinian developers fructifying Saudi savings.